



Final Report

SEQ Price Monitoring for 2012-13

Part A – Overview

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PREAMBLE

The Authority's price monitoring role for 2012-13 relates to the prices, costs and revenues of two South East Queensland (SEQ) water and wastewater retail/distribution entities – Queensland Urban Utilities (QUU) and Unitywater.

In this final year of the three-year price monitoring period, the Authority is required to monitor, amongst other things:

- (a) for distribution and retail water and wastewater services for households and small business customers, the change in prices between 2011-12 and 2012-13 against a consumer price index (CPI) cap (of 1.3%); and
- (b) for water and wastewater services not subject to the CPI cap, the change in prices between 2011-12 and 2012-13 having regard to the change in revenue from these services against the change in the total prudent and efficient costs of the relevant activities.

Changes in the prices of distribution and retail water and wastewater services for households and small businesses differ across the two entities but do not exceed the price cap of 1.3%. The total bill for households has decreased overall when the State Government bulk water rebate is taken into account.

For QUU, revenue for non-capped services which include trade waste, recycled water charge and sundry services is forecast to increase by 1.19% in 2012-13 which is less than the increase in the prudent and efficient costs of the relevant activities (4.61%). For Unitywater, revenue for non-capped services is forecast to increase by 5.64%, which is slightly higher than the increase in the prudent and efficient costs of the relevant activities (5.41%).

The Authority's estimates of the efficient cost of providing services in 2012-13 (i.e. the Authority's maximum allowable revenue or MAR) are lower than those of the entities. The main differences in estimates of costs relate to employee expenses, corporate costs and other materials and services.

However, notwithstanding this, the Authority has found that, for 2012-13:

- (a) QUU's forecast total water and wastewater revenues of \$834.67 million are 6.26% below the Authority's MAR of \$890.40 million; and
- (b) Unitywater's forecast total water and wastewater revenues of \$438.30 million are 8.50% below the Authority's MAR of \$479.04 million.

The Authority found no evidence of an exercise of monopoly power in 2012-13.

Opportunities for the entities and participating councils to seek efficiencies in the costs of providing retail and distribution water and wastewater services should continue to be identified and pursued.

Over the three-year price monitoring period, the transparency and review provided by price monitoring has contributed to an environment which has constrained the entities from exercising their market power and reduced their costs of service delivery. In this regard, the entities have reduced their capital expenditure estimates over the three-year period by around \$1.1 billion, due to deferrals and adjustments to capital programs and projects. The entities' operating expenditure estimates over the period have fallen by \$127 million from those originally forecast. In addition, the entities have improved their internal operational and forecasting processes, often in response to initiatives identified in the Authority's reports. At the same time, a number of issues remain outstanding, particularly demand forecasting which is still relatively unsophisticated and needs to be improved.

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1. OVERVIEW

1.1 Introduction

This is the final year of price monitoring of the retail and distribution water and wastewater activities in South East Queensland (SEQ) by the Authority.

The Authority's price monitoring investigation for 2012-13 has focussed on the monopoly distribution and retail water and wastewater activities of Queensland Urban Utilities (QUU) and Unitywater. Allconnex Water is no longer responsible for the delivery of water and wastewater activities and the Gold Coast, Logan and Redland City Councils have not been referred to the Authority for review for 2012-13.

1.2 Ministerial Direction

In accordance with the Ministerial Direction under section 23A of the *Queensland Competition Authority Act 1997* (the QCA Act) (see **Appendix A to Part B**), the Authority must, for QUU and Unitywater (the entities):

- (a) monitor the annual change in prices of distribution and retail water and wastewater services for households and small business customers having regard to the consumer price index (CPI) price limit (price cap) as described in relevant legislation;
- (b) monitor the annual change in prices for water and wastewater services not included in the CPI price limit (non-capped services), having regard to the change in revenue from these services compared to the change in the total prudent and efficient costs of carrying on the relevant activity;
- (c) provide timely and transparent information to customers about the costs and other factors underlying the provision of water and wastewater services, including distinguishing the bulk and distribution/retail costs to the extent that it is possible given the availability and reliability of relevant information; and
- (d) monitor the entities' revenue from water and wastewater activities against their total prudent and efficient capital and operating costs (the maximum allowable revenue or MAR).

1.3 Approach

There is a wide range of prices for the many services and customers of the entities. Under the *South-East Queensland Water (Distribution and Retail Restructuring) Act 2009*, a CPI price cap applies to the retail and distribution component of water and wastewater charges in 2012-13 for specified customers. The specified customers include residential and small business customers and any other customer who passes on charges to either of these groups. Under the legislation, the CPI cap for 2012-13 is 1.3%.

The Authority has reviewed all retail and distribution water and wastewater charges against the CPI cap, except those specifically excluded (that is, trade waste and recycled water). Following advice from the (then) Queensland Water Commission (QWC), one-off or sundry charges have also been treated as non-capped services.

The Authority has monitored the change in prices of non-capped services by comparing the change in revenues attributable to these services against the change in the prudent and efficient costs of the relevant activity.

For continuity with previous years' reports, the Authority has also noted changes in residential bills and average prices.

The Authority has reviewed the entities' capital and operating expenditure forecasts for prudence and efficiency. In undertaking this review, the Authority is required to accept:

- (a) the initial regulatory asset base (RAB) as at 1 July 2008 as advised by the Minister for Natural Resources, Mines and Energy and Minister for Trade (the Minister);
- (b) actual capital expenditure, excluding establishment costs, included in council financial accounts from 1 July 2008 to 30 June 2010;
- (c) allowable establishment costs as advised by the Minister;
- (d) contributed, donated and gifted assets and those funded through capital contributions from 1 July 2008 to 30 June 2010; and
- (e) the prices charged by the SEQ Water Grid Manager (WGM)¹ for bulk water storage, treatment and delivery.

In monitoring revenues, the Authority has adopted the forecasts of demand, revenue and costs that were available at the time prices were set. Any material differences in costs arising from subsequent information has, however, been identified.

Under section 26 of the QCA Act, the Authority must have regard for a range of related matters. Where relevant to this report, these have been taken into account. The information provided by the entities on the impact of the floods in SEQ has been taken into account in this report where relevant.

1.4 Consultation

The Authority has liaised extensively with the entities and relevant agencies prior to, and during, this review. To facilitate the review, the Authority has:

- (a) previously prepared a framework for price monitoring and supporting information requirements *SEQ Interim Price Monitoring Information Requirements* (December 2010) and *SEQ Interim Price Monitoring Framework* (April 2010);
- (b) prepared draft information templates and associated guidelines (May 2010), with revised information requirements for 2011-12 released in August 2011. Following further review with the entities, revisions were introduced to the information requirements for 2012-13 *SEQ Interim Price Monitoring Information Requirements for 2012-13* (August 2012);
- (c) met with the entities to identify and address relevant issues;
- (d) invited submissions from interested parties;
- (e) commissioned independent consultants to review aspects of the entities' submissions;
- (f) published all public submissions on its website;

¹ On 1 January 2013, the SEQ WGM was merged into Seqwater. Bulk water charges are now collected by Seqwater.

- (g) released a Draft Report for comment following consideration of all submissions and reports received to that date; and
- (h) considered all submissions received on the Draft Report in preparing this Final Report.

As in previous years, this Final Report has two parts. Part A presents an overview of key findings. Part B details the Authority’s assessment of the entities’ proposed costs.

1.5 Prices

There is a wide range of prices set by the entities as a result of the wide range of services provided to customer groups in SEQ.

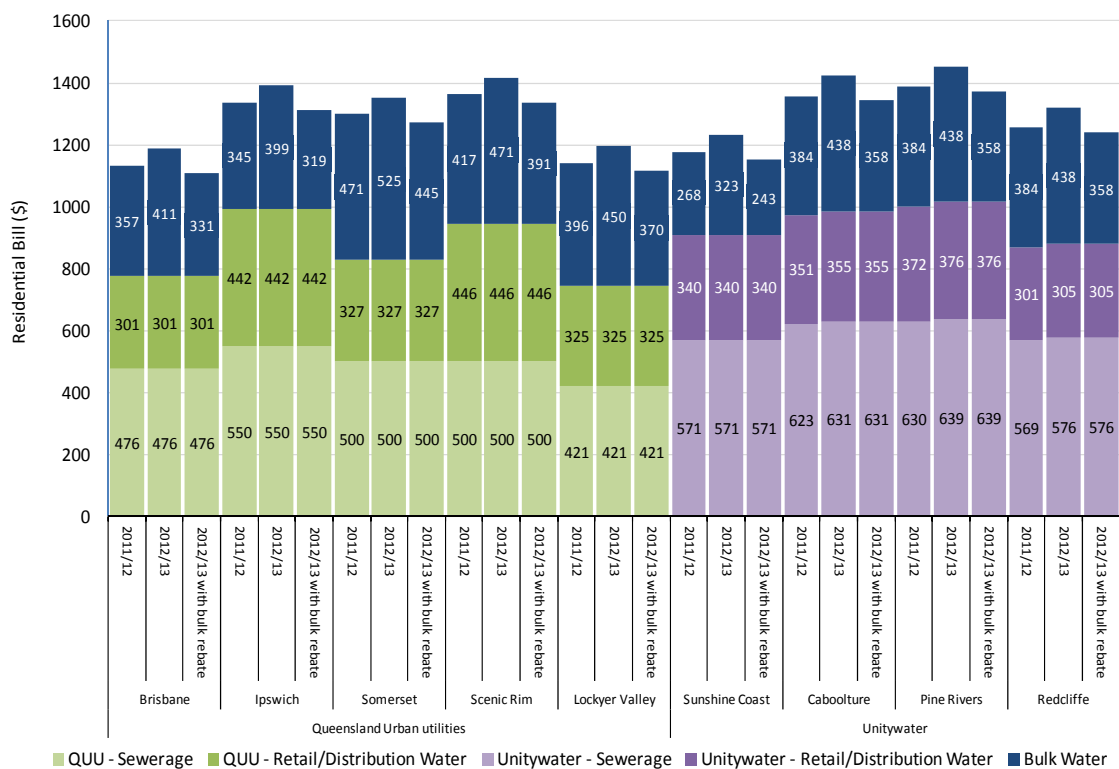
Capped Prices

The increase in prices of distribution and retail water and wastewater services for households and small businesses differs across SEQ, but do not exceed the CPI cap of 1.3%.

Residential bills (which include water and wastewater, and the bulk water component) have decreased across all SEQ council areas. This is due to the State Government Bulk Water Rebate of \$80 (identified separately below) which has more than offset the increase in bulk water charges.

The residential bills used in the Authority’s analysis have been estimated on the basis of usage of 200 kl of water per year, the level adopted for national performance reporting (National Water Commission (NWC), 2010). As there is no national standard for wastewater, the analysis has been based on the approach adopted in each council area.

Chart 1.1: Total Residential Bills



Notes: Based on metered usage of 200kL per annum and wastewater charge per connection (with one pedestal where relevant). Residential bills in Caboolture, Pine Rivers and Redcliffe are net of the Moreton Bay Council rebate in 2011-12 and 2012-13. Source: QUU (2012) and Unitywater (2012).

Non-Capped Prices

Non-capped services include trade waste, recycled water and one-off or sundry services.

For QUU, the change in revenues of non-capped services (1.19%) does not exceed the change in prudent and efficient costs of the relevant activities (4.61%). For Unitywater, the change in revenues of non-capped services (5.64%) is slightly higher than the increase in the costs of the relevant activities (5.41%).

Average Prices

Average prices have been calculated by dividing total revenues by volumes – per kl (for water) and per connection (for wastewater)². Average prices provide, at best, a broad overview of changes in prices. They encompass services which are both capped and non-capped as well as retail and distribution and bulk prices (which are outside the entities' control).

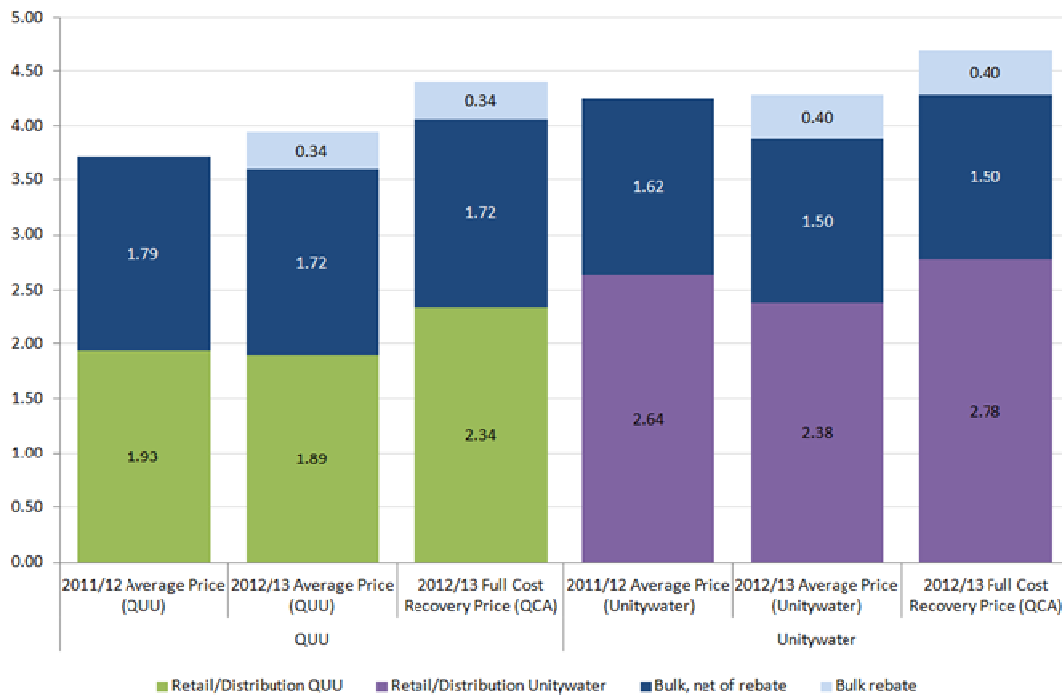
Average prices provide a measure of revenue by a common base unit. Therefore, the increase in average price cannot be used to determine compliance with the CPI cap (for which actual charges must be used).

The retail-distribution component of average water prices in 2012-13 was lower than in 2011-12. The impact of the bulk water rebate is separately identified in Chart 1.2. Average wastewater prices increased slightly. Charts 1.2 and 1.3 refer.

The average price charged by the entities is below that implied by the Authority's analysis of costs and demand for 2012-13 even before taking account of the Government rebate. For clarity, the Authority's 2012-13 price in the below charts reflects the Authority's estimate of the prudent and efficient costs of service delivery divided by the Authority's estimate of kL sold (for water) or connections (for wastewater). See subsequent sections and Part B.

² The Australian Bureau of Statistics (ABS) adopts a similar approach to calculate an average water price in national water accounts – the ABS average price is derived by dividing a state's total residential water revenue (\$) by residential water consumption (kL) (ABS, 2010).

Chart 1.2: Average Water Prices (\$/kL)



Note: Average entity water price = Annual entity water revenue (\$) / total kL sold. Average QCA price = QCA MAR / QCA kL (water). Council rebates have not been deducted. Source: QUU (2012 and 2011), Unitywater (2012 and 2011), QCA calculations (see Part B).

Chart 1.3: Average Wastewater Prices (\$/connection)



Note: Average entity wastewater price = Annual entity wastewater revenue (\$) / total connections. Average QCA price = QCA MAR / connections (wastewater). Council rebates have not been deducted. Source: QUU (2012 and 2011), Unitywater (2012 and 2011), QCA calculations (see Part B).

1.6 Costs

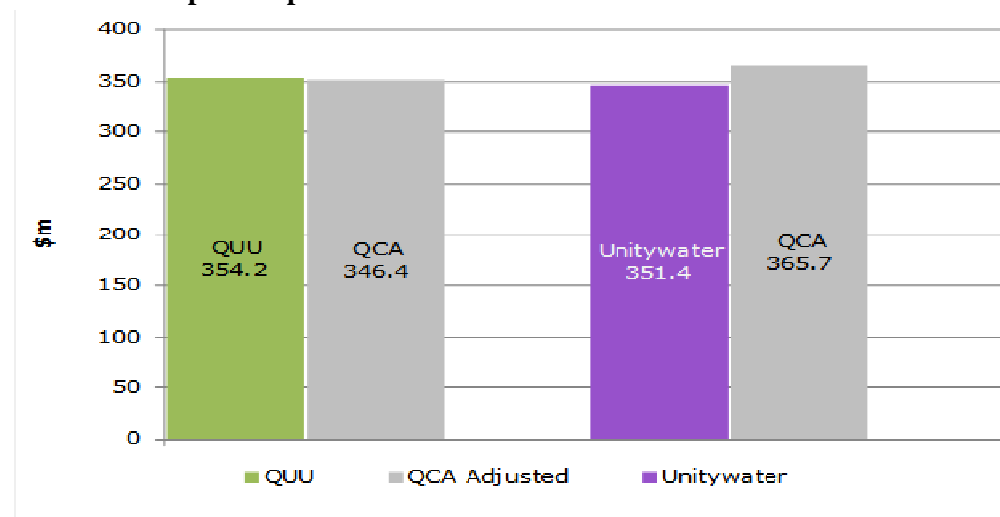
For 2012-13, SEQ water and wastewater prices were generally set with regard to the CPI cap. The increase in costs was not a key factor in pricing decisions.

The Authority's estimate of the prudent and efficient costs forms the Authority's MAR. The costs of providing water and wastewater activities include distribution and retail costs and, bulk water costs. The distribution and retail costs include operating and capital costs. The capital costs relate to the cost of infrastructure necessary to deliver services. These capital costs include depreciation (return of capital), an allowance for the cost of debt and a return for the risks involved (return on capital).

The Authority conducted an independent review of the prudence and efficiency of the entities' capital expenditure forecasts (Chart 1.4). The Authority reviewed a sample of capital projects and programs and adjusted the entities' estimates to reflect its view of prudent and efficient capital expenditure.

Unitywater's capital expenditure was increased by the Authority, as during the review Unitywater noted that it had understated the amount of capitalised interest and applied a 7.11% weighted average cost of capital (WACC). The Authority is required to use a 9.35% WACC benchmark in accordance with the Ministerial Direction.

Chart 1.4: Capital Expenditure in 2012-13



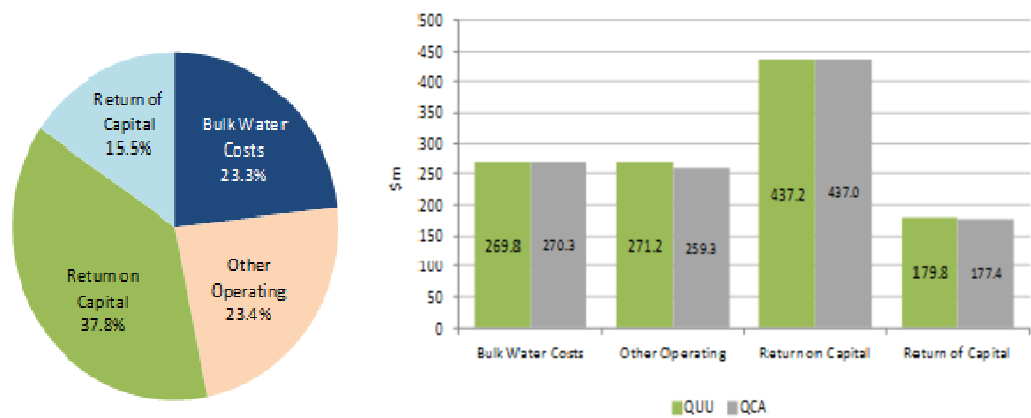
Source: QUU (2012), Unitywater (2012), QCA calculation (see Part B)

The Authority also conducted an independent review of the reasonableness of the entities' operating costs. The entities' costs were assessed against the efficiency targets from the Authority's 2010-11 price monitoring review and other benchmarks. Potential efficiency savings of around 4-5% in non-bulk operating costs were identified, arising primarily in electricity, employee expenses, corporate costs and other materials and services.

Following the Draft Report, Unitywater noted it had understated depreciation in its original cost estimates. The Authority accepted Unitywater's revised approach.

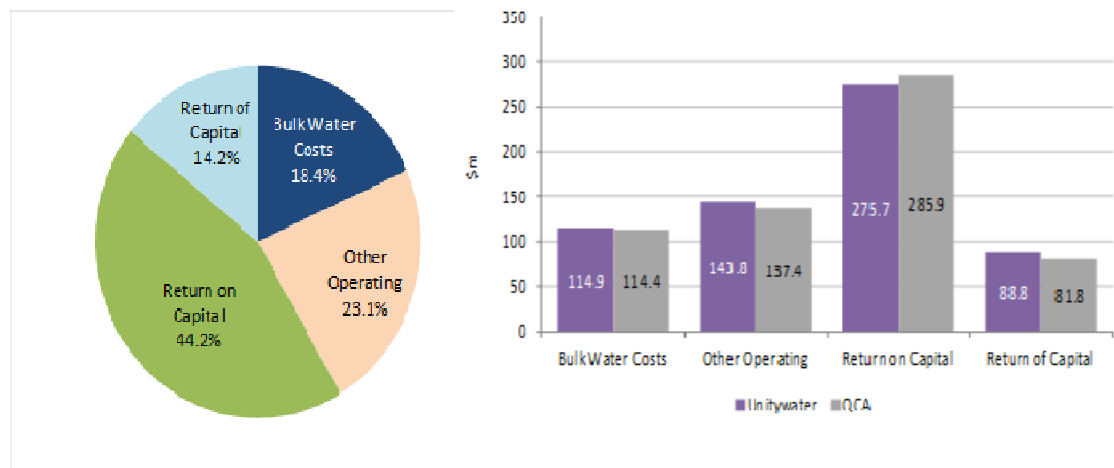
Charts 1.5 and 1.6 outline the entities' proposed costs compared with the Authority's estimate of costs. Part B provides more detail.

Chart 1.5: QUU Components of Proposed and Estimated Costs (2012-13)



Note: Other Operating costs include tax. Source: QUU (2012), QCA calculation (see Part B).

Chart 1.6: Unitywater Components of Proposed and Estimated Costs (2012-13)



Note: Other Operating costs include tax. Source: Unitywater (2012), QCA calculation (see Part B).

In the main, the differences between the entities proposed costs for 2012-13 and the Authority’s arise from:

- (a) distribution and retail operating costs – the Authority has identified potential savings of around 4-5% in non-bulk operating costs, arising in electricity, employee expenses, corporate costs and other materials and services; and
- (b) for Unitywater, the Authority capitalised work-in-progress at the WACC benchmark of 9.35% and adjusted the calculation of depreciation.

Under the Direction, the entities have a choice of approaches to the treatment of capital contributions and the Authority has recognised their revenue offset approach in its calculations.

1.7 Revenues

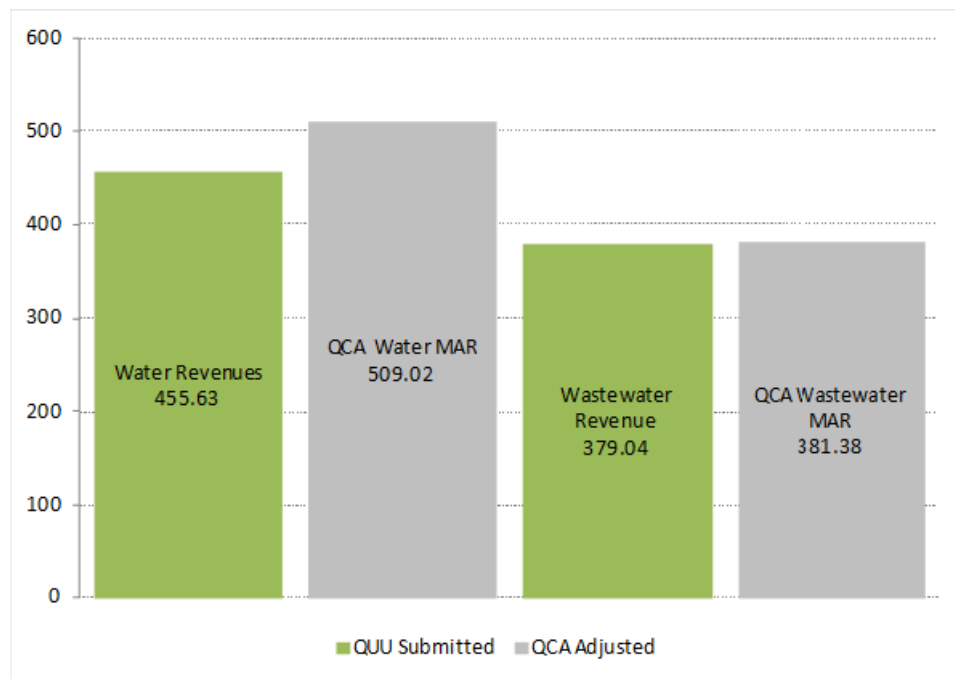
Under the Ministerial Direction and the SEQ Price Monitoring Framework (QCA, 2010) accepted by the Ministers, the Authority must monitor the revenues of each water and wastewater activity against the MAR.

QUU

For QUU for 2012-13:

- forecast water revenue of \$455.63 million is below the Authority's MAR of \$509.02 million;
- forecast wastewater revenue of \$379.04 million is marginally below the Authority's MAR of \$381.38 million; and
- as a whole, QUU's forecast revenue of \$834.67 million is below the Authority's MAR of \$890.4 million.

Chart 1.7: QUU Revenues and QCA MAR (\$m 2012-13)

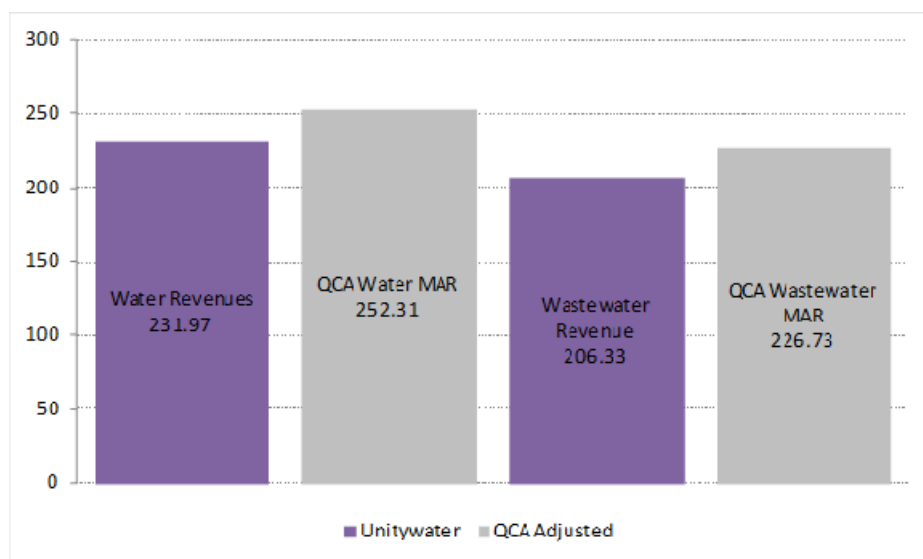


Source: QUU (2012), QCA calculation (see Part B).

Unitywater

For Unitywater for 2012-13:

- forecast water revenue of \$231.97 million is below the Authority's MAR of \$252.31 million;
- forecast wastewater revenue of \$206.33 million is below the Authority's MAR of \$226.73 million; and
- as a whole, Unitywater's forecast revenue of \$438.30 million falls below the Authority's MAR of \$479.04 million calculated by the Authority.

Chart 1.8: Unitywater Revenues and QCA MAR (\$m 2012-13)

Source: Unitywater (2012), QCA calculation (see Part B).

Analysis

Some of the differences between the entities' forecast revenues and the Authority's MAR arise from differences in estimates of costs and demand.

Based on the Authority's analysis, all of the entities' forecast revenues lie below the Authority's MAR. The Authority has also calculated the revenues that would arise under the Authority's demand estimates and the entities' prices. These estimates of the entities' revenues also lie below the MAR.

As the entities' revenues (as forecast by the entities and as estimated by the Authority) in 2012-13 are below the MAR, there is no evidence of an exercise of monopoly power in 2012-13.

Both QUU and Unitywater proposed to recover past under-recoveries in future years. However, they did not provide a specific price path nor supporting information for consideration by the Authority.

1.8 Progress under the Current Direction

The general objective of price monitoring is to constrain a monopoly activity exercising its market power.³

The role of the Authority in addressing this objective is set out in the current Ministerial Direction. As noted previously, the Authority is required to transparently monitor annual changes in the entities' prices of distribution and retail water and wastewater prices for households and small businesses against the CPI. The Authority is also required to monitor the change in the revenues of other (non-capped) services against the change in the prudent and efficient costs of carrying on the relevant activity.

The Authority is further required to identify the costs and other factors underlying the provision of water and wastewater activities and review entities' revenues against their total

³ Explanatory notes to the *Queensland Competition Authority Amendment Bill 2008*.

and prudent and efficient costs (the MAR). A monopoly could be exercising its market power where revenues significantly exceed the MAR for a sustained period.

Outcomes⁴

Price monitoring has met its general objective over the past three years.

Over the period, the entities have revised their original cost forecasts made in 2010-11 on the basis of council projections. The entities have significantly reduced their capital expenditure estimates over 2010-13 by around \$1.09 billion, due to deferrals and adjustments to capital programs and projects.⁵ The entities have also reduced their operating expenditure estimates over 2010-13 by \$127.38 million from those originally forecast.⁶

The entities have complied with the CPI cap. The change in revenues from non-capped services has been less than the increase in costs or the increase was not material.

On the basis of its review of the prudence and efficiency of costs (and a 2% per annum savings target), the Authority's total prudent and efficient costs have been \$77.49 million below those estimated by the entities over 2010-13.⁷ This includes a saving in non-bulk operating costs of \$33.81 million and a saving in capital related costs of \$38.34 million. The remaining \$5.31 million relates to bulk water and tax.

Nevertheless, over the three years of price monitoring, the entities' revenues have been below the Authority's estimate of total prudent and efficient costs. Therefore, the Authority has not identified any exercise of market power.

In conclusion, the transparency and review provided by price monitoring has contributed to an environment which has constrained the entities from exercising their market power and reduced their costs of service delivery.

Processes

Over the price monitoring period 2010-2013, the entities have developed and improved their processes and systems to establish the prudence and efficiency of costs.

In its 2010-11 price monitoring report, the Authority identified a range of initiatives that would improve the entities' internal processes. There has been progress in a range of these areas, including:

- (a) a documented approach to forecasting demand for all purposes, with procedures and protocols established for the collection and collation of data;
- (b) the consideration of prudence and efficiency of capital expenditure, and the reasonableness of operating costs, from a regional perspective;
- (c) only commissioned capital expenditure included in the regulatory asset base (RAB) and therefore prices;
- (d) a standardised approach to cost estimating, including a standardised approach to estimates for items such as contingency, preliminary and general items, design fees

⁴ This section relates to all entities reviewed by the Authority over the price monitoring period, including Allconnex.

⁵ The sum of the difference between the entities' capex for 2010-13 in their original and their latest submissions.

⁶ The sum of the difference between the entities' opex for 2010-13 in their original and their latest submissions.

⁷ The sum of the difference between the QCA MAR and the entities' total costs in each year of price monitoring.

- and contractor margins, so that there is uniformity of cost estimating across all proposed major projects;
- (e) a summary document to be prepared for identified major projects so as to facilitate standardised reporting;
 - (f) an implementation strategy to be developed for each major project that includes recommendations on delivery methodology, program and a risk review process; and
 - (g) a ‘toll gate’ or ‘gateway’ review process to be implemented so that appropriate reviews are undertaken at milestone stages for selected projects.

However, demand forecasting remains relatively unsophisticated. Although this has been considered reasonable given the emerging status of the entities, the Authority has recommended further development in this area. In particular, that the entities develop and compare different approaches to demand forecasting for future use in SEQ.

A key initiative that was originally identified but has not been addressed is for pricing to be demonstrably based on costs and other relevant factors. The Authority’s role as noted above is focussed on the aggregate revenues and costs of relevant activities. The cost allocation and pricing principles underlying individual prices are yet to be subject to detailed review.

Finally, in response to the entities’ proposals for an unders and overs regime, the Authority has not been in a position to provide detailed guidance as the detailed data, modelling and assumptions have not been provided by the entities.