QUEENSLAND UrbanUtilities

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Dr Malcolm Roberts
Chairperson
Queensland Competition Authority
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(sent via water@qca.org.au)

Dear Malcolm

Submission to the Staff Working Paper for the SEQ Retail Water Annual Performance Monitoring Framework

Thank you for the opportunity to provide comment on the Queensland Competition Authority (QCA) SEQ Retail Water Annual Performance Monitoring – Guidance Paper (Guidance Paper). We acknowledge the significant amount of work that has been undertaken thus far in developing the proposed framework from 1 July 2015.

Queensland Urban Utilities (QUU) understands the importance of effective economic regulation. It ensures that the long-term interests of customers are protected and that the long-term financial viability of distributor-retailers (DRs) is maintained.

QUU acknowledges the movement towards a lighter-handed framework, which in itself requires some degree of regulatory discretion. However, QUU considers that more clarity is required from the QCA on how the framework will be implemented in practice.

The primary concern for QUU at present is that pricing decisions for 2015/16 are currently being considered by Boards and there is no finalised regulatory framework for 2015/16 and no final guidance on the cost of capital methodology. These significant uncertainties pose risks when considering pricing decisions as QUU is unsure of the detail on how it will be assessed in an ex-post regulatory environment.

While this Guidance Paper provides further information on the specific information required under Levels 1 and 2 of the proposed framework, further clarity is being sought by QUU on the details of some key decision points and the analysis that may be subsequently undertaken by the QCA.

The most significant concern that QUU has with the proposed framework is that the QCA is yet to provide a final position in relation to its preferred weighted average cost of capital (WACC) methodology. Given that the value of the WACC estimate has a material impact on the calculation

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of the maximum allowable revenue (MAR), this has caused uncertainty with regard to price setting for the upcoming year.

The QCA states in the Guidance Paper that the calculation of any under/over-recoveries will be based on its Reference MAR, which will use the QCA's Benchmark WACC. Therefore if a business intends to maintain a QCA verified under/over balance there is no benefit in the business proposing an alternative WACC for pricing purposes, as stated as an option by the QCA.

QUU's main concern with the proposed QCA methodology for setting the WACC is the potential for significant swings in the WACC leading to volatility in customer pricing. Given this QUU proposes that:

- The QCA adopt the trailing average approach to calculating the cost of debt as this will mitigate against significant short-term movements in the debt market (while this would result in annual updates to the estimate, the magnitude of the adjustments would be lessened due to the trailing average approach). This corresponds to QUU's internal debt management strategy.
- Adopt an independent long-term estimate of WACC which would remove any price risks from short-term movements in the markets.

If the QCA's view is that there is insufficient merit in using an average approach for setting the WACC for the water business, QUU requests that the QCA provide the benchmark WACC and remove the current uncertainty.

Volatility in the WACC can be managed to a more limited extent using an under/over-recoveries balance. However, the usefulness of this compared to an average WACC is dependent on both the timeframes for managing the balance and the method used by the QCA in reporting the balance.

It is unclear as to how the under/over-recoveries will be incorporated into the MAR calculation. QUU's view is that any under or over-recoveries should be incorporated as a building block within the calculation of the MAR for the particular year – i.e. the MAR for 2018/19 includes the carry forward under/over-recoveries balance at the end of 2017/18.

In looking at other jurisdictions, the Australian Energy Regulator's (AER's) post-tax revenue model implies that under or over-recoveries resulting from the previous regulatory control period are incorporated as a revenue adjustment in the building blocks calculation.[1] This would align with QUU's view above.

The remainder of this letter addresses some of the other issues that require clarity from the QCA, while a list of more detailed comments is included as an appendix.

QCA Reference MAR

QUU is unclear as to what will happen to the calculation of the Reference MAR where the QCA does not accept some aspect of the businesses' actual costs. QUU is seeking an explanation from the QCA as to the process for:

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[1] See Row 193, Sheet PTRM input of AER's Post-Tax Revenue Model

- excluding certain costs from the Reference MAR
- how this will impact on future updates of the Reference MAR and
- how it would impact on the incorporation of any X-factor to the Reference MAR

The QCA states that where a business submits information based on levels 3 or 4, it will adjust its Reference MAR to account for this information where appropriate. However the QCA then state that it will apply the X-factor to the revised MAR – it is not clear why the QCA would necessarily be applying the X-factor.

Furthermore, the QCA needs to further outline (through worked examples) how the outperformance incentive would be calculated and incorporated with any updating of the Reference MAR. It is unclear whether the outperformance incentive would be automatically applied by the QCA if a business submitted cost information that complied with the incentive, or whether it would only be applied through application from the business.

Calculation of the average price increase

There are a few issues that need to be considered when using a threshold of average price increases where the calculation is based on revenue and demand.

Firstly, the QCA needs to be aware of other factors that impact on the inputs that the QCA propose to use in the 'average price' calculation. The information is based on actual results for the year, however there are a number of things that can impact this, such as retrospective billing and that the connected properties collected under Service Quality indicators are end of year figures not the mid-point of properties for the year.

Secondly, the following diagram highlights the issue of having a simple average price calculation (based on QUU's interpretation of the Guidance Paper) based on revenue and demand. Under this stylised example, the revenue is completely driven by water usage and the business applies an inclining block tariff. From Year 1 to Year 2, the price does not change, however the demand profile has changed slightly whereby one customer is now paying for one unit of water in the 2nd volumetric tier. This impacts both demand and revenue for Year 2. It can be seen from the table below that under the QCA's proposed approach to calculating the change in the average price, this example would result in an outcome where the business could potentially breach the threshold even though prices have not changed. The calculation shows that the business has increased its average price across the business by 1 or 2 per cent (depending on if you use the constant demand proposed by the QCA). This is even though the business has applied a price freeze from Year 1 to Year 2.

Demand	Year 1	Year 2	
1st Tier	100	100	
2nd Tier		1	
Total	*100*	*101*	
Price			
1st Tier	1	1	
2nd Tier	2	2	
Revenue	100	102	
Average Price			
Simple Calculation	1	1.01	1.0% increase
QCA (constant demand)	1	1.02	2.0% increase

The QCA's proposed approach of using consistent demand numbers (Year 1), actually results in a higher distortion of the calculation (seen at the end of the diagram).

Further to this, the approach put forward by the QCA in the Guidance Paper appears to be different to the approach put forward in the SEQ Retail Water Long-Term Regulatory Framework – Annual Performance Monitoring, Final Report (Report), creating further confusion in terms of how the QCA will calculate the measure for this threshold test.

This is an important aspect of the framework as it is the key determinant to whether the business is required to provide a greater degree of information to the QCA. Therefore Queensland Urban Utilities proposes that the QCA provide worked examples of how it intends to calculate the changes in average price.

In addition the Guidance Paper is silent on how the QCA would treat a breach of Level 2 at one service level, water or sewerage, due to tariff reform or rebalance of service tariffs. QUU suggest a further check of a threshold breach be adopted based on an average over both services based on properties.

Justification requirements for breaches

The Guidance Paper provides further detail on the information requirements for situations when businesses do not breach Level 2 of the proposed framework. What QUU is seeking however, is what level or type of justification is required for the QCA when the Level 2 threshold is breached. This aspect of the framework is one of the key determinants of whether the proposed regulatory framework would actually result in a lighter-handed regulatory framework or not.

If for example there is a significant capital project commissioned in the year of review, what information is required given that a review of prudency and efficiency is not to be conducted?

If the business and the QCA have different understandings of the level of justification required to satisfy the QCA of the reasons of any breach this could potentially result in a heavier-handed framework than what is intended. QUU understands that the QCA cannot specify all variations of potential breaches prior to the start of the framework, however the development of guiding criteria would assist in creating a more common understanding.

In order for the framework to operate as it is intended (light-handed), it is QUU's view that the boundaries of the framework and the rules under which it will be implemented need to be clearly established to reduce any confusion and uncertainty. While this may require additional work up-front, this will lead to a more effective regulatory framework that allows for a greater sense of 'self-regulation' and thereby limiting any unnecessary regulatory burden during times of assessments.

If you have any queries in relation to this submission please contact Fiona Anderson on (07) 3855 6159.

Yours sincerely

Louise Dudley

LOUISE DUDLEY
Chief Executive Officer
Queensland Urban Utilities

cc. George Theo, CEO, Unitywater

Enc. Appendix: Detailed Comments

APPENDIX: DETAILED COMMENTS

Page	Reference	QUU Comment	Purpose
Page 3	CPI	The reference to the RBA forecast being used for prices and **costs** conflicts with page 27 point (d) which implies that costs (RAB roll-forward and MAR) will use actual CPI that is, there is a difference. QUU takes actual CPI to be ABS All Groups Brisbane CPI March to March as per previous regulatory framework. Are the below statements correct in regards to the use of CPI in the recommended framework? • Prices CPI is based on the RBA inflation forecast or the mid-point of the RBA forecast from the February Statement of Monetary Policy. • Actual costs are assessed against CPI based on ABS All Groups Brisbane CPI March to March.	Clarity
Page 4	"Retailers would be required to submit **policy** documentation relating to any tariff changes."	This statement is not required as the intent is covered under Level 1 Pricing Principles, plus it introduces the term **policy** which has not been used in the Report.	Clarity
Page 5	Monitoring subsequent year's prices. The QCA will note the price increases, to provide timely information to customers. etc	This is new since the Report and should not be introduced into a Guidance Paper. Also QUU questions how this will provide timely information to customers, as they will have already received several bills at the new prices prior to the QCA draft reports release. Are the business expected to provide the prices?	New
Page 9	Retailers to submit annual performance against the indicators below.	QUU notes that this is a change from the Report as previously QCA was to collect these from DEWS.	Noting
Page 13	Step 2 Performance over time	Consideration needs to be given to how the moving average will be reported if a target is set to a higher service level, and the first year of the new target meets the target but the moving average does not.	Clarity

		Use of the terms "above and below" need adjusting for clarity as it implies higher results for all targets is better.	
Page 14	Step 3 Performance against other providers	How will varying targets be managed in reporting across businesses. A business may appear to be below others but are meeting their target. Charts need reference to targets.	Clarity
Page 14	Step 4 - Overall assessment First paragraph	States first three steps summarised but then refers only to 1 and 2.	Editorial
Page 18	The Annual Performance Monitoring Report referred to using the Paasche index	Information on revenues by residential customers is not sufficient to calculate the average prices using this particular index. As outlined in the above letter, QUU has concerns with the calculation of an average price change and wants clarity on how the QCA plans to calculate the average price using previous year volumes?	Clarity
Page 19	"This reference MAR will be used, when necessary, to compare total revenues to total efficient costs, **and to estimate unders and overs balances."**	What use is this estimate if businesses have to supply cost information to claim unders and overs? (Page 27) Thereby over-riding the QCA's calculated Reference MAR.	Clarity
Page 20	Use of the term the QCA **may** update its Reference MAR …	Is the **may** only related to "The QCA would need to be satisfied with the retailer's performance in customer engagement, strategic investment planning and service quality."	Clarity
Page 24	Cost categories	What are the consequences for updating the Reference MAR of not providing opex split into all the cost categories?	Clarity
Page 25	Ministerial Direction to set prices	Is this intended to be a separate Direction to the one to conduct Performance Monitoring	Clarity
Page 25	Price determination without costs of service review	Need to add "and" between a) and b), as a) alone does not warrant a cost of service review.	Clarity

		Timing for submissions for a Price Determinations are very short, is it correct to assume that the business is not to have a significant role in providing information for the Determination such as would occur in a standard Price Determination? In the Report, the QCA indicated that it would freeze prices at CPI while it was undertaking a deterministic review – QUU is seeking clarity on how this fits into the timeframes outlined in the Guidance Paper.	
Page 26	The cost of service review may, at the QCA's discretion, apply to the monitored year, the next year or the following year.	This is new since the Report and should not be introduced into a Guidance Paper.	New
Page 27	Approach to unders and overs Statements before and after dot points a) to d)?	Reference to updating data from the QCA's 2013-2015 review is only for 2014/15, this should include 2013/14. What is the difference between the apparent conflicting statements on publishing estimated unders and overs?	Clarity
Page 27	How will QCA maintain an unders and overs balance? "The QCA would **verify** the costs…"	What does this mean, given that there is no prudency and efficiency review? Can cost information supplied as the roll-forward of the RAB and operating costs either voluntarily, or as part of Level 3 or Level 4 be considered sufficient to update the Reference MAR?	Clarity
Page 28	Once QCA has incorporated these costs items it would not revisit them unless there is a material change.	If based on actual costs, these will not change once signed off therefore what is meant by material change?	Clarity
Page 28	Practical issues with Outperformance	Retailers need an example template of how calculations will be managed. How will the following be managed: • Cost reduction in one year that is not ongoing, eg due variation in expensed	Clarity

		investment items such as information technology; • Years where the retailer has passed on some of the cost savings but not all	