

From: Ross Muir [REDACTED]
Sent: Tuesday, 10 July 2012 4:36 PM
To: Angus MacDonald
Cc: Matt Bradbury; Adam Kay-Spratley; Colin Nicolson; Damian Scholz
Subject: Mortonvale Contract matters

Angus

This morning you raised three questions/issues re Mortonvale Pipeline:

1. Whether or not Seqwater is able to apply a 'part c' charge to Mortonvale Pipeline customers (Question 1)
2. The costs recovered under the capital charge for the Mortonvale Pipeline, and whether there is potential for double recovery of renewals costs if a renewals annuity is included in the lower bound reference tariffs (Question 2);
3. How the QCA should deal with a termination fee for Mortonvale given the existing contract has very specific provisions already allowing for early termination (Question 3).

I understand you are drafting the Regulatory Framework chapter this week that relate to these issues, so we have attempted to provide you some responses ASAP. Please consider these our initial responses to these matters. Please note we have not been able to obtain a legal review of the matters raised or our response.

We would also appreciate the opportunity to review the regulatory framework chapter before it is finalised for the draft report.

Please don't hesitate to call if you have any questions or if we have misunderstood the issues raised.

Cheers

Ross.

Question 1.

Seqwater understands this question arises from one possible reading of the Mortonvale contract, clause 5.1(b), which states the customer must pay "*Water charges prescribed for the supply of water from Lake Clarendon as determined annually under the Water Resources (Rates and Charges) Amendment Regulations or subsequent legislation.*"

This matter was addressed in 2004 in a letter to customers from SunWater (attached). In short, this letter states that subsequent legislation is now in place – namely the Rural Water Pricing Direction Notice, and that prices directed under this notice now apply in relation to 5.1(b). Please note that this Direction Notice was amended and updated and a direction remains in place today (ie the Rural Water Pricing Direction Notice (No 1) 2011).

Seqwater also notes that the 2006 SunWater review set tariffs for Mortonvale that were bundled, but included the lower bound pipeline costs as well as Mortonvale's share of bulk

water costs in the Central Lockyer. This accords with our understanding of pricing practices since the 2000 water reforms, where the original *Rural Water Pricing Direction Notice (No 1) 2000* was made. Therefore, historic practice for at least the past 12 years has been to include the lower bound costs of the pipeline, along with Mortonvale's share of bulk water costs in the Central Lockyer, into lower bound reference tariffs for Mortonvale. Price paths and CSO for Mortonvale were set based on these reference tariffs.

It is also implausible that the contract would have been intentionally made to exclude any recovery of lower bound costs in 1995, given COAG had just established clear national water pricing principles in 1994. These principles for rural water were:

1. that where charges do not currently fully cover the costs of supplying water to users, agree that charges and costs be progressively reviewed so that no later than 2001 they comply with the principle of full-cost recovery with any subsidies made transparent consistent with 3(a) (ii) above;
2. to achieve positive real rates of return on the written-down replacement costs of assets in rural water supply by 2001, wherever practicable;
3. that future investment in new schemes or extensions to existing schemes be undertaken only after appraisal indicates it is economically viable and ecologically sustainable;
4. where trading in water could occur across State borders, that pricing and asset valuation arrangements be consistent;
5. where it is not currently the case, to the setting aside of funds for future asset refurbishment and/or upgrading of government-supplied water infrastructure

Refer http://www.coag.gov.au/coag_meeting_outcomes/1994-02-25/docs/attachment_a.cfm

Accordingly, we do not believe it is necessary for the QCA to examine this matter in its draft or final report. Indeed the QCA should be cautious about taking a view on the contract terms when this is ultimately a matter between Seqwater and its customers.

Question 2.

Seqwater has already made attempts to find definitive information setting out how the capital charge was calculated, but has been unsuccessful.

Nonetheless, Seqwater is satisfied that the capital charge was set to recover the original capital cost of the pipeline, and did not include any allowance for future cost recovery such as renewals expenditure. This view is supported by:

- a) the descriptions in the contract itself, namely payment of an 'annual capital contribution' to the 'capital cost of the distribution network' ((5.1(a));
- b) the fact that prices were set in 2000 that included a price path towards lower bound cost recovery at the pipeline, in addition to the capital charge; and
- c) the fact that the price review in 2006 continued to include lower bound costs of the pipeline into the cost base for pricing purposes.

Also, there is no double-recovery between the depreciation and return on asset component implicit in the capital charge, and the renewals annuity. Importantly, the renewals annuities were first set in 2000 at zero opening balances, meaning the original cost of the Mortonvale Pipeline was not included in the renewals calculation. Rather, the renewals annuity recovers forward-looking costs of asset renewal and rehabilitation. It does not recover the original investment in the distribution pipeline.

In closing, Seqwater submits there is insufficient evidence to support a different interpretation to that which has existed historically. This long-standing interpretation is that the capital charge was set to provide an annual capital contribution to the capital cost of the pipeline, and did not include any allowance for ongoing renewals.

Question 3.

The contract provides rights to the customer to terminate the contract at any time by “*early redemption of the capital component in accordance with Section 9 of this Agreement or by other arrangements as agreed to by the Corporation*”. Under Section 9.1, the customer can discharge their obligations to pay the capital charge (levied under Section 5.1(a) through a single payment). The contract sets out a calculation for this payment.

In Section 9.2, the contract states “*From the date this payment is made, the Proprietor shall be liable only for the Annual Water Charge as set out in Section 5.1(b)*”. As indicated in our response to Question 1 above, Seqwater expects that the prices set as a result of the QCA’s review and subsequent Direction Notice to Seqwater (parts A, B, C and D) for Mortonvale are relevant to S5.1(b). Accordingly, a termination fee can be set that relates to these tariff components for the pipeline (being part C) in addition to the termination fee for the capital charge.

In closing, if a customer was to terminate access in the pipeline, they would pay:

- A termination fee for the capital charge levied under 5.1(a), as calculated in 9.1 of the contract; and
- payment of a further termination fee in relation to the charges under 5.1(b), and specifically the fixed charge for the distribution system (part c) subject to the terms of the contract allowing this to occur;
- Part A and B in relation to bulk water services, annually (assuming they continued to hold the WAE).

Seqwater has a mandatory Alcohol and Other Drug screening program in place at our worksites. All employees, contractors and visitors to Seqwater sites may be randomly selected to participate in Alcohol and Other Drug testing. By entering any Seqwater site, you agree to submit to random testing. These processes are explained further in the Seqwater Conducting Alcohol and Other Drugs Procedure and the Seqwater Managing Alcohol and Other Drugs Procedure.