Unitywater
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Dr Malcolm Roberts
Chairman
Queensland Competition Authority
GPO Box 2257
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31 July 2014

Dear Malcolm

Unitywater response to QCA Annual Performance Reporting Paper

Thank you for the opportunity for Unitywater to provide input into the QCA's ongoing response to the Ministers' Direction Notice (the Direction) requiring the QCA to investigate and report on a long-term regulatory framework for the SEQ Distribution Retailers (DRs) and specifically the Technical Paper titled SEQ Long-Term Regulatory Framework – Annual Performance Reporting Paper (the Paper) that the QCA released in June 2014.

In responding to the Paper, Unitywater is keen to ensure that:

a. The recommendations in the Paper are consistent with the outcomes sought by adoption of the light handed annual performance monitoring approach recommended by the QCA in the Regulatory Framework Position Paper.

b. The benefits from any compliance requirements imposed under the CPI-X approach recommended by the paper exceeds the associated costs.

In Unitywater's previous submission on the form of regulation, Unitywater noted that possible regulatory approaches extended along a continuum from self-regulation to full cost of service regulation. The QCA's consideration should not be unnecessarily limited but should give due consideration to the full range of options especially in light of the Ministers' requirement that the recommended form of regulation should ensure that costs not exceed benefits.

Further, the alignment of interests between property occupiers as both DR customers and owners together with the fact that Unitywater has consistently under-recovered in terms of total revenue compared to the QCA's estimate of maximum allowed revenue suggests there is no economic cost/benefit justification for intrusive and costly economic regulation of Unitywater.

As such, Unitywater remains concerned that the QCA's proposed performance monitoring approach is likely to be unnecessarily prescriptive and expensive to implement. Given this background, in reviewing the Paper, Unitywater is concerned that:

a. The current recommendations do not substantially reduce the regulatory burden compared to the current arrangements (particularly in terms of reporting requirements).

b. That the approach recommended is inconsistent with the aim of implementing a light-handed form of regulation.

c. The recommendations focus on providing evidence of processes being in place rather than on the outcomes of the organisation's processes eg. Customer engagement indicators such as newsletters, media releases relevant to customers, customer committee membership, customer engagement strategy rather than customer satisfaction survey results.

d. There is no assessment of the potential impact of the reporting requirements and as such, no assessment of whether the recommended approach satisfies the Ministers' Direction that the cost of implementing the proposed arrangements do not exceed the benefits.

e. Any analysis of performance should be based on a multi-year framework reflecting performance over an extended timeframe rather than focusing on a single year which risks either providing unintended incentives to minimise immediate efficiency improvements so as to enable improvements to be gradually implemented in order to satisfy the CPI-X test or where large one off benefits are delivered to customers and are offset by CPI increases will result in additional reporting obligations by the D-Rs.

f. Given factors including:

   i. The ownership structure of the business which aligns the interests of customers and owners (as discussed in detail in Unitywater's June submission).

   ii. The fact that the QCA's previous reviews have identified that Unitywater has historically under-recovered revenue in comparison to the QCA's efficient cost MAR estimate.

   iii. That Unitywater expects to continue to under-recover revenue compared to the QCA's efficient cost MAR estimate for the foreseeable future.

   iv. That the QCA proposes to allow any MAR under-recovery to be compounded forward at WACC for a minimum of the ten year period till 2025.

   There is unlikely to be any cost-benefit justification to impose material reporting requirements on Unitywater such as those outlined in Section 4 of the Paper.

Further details regarding Unitywater's views on the position paper are set out in **Attachment 1** and a response to the QCA's request for information regarding the cost of regulation are set out in **Attachment 2**.

In conclusion, Unitywater considers that it would be more appropriate, more efficient and equally informative, to assess DRs pricing over an extended time frame and at a suitably high level, for example $/connection rather than in a detailed component pricing sense. Further, there should be no requirement on DRs to automatically report extensive information given that there is no evidence that the associated regulatory costs would be matched by offsetting benefits.

Yours sincerely

P. Thomson

Pauline Thomson
Chief Financial Officer

CC. George Theo, Chief Executive Officer, Unitywater

Response to key issues

Set out below are Unitywater's specific views on the three key issues set out in the Paper:

a. CPI-X
b. under and over recovery of revenue
c. information requirements.

1. CPI-X

Under the QCA's proposed light-handed performance monitoring regulatory framework, the QCA will assess DRs year-on-year price changes against a CPI-X comparator. A price change in excess of the comparator with respect to prices or components of prices will trigger various potential levels of regulatory review and associated information requirements.

While Unitywater understands that under the QCA's proposed form of regulation, there is a need for a trigger mechanism to invoke increased regulatory oversight, Unitywater remains concerned that a sufficient case has not been made for the proposed form of regulation and that the CPI-X trigger suffers from a number of problems including:

a. The current proposed CPI-X approach is based on single year analysis of price changes. Such an approach is likely to be regularly triggered due to factors unrelated to the misuse of market power or other drivers of economic regulation and is likely to provide unintended incentives such as an incentive to delay efficiency improvements or tariff reform so as to ensure that the change in any given year is consistent with ensuring the CPI-X trigger is not exceeded.
b. Unitywater is currently undergoing both significant structural change and a tariff reform process which makes analysis of changes in current costs and prices irrelevant.
c. CPI-X is a high level measure and should only be applied to aggregate prices. For example, $/connection with respect to both water and sewerage services.

On the basis of the above, Unitywater would suggest that a CPI-X trigger mechanism should be based on a smoothed multi-year analysis and should consider changes in aggregate prices and revenues, for example $/connection rather than any analysis of tariff structures.

2. Under and over recovery of revenue

The QCA has proposed that DRs recognise any under-recovery of revenue compared to the QCA assessment of prudent and efficient costs and recover this amount on an NPV neutral basis over ten years with the possibility of a further extension upon request. Unitywater supports the views expressed by the QCA with respect to under and over recovery of revenue.

Objective reference: A2408008

Particularly, Unitywater agrees that DRs should be able to smooth revenue recovery over an extended period. If this concept is consistently applied it would suggest that the QCA should not invoke additional reporting requirements for a single year CPI-X trigger event, but rather should consider multiyear performance as discussed above.

Indeed, the fact that Unitywater has materially under-recovered against the QCA's estimate of prudent and efficient costs over recent years (and is likely to continue to under-recover over the foreseeable future) suggests that there are limited circumstances in which detailed review could be justified.

One important point to note is the QCA's view that under-recovery prior to 1 July 2013 was the result of a legitimate exercise of the retailers' discretion to forgo these revenues and accept a lower rate of return. This statement is factually incorrect as prices in 2011-12 and 2012-13 were capped at CPI by the Fairer Water Prices legislation. DRs should therefore be able to legitimately carry forward under-recoveries incurred over that period for offset against any future over recoveries.

Unitywater supports the views expressed by the QCA with respect to under and over recovery of revenue.

3. Information requirements

The Paper notes that the QCA does not propose to establish specific information return templates. Nevertheless, Section 4 of the Paper does go into considerable detail with respect to Information Requirements. The QCA has identified a total of five indicative information reporting scenarios with level 5 being associated with a full cost of service review with the Paper outlining four lesser levels of information reporting.

The Paper indicates that DRs must self-assess in terms of providing the appropriate level of information in support of their pricing decisions. Previously in discussions, the QCA has indicated that under the proposed light handed performance monitoring regime information collection by the QCA would largely rely on internal QCA researchers accessing publicly available information. However, the Paper outlines information requirements that imply significant compliance effort on the part of Unitywater and which are not considered to be light-handed. Further these information requirements have not been subject to any cost benefit analysis to assess their consistency with the Ministers' requirement that the costs not exceed the benefit from the regulatory approach recommended by the QCA.

For example, level 1 reporting is supposed to be representative of the base-line information that each DR is expected to submit each year. This information includes:

a. bulk water charges ($/KL) even though these are set by Seqwater and are in no sense controlled by DRs
b. tariff schedules – showing the full suite of charges for the current and previous years by tariff group and region
c. example impact on representative customers
d. details of customer engagement strategy
e. details of direct customer consultation
f. details of customer consultation committee
g. details of customer surveys and studies

h. customer charter and feedback
i. customer service standards and feedback
j. details of Netserv plan
k. details of capital works programs and co-ordination with other plans
l. details of asset management standards
m. details and examples of project evaluation and options analysis.

In Unitywater's view, the above list is unreasonable especially in the context of the minimum reporting requirements DRs are expected to meet. In addition, many of these items are focused on the DRs having a process in place as opposed to the outcome which would demonstrate the effectiveness of a process.

The Paper goes on to show increasing information levels that rapidly expand the data requirements to incorporate detailed revenue and cost information. The impact of the suggested information requirements is that there is unlikely to be any significant saving associated with the move to the QCA's recommended performance monitoring framework compared to the previous heavy-handed price monitoring.

In conclusion, Unitywater considers that it would be more appropriate, more efficient and equally informative, to assess DRs pricing over an extended time frame and at a suitably high level, for example $/connection rather than in a detailed component pricing sense. Further, there should be no requirement on DRs to automatically report extensive information given that there is no evidence that the associated regulatory costs would be matched by offsetting benefits.

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Unitywater views on cost of regulation

In response to the QCA's request for information on costs of economic regulation, Unitywater has two principal concerns with any assessment of the costs of regulation, namely:

a. Uncertainty over the impact of implementation of the Queensland Competition Authority's (QCA) proposed light-handed regulation.

b. Any estimation of cost needs to be undertaken with due consideration to the purpose for which that information will be used.

These issues are briefly addressed below.

1. Uncertainty over cost impacts of regulation

Assessment of the costs of economic regulation for Unitywater requires consideration of a number of issues, including:

a. Unitywater has not separately captured all of the costs incurred in relation to economic regulation and as such does not have aggregate detailed cost estimates.

b. A significant component of the burden of economic regulation has been the level of managerial resources dedicated to addressing regulatory compliance and reporting issues on an ad-hoc basis and the likely negative impact on business efficiency.

During 2012-13 Unitywater directly incurred costs of $0.6M (excluding regulatory fees) in meeting QCA information requirements. Direct costs related to having a Manager of Economic Regulation co-ordinate the development of the submission and completion of the templates, a regulatory specialist responsible for completion of the templates and external advisors who assisted in the development of the RAB. In addition to these direct resources, planning engineers, project delivery staff, management and financial accountants and senior management also contributed to review and input into the submissions and templates with final review and approval by Unitywater's Board. As Unitywater office staff do not complete timesheets these costs have not been separately captured as a cost associated with meeting the requirements of the QCA.

In terms of the reporting requirements under the light handed framework Unitywater remains concerned about the impact on the business as while during discussions the QCA has indicated that a pragmatic approach to information collection would be adopted with significant reliance on QCA accessing publicly available information, the Technical and Position Papers circulated by the QCA seem to suggest a significantly greater reporting role for Distribution Retailers (DRs). Indeed, Unitywater is concerned that there will be no significant reduction in cost associated with the proposed regime compared to the 2013-15 price monitoring investigation, or compared to adoption of a heavy-handed building block price setting exercise.

Notwithstanding the above, Unitywater believes that uncertainty over the exact nature of the QCA's proposed form of regulation and therefore over the magnitude of associated costs is not an impediment to undertaking appropriate cost-benefit analysis as discussed in the next section.

Objective reference: A2408717

2. Purpose for collection of cost information

Unitywater understands that the QCA is seeking information on the costs to DRs of economic regulation in order to address the Ministers' Direction that the QCA's recommended form of regulation should ensure that the costs do not exceed the benefit. Assessment of this requirement suggests the need for detailed economic cost-benefit analysis to be undertaken.

Cost-benefit analysis essentially requires that the ratio of benefits to costs is positive in order to justify imposition of a particular form of regulation. As outlined in Unitywater's June response to the QCA's Form of Regulation and Pricing Principles Position Papers, Unitywater considers that the only benefit from ongoing economic regulation is related to the role of the QCA as an independent party attesting to the reasonableness of DRs prices (a task that could be equally addressed by other means and which does not imply any economic efficiency improvement from the removal of monopoly pricing). Further, the value of this role is not clear but is, in Unitywater's view, unlikely to be material when compared to any reasonable estimate of the cost of regulation.

In previous submissions Unitywater has noted that there has been no evidence of any previous monopoly pricing behaviour on the part of Unitywater and that Unitywater's revenue has historically been lower than the QCA's estimate of efficient costs, a situation that Unitywater expects to continue over the foreseeable future. As such, there is no removal of monopoly pricing benefit associated with DR economic regulation. Similarly, any reduction in costs that Unitywater may achieve cannot be attributed as a benefit of regulation as under the QCA's pricing approach such cost reductions would not result in price reductions to customers but rather in returns to shareholders increasing closer to the level recommended by the QCA.

The net impact of these factors is that the benefits from regulation cannot be quantified so that it is not necessary to accurately estimate costs as there is no prospect of a positive benefit/cost ratio given the reality that costs will be material.

Objective reference: A2408717