SEQWATER'S 11 MARCH 2013 SUBMISSION / RESPONSE TO QCA REQUEST OF 25 FEBRUARY 2013

11 March 2013

From: Colin Nicolson
Sent: Monday, 11 March 2013 9:52 AM
To: Angus MacDonald
Cc: Damian Scholz
Subject: QCA Information Request 25 February 2013 -- Clarifications and Omissions from Seqwater Submission

Hello Angus

Here are the outstanding responses to the above information request.

QCA Question A.5.

Define 'reasonable' – SKM allowed a 30% margin to establish prudent and efficient costs – and specify your alternative approach to establish 'reasonable' costs and any high-option analysis costs savings.

Seqwater Response to Item A.5

In defining "reasonable", Seqwater refers to the joint submission from Seqwater, LinkWater and WaterSecure to the QCA dated 25 January 2010 in response to the Authority's Draft Report SEQ Price Monitoring Information Requirements for 2010/11 where reference was made to the Australian Energy Market Commission decision rule that required the Australian Energy Regulator to accept a business' proposal if it is satisfied that the amount "reasonably reflects" efficient and prudent costs based on realistic estimates of forecast demand and the relevant expenditure objectives.

Seqwater notes that, whilst SKM allowed a 30% margin to establish prudent and efficient costs which allows some scope for differences, there was no recognition of the "relevant expenditure objectives". The purpose of the renewals forecasts is, along with the closing ARR balances, to establish the renewal annuity which is a funding mechanism for past, present and future renewals expenditure. The renewal annuity is reset each price path based on the renewals forecast for the next regulatory period plus the 20 year planning period. It should therefore be noted that the renewal annuity is a continuous, self-adjusting mechanism.

Given the timeframe over which the renewals forecasts are made which is up to 25 years into the future, and noting the views expressed by the Expert Panel on Energy Access Pricing on pages 74 and 75 of their "Report to the Ministerial Council on Energy" (April 2006) where it was said "Many of the inputs required to derive access prices cannot be estimated with precision, or pertain to future outcomes that cannot be forecast with precision. Thus, there is a range (and potentially, a wide range) within which a reasonable person may consider that the relevant input may reside – and, consequently, a range (and potentially, a wide range) within which the access price that is derived will reside", it is Seqwater's view that a reasonableness or on-the-balance-of-evidence objective test should be applied. Relevant matters to be considered would include:

- *the need for the proposed renewal project in light of the available engineering evidence and risk analyses;*
- *the nature of the work proposed; and*
- *the method of forecasting costs.*

This approach requires the exercise of professional judgement rather than the establishment of a quantitative measure.

It is important to note that the view expressed above is made in the context of Seqwater's whole-of-entity planning processes. The renewal annuity applies to irrigation only and the renewals forecasting processes are undertaken for irrigation pricing purposes only. Consequently, there are limited opportunities to take advantage of economies of scale. Seqwater's concern is that the greater the level of precision required (e.g. ±30% compared to "potentially, a wide range") will result in higher planning costs which will not be offset for customers by a lower annuity component to the prices.

Savings from not undertaking high-level options analyses are dealt with in a separate submission.

QCA Question E

On Page 14, in relation to insurance, we do not find the submission compelling, that is, we still believe that with its limited scope (and increased size since the merger, Seqwater should be able to achieve productivity gains in insurance – if not annually – then please clarify the type of cost savings that could be achieved periodically (and outline the dates and period). If Seqwater wished to build its case in this regard, suggested information could include:

1. reference to an independent benchmark indicating that insurance costs are forecast to rise (or fall); and/or

2. impact of climate change on future events that require insurance and reported (by insurance companies) impacts on future water infrastructure insurance premiums.

Seqwater Response to Item E

It is Seqwater's experience that general insurance benchmarks are not always a strong guide to actual insurance premiums. This is because insurance premium outcomes are heavily influenced by the strength of the case put forward to insurers. In 2012, Seqwater achieved the best-case outcome of no increases for its 2012-13 insurance premiums despite facing predicted rises of up to 30%.

There are a number of factors impacting Seqwater's future water infrastructure insurance premiums. The amalgamation of the Seqwater and LinkWater assets into one portfolio for insurance purposes may produce insurance premium savings. However, Seqwater's claims history arising from the 2010-11 floods and subsequent flood events is likely to moderate the savings and the pending class action arising from the 2010-11 floods adds another level of uncertainty that is likely to be priced into insurance premiums thus further eroding potential savings.

Although increasing the level of deductibles will reduce insurance premiums, when an insurable event occurs and damage is sustained to Seqwater's assets, all deductible costs (i.e. costs that cannot be claimed) are legitimately included in water supply scheme costs and a share is allocated to *irrigators. Consequently, it is unwise to increase deductibles merely to reduce premiums to meet a productivity reduction.*

In view of the significant uncertainty posed primarily by the pending class action in the negotiation of future insurance premiums, Seqwater submits that insurance premium costs should be excluded from the calculation of productivity gains.

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