

Draft Report

SEQ Price Monitoring for 2013-15 Part A – Overview

January 2014

We wish to acknowledge the contribution of the following staff to this report:

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SUBMISSIONS

Closing date for submissions: 28 February 2014

This report is a draft only and subject to revision. Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (QCA). Therefore submissions are invited from interested parties. The QCA will take account of all submissions received.

Written submissions should be sent to the address below. While the QCA does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by email. Submissions, comments or inquiries regarding this paper should be directed to:

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Confidentiality

In the interests of transparency and to promote informed discussion, the QCA would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available.

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Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office, or on the website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact us on (07) 3222 0555.

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EXECUTIVE SUMMARY

Introduction

Price monitoring is intended to constrain a monopoly activity from exercising its market power.

As directed, the QCA has monitored the 2013-15 prices, costs and revenues of the distribution and retail water and sewerage activities of five South East Queensland (SEQ) entities – Unitywater, Queensland Urban Utilities (QUU), Logan Water, Redland Water and Gold Coast Water.

The QCA has also monitored the entities' revenues against the prudent and efficient costs of water and sewerage services.

Key Findings

Prices for distribution and retail water and wastewater services changed significantly across SEQ in 2013-14. Prices for 2014-15 are yet to be set. Where there are changes in tariff structure, the best measure of the impact of price changes on customers is the change in bills.

Residential bills have increased in all areas across SEQ in 2013-14, from 4.7% in Logan (ex Beaudesert) to 38.8% in Moreton Bay (Redcliffe). These estimates include increases to bulk water charges and the removal of government rebates. That is, not all of the increase is attributable solely to the entities.

The QCA independently investigated the entities' budgeted costs. The QCA concluded these could be reduced by \$136 million across 2013-15. In some instances, the QCA reduced the entities' estimates of the return on capital to reflect the benchmark WACC and more appropriate asset values. Further, distribution and retail operating costs were reduced to reflect lower tax estimates and corporate costs for some entities. Bulk water costs were also reduced for some entities, reflecting the QCA's lower demand forecasts.

However, Unitywater, QUU, Logan Water and Gold Coast Water's aggregate revenues lie below the QCA's estimates of their prudent and efficient costs. As a result, the QCA found no evidence of an exercise of monopoly power for these entities in 2013-15.

With regards to Redland Water, the QCA has concerns with its approach and modelling that are yet to be resolved. As a result, the QCA is unable to establish whether Redland Water is exercising its monopoly power. Redland Water has an opportunity to take these concerns into account setting prices for 2014-15 and has indicated that it will do so.

Overall, the QCA considers that the transparency and review provided by price monitoring continues to contribute to an environment which ensures a focus is maintained on reducing the costs of service delivery and constrains the entities from exercising their market power.

The QCA also notes that when informing customers of changes in their 2013-14 bills, entities provided information on the increase in bills that only related to changes in retail-distribution prices. For customers to understand the implications of changes to their bills, entities should in future provide their customers with comprehensive information on the increase in each component of the bill and the overall (net) change.

Entities are also progressing further reforms, and further improvements in policies and practices related to ensuring cost effective service delivery are identifiable.

The Draft Report is in two parts. Part A provides an overview of key findings. Part B is comprised of entity-specific reports. Comments on this Draft Report are due by 28 February 2014. All comments will be taken into account in preparing the Final Report due 31 March 2014.

THE ROLE OF THE QCA – TASK, TIMING AND CONTACTS

The Queensland Competition Authority (QCA) is an independent statutory authority to promote competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements.

In 2012, that role was expanded to allow the QCA to be directed to investigate, and report on, any matter relating to competition, industry, productivity or best practice regulation; and review and report on existing legislation.

Task, timing and contacts

The QCA has been referred the distribution and retail water and sewerage activities of five South East Queensland (SEQ) entities – Unitywater, Queensland Urban Utilities (QUU), Logan Water, Redland Water and Gold Coast Water for a price monitoring investigation. The Ministerial Direction is available at Appendix A to the Part B reports and on the QCA website www.qca.org.au.

The QCA has released this Draft Report to assist interested parties in preparing submissions for its investigation. The Draft Report is in two parts. Part A provides an overview of key findings. Part B is comprised of five entity-specific reports.

Key dates

| | |
|---|--|
| Receipt of terms of reference: | 31 January 2013 |
| Due dates for entities' initial submissions: | 30 June 2013 (QUU and Unitywater) 30 September 2013 (Logan Water, Redland Water and Gold Coast Water) |
| Release of draft report: | 31 January 2014 |
| Due date for submissions on the Draft Report: | 28 February 2014 |
| Final Report to government: | 31 March 2014 |

Registration of interest

Interested parties wishing to register interest in the QCA's price review can do so by emailing water@qca.org.au.

Contacts

Enquiries regarding this project should be directed to:

ATTN: Catherine Barker
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1 OVERVIEW

1.1 Introduction

This is the fourth price monitoring review of distribution and retail water and sewerage activities in south-east Queensland (SEQ) by the QCA.

The QCA's price monitoring investigation for 2013-15 relates to the distribution and retail water and sewerage activities of Unitywater, Queensland Urban Utilities (QUU), Logan Water, Redland Water and Gold Coast Water.

The general objective of price monitoring is to constrain a monopoly activity exercising its market power.¹ The Ministerial Direction defines the QCA's task and approach.

1.2 Ministerial Direction

The Ministerial Direction under section 23A of the *Queensland Competition Authority Act 1997* (the QCA Act) (see Appendix A to Part B reports) requires the QCA to:

- (a) monitor the change in prices of distribution and retail water and sewerage services for residential and non-residential customers
- (b) provide information to customers about the costs of water and sewerage services, distinguishing the bulk and distribution/retail costs
- (c) monitor water and sewerage revenues against their total prudent and efficient capital and operating costs (the Maximum Allowable Revenue or MAR).

Further, as required, the QCA established a benchmark weighted average cost of capital (WACC) of 6.57% and advised entities by 31 January 2013. Supporting information is on the QCA website.

1.3 Approach

Under price monitoring, the QCA investigates prices, costs and revenues. In particular, the QCA is required to monitor the change in prices of water and sewerage services, provide information to customers about the costs of supply and monitor revenues against prudent and efficient costs.

To monitor prices, the QCA focuses on prices faced by residential and non-residential customers and residential bills.

To inform customers about costs, the QCA publishes the costs which underpin prices and conducts a review of these capital and operating costs (based on a sample of items).

The review seeks to establish whether the costs are genuinely required (prudent) and as low as possible (efficient). Other underlying factors such demand forecasts, asset values and rates of return are also reviewed. The resulting estimates of prudent and efficient capital and operating costs form the QCA's MAR.

In monitoring revenues against the MAR, the QCA considers revenues and costs at the time of setting prices. This comparison forms the basis for determining whether there is any evidence

¹ Explanatory notes to the *Queensland Competition Authority Amendment Bill 2008*.

of an exercise of monopoly power. A monopoly could be exercising its market power where revenues significantly exceed the MAR for a sustained period.

This Draft Report has two parts. Part A presents an overview of key findings. Part B details the QCA's assessment of the entities' proposed costs.

1.4 Consultation

The QCA has liaised extensively with the entities and relevant agencies prior to, and during, this review. Prior to the review, the QCA prepared the SEQ Interim Price Monitoring Framework (April 2010) and SEQ Interim Price Monitoring Information Requirements (December 2010). Following reviews with the entities, the QCA revised the information requirements and held a workshop with stakeholders in March 2013 leading to the release of revised information requirements for 2013-15.

During the 2013-15 review, the QCA has met with the entities to identify and address relevant issues, invited submissions from interested parties, commissioned independent consultants to review aspects of the entities' submissions and published all public submissions and reports on its website.

1.5 Prices

There is a wide range of prices set by the entities as a result of the wide range of services provided to customer groups in SEQ.

Prices for distribution and retail water and sewerage services to residential and non-residential customers did not change uniformly across SEQ in 2013-14. The changes ranged from a fall of 34.8% in fixed water charges in Logan to an increase of 266% in tier 1 volumetric water charges in Moreton Bay in 2013-14. Prices for 2014-15 are yet to be set.

Table 1 Changes in distribution and retail water and sewerage prices in 2013-14

| <i>General movements</i> | <i>Range of changes</i> |
|---|---|
| Unitywater – Restructure of residential prices to increase the volumetric component, general prices increase by 3% | Ranges from a fall of 15.2% in fixed water charge to an increase of 266% in tier 1 water volumetric charge in Moreton Bay. |
| QUU – Prices increase by 3.9%. Some sundry charges rationalised and harmonised across QUU. | General rise of 3.9%, greater variation in sundry charges. |
| Logan Water – Harmonisation of fixed water charges. Fixed sewerage charge increase by 14.5%. | Ranges from a fall of 34.8% in fixed water charge for the former Beaudesert area to an increase of 23.1% in the same charge for the former Gold Coast area. |
| Redland Water – Charges set to achieve cost recovery over ten years. | Ranges from a fall of 13.2% in fixed sewerage charge to an increase of 20.3% in the tier 1 volumetric water charge. |
| Gold Coast Water – Prices increase by 2.1% | Prices increase by 2.1%. |

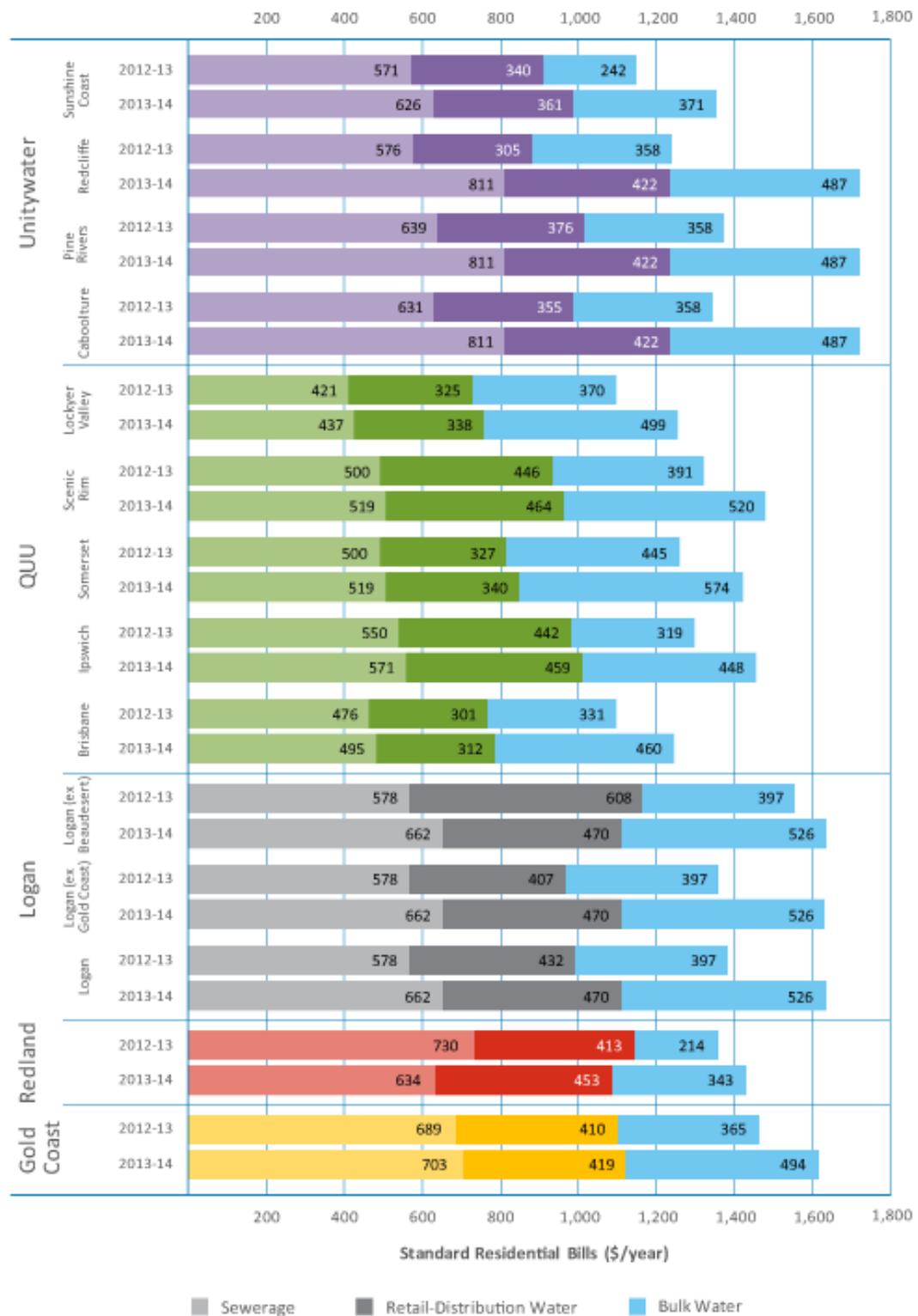
Source: Unitywater (2013a), QUU (2013a) GCW (2013a), LW (2013a) and RW (2013a).

Where there are changes in tariff structure, the best measure of the impact of price changes on customers is the change in bills.

Residential bills have increased in all areas across SEQ in 2013-14, from 4.7% in Logan (ex Beaudesert) to 38.8% in Moreton Bay (Redcliffe). These estimates include increases to bulk

water charges, the removal of the bulk water rebate and some council rebates. That is, not all of the increase is attributable solely to the entities.

Chart 1 Total Residential Bills (\$)



Notes: Based on metered usage of 200kL per annum and wastewater charge per connection (with one pedestal where relevant). Source: Unitywater (2013a), QUU (2013a) GCW (2013a), LW (2013a) and RW (2013a).

The residential bills used in the QCA's analysis have been estimated on the basis of usage of 200 kilolitres (kl) of water per year, the level adopted for national performance reporting (NWC

2010). As there is no national standard for sewerage, the analysis has been based on the bill for a detached residence in each council area.

The QCA also notes that when informing customers of changes in their 2013-14 bills, entities provided information on the increase in bills that only related to changes in retail-distribution prices. For customers to understand the implications of changes to their bills, entities should in future provide their customers with comprehensive information on the increase in each component of the bill and the overall (net) change.

1.6 Costs

The QCA has estimated the prudent and efficient costs of providing water and wastewater services in SEQ. These costs, which constitute the QCA's MAR, include distribution and retail costs, and bulk water costs.

The QCA MAR is informed by its independent review of the prudence and efficiency of entities' capital and operating expenditure.

Asset values

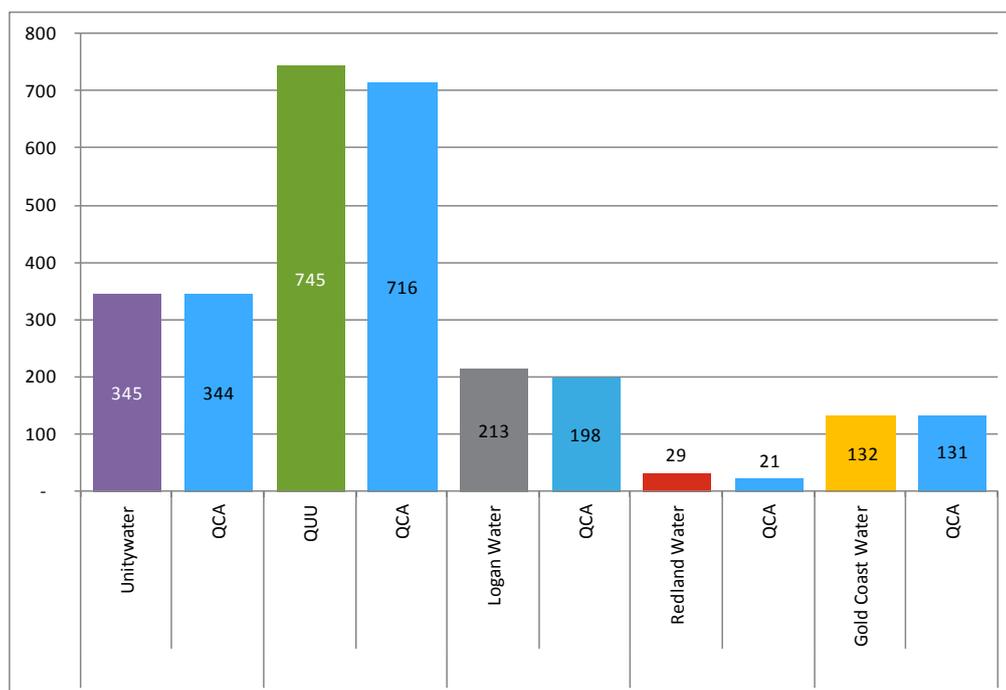
A key input is the initial Regulatory Asset Base (RAB). The QCA adjusted Unitywater's, Logan Water's, Redland Water's and Gold Coast Water's RAB to reflect the requirements set out in the Ministerial Direction. QUU's starting RAB was accepted.

Capital expenditure

The QCA reviewed a sample of capital projects and programs and adjusted the entities' estimates to reflect its view of prudent and efficient capital expenditure.

Overall, the QCA identified potential savings of \$51.9 million (3.5%) over 2013-15. A comparison of the entities' proposed capital expenditure in 2013-15 is compared to the QCA's in Chart 2. Savings generally arose from deferrals and from the use of relevant benchmarks.

Chart 2 Capital Expenditure in 2013-15 (\$m)



Source: Unitywater (2013b), QUU (2013b), LW (2013b), RW (2013b), GCW (2013b), QCA calculations (Part B).

Also relevant to comparisons of capital expenditures with those of previous years, entities have a choice of approaches to the treatment of contributed assets and capital contributions.

QUU and Unitywater previously applied a revenue offset approach and have now changed to asset offset. All entities (except Redland Water) have now applied an asset offset approach. This approach reduces the impact of volatility of prices, by recognising the benefits of capital contributions to users over the life of assets. Redland Water has adopted the asset offset approach for contributed assets and the revenue offset approach for cash contributions. The change in approach has offset changes in other costs in the years under review.

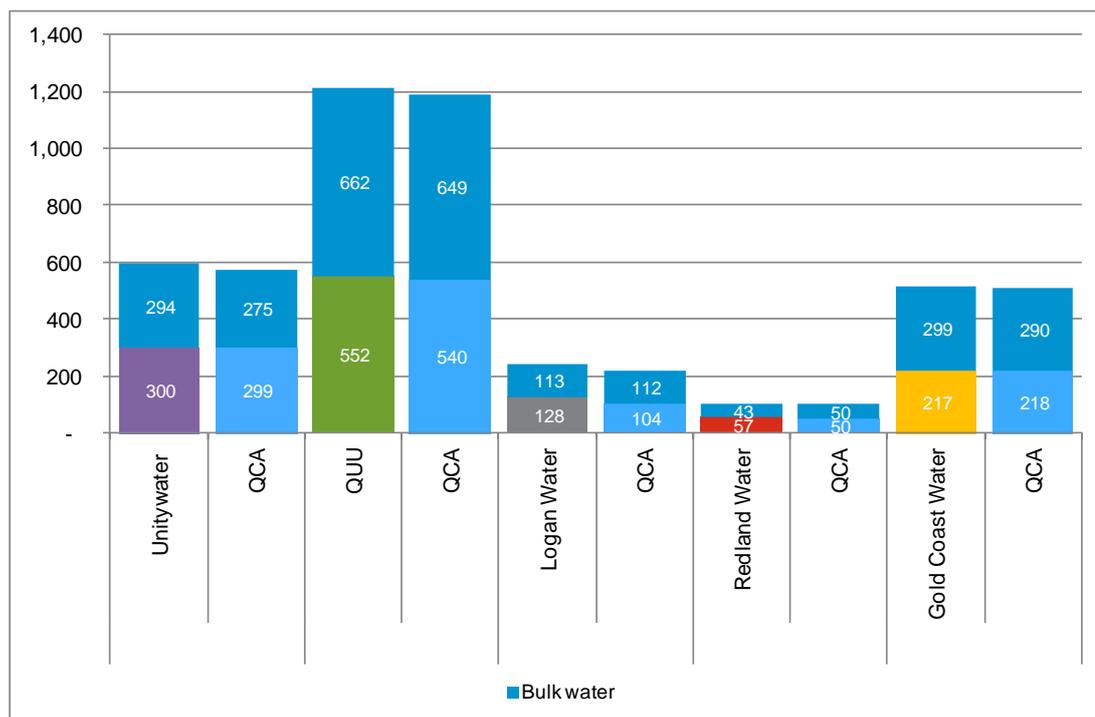
Capital Costs

The QCA estimated a lower return on capital in some instances due to the use of a different WACC (Unitywater) and lower opening asset values for some council water businesses.

Operating costs

Potential savings of \$43 million in non-bulk operating costs were identified in the QCA's review of the entities' price monitoring submissions, relating primarily to tax and corporate costs. The QCA found potential savings of \$34 million in bulk water costs, due to lower estimates of future demand.

Chart 3 Operating costs in 2013-15 (distribution and retail and bulk components) (\$m)

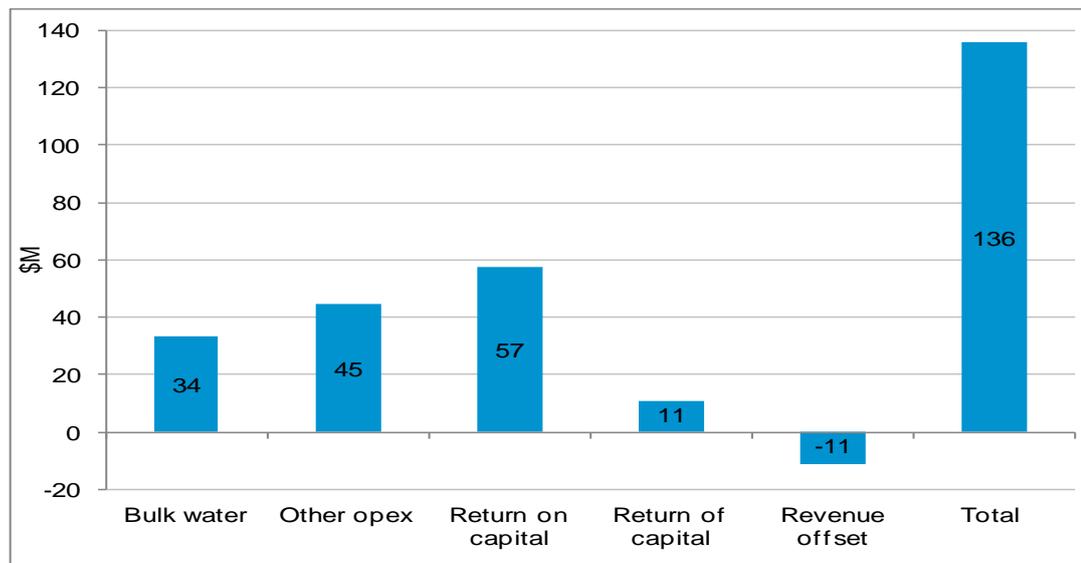


Note: The QCA review of operating costs is based on the entities' submitted operating costs. Source: Unitywater (2013b), QUU (2013b), LW (2013b), RW (2013b), GCW (2013b), QCA calculations (Part B).

Total costs

Following its review of the entities' budgeted costs, the QCA concluded the costs of supplying water and sewerage activities could be \$136 million lower across 2013-15.

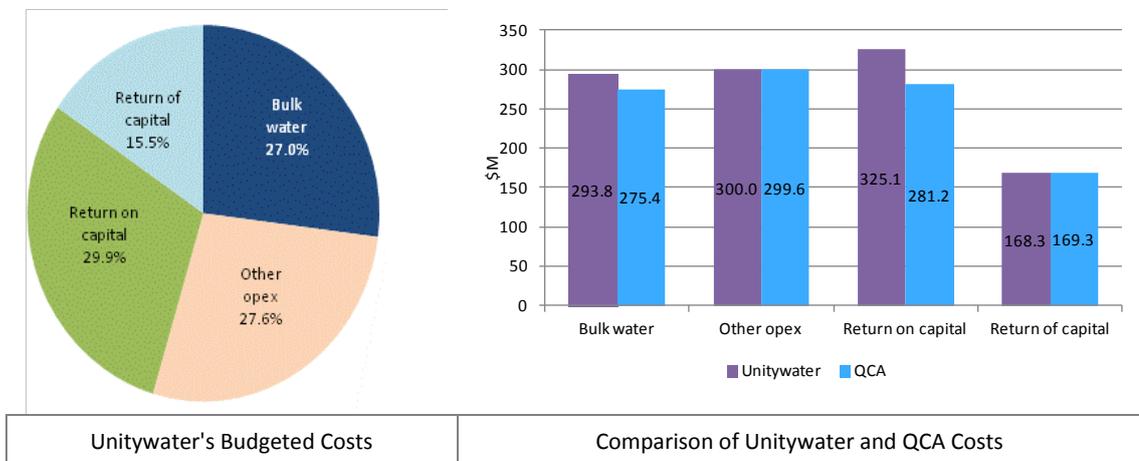
Chart 4 Components of QCA cost savings (\$m)



Note: Redland Water's budgeted costs differ from their price monitoring submission. The savings in operating costs in Chart 4 (\$45m) are higher than in Chart 3 (\$43m), due to data differences between Redland Water's budgeted costs and its price monitoring submission. The difference in revenue offset for Redland Water acts to increase total costs and is a negative saving. Source: QCA calculations (Part B).

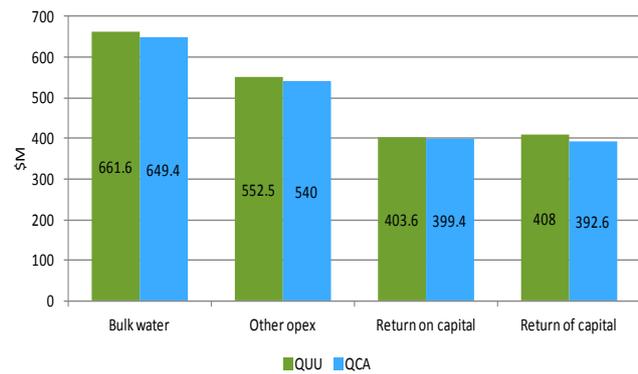
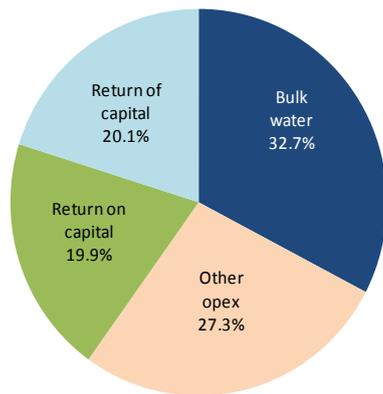
The charts below disaggregate costs by entity, comparing entities' budgeted costs with the QCA's estimates of prudent and efficient costs. Part B provides more detail.

Chart 5 Unitywater Costs in 2013-15



Source: Unitywater (2013c), QCA calculations (see Part B).

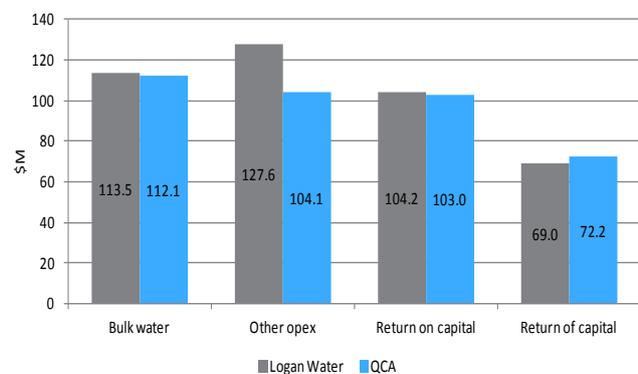
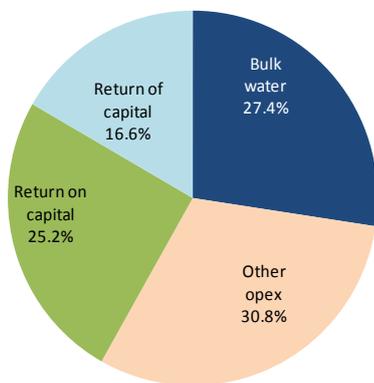
Chart 6 QUU Costs in 2013-15



| | |
|----------------------|---------------------------------|
| QUU's Budgeted Costs | Comparison of QUU and QCA Costs |
|----------------------|---------------------------------|

Source: QUU (2013c), QCA calculations (see Part B).

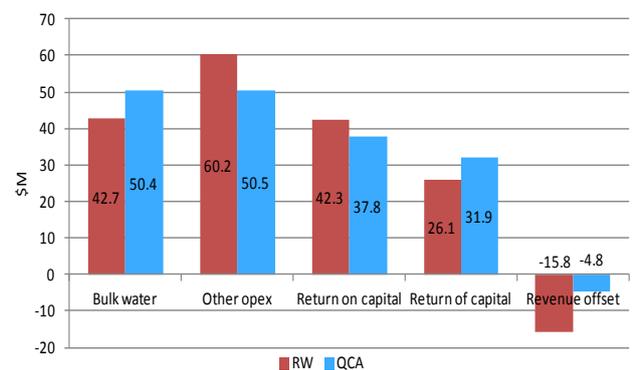
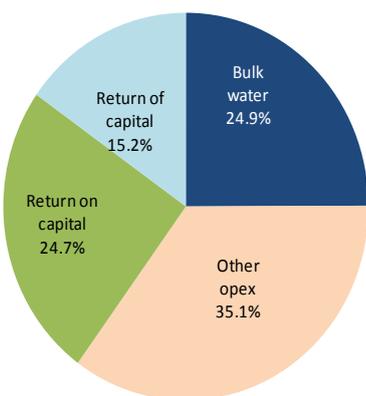
Chart 7 Logan Water Costs in 2013-15



| | |
|------------------------------|---|
| Logan Water's Budgeted Costs | Comparison of Logan Water and QCA Costs |
|------------------------------|---|

Source: LW (2013c), QCA calculations (see Part B).

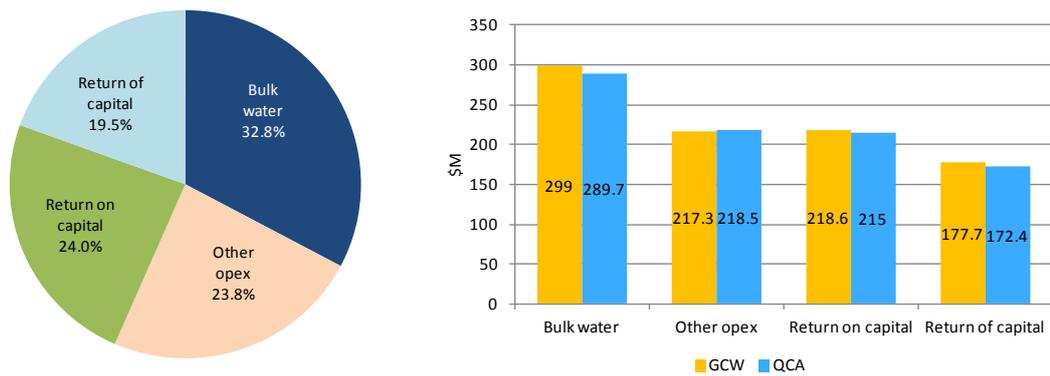
Chart 8 Redland Water Costs in 2013-15



| | |
|--------------------------------|---|
| Redland Water's Budgeted Costs | Comparison of Redland Water and QCA Costs |
|--------------------------------|---|

Note: Redland Water costs are sourced from its pricing model and differ from its price monitoring submission.
Source: RW (2013c), QCA calculations (see Part B).

Chart 9 Gold Coast Water Costs in 2013-15



| | |
|-----------------------------------|--|
| Gold Coast Water's Budgeted Costs | Comparison of Gold Coast Water and QCA Costs |
|-----------------------------------|--|

Source: GCW (2013c), QCA calculations (see Part B).

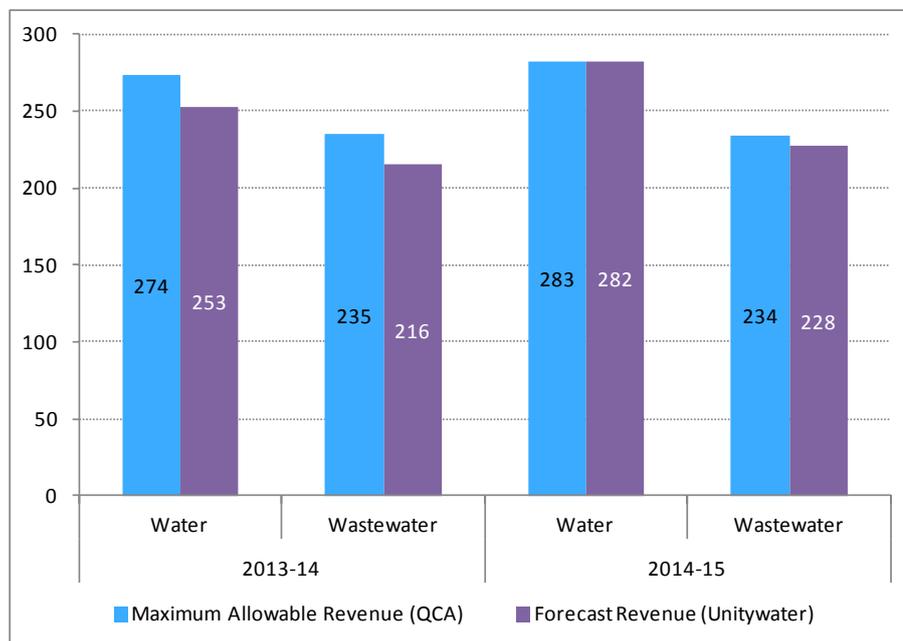
1.7 Revenues

Under the Ministerial Direction the QCA must monitor the revenues of each water and wastewater activity against the MAR.

Unitywater

Unitywater's water and sewerage revenues are below the QCA MARs in 2013-15.

Chart 10 Unitywater Revenues and QCA MAR (\$m)

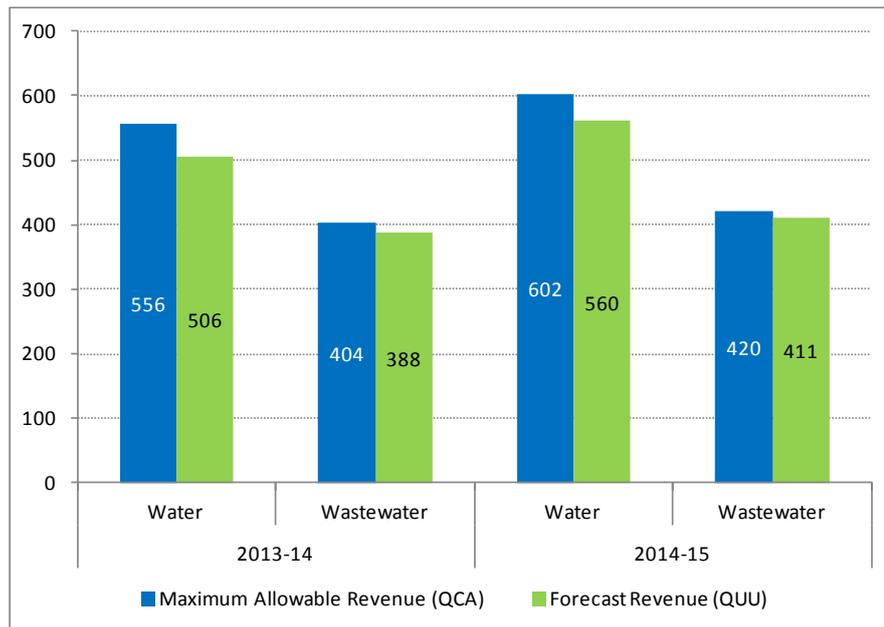


Source: Unitywater (2013b), QCA calculations (Part B).

QUU

QUU's water and sewerage revenues are below the QCA MARs in 2013-15.

Chart 11 QUU Revenues and QCA MAR (\$m)

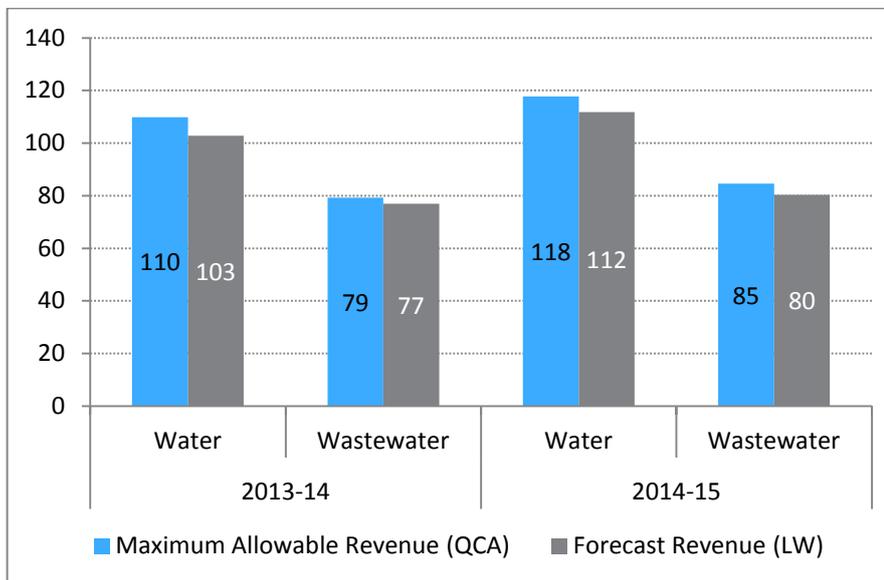


Source: QUU (2013b), QCA calculations (Part B).

Logan Water

Logan Water's water and sewerage revenues are below the QCA MARs in 2013-15.

Chart 12 Logan Water Revenues and QCA MAR (\$m)

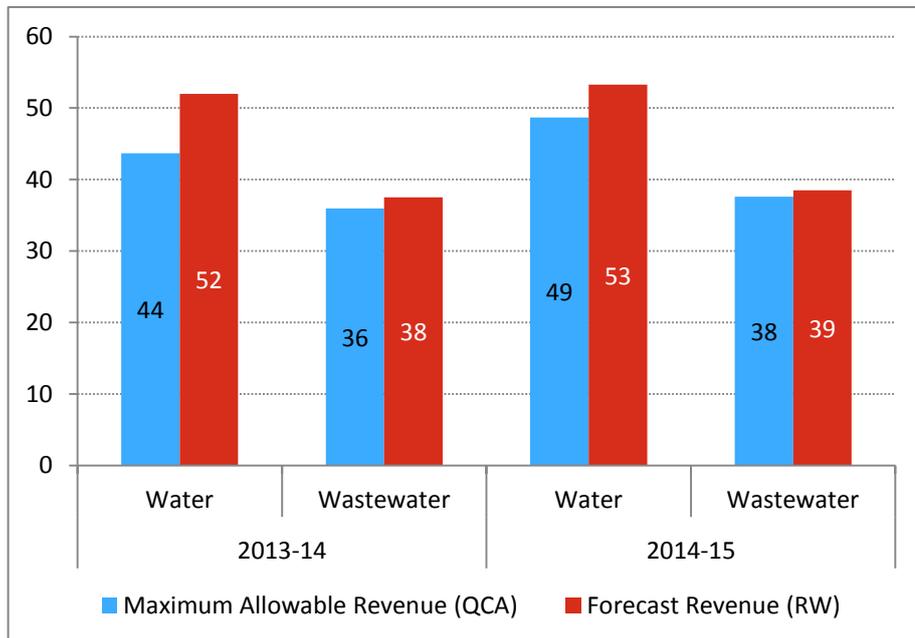


Source: LW (2013b), QCA calculations (Part B).

Redland Water

Redland Water's water and sewerage revenues are above the QCA MARs in 2013-15.

Chart 13 Redland Water Revenues and QCA MAR (\$m).

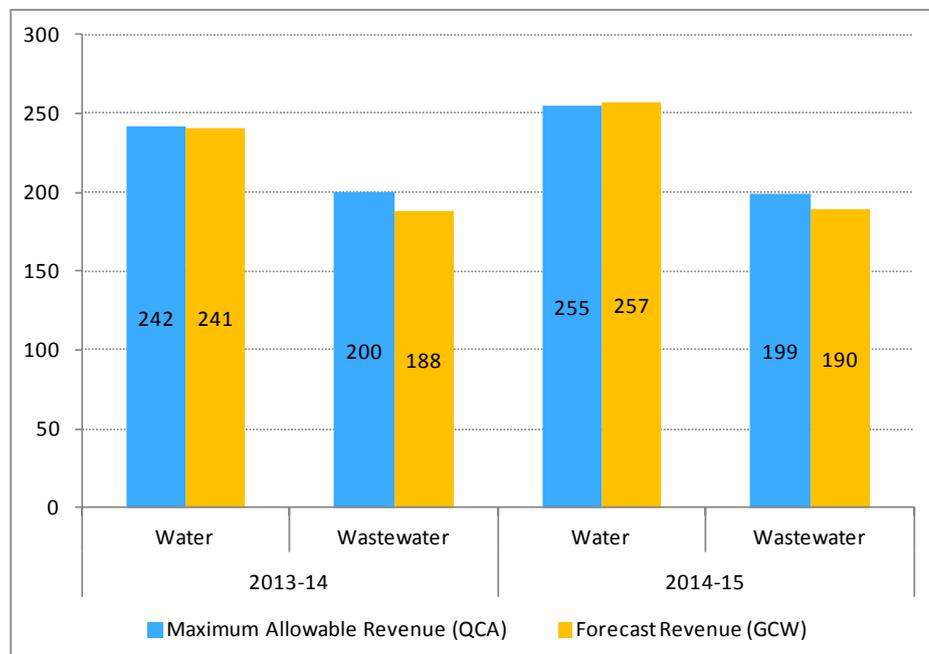


Source: RW (2013b), QCA calculations (Part B).

Gold Coast Water

Overall, Gold Coast Water's water and sewerage revenues are below the QCA MARs in 2013-15.

Chart 14 Gold Coast Water Revenues and QCA MAR (\$m)



Source: GCW (2013b), QCA calculations (Part B).

Market power

Overall, Unitywater, QUU, Logan Water and Gold Coast Water's revenues lie below the QCA's estimates of their prudent and efficient costs in 2013-15.

As a result, the QCA found no evidence of an exercise of monopoly power for Unitywater, QUU, Logan Water and Gold Coast Water in 2013-15.

With regards to Redland Water, the QCA notes that its revenues are 9.3% above the QCA's estimates of prudent and efficient costs in 2013-15. This results from Redland Water's approach to smoothing prices over 10 years, whereby over-recovery in earlier years is returned to users in under-recovery in later years.

The QCA supports the principle of price smoothing. However, the QCA has concerns with the 10-year model applied by Redland Water and negative retail-distribution prices in future years.

In view of these concerns, the QCA cannot establish whether there is an exercise of market power by Redland Water. Setting 2014-15 prices provides an opportunity for Redland Water to address these concerns and demonstrate that there is no exercise of monopoly power. Redland Water has advised it will take the QCA's concerns into account in setting 2014-15 prices.

Should there be concerns regarding 2014-15 prices, the Government can refer any of the SEQ entities to the QCA for more detailed review.

1.8 Policies and Procedures

In 2013-15, the QCA has continued to review the entities' policies and procedures to establish the prudence and efficiency of costs. The 2013-15 review has identified a range of areas of potential improvement to achieve good industry practice. In some cases, the entities were aware of issues and improvements were already planned. In others, the QCA review provided an opportunity to consider new perspectives and approaches to enhance current practice.

For example, in capital planning and asset management, the QCA's consultant SKM found that:

- (a) QUU needs to develop its benefits realisation and improve consistency with asset management standards. QUU has plans in place to do so
- (b) Unitywater's asset management system was not yet consistent with good industry practice. SKM noted that Unitywater has not yet fully implemented its Consolidated Asset Management System (CAMS) which will improve asset management
- (c) Gold Coast Water's asset management system was not robust but SKM noted Gold Coast Water is developing a compliance program
- (d) Logan Water's asset management system was not robust but SKM noted Logan Water has identified a number of tasks to improve asset management in the business
- (e) Redland Water's documentation and compliance requirements were not addressed adequately but SKM noted Redland Water is developing a comprehensive program of planned improvements.

SKM did not quantify any savings that could arise from potential improvements to policies and procedures.

The QCA's price monitoring role is focussed on the aggregate revenues and costs of relevant activities. The pricing principles underlying individual prices are subject to detailed review in the QCA's concurrent review of the SEQ regulatory framework post 2015 and pricing principles.

GLOSSARY OF ACRONYMS, TERMS AND CONDITIONS

G

GCW Gold Coast Water

K

kl Kilotitres

L

l/p/d Litres per person per day

LW Logan Water

M

m Million

MAR Maximum Allowable Revenue

N

NWC National Water Commission

Q

QCA Queensland Competition Authority

QUU Queensland Urban Utilities

R

RAB Regulatory Asset Base

RW Redland Water

S

SEQ South East Queensland

W

WACC Weighted Average Cost of Capital

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