QUEENSLAND
UrbanUtilities

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28 February 2011

Mr E J Hall
Chief Executive Officer
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GPO Box 2257
Brisbane Qld 4001

Dear ~~Mr Hall~~

Submission to the Queensland Competition Authority - Draft SEQ Interim Price Monitoring Report

This submission is the Queensland Urban Utilities (QUU) response to the Queensland Competition Authority's (the Authority) request for comments on the Draft Report SEQ Interim Price Monitoring (the Report) for 2010/11.

Our submission is structured with initial general comments on the findings of the Report followed by our response on specific issues.

Due to the timing of the response it has not been possible to fully consult with our Board. Accordingly, QUU reserves the right to make a further submission following such consultation.

General Comments

QUU acknowledges the Authority's findings that, *"as revenues in 2010/11 do not significantly exceed the maximum allowable revenue (MAR) based on the available information, there is no evidence of an exercise of monopoly power in 2010/11."*

We note the Authority's findings that:

- *"its estimates of the costs of providing services in 2010/11 (the Authority's MAR) were not significantly different from those of the entities."*
- *QUU's forecast operational expenses for 2010/11 are generally reasonable, as the Authority's current estimates are consistent with QUU forecasts which already include a $43 million reduction in operating costs.*
- *The Authority's analysis found that the initial estimates of capital expenditure in 2010/11 provided by QUU were prudent and efficient.*

QUU is generally satisfied with the findings of the Authority as set out in the Report. There are a number of matters of a technical nature that we have responded to in this submission.

Specific Issues

1. Post Pricing Setting Adjustments

In QUU's price monitoring submission we advised that price setting for the 2010/11 year was undertaken using the best information available to QUU at the time of setting prices in June 2010. The full operations of QUU commenced on 1 July 2010. In addition QUU stated that in considering the weighted average cost of capital (WACC), QUU considered not only the economic rate of return that should be used but also the impact of price increases on customers. This rate was selected having regard to this being the first time QUU set prices and to ensure a conversative approach to price setting for 2010/11 in view of the number of uncertainities in relation to the regulatory framework application.

It would appear that the Authority has chosen to make some adjustments to QUU's building block values and hence maximum allowable revenue (MAR) based on information only available post the time of price setting. The particular items of adjustments are detailed below.

1.1. Commissioned capital expenditure

QUU stated in our pricing submission that at the time of pricing we believed that as incurred capital expenditure would be included in the calculation of MAR and that pricing had been set based on this information. This was consistent with the two other distributor-retailers that were either unable to provide information or provided an estimate. In July and August 2010, QUU worked to develop the information on the capital expenditure expected to be commissioned in next three years. Again the Authority assessed our pricing on the basis of this information available to QUU only after pricing setting. We ask that our estimated revenue be assessed on the as incurred capital expenditure as this is the information that we had at the time of price setting. The resulting difference should be reported to enable a proper assessment of the forecasts of revenue made at the time of setting prices.

Further we ask that the Authority provides its analysis (and comparison with other regulators) of as incurred versus commissioned capital expenditure particularly in relation to the revenue offset approach. To complete our understanding clarification on the treatment of the capital revenues under the commissioned approach would also be of assistance.

1.2. Wastewater connections

Connection data was provided by Councils prior to 1 July 2010 and relied on by QUU for the price monitoring submission. Billing by QUU occurred throughout July and August 2010 and provided a greater level of accuracy particularly in classification of customers between non-residential and residential. The Authority adjusted QUU residential connections for 2010/11 using billing data provided post 31 August 2010 by QUU. The significant portion of the adjustment was to correct the classification of customers between non-residential and residential. In order to accurately reflect the adjustment made, Table 10 requires a note to the effect that the non-residential connections for Ipswich required a reduction as part of the correction to the residential connections.

1.3. Tax treatment of non cash donated assets

The draft Local Government Tax Equivalents Manual was received by QUU on 13 August 2010. Confirmation of the Treasurer's approval for the application of the tax equivalents arrangements was received on 18 October 2010.

The timing of the finalisation of the above matters has meant that there was uncertainty about the application of the Local Government Tax Equivalent to QUU at the time of setting prices.

Whilst we note that the Report comments that, the Authority's approach reflects recent advice relating to the treatment of tax under the Local Government Tax Equivalents (2010) which indicates that less tax is payable than expected by the entities, the difference in tax calculation alone results in QUU being shown as over recovering under the Authority's MAR assessment. We ask that the Authority report the difference due to the tax treatment on non cash donated assets.

To ensure the correct treatment of tax, how the tax equivalents arrangements are to be applied in the regulatory tax calculation included in the MAR still requires guidance and clarification refer 2 below.

2. Tax calculation

There is a significant difference between QUU's calculation of the tax allowance and the Authority's. The Authority notes that QUU is at full cost recovery. Even at full cost recovery the water activity is showing a tax loss. This tax loss appears to derive in part from the imbalance in the return allocated to debt holders (interest) and that allocated to owners of QUU as a result of the WACC having a higher cost of debt than the cost of equity. QUU are currently seeking expert advice on the taxation calculation however given the timeframe QUU have not been able to include the advice in this response. QUU will provide this advice when received.

However we note the following inconsistencies in the application of Local Government Tax Equivalents to the regulatory tax calculation which require clarification.

- Interest expense is calculated on the average regulatory asset base including donated assets (2008 to 2011). Interest incurred in earning non assessable income is not normally deductible however no adjustment has been made.
- Deductible interest expense calculated on the average regulatory asset base includes indexation. An increase in the value of an asset in accounting terms is normally attributed to the owner of the asset not the debt provider.

It should also be noted that at the time of price setting QUU did not have access to tax depreciation values from the two Council businesses that were part of the Local Government Tax Equivalent Regime. This information is currently being obtained and will form part of next price monitoring submission.

3. Treatment of Capital Contributions

The Authority's report offered an opportunity to highlight the difference in the treatment of capital contributions under the asset offset and revenue offset approach. Whilst QUU is reported as marginally over recovering under the revenue offset approach, the selection of the asset offset approach would result in a significant under recovery in the order of $58M for water and $82M for wastewater in the 2010/11 year.

Providing comparison information of the two approaches is critical to aid customers and other stakeholders in understanding movements between years should a change in the treatment of capital contributions be adopted.

The Authority notes that comparison between the three distributor– retailers should not be made due to the different treatment. Inevitably comparisons will be made and in fact have been made as seen in recent media reporting and provision of this information will assist in the reporting of information to customers.

The Authority commented that the asset offset approach to the treatment of capital contributions has a lesser immediate impact than the revenue offset approach. This comment requires clarification as it could be interpreted that the asset offset has a lesser impact on revenue than the revenue offset.

4. Efficiency Targets

QUU is committed to minimising price increases to customers. As previously announced QUU has already included $43M of cost reductions in budgeted operating expense and a further $8M from capital expenditure reductions contributed to price reductions in the 2010/2011 year. Further targeted reductions of $5M for each of 2011/12 and 2012/13 have been announced.

4.1 Efficiency gains

The Authority has set an efficiency target of a 2% reduction on non-bulk operating costs for 2011/12 and 2012/13 for the distributor-retailers. The target set for QUU is 4.2% as QUU's has previously announced a $5M annual reduction for 2011/12 and 2012/13.

The Authority provides no discussion on the setting of this target, or analysis in support of the target of 4.2% particularly in relation to QUU. Supporting information particularly in relation to QUU will assist QUU in achieving the targets set.

A number of initiatives are already underway including improved procurement practices for operating and capital expenditure, benchmarking, integration and organisational design projects.

4.2 Operating cost benchmarks

The Authority has used the SKM analysis of benchmark operating costs taken from the National Water Commission Performance Report. While acknowledging that finding suitable benchmarks is always challenging, care needs to be taken to ensure like for like comparisons. For example in comparing water the bulk costs have been removed, however the dividing line between bulk and distribution is not clearly defined. QUU has many mains and reservoirs that add to electricity and maintenance costs that previously would have been considered bulk. We are seeking to access the detailed calculations by SKM to further understand the opportunities for improved performance.

5. WACC reasonable range

QUU raised this issue in our earlier submission in response to the weighted average cost of capital (WACC) and due to its importance we re-iterate it here. The proposed WACC is a point estimate which is contrary to the Ministerial Direction, which required the Authority to:

"(g) consider a weighted average cost of capital (WACC) within a reasonable range of values for 2010-11.

Given the particularly low proposed cost of equity the point estimate has to be considered to be at the very low end of a range. The Report does not make any comment on the reasonableness of the MAR derived using WACC within a reasonable range when compared to forecast revenue.

The original report commissioned by the three distributor-retailers from CEG provided a range for WACC. We ask that the Authority consider WACC within a reasonable range and provide the corresponding reasonable range for MAR.

6. Tariff reviews implied

The Report states that, "the Authority has not sought to review prices (or tariff structures) in detail in this first review...", however we note that under the Ministerial Direction that the Authority is directed to monitor the revenues of each activity in the interim regulatory period. Significant work is required to reform tariff across the QUU. In order to effectively commence this work the pricing principles to be applied and the form of regulation needs to be consulted and developed with the Authority, the community and customers. We note that the Authority will shortly be commencing its process for providing guidance on these matters. The timing of resolution of these matters will be critical to the pricing proposal for the deterministic period.

7. Flood event

QUU infrastructure has sustained significant damage as a result of the flooding events in Brisbane, Ipswich, Lockyer Valley and Somerset Council areas. The estimate of damage stands at $55M. QUU has insurance cover however insurance will not cover all of the costs. As noted by the Authority these costs are not currently included in the Report.

8. Information requirements

QUU notes the expectations of the Authority for further disaggregation and provision of information. QUU welcomes the opportunity to discuss these requirements in more detail and work with the Authority to determine how appropriate information requirements can be met.

Accounting and other systems will continue to be key constraints on providing more disaggregated information. This together with the timing of the issuance of the Authority's report means that there is little time to make significant modification to systems.

9. Matters requiring guidance

During the interim price monitoring period the distributor-retailers are responsible for setting prices. Whilst we acknowledge that the Authority does not have responsibility for price setting in the interim period the Authority will adopt positions and methodologies when calculating the MAR that will be used to assess the revenue of the entities. As such guidance in accordance with clause (b) of the Ministerial Direction is requested.

Matters which we seek Authority guidance on application are:

- the treatment of flood related operating and capital costs and any associated insurance recovery
- the treatment of the smoothing of capital revenues
- discussion of the relative merits of asset offset (stated as the Authority's preferred treatment of capital contributions) compared to the revenue offset approach for the treatment of capital contributions
- the treatment of any actual under recoveries or over recoveries
- the differences in regulatory tax treatment for asset offset in comparison to revenue offset

Thank you for the opportunity to provide our response.

Yours sincerely

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NOEL K FAULKNER
Chief Executive Officer
Queensland Urban Utilities

Cc: Mr Rick Stankiewicz, Queensland Competition Authority