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The Chief Executive Officer
Queensland Competition Authority
G.P.O. 2257
Brisbane Qld.4001

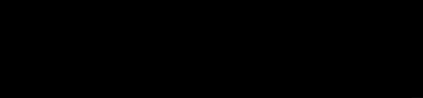
Re: Draft Report SEQ Interim Price Monitoring for 2010/11-Part B

Dear Sir/Madam,

The Queensland Competition Authority (QCA) has invited public comment regarding its Draft Report SEQ Interim Price Monitoring for 2010/11-Part B (the Report). Please consider this supplementary submission providing a copy of the correspondence cited from the Queensland Ombudsman in support of the assertion appearing paragraph 7 of page one of my letter dated 25 February relating to Treasury's advice to the Ministers QCA in late 2006.

Paragraphs 5 and 6 of page 2 of the Ombudsman's correspondence dated 16 November 2009 address this matter.

Yours sincerely,



R.J. Koerner

Cc: Letter Queensland Ombudsman Ref: 2009/01549 dated 16 November 2009.

- 3 MAR 2011

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Our ref: 2009/01549

16 November 2009

Mr Richard Koerner
31 Fauna Terrace
COOLUM BEACH QLD 4573

Dear Mr Koerner

Your complaint against the Sunshine Coast Regional Council

I refer to your complaint to us about the Sunshine Coast Regional Council's (Council) water and sewerage charges for Maroochy Water Services (MWS).

I have now completed my preliminary inquiries in relation to your complaint with Council and Queensland Treasury (Treasury) and write to advise you of my preliminary views.

Background

MWS was declared a government monopoly business activity under Part 3 of the *Queensland Competition Authority Act 1997* in June 2001.

In late 2001 the former Maroochy Shire Council (MSC) commissioned a review of MWS water and wastewater prices to ensure MWS were setting prices in accordance with legislative and regulatory requirements. MWS water and wastewater prices were frozen at their 2001-02 levels while the study was undertaken. The outcome of the preliminary pricing investigation was presented to MSC and the MWS Advisory Board in March 2003. It highlighted a number of areas that required further study prior to any decisions being made on MWS pricing levels, including an optimisation assessment of water and wastewater assets.

The MWS Advisory Board also made a recommendation in March 2003 that a concern be expressed to MSC that the pricing assumptions in the 2003-04 Business Plan budget had the potential to cause MWS to exceed Queensland Competition Authority (QCA) revenue guidelines. Whether the MWS Advisory Board's recommendation was related to the outcome of MSC's preliminary pricing investigation into MWS is unknown.

In May 2003 the Coolum Beach Progress and Ratepayers Association wrote to the Minister for Local Government and Planning requesting MWS service charges to be independently investigated by an appropriate state government agency. The concerns expressed included:

- the valuation of MWS's asset base (in particular, sewerage assets and level of working capital)
- high water and sewerage charges in comparison with other councils, and

- a loss of transparency in financial reporting following MSC's decision to dissolve the MWS Advisory Board.

The Coolum Beach Progress and Ratepayers Association's request was forwarded to Treasury in December 2003, and in February 2004 MSC was advised Treasury had made a decision to investigate MWS pricing levels.

MSC had undertaken further work on its own pricing investigation between March 2003 and February 2004, including a revaluation of MWS assets and a review of the rate of return on capital. However, following Treasury's advice it decided to cease work on its pricing investigation until the complaint was resolved. The price freeze at 2001-02 levels was maintained.

Treasury's investigation was completed in mid 2005. It found that MWS's actual rate of return on assets varied between 7.7 to 9.0 per cent over the years 2000-2003 and that this rate of return was not excessive and was within the reasonable range, although at the high end, when compared with a range of reasonable returns of 8.0 to 8.6 per cent.¹

On the basis of the outcome of Treasury's investigation, in June 2005 the Ministers for the QCA made a decision not to refer the issue of MWS service charges to the QCA but instead recommended that the MSC commission an optimisation study to ascertain whether the MWS asset base needed to be adjusted. In coming to their decision the Ministers noted Treasury's advice that the revaluation of MWS assets in 2003 and the extent of optimisation applied in the analysis was considered fair and reasonable by MSC's external auditors and consistent with accepted regulatory methodology. The Ministers' decision was to remain subject to review.

MSC advised Treasury in May 2006 that the optimisation study would be commenced in June 2006 and expected it to be completed by December 2006. However, in December 2006 MSC advised Treasury that it had decided not to prepare the optimisation study due to anticipated reforms to water arrangements in South East Queensland and limited organisational capacity/resources.

Upon receipt of MSC's advice, Treasury recommended to the Ministers for the QCA to reconsider referring MWS to the QCA for a prices oversight investigation. Given the substantial reforms occurring for local governments and water services across South-East Queensland, in August 2007 the Ministers for the QCA decided not to refer the matter to the QCA on the grounds that MWS's retail operations and charging would be reformed and monitored as part of institutional reforms to water supply in South East Queensland.

MWS was consolidated into Sunshine Coast Water (SCW), a commercial business unit of Council, following the local government amalgamations in March 2008 in which MSC was amalgamated with the former Noosa City and Caloundra City Councils.

As part of the South East Queensland water reforms the State assumed ownership of all bulk water supply, transport and water treatment functions of MWS in early 2008 resulting in Council having to purchase bulk water from the new SEQ Water Grid Manager (a State statutory authority) from 1 July 2008 at a substantially higher price set by the Queensland Water Commission.

¹ No analysis was made by Treasury of the allegations of a loss of transparency of financial reporting as this was outside the scope of Treasury's analysis.

From 1 July 2010 the following responsibilities will cease to be Council's responsibility and will be placed in the hands of a local government owned retailer which is a separate legal entity from Council:

- sell water supply and sewerage disposal services to Sunshine Coast households and businesses
- purchase treated water from the SEQ Water Grid Manager
- contract and pay the new distribution entity² to deliver water to their customers, and
- contract and pay the new distribution entity to collect, treat and dispose of sewerage from their customers.

Your complaint

Your complaint is that Council has failed to perform:

- its statutory prices oversight obligations when setting MWS water and sewerage charges for the 2008-09 financial year and developing forward estimates of MWS water revenue, and
- the optimisation study of MWS recommended by Treasury in 2005.

You allege as a result of the above that MWS service charges are set above the ceiling level limits permitted by the *Local Government Act 1993* and the *Local Government Finance Standard 2005* for commercial business units that are also natural monopoly service providers.

Material considered

In the course of my review of your complaint I have considered your submissions in your correspondence to us, the documents you have provided, and Council's and Treasury's responses to my preliminary inquiries.

Council's response

Council's position is that its water and sewerage prices setting methodology is consistent with legislative requirements and that it is actually undercharging in relation to full cost recovery. Council also considers that the optimisation study is no longer relevant in the context of the current reforms to water supply arrangements in South East Queensland.

Council believes its position is demonstrated by the following:

- Investigations by Treasury over the period 2003-05 found that MWS prices were not excessive with a return on assets at an acceptable level
- Council was not required to undertake any further action in relation to the optimisation study proposed by Treasury following discussions in 2006
- The independent business valuation conducted by the Queensland Government for stage 1 of the water reforms found no basis for overcharging and actually made an upward adjustment to revenues for the valuation process
- QCA's 2008 Retail Price Monitoring Investigation in the South East Queensland Urban Water Sector identified no issues in relation to Council's attribution of increases in water prices.

² The new distribution entity will own all water and sewerage distribution infrastructure and be a separate legal entity from Council whose shares are owned by Council and the Moreton Bay Regional Council.

Water and sewerage charges

In the period 2001-02 to 2007-08, MWS water consumption charges:

- remained the same from 2001-02 to 2005-06
- increased in 2006-07 to offset negative revenue impacts associated with reduced water demand, and
- increased in 2007-08 by CPI ahead of the bulk water assets takeover by the State Government.

The relevant price increase was 0.87/kL to 0-300kL = \$0.95/kL and >300kL = \$1.30kL.

In the same period, MWS wastewater charges:

- remained the same from 2001-02 to 2003-04
- increased over the period 2004-05 to 2006-07 as a result of the implementation of a new wastewater pricing policy (which reduced the extent of revenue collected from non-residential customers) and to offset negative revenue impacts associated with reduced water demands, and
- increased in 2007-08 by CPI ahead of the bulk water assets takeover by the State Government.

The relevant price increase was \$451.70 to \$494.00.

No price increases during the period 2001-02 to 2007-08 were made to increase revenue. Comparative information of MWS water prices with median South East Queensland prices over these years also shows that MWS water prices were well below average in the region, although MWS wastewater prices were slightly above average.

In the 2008-09 budget Council 'harmonised' the water charging structure from the three previous different charging structures applied by the former councils. Leading into the budget process Council reviewed the revenue levels and anticipated full cost recovery targets to evaluate each former council's full cost recovery position. The assessment indicated that to reach a full cost recovery pricing position consolidated Council water and wastewater revenues needed to be increased by 28 per cent. In relation to the MSC area, the extent of increase was 7 per cent for water and 37 for wastewater. If an optimisation study was undertaken and the asset base reduced by 10 per cent the extent of increases were still 4 per cent for water and 32 per cent for wastewater. This assessment utilised the price path to full cost recovery using asset values based on audited financial information. The increases reflect the fact that despite considerable increases in capital and operating costs, the period in which MWS water and wastewater prices were frozen resulted in MWS revenues not being able to keep pace with the level of full cost recovery and they therefore declined considerably in real terms.

Council also took into account the impact of the South East Queensland water reform process when setting prices for 2008-09. As part of the compulsory acquisition of bulk water assets of Council (including MWS) an independent valuation of the assets of the water business was undertaken by the State Government. This was used to determine compensation to be paid to Council as well as the basis for Council's future shareholding in the distribution business and future retail water prices across South East Queensland. In order to ensure that prices were consistent with this methodology, Council adopted price increases for water and wastewater on the basis of recovering:

- the increase in bulk water charges from the State Government
- the increase in operating costs incurred as a result of cost inflation

- any additional capital investment made in infrastructure required to service the region.

The extensive due diligence process associated with the State Government acquisition of bulk water assets did not identify any concerns regarding MWS pricing levels relative to full cost recovery. In fact, an upwards adjustment was made to utility charge revenues in the business valuation process by the State Government to reflect the negative impact on business profitability (relative to full cost) of the pricing investigation undertaken between 2003-05 and Council's freezing of prices for a considerable period while the investigation was being undertaken.

The shareholder return on capital for the former councils' water businesses is reported in Council's 2008-09 Financial Statements as:

- CalAqua - \$1,809,000
- Noosa Water Services - \$1,810,000
- MWS - \$20,000,000.

The reasons for this are twofold. First, the shareholder return is based on assets not connections and the amount of bulk water assets transferred from Council to the State Government for each area was different (MWS was 4 per cent, CalAqua was 11 per cent, and Noosa Water Services was 20 per cent) resulting in the percentage for calculating the asset base for MWS being higher than the other two. Second, prior to the amalgamation Noosa Water Services and CalAqua had a much lower rate of return than MWS of between zero and 1 per cent.

Optimisation study

Following Treasury's request in June 2005 Council undertook network analysis for water supply and system capacity evaluations for certain wastewater catchments and additional studies into the appropriateness of internal service charges and other matters. Communication also continued between Council and Treasury regarding certain pricing principles during this time.

Detailed terms of reference were developed by Council and sent to selected tenderers in September 2006. The terms of reference required careful consideration by Council given that no regulatory precedent had been set by the QCA. The QCA indicated to Council it was unable to review or 'sign off' on the terms of reference due to a potential conflict of interest should it be requested to undertake the study. A successful tenderer was selected by Council in October 2006 at a cost in excess of \$100,000.

However, the process was then halted due to the South East Queensland water reforms takeover of bulk water assets from Council by the State Government and transfer of Council's remaining water assets to a new entity. Council met with Treasury in December 2006 to discuss the issue and the outcome of the meeting was that Treasury would advise Council in writing of whether an optimisation study was still required. Council followed up with Treasury in early 2007 and was informed that the Treasurer was still considering the matter. It has received no correspondence from Treasury regarding the matter since.

Council considers there would be no benefit to the community if the optimisation study was undertaken now given the South East Queensland water reforms.

Treasury response

Water and sewerage charges

Treasury has not taken any further monitoring or review of MWS's water and wastewater charges since it recommended the optimisation study in June 2005. It does not have access to sufficient information to provide an opinion on the 2008-09 charges. Further, with the amalgamation of MWS into Council, water and sewerage charges for 2008-09 would be considered for Council, not the historic local government areas with the larger region.

In July 2008, the QCA undertook a study of the prices of the 10 amalgamated South East Queensland local government water businesses supplied with bulk water by the SEQ Water Grid Manager. The scope of the QCA's investigation was restricted to reconciling retail charges to the increased cost of bulk water only, specifically:

- the extent to which increases in retail water prices were attributed by local governments to increases in bulk water grid costs, and
- whether the attributed increases went beyond that required to recover the increase in bulk water grid costs.

The results of the QCA's investigation were publicised in *Final Report Retail Price Monitoring on the SEQ Urban Water Sector Sunshine Coast Regional Council* (QCA Final Report).

The QCA Final Report indicated that while there was only a 2 per cent change in the bulk water price from 2007-08 to 2008-09 (\$683/ML to \$700/ML) residential water bills for households consuming 250kL per annum in the MSC area increased 18 per cent (\$390 to \$460). Based on Queensland Water Commission data the QCA's opinion was that bulk water increase for Council would have added \$9 to the 2008-09 water price. Council disputed the QCA's assessment and argued that the significant increase in its bulk water price (beyond that estimated by the Queensland Water Commission³), combined with inflation impacts, fall in water consumption, and the impact of the Maroochy price freeze, justified an even greater increase in water prices than those adopted by Council. Council also said that the Queensland Water Commission's bulk water price estimate of 2007-08 was not reflective of Council's actual cost/price and that comparisons could not be made between the residential water bills of Council and the three previous councils due to the adoption of uniform pricing by Council.

The findings of the QCA's Final Report were:

1. Council had made a number of statements in relation to increased costs resulting from the water reform process but had not attributed any specific portion of the increase to the retail water price to the increase in the bulk water price in its official budget documentation of media releases.
2. The QCA was unable to assess whether the attributed increase to retail water prices went beyond those required to recover the increase in bulk water prices as Council did not make a clear and unambiguous attribution of the specific portion of the retail water price increase to the increase in the bulk water price.

³ The Queensland Water Commission's estimate of the 2007-08 bulk water price was \$683/ML where Council considered that the bulk water price was closer to \$575/ML.

Optimisation study

Treasury's strong view is that an optimisation study of MWS no longer remains a relevant factor for Council and would not provide value in the current water reform process for South East Queensland.

In 2007, Treasury engaged KPMG to conduct a whole-of-supply-chain asset valuation based on a discounted cash flow methodology. This valuation was used to establish the value attributable to bulk assets designated for transfer to the new State-owned bulk water authorities. The asset valuation and regulated asset bases for the to-be-created distribution and retail entities is likely to be based on the KPMG valuation model, although this matter is still being discussed.

Previous advice from the Queensland Water Commission and Treasury to the Council of Mayors – South East Queensland has been to caution that it would not be in the public interest for a wide-spread revaluation of existing assets, which do not provide any additional service potential for consumers, to be the basis for a material price increase. Council of Mayors – South East Queensland has also been advised that the State Government will take a strong view that owners of existing water supply assets should not be taking actions that will result in substantial price shock for consumers, given the unavoidable price impact associated with the infrastructure under construction to respond to the Millennium Drought and secure the future supply necessary to provide for the region's growth.

Discussion

Water and sewerage charges

Your concerns about the MWS service charges for the 2008-09 year are based on what you claim to be manipulation of the value of the MWS regulatory asset base and an excessive shareholder return on capital. You have alleged that Council has not followed the correct method in calculating the regulatory asset base – in particular, that it has not deducted debt allowing Council to double recover on what is a financing element of operating costs. You have also alleged the regulatory asset base data provided by Council to Treasury in 2004 was inflated and created a false picture of the shareholder return on capital (which was in reality much larger because of the actual smaller value of the regulatory asset base) and that the Treasury study is therefore flawed and cannot be relied upon.

Subsequent to your original complaint, you have also requested us to investigate Council's 2009-10 water prices as the budget papers indicate the return of the regulatory capital base for SCW will amount to \$26.5M – an increase on the \$24M total in the 2008-09 budget – whereas you estimate the permissible return is around \$10M. You have further suggested we should reconsider our decision not to investigate the Coolum Resident's Association's earlier complaint to us (reference no 2007/12552) relating to water prices for MWS for previous years as special circumstances prevented you from bringing that complaint within time.

After consideration of your submissions and Council's and Treasury's responses to this issue, my preliminary view is that there is insufficient evidence on which I could form an opinion that Council's actions in relation to its calculation of the regulatory asset base of MWS, and the affect of this calculation on water and wastewater service charges for 2008-09, are unlawful, unreasonable, unfair or otherwise wrong. My reasons for this are as follows.

1. Council's revaluation of MWS assets in 2003 was the result of its own internal pricing investigation undertaken to ensure that Council was complying with its legislative requirements.
2. The 2003 revaluation of MWS assets and the extent of optimisation applied in the analysis was considered fair and reasonable by Council's external auditors and consistent with accepted regulatory methodology.
3. MSC has requested advice from Treasury on the appropriate Weighted Average Cost of Capital to use for its business units, including MWS, in June 2003, July 2005 and July 2007.
4. Treasury's pricing investigation of MWS concluded that MWS was not earning an excessive rate of return and that the rate was within the reasonable range, albeit at the high end.
5. The due diligence process associated with the State Government acquisition of bulk water assets of MWS carried out by KPMG did not identify any concerns with MWS pricing levels relative to full cost recovery.
6. Water and wastewater prices were frozen by MSC at 2001-02 levels until 2004-05 for wastewater and 2006-07 for water and Council has provided reasons for the increases in the prices other than to increase revenue.
7. The water and wastewater prices for the 2008-09 year were attributed by Council to its assessment of full cost recovery for each former council area using asset values based on audited financial information and its consideration of the impact of the South East Queensland Water reforms.

On the basis of the above, I do not propose to investigate your allegation that Council has not performed its prices oversight obligations with respect to the 2008-09 or 2009-10 years under section 23(1)(f) of the *Ombudsman Act 2001* as I consider that any investigation is unnecessary or unjustifiable.

I also do not consider from my review of the material that any new information exhibiting special circumstances has been provided that would make me reconsider my previous decision not to investigate the issues raised in the Coolum Residents Association's previous complaint because it was out of time under section 20(1)(c) of the *Ombudsman Act 2001*.

Optimisation study

Our inquiries revealed that Council took significant steps in relation to the preparation for the optimisation study following Treasury's request in June 2005 but that discussions between MSC and Treasury in December 2006 resulted in no further action being taken. The internal Treasury review in relation to MWS scheduled to be undertaken following the optimisation study did not occur as a result of the optimisation study not being completed.

I am satisfied from the information provided by Council and Treasury that this is what occurred. I do not consider that there is any evidence to support your allegation that the optimisation study was performed but not released due to the findings being contrary to those desired by Council and Treasury, or that the 2007 internal Treasury study was completed. Due to the adoption of the tender process by Council (which terms of reference I have viewed), it is also clear that the optimisation study was not outsourced to Cardno MBK like previous optimisation studies, as you have suggested.

Council and Treasury have indicated that the optimisation study would no longer be of any value as:

- The assets of MWS are now being used differently as a result of the local government reform process
- The bulk water assets of MWS have been independently valued by KPMG as part of the State Government acquisition process and are no longer owned by Council
- MWS's remaining assets will be transferred to the new distribution entity by 1 July 2010 and the valuation used for these assets is likely to be based on the KPMG valuation model
- It would not be in the public interest for a revaluation of existing assets as it would not provide any additional service potential for consumers in light of the current South East Queensland water reform process.

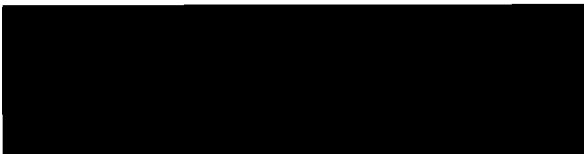
My preliminary view is that Council's and Treasury's assessment of this issue is correct and that there would be no value in Council performing the optimisation study at this time. I do not propose to investigate this aspect of your complaint under section 23(1)(f) of the *Ombudsman Act 2001* as I consider that an investigation is unnecessary or unjustifiable.

Conclusion

I invite you to make further submissions in relation to my preliminary views to assist our further consideration of your complaint. I will decide how we will proceed in light of any further submissions. If you do not make any further submissions within a reasonable time I will proceed to close the file.

If you have any queries, please contact Investigator Scott Edwards on (07) 3005 7000 or ombudmsman@ombudsman.qld.gov.au.

Yours faithfully



Craig Allen
Assistant Ombudsman
Local Government & Infrastructure Team