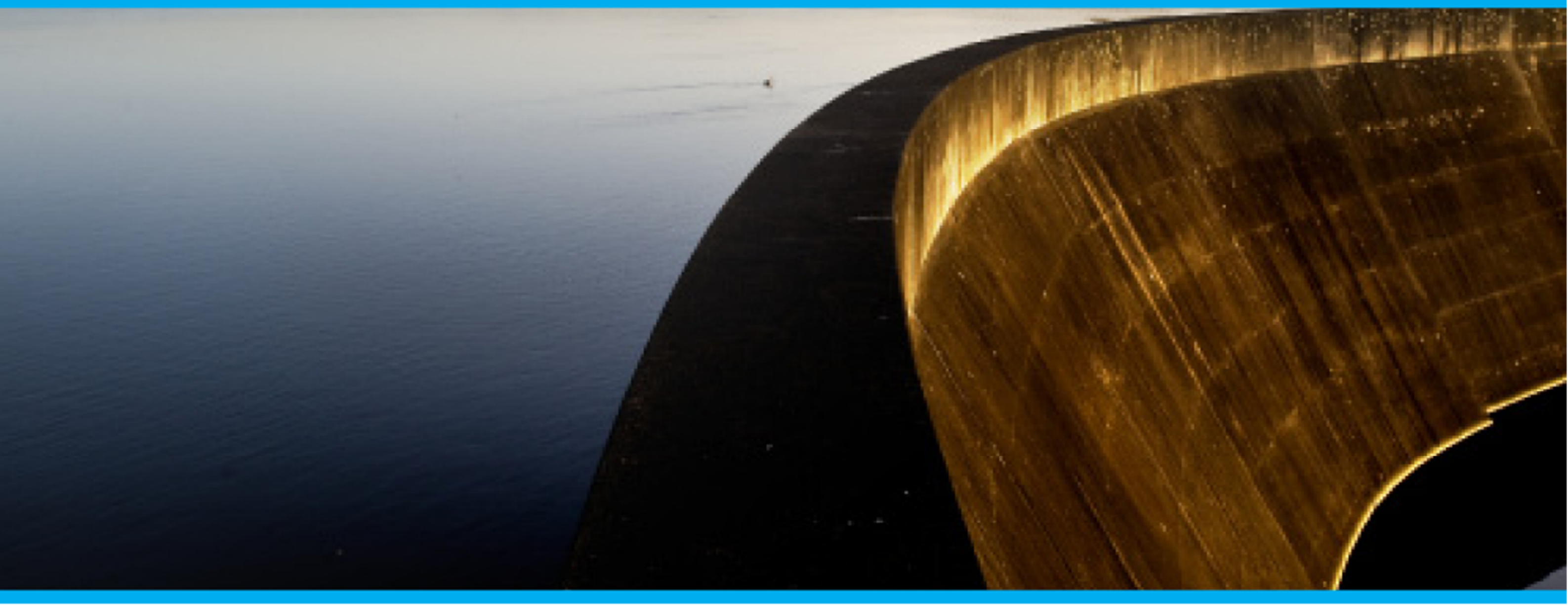
Seqwater Response to Draft Queensland Competition Authority Report

SEQ bulk water price path 2015-18

30 January 2015



SOURCE STORE SUPPLY

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1. Executive Summary

On 30 November 2014 the Queensland Competition Authority (QCA) issued a draft report for comment from stakeholders including the wider community as part of its investigation into SEQ bulk water prices for FY15-18. The closing date for comments is 30 January 2015.

Seqwater is of the opinion that overall the draft report is measured and reasonable in its findings. There are a few select draft findings and recommendations which Seqwater will address in this response.

The majority of the proposed capital that has not been deemed prudent and efficient relates to projects that are well into the future. In this response further information clarification is provided for the Somerset upgrade project and a small component of the Green Hill pipeline project. Seqwater is not proposing to provide any further information for other projects as most are well into the future and given the current level of investigation Seqwater accepts the QCA's recommendations.

A common theme in the operating cost findings is reconciliations of account codes between FY14 actual expenditures and FY15 Q1 forecast expenditures. In presenting a holistic reconciliation of account codes in this response Seqwater demonstrates that many of the comparisons that led to findings of inefficiency should be reconsidered.

The electricity review was undertaken by QCA internally. The findings were that QCA accepted Seqwater's cost forecasts, however differed in its view of the appropriate escalators to use for the outer year forecasts. These and other escalators are relatively subjective and Seqwater will indicate its views on the QCA findings on an individual basis.

In this response Seqwater seeks an efficiency finding on approximately $15M pa of operating costs (~6% of total operating costs or ~2% of allowable revenue).

Other regulatory issues largely relate to the various true-up mechanisms proposed by Seqwater and the QCA response to those. In essence Seqwater is seeking a situation where its actual efficient costs are the basis for the price path going forward. Mid-period adjustments would only result from catastrophic circumstances. The true-up to efficient actuals proposed by QCA are acceptable to Seqwater as it provides a fair result for supplier and customer.

Seqwater makes no substantive comment on pricing as this is a Government policy issue.

2. General Commentary

Seqwater notes that the introductory three chapters of the QCA Draft report reflect factual information about Seqwater and QCA's subsequent analysis.

These sections contain relatively uncontroversial summations of Seqwater and its legislative, regulatory, water security and operational environment.

Chapter three addresses issues of demand. QCA notes that the per capita consumption adopted by Seqwater is consistent with the requirements of the Minister's Referral Notice.

3. Capital Costs

The Capital costs component of the QCA draft report covers "costs of infrastructure and other assets used to deliver services".

A key component of that is the 30 June 2013 RAB which was set by the Minister following submission of data from Seqwater to QCA early in 2014. The data was derived from the official financial records of Seqwater.

QCA notes that Seqwater has evidence of good industry practice and areas for improvement. The areas for improvement are largely in areas identified by Seqwater itself. However the QCA and its consultant have identified a number of other areas as well. In either case Seqwater has or is taking measures to improve its policies and processes to address these concerns.

Draft recommendation 4.1

"Seqwater improve capital planning and delivery policies and procedures by further progressing from short-term to longer-term delivery focus, improve awareness and consistency in their application and incorporate maintenance and non-capital options in asset management planning."

Seqwater response - Seqwater notes the recommendation and confirms that implementing sound long term asset management planning has a high priority for the business.

Draft Recommendation 4.2

"Seqwater's forecast capital expenditure for 2013-28 be reduced by $321.0M"

Seqwater response - QCA and their consultants CH2M Hill were required to sample a maximum of 10 capital expenditure projects for review. Seqwater accepts the QCA findings in all cases except for the Mt Crosby to Green Hill Renewal and Somerset Dam Stabilisation projects.

Seqwater's responses to findings for the proposed Mt Crosby to Green Hill Renewal and Somerset Dam Stabilisation projects are presented in Appendices A and B respectively.

Further the QCA's inflation rate adjustments which affects the "Inflationary Gain" component and hence "Depreciation" by applying actual rather than forecast inflation are accepted by Seqwater.

4. Operating Costs

Seqwater has sought to provide further clarification and justification for a number of operating cost items including demonstration of the impact of rationalising account codes. Clarification and justification for these is broadly in the order in which they appear in the draft QCA report. Information and Communications Technology (ICT) operating costs are addressed in a holistic standalone response in Appendix C. Where warranted other specific costs items have supporting narrative appendices.

Draft recommendation 5.1

"Seqwater continue to improve its governance, corporate planning and procurement activities by improving awareness of their requirements and strengthening linkages between KPIs and corporate priorities."

Seqwater notes this recommendation.

Employee Expenses

Addressing findings relating to the employee expense cost category in section 5.6 of the QCA's draft report Seqwater provides the following information.

QCA has made a net downward adjustment of $1.4M in 2014-15 for employee costs. This has resulted from recalculation of a number of cost items. Seqwater agrees that the change proposed by allowance for Workers Compensation Expenses is appropriate. For the other costs categories of Salaries and Wages – Award, Annual Leave and Annual Leave Loading Seqwater agrees with the recommendations and is modifying the 2015-16 budget processes to align with the QCA's recommendations by standardising cost allocations to improve consistency and transparency.

For the other salaries, QCA agreed with CH2MHill's recommendation of a $1.6M reduction in costs from 2017-18. Seqwater is submitting further detailed information to demonstrate that the overall and individual ICT spend, including ICT employee expenses is efficient (refer Appendix C).

Other adjustments proposed by Seqwater that were not accepted include:

- An increase in APDD employee costs of $0.2M (real) in each of 2016-17 and 2017-18 and $0.1M thereafter. Seqwater accepts the QCA's finding.
- An increase in employee costs of $0.2M from 16-17 to cover pro-rata ICT costs. Seqwater accepts QCA's finding.

Materials and Services

Addressing findings relating to the contract services cost category in section 5.6 of the QCA's draft report Seqwater provides the following information.

Training – external

Seqwater has been notified by QCA that this item was included in error. Both the text and spreadsheets should be adjusted to recapture these in Seqwater's efficient costs.

Consultancies – Information Technology

A detailed explanation of this expense is contained in Appendix D – Consulting Costs – ICT. The FY15 ICT expenses identified in natural account 522209 – Consultancy – Information Technology have been incorrectly classified. The ICT portfolio is aligned to the ICT Strategy which was approved by the Seqwater Board in October 2014. The ICT Strategy and the resulting expenditure forecast is to design the systems required to effectively support the business and drive further efficiencies.

Funds identified as "consultancy" within the budget are made up of aggregated cost estimates for operationally funded resources such as Project Managers, Solution Architects, Business Analysts and specific Vendor engagement based on approved a portfolio of Initiative Assessment Submissions. The ICT consultancies spend is misclassified and is more correctly identified as "contractors" as per the table below.

ICT ($ nominal)	FY14A	FY15 Q1	FY14/15 Q1 revised
522207 – Consultancy – Others	$11,700	-	-
522209 – Consultancy – Information Technology	$1,651,327	$3,796,350	$42,662
522214 – Consultancy – Process Improvement	$38,429	$20,000	-
(proposed new natural account) - Contractor - ICT Professional	-	-	$3,357,721
(proposed new natural account) – ICT Professional Services	-	-	$415,967
Grand Total	**$1,701,456**	**$3,816,350**	**$3,816,350**

Of the $3.8M in natural account 522209 in the FY15 Q1 forecast, $2.9M is project delivery operating costs to deliver the ICT Strategy with the remaining $0.9M relating to business as usual operating costs in the wider ICT Team, including a reduction of $380,000 from FY14 based on the decommissioning of SAP. Key projects underpinning the ICT Strategy include:

Project	Alignment	Brief description
Performance and Resilience	Compliance	Align ICT Services to business expectations and understand ICT delivery costs.
ICT Assets	Renewal, Compliance	Decommission legacy systems, improve efficiency of Asset life cycling
Electronic Document and Records Management (eDRMS)	Compliance	Enhance organisational commitment to, and knowledge of, good record-keeping practices, including training and education
Business Intelligence/Data Warehouse	Growth	Define a corporate data model and identify key source systems, Establish a supported data

Project	Alignment	Brief description
Corporate Information System (CIS) – ERP	Compliance	Identify key data to be managed through the CIS and improvements in timeliness, quality and ability to support corporate reporting, Prioritise and roadmap.

Consultancies - Other

Seqwater does not accept the recommended reduction of $5.1M in the undifferentiated consultancy services natural account code. To understand variances and to assess prudency and efficiency of the forecast undifferentiated consultancy services, this individual consultancy cost type/line item needs to be assessed in the context of the total consultancy spend. This is important in assessing these costs as the nature and scope of consultancy expenditure varies regularly to meet business needs. Investigating individual account codes can thus provide an inaccurate or misleading picture of expenditure and the underlying business drivers. Analysis of consultancy costs has been performed specifically on a Team basis for natural account 522207, and for additional consultancy natural accounts where this serves to increase transparency and understanding.

The main driver of these variances is changes in allocation between natural account codes, principally driven by consolidation of some line items/activities as the budgeting process has evolved post-merger. A detailed explanation, reconciliation and justification of total consultancy costs (and the undifferentiated consultancy services natural account code) is included in Appendix D.

Increases have two principal explanations/justifications: 1) apparent increases which are accounted for when performing a “like-for-like” account code reconciliation (ie, $1.7M of the $1.8M apparent increase for natural account 522207 – Consultancy Others in the PSRI Team), and 2) genuine increases resulting in a higher forecast FY15 spend, many of which are offset by reduction in other areas. Examples include MCS Strategy development of $0.73M, WCRWS shutdown technical advice $1.3M, Wivenhoe and Somerset Dams Flood Upgrade Operations Feasibility Study of $0.68M, Flood Storage Infrastructure Study of $0.43M, enterprise portfolio and risk management framework $0.15M and treated water delivery system optimization $0.25M. Major variances by Team are discussed in Appendix D.

Control systems maintenance services

There is an element of correction of coding and mismatching that has occurred under this account code. In reality Seqwater has expended close to budget for the 2013-14 year and forecasts similar expenditure in the 2014-15 year. Consequently Seqwater requests that the original budgeted Seqwater proposed expenditure of $1.3M be accepted.

As per the detailed explanation included in Appendix E, CH2MHill and subsequently QCA have based their findings on a view that there has been an increase in expenditure for this item year on year (yoy) by reference to the natural account code. A holistic analysis shows that only using the natural account code as its tool for comparison does not allow an “apples with apples” yoy comparison. In this review QCA has otherwise allowed expenditure for activities where there was no yoy change. Seqwater states that the previous year’s actual and FY15 year budget are similar in this case and therefore the FY15 budget should be approved.

Electrical maintenance services

The approach of comparing actual costs against budget for this specific account code (522084) does not provide an "apples with apples" comparison. Seqwater uses 522084 to allocate the budget but actual expenditure for the electrical maintenance services activity is recorded against numerous account codes. Seqwater proposes that the original budget be accepted. A detailed explanation is included in Appendix F.

Salaries and wages – Veolia

CH2Mhill suggested that the FY15 budget be accepted if justification was provided. However QCA has proposed a $7.2M reduction in this cost item, reducing it to zero. Seqwater does not agree with this finding and a detailed explanation is included in Appendix G. This states that the actual costs in FY13 were $8.9M but were listed by CH2MHill as being only $2.3M. On a like for like basis these cost were $8.3M in FY14, and are forecast to reduce by $1.3M in FY15 to $7.0M. Despite continuing to decrease over time, both MWA assets need to be maintained whilst in hot standby and mothball modes. Seqwater is continually seeking to further optimse all MWA expenditure, including this cost category.

Repair and maintenance costs – Veolia

QCA has proposed a $2.1M reduction to this costs item. Seqwater partially agrees with this recommendation. This was a one-off cost to provide for decommissioning of the Western Corridor Recycled Water Scheme (WCRWS) in 2014-15. It should be included in 2014-15 efficient costs but not carried forward into subsequent years. A detailed explanation is included in Appendix H.

Variable chemical costs

Seqwater accepts that the reduction of $0.2M for 2014-15 is appropriate as it is the result of a clerical error.

Chemical costs – Gold Coast Desalination Plant

Seqwater notes the CH2M Hill analysis is affected by not assessing financial year variances on a comparable basis. A detailed explanation is attached in Appendix I.

Escalation rate – contract services

QCA accepted CH2M Hill's proposal to accept Seqwater's methodology and weightings for various input indices. CH2M Hill updated the input values for the non‐residential building construction index (NRBCI), Queensland and Seqwater has identified a slight inconsistency in the methodology for updating the index and recommends the appropriate escalation rate is 2.45%. Further detail is contained in Appendix J.

GPS/PDA fleet costs

QCA accepted CH2M Hill's proposal to maintain 2014-15 expenditure as submitted and then reduce by two thirds over the forecast period to 2028. Seqwater believes it can accurately justify the higher expenditure level than that accepted by the QCA both in the QCA text and as listed in its operating cost spreadsheet (note: these two sources are different). Taken over five year periods, Seqwater proposes expenditures of $290k per annum for the first three years, reflecting the purchase / replacement period, with the remaining two years reduced to $80k reflecting the maintenance period. This expenditure is forecast to continue on a five year cycle. A detailed explanation is attached in Appendix K.

Other adjustments to materials and services costs

Table 48 in section 5.6.3 of the draft QCA report notes a number of other adjustments to 2015-28 materials and services expense items:

- Contract Services – Seqwater agrees with QCA's response confirming Seqwater's proposal that provision be made for $0.5M (real) in consultancy fees every three years to assist with QCA review responses.
- Chemical disposal cost of $0.2M per annum. The shutdown of WCRWS is expected to lead to a reduction in chemical disposal costs. Seqwater agrees with recommendation that this cost item be deleted from 2015-16 onwards.
- Operations – treated water. Seqwater agrees with QCA's recommendation regarding the $4.1M of sludge handling costs from 2019-20.
- SPT – "pro-rata" ICT costs. Seqwater agrees with QCA's recommendation regarding $0.6M pa from 2016-17.
- WSSP – Seqwater agrees with QCA recommendation that allowing $1.3M (real) every three years for regulatory fees would amount to double-counting based on how the operating cost model is presented.
- ICT – hardware support and maintenance ($0.2M real pa increase from 2015-16). A holistic ICT analysis is attached in Appendix C.
- Legal expense – real estate and commercial property law ($0.1M real increase from 2015-16). Seqwater accepts the QCA's finding.
- QCA fees ($0.6M pa from 2016-17). Seqwater agrees that $0.6M should be removed in each third year commencing 2016-17.

Electricity

QCA accepted Seqwater's baseline electricity costs and demand.

Escalation rates - electricity

QCA did not accept Seqwater's proposed escalation rates. Seqwater's proposal was based on advice from PricewaterhouseCoopers (PwC) using SKM MMA's electricity price for Queensland industrial customers under the medium scenario which resulted in nominal growth rates of 6.03% per annum for 2015-28.

QCA proposed electricity price escalation of 2.5% for 2015-18 and 2.7% for 2018-28. Whilst Seqwater does not agree with the QCA recommendations (particularly since average price rises for Brisbane from 2007 to 2013 were 11.2%), it will not challenge the outcome however notes that whilst price forecasts may moderate, they are unlikely to moderate to no real growth to FY18. Future electricity prices are very difficult to reliably predict and Seqwater is unable to offer any further evidence to that already provided.

Page 64 of the QCA report states that an annual increase in electricity consumption of 3% was applied to all of the forecasts and that this is in line with the Referral Notice. However Seqwater's demand figures vary between years with higher growth in the early years and later growth in the later years. Seqwater believes that these its demand growth rates which are used elsewhere in the report should be used for electricity consumption growth changes.

5. Regulatory Issues

Seqwater agrees with the general thrust of Chapter 8 regarding future reviews and other regulatory issues. In summary it recommends that Seqwater only bears operating cost risk over the regulatory period. All other costs (capital, cost of debt, etc) are subject to an end of period true up. The true up will review whether capital expenditure was prudent and efficient and incorporate actual revenues.

Operating cost can be adjusted for change in law, emergency events etc. at the end of period true up. Operating costs due to changes in source deployment have a more onerous requirement. The draft report notes that Government policy determines that the MWA's will have supply maximised should storages fall to 40% and that "in these circumstances, Seqwater has little control over the response as it is determined by Government". However outside of these specific circumstances the report notes that "to the extent that Seqwater can control costs associated with changes in the utilization and deployment of assets….Seqwater should not be compensated for any losses". In this context QCA is asked to consider clarifying expectations about what happens when the GCDP and WCRW ramp-up in later years.

QCA requires Seqwater to bear operating cost risk within the period. Seqwater seeks clarity regarding the application of Section 8.4.1 which reads at the moment that the true up is to actuals without reference to the separate treatment of operating costs.

Seqwater agrees with QCA when it noted that the true-up occurs through the updates to price path debt.

QCA also contemplates the next price review and sets out a timetable for the next review. Seqwater will commence planning to manage around these timeframes.

QCA also suggest the scope of this next review. Some of these items are helpful (e.g. rate of return) whilst others are a signal of a change in approach (e.g. indexation of prices at CPI versus a different (lower) approach).

In summary:

- Seqwater seeks clarity regarding section 8.4 in relation to the price path true-ups mechanism
- Seqwater seeks greater clarity regarding recommendations for altered provisions regarding cost risk and supply sources election, specifically regarding the approach to utilizing MWA's. Whilst this may not be an issue for the current period, it may mean in the future that some provision for switching to higher cost sources is made, either in the cost forecasts or otherwise

QCA Draft Recommendation 8.1

"Where Seqwater can demonstrate that it is unable to manage the impact of unexpected changes to water demand or supply which causes a change in revenue or prudent and efficient costs:

- **a material change be eligible for a mid-price path review**

- **where not subject to a mid-price path review, the change be recouped by an end-of-period adjustment."**

Seqwater notes this recommendation.

QCA Draft Recommendation 8.2

"Any unexpected changes to capex be addressed during an end-of-period review, and be subject to an assessment of prudency and efficiency"

Seqwater notes this recommendation.

QCA Draft Recommendation 8.3

"Seqwater bear operating risks other than those related to Review Events"

Seqwater notes this recommendation.

QCA Draft Recommendation 8.4

"Where Seqwater can demonstrate that it is not at fault for an emergency event which causes a change in revenue, or prudent and efficient costs:

- **a material change be eligible for a mid-price path review**
- **where not subject to a mid-price path review, the change be recouped by an end-of-period adjustment."**

Seqwater notes this recommendation.

QCA Draft Recommendation 8.5

"Where the impact of law or Government policy on water prices is unambiguous, it be automatically passed through by Seqwater to customers"

Seqwater notes this recommendation.

QCA Draft Recommendation 8.6

"Where Seqwater can demonstrate that it is unable to manage the impact of law or Government policy on bulk water prices which cause a change in revenue, or prudent and efficient costs:

- **a material change be eligible for a mid-price path review**
- **where not subject to a mid-price path review, the change be recouped by an end-of-period adjustment."**

Seqwater notes this recommendation.

QCA Draft Recommendation 8.7

"Where Seqwater can demonstrate that it is unable to manage the impact of feedwater quality which causes a change in revenue, or prudent and efficient costs:

- **a material change be eligible for a mid-price path review**
- **where not subject to a mid-price path review the change be recouped by an end-of-period adjustment."**

Seqwater agrees with this recommendation, noting that it generally has limited or no, capacity to mitigate events that affect feedwater quality and which consequently affect treatment costs

QCA advises that it is required to adopt the QTC forecast long-term cost of debt, currently 6.25%. Seqwater seeks clarity that QCA are specifying that a true-up to the actual cost of debt is a decision for Government at its next review.

QCA Draft Recommendation 8.8

"Seqwater recover the cost of debt advised by QTC"

Seqwater agrees with this recommendation, subject to clarification that there be a true-up to the actual cost of debt.

QCA has provided a substantive discussion regarding mid-price path reviews and recommends that any such action be determined by Government. Seqwater accepts that the practicality of the situation is probably best suited to a Government response. With its unusually high level of gearing and faced with other Government and regulatory restrictions it would probably require a complex or major set of circumstances that would require Government involvement.

Draft recommendation 8.9

"The need for a mid-price path review be determined by the Government"

Seqwater notes this recommendation.

Draft recommendation 8.10

"Seqwater report the actual price path debt and cost recovery position on a quarterly basis to QTT and DEWS"

Seqwater submits that this reporting should be at the most frequent on annual basis. This frequency provides for a meaningful assessment of the actual price path debt and cost recovery position, balancing the likelihood of a material change to these values over a short timeframe and the workload to meet regulatory reporting requirements (especially updating the RAB). Much operating and capital cost expenditure information is already available through existing Government reporting channels, however Seqwater notes that the actual price path debt and cost recovery position are not currently reported.

Draft Recommendation 8.11

"Seqwater may apply to the Government for a mid-price path review if changes in revenues and cost impact on estimated 2020-21 prices"

The use of 2020-21 prices only is confusing. QCA may mean 2018-28. On the proviso that that the dates are changed Seqwater notes this recommendation.

Draft Recommendation 8.12

"A future review of Seqwater's expenditure be completed by 30 April 2018"

Seqwater notes this recommendation.

Draft Recommendation 8.13

"The Government considers whether the scope of future reviews should broaden to include matters such as tariff structure, rate of return and demand forecasts"

Seqwater notes this recommendation.

Draft Recommendation 8.14

"The next scheduled review include an end-of-period adjustment for prudent and efficient costs and actual revenues"

Seqwater notes this recommendation.

Draft recommendation 8.15

"The end-of-period review only reconcile costs and revenues that correspond to risks borne by customers"

Seqwater notes this recommendation.

Scheduled Future Reviews

Seqwater appreciates QCA addressing the issues of scheduled future reviews, especially regarding potential timing. Seqwater agrees that the scope for future reviews is essentially matters for Government policy decisions. However there are some matters raised by QCA with which Seqwater concurs.

Seqwater agrees that a five year regulatory period is appropriate for the period following the current 2015-18 price path. The tariff structure is in need of review given the largely fixed nature of its costs. It would be appropriate for the cost of debt rate of return to be reconsidered and whether escalating prices by inflation only is appropriate.

Seqwater agrees that mid-price path reviews should only be required in limited circumstances and that an end-of-period review with zero thresholds satisfies the desire to minimise the regulatory burden whilst providing a fair and reasonable outcome for Seqwater and its customers.

6. Pricing Issues

QCA has addressed a number of pricing issues in Chapter 7 of its draft report. Seqwater has an interest in the pricing in ensuring that it meets the requirements of the Referral Notice in allowing the recovery of efficient and prudent costs incurred between 1 July 2008 and 30 June 2028 and the repayment of price path debt by 2027-28.

Along with the process currently underway and subject to a continuation of the current proposed approach (including true-ups to actuals) as provided for in other sections of the QCA draft report, Seqwater is satisfied that these objectives are being met.

The issues of the various price paths amongst different Local Government areas and the timing of reaching a common point are policy issues for Government and Seqwater makes no comment on these matters.

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Appendix B: Somerset Dam Stabilisation Project

Appendix C: Information and Communications Technology

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