Seqwater 2012-13 Grid Service Charges

Response to Draft Report of the Queensland Competition Authority

May 2012

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Executive Summary

Grid Service Charges are the amounts that Seqwater can charge the Water Grid Manager for bulk water services.

The SEQ Water Market Rules provide for the Queensland Competition Authority (also known as the Economic Regulator) to investigate and recommend the Grid Service Charges applicable to Grid Service Providers such as Seqwater.

On 30 April 2012 the Queensland Competition Authority released a Draft Report following its investigations. This submission is to provide comment and a response to the Draft Report.

Regarding fixed operating costs, Seqwater's proposed regulatory budget for 2012-13 was $236.0M. The QCA's Draft Report did not approve $0.6M of those costs, suggested the transfer of $4.3M for sludge disposal costs into variable operating costs, [redacted]

In response to these draft findings, this submission suggests the continued inclusion of sludge disposal costs in fixed costs due to the large impacts on variable costs on a plant-by-plant basis, due to the non-linear relationship between the quantities of sludge produced and the costs incurred in disposing of that sludge and also due to the volume risks that may be imposed.

This submission also provides additional information and commentary relating to the prudency and efficiency of the $0.6M in fixed operating costs not approved in the QCA's Draft Report. Furthermore, this submission outlines an additional $2.8M in fixed operating costs that will be required by Seqwater in 2012-13 to complete proposed decommissioning works at specific WTPs.

Regarding variable operating costs, Seqwater's proposed regulatory budget for 2012-13 acknowledged that there would be continuing uncertainty in forecasting some variable costs, particularly energy costs.

While Seqwater submitted interim forecasts, and the QCA's Draft Report contains some different forecasts, Seqwater considers that variable costs cannot be finalised until definitive advice is available in relation to many key aspects of energy costs. The necessary information includes the setting of network costs and environmental charges, the impact of the carbon tax, government policy direction relating to existing carbon offsets, and the outcome of moving the GCDP and WCRWS from notified tariffs to contestable market contracts. Some, but not all, of this information will become available in time for the QCA's Final Report. This submission therefore strongly supports mechanisms that will effectively pass through the actual costs of energy incurred by Seqwater in 2012-13.

Regarding capital expenditure, Seqwater's proposed regulatory budget for 2012-13 focused on the capital expenditure proposed within the 2012-13 year being reviewed. The QCA's Draft Report made a number of recommendations not to approve specific capital projects, including capital expenditure proposed for years after 2012-13.

Seqwater notes that this approach in the Draft Report has the effect of confusing those findings that impact Seqwater's 2012-13 GSCs, against those that may or may not have an eventual impact on Seqwater's financial position in future years. Specifically, Seqwater notes that the Draft Report did not approve $37.1M of proposed capital expenditure in 2012-13, but only $5.9M relates to projects that will be commissioned in 2012-13, and which will impact on Seqwater's 2012-13 GSCs. An additional $1.9M relates to projects that are being commissioned in 2011-12, which will also impact on Seqwater's 2012-13 GSCs if not approved in the QCA's Final Report. All other proposed capital expenditure relates to projects that are not being commissioned in 2012-13, will not impact upon 2012-13 GSCs, and are likely to be considered again in future review processes.

In response to the Draft Report findings on capital projects, this submission seeks to outline new and additional information relating to the prudency and efficiency of most of those projects that were not approved or were only partially approved in the Draft Report. For a few projects, however, new information suggests that these projects be postponed or need not continue. This includes three capital projects proposed in Seqwater's initial submission of February 2012, which were not approved in the Draft Report:

- North Stradbroke Island WTP Upgrade ($1.1M in 2012-13 and $3.0M in 2013-14, now to be postponed for at least one year following advice from the former DERM (now DEWS));
- South Maclean WTP Upgrade ($2.3M in 2012-13 and $2.1M in 2013-14, not to be continued as recent work, including under the QWC sub-regional planning process, suggests this WTP may be decommissioned); and
- a renewal item at the Mount Crosby Westbank WTP ($0.3M in 2011-12, which was not incurred because this renewal work has been postponed).

There is also one capital project that was approved in the Draft Report, namely the Wyaralong WTP Works ($1.0M in 2012-13 and $1.0M in 2013-14), which is now likely to be postponed following recent WGM advice that the new WTP is not needed, possibly until as late as 2024-25.

For a small number of capex projects which were not approved due to their very early stage of development, this submission provides an update on progress. Whilst it is unlikely that all of these projects have developed to the point that prudency and efficiency can be conclusively established, this submission proposes that these projects remain in the capital

programme because Seqwater considers that they are still likely to continue on the balance of probabilities.

In any event, these are multi-year projects not due to be commissioned in 2012-13 and therefore do not impact 2012-13 GSCs. However, this issue raises an important future question of regulatory budgeting for Seqwater, which is discussed in detail in this submission. In practice, at any point in time, there is likely to be a list of projects in Seqwater's capital programme that are in early stages of development and unlikely to have sufficient detail to substantiate their prudency and efficiency. Concurrently, Seqwater is required to budget on the basis of its likely costs, and is also required to align its regulatory budget with its other financial budgeting processes. Seqwater considers that it is important to establish (and requests that the QCA notes in its Final Report) that:

- the withholding of approval by the QCA in these circumstances is not necessarily the same as a rejection or a negative finding as to the suitability or necessity of the project;
- for all projects, particularly multi-year projects, the review is not final and there will be further reviews relating to the project, including an ex-post review once the project is completed; and
- due to the regulatory process governing the review, findings that relate to capital expenditure in the forward years (after the financial year being reviewed) do not have any financial impact on Seqwater.

Lastly, this submission provides an update on those events that have occurred in 2011-12 that need to be considered under the price review provisions, and where final information will need to be provided by Seqwater following the end of the financial year. This information will form the basis of a separate submission to the QCA, outside of this review process and after the release of the QCA's Final Report.

Chapter 1 – Introduction

Seqwater is the sole supplier of bulk drinking water in South East Queensland (SEQ).

Seqwater is a Grid Service Provider (GSP) that stores and treats water from dams, weirs, bores and other water storages, and also supplies desalinated water from the Gold Coast Desalination Plant (GCDP) and purified water from the Western Corridor Recycled Water Scheme (WCRWS). Seqwater is also responsible for managing:

- the catchments which surround its water sources;
- flood mitigation services;
- recreation facilities and services; and
- irrigation services.

Together with Linkwater, which transports the water through pipelines into the distribution system, Seqwater supplies bulk water to the SEQ Water Grid Manager (WGM). The WGM then sells the treated water to the council-owned retail distribution water companies (Unitywater, Allconnex Water and Queensland Urban Utilities), and other industry customers. Figure 1.1 below illustrates Seqwater's role in the structure of the water industry in SEQ.

The SEQ Water Market Rules (Market Rules) provide for the Queensland Competition Authority (QCA) (also known as the Economic Regulator) to investigate and recommend Grid Service Charges (GSCs) applicable to GSPs for the period from 1 July 2012 to 1 July 2013.[1]

The GSCs are the amounts that Seqwater can charge the WGM for bulk water services. The Market Rules also specifically provide for the Price Regulator (the Minister for Energy and Water Utilities) to issue a Direction Notice to provide further instructions to the QCA in terms of how it conducts its investigation.[2]

A more complete explanation of the Seqwater business and other relevant background is contained in Chapters 2 and 3 of Seqwater's initial submission to this review.[3]

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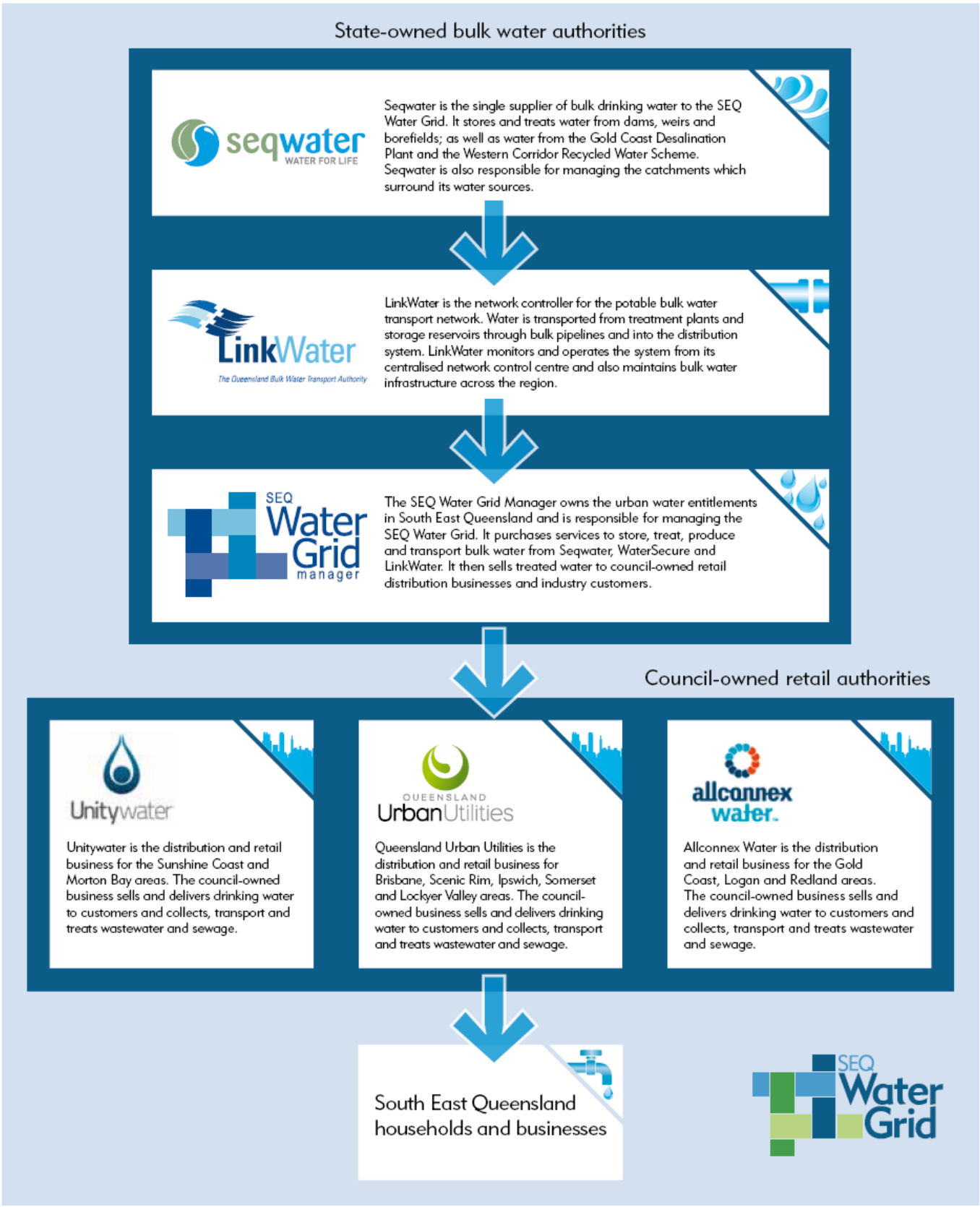
1 8.4(a)(ii) SEQ Water Market Rules, 1 July 2011.

2 8.3(c) SEQ Water Market Rules, 1 July 2011.

3 *Seqwater 2012-13 Grid Service Charges Submission to the Queensland Competition Authority,* February 2012.

Figure 1.1 **– Structure of SEQ water industry**



1.1 This submission

This submission is to provide comment and a response to the Draft Report of the QCA, following its investigation of the Grid Service Charges (GSCs) that Seqwater can charge the Water Grid Manager for bulk water services in 2012-13.

This review process is the second review of Seqwater's GSCs by the QCA, and is also the first review since Seqwater merged with WaterSecure. Therefore, this submission is essentially the first regulatory submission of the new merged entity. It is also the first time the merged entity has prepared a single budget and forecast of its operating and capital costs.

For financial years prior to 2011-12, the Queensland Water Commission (QWC) was the Economic Regulator providing advice to the Price Regulator for these purposes.

This submission is intended to be read in the context of Seqwater's initial submission to the QCA in this review, which was submitted in February 2012. For more information about the Seqwater business and other relevant background, refer to Chapters 2 and 3 of Seqwater's initial submission.[4]

This submission is set out as follows:

- Chapter 2 provides comment and a response to the QCA's recommendations relating to Seqwater's capital programme, including estimated actual capital expenditure in the current year (2011-12), forecast capital expenditure in the review period (2012-13), and forecast capital expenditure in the forward years (2013-14 to 2016-17);
- Chapter 3 provides further information in relation to Seqwater's Regulatory Asset Base (RAB) and working capital requirements for 2012-13;
- Chapter 4 provides an update on market-sensitive parameters in relation to Seqwater's Weighted Average Cost of Capital (WACC);
- Chapter 5 provides comment and a response to the QCA's recommendations relating to Seqwater's forecast fixed operating expenditure for 2012-13;
- Chapter 6 provides comment and a response to the QCA's recommendations relating to Seqwater's forecast variable operating expenditure for 2012-13;
- Chapter 7 provides comment and a response to the QCA's recommendations relating to Seqwater's forecast allowable costs for 2012-13;

[4] *Seqwater 2012-13 Grid Service Charges Submission to the Queensland Competition Authority,* February 2012.

- Chapter 8 provides an update on Seqwater's estimated allowable costs in 2011-12 and 2012-13; and
- Chapter 9 provides comment and a response to the QCA's recommendations relating to a number of other economic regulatory issues.

1.2 Glossary of defined terms

Figure 1.2 is a glossary of terms defined in this document.

***Figure 1.2* – Glossary of defined terms**

Defined term	Explanation
ADWG	Australian Drinking Water Guidelines
AEMO	Australian Energy Market Operator
AWTP	Advanced Water Treatment Plant
BOOT Scheme	Build-Own-Operate-Transfer Scheme
Capex	Capital Expenditure
CSO	Community Service Obligation
DR	Distributor-Retailer
EBA	Enterprise Bargaining Agreement
Economic Regulator	Queensland Competition Authority (see also QCA)
FAMP	Facilities Asset Management Plan
FTE	Full Time Equivalent
GCDP	Gold Coast Desalination Plant
GL	Gigalitre (1,000 ML)
GSC	Grid Service Charge
GSP	Grid Service Provider
ICT	Information & Communications Technology
Information Requirements	QCA, *SEQ Grid Service Charges 2012-13 Information Requirements*, 2012.

Information Return	Seqwater's provision of information in response to the Information Requirements
IROL	Interim Resource Operations Licence
kW	Kilowatt
kWh	Kilowatt hour
LinkWater	Queensland Bulk Water Transport Authority
Market Rules	South East Queensland Water Market Rules
ML	Megalitre
MWh	Megawatt Hour
NPV	Net Present Value
Opex	Operating Expenditure
Price Regulator	Queensland Minister for Energy and Water Utilities
PRW	Purified Recycled Water
QCA	Queensland Competition Authority
QTC	Queensland Treasury Corporation
QWC	Queensland Water Commission
RAB	Regulatory Asset Base
RFI	Request For Information
ROP	Resource Operations Licence
SCADA	Supervisory Control And Data Acquisition
SEQ	South East Queensland
Seqwater	Queensland Bulk Water Supply Authority
SKM	Sinclair Knight Mertz, Consulting To QCA

SOP	System Operating Plan
WACC	Weighted Average Cost of Capital
WAE	Water Access Entitlements
WaterSecure	Queensland Manufactured Water Authority, merged with Seqwater on 1 July 2011
WCRWS	Western Corridor Recycled Water Scheme
WGM	Water Grid Manager
WH&S	Workplace Health & Safety
WTP	Water Treatment Plant
WWTP	Wastewater (Sewage) Treatment Plant

Chapter 2 – Capital expenditure

This Chapter provides comment and a response to the QCA's recommendations relating to Seqwater's capital programme.

Regulatory budgeting and Seqwater's capex programme

As noted in its initial submission, Seqwater's capital expenditure programme reflects its understanding of its asset requirements, service needs, and conditions and risk factors, as at the time of submission.

Furthermore, under the existing regulatory arrangements, Seqwater only receives revenue for a capital project once that project has been included in Seqwater's RAB. A capital project is not included in the RAB until it has been deemed prudent and efficient by the QCA in an ex-post review (i.e. after the project has been completed and commissioned).

In preparing its submission, consistent with previous submissions dating back to 2008-09, Seqwater took the view that its regulatory budget should closely align to its financial budget. Seqwater's approach to budgeting was to budget for capital projects that it considered were likely, on the balance of probabilities, to be needed in the relevant period in order to meet its obligations and business needs. The financial budget is used for internal forecasting and is provided as an input to the Queensland Treasury Tridata process, which is a whole-of-government forecasting practice.

In fact, the QCA's Information Requirements[5] require that, as a matter of principle, Seqwater's "Information returns must be consistent with the statutory accounts and Budget of the entity", and require the Seqwater Board to attest to this.

As such, Seqwater considered that it was appropriate to include capital expenditure that met the test of budget alignment, even in cases where a project was conditional on independent events such as the outcomes of regional planning studies or government decisions. Seqwater's regulatory budget therefore included proposed capital expenditure on a number of conditional projects, notably a number of projects contingent on the outcomes of the Scenic Rim Regional Planning Study, which is due for completion shortly.

The WGM's submission disagreed with this approach, suggesting that Seqwater's capital budget should not include certain conditional projects, because that would potentially secure endorsement of expenditure before the final option for those projects was determined.

As noted above, the prudency and efficiency of any project is determined after the project is completed and the expenditure has been incurred. So the risk in question would only arise if Seqwater continued with a conditional project in spite of the relevant event or condition not

[5] QCA, *SEQ Grid Service Charges 2012-13 Information Requirements*, 2012, section 4.2 and section 8.

occurring, and only then if the QCA felt sufficiently bound by its earlier decision that it would not make a negative finding after the project was completed.

Seqwater noted that its own internal processes and procedures would prevent it from proceeding with a conditional project after it became clear that the necessary condition would not be met. By way of example, in March 2012, after lodging its initial submission, additional information (notification from a government department that a policy decision would not be advised for another year) was received, making it clear that the proposed expenditure on North Stradbroke Island WTP would not go ahead before then, and this project has now been removed from Seqwater's 2012-13 capital programme (discussed further below).

Seqwater also suggested that, in order to resolve this issue, it may be possible for the QCA to consider making findings of prudency that are conditional on the same event or condition as a project itself. That way, the QCA would not be providing an unconditional finding of prudency and could easily make a negative finding without feeling bound by precedent.

Nonetheless, in its Draft Report, the QCA decided that the WGM's approach was "less risky" and that: [6]

> *unless there is other compelling information, the absence of a relevant planning study and options analysis will normally exclude the proposal from inclusion in GSCs in the relevant year, with consideration delayed until such information is available.*

Seqwater acknowledges the WGM's concerns in this matter, although notes that this issue will continue to arise in future reviews. Economic regulatory reviews are conducted at a point in time, and at any point in time Seqwater is likely to have a number of capital projects that are in the early stages of development (prior to various conditions being met or options analysis being prepared) but where it is expected, on the balance of probabilities, that some expenditure will be needed in the year being reviewed. In fact, this issue is likely to become more problematic when the regulatory regime moves to reviewing multiple years at a time, as is planned, because the gap between the time of the review and the timing of proposed expenditure will grow larger.

Seqwater is faced with a difficult choice in these circumstances. Either it must continue to budget for conditional projects that it considers likely to eventuate, and risk the potential reputational harm that comes from the QCA withholding a positive finding of prudency, or it must remove such items from its regulatory budget, losing an opportunity to have the capital projects considered by the QCA and other stakeholders, and creating discrepancies between its regulatory and financial accounts.

[6] QCA, 2012, page 36.

Seqwater's preference is to maintain consistency between its regulatory and financial budgets, and to give the QCA and other stakeholders more, rather than fewer, opportunities to consider its capital programme. However, Seqwater is concerned that this approach will lead to incorrect conclusions being drawn about the rigour of its capital programme. For example, it might be concluded that approval of projects is being withheld by the QCA because those projects are considered to be "bad" projects, as opposed to merely being projects in early stages of development.

Therefore, Seqwater believes it would be helpful in these circumstances for the QCA to publish, alongside its consideration of Seqwater's capital budget, some statements to explicitly note how, in the approach being proposed:

- there will be a list of projects in Seqwater's capital programme where approval will be automatically withheld by the QCA as a matter of course, given the early stages of development of those projects;
- in these circumstances, the withholding of approval by the QCA is not the same as a rejection or a negative finding as to the suitability or necessity of the project; and
- for all projects, particularly multi-year projects, the review is not final and there will be further reviews relating to the project, including an ex-post review once the project is completed.

Seqwater notes that SKM made similar statements on this matter, which could be used as the basis of any similar statements by the QCA; [7]

> *Comparing the project status to the information adequacy illustrates that projects further along the implementation journey are more likely to have more adequate information and be assessed as prudent and efficient. It is noted that this assessment is at a specific point in time, and that the purpose of this review to determine the validity of entry of costs into the RAB.*
>
> *Consequently there is a situation whereby this review is unable to confirm the prudency or efficiency due to its position in the implementation journey, whilst good practice requires an allowance to be made in Seqwater's forward budget.*
>
> ***Where prudency and/or efficiency cannot be established, this does not solely mean that the project is inappropriate, it may mean that the status of the project is not sufficiently progressed to enable confirmation of entry of all costs into the RAB.*** *[emphasis added]*

In conclusion, Seqwater submits that the issue of budgeting for capital projects in the early stages of development, including conditional projects, should be given further consideration,

[7] SKM, 2012, page 38.

with input from stakeholders such as the GSPs and the WGM, prior to the next review process.

Review timing and future reviews

Seqwater also notes that the review of a number of its capital projects was impacted by findings of "insufficient information". In the case of conditional projects (discussed above), more information will not be available until some autonomous event occurs, such as a regional planning study being completed.

In most other cases, however, Seqwater considers that the findings of insufficient information are at least partially a function of the short timeframes affecting both Seqwater and QCA/SKM in this review, and Seqwater is currently in the process of compiling the information identified as being needed, in time for the QCA's Final Report. The relevant projects are identified and discussed in more detail in sections 2.1 to 2.3 below.

To summarise the timing constraints, the QCA engaged SKM to conduct the investigation and review of Seqwater's proposed expenditure, including its capital programme. The QCA confirmed the initial sample of capex projects to Seqwater on Thursday, 1 March 2012, and SKM's first Requests For Information (RFIs) on that sample were received by Seqwater the following day, on Friday, 2 March 2012.

The investigation was conducted over the following three weeks, until Friday 23 March. In that period, Seqwater compiled the responses to those initial RFIs, involving more than 500 questions, facilitated interviews between SKM and the project managers for various projects, as well as answering follow-up RFIs on projects as specified by SKM. In total, over that short time period, Seqwater compiled over 300 documents and pieces of information requested and participated in a dozen interviews.

Seqwater cooperated fully with the investigation process and worked beyond normal business hours to respond to requests and queries, as noted in SKM's report.[8] Two days prior to the investigation deadline, Seqwater provided a summary of the information and documents provided to SKM and sought advice as to whether any additional information was required. No response was received, although Seqwater considers that the review timeline may have prevented the investigators, SKM, which was under intense time pressures, from identifying the additional information needed within the investigation period. Seqwater submits that even a small amount of additional time in this stage of the review may have allowed the investigators to expressly identify the additional information needed and provided Seqwater with an opportunity to compile it.

[8] SKM, 2012, page 15.

In any case, Seqwater is currently compiling the additional information identified, has already provided some of this information to the QCA, and is seeking to provide all of the identified information in time for the QCA's Final Report.

New approach to categorising capex projects

Seqwater notes that the QCA's Draft Report uses a different method of categorising capital projects compared to the approach taken by the QCA in last year's review.

Previously, the QCA categorised capital projects according to the financial year in which the capital expenditure occurred, focusing on the capital expenditure in the financial year that corresponded with the review year. In this review, the QCA has categorised capital projects according to the year in which the project is due to be completed (i.e. the anticipated date of commissioning).

To accommodate the QCA's new categorisation, this submission has grouped capex projects into those due to be commissioned in 2011-12, those forecast to be commissioned in 2012-13, and those forecast to be commissioned in the forward years from 2013-14 to 2016-17 (sections 2.1, 2.2 and 2.3, respectively). Note that this categorisation is different to that used in Seqwater's initial submission of February 2012, which was prepared to align with the QCA's prior approach to categorising capex projects.

One result of the QCA's new approach is that the Draft Report, for the first time, draws conclusions about the prudency and efficiency of capital expenditure proposed for years other than the review year in question. For multi-year projects, involving expenditure over multiple financial years, if the expenditure in the review year is found not to be prudent and efficient, that conclusion has been carried over to the later years of proposed expenditure.

This result is partially a function of Seqwater seeking review of multi-year projects to minimise its regulatory risks, and partially a function of the issues affecting projects in the early stages of development (discussed in detail above).

The concern for Seqwater is that incorrect conclusions may be drawn about the true financial implications when the QCA withholds approval for multi-year projects. For example, in the QCA's Draft Report, if all of the amounts are totalled for capex that is not yet approved, over 60% relates to expenditure planned for the years after the review period, and over 90% relates to capital projects not due to be completed or capitalised until after the review period.

Seqwater believes it would be helpful in these circumstances for the QCA to publish, alongside its consideration of Seqwater's capital budget, some statements to explicitly note how:

- due to the regulatory process governing the review, findings that relate to capital expenditure in the forward years (after the financial year being reviewed) do not have any financial impact on Seqwater; and
- for all projects, particularly multi-year projects, the review is not final and there will be further reviews relating to the project, including an ex-post review once the project is finished and completed.

Furthermore, there is an issue relating to the way that the QCA's Draft Report represents the impacts when the QCA withholds approval of a capital project on the basis that it is not yet proven to be efficient.

Seqwater's understanding is that any finding of inefficiency will normally lead to the QCA entering that capital project into the Seqwater's RAB at a dollar value that is less than the expenditure incurred. The dollar value entered into the RAB would reflect what the QCA considered to be an efficient cost for the project, and except in unusual circumstances that amount would be a (non-zero) percentage of the expenditure incurred. Currently, however, the QCA's Draft Report recommends a zero amount in cases where a capital project has not yet been proved to be efficient.

Seqwater submits that for cases where the QCA withholds approval on the basis that a project is not efficient, the QCA should consider making a finding as to how much of the proposed expenditure would be considered efficient, and substitutes that number for the zero dollar figures currently being presented in the Draft Report.

2.1 Capex projects to be commissioned in 2011-12

The QCA's recommendations relating to Seqwater's capital programme in 2011-12 identified four projects due to be capitalised in 2011-12, where approval has not yet been provided. In total, these capital works amount to $1.9M, which is approximately 0.4% of the total approved capital expenditure for 2011-12.

There are four capital projects where approval has not yet been provided by the QCA. In each case, it is a question of efficiency rather than prudency, and the QCA Draft Report identified specific additional information that would assist it in approving the expenditure. In each case, Seqwater has already compiled the additional information identified and has provided that information to the QCA, in time for the QCA's Final Report.

These projects are discussed individually below:

Mt Crosby Westbank WTP Renewals

In SKM's investigation,[9] it concluded that the expenditure on the Mt Crosby Westbank renewals was efficient.

When the project was originally considered and approved in the previous year's review process, it consisted of four renewals items. However, throughout the 2011-12 year, an additional three renewal items were identified by Seqwater. The three renewal items were:

- item 5 – clearwater pump 12;
- item 6 – clearwater pump 13; and
- item 7 – raw water pump 5.

SKM concluded that items 5 and 6 were efficient. SKM concluded that $514,000 (the estimated actual cost of $328,033 for the original four items included plus an additional $185,800 for items 5 and 6) was efficient. However, SKM expressed concern that Seqwater appeared to have completed these projects using its operating expenditure. Seqwater acknowledges that the work was undertaken on the clearwater pumps was undertaken by its Infrastructure Maintenance team, which could lead to the conclusion that it was expensed. However, Seqwater is able to confirm that expenditure on items 5 and 6 was definitely coded and incurred as capital expenditure not operating expenditure. Seqwater therefore seeks QCA approval for the additional expenditure ($185,800) associated with these items.

Regarding item 7, the raw water pump 5, SKM's report noted that "Seqwater has advised that item 7 is on hold and is not expected to be completed before 30 June 2012. Seqwater confirms that this remains the case and that it is not intending to incur or seek approval of

[9] SKM, March 2012 report, Grid Service Charges 2012-13: Phase 2 – Assessment of Capital and Operating Expenditure.

the expenditure for item 7 ($300,000) given that this sub-project has been placed on hold and is not expected to be completed before 30 June 2012.

Mt Crosby Eastbank WTP Renewals

SKM concluded that the expenditure on the Mt Crosby Eastbank Renewals was efficient.

SKM identified three sub-projects for which insufficient information was provided:

- sludge pipe work ($220,000);
- asbestos removal ($150,000); and
- switchboard replacement ($150,000).

The QCA in its draft report excluded the three sub-projects, totalling $520,000, from recommended GSCs pending the provision of additional information. The information required was identified as:

- a breakdown of costs by sub-project including project management, design and contingencies;
- standards of works;
- evidence of procedures used; and
- a project plan.

Seqwater has provided the required documentation relating to the three sub-projects in question. To summarise, the three projects have been completed during the year at a lower than forecast cost. The rationale for the capital expenditure and the breakdown of the costs have been provided to the QCA, along with reasons for variations from the original forecasts. In addition, the standard of works and procedures adopted in order to manage risks has also been detailed.

On this basis, Seqwater seeks approval for additional expenditure of $435,135 associated with these three sub-projects of the Mt Crosby Eastbank Renewals Projects, comprising:

- $219,925 associated with the Sludge Pipeline;
- $118,862 associated with Asbestos removal; and
- $96,348 associated with the switchboard replacement.

Mt Crosby Eastbank WTP High Voltage Renewals

SKM concluded that there was insufficient information to assess the proposed expenditure on this project as efficient. In particular, they identified the following additional information that would be necessary for approval:

- reasons for the $684,000 increase over the previously approved value (such as changes to the scope of works and market tender rates); and
- pre- and post-contract scope of works and the tender review report.

The original Seqwater forecast for the project was developed prior to the release of tenders. The scope of works did not change between the first cost estimate and the cost under the tender. Tender bids were received from four companies, with all tenders coming in over budget.

Accordingly, the difference between the original QCA approved value and the Seqwater cost estimates is substantially explained by the initial underestimation of project costs. In addition, the original contingency was subsequently increased to reflect the increase in total project costs. Seqwater has separately provided to the QCA a detailed explanation of the project scope and tender applications and, on the basis of the additional information, seeks approval for the additional expenditure of $684,000 associated with Mt Crosby Eastbank High Voltage renewals project.

Esk WTP Renewals

SKM concluded that there was insufficient information to assess the proposed expenditure on this project as efficient. In particular, they identified the following additional information that would be necessary for approval:

- information as to why one of the three items previously reviewed is now excluded;
- reasons for the cost variance between the approved and actual cost for the two remaining items;
- information as to why three additional items were included in the budget, and a breakdown of their costs and information as to how those costs were calculated;
- more information around the standard of works adopted and method of procurement;
- the identification of any efficiency gains; and
- information about the allocation of overheads.

Seqwater has separately provided to the QCA a summary of the six items which comprise the Esk WTP Renewals and the reasons for the variation from original 2011-12 approved forecasts.

The variance between the previously approved value and Seqwater estimated actual costs can be explained by the following:

- three items (raw water pump station, clearwater tank roof replacement and main switchboard replacement) were previously approved in 2010-11, but not completed during that year. These projects were subsequently carried forward to 2011-12, with two items experiencing relatively large cost increases compared with their initial estimates (reflecting a more representative scope of work);
- a minor increase in the cost of the site road;
- a minor decrease in the cost of the raw water intake screen; and
- the inclusion of costs associated with an office for the operations manager. These costs were included in the original 2011-12 approved value, but mistakenly omitted from Seqwater's 2011-12 forecast provided as part of the 2012-13 submission. More detailed scoping of the project resulted in an increase in costs from the original estimate. Seqwater confirms that the project is a capital project and thus should remain in the capital budget.

Seqwater has also now identified that three of the original sub-projects are not expected to be delivered during 2011-12 and are likely to be deferred to 2012-13. Seqwater has adjusted its 2011-12 cost estimates accordingly.

In summary, based on the latest cost estimates and the justification supporting efficiency of 2011-12 capex for the Esk WTP, Seqwater seeks approval for additional capital expenditure (over the $84,500 currently approved) of $247,330 consisting of:

- $182,000 associated with the clearwater Tank:
- $38,142 associated with the raw water pump; and
- $111,688 associated with the office for the operations manager.

2.2 Capex projects to be commissioned in 2012-13

The QCA's recommendations relating to Seqwater's capital programme in 2012-13 identified eight projects due to be commissioned in 2012-13 where approval has not yet been provided in relation to a total amount of $5.9M in capital works (comprised of $5.1M of proposed expenditure in 2012-13 and $0.8M of earlier expenditure in 2011-12).

Note that this list excludes a $0.5M amount relating to Mt Crosby Eastbank WTP Renewals, which appears to have been incorrectly applied in the QCA Draft Report to a 2012-13 project (discussed below).

These projects are discussed individually below:

North Pine WTP Filter Upgrade

SKM concluded that there was insufficient information to assess the proposed expenditure on this project as efficient. In particular, they identified the following additional information that would be necessary for approval:

- reasons for the $751,000 increase over the previously approved value;
- more information about the standard of works adopted;
- more information about the delivery method (for example, design and then construct or design and construct) and the tender process;
- more information about the current status of the works program; and
- information about the allocation of overheads.

Seqwater note that the latest estimated actual spend for 2011-12 is $258,000 due to the delays involved with this project. The cost plan which forecast total costs in 2011-12 of $2,551,000 is therefore superseded. Actual expenditure to date this financial year is $129,000.

Seqwater has separately provided to the QCA the information required. Essentially, the variance reflects delays in project delivery and Seqwater's estimation of the most likely timing of contingency payments, to reflect the timing of the riskier elements of the project. The overall budget for the project has not changed since the business case was developed in September 2010.

In conclusion, the previously approved value for this project is in excess of the expenditure incurred during 2011-12 due to delays. Overall, the project scope and value has not changed. The approved value for the capital expenditure associated with this project for 2011-12 is in excess of the amount spent by $1,542,000.

Various WTPs Chemical Dosing Improvements

SKM concluded that there was insufficient information to assess the proposed expenditure on this project as efficient. In particular, they identified the following additional information that would be necessary for approval:

- information about the procurement method, in particular conformity with the over-arching procurement policy;
- current status of project;
- identification of any efficiency gains;
- information about allocation of overheads to the various improvement projects;
- listing of projects showing cost breakdown on the original budget and actual estimated expenditure; and
- documentation demonstrating method of identifying the various projects.

The original forecast for 2011-12 was determined before the scope of the works had been formulated and as such was a preliminary figure which proved to be inadequate. Twenty-five projects were prioritised to be delivered in 2011-12. The cost estimate for these works was $1,131,766, which accounted for approximately 3.8% of total expenditure associated with the Fluoridation Stage 1 and 2 projects.

Seqwater have provided the QCA with a breakdown of the revised forecast figure of $1,132,000, along with documentation as to how projects were prioritised.

All except 2 of the 25 projects are expected to be completed by 30 June 2012. The Hopper Humidity Control and the Stage 2 Parcel 2 High Level Safe Access will both be undertaken in 2012-13, with some of the cost savings from other projects distributed across both.

In conclusion, Seqwater seeks QCA approval for the additional expenditure of $382,000 associated with the various WTPs chemical dosing improvements.

GCDP Autoflush Project

The GCDP Autoflush project was found to be prudent and partially efficient. The QCA highlighted that in terms of the projects costs, $0.4M would not be approved on the understanding that the Construction Alliance would be funding this amount rather than Seqwater.

Seqwater can confirm the cost of the manual flushing system is to be funded by the Construction Alliance, and so does not contest the findings of the QCA's Draft Report.

Woodford WTP Renewals and Caboolture WTP Renewals

Seqwater's initial submission of February 2012 proposed minor renewals work at the Woodford WTP and Caboolture WTP in 2012-13. At that time, the existing Grid Instructions required continued supply from those plants.

However, the WGM's submission then recommended rationalising the Woodford and Caboolture WTPs, which appeared to be inconsistent with the Grid Instructions. The QCA's Draft Report stated that the WGM's submission would be accepted as the new position and recommended that no further capital expenditure be approved for Woodford WTP or Caboolture WTP. On this basis, the QCA determined that the $274K of proposed renewals at Woodford WTP, and $511K of proposed renewals at Caboolture WTP, was not prudent.

The most recent (Draft) Annual Operations Plan (Grid Instructions) now indicates that no supply will be required from Woodford WTP or Caboolture WTP under "the preferred operating mode". It then states that:

- in general, other supply options will be used in preference to the Caboolture and Woodford WTPs, due to costs and water quality risks associated with raw water quality at those plants;
- subject to further consultation with Unitywater, based on security measures and cost efficiency outcomes, there are potential benefits in permanently discontinuing supply from the Caboolture and Woodford WTPs; and
- in the interim, production will not be required from Caboolture and Woodford WTPs, other than in a response to an adverse asset or water quality issue.

These statements imply it is still possible that supply from these WTPs may be required should some adverse event occur. In that event, if the QCA Draft Report position was maintained, Seqwater will not have undertaken the renewals work needed at those plants, which could put Seqwater at risk of being unable provide to the required supply water. For that reason, Seqwater has not at this stage removed the proposed renewals works from its capital programme. However, if it is able to be confirmed that the WGM will not require future supply from these WTPs then Seqwater will not undertake the proposed renewals or incur the related expenditure.

Luggage Point AWTP BP Connection

The QCA Draft Report determined that this project was prudent, conditional on a finalised contract for supply of purified recycled water (PRW) to BP, as accepted by Seqwater.

Seqwater confirms that it will provide further advice to the QCA when a supply contract has been finalised and accepted.

Kooralbyn WTP Clarifier Upgrade

On 18 January 2012, the WGM noted in its 2010-11 Annual Market Rules Review that Kooralbyn WTP had water quality issues including the presence of protozoa. Ingestion of protozoa is a serious human health issue. Seqwater investigated the WGM's suggestion of water quality problems at the Kooralbyn WTP. The suggested solution is to repair the WTP's clarifier ($0.5 million) at the Kooralbyn WTP in 2012-13. Seqwater submitted that that these upgrades were required for water quality compliance.

As part of the QCA's investigation into this project the WGM submitted to the QCA that it wanted Seqwater to do further testing before proceeding with this project. Therefore, the QCA have not yet allowed this project into the RAB in 2012-13.

Seqwater considers the WGM has recommended a risky path of wait-and-see. However, Seqwater is not in a position to construct infrastructure without the certainty that it can recover the money invested. Seqwater has not at this stage removed the proposed works from its capital programme. Given the risks involved, Seqwater proposes to continue with the proposed works unless it is able to be confirmed that the WGM recognises and accepts these risks and still does not wish for this project to be undertaken in 2012-13, in which case Seqwater will not undertake the proposed works or incur the related expenditure.

Rathdowney WTP Works

Seqwater proposed sludge handling upgrades ($0.7 million) to the Rathdowney WTP in 2012-13. The WGM recommended that further information was required to demonstrate the need for this expenditure.

Seqwater's investigation showed that, due to poor sludge management, supernatant from the WTP overflows to the Logan River. This is a breach of Seqwater's general statutory environmental duty, which requires that it must not carry out any activity that causes, or is likely to cause, environmental harm unless it takes all reasonable and practicable measures to prevent or minimise the harm.

The penalties for breaching the environmental duty are fines that run into the hundreds of thousands of dollars. Seqwater considers this investment is reasonable considering it is required to meet Government legislation and to avoid environmental fines.

Bundamba AWTP Chemical Building Covers

In its initial submission of February 2012, Seqwater proposed undertaking $1.0 million of capital expenditure to construct chemical storage area covers at the Bundamba AWTP in 2012-13.

The Bundamba AWTP chemical covers project (previously a Watersecure project) was deferred following its consideration in the previous year's regulatory process, where only one half of the project (both halves being for chemical covers) was given approval. WaterSecure decided not to continue with either project until both were approved; hence both projects were included for consideration in the current review by Seqwater. The QCA Draft Report maintained approval of the item of work previously approved, and made no allowance for increased costs in the interim period. The Draft Report stated that additional information would be required to reconsider the rejected component as prudent.

The Draft Report suggests that Bundamba 1B AWTP remains decommissioned. In fact Bundamba 1B is not a decommissioned asset. Rather, the plant is functioning in hot standby operational mode and there has been no formal decision in relation to decommissioning. Furthermore, it is important to consider that the operational setup of Bundamba AWTP does not involve a duplication of chemical tanks for each of 1A & 1B elements of the plant. The operational status of one half of the plant therefore does not halve the capital requirements relating to the chemical tanks. That being said, at this stage Seqwater does not propose to further pursue approval for the Bundamba AWTP chemical building covers project in this 2012-13 regulatory process.

Wyaralong WTP Preliminary Design and Capitalised Interest

The QCA Draft Report states that costs relating to the Wyaralong WTP will not be included in the RAB until the WTP is completed and commissioned. Furthermore, the QCA states that the interest incurred on the expenditure to date should be capitalised at the cost of debt that applies to the Wyaralong WTP. This approach is consistent with the QCA's approach in last year's review. The QCA has also previously made recommendations about the circumstances in which Seqwater might recover its expenditure earlier, including in situations where the project was abandoned or postponed.

Given that the submission of the WGM suggested that building the Wyaralong WTP should be deferred, possibly out to 2024-25, and that the preliminary findings of the Scenic Rim regional planning study appear to confirm this view, Seqwater has sought further advice from QWC as to whether this project is proceeding and over what timeframe. Until further advice is received, Seqwater is proposing not to incur capital expenditure on the Wyaralong WTP in 2012-13.

In accordance with the QCA's past recommendations, if the Wyaralong WTP project is to be abandoned or deferred indefinitely, including deferral as suggested by the WGM, Seqwater submits that the expenditure incurred to date, including interest incurred on that expenditure, would be included in the RAB at 30 June 2012.

2.3 Capex projects to be commissioned post 2012-13

The QCA's recommendations relating to Seqwater's capital programme in 2012-13 identified thirteen projects due to be commissioned after 2012-13 where approval has not yet been provided.

These projects are discussed individually below:

Lowood WTP Sludge Handling Project

Between 2012-13 and 2013-14 Seqwater proposes to improve its sludge handling at the Lowood WTP ($3.3 million). Seqwater submitted that planning work is currently underway on this project due to environmental requirements. The Lowood WTP has difficulty dealing with its sludge issues even though it operates below 50% capacity. Recent wet weather created a significant overflow incident and has placed this WTP at risk of breaching environmental law.

SKM found that the scope of works for this project was yet to be determined. With regards to efficiency, SKM found that the project was not sufficiently progressed to demonstrate the selection of an efficient option. SKM said the continued investigation was prudent however the capital expenditure of the solution could not be confirmed.

Seqwater considers this issue serious given the high likelihood of breaching the law if action is not taken. The options study for this project is due for completion shortly and some part of the project will be required in 2012-13. Seqwater propose to separate this one large project into several smaller projects to enable quick response to avoid further risks.

North Stradbroke Island WTP Upgrade

After Seqwater's initial submission of February 2012, new information was provided by DERM (now DEWS) advising that its policy decision regarding water allocations and source extraction on North Stradbroke Island would be delayed until 2013-14.

Given DEWS' new timeframe, Seqwater has now decided to postpone the proposed capital expenditure at the North Stradbroke Island WTP in its budget until 2013-14.

Seqwater is therefore proposing not to incur capital expenditure on the North Stradbroke Island WTP in 2012-13, and the $1.1M originally budgeted will be delayed until 2013-14, to be discussed again in Seqwater's submission in next year's QCA review, dependent on DEWS' final policy decision.

Maroon Dam Safety Upgrade Project

The QCA's Draft Report indicated that, while the project was assessed as prudent, additional information was required from Seqwater to allow an assessment of efficiency. In addition, the QCA indicated that the extent and status of the associated DEWS subsidy required clarification.

Seqwater has provided additional information to the QCA regarding project scope and costing. In particular, Seqwater has provided cost estimates prepared by GHD in September 2011 used to underpin Seqwater's business case.

The status of the subsidy for the dam safety works relating to the Maroon Dam is currently still subject to confirmation. Seqwater has been in contact with DEWS about this issue and has requested additional information as soon as possible. As additional information becomes available, Seqwater will advise the QCA on the nature of the subsidy and its appropriate treatment in relation to its 2012-13 capital expenditure program.

In the meantime, Seqwater considers that it would be appropriate and consistent with regulatory precedent to include the total cost of the upgrade in the RAB. The implications of the subsidy, in terms of the effect on GSCs, should be determined after receiving specific advice from the grantee about the intended price consequences. As mentioned in the QCA's 2000 statement of regulatory pricing principles:

> *"The appropriate approach to regulatory recognition of capital subsidies depends, largely, on the purpose of the grant. In this regard, the purpose may include employment generation, assisting local government to meet funding shortfalls or reducing the service costs to a particular consumer or group of consumers. In the absence of any specific agreement or agreed purpose, or evidence to suggest that a particular outcome was intended, the treatment of past and future grants should be at the asset owner's discretion."*

This approach accords with the QCA's later treatment of capital contributions generally, such as its consideration of federal government grants to the Burdekin Dam in the review of Burdekin-Haughton water charges.

Flood Damage Assessment & Repairs Projects

The flood damage assessment and repairs projects involve remediation works at multiple sites to repair damage caused by the January 2011 Queensland flood event.

In its review of these works, SKM concluded that the expenditure was prudent, that "the scope of the works was appropriate, that the standard of works were consistent with industry practice, and the costs appeared to be reasonable and should be market tested."

However, SKM was not prepared to make a finding with respect to efficiency, until further information was provided relating to the breakdown of total costs associated with the projects across the full three years between 2011-12 and 2013-14. Specifically, Seqwater had provided SKM with full cost information relating to $14.9M of proposed expenditure, which explained the $9.8M budget in the year being reviewed, 2012-13, as well as the $3.0M budget in 2013-14. However, it had not provided cost information to explain the budgeted $6.6M in 2011-12, since the Request For Information (RFI) from SKM identified the 2012-13 budget as the subject of the review.

The information requested by SKM has now been compiled by Seqwater and provided to the QCA. The $6.6M for 2011-12 was budgeted to cover damage assessments, remediation design work, and any preliminary, minor or early works that could be completed in 2011-12, particularly at Wivenhoe Dam where significant channel clearing was required. Seqwater now estimates that the actual expenditure in 2011-12 will total only $3.5M, including $1.7M relating to the first stage of work and channel clearing at Wivenhoe Dam, and other preliminary and minor works across other asset locations. The difference between the budgeted amount and the estimated actual expenditure in 2011-12 is considered not to be needed and is unlikely to be incurred now that the total scope of works is established. In other words, the most current information suggests that the capital expenditure on these works will be $3.5M in 2011-12, $9.8M in 2012-13 and $3.0M in 2013-14, for a total of $16.3M. The additional information needed to complete the breakdown of estimated actual costs in 2011-12 has been included by Seqwater in the information provided to the QCA.

South Maclean WTP Upgrade

In the 2012-13 regulatory budget submission, Seqwater proposed an upgrade to the South Maclean WTP, at an estimated cost of $4.4 million, to be commissioned in 2013-14.

The WGM submitted that in the forthcoming Annual Operations Plans (and all subsequent Grid Instructions) the South Maclean Demand Zone would be supplied from the Southern Regional Water Pipeline. In summary, the WGM manager's stated position was given that no supply from the asset was required, South Maclean could be permanently decommissioned, avoiding the need for future capital expenditure.

Seqwater submitted that although South Maclean WTP was not included in the option analysis for the Scenic Rim planning study, this was not a direct indication that South Maclean was no longer required. The QCA accepted that allocation from the plant was included in the current Annual Operating Plan (November 2011), but with a caveat that it pre-dated the WGM's submission (February 2012), and that the QCA considered that the WGM's submission constituted relevant information provided to Seqwater in accordance with the SOP, concluding that Seqwater's proposed capital expenditure on the South Maclean WTP was not prudent. To this end, Seqwater also note that the WGM's submission and the

recently released draft Annual Operating Plan (2012) are the first instances of Seqwater being formally advised that supply from this plant is not required. On this basis, Seqwater is willing to concede that the proposed capital expenditure may no longer be required, subject to a formal review of this WTP and alternate options for supply to the area.

The report for the Scenic Rim Regional Planning Study is currently with the QWC and Linkwater, and is due to be finalised in the very near future. Seqwater believe that with planning now further progressed, and involvement from all Grid Partners, the view regarding South Maclean WTP is now becoming more firm, albeit not formally agreed.

In light of these developments Seqwater is not currently proposing to pursue QCA endorsement of an upgrade to South Maclean WTP in the 2012-13 regulatory process.

Canungra WTP & Canungra Offstream Storage

Seqwater forecast expenditure of $1.4m for the Canungra WTP upgrade and off-stream storage (OSS) for 2012-13, from a combined project budget of $5.5M . The WGM submitted that the proposed capital expenditure presupposed the outcomes of the Scenic Rim Regional Planning Study. The QCA agreed that there is still considerable uncertainty related to this project, and greater substantiation is required if the forecast capex for 2012-13 is due to other drivers.

The final report for the Scenic Rim Regional Planning Study is currently with the QWC and is due to be finalised in the very near future. LinkWater released the results of their modelling (May 2012) (see Canungra Options Final Model Memo – 220512.pdf). LinkWater conclude that, based on the financial modelling, the preferred solution for the long-term supply to the Canungra township is an upgrade to the existing WTP in lieu of a pipeline connection to the Water Grid as it is the most cost effective option. There is some uncertainty around the construction of the OSS as it is generally thought that this would be an expensive option relative to tankering in the water and is thus regarded as not prudent. Therefore, there remains a residual risk around raw water security such that future assessments will need to consider the costs and benefits of constructing a local OSS and/or connection to the adjacent Coomera River.

Seqwater has provided the QCA with the business planning around these options, with a business case currently being developed to reflect the preferred option. Both the Canungra WTP Upgrade Concept Design Report (October 2011) and the Canungra WTP Upgrade Preliminary Design Report (February 2012) have been provided to the QCA.

The above mentioned reports were prepared by Hunter Water Australia (HWA) on behalf of Seqwater. HWA state that the most pressing issue facing the Canungra plant is its limited treatment capacity due to whole of plant limitations, including the clarifier and filter. They estimate that the plant will be unable to meet projected water demand by 2013. Ageing

assets and equipment are also a major issue for ensuring production of water that meets Seqwater's specification, particularly in terms of pathogen reduction. The recent HWA asset condition assessment concluded that considering the age and the operational issues reported, most of this plant will require replacement within the next five years (noting that some equipment has been recently replaced).

Identified raw water quality risks are mainly turbidity and colour events, pathogen risks and potential taste and odour and algal toxins.

HWA state that "refurbishing the existing plant or recommissioning the Cedar Grove WTP asset may turn out to be a 'band-aid' solution. A new treatment plant should be considered as the only reliable long-term solution for Canungra. As a result, this Preliminary Design has focused on the new plant design."

In response to comments made by the SEQ Water Grid Manager, Seqwater has undertaken analysis around the various demand scenarios and the timing for additional capacity (documentation separately provided to the QCA). On the demand side, the base estimate demand series put forward by the WGM in the specification study appears to overestimate future demand, with the source of this attributable to a rebound factor during 2011-2016. As pointed out in the WGM's recent submission to the QCA, the rebound is expected to be lower than originally anticipated. On adjusting the estimated demand series for this, there could be scope to make savings from deferring CAPEX until forecast demand triggers a need for increased capacity.

While the base estimate suggests that additional capacity will be required during the first five years, the sensitivity test results suggest that capacity is not required to be increased until the period 2016 to 2021. However, on analysing recent demand for Canungra WTP, the demand is increasing rapidly towards pre-drought figures (documentation separately provided to the QCA).

Seqwater had budgeted $900,000 for the Canungra WTP and $500,000 for the OSS in 2012-13. This has since been revised to $1,251,000 for the Canungra WTP, with no proposed spend for the Canungra OSS. The revised Canungra WTP upgrade project has an estimated total project cost of $4M, with commissioning expected in 2013-14.

Kooralbyn WTP Sludge Handling Works

Seqwater proposed sludge handling upgrades ($1.15 million) to the Rathdowney WTP in 2013-14. The WGM recommended that further information was required to demonstrate the need for this expenditure.

Seqwater's investigations show that supernatant now overflows from the drying lagoon to a property across the road. This problem is caused by poor sludge management and design creating the need to drain the clarifier regularly. This is a breach of Seqwater's general

statutory environmental duty, which requires that it must not carry out any activity that causes, or is likely to cause, environmental harm unless the person takes all reasonable and practicable measures to prevent or minimise the harm.

The penalties for breaching the environmental duty are fines that run into the hundreds of thousands of dollars. Seqwater considers this investment is reasonable considering it is required to meet Government legislation.

New Kilcoy WTP

The Kilcoy WTP project was included in Seqwater's 2011-12 regulatory submission to the QCA forecasting expenditure in 2011-12 at $6.6M and a total project spend of $11.5M. Following market response to tenders, Seqwater provided further details to the QCA during the 2011-12 review advising that the budget for the project had been revised to, and approved by the Seqwater board at, $17.8M.

In its 2012-13 regulatory submission, Seqwater submitted the following anticipated expenditure for the Kilcoy WTP project:

- $6.578M in 2011-12;
- $8.353M in 2012-13; and
- $1.217M in 2013-14.

In the QCA's Draft Report, the QCA has noted its approval of these amounts. However, Seqwater notes that there was expenditure of $0.506M spent in 2010-11 which was not required to be included in the submission template but forms part of the total project budget.

Seqwater has also determined that an amount of $1.168M which was re-phased from 2012-13 to 2011-12 was inadvertently excluded from the anticipated expenditure submitted in its Information Return for 2011-12. However this amount had been correctly deducted from the 2012-13 amount. Consequently, anticipated expenditure for 2011-12 was shown in the Information Return as $6.578M instead of $7.746M. Expenditure of $8.353M for 2012-13 and $1.217M for 2013-14 included in the Information Return is correctly stated.

The total project value is correctly expressed as follows:

- $0.506M expended in 2010-11;
- $7.746M to be expended in 2011-12;
- $8.353M to be expended in 2012-13; and
- $1.217M to be expended in 2013-14.

Seqwater submits that the total project value should be $17.8M. This is consistent with the revised budget of $17.8M mentioned on page 37 of the QCA's final report "SEQ Grid Service Charges 2011-12" and the budget investigated by SKM.

Seqwater also acknowledges the QCA's explicit recommendation for further discussions with the Water Grid Manager. Seqwater can confirm that several discussions have already taken place since the QCA Draft Report was released, and that Seqwater will provide further advice to the QCA when these discussions are finalised.

Beaudesert WTP

The QCA accepted SKM's conclusion that it was not possible to conduct as assessment of prudency or efficiency of Seqwater's budgeted expenditure on the Beaudesert WTP of $2.5M for 2012-13, given the early stage of development of the project. The scope, cost and standards had not yet been determined. SKM acknowledged that it would be prudent to complete the options assessment, as planned, in order to confirm the most appropriate way forward.

The final report for the Scenic Rim Regional Planning Study is currently with the QWC and is due to be finalised very soon after this submission is lodged. LinkWater released the results of its modelling on 21 May 2012, provided separately to the QCA, which stated that:

> *Based on the financial modelling and a resolution by the collaborate planning team, the preferred direction for the supply to Beaudesert is to undertake the initial 4ML/d "Stage" upgrade of the Beaudesert WTP. This upgrade will delay the need for the construction of a pipeline or major upgrade at Beaudesert WTP for a number of years. During this time, improved understanding will be available on the projected growth in bulk water demand and the preferred implementation of other regional bulk water sources (eg. Wyaralong WTP).*

The October 2011 Beaudesert WTP Upgrade Concept Design Report (CDR) (prepared by Hunter Water Australia on behalf of Seqwater) states that "major capital investment where not critical at Beaudesert WTP is not desired." It notes that, in terms of water quality, Beaudesert WTP meets the requirements of the ADWG and Seqwater's bulk water contract. However, Seqwater seeks to enhance treated water quality at its sites beyond these levels (documentation provided to SKM). Seqwater targets these higher water quality levels to ensure appropriate risk mitigation – the use of such a risk-based approach for water treatment activities is mandated by the ADWG.

A (draft) preliminary design report prepared on behalf of Seqwater (and provided separately to the QCA) lists the key issues at this WTP as ageing assets and equipment, and ensuring production of water that meets Seqwater's specification, particularly in terms of pathogen reduction. It notes that "the recent asset condition assessment has concluded that

considering the age and the operational issues reported, most of the Beaudesert WTP will require replacement within the next five years (some equipment has been recently replaced).” And “Identified raw water quality risk are mainly turbidity and colour events, ammonia, pathogens, potential taste and odour and algal toxins.”

The cost estimate put forward for the upgrade to the existing 4ML/d plant (P90) was $740,000. This proposed refurbishment of existing plant would see the following work undertaken within the next two years:

- The raw water inlet screen system will be modified to operate under high river flow conditions;
- Raw water on-line instrumentation including UV254 and turbidity;
- The existing filters will be retained in their current arrangement. It has been identified that there are a number of spare parts, 4-way valves, limit switches etc, that can be obtained from the Capalaba WTP should there be a mechanical failure of these items;
- The existing clarifier mechanism will be replaced with a new unit; and
- UV disinfection will be installed at the combined outlet of the existing filters.

They also note that the existing filters are in a serviceable condition and will require remedial work to remove accumulated sludge. Significant remediation work will also be required within the next 2 years on the clarifier mechanism.

In response to comments made by the SEQ Water Grid Manager, Seqwater has undertaken analysis around the various demand scenarios and the timing for additional capacity (documentation separately provided to the QCA). On the demand side, the base estimate demand series put forward by the WGM in the specification study (SEQ Water Grid Manager 2012 report Beaudesert and Canungra: Service Specifications) appear to over-estimate future demand, with the source of this attributable to a rebound factor during 2011-2016. As pointed out in the WGM’s recent submission to the QCA, the rebound is expected to be lower than originally anticipated. Seqwater’s internal analysis of capacity suggests that additional capacity will be required between 2011 and 2016 (i.e. when excess capacity becomes negative) under the base estimated demand series and between 2016 and 2021 under the sensitivity test estimates.

This project also has a compliance driver, in order to ensure a reliable supply in terms of both quality and quantity of water. The CDR by HWA notes that two key factors prevent the ability to produce the capacity amount of 4.3ML/day. Firstly the clearwater tank is not baffled, resulting in bypassing of filtered water through the tanks and reduced disinfection capability. As a result, treated water production is restricted to 3.25ML/day. Secondly, during periods of increased flow in the Logan River, the intake screens at the raw water pump station restrict the flow into the pump well. There are also other aspects of the plant that require renewal

that are included in the capex forecast. Additionally needed is a process improvement to increase pathogen treatment at the plant due to the type and condition of the filters at Beaudesert, given a catchment risk assessment which shows that the water source is compromised.

Seqwater had budgeted $2.5M for the Beaudesert WTP in 2012-13. Given the recent developments and planning work, the budget for 2012-13 has now been revised to reflect the proposed expenditure associated with the above refurbishments to the Beaudesert WTP, estimated at $740K.

Image Flat WTP

Seqwater proposed to upgrade the Image Flat WTP at an estimated cost of $11.5M, to be undertaken over 2012-13 to 2015-16.

On the basis of alternative supply sources to the region (such as the Northern Pipeline Interconnector), the WGM submitted that supply from the asset would no longer be required and Image Flat WTP could be decommissioned until 2025, deferring the need for future capital expenditure.

Seqwater believe that even though sub-regional planning has further progressed with involvement from all Grid Partners, the view regarding Image Flat WTP is still somewhat uncertain, and certainly not agreed. For instance, Seqwater hold that the NPI should be developed as an augmentation to ongoing supply from Image Flat WTP – hence these projects are not necessarily mutually exclusive, as was highlighted in the commissioned planning report Options for Bulk Supply to the Image Flat Sub-Region (2011) (documentation separately provided to the QCA). Seqwater will continue engaging with the other grid participants on the future of Image Flat WTP, and are confident options are being thoroughly assessed through the grid planning forums.

Medium and Long Term considerations for utilization of Image Flat aside, the 2012-13 proposed works were for sludge handling and chemical dosing – work that is required to maintain Seqwater's legislative compliance, and are required even if Image Flat WTP is to provide supply for only another few years. Seqwater is currently bearing the risk of unauthorised discharges of sludge to the environment, during high rainfall or other dirty raw water quality events. Further, due to the condition of the existing chemical dosing equipment, Seqwater is also at risk of being unable to meet its Grid Contract obligations as the capacity of the plant is severely restricted during such high rainfall or other dirty raw water quality events.

While planning work is undertaken and the draft Annual Operating Plan (Grid Instructions) still requires supply from Image Flat WTP, Seqwater contends that the estimated $1.0M

expenditure for 2012-13 is considered prudent given the associated legislative requirements, and requests the QCA to reconsider the draft finding for this item in the final report.

Capalaba WTP Works Stages 1 & 2

The Capalaba project is separated into two distinct stages. Stage one, ($10 million) consists of mainly renewing parts of the WTP that are at the end of their economic life. Stage two, ($5 million) consists of possible improvements to the water quality. Stage 1 is scheduled to start construction in 2012 and for completion in 2014-15. Stage 2, is only a concept at this time however, a possible start date is in 2013-14 and completion in 2015-16. The QCA has assumed these two projects are one project which is incorrect. Stage 2 does not involve proposed expenditure within the timeframe being considered in this review. Seqwater is not yet seeking approval for the stage two for Capalaba.

The QCA's Draft Decision included comments from the WGM relating to the Capalaba WTP. The WGM discussed the possibility of the North Stradbroke Island (NSI) WTP being used to supply the Redlands area at times when the Capalaba WTP is not able to meet water quality standards. The WGM said this option and a 'sub-regional supply strategy' could enable the Capalaba project to be deferred by up to 5 years. In its submission the WGM said any upgrades for trihalomethanes (THMs) compliance should only be undertaken once the operating strategies have been demonstrated not to be effective and once all of the options recommended by the investigation have been considered in detail.

Seqwater suspects the WGM and the QCA are confusing stage 1 & 2 of the Capalaba WTP Upgrade. Stage 1, includes work that is mainly renewal of assets at the end of their economic life, some parts to meet environmental regulation and replace old equipment that does not meet WH&S regulations. Seqwater has completed an extensive Business Case and has a consultant's report showing all options considered for stage 1 of the Capalaba WTP. The Business Case has now been supplied to the QCA for consideration.

Molendinar WTP Works

At the time of Seqwater's initial submission in February 2012, the proposed Molendinar WTP Works project was at a very early stage of development. Seqwater's sub-regional planning work for this WTP, along with the Mudgeeraba WTP, had only just commenced, so Seqwater prepared an indicative budget, including $2.0M in 2012-13, with all proposed expenditure, particularly in the forward years, being conditional on the outcomes of the study and the future of the plants.

As discussed at the beginning of this Chapter, Seqwater's approach to budgeting was to budget for capital projects that it considered were likely, on the balance of probabilities, to be needed in the relevant period in order to meet its obligations and business needs. As such, Seqwater considered that it was appropriate to include capital expenditure on conditional

projects such as this one, and furthermore considered that its own internal processes and procedures would prevent it from proceeding with a conditional project if it became clear that the necessary condition would not be met.

Due to the early stage of development of this project, SKM considered that it could not assess the prudency or efficiency of the project until such time that an options analysis and a business case were completed.

At the time of preparing this submission, the sub-regional planning work, in conjunction with Linkwater, Allconnex and the WGM, has now progressed, and the parties are agreed that plant augmentation is not required, but that renewals to assets within the facilities will be required. These renewals will guarantee that these assets and facilities can continue to supply water of sufficient quality, into the future, and ensures that Seqwater maintains compliance with the Grid Contract and other obligations.

Furthermore, an options study has now been completed, which has been separately provided to the QCA. The proposed scope of works for Molendinar WTP is now more certain, based on the renewals work required. Seqwater estimates that the budget likely to be required to complete the works is $1.65M in 2012-13. Seqwater considers that this updated information, and the reduction in the 2012-13 budget, reflects the refinement of the scope of works through the normal progression of planning work along the scheduled timeframe. Following this standard process and timeline, Seqwater is now to prepare its own options analysis and business case, which is likely to be completed from late August 2012.

SKM's report suggested that it would not be possible to approve this project for prudency and efficiency until an options analysis and business case has been prepared and approved. While an options study has now been completed and provided, the schedule for the development of this project means that a business case will not be approved until after the QCA's Final Report is due. Seqwater has noted earlier in this submission how, at any cut-off date, there will likely always be some projects in Seqwater's capital programme that are at the same early stage of development.

Mudgeeraba WTP Works

Similarly to the Molendinar WTP Works above, the proposed Mudgeeraba WTP Works project was at a very early stage of development at the time of Seqwater's initial submission in February 2012. Seqwater's sub-regional planning work for this WTP, along with the Molendinar WTP, had only just commenced, so Seqwater prepared an indicative budget, including $2.0M in 2012-13, with all proposed expenditure, particularly in the forward years, being conditional on the outcomes of the study and the future of the plants.

As discussed at the beginning of this Chapter, and above, Seqwater's approach to budgeting was to budget for capital projects that it considered were likely, on the balance of

probabilities, to be needed in the relevant period in order to meet its obligations and business needs. As such, Seqwater considered that it was appropriate to include capital expenditure on conditional projects such as this one, and furthermore considered that its own internal processes and procedures would prevent it from proceeding with a conditional project if it became clear that the necessary condition would not be met.

Due to the early stage of development of this project, SKM considered that it could not assess the prudency or efficiency of the project until such time that an options analysis and a business case were completed.

At the time of preparing this submission, the sub-regional planning work, in conjunction with Linkwater, Allconnex and the WGM, has now progressed, and the parties are agreed that plant augmentation is not required, but that renewals to assets within the facilities will be required. These renewals will guarantee that these assets and facilities can continue to supply water of sufficient quality, into the future, and ensures that Seqwater maintains compliance with the Grid Contract and other obligations.

Furthermore, an options study has now been completed, which has been separately provided to the QCA. The proposed scope of works for Mudgeeraba WTP is now more certain, based on the renewals work required. Seqwater estimates that the budget likely to be required to complete the works is $0.50M in 2012-13. Seqwater considers that this updated information, and the reduction in the 2012-13 budget, reflects the refinement of the scope of works through the normal progression of planning work along the scheduled timeframe. Following this standard process and timeline, Seqwater is now to prepare its own options analysis and business case, which is likely to be completed in late 2012.

SKM's report suggested that it would not be possible to approve this project for prudency and efficiency until an options analysis and business case has been prepared and approved. While an options study has now been completed and provided, the schedule for the development of this project means that a business case will not be approved until after the QCA's Final Report is due. Seqwater has noted earlier in this submission how, at any cut-off date, there will likely always be some projects in Seqwater's capital programme that are at the same early stage of development.

Boonah Kalbar WTP Works

The work to be completed as part of this project includes:

- Component 1 - New raw water pump station at The Gorge and new pipeline delivering raw water to the existing Kalbar water treatment plant;
- Component 2 - Control system improvements to allow unmanned operation with caustic dosing system and chemical dosing upgrade; and

- Component 3 - Improvements to the sludge treatment facilities.

In its response to Seqwater's initial submission, the WGM raised concerns with the project, arguing that the required capital expenditure was not required at this time.

The QCA concluded that Seqwater's submission and SKM's review had addressed the WGM's concerns regarding component 1 of the project, and accepted SKM's recommendation that component 1 was prudent and efficient.

While SKM found that component 2 and 3 were prudent, SKM and the QCA indicated that further information was required before these components could be deemed efficient.

Seqwater acknowledges that additional information is required to be provided in relation to components 2 and 3. While initial scoping has been completed, detailed scoping and timelines are yet to be finalised. Seqwater intends to provide the QCA with these details and further expenditure justification once completed.

Chapter 3 – Regulated Asset Base

The Direction Notice states that the QCA is to accept the opening Regulated Asset Base (RAB) value as at 1 July, 2011 as advised by the Price Regulator and is not to be reviewed or subject to optimisation.

The Information Requirements also state that the QCA intends to source July 2011 RAB estimates from the Price Regulator, and will roll forward the RAB to 1 July 2012 taking into account capital expenditure, depreciation, disposals and asset inflation over the 2011-12 period.

Opening RAB

Seqwater notes that Table 4.1 in the QCA's Draft Report, relating to Seqwater's opening RAB as at 1 July 2011, does not total correctly for non-drought assets, due to the non-inclusion of the Redlands Land component valued at $534K.

Proposed 2011-12 capital expenditure

Furthermore, Table 4.2 in the QCA's Draft Report, relating to Seqwater's proposed capital expenditure in 2011-12, fails to include $17.9M of proposed capital expenditure that was outlined in Chapter 6 of Seqwater's initial submission of February 2012, as well as Attachment 7 in its Information Return. The $17.9M includes $15.5M in 2011-12 capital expenditure that is due to be capitalised after 30 June 2012, and $2.4M in additional (new) capital projects due to be capitalised within 2011-12.

Recommended capital expenditure

The QCA's Draft Report, in Table 4.27, recommends certain capital expenditure totals for the 2011-12, 2012-13, and post 2012-13 periods. Seqwater notes that these totals are impacted by an amount of $0.5M which appears to have been incorrectly applied to a 2012-13 project in the Draft Report, whereas it should have been applied to the Mt Crosby Eastbank WTP Renewals project in 2011-12. This issue, which is discussed further in section 2.2 above, has the effect of skewing the total non-drought expenditure figures in both 2011-12 and 2012-13.

Also, Table 4.27 proposes an adjustment of $0.8M to Seqwater's drought expenditure in 2012-13, which does not appear to be explained in the surrounding commentary. Seqwater considers that this amount may pertain to land and legal costs for the Wyaralong WTP site.

Furthermore, Seqwater notes that the recommended capital expenditure amounts make no account for capitalised interest.

Figures 3.1 and 3.2 below indicate the interest costs that should be capitalised for both drought and non-drought multi-year capital projects with expenditure in 2011-12 and/or 2012-13. It does not include projects commissioning after 2012-13, nor does it include expenditure from 2010-11, which is already entered into the RAB due to the QWC's approach to setting the RAB in earlier reviews.

***Figure 3.1* – Interest costs for multi-year capital projects commissioning in 2011-12**

Project	Approved amount	Total interest during construction (actual $)
Mudgeeraba WTP - Pipework Reconfiguration	760,000	33,882
Image Flat WTP Pipework Reconfiguration	580,000	25,858
Ewen Maddock WTP Upgrade (Defects Liability)	260,000	11,591
North Stradbroke Island Borefield SCADA Upgrade	204,222	9,105
TBB Remote SCADA Upgrade	240,000	8,731
Treated Water Storage	100,000	4,458
Process Control Infrastructure	200,000	8,916
Power Supply Review	4,410,000	196,607
Access to Critical Infrastructure (Road and Alternatives)	508,800	22,683
Communication Systems - Data and Alarms at WTPs	150,000	6,687
Remote Access and Control	100,000	4,000
SouthMclean WTP	54,000	2,407
Landers Shute Stage 2 Trunk Main Upgrade	1,120,000	40,743
Gibson Island change request capex	1,250,000	56,000
Gibson Island practical completion	6,085,000	271,000
Mt Crosby WTPs Critical dosing	705,000	31,430
North Pine Dam Upgrade	873,000	31,757
Total	**17,600,022**	**765,856**

***Figure 3.2* – Interest costs for multi-year capital projects commissioning in 2012-13**

Project	Approved amount	Total interest during construction (actual $)
North Pine WTP Filter Upgrade - not renewals	2,297,000	288,077
Mt Crosby WTPs Upgrade Water Quality Improvements	3,793,000	489,679
North Pine Flouride upgrade	1,103,000	157,218
Mt Crosby EastBank WTP Upgrade-high voltage	690,000	101,889
Molendinar WTP Pipework Reconfiguration	355,000	5,173
Canungra WTP Upgrade	1,017,100	57,639
Jimna WTP Upgrade	1,911,000	111,379
Chemical Dosing Improvements (Concept & Feasibility)	750,000	110,748
SCADA Strategy Planning - Specifications & Scope	1,200,000	177,197
SCADA Remote Access	1,461,000	206,791
Sludge/Solids Handings Capacity during an Event	940,000	97,598
Holts Cameron Hills	2,263,386	164,134
Chemical Storage Area Covers	457,876	20,527
Swanbank Cross Connection	1,000,000	44,830
Storage Capacity for LPAWTP PRW at GIAWTP	316,000	14,166
Automatic Air Bleed Systems for Hydrogen Peroxide Dos	38,000	1,704
Treated Water Pump Bypass Valve Automation	131,000	5,873
Automated Lime Cleaning Citric Acid Additions	48,000	2,152
MF Rotary Strainer Hoist	45,000	2,017
PVC Pipework on Sulphuric Acid Dosing System	106,000	4,752
Upgrade SCADA System	900,000	40,347

Project	Approved amount	Total interest during construction (actual $)
Land	19,000,000	851,777
Cranes for Equipment above RO Trains	167,000	7,487
Additional Chemical Batching Showers	61,000	2,735
Trade Waste Analyser Sample Pump	50,000	2,242
BP Connection	825,000	36,985
Industry Customers Supply - Hot Tap ea	100,000	4,483
Raw Water Pumping Station Crane Works	76,000	3,407
Vehicle & Machinery Wash Down Area and Storage	316,000	14,166
Goodna High Lift Raw Water Overflow Strategy	148,000	6,635
All-Weather Access Track - Scrubby Creek	374,000	16,767
Improve Network Assets Security	566,000	25,374
EG Network Asset Labour Costs VWA Project Related	1,227,000	55,007
Autoflush of SAF Pumps and Headers	1,544,000	69,218
Centrifuge Crane Access Platform	43,000	1,928
Pressure Threaded Connections	2,312,000	103,648
Installation of Duckbill Nozzles	247,000	11,073
SCADA Reports Rectification Works	97,262	4,360
Alarms Rectification Works	114,759	5,145
Wivenhoe Riparian Resilience Project	200,000	8,966
Mid Brisbane River Riparian Resilience Project	200,000	8,966
Total	**48,490,383**	**3,344,258**

Calculation of the capital charge

The QCA's Draft Report advised of a computational modelling error, relating to its calculation of the timing of cash flows comprising the 2011-12 Capital Charge. The QCA advised its estimate of the size of its error was $7.3 million under recovery for pre-merger Seqwater and $4.2 million for the former WaterSecure (total $11.5 million) in the 2011-12 year.

Seqwater has subsequently met with the QCA in relation to this issue, and it has been proposed that differences in the modelling of capital charges and cash flows need to be reconciled and agreed going forwards. It is submitted that these modelling issues form the basis of future discussions, with the aim of aligning Seqwater's and the QCA's approach to modelling cash flows and the calculation of the Capital Charge.

Working capital

Seqwater also notes that the QCA Draft Report does not align with its understanding of the calculation of working capital, due to the treatment of critical spares.

Chapter 4 – Rate of Return & Weighted Average Cost of Capital

4.1 Rate of return

Seqwater receives a return on drought assets equal to the actual cost of debt, and a return on non-drought assets equal to a pre-tax nominal Weighted Average Cost of Capital (WACC). Most of the parameters to be used in determining the WACC are specified in the Direction Notice.

The Direction Notice specifies that the cost of debt parameter in the WACC is to be equal to the forecast cost of debt (including administration and capital market charges and the Competitive Neutrality Fee) for each GSP as advised by QTC.

Seqwater notes that QTC lodged a submission to the QCA providing updated information on the cost of debt for Seqwater's drought and non-drought assets.

Chapter 5 – Fixed Operating Costs

Seqwater proposed fixed operating charges of $236.0M for 2012-13. The QCA engaged SKM to review the prudency and efficiency of Seqwater's fixed operating costs, and between them the QCA and SKM sampled 12 fixed operating cost items (accounting for 14% of Seqwater's total proposed fixed operating costs for 2012-13).

As a result of the review, the QCA has recommended that Seqwater receive fixed operating charges of $230.6M in 2012-13.

The $5.4M difference includes:

- $4.3M in sludge disposal costs that were found to be prudent and efficient, but which the QCA believed should be included in Variable Operating Costs rather than Fixed Costs (with no net difference to Seqwater's total Grid Service Charges for 2012-13 assuming that the forecast supply volumes eventuate);
- $0.1M in forecast repairs and maintenance on the WCRWS pipeline network, which the QCA Draft Report found to be prudent but not efficient;
- $0.3M in forecast employee expenses at the Bundamba AWTP, which the QCA Draft Report found to be prudent, but where there was insufficient information to approve the expenditure as efficient;
- $0.2M in forecast recruitment costs, which the QCA Draft Report found to be prudent but not efficient; and
- [redacted]

This section sets out Seqwater's comments and response to each of these findings. It also outlines some new information available to Seqwater in relation to its likely fixed operating costs in 2012-13.

5.1 Sludge disposal costs

Seqwater forecast $4.3M in sludge disposal costs in 2012-13. The QCA Draft Report found these costs to be prudent and efficient, but also decided that sludge disposal costs should henceforth be included in Variable Operating Costs rather than in Fixed Operating Costs.

This is a change from the approach taken in previous years. Previously, sludge disposal costs at Seqwater's WTPs had been approved as Fixed Operating Costs and the only sludge disposal costs treated as Variable Costs had been those incurred by WaterSecure (merged with Seqwater on 1 July 2011) at the GCDP and the AWTPs.

There were four main reasons – expanded upon in Seqwater's initial submission – why Seqwater did not consider that $/ML is an appropriate measure on which to assess sludge disposal costs at its WTPs. Essentially, there is rarely a clear, linear relationship between the ML of treated water produced and the amount of sludge waste produced. Furthermore, depending on the plant in question and the method of sludge disposal utilised, there is often no linear relationship between the quantity of sludge produced and the costs associated with its disposal. By way of example, at Mt Crosby Eastbank WTP, one of Seqwater's largest WTPs which utilises on-site sludge drying methods combined with heavy machinery hire, the most significant costs associated with sludge disposal are for the machinery hire, and these costs are essentially fixed periodical costs that bear little correlation with the quantity of sludge on site, other than for infrequent occasions where the quantity of sludge passes a tipping threshold and the costs escalate significantly from there due to the need to transport the sludge to off-site locations.

Seqwater considered that the opposite situation is true for the purified recycled water plants, including the GCDP and the WCRWS, where the quality of the water source is more consistent and the disposal costs are more closely related to the quantities of sludge produced, and hence sludge disposal costs were submitted as a variable cost.

The QCA stated that it considered sludge disposal to be a variable cost on the basis that "sludge is a direct by-product of water treatment, and costs associated with its disposal should therefore be considered a variable cost".[10] This statement assumes that the costs of sludge disposal vary with output, and as set out in Seqwater's submission, this is not the case. That is, the above conclusion in the draft report confuses sludge production (which is mostly variable) with the costs of disposing of that sludge (which are generally fixed, as indicated above).

The QCA also acknowledged that the cost relationship might be non-linear, but set a test that costs should have no correlation to output in order to continue to be considered as part of the fixed charge. The cost structure for sludge disposal is slightly different at each WTP,

[10] QCA (2012), page 1130.

depending on the technology used and the contractual arrangements with suppliers. Seqwater has not been able to conduct a plant-by-plant analysis to identify those aspects (if any) of sludge disposal costs that do not correlate with output, and those that do. However, Seqwater is willing to undertake such analysis and present this to the QCA for future grid service charge investigations for 2013-14 and beyond.

In the meantime, Seqwater submits that the current arrangements, where sludge disposal costs are treated as a fixed costs at WTPs, be continued for 2012-13 on the basis that this approach is less likely to assign (in error) material volume risk to Seqwater.

If the QCA is to maintain its decision that sludge disposal costs be treated as Variable Operating Costs in the future, Seqwater is cognisant that there will be greater financial impacts in the future resulting from any differences between the WGM's forecast volumes and actual volumes supplied. Historically, volume forecasts have been consistently higher than the volumes actually supplied. If this trend were to continue, Seqwater would suffer financial impacts to the extent that its sludge disposal costs are only partially correlated with volume.

Seqwater proposes that this risk can be minimised in two ways, should the QCA decide to recover all sludge disposal costs via the Variable Operating Charge.

Firstly, the risk can be minimised if there is an agreed process for Seqwater to apply for any additional costs associated with abnormal weather events causing poor raw water quality, which in turn can increase sludge disposal costs.

In relation to chemical cost forecasts (discussed below), the QCA suggested that its preferred approach for dealing with poor water quality events is for Seqwater to quantify its additional chemical costs in these cases and apply to recover those costs in arrears. Seqwater considers that it would be appropriate to include sludge disposal costs with chemical costs in a process of this kind, for similar reasons, and seeks confirmation from the QCA that the review process and related thresholds do allow for the recovery of such costs.

Such a process is examined further in the discussion below on chemical costs, but one aspect also worth mentioning in relation to sludge disposal costs is the question of where to draw the line between what is the expected level of raw water quality versus what should be counted as an extraordinary event (where Seqwater should make a request to recover additional costs incurred). In practice, raw water quality changes continuously at different sources. There are identifiable seasonal variations in raw water quality as well as trends associated with longer term weather patterns. For example, an expected or "average" raw water quality in a typical month looks very different to the expected raw water quality for the months during the summer wet season. Furthermore, the average raw water quality over the past few years of relatively high rainfall is very different to the average raw water quality recorded in the years of the recent Millennium drought. As a result of these differences,

Seqwater considers that it would be unreasonable to base cost forecasts on the basis of a typical month's raw water quality, when it is well known and reasonably anticipated that raw water quality will be significantly worse for a small number of months every year. Seqwater has commenced formulating an average raw water quality based on multiple years' worth of raw water quality data, including years before and after the Millennium Drought, but excluding extreme events like the January 2011 Queensland Floods.

The second way to minimise the risk of financial impacts from treating sludge disposal as a variable cost is to conduct a true-up at the end of 2012-13 to ensure that in practice there is a direct pass-through of the actual costs of sludge disposal incurred, accompanied by supporting analysis showing the relationship between volumes produced and the line items for sludge disposal, on a monthly basis. This would then enable recovery of the fixed and variable costs of sludge disposal where they actually fall.

Seqwater strongly agrees with the proposal that a true up occur in the area of energy costs, due to the agreed uncertainty surrounding electricity cost forecasts in 2012-13 for reasons such as the introduction of the carbon tax. Given the QCA Draft Report agrees that sludge disposal costs are similarly difficult to forecast, a true-up process for 2012-13 would ensure that the actual variable costs of sludge disposal will be recovered through Variable Operating Charges, while the actual fixed costs of sludge disposal are also recovered, thus meeting the requirement to insulate Seqwater from volume risk.

If no mechanisms are set up to mitigate the risks of non-recovery of sludge disposal costs through variable operating charges, this would have the effect of imposing volume risk on Seqwater, contrary to the express instructions contained in the Ministerial Direction.

5.2 Bundamba AWTP – employee expenses

Seqwater's regulatory budget includes a forecast $2.4M of labour costs at Bundamba AWTP for 2012-13. As part of the Western Corridor Recycled Water Scheme, the operation of the Bundamba AWTP is outsourced to Veolia Water Australia (Veolia) under a 15 year operations and maintenance agreement. Hence, employee expenses are generally related to Veolia's labour costs, but there is an additional Seqwater direct labour component for plant operations, including maintenance tasks that are not outsourced to specialist third party maintenance contractors.

As noted in the QCA draft report, Seqwater requires Veolia to model its labour requirements for the various associated tasks, and undertakes analysis of Veolia's staffing resources as part of the budget review with Veolia - SKM acknowledges this represents good practice given the information that is available.

SKM raised concern over why the employee cost allocated to Bundamba AWTP increased by almost 18% in 2012-13, particularly given the number of FTEs employed by the WCRWS in total reduced by 1.9% from 67.8 in 2011-12 to 66.5 in 2012-13. SKM premised there should be no impact on the operating expenditure and hence employee cost at Bundamba AWTP as project management costs were directly related to the proposed capital program. In the absence of additional information explaining the cost increase, SKM concluded that the increase was not justified. Instead, SKM recommended an efficient labour cost for the Bundamba AWTP was $2.09M for 2012-13, an amount based amount on a 3.5% increase to hourly rates in conjunction with a 1.9% decrease in the required number of FTEs (relative to 2011-12 costs).

Seqwater has provided additional information to SKM in order to justify the forecast increase in Bundamba AWTP labour costs for 2012-13. The information provides the granular detail surrounding the changes being driven by broader Bundamba AWTP / WCRWS operating and corporate considerations, which is driving the increasing labour cost. These include:

- Conversion of some consulting roles into FTE's for 2012-13 resulting in a transfer of budgeted costs from the consulting budget to the labour cost budget;
- Transfer of some operations management functions from the WCRWS office to the Bundamba AWTP (increasing the Bundamba AWTP labour budget for 2012-13); and
- A reduction of maintenance costs due to less reliance on external contractors as compared to 2011-12, but with an associated increase to the Bundamba AWTP labour budget for 2012-13.

Seqwater has budgeted prudently and efficiently for the Bundamba AWTP 2012-13 labour cost, and given the additional information provided, request the QCA to reconsider the partial efficiency finding for this item in the draft report.

5.3 Recruitment fees

In the Draft Report the QCA accepted the findings of its consultant SKM that all components of Seqwater's People and Culture 2012-13 cost forecasts were prudent and efficient, with the exception of external recruitment fees.

SKM noted that of the 121 permanent roles Seqwater expects will require recruitment in 2012-13, 22 of these roles were assumed to be sourced using external recruitment agencies, with 90% of budgeted recruitment costs representing the associated placement fees. SKM proposed that for the majority of the 22 roles external recruitment processes were not required, and recommended that external recruitment should only be engaged to identify senior level staff and above, which by SKM's criteria equated to six of the 22 positions. As such SKM deemed Seqwater's external recruitment costs for 2012-13 to be inefficient and recommended a revised figure of $264,400 was more appropriate on the basis of their

approach, a reduction of $196,600 to the Seqwater forecast recruitment cost. In the draft report, the QCA adopted SKM's revised external recruitment cost estimate.

The availability of capable staff for all areas of Seqwater to meet its operating and strategic requirements requires a variety of recruitment strategies to be engaged in order to attract the most suitable candidate, and the costs incurred will depend on the strategy engaged. Seqwater re-iterates that even with the expected increased volume in recruitment to be undertaken over 2012-13, all efforts will be made to fill vacancies using in house recruitment resources, with agencies only being engaged when additional capabilities (e.g. head hunting) are required for unique and specialist roles. To this end, Seqwater believe there is a disconnect between the rationale SKM have applied in reducing 2012-13 budgeted external recruitment fees and Seqwater recruitment strategies, particularly given current labour market circumstances.

In managing and operating dams, weirs, water treatment plants, bores and other water assets across South East Queensland, Seqwater maintains all the functions associated with owning a large base of infrastructure assets. The organisation also has regulatory and compliance obligations which are largely technical or scientific in nature (e.g. water quality monitoring). As a consequence of these institutional characteristics, many roles within Seqwater require specialist knowledge or technical acumen and it is these roles that are predominantly and necessarily sourced through external recruitment firms, not the 'senior management/staff' roles envisaged in SKM's criterion for eligibility to incur external recruitment costs.

Seqwater believe the use of external recruitment agencies to source specialist / technical roles is prudent and cost effective, especially in light of a generally tightening Australian labour market, which in the case of Queensland is likely further exacerbated given the myriad of resource projects competing for the specialist / technical labour described above. As an anecdotal example, the demand for Asset Planning Engineers and Environmental Scientists within Queensland has risen markedly with the rapid development of the CSG to LNG industry over the past few years.

In such tight market circumstances, the cost of procuring the information advantage an external recruiter enjoys with regard to established networks, existing talent pools and expertise in market segments (specialist / technical) would likely be lower than the costs Seqwater may have to incur to fill specialist / technical vacancies internally (these include the opportunity cost of lost time, the need to run another recruitment process to fill the initial vacancy following a failed round, as well as the direct and indirect effect on Seqwater's business caused by the productivity loss of a foregone labour resource over the recruiting period). Further, the use of external recruiters provides Seqwater with additional risk mitigation, given the placement guarantee offered by external agencies.

Given the emphasis of Seqwater's recruitment strategy is to target specialist / technical candidates through external agencies out of necessity due to current labour market dynamics, SKM's premise that only 'senior management/staff' roles are eligible for external recruitment processes seems disjointed from recent market realities – specifically the approach disregards the on-going 'war for talent' in regard to specialist / technical roles that are subject to increasing demand arising from the resources boom. SKM's premised external recruitment eligibility criterion also requires further validation given it is based solely on a stated salary package level, with no reference to associated role descriptions/skill sets, or benchmarking with regard to how equivalent roles are recruited.

5.4 Other fixed operating costs

There are a few areas where Seqwater has now forecast additional or changed needs requiring fixed operating expenditure in 2012-13, as follows:

QCA regulatory fees

On 15 May 2012, the QCA advised Seqwater that its regulatory fees for 2012-13 would increase by 5.8% to $1,366,000. Seqwater had forecast an amount of $1,366,936. In other words, Seqwater now has need of $936 less in Fixed Operating Charges in 2012-13 to recover the costs of the QCA regulatory fees.

Decommissioning costs

Seqwater has now forecast additional fixed operating expenditure of $2,765,000 in 2012-13 relating to the proposed decommissioning of assets. Specifically, the proposed decommissioning is of WTPs which are currently not being used or are scheduled not to be used, because they are either non-operational or will not be required to supply water to the SEQ Water Grid. A business case and other related documentation relating to this proposed work has been separately provided to the QCA.

Furthermore, the WGM's submission of April 2012 made a number of recommendations relating to the potential rationalisation of particular assets, including both the Woodford WTP and the Caboolture WTP, mirroring the outcomes of regional planning already conducted by Seqwater and supplied to the WGM.

On the basis of the WGM's advice that supply will not be needed from the Woodford WTP and Caboolture WTP in 2012-13, the QCA's Draft Report recommends that all proposed capital expenditure on those WTPs is not prudent and should therefore not proceed.

These WTPs are discussed separately in section 2.2 above. As noted in Seqwater's response to the WGM's submission, a decision that supply is not required from the Woodford WTP or Caboolture WTP will lead to a need for operating expenditure associated with the decommissioning works. However, if the decision is made to decommission either of these WTPs, it is likely that there will be additional expenditure needed in 2013-14 to complete this work, which would then be detailed in Seqwater's submission in next year's QCA review.

The outcome of this change is that Seqwater's total proposed Fixed Operating Charges increase by $2.765M in 2012-13.

Veolia margin

Seqwater has identified an amount of [redacted] that was included in its initial submission of February 2012, which was mistakenly double counted in both the 2012-13 Capital Budget as well as in the 2012-13 Fixed Operating Budget. Seqwater has determined that this figure should only exist in the Capital Budget, and therefore the amount of Fixed Operating Charges proposed for 2012-13 should be reduced accordingly by [redacted]. This change has already been effected in the QCA Draft Report.

5.5 Total proposed fixed operating costs

Taking into account the additional information provided in this Chapter, Seqwater's total proposed Fixed Operating Charges for 2012-13 are now $238.2M. The changes between Seqwater's initial submission and this submission are outlined in Figure 5.1 below.

***Figure 5.1* – Total proposed Fixed Operating Charge 2012-13**

Fixed Operating Cost Item	Seqwater's initial 2012-13 Regulatory Budget ($K)	QCA Draft Report recommendation ($K)	Seqwater's updated 2012-13 Regulatory Budget ($K)
Pipeline Network Repairs & Maintenance	2,997	2,873	2,873
Bundamba AWTP Employee Expenses	2,419	2,085	2,419
People & Culture Fixed Operating Costs	4,350	4,154	4,350
Molendinar WTP Sludge Disposal Fees	1,289	26	1,289
Other Sludge Disposal Costs	3,059	0	3,059
QCA Fees	1,367	1,367	1,366
Decommissioning Costs	900	900	3,665
[redacted]			
Other Fixed Operating Cost Items	[redacted]	219,192	219,192
Total	[redacted]	**230,597**	**238,213**

Chapter 6 – Variable Operating Costs

Seqwater submitted interim forecasts of variable operating costs, noting that a number of its input prices were not known at the time of making its submission. Seqwater noted it would present updated variable operating cost information to the QCA as this came to hand with a view to finalising its cost proposals prior to the final report.

Seqwater made a number of interim assumptions about variable costs. The QCA reviewed these assumptions and made downward adjustments. The QCA also indicated it would exclude green energy costs and the cost of meeting carbon neutrality commitments at the GCDP absent any government directive.

The QCA also recommended that contingency allowances in chemical costs be removed, and instead recovered if and when they are incurred, through the price review mechanism.

As indicated in Chapter 5, the QCA also re-classified sludge disposal costs at WTPs as variable, rather than fixed.

The QCA has calculated total variable operating charges of $39.9M in 2012-13, based on a forecast supply volume of 282,587ML.

Seqwater's response to the Draft Report is set out in this chapter. In summary, Seqwater submits that:

- in relation to electricity prices at WTPs:
    - Seqwater submits that the variable operating costs should be based on the actual electricity price paid by Seqwater under its contracts (once known), given these contracts have been subject to competitive procurement. Seqwater expects that it will have final network prices in early June, and will provide updates to the variable operating charge prior to the Final Report;
    - Seqwater has been advised that Carbon Tax costs will vary on a monthly basis, and given the difficulty in forecasting this cost, Seqwater submits the actual tax costs are passed through on a monthly basis;
    - prices should include other statutory environmental charges[11]. This charge changes annually on a calendar year cycle, and Seqwater foreshadows the need to make a review application to account for the change at the end of the 2012-13 year;
    - Seqwater has now received advice from government in relation to future green energy requirements at WTPs which will require adjustments to the GSCs; and

[11] These are payable in accordance with the *Renewable Energy (Electricity) Act 2000*.

  - there appear to be errors in the QCA's recommended prices that result in the variable operating charge being less than the QCA intended.

- in relation to electricity prices at the WCRWS and GCDP, Seqwater now does not expect to have final contracted prices in place until August, 2012. Consequently, Seqwater proposes that an interim charge applies for 2012-13, followed by an end-of-period adjustment to reflect the variable operating charge(s) that would have applied adopting the actual electricity prices payable during the year;

- in relation to the costs for achieving carbon neutrality at the GCDP, Seqwater notes the Market Rules require that GSCs recognise government policy settings, objectives and statements for secure water supply in SEQ. There is clear evidence of a policy requirement for the GCDP (which was constructed to secure regional water supplies) to be carbon neutral at the time RECs were purchased. Accordingly, the QCA should, as a minimum, enable Seqwater to recover the cost of the remaining RECs purchased following completion of the GCDP. Furthermore, Seqwater has now received advice from government in relation to future carbon neutrality requirements at the GCDP which will require adjustments to the GSCs;

- in relation to chemical costs, Seqwater submits the 'contingency' allowance reflects the additional costs that usually arise during the year due to seasonal changes in water quality, and that this contingency should be included in the variable operating charge;

- in relation to sludge disposal costs at WTPs, Seqwater submits there is insufficient evidence to change approach and recover these costs through the variable charge. The QCA's approach will expose Seqwater to volume risk, and the resulting price signals to the WGM will be distorted.

6.1 Electricity costs

The QCA did not agree with some of Seqwater's forecasts of the increases in electricity costs likely to result from the introduction of the carbon tax and from rising network costs. However, the QCA also noted that its own forecasts were preliminary and that electricity costs would be reforecast later in the review process, following the receipt of additional information.

Seqwater has a contract with TRUenergy for electricity at its various WTPs, and is in the final stages of procurement for electricity contracts at the WCRWS and GCDP[12]. Seqwater's electricity costs for 2012-13 will be determined by the prices paid under these contracts.

As at the time of making its submission, Seqwater did not have information about electricity prices under these contracts, in particular:

- the procurement process for electricity at the WCRWS and GCDP was not complete at the time; and
- for the existing contract for supply to WTPs, Seqwater had not received advice from its retailer, TRUenergy, about the price impacts from the pass through of network charges and carbon tax. Changes to statutory environmental charges (due in January 2013)[13] were also difficult to predict.

Seqwater's submission in relation to electricity costs are set out below.

Principles for the basis of the electricity price used in the variable charge

Seqwater provided interim estimates of energy prices in its submission, but on the basis that these would be updated once the actual prices were known. In its Draft Report, the QCA has presented its own forecasts of these price impacts. In some cases there is considerable difference between the two. Despite this, Seqwater submits that the variable charge should be based on the actual electricity prices paid by Seqwater under competitively procured contracts, as well as the actual carbon tax costs. In short, Seqwater should not be exposed to the risk of forecasting error given the uncertainties about electricity costs in the forthcoming year.

The application of this principle is discussed below.

[12] As indicated in Seqwater's initial submission of February 2012, this was necessary as notified tariffs will no longer be available at these sites from 1 July, 2012.

[13] Payable under the *Renewable Energy (Electricity) Act 2000*.

Application - WTPs

Seqwater expects to have information about the actual network prices in early June, 2012 and proposes that the QCA recommend variable operating charges at WTPs based on these actual prices. Seqwater will provide further information about these network prices and provide updated variable operating charges to the QCA prior to Final Report.

Seqwater has received advice from its energy provider subsequent to its submission about the carbon tax. The energy provider has advised Seqwater that, in practice, the carbon tax payable (and passed through to Seqwater) will vary on a month-to-month basis throughout the year, because – the Carbon Intensity Factor (set by the Australian Energy Market Operator (AEMO), a determinant of the tax cost – will change on a monthly basis. This means that the price impact of the carbon tax will be difficult to forecast over a 12-month period. Seqwater therefore submits that the carbon tax impacts are recovered on a cost pass-through basis, invoiced monthly to the WGM to reflect the actual cost for the previous month.

Statutory environmental charges will also change mid-period as they are set on a calendar year basis. Indeed the obligations on Seqwater's energy provider are expected to increase from 1 January 2012 (on a calendar year basis) as a result of changes made by the Office of the Renewable Energy Regulator (ORER). Under Seqwater's energy contract these statutory charges are to be passed on to Seqwater. Hence it is likely that the difference in cost will need to be recovered under the end-of-year review mechanism.

The above proposal will result in the following in relation to electricity costs:

- a charge per ML, incorporating the contestable energy and network aspects of the electricity price paid at each site, as well as an estimate of the statutory environmental charge for the year; and
- a pass through of the actual costs of statutory environmental charges and carbon tax over the preceding month.

Figure 6.1 below provides a summary.

***Figure 6.1* – Proposed arrangements for adjusting the variable charge for energy**

Component	Current status	Proposed arrangement	Justification
Contestable energy	Known at WTPs. Will be known by 30 June, 2012	Actual price incorporated into variable operating charge	Contestable tender process represents efficient cost
Network costs	Expected to be known after 31 May, 2012.	Actual charges incorporated into variable operating charge.	Price are outside Seqwater control. Actual price represents efficient cost.
Statutory environmental charges	Charges to 30 December 2012 will be known by 30 June, 2012. Charges will be revised after January 2013.	Recover actual environmental charges via the end of period review mechanism.	Statutory charge outside the control of Seqwater.
Carbon tax impacts	The precise cost is not known. Moreover, Seqwater has been advised by TRUenergy that the tax cost (which is passed through to Seqwater) will vary each month.	Monthly claim based on actual costs incurred	Tax outside the control of Seqwater. The actual cost remains difficult to predict.

Application – WCRWS and GCDP

Seqwater has undertaken extensive analysis of its load requirements at these sites, as it is concerned about the risks and costs associated with mis-forecasting loads when entering into contestable energy contracts.

While Seqwater submits this delay is justified, it has meant that Seqwater is unlikely to enter into a contestable contract before the end of August, 2012. In the meantime, Seqwater anticipates that it will utilise transitional tariffs from 1 July, 2012. Seqwater has not been informed about the prices payable under these transitional tariffs though this should occur before 30 June, 2012.

Consequently, Seqwater proposes that an interim variable operating charge at the GCDP and or WCRWP apply, based on the best information available when the Final Report is

prepared. This interim charge will apply for 2012-13, on the basis there will be an end of period adjustment to reflect the actual electricity prices paid.

In order to implement this, Seqwater will calculate a 'shadow variable charge' based on the actual electricity prices payable during the year.[14] The end of year adjustment will then correct for the variable charge revenue received, against that which would have been received if the 'shadow variable charge' applied. It is also proposed for the actual carbon tax costs and any other statutory environment charges relating be invoiced to the WGM on a monthly pass through basis.

The following sections examine some of the issues raised by the QCA in relation to Seqwater's interim forecasts. However, Seqwater notes many of the issues relate to different views on forecast costs which are irrelevant given Seqwater's proposal above.

Interim assumptions

Carbon Tax

The QCA Draft Report forecast that there would be an 82% cost pass through of the carbon tax reflected in retail electricity prices, which would lead to an overall increase of 10% in Seqwater's electricity costs.

Seqwater has now received further advice from its energy provider indicating the proportion of carbon tax costs to be passed through to Seqwater. This advice has been separately provided to the QCA.

Network costs

The QCA Draft Report forecast that there would be a 16.44% increase in distribution costs and a 13.38% increase in transmission costs, which would lead to an overall increase of 8% in Seqwater's electricity costs. The QCA's approach appears to reflect the headline increases allowed by the AER for Energex and Powerlink respectively. However, some of Seqwater's network costs are calculated on a site-specific basis, and the rate of increase will be different to the headline rate announced by the AER. As set out above, Seqwater will provide the QCA with the actual cost increases it will incur amended variable charges at WTPs once those costs have been formally advised by Energex.

Statutory environmental charges

Various environmental schemes under the *Renewable Energy (Electricity) Act 2000*, such as the Federal Government's Renewable Energy Target scheme, comprising the Large-scale Renewable Energy Target (LRET) and the Small-scale Renewable Energy Scheme (SRES),

[14] Along with any consequential adjustments for operator margin.

as well as the Green Energy Certificate scheme (GEC), place financial obligations on electricity retailers. These costs are passed on to Seqwater under its electricity supply agreement.

At the time Seqwater prepared its submission, Seqwater's energy provider was not aware of the actual charges to be applied for 2012, as ORER had not made its final determination. As such, the costs forecast in Seqwater's regulatory budget were based on information that Seqwater's energy provider had at that time for both the 2012 and 2013 calendar years. However, in the QCA's own forecasts of electricity prices, in Table 4.53 of the Draft Report, it appears that no allowance has been made for the increases in electricity prices due to rising environmental charges.

Nonetheless, on the basis of the increase in obligation levels advised to date, Seqwater has forecast that pricing for both the LRET and SRES has increased for the 2012 calendar year, resulting in an additional cost for both 2011-12 and 2012-13 financial years. Seqwater will seek to recover the differences between forecast and actual charges via the end of year review mechanism.

QCA's adjusted variable charges

The QCA re-calculated the variable electricity costs based on its revised assumptions, and published these calculations in Table 4.53 of the Draft Report. Seqwater was subsequently provided the calculations that underpinned these adjustments. Seqwater has reviewed these calculations and believes there are errors in the QCA's approach. Seqwater acknowledges this may stem from the confusion about the baseline used to apply increases to electricity costs. Seqwater will provide more detail about this calculation and proposes to work with the QCA to address this matter.

Carbon neutrality and RECs at the GCDP

The QCA Draft Report stated that when a GSP proposes to incur expenditure in response to a government instruction, the expenditure may not be considered prudent and may not be recoverable by the GSP, unless the instruction takes the form of a "specific government direction".

In the draft report, the QCA considered that a formal Government direction was required in order for the cost of RECs to be recovered in GSCs. The QCA required that until formal government advice was received, electricity costs should exclude the cost of RECs.

Seqwater considers that the prior purchase of RECs (by WaterSecure at the time) was in response to a clear government requirement for the GCDP to be carbon neutral. Separately to this submission, Seqwater has provided the QCA with a copy of tender documents and email communications relating to this initial purchase of RECs. The documents demonstrate

how the decision to purchase RECs to offset the carbon emissions of the GCDP was not just instructed by government, but was implemented with the active participation and oversight of government officials and departments including the Offices of the Premier and the Deputy Premier and Minister for Infrastructure and Planning.

While these instructions did not take the form of a formal direction (the QCA's proposed test), it is clear that the government's policy at the time was for the GCDP to be carbon neutral. The Market Rules require that GSCs are set in recognition of government policy settings, objectives and statements regarding the secure, reliable multi-source supply of water to customers in the SEQ Region.[15] The GCDP was constructed in response to the Millennium Drought and was (and remains) an integral part of the reliable, multi-source supply for the region. The policy requirement for the GCDP to be carbon neutral was made in this context, and should therefore be recognised. That is, the QCA test should also allow expenditure made in response to government policies about water source developments made to secure the water supply for SEQ. Applying this test, which Seqwater submits is a requirement of the Market Rules, would mean, at the very least, the cost of the remaining RECs purchased to meet the policy requirement can be recovered, as they are surrendered, through GSCs as has been the practice to date. The government instructions received by Seqwater did not specify an end to the carbon offset arrangements, nor had Seqwater been informed that the government policy was overturned or amended.

As indicated in its initial submission of February 2012, Seqwater sought advice from government about whether the policy requirement is to continue before committing itself to further expenditure. On 25 May 2012, Seqwater received advice (separately provided to the QCA) confirming the existence of these government requirements, but also stating an intention for these policies to be discontinued, to ensure agencies are not subjected to overlapping state and federal obligations when the carbon tax is introduced. On the basis of this recent advice, Seqwater accepts that the GSCs should be reviewed to remove costs associated with the purchase of new RECs from 1 July 2012.

Green Energy

Similarly to the above discussion on RECs, Seqwater had sought advice from government about green energy requirements. On 25 May 2012, Seqwater received advice (separately provided to the QCA) confirming the existence of these government requirements, but also stating an intention for these policies to be discontinued, to ensure agencies are not subjected to overlapping state and federal obligations when the carbon tax is introduced. On the basis of this recent advice, Seqwater accepts that the GSCs should be reviewed to remove the costs associated with green energy from 1 July 2012.

[15] Refer clause 8.10.

6.2 Treatment chemical costs

The amount of treatment chemicals used (quantity / ML production) will be different at each site depending on the raw water quality characteristics and the type of treatment process employed to achieve nominated water quality standards. Poor water quality events, often a result of heavy rainfall and elevated turbidity in raw water sources, generally leads to a need for greater use of chemicals to produce a unit of treated bulk water.

In its Draft Report, the QCA proposed removing a number of chemical "contingencies" budgeted by Seqwater at specific WTPs. The QCA suggested that its preferred approach for dealing with poor water quality events is for Seqwater to quantify its additional chemical costs in these cases and apply to recover those costs in arrears.

However, this proposal may be based on a misunderstanding of the nature of the chemical contingencies budgeted by Seqwater. In fact, these "contingencies" might be better identified by Seqwater as "typical seasonal loading". They are not intended to act as an insurance against possible extraordinary raw quality events; rather they reflect an estimate of the additional costs that Seqwater will in all probability incur, due to the known likelihood that certain periods of the year (the summer wet season, dam releases, algal bloom and temperature changes) entail poorer raw water quality and higher treatment chemical costs to ensure that treated water quality is maintained in accordance with compliance requirements.

In practice, raw water quality changes continuously at different sources. There are identifiable seasonal variations in raw water quality as well as trends associated with longer term weather patterns. For example, an expected or "average" raw water quality in a typical month looks very different to the expected raw water quality for the period of the summer wet season due to the persistence of these changes over time. Furthermore, the average raw water quality over the past few years of relatively high rainfall is different to the average raw water quality recorded in the years of the recent Millennium drought. As a result of these differences, Seqwater considered that it would be unreasonable to base cost forecasts on the basis of a "normal" month's raw water quality and equally unreasonable to base cost forecasts on extreme event conditions. It is well known and reasonably anticipated that raw water quality will be significantly worse for a minority period of most years, but the severity of the worsening of raw water quality will vary year to year. The contingencies included by Seqwater were calculated to ensure that there was seasonal loading to reflect the known likelihood that the summer wet season will add to treatment chemical costs for only a part of the year. Just as Seqwater's chemical cost forecasts for the remainder periods that form the "average", majority of the year, the contingencies budgeted by Seqwater for the wet season were based on historic records of raw water quality.

There is then also the issue of Seqwater making applications to recover unexpected costs from extreme events. This involves a question as to where to draw the line between what is the expected level of raw water quality (to be included in the budget) versus what should be

counted as an extraordinary event (where Seqwater should lodge a request to recover additional costs incurred).

Seqwater considers that the definition of an abnormal raw water quality event should be drawn above those events that would in probability be expected to occur over a typical summer wet season. Defining a typical summer wet season should be based on actual raw water quality trends and should exclude extreme drought and flood events. Any alternative approach would likely involve Seqwater having to lodge requests to recover the costs of the summer wet season almost every year.

If it would assist the QCA, Seqwater has commenced investigating the feasibility of formulating an average raw water quality measure (for each WTP) based on multiple years' worth of raw water quality data, including years before and after the Millennium Drought, but excluding extreme events such as the January 2011 Queensland Floods. This approach would help to demonstrate the spread the costs of an average summer wet season across the year, which is an alternative approach to applying a seasonal loading that appears as a "contingency".

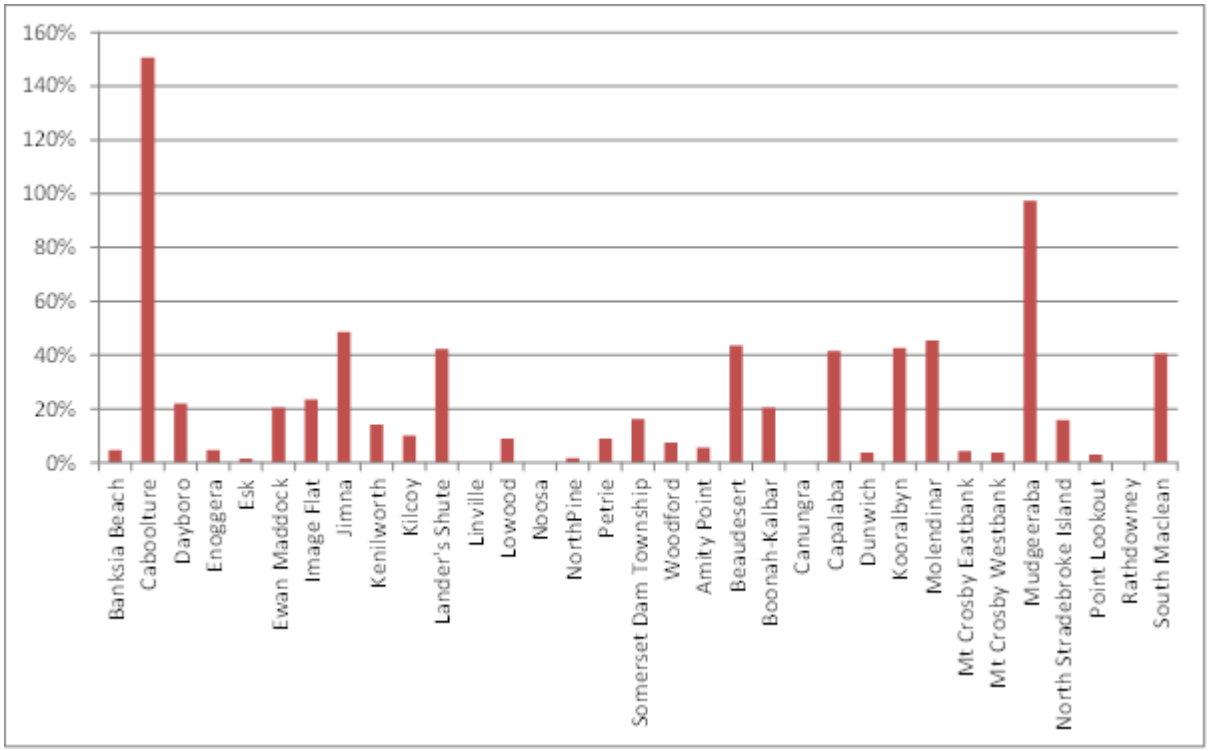
Finally, Seqwater foreshadowed in its draft report that chemical costs at Molendinar and Mudgeeraba are likely to change following changes made by the WGM to water quality requirements. Seqwater proposes to recover increased costs in 2011-12, and 2012-13 through the end of year review mechanism.

6.3 Sludge disposal costs

Seqwater forecast $4.3M in sludge disposal costs in 2012-13. The QCA Draft Report found these costs to be prudent and efficient, but also decided to include sludge disposal costs in Variable Operating Costs rather than in Fixed Operating Costs, which is a change from the approach in previous years.

In Chapter 5 of this submission, Seqwater put forward its reasons why these costs should continue to be treated as fixed. The consequences of this decision are significant in terms of the price signals to the WGM. Figure 6.2 below shows substantial increases to the variable operating charge would occur from recovering sludge disposal costs from the variable charge.

***Figure 6.2* – Percentage increase in variable operating charge due to inclusion of sludge disposal – WTPs**



Seqwater does not agree that sludge disposal costs are variable, and while there is insufficient information to establish the precise relationship between output and individual aspects of the sludge disposal costs at each WTP, there is similarly insufficient information to warrant any change. That is, the QCA has not demonstrated empirically that these costs are variable.

The price impacts are significant and distort the price signal to the WGM, which in turn may distort future decisions about utilisation at each WTP and indeed future SOPs. Accordingly, Seqwater submits that more evidence is required before a change in approach should occur.

Secondly, a premature change in approach (without greater evidence) effectively creates volume risk for Seqwater, contrary to the requirements for the QCA under this review.

On balance, Seqwater submits that there are sufficient grounds for the QCA to be cautious about any change in approach given the consequences of error. Seqwater proposes that more information and analysis is gathered during the forthcoming year, and submits that the QCA defer any recommendations to change the treatment of sludge costs until the 2013-14 year.

6.4 Invoicing for variable charges

Seqwater notes that in the determination of GSCs for 2011-12, when the Price Regulator applied the QCA's recommendations on GSCs, Seqwater was issued with invoicing instructions that had the effect of applying a cap on the total variable operating charge that Seqwater could recover in 2011-12. This outcome appeared contrary to the policy intention that Seqwater be immune to volume risk.

While this issue is unlikely to have had any real financial impact in 2011-12, because actual demand is likely to be lower than forecast volumes, Seqwater considers that the issue may have real financial implications in future years if similar invoicing instructions are issued. Seqwater has raised this issue directly with the QWC. It may also be helpful, in its recommendations to the Price Regulator, for the QCA to provide advice on the application of variable operating charges to Seqwater's invoicing procedures.

Chapter 7 – Allowable Costs

2011-12 Allowable Costs Summary

The Price Regulator approved allowable costs totalling $20,489,037, of which $17,915,537 related to the expected expenditure in the 2011-12 year.

***Figure 7.1* – 2011-12 Allowable Costs approved by the Price Regulator**

	2011-12 QCA	Invoicing adjustment 2010/11	2011-12 Approved
Seqwater	$ 9,218,980	$ 2,573,500	$ 11,792,480
WaterSecure	$ 8,696,557	$ -	$ 8,696,557
	$ 17,915,537	**$ 2,573,500**	**$ 20,489,037**

As indicated in Figure 7.1 above, there was an adjustment for allowable costs to account for an additional $2.573M of allowable costs over and above the amount approved for 2010-11. Seqwater is also required to provide information to the Price Regulator on other allowable cost items for the 2010-11 year. These matters are outside the scope of the QCA review.

The actual allowable costs incurred in 2011-12 are to be recovered in the final Grid Service Charges. Section 7.1 provides information about Seqwater's expected expenditure on those approved allowable costs in the 2011-12 year.

2012-13 Allowable Costs Summary

Seqwater proposed allowable costs of $10.6M for 2012-13 based on a single line item, being the forecast QWC Levy for 2012-13. This is discussed in section 7.2.

7.1 2011-12 Allowable Costs

The Price Regulator approved Allowable costs for 2011-12 of $17.915M (exclusive of 2010-11 adjustments). This was below the aggregate proposed by Seqwater and WaterSecure, of $40.6M. Figure 7.2 below shows the break-up of the approved items.

***Figure 7.2* – Components of Allowable Costs**

2011-12 Allowable Costs Components ($M)			
	WaterSecure	Seqwater	TOTAL
Working Capital	$ 2.9	$ 3.4	$ 6.30
QWC Levy	$ 5.2	$ 5.2	$ 10.40
QCA Fee	$ 0.6	$ 0.6	$ 1.20
	$ 8.7	**$ 9.2**	**$ 17.90**

Amounts to not reconcile due to rounding.

In addition, the QCA approved for Seqwater the following items, pending further information being provided by Seqwater about the costs:

- Integration Costs;
- Participating in the Floods Commission of Inquiry; and
- Land and Property Tax

The costs from flood damage to the WCRWS were also noted as allowable costs in WaterSecure's submission, although the QCA stated "flood damage costs can be incorporated into GSCs once the final amounts are ascertained under the review arrangements".[16] Accordingly, these costs are addressed in Chapter 8.

With the exception of working capital, allowable costs are payable based on the actual costs incurred. At the time of making this response to the draft report, Seqwater only has information for part of the 2011-12 year, and proposes that the final allowable costs should be determined based on final data.

The current information relating to each of the allowable costs above is set out below.

Working Capital

It is expected that working capital will continue to be charged as indicated in the QCA's Final Report, at $6.3M, without any adjustment.

[16] QCA, *Final Report SEQ Grid Service Charges 2011-12*, (2011), p 104.

QWC Levy

For 2011-12, the QCA found the QWC Levy to be prudent and efficient, but it recommended that Seqwater's allowable costs be reduced by $3.8M to account for the fact that the QWC Levy in 2010-11 was $3.8M less than was originally forecast and approved.

However, Seqwater had already accounted for this difference in its invoicing of the WGM within 2011-12, highlighting there is no need for any additional deduction to account for this.

Integration costs

While most costs relating to the merger between Seqwater and WaterSecure occurred in the 2010-11 year, some costs have continued into 2011-12. These costs are ICT related costs which are currently forecast at $1.5M for 2011-12. These costs include project costs involved in running dual operating systems, the transfer of data and the physical locations of the operating environments.

Seqwater does not expect it will be in a position to lodge a final claim to the QCA for integration costs prior to the QCA publishing its final report. Instead, Seqwater proposes to submit a final claim when making its submission for 2013-14 GSCs.

Floods Commission of Inquiry

Seqwater has continued to incur costs in responding to the Floods Commission of Inquiry since 1 July, 2011. It is currently expected that the 2011-12 costs for this period will be in the order of $4.0M based on 2011-12 Q2 estimate.

These costs are separate to the costs of implementing the findings of the Inquiry- these are dealt with as cost imposts under the QCA's review thresholds for 2011-12. These costs are set out in Chapter 8.

Seqwater will endeavour to provide the QCA with final costs and supporting information in time for consideration by the QCA's final report.

7.3 2012-13 Allowable Costs

Seqwater proposed allowable costs of $10.6M for 2012-13 is based on a single line item, being the forecast QWC Levy for 2012-13.

Seqwater proposed allowable costs of $10.6M for 2012-13 based on a single line item, being the forecast QWC Levy for 2012-13. The 2012-13 QWC levy is estimated by Seqwater on the basis of the 2011-12 QWC Levy, escalated for inflation.

Seqwater has raised the matter of a correction to the QCA's 2011-12 Levy adjustment (see section 7.1, *QCA Levy* above), and expects that the $3.8M reduction in its allowable costs for 2012-13 will be reversed in the QCA's Final Report.

Chapter 8 – Review of 2011-12 GSCs

The Market Rules include provisions that enable a review of bulk water charges in the event of a material change in the costs incurred by a Grid Service Provider. Such a review can be triggered as a result of either the QCA becoming aware of a material change or a Grid Service Provider or the WGM lodging an application, subject to the review thresholds.

The Direction Notice requires the QCA to consider any adjustments required due to an over or under-recovery of Grid Service Charges in 2011-12, as described in the QCA's Review Thresholds document. Seqwater understands this document to be the QCA's final report.[17]

Seqwater has incurred additional costs resulting from events that meet the review criteria and thresholds set by the QCA. Seqwater has not applied for a mid-year review arising from these changes, but instead proposes an end-of-period adjustment, and notes that QCA has indicated that application can be made up to 30 April, 2012 and incorporated into 2012-13 GSCs.

This section provides an update of the events and claims known at this stage and currently under consideration for application for review.

8.1 Timing issues

As set out above, the Direction Notice requires the QCA to consider any adjustments required due to an over or under-recovery of Grid Service Charges in 2011-12 in recommending 2012-13 GSCs.

Seqwater is required to make its submission for 2012-13 GSCs part way through the 2011-12 year, meaning that:

- the costs for events that have occurred in 2011-12 are not yet known in full; and
- other events may occur between now and 30 June, 2012, which of course cannot be included in this submission.

The QCA acknowledged this issue, and in its Information Requirements stated that:

> *... the Authority will include any relevant adjustments in Draft GSCs identified as at 29 February 2012 (when information returns are due), and will make further adjustments in the Final Report where necessary, to take account of adjustments known as at 30 April, 2012. Any subsequent adjustments should be made in any subsequent annual review.* [18]

[17] In its Final Report, page 156, the QCA concluded that GSPs should remain exposed to the risk of over or under recovery of 2011-12 operating costs.

[18] QCA, SEQ Grid Service Charges 2012-13 Information Requirements, 2012, page 16.

The following section provides a brief overview of the claims under consideration to date for the 2011-12 GSC , in terms of the types of event, details of the additional cost and estimates / year to date actual where applicable.

Further to this update, Seqwater will provide a formal application to the QCA for these claims when it reasonable to do so – i.e. when the underlying projects / costs are complete for 2011-12. This formal application will address the matters the QCA set in terms of making an application for a review of GSCs, namely:

- demonstration of the business case for expenditure, including justification of the expenditure in terms of the GSP's approved strategic and operational plans;
- demonstration that the expenditure is the most cost-effective means of achieving the required outcome;
- demonstration of compliance with internal governance (including board approvals), business case approvals, procurement and project management processes and audit;
- where a significant emergency event has occurred, demonstration of how the additional costs are required to meet the requirements of the SEQ Water Grid Emergency Response Plan; and
- detailed supporting documentation enabling independent engineering review or other assessment of the reasonableness of capex or opex (with relevant details as indicated in earlier Chapters).

8.2 Update of Likely claims – 2011-12 GSC review

Seqwater has incurred additional costs resulting from events that meet the review criteria and thresholds set by the QCA. Seqwater has not applied for a mid-year review arising from these changes, but instead proposed an end-of-period adjustment.

Likely Claims Update

This section provides an update to the previously indicated events and a revised estimation of claims known at this stage and currently under consideration for application.

Summary of 2011-12 revised price review claims under consideration

Type	Description	Revised estimate of cost impact $M
Change in law or government policy	Additional requirements under the Environmental Protection and Biodiversity Act for Banksia Beach WTP and borefield	0.2
	Changes in water quality standards required by the SEQ Water Grid Manager at Molendinar and Mudgeeraba WTPs	0.1
	Implementing the interim findings of the Floods Commission of Inquiry	1.8
	Increases to council waste charges	0.4[19]
	Compliance with the new Disaster Readiness Amendment Bill	TBA
	Compliance costs following the implementation of the Koala Protection Policy	0.1
	Impacts on energy costs from the pass through of costs arising from the Renewable Energy (Electricity) Act 2000.	0.7
	Impacts on energy costs from the pass through of Higher network charges and market charges	0.3
	Additional operating costs arising from the Waste Reduction and Recycling Regulation (Qld) 2011	0.1
	Additional compliance costs arising from the Waste Reduction and Recycling Regulation (Qld) 2011	0.1
Changes in forecast demand for water	The forecast demands used to develop 2011-12 Variable Charges for the Luggage Point and Bundamba AWTPs are well above actual demand. This has meant that the plant has had to operate under start-stop mode to produce smaller daily volumes, increasing the energy and other costs for small production runs. Analysis shows that the actual variable costs to January 2012 at these plants has been around $0.5M higher than the variable charge revenue. This under-recovery is due to the increased costs from these short production runs which are a result of a change in the WGM's demand forecast. The annual impact could therefore be around $1.0M	1.0
Emergency events	Post-flood water quality investigations	0.1
	Flood repair costs that are operating costs.	TBA[20]

[19] Financial Year to date April 30.

[20] Net of any insurance recoveries.

The QCA defined specific categories as triggering a change to 2011-12 GSCs; Seqwater has claims in the categories of:

- a change in law or change in government policy;
- emergency events;
- change in demand or supply source; and
- change in actual cost of debt.

Change in law or in Government Policy

EPBC Act approval requirements – Banksia Beach WTP

The approval under the *Environmental Protection & Biodiversity Conservation Act* (Cth) (EPBC Act) for operating the Banksia Beach WTP requires that Seqwater meet approval conditions given by the federal DSEWPaC[21] (decision notice 2007/3396). One of these approval conditions is delivery of the Banksia Beach Borefield Operating Management Plan (BOMP), which sets out how Seqwater meets the objectives of the Environmental Management Plan (EMP). One of the requirements of the BOMP is for Seqwater to conduct a 3 year review of the performance of the BOMP and revise where necessary. The initial 3 year period was reached in September of 2011.

Seqwater is bound by the approvals made under the EPBC Act (s16 and 17B) under Wetlands of International Importance.

The approval conditions provide for the protection of the Moreton Bay Ramsar site. Although this requirement existed prior to June 2011, the extent of requirements was not evident during budget development (which was submitted in December 2010). Following ongoing community concern around the project and scrutiny by the State Environment Minister Robertson, it was decided to expand this review from a simple review of the performance of the BOMP to an independent external review of the adequacy of the BOMP and the fundamentals of its development. This substantially altered the expected budget for this process, imposing additional costs on Seqwater which were not originally included in the 2011-12 expenditure forecasts.

In order to meet the above specified additional requirements, Seqwater has had to engage consultants at an estimated cost of $0.2M.

[21] Department of Sustainability, Environment, Water, Population and Communities.

Change in water quality standard – Molendinar and Mudgeeraba

The WGM has requested increases to the residual chlorine for water treated at the Molendinar and Mudgeeraba WTPs. The WGM Contract has been amended to increase the residual chlorine to 1.7-1.8 mg/L initially to improve chlorine levels in the Gold Coast water supply network. The exact level is subject to a trial which commenced in December 2011, in conjunction with ALLCONNEX and the WGM, but the 2011-12 contract has been amended from a maximum of 1.5 to 2.5 mg/L (ref D/11/11412 letter from WGM to Seqwater).

The WGM's initial request to increase the levels to 1.7 to 1.8 mg/L (an increase of approximately 0.5mg/L). However, Seqwater suggested a trial before fully agreeing to this increase, so that the impact on Seqwater's operations and infrastructure could be evaluated, along with demonstration of improvements to the water supply system. The trial requires an increase in chlorine dosing and consequently variable chemical costs.[22]

The variable costs at these plants were developed on the basis of quality standards that existed at the time. The increased costs to achieve the new chlorine residuals are currently being assessed as part of the trial. The final costs will be advised to the QCA once this information can be established.

Implementing the interim findings of the Floods Commission of Inquiry

In August 2011, the Queensland Government released its interim response to the findings of the Commission of Inquiry into the Queensland floods. A number of these recommendations relate to Seqwater directly or indirectly in terms of their implementation:

- review all arrangements for the operation of dams during flood events for the entire wet season by 30 September each year;
- formal training exercises for all staff and engineers who may be involved in flood operations;
- review of the manuals for Wivenhoe and North Pine and submission of the draft manuals to DERM for approval before 1 October 2011 (to include peer review of the manual by an independent expert);
- recruit and train additional flood engineers to ensure that at least five flood engineers are available for flood operations and establish a formal flood event operation training program for junior engineers; and
- assess compliance with various government guidelines and publications relating to dam safety management.

[22] There is potential for this increased chlorine dosage to bring forward capital or renewal costs for chemical storage or standby pumps, however, no other material variable costs are expected.

In response to the COI findings, Seqwater has developed an implementation action plan, highlighting the actions that are to be taken to address the Commission's recommendations in addition to monitoring implementation progress.

The costs of implementing these and other outcomes from the COI were not included in Seqwater's expenditure proposals for 2011-12, and consequently are in addition to 2011-12 GSCs. The majority of costs relate to additional consultancies and contractors (not included in 2011-12 GSCs), although there has been some minor re-deployment of labour (some of which were included in 2011-12 GSCs).

In order to implement the above requirements, Seqwater has incurred an estimated $1.8M in additional costs over 2011-12.

This work will continue into 2012-13, and the costs of this work have been included as Fixed Operating Costs. However, no provision has been made for any further recommendations arising from the Inquiry's final report. Such costs, to the extent they occur in the 2011-12 year, will be included in Seqwater's final claim.

Council waste charge increases

Sunshine Coast Regional Council have re-assessed their waste charges for water treatment residues and increased those fees. These decisions were taken by council after GSCs were presented and reviewed by QCA. This impacts Seqwater operations at Noosa, Image Flat and Landers Shute WTPs.

This change in refuse charges, which has been significant ($25 per ton to $110 per ton, the new charges were effective December 2011), is a result of a change in local government charging policies under the Local Government Act s262 (3)(c). In effect, the increases reflect a change in council policy to charge market rates for these services – this is in effect a change to a statutory charge and Seqwater has no option but to pay the increase or seek an alternative provider.

The Sunshine Coast Council change to the rate for waste disposal has caused Seqwater to incur an additional $0.4M in charges to 30 April, with further additional expenditure expected to be incurred to year end at 30 June.

Koala Protection Policy

The State Government introduced the State Planning Policy 2/10 Koala Conservation in South East Queensland (Koala SPP) and the South East Queensland Conservation State Planning Regulatory Provisions (Koala SPRP) in May 2010. This policy was developed to provide direction to plan for an increase in koala habitat in SEQ and particularly in the SEQ Koala Protection Area (SEQKPA), which encompasses the Local Government Areas of the Sunshine Coast, Moreton Bay, Redlands, Ipswich, Gold Coast, Logan and Brisbane.

This imposes additional costs to Seqwater which were not originally included in the 2011-12 expenditure forecasts. The policy was brought into place by DERM on the 31 May 2010. There was no indication from DERM that they would be auditing this Policy so soon after its introduction (within its first year). Seqwater became aware of the need for auditing of activities from June 2010 to June 2011 in September 2011.

In order to meet the requirements of the policy, Seqwater has had to employee a consultant at an estimated total cost of $0.1M.

Renewable Energy (Electricity) Act 2000

The Federal and state energy schemes specify that Energy Retailers are obliged to purchase a prescribed proportion of their annual energy purchases from certified green energy generation. Unless complied with the Retailers are exposed to default costs which are in excess of the costs which are passed through to customers.

The Federal Government implemented a number of changes to the Renewable Energy (Electricity) Act 2000[23] that took effect on 1 January 2011. The outcome of the legislative changes was two new renewable energy charges to replace the existing Renewable Energy Certificate (REC) charge.

- LRET - Large Renewable Energy Target
- SRES - Small Renewable Energy Scheme

In accordance with Seqwater's energy supply contract the Retailer passes through the cost impact of these changes which are based on calendar year cycles. Seqwater was not aware of these changes when preparing its 2011-12 expenditure forecasts as these were prepared prior to this Act being passed, and Seqwater's energy retailer, TRUenergy, had not advised Seqwater of the impacts until the costs were passed through in reviewed electricity tariffs.

Seqwater has recently received correspondence from the retailer stating the final obligations that were issued by the Regulator (following their annual review) in late February and would commence in Seqwater's April invoicing, including back charges for the March 2012 quarter. The further increase is due to the change in obligations levels for the LRET from 8.72% to 9.15%.

The combined increase in electricity costs due to the SRET and LRET charges is estimated at $0.7M, with this calculated for all WTPs at contestable sites.

[23] Information can be accessed on the Office Of Renewable Energy Regulator website at. http://www.orer.gov.au/lret-sres-updates/index.html.

This additional cost only relates to the black energy consumption. As such, it does not relate to the Greenpower premiums, which are premiums paid on the black energy costs, with Seqwater procuring 10% of its total energy consumption as green energy.

Higher Network Cost and Market Charges Components in Energy Charges

In accordance with Seqwater's energy supply contract the Retailer passes through the cost impact of these changes which are based on calendar year cycles. Seqwater was not aware of the quantum of changes when preparing its 2011-12 expenditure forecasts.

The combined increase arising from the additional pass through to Seqwater's electricity costs is estimated at $0.3M.

Waste Levy

The waste levy was introduced under the *Waste Reduction and Recycling Act 2011* in December 2011, after GSCs were presented and reviewed by QCA. The waste levy relates to Seqwater's WTPs transferring sludge to landfills (Noosa, Image Flat, Petrie and Landers Schute WTPs).

To April 30 the Waste Levy has caused Seqwater to incur an additional $0.1M in charges, with further expenditure expected to be incurred to year end at 30 June.

On the date of this submission, Seqwater received further advice relating to the cessation of this levy, which will not impact upon Seqwater's cost claim for 2011-12, however will require Seqwater to undertake further work to estimate the likely impact on costs in 2012-13. The impacts will be in the area of sludge disposal costs for certain WTPs, and Seqwater proposes to undertake this work and provide the necessary further advice to the QCA alongside the other information contained in this section.

Waste Reduction and Recycling Regulation (Qld) 2011

The *Waste Reduction and Recycling Regulation (Qld) 2011* was legislated in December 2011. It requires Seqwater to develop and submit a Waste Management Strategy by August 31, 2012. This regulation did not exist and its requirements were not foreseeable at the time of forecasting fixed operating costs and submitting these to the QCA for 2011-12 GSCs. Under section 148 of the Act, "State entity reporting", Seqwater is required to, by the 31st August 2012, report upon those waste management statistics and activities as outline within the Act.

In order to meet these requirements, Seqwater has had to employ a consultant at an estimated total cost of $0.1M.

Emergency events

Post-flood water quality investigations

Requests were made from the regulator to investigate water quality issues issues associated with the Lockyer and Upper Brisbane Catchments post flood. The process by which Drinking Water Quality is managed is an adaptive one, whereby the risk to drinking water quality from Seqwater's WTPs is reviewed annually and following particular events. Following the 2011 flood, an Information Requirement Notice was given to Seqwater under s96 of the *Water Supply (Safety and Reliability) Act 2008* by DERM on 1 December 2011. This additional information was for approval of a drinking water quality management plan for Queensland Bulk Water Supply Authority (*trading as* Seqwater). The additional information was required by 2 March 2012. Failure to comply with this notice without reasonable excuse would have see the application for approval taken to have been withdrawn.

The project includes identifying and reviewing existing hydrogeological/geohydrological models for Lockyer and Upper Brisbane catchments and developing conceptual models to capture understanding of the surface water-ground water interactions and the impacts of climatic scenarios in the Lockyer Creek and upper Brisbane River catchment.

Nothing formal has been requested regarding the Lockyer but this has been discussed and there is an expectation as part of the continual improvement process that this will be documented in the Drinking Water Quality Improvement Plan for the Seqwater Drinking Water Quality Management Plan, which is approved by the OWSR. There is also interest in this issue from QUU, Linkwater and the SEQ WGM. The project is also aimed at providing recommendations re any further investigation to fill identified information gaps. A report and model is to be developed by 25 June 2012, with this expected to be submitted with revisions to approved DWQMPs.

The water quality investigations are a requirement under the Grid Contract and are therefore primarily driven by regulatory compliance. However, the flood has contributed to the need to provide additional information in order to satisfy the approval process, given the effect of the flood on risks associated with Water Quality. Therefore, the unbudgeted component of this expenditure ($0.04M) would fall under the prescribed event of an emergency event.

Damage repair costs from January 2011 floods - WCRWS

In its 2011-12 submission to the QCA, WaterSecure explained that the January 2011 floods had caused damage to various assets across the WCRWS. At that time, non-recoverable damage (net of insurance proceeds) was estimated at $0.7M at the Bundamba AWTP and $3.1M across the pipeline network (total $3.8M).

In its Final Report, the QCA set out the treatment for this expenditure by reference to the draft report (which was not altered):[24]

> *WaterSecure... proposed a $3.8 million allowance for flood damage costs across the WCRW scheme. In order to avoid double counting, and to also align with the actual 2011-12 data template... the Authority did not recommend including these items as Allowable Costs... Flood damage costs can be incorporated in GSCs once the final amounts are ascertained under the review arrangements (Chapter 7).*

As at May 2012, the total expenditure incurred to date was $3.22M, with additional costs expected to completion at 30 June 2012 (phase 1 insurance claims have been received - [redacted] Phase 2 claims have been submitted).

Change in actual cost of debt

In its final report, the QCA stated it proposed to make adjustments to 2011-12 GSCs to account for changes in actual costs of debt and the revised RAB as required under the Direction Notice, and absent any change that had a material impact, the adjustments would be made at the same time as 2012-13 GSCs are determined.

Meetings have been held with QTC regarding interest calculations which underlie Seqwater's cost of debt and hence Capital Charge. Seqwater intend to engage with the QCA on this issue prior to publication of the GSC 2012-13 Final Report.

[24] QCA, 2011, page104.

Chapter 9 – Economic Regulatory Issues

This Chapter provides comment and a response to the QCA's recommendations relating to a number of other economic regulatory issues, including the future approach to unregulated (non-grid) activities, and the benchmarking review and duplication of effort review conducted by SKM.

9.1 Benchmarking and duplication of effort reviews

As part of the QCA's investigation of Grid Service Charges, the QCA engaged SKM to conduct a benchmarking review of 2011-12 fixed and variable operating expenditure of Seqwater. In addition, SKM were asked to determine the potential duplication of effort between Seqwater, their alliance contractors and the Water Grid Manager and provide an assessment of potential efficiency gains arising from the WaterSecure merger.

The results of SKM's benchmarking review indicated that:

- the pre-merger and post-merger operating costs per ML supplied for Seqwater were substantially lower than the majority of the reference utilities; and
- Seqwater's employee costs per full time equivalent (FTE) were higher on average than the majority of reference utilities in Australia.

The QCA acknowledged the limitations of the benchmarking assessment, particularly regarding the lack of comparative organisations and the limited data available at the time of the Draft Report. The QCA also noted that Seqwater's average employee costs are largely determined by its EBA, and therefore recommended that it was not appropriate to adjust the GSCs as a result of SKM's benchmarking analysis.

Notwithstanding these recommendations, the QCA proposed advancing its benchmarking assessment for the Final Report.

SKM's review of duplication of effort between the GSPs, Seqwater and LinkWater, their contractors and the WGM, indentified a number of areas where duplication of effort potentially existed and where savings could therefore potentially be made. However, the QCA's Draft Report stated that SKM's review was not sufficiently detailed to establish whether duplication of effort existed and whether cost savings could be achieved, concluding it was therefore not appropriate to adjust the GSCs at this stage.

Similar to the benchmarking assessment, the QCA proposed advancing its duplication of effort review for the Final Report.

Seqwater recognises the importance of benchmarking to the QCA's review and is keen to work with the QCA to develop meaningful benchmarking information. In particular, Seqwater considers that benchmarking could form a useful longer term exercise, allowing Seqwater's costs to be examined and compared between years. However, the usefulness of benchmarking is dependent on the choice of metrics examined. As per the QCA's assessment, Seqwater has concerns with benchmarking at an organisational level, particularly with respect to the lack of suitable comparable peer organisations. Seqwater explained these concerns in its previous submissions, including its 2011-12 submission of March 2011. More recently, Seqwater has provided information to the QCA and SKM regarding issues associated with the typical benchmarking metrics and their applicability to Seqwater and identified a number of alternative and useful metrics.

Seqwater also acknowledges that there are potential cost savings arising from the duplication of effort between participants in the bulk water sector and similarly looks forward to working cooperatively with the QCA in the future to identify areas of duplication and determine optimal service delivery solutions.

The QCA Draft Report indicates that additional analysis will be undertaken regarding benchmarking and duplication of effort prior to the release of the Final Report. Specifically, the Draft Report states that:

> *The QCA has not made any direct adjustment to GSCs as a result of SKM's findings regarding merger, duplication of effort and benchmarking. The QCA will progress consideration of such opportunities for the Final Report.*

While Seqwater accepts that additional analysis may be warranted, the above statement suggests that, as a result of this analysis, the QCA in its Final Report may make adjustments to Seqwater's forecast expenditure. Seqwater considers it inappropriate for the QCA to make any such amendments without providing Seqwater the opportunity to participate in their development or, at the very least, to provide a response to such decisions. To do otherwise would be inconsistent with the QCA's obligations under the Ministerial Direction Notice and would deny Seqwater the requisite natural justice. Specifically:

- the Direction Notice requires that, in making its recommendations, "(t)he Authority must consult with all relevant parties..."; and
- the hearing rule element of the principle of natural justice requires the QCA must give an opportunity to parties whose interests may be adversely affected by its decision the opportunity to be heard.

Seqwater considers that details of proposed adjustments (including the quantum of those adjustments) should be provided prior to a Final Report. Doing so ensures that Seqwater (and other stakeholders involved in the review process) have an opportunity to respond to proposed amendments prior to the release of the Final Report. In other words, amendments

not identified in the Draft Report should not be unilaterally introduced by the QCA in its Final Report. Accordingly, Seqwater strongly opposes any adjustment to forecast expenditure on the basis of additional analysis undertaken by the QCA following the release of the Draft Report.

Notwithstanding issues of due process, Seqwater considers that there is insufficient time between the Draft and Final Reports to conduct a comprehensive benchmarking review or accurately determine possible cost savings resulting from duplication of effort. Seqwater also questions the timing of additional analysis concerning potential duplication of effort given the uncertainty associated with the Queensland Government's proposed restructure of the bulk water sector. Seqwater considers that such a review would more appropriately be conducted following the resolution of the proposed restructure.

Irrespective of the timing, Seqwater considers that, to ensure these reviews produce meaningful results for both the QCA and Seqwater and facilitate the development of the SEQ bulk water sector, it is essential that Seqwater be permitted to participate in the review process.

Seqwater notes that it has invested significant time in determining meaningful benchmarks to assess its performance against other organisations and has identified a range of correction factors necessary to ensure comparability across organisations. Similarly, Seqwater has strong views concerning the nature and timing of possible cost savings from both the merger of Seqwater and WaterSecure and the duplication of effort in the bulk water sector.

Seqwater looks forward to sharing this information with the QCA and working cooperatively to develop a robust and meaningful benchmarking framework and identify achievable efficiencies and cost savings in the provision of services.

9.2 Unregulated assets and services

The QCA's Draft Report identified a number of non-grid activities and proposed the revenue associated with these activities be shared between Seqwater and grid customers. In particular, the QCA identified non-grid revenue associated with mini-hydro generators at Wivenhoe and Somerset Dams and revenue earned from third party leases for telecommunications equipment.

The QCA indicated that, in the case of the mini-hydro facilities, 50% of the revenue (net of direct operating costs) should be offset against water charges on the basis that this represents compensation for the capital costs and non-direct costs associated with the hydro-plant incurred by water grid customers.[25]

The QCA adopted the same sharing arrangement for revenue earned from third party leasing for the placement of third-party telecommunications equipment. Specifically, the QCA argued that 50% of the revenue should be offset against water charges.

Seqwater agree that water grid customers should receive some compensation for the use of water grid assets for hydro or other non-regulated purposes. However, Seqwater also notes that it needs to be appropriately incentivised to encourage use of water grid assets by other parties, particularly where this usage results in positive outcomes for all parties.

At the same time, there are a number of arrangements that have been subject to interim arrangements, pending detailed review as part of a longer term regulatory investigation. This includes the treatment of these non-regulated revenues, as well as the allocation of non-direct costs to the WGM and other users (including irrigators and non-regulated assets).

Seqwater is concerned that the QCA has considered this issue in isolation and prematurely. Moreover, the impacts for GSCs are negligible – around 0.04%.

Seqwater therefore submits that the interim arrangements should be continued for 2012-13, as was accepted by the QCA for 2011-12, and that treatment of the pre-existing and any future non-regulated assets be considered more fully once the longer-term regulatory regime is in place. In particular, the long term review of irrigation pricing for 2013-14 to 2016-17 will entail considerations of some broader cost allocation issues that may assist when determining the future treatment of the costs and revenues associated with unregulated activities.

[25] The regulatory treatment of the relevant hydro facilities reflects legacy issues associated with the initial transfer of assets to Seqwater. In general, such assets would not typically be included in the regulatory asset base.