


SEQ Water and Wastewater Price Monitoring 2012-13 Queensland Urban Utilities

460502-32-003 Version 2.0

Review of Response to QCA Draft Report

Queensland Competition Authority

March 2013

Document History

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This document has been issued and amended as follows:

| Version | Date | Description | Created by | Checked by | Approved by |
|---------|---------------|----------------------|------------|------------|-------------|
| 1.0 | 11 March 2013 | Draft Report | JOS/MF/GH | JOS | JOS |
| 1.1 | 11 March 2013 | Updated Draft Report | JOS/MF/GH | JOS | JOS |
| 2.0 | 28 March 2013 | Final Report | JOS/MF/GH | JOS | JOS |
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Halcrow Pacific
Level 40, 385 Bourke Street, Melbourne VIC 3000, Australia
GPO Box 1841, Melbourne VIC 3001
Tel +61 3 8682 3900 Fax +61 3 8682 3999
www.halcrow.com

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1 Introduction

This document provides Halcrow's comments in respect of issues raised in Queensland Urban Utilities' (QUU's) formal response to the Queensland Competition Authority's (QCA's) Draft Interim Price Monitoring Report for 2012/13.¹

QUU's comments are presented in a letter to the Chief Executive Officer of the QCA dated 1 March 2013 (hereinafter referred to as 'QUU's Response' or 'its Response'). Some additional supporting information has been submitted, as listed in **Section 2**.

Halcrow's comments are provided in respect of (and limited to) issues that relate to findings presented in Halcrow's report to the QCA.²

¹ QCA, *Draft Report, SEQ Price Monitoring for 2012-13; Part A – Overview*, January 2013 and QCA, *Draft Report, SEQ Price Monitoring for 2012-13; Part B – Detailed Assessment*, January 2013.

² Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013.

2 Additional Information Submitted

Additional information submitted by QUU in support of its comments includes the following:

- EPA Application to the Planning and Environment Court, Reference BD 2472/05 dated 8 July 2005.
- Integran, *Review of Practical Measures for Minimising Dry Weather Overflows from Sewerage Pumping Stations*, April 2006.

3 General Comments

3.1 Benchmarking

Halcrow notes and accepts QUU's contention that benchmarking has limitations. It is, in part, for this reason that benchmarking is generally used as an indicator rather than an absolute measure. Halcrow's preferred approach is to assess expenditure on an activity or 'bottom up' basis, however, this becomes difficult when inadequate/insufficiently detailed information is available for analysis as was the case for aspects of this review.

As alluded to by QUU, the value of benchmarking is dependent upon the quality of information and the extent to which 'like for like' comparison can be made between comparators. This approach is again constrained by the availability of suitable comparators and the availability of suitable data for analysis. In the case of the water industry, each entity has its own characteristics, which restricts the availability of strictly 'equal' comparators. Furthermore, data available for analysis (in respect of comparators) is generally limited to that which is available in the public arena.

Given the inadequacy of the available information for detailed analysis, Halcrow did use benchmarking for some elements of its assessment of QUU's operating and capital expenditure. It does, however, acknowledge that this approach has limitations.

3.2 Asset Intensity

In QUU's Response, it contends that some of Halcrow's assessment assumes a causal relationship without identifying whether such a relationship exists. It cites a reference to QUU's networks being less asset intensive than Unitywater's, and suggests (in respect of Halcrow's further assessment) that "*therefore a lower unit operating cost is expected for employee expenditure.*"

In order to provide additional rigour than a simple assessment of operating cost per unit of service delivered, Halcrow made a high level comparative assessment of unit costs taking into account the extent of infrastructure required to provide the service.³ This assessment was initially undertaken in respect of total operating expenditure (excluding the cost of bulk water)⁴ and was subsequently used in support of the comparative assessment of employee expenses.⁵

Halcrow maintains that operating expenditure is impacted by the extent of infrastructure to be operated and maintained; each additional unit of infrastructure, eg. additional pumping station or treatment plant, will attract additional operating

³ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 35.

⁴ Ibid.

⁵ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 61.

expenditure. Whilst the scope of operational activity required in each case will be in part dependent upon the size and complexity of the assets, the number of asset units provides the basis for a reasonable high level assessment. All assets need to be operated and maintained, and (extrapolating the concept) this requires a measure of labour input.

QUU contends that Halcrow's assessment does not take into account other factors that arise in respect of (are a consequence of) having a denser network, such as traffic management, service interruption and permits to work. Halcrow acknowledges this contention, however, questions the level to which these activities will vary in a denser (in respect of customer service points) network. The following comments are provided:

- Facilities such as reservoirs, treatment facilities and pumping stations are typically (but not always) located on dedicated sites; traffic management is not normally expected to be necessary in respect of operation or maintenance of these facilities. Maintenance of pipeline assets is more likely to incur the need for traffic management activities, however, this need will be more directly related to the number of incidents rather than the density of customer service points.
- Service interruptions (which will typically be more applicable to pipeline assets) will be more extensive for a denser network, however, the additional costs are expected to be limited. Notifications to customers are expected to be more extensive, but will be dependent upon the extent (for example) of water network 'shut of blocks'. Penalties for breaching service standards (eg, number of service interruptions) will potentially be more extensive.
- Most asset managers require the implementation of a 'permit to work' system. Whilst there may be some additional costs associated with obtaining permits in respect of a greater number of adjacent services, the associated costs will again be more directly related to the number of incidents rather than the density of customer service points.

On balance, whilst operation and maintenance of a higher density network (lower asset intensity)⁶ may be expected to attract some additional consequential costs, Halcrow believes that these will be predominantly restricted to pipeline assets and are expected to be limited. On the basis of Halcrow's assessment,⁷ given that the lengths of QUU's and Unitywater's sewerage pipelines per property serviced are similar, QUU may attract limited additional consequential costs. Given that there is approximately 37 percent additional pipeline length per megalitre of water delivered for Unitywater in comparison to QUU, and whilst QUU may attract some additional consequential costs, per unit operating costs (excluding bulk water costs) are expected to be lower for QUU than for Unitywater.

⁶ For the purposes of this assessment, the following interpretation has been adopted:

- Higher asset intensity means more infrastructure (assets) per unit of service delivered; and
- Network density relates to number of customers serviced by each unit of infrastructure (eg, customers per kilometre of pipeline).

⁷ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 35.

4 Operating Expenditure

4.1 General

Halcrow rejects QUU's contention⁸ that it did not consider comment provided by QUU prior to issue of its Final Report to the QCA due to time constraints. Comments provided by QUU in response to Version 1.3 of Halcrow's report to the QCA on 19 December 2012 and a spreadsheet subsequently provided to the QCA on 9 January 2013 were reviewed in some detail.

Specific comments were made in an email to the QCA dated 8 January 2013 and a number of changes were also made to Halcrow's report prior to final (Version 2.2) issue, reflecting (within reason) the contentions presented by QUU.

4.2 Employee Expenses

4.2.1 General

QUU has raised issues in respect of Halcrow's assessment of its Employee Expenses, specifically Halcrow's assessment that:

- QUU has higher labour costs than its peers, particularly for water services;
- Incurring excessive additional labour costs on the shift of emphasis from reactive to proactive maintenance planning (there should be offsetting savings); and
- Engaging a greater number of employees than would otherwise be required to meet the expedited separation program stemming from a change in timing and project scope.

Comments in respect of the issues raised by QUU are set out in the following sections.

4.2.2 Higher Labour Costs than Peers

QUU contends that Halcrow has not provided evidence in support of its view that QUU has higher labour costs than its peers, particularly for water services. The basis of Halcrow's assessment is presented in its report to the QCA,⁹ which identifies the following key inputs:

- Benchmarking based on NWC Indicators which indicates that QUU's unit costs for the provision of water services are almost 50 percent higher than its interstate peers; and
- An analysis of QUU and Unitywater labour costs which, when the asset intensity in relation to service units (or connection density per kilometre of main) is taken into account, suggests that a reduction in labour costs is appropriate.

⁸ QUU letter to the Chief Executive Officer of the QCA dated 1 March 2013, pages 5 and 8.

⁹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 67.

Whilst the benchmarking assessment (based on NWC Indicators) could not be undertaken on the basis of expenditure type (in this case labour), Halcrow considers it reasonable to assume that, given QUU's employee expenses comprise some 36.5 percent of total operating expenditure (excluding the cost of bulk water) and no apparent difference in the components that together comprise total operating expenditure was observed, the additional cost in comparison to its peers must be reflected in its employee costs (as well as other cost elements).

Halcrow considers that the discussion in relation to the comparison of combined employee and contractor costs, with cognisance of the relative asset intensity, for QUU in comparison with Unitywater provides support to its assessment.

Halcrow acknowledges that a fully detailed comparative assessment could not be undertaken due to the absence of sufficiently detailed information from either QUU or its peers, however, is satisfied in principle with the conclusions drawn.

4.2.3 Impact of Shift to Proactive Maintenance Planning

As outlined in its report to the QCA,¹⁰ Halcrow understood on the basis of information provided by QUU that “the number of direct water employees is increasing by 32 to 259FTE” and that “The increase in the number of water employees stems from the additional maintenance effort (planned and reservoir maintenance)...”.

Further information¹¹ indicated that:

“The increases in water expenses for 2012/13 are primarily due to [adjustments including]:

- Increase in planned maintenance for water assets in 2012/13 compared to 2011/12 [not quantified]
- Increase in reservoirs maintenance program of \$1.1m.”

This suggests that the proposed increase in employee expenses associated with planned maintenance is in excess of the \$880,000 now identified by QUU. If the increase of 32FTE in the number of direct water employees is principally related to planned maintenance, this is expected to equate to an increase in the order of \$3.2 million, which would be in addition to the additional subcontractor services discussed in **Section 4.4**.

QUU appears to contend that reductions in respect of planned maintenance are double counted due to the adjustment recommended in respect of Other Materials and Services. As outlined in **Section 4.4**, the adjustment in respect of Other Materials and Services expenditure relates to subcontractor costs (as opposed to employee expenses).

In respect of the expected offsets arising from the implementation of a planned maintenance approach, in its report to the QCA, Halcrow commented as follows:¹²

¹⁰ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 58.

¹¹ QUU response to Halcrow's Request for Information (QUU RFI-2) (attachment to email dated 26 November 2012).

¹² Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 96.

“Halcrow sought to understand why there is no apparent reduction in maintenance cost following the implementation of a planned maintenance. An optimised maintenance program will typically incorporate a planned/preventative maintenance program; this is understood to be QUU’s objective. Moving to such a maintenance approach would, however, be expected to result in a reduction of overall maintenance expenditure, if not immediately, then in following years. Halcrow note that QUU’s forecast operating expenditure remains constant in nominal terms (effectively a minor reduction real terms) in 2013/14, however, are forecast to increase significantly again in 2014/15.”

Halcrow further acknowledged¹³ that, in the short term, the implementation (by QUU) of a more proactive approach to maintenance is driving increases in operating expenditure.

Accordingly, Halcrow accepts QUU’s contention that there will be no direct labour offset in respect of the shift to increased planned maintenance in 2012/13, however, remains of the view that the increase in employee expenses attributable to planned maintenance is excessive, particularly when coupled with the increase in related subcontractor services.

4.2.4 Employee Cost of Separation Program

Halcrow acknowledges that it has not undertaken a detailed comparative assessment of outsourcing resource requirements or costs. The judgement in respect of efficiency of employee expenses associated with the ICT Separation Program is based on observations made during the conduct of the review of both QUU and Unitywater.

Halcrow formed the impression that a the program is attracting a premium cost in respect of both resource and expenses due to the now tight timeframe within which the program must now be delivered. Whilst, as Halcrow understands, the timeframe for separation has been imposed by Brisbane City Council, Halcrow is of the view that a more proactive approach would have led to improved efficiencies.

Halcrow notes that expenditure associated with the ICT Separation Program has been excluded from adjustments proposed in respect of QUU’s corporate costs (refer **Section 4.3.2**).

4.2.5 Halcrow’s Recommendation

In its report to the QCA, Halcrow recommended that QUU’s forecast employee expenses for 2012/13 be reduced by \$4.84 million (ie. 5 percent) to \$30 million to reflect the assessed efficient level of employee expenses.¹⁴ Given that, following a review of the comments/issues raised by QUU, Halcrow does not consider that there is demonstrated justification to change the basis of its assessment, no change to the previous recommendation is proposed.

¹³ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 21.

¹⁴ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 112.

4.3 Corporate Costs

4.3.1 General

Halcrow's comments in respect of the use of benchmarking are presented in **Section 3.1**. Halcrow acknowledges that, given the inadequacy of the available information, it did use benchmarking for elements of its assessment of corporate costs.

4.3.2 Comparisons with Sydney Water

As previously advised to the QCA,¹⁵ whilst Sydney Water figures were included in the benchmarking analysis of corporate costs for comparative purposes, Halcrow's assessment was made more specifically against the Council on the Cost and Quality of Government (CCQC)¹⁶ benchmark which indicates that, for agencies of greater than 350 FTE employees, corporate costs should be in the order of 10-12 percent of total operating costs. The Sydney Water figures, coupled with the comment provided in the WS Atkins/Cardno report (as referenced) were included in Halcrow's report primarily to demonstrate that another (similar) water company is operating close to the CCQC benchmark. Sydney Water has not been used as a direct comparator; it appears that QUU fails to recognise this point.

As noted above (and contended by QUU), benchmarking is dependent upon the quality of information and the extent to which 'like for like' comparison can be made between comparators. Whilst QUU suggests that additional costs should be added to Sydney Water's identified corporate costs, Halcrow is of the view that it was more appropriate to exclude some 'corporate costs' reported by QUU on the basis that they would be more appropriately directly allocated (eg. Operations administrative costs).¹⁷ This assessment was made in cognisance of the QCA's definition of Corporate Costs;¹⁸ the adjustment was made on the basis of the available cost breakdown. Upon further reflection, it may not have been appropriate to remove the 'Strategy and Growth' costs, however, these amounted to only 0.2 percent of total operating expenditure thereby having minimal influence on the analysis.

It should be noted that this adjustment to Corporate Costs for the purposes of comparison with the benchmark was made with reference to the QCA's definition to the extent possible using the available cost descriptions and breakdown. It was not necessarily aimed at achieving direct alignment with Sydney Water; there was inadequate information available in either case for direct alignment.

¹⁵ Email Halcrow to QCA, *Response to QUU Comments on Draft Report*, 8 January 2013.

¹⁶ Reference to the CCQG benchmark was drawn from: QCA, *Final Report; SEQ Interim Price Monitoring for 2011-12; Part B - Detailed Assessment*, March 2012, page 345. It is noted that the Council on the Cost and Quality of Government (CCQG) is now known as the Performance Improvement Branch, Department of the Premier and Cabinet, New South Wales.

¹⁷ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 84.

¹⁸ QCA, *SEQ Interim Price Monitoring Information Requirements for 2012-13*, August 2012, page 19.

On the basis of this refined allocation, and with allowance for one-off expenditure of \$10 million in respect of the ICT Separation Program, Halcrow assessed QUU's corporate costs to be \$53.27 million (or 20 percent of Total Operating Expenditure) for the purposes of comparison with the 10-12 percent benchmark.¹⁹

The \$58.66 million corporate costs which was reported as a subsequent estimate provided by QUU²⁰ was drawn (potentially incorrectly due to lack of clarity) from information provided to the QCA.²¹ Whilst, as contended by QUU, it did supply a figure of \$53.4 million as a more correct estimate of its corporate costs, the basis for this was not demonstrated and therefore not reported in Halcrow's report to the QCA.

Further information has been provided in respect of the derivation of the \$53.4 million corporate costs proposed by QUU following discussions between QCA and QUU representatives.²² The derivation is still not, however, understood by Halcrow in the absence of explanation.

It is, however, noted that the \$53.4 million proposed by QUU equates closely to the \$53.27 million value adopted by Halcrow.

4.3.3 10-12% Benchmark

Halcrow acknowledges that reference to the Council on the Cost and Quality of Government (CCQG) benchmark was drawn for the QCA's 2011/12 Interim Price Monitoring Report.²³ The QCA's report credited the extract presented in Halcrow's report to the QCA²⁴ as follows:

"SKM noted that in its 2010-11 Submission, Unitywater states that:"

Upon review of both SKM's report to the QCA²⁵ and Unitywater's Submission,²⁶ it appears that (as claimed by QUU) the information was drawn from its source by SKM rather than Unitywater.

¹⁹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 84.

²⁰ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 85.

²¹ QUU spreadsheet, *Corporate Costs v1.1.xlsm*, provided to the QCA on 9 January 2013.

²² Email QCA to Halcrow, FW: *QUU Response to QCA Draft Report*, 6 March 2013 and attachment (*QUU Corporate Costs v1.1 – Wills notes (509453_1).xlsm*).

²³ QCA, *Final Report; SEQ Interim Price Monitoring for 2011-12; Part B – Detailed Assessment*, March 2012, page 345.

²⁴ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 83.

²⁵ SKM, *SEQ Interim Price Monitoring: Assessment of Capital and Operational Expenditure; 2010/11 Interim Price Monitoring of SEQ Water and Wastewater Distribution and Retail Activities; Queensland Urban Utilities, Allconnex Water and Unitywater*, December 2010, page 253.

²⁶ Unitywater, *Response to Interim Price Monitoring Information Requirement; Water and Sewerage Treatment, Distribution and Retail Activities*, August 2010.

Notwithstanding, the source information can be found referenced in a report *Corporate Overheads of Local Governments*²⁷ prepared for the Independent Inquiry into the Financial Sustainability of NSW Local Government. This document reports a range of corporate overhead percentage benchmarks developed by CCQG for use with State Government agencies.²⁸

4.3.4 Providing Corporate Costs in the Authority's Template

Halcrow notes QUU's comments in respect of the Authority's Data Template. Halcrow provided comments in respect of the Data Template and QUU's compliance with requirements in completing the Template in its report to the QCA.²⁹

4.3.5 Statement that 2011/12 Corporate Costs may be Understated

As noted by QUU, Halcrow questioned the possibility of \$6.0 million of expenditure in respect of the ICT Investment Program.³⁰ In its response, QUU references its 2011/12 Information Return, which states:³¹

"The Corporate Costs forecast for 2010/11 are \$43.8 million, and \$52.0 million for 2011/12. One-off set-up costs of \$4.3 million are included in 2010/11. The costs in 2011/12 include the following initiatives over \$500,000:

ICT Investment Programme \$6.0 million

....."

If QUU's comments are correctly interpreted, it contends that the total Corporate Costs forecast of \$52.0 million for 2011/12 was mistakenly understated by the \$6.0 million attributable to the ICT Investment program.

Halcrow again notes that, whilst this may be the case, the QCA's 2011/12 Interim Price Monitoring Report³² indicates that the increase in Corporate Cost from \$43.76 million in 2010/11 to \$52.01 million in 2011/12 was justified in part by expenditure of \$6 million in respect of the ICT investment program. This assessment does not correlate with QUU's contention.

²⁷ DG & AB Maxwell Consulting Accountants, *Corporate Overheads of Local Governments; Executive Summary; Prepared for the Independent Inquiry into the Financial Sustainability of NSW Local Government*, undated (Inquiry commissioned September 2005 to report by 30 April 2006).

²⁸ Ibid, page 4.

²⁹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 4.

³⁰ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 80.

³¹ QUU, *Information Return 2011/12*, 31 August 2011, page 60.

³² QCA, *Final Report; SEQ Interim Price Monitoring for 2011-12; Part B - Detailed Assessment*, March 2012, page 99.

4.3.6 Ratio Benchmarking

In its report to the QCA,³³ Halcrow presented indicative ratios of corporate cost in comparison to the number of employees (FTE), customer connections (based on number of water connections) and revenue; this was consistent with ratio benchmarking reported in the QCA's 2011/12 Interim Price Monitoring Report.

QUU has questioned why the two NSW water businesses for which ratio benchmarking was reported in the QCA's 2011/12 Interim Price Monitoring Report were not included in the assessment presented in Halcrow's report to the QCA.³⁴ Given that updated figures in respect of Sydney Water were able to be determined from information available in the public arena, these figures were reported and assigned. As Halcrow was not aware of, and did not readily have the information to determine the identity of each of the two NSW water businesses, these were both excluded to avoid duplication.

As noted by QUU, in its analysis Halcrow suggests that the key ratio considered is the ratio of corporate costs to customer numbers as this shows most clearly the impact of the level of corporate costs to customer bills. Whilst QUU is consistent with Unitywater on the basis of this measure, its ratio is double the figure for most interstate comparators.

QUU suggests (as does Unitywater)³⁵ that comparison on the basis of the ratio of corporate costs to revenue is more appropriate than a connection based comparison, its principal argument against the later approach being that customer charges comprise both fixed and variable components. Halcrow acknowledges that fixed and variable components are likely to be differently impacted by corporate cost allocations.

The benchmarking presented in Halcrow's report to the QCA³⁶ shows that QUU is broadly consistent with its comparators on the basis of the ratio of corporate costs to revenue. This ratio is, however, proportional and consequently conceals any direct/absolute measure of the cost impact. Higher absolute cost (cost per connection), whilst the proportion of revenue being attributable to corporate costs is consistent to its comparators, may be indicative of higher overall costs on the part of the entity being reviewed.

Halcrow notes that the Indicative Corporate Cost Ratios presented in Table 5.46 of its report to the QCA³⁷ in respect of QUU were based on the Corporate Costs proposed by QUU prior to any adjustment, ie. \$68.4 million. In order to show the impact of the adjustment discussed in **Section 4.3.2**, assessment based on Corporate Costs of \$53.27 million is also presented in **Table 4.1** (additional assessment shown in red).

³³ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 85.

³⁴ Ibid.

³⁵ Unitywater letter to the Chairman of the QCA dated 28 February 2013.

³⁶ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 85.

³⁷ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, Table 5.46, page 85.

Table 4.1: Indicative Corporate Cost Ratios (Updated)

| Water Company | Indicator | | |
|---|-----------|------------------------|------------|
| | \$/FTE | \$/customer connection | \$/revenue |
| QUU (based on Corporate costs of \$68.4 million) | 52.9 | 123.8 | 69.9 |
| QUU (based on Corporate costs of \$53.27 million) | 41.2 | 96.4 | 54.4 |
| Unitywater | 38.6 | 122.1 | 66.6 |
| Sydney Water | 39.5 | 66.8 | 53.0 |
| Victorian water retailer/distributor (1) | 109.6 | 80.5 | 77.0 |
| Victorian water retailer/distributor (2) | 89.5 | 62.5 | 78.5 |
| Victorian water retailer/distributor (3) | 64.7 | 35.0 | 43.2 |

Note: Figures for Queensland Urban Utilities and Unitywater sourced from their respective Interim Price Monitoring Information Return/Submission; figures for Sydney Water sourced from the expenditure review consultant's report;³⁸ and figures for Victorian water companies escalated from figures presented in the QCA's 2011/12 Interim Price Monitoring Report).³⁹

4.3.7 Transfer of Staff – Corporate to Operations

QUU has questioned the allowance made by Halcrow in respect of staff transferred from Corporate Services into Operations. In its report to the QCA, Halcrow estimated the value of the transferred staff (FTEs) as approximately \$4.0 million (30.9 @ \$129,400, where \$129,400 is the average cost of Corporate Services staff in 2012/13).

Upon further review, Halcrow acknowledges that the transferred staff should be costed at an alternative rate; \$102,320 is the average cost of Operations staff in 2012/13. On this basis, the cost attributable to the 30.9 transferred staff equates to approximately \$3.162 million.

4.3.8 Halcrow/Authority Recommendation

In its report to the QCA, Halcrow recommended that QUU's forecast corporate expenses for 2012/13 be reduced by \$4.0 million to \$64.4 million to reflect the assessed efficient costs of providing corporate services.⁴⁰ Halcrow provides the following revised assessment of efficient corporate costs on the basis of the discussion outlined above:

- Corporate costs in 2011/12, as reported in the QCA's Interim Price Monitoring Report, was \$52 million. QUU contends that this amount was underreported by approximately \$6.0 million, and that the corrected figure should be \$58.2 million.⁴¹

³⁸ WS Atkins/Cardno, *Final Report; Detailed Review of Sydney Water Corporation's Operating and Capital Expenditure*, November 2011.

³⁹ QCA, *Final Report; SEQ Interim Price Monitoring for 2011-12; Part B - Detailed Assessment*, March 2012, page 99.

⁴⁰ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 87.

⁴¹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 80.

- As outlined in **Section 4.3.5**, Halcrow does not consider that inclusion of the additional \$6.2 million is justified. On this basis, the reported corporate expense allowance of \$52 million reported in 2011/12 is adopted as the baseline value.
- As reported by QUU,⁴² additional corporate expenditure associated with year-on-year variance of 'new initiatives' amount to \$10.2 million; of this amount, \$9.4 million relates to the ICT Separation Program. Notwithstanding Halcrow's assessment that some expenditure identified as 'new initiatives' should more appropriately be identified as 'business as usual' expenditure,⁴³ the additional \$10.2 million is considered justified.
- An adjustment for the transfer of staff from Corporate Services to Operations at the end of 2011/12, amounting to \$3.162 million must be taken into account.
- On this basis, the justified corporate expenses amount to \$59.04 million, which comprises:
 - \$52 million (2011/12 baseline);
 - plus \$10.2 million (additional 'new initiatives');
 - less \$3.16 million (cost of staff transferred to Operations).
- On this basis, the forecast corporate expenses for 2012/13 are overstated by \$9.36 million (\$68.4 million less \$59.04 million).

An alternative assessment can be undertaken as follows:

- Halcrow's assessment of corporate expenses for (benchmarking purposes) amounts to \$53.27 million (refer **Section 4.3.2**). This equates to approximately 20 percent of total operating expenditure (excluding the cost of bulk water).
- The CCQG benchmark in respect of corporate expenses is 10-12 percent of total operating expenditure (exclusion of bulk water costs is considered appropriate in this case). Adopting the upper bound of the range (12 percent), corporate expenses should amount to approximately \$32.0 million. On this basis, a reduction of \$26.73 million (\$53.27 million less \$32.0 million) is justified.
- Accepting, however, that QUU is not operating at, but is moving towards the benchmark allowance (which can be considered to represent fully efficient operation), a reduction based on (say) 16 percent of total operating expenditure could be adopted. On this basis, a reduction of \$10.63 million (\$53.27 million less \$42.64 million) would be more reflective of the efficient corporate expenses.

Considering these two alternative assessments, Halcrow considers that a reduction in the order of \$10.0 million in forecast corporate expenses is justified. On this basis, the adjusted efficient amount of corporate expenses is \$58.4 million.

⁴² QUU, *QCA Interim Price Monitoring: Information Return 2012/13*, 31 August 2012, page 57.

⁴³ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, Table 5.54, page 47.

4.4 Planned Maintenance

On the basis of information available, in its report to the QCA,⁴⁴ Halcrow reported a \$10.82 million (245 percent) increase in subcontractor costs related to planned maintenance from 2011/12 to 2012/13 (\$4.42 million to \$15.24 million). Halcrow acknowledges that, in comments provided in response to Halcrow's draft report to the QCA,⁴⁵ QUU indicated that the expenditure for 2011/12 was incorrectly reported and nominated \$7.352 million; it did not, however, demonstrate or explain the compilation of this figure.

Additional information/explanation now provided during discussions between QCA and QUU representatives enables the figure proposed by QUU to be reconciled:⁴⁶

"QUU's estimate of \$7,352k is taken from the QCA 12-13 (Budget) and 11-12 (Actual) Total Costs with QCA definitions.xlsx. It is the sum of all 2011-12 cost codes in both Other Materials and Services and Other that start with 654,xxx. While Halcrow correctly identified the cost category of 'contractor/sub-contractor costs' in the 2012-13 budget, QUU noted that the 2011-12 actuals sometimes include greater cost disaggregation than budget. In this instance, there are other 2011-12 cost sub-categories such as 'contractor/sub-contractor costs – educting and cctv' which, if included, increase the 2011-12 estimate from \$4,415k to \$7,352k."

In light of this clarification, Halcrow has been able to reconcile the subcontractor costs amounting to \$7.352 million (\$7.536 million including 2.5 percent escalation), although notes that this amount includes some \$0.583 million designated as "Contractor/Sub-Contractor Costs – Capital Program", which tends to suggest that this portion should be excluded (this would result in 2011/12 planned maintenance related subcontractor costs amounting to \$6.768 million (\$6.937 million)).

On this basis, the increase in subcontractor costs related to planned maintenance would amount to \$7.700 million (\$8.299 million if costs related to the capital program are excluded).

QUU has also now provided details of its proposed increase in planned maintenance.⁴⁷ Schedules outlining proposed maintenance activities which would result in an increase of \$7.634 million in QUU's planned maintenance expenditure are presented. Although not stated, it is assumed that this represents additional work proposed to be undertaken by subcontractors during 2012/13.

⁴⁴ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, Table 5.54, page 94.

⁴⁵ QUU, *QUU Response to Revised Halcrow Report* (attachment to email dated 19 December 2012) (QUU response to: Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 1.3)*, December 2012).

⁴⁶ Email QCA to Halcrow, FW: *QUU Response to QCA Draft Report*, 6 March 2013.

⁴⁷ Email QUU to QCA, FW: Further information in relation to Planned Maintenance, 4 March 2013 and attachment (*Detail of Increase in Planned Maintenance for QCA.xls*).

The activities identified in the schedules appear appropriate, however, a listing of the base activities has not been reviewed to verify that the identified activities are all additional activities. In the absence of further breakdown (scope and costing), it is not possible to make an effective assessment of the efficiency of the nominated aggregate costs. Notwithstanding, the cost estimates appear likely to be of an appropriate order for the described activities.

On the basis of this information in respect of the additional planned maintenance activities, the additional subcontractor costs appear to be justified. Halcrow does, however, have concerns in respect of the practical implementation of this additional work (on top of existing programs) and realisation of the associated expenditure. Halcrow's assessment of the "*more likely scenario*"⁴⁸ was intended to be an assessment (albeit high level) of the workforce growth that might be reasonably expected within a twelve month period.

In consideration of this further assessment, Halcrow proposes that a reduction of \$3.70 million (\$7.70 - \$4.0 million) be applied to the forecast Other Materials and Services expenditure in 2012/13. This should be increased to a reduction of \$4.30 million (\$8.30 - \$4.0 million) if costs that appear to be related to the capital program are excluded.

⁴⁸ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, Table 5.54, page 113.

5 Capital Expenditure

5.1 “Low Appetite for Risk”

As noted by QUU in its Response, in its report to the QCA, Halcrow expressed the view that on the basis of its review of a sample of capital projects, QUU appears to have a low appetite for risk. This view was arrived at based on the understanding developed of QUU’s approach to planning and budgeting for its capital program.

More specifically, this assessment based on:

- the adopted ‘Zero failure’ driver for the Sewer Pump Station Reliability Program;
- the adopted contingency rates, which Halcrow considered in a number of cases to be excessive for the nature of the works involved and the expected stage of project development (particularly given that work was programmed for implementation in the current forecast year;
- the apparent absence of ongoing condition assessment as a driver of renewals expenditure; and
- the adoption of a CDI delivery approach, which provides QUU with an element of control without the overall responsibility for delivery.

5.2 Contingencies

In its Response, QUU notes its disagreement with Halcrow’s view that the contingency allowances it has set are excessive and provides an overview of the approach it uses to determine these allowances. More specifically, it notes that:

“QUU determines contingencies for its stand-alone projects and rolling programs after careful consideration of the scope, scale, risks and complexity of each project. The project risks and by association, its contingencies are evaluated at various stages of the project life-cycle prior to construction. These stages include pre-feasibility stage, pre-market and at post market stage.

Project risks and contingencies also differ between “Greenfield” and “Brownfield” sites, and also between, mechanical and electrical works and network augmentation works.”

Halcrow acknowledges this approach to be appropriate in principle, and recognises that contingencies appear to have been assessed on a case by case basis. It, however, maintains its concerns in respect of the magnitude (ie. proportion of base cost) of the adopted contingency allowances, which are greater than those typically adopted when the stage of development is taken into account.

QUU cites the Sewer Rising Main Renewals Program as illustrating the fact that it assesses contingencies on a case by case basis, with contingency allocations as follows:

“For projects which were straightforward and like-for-like replacements with little or no stakeholder involvement, contingencies of 10% were allocated, other more complex works were allocated 20%.”

Halcrow notes that for the Sewer Rising Main Renewal projects reviewed, the minimum contingency allowance amounted to 20 percent with others (excluding the Indooroopilly Road projects) attracting allowances of 23 percent.

QUU advises that, in the case of the Indooroopilly Road Railway Bridge Crossing and High Point Rising Main projects, higher contingency allowances were allocated due to anticipated extensive consultation with multiple stakeholders, including Queensland Rail and Brisbane City Council. Whilst extensive consultation may have been required, given the forecast expenditure of almost \$4 million in 2012/13, Halcrow would expect stakeholder consultation to be well advanced and (consequently) cost implications reasonably well understood at the time of 2012/13 budget preparation.

Furthermore, Halcrow would generally expect planning for the majority of works to be implemented in the forecast year to be developed to a relatively high level of definition, sufficient to attract contingency allowances in the range 10-15 percent, at the time of budget preparation. Accordingly, Halcrow has recommended adjustments on this basis, with higher allowances for some more complex projects where the need has deemed to have been demonstrated.

Whilst the Evans and Peck report was referenced in Halcrow's report to the QCA,⁴⁹ Halcrow notes that it has not adopted the view that "*projects with a delivery horizon of 0-5 years should have a contingency allowance of 5-10 percent.*" The reference was included to provide alternative comment that is (in part) supportive of the lower end range of contingency allowances recommended by Halcrow (ie. 10-15 percent).

The contingency allowances recommended by Halcrow are also consistent with previous recommendations to the QCA⁵⁰ in respect of typical confidence levels for estimates at various stages of design development, which are as follows:

- detailed design/tender stage: ± 10 percent;
- preliminary design: $\pm 15-25$ percent; and
- concept design: $\pm 25-35$ percent.

Halcrow also notes that, from an overview perspective, QUU is being funded to deliver a capital program, the delivery of which will result in 'swings and roundabouts' whereby some projects within the program are delivered below estimate and others above estimate. Whilst it is reasonable to build up the overall program estimate on a project by project basis, with an allowance for contingency (based on the level of definition at the time of estimating), it is not reasonable to base a customer funded capital program on the assumption that the worst case scenario will apply for all projects.

Consequently, Halcrow maintains that the adjustments it has recommended are appropriate.

⁴⁹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page 133.

⁵⁰ Halcrow, *SEQ Interim Price Monitoring: Assessment of Capital Expenditure on Various Sewage Treatment Plants; Review Report*, October 2010, page 51.

5.3 Manly Elevated Steel Tank

In its Response, QUU has acknowledged that the only costs associated with making the structure of the Manly Elevated Steel Tank safe should be included in the cost base. In Halcrow's report to the QCA,⁵¹ it was assumed (in the absence of a detailed breakdown on cost) that the cost of the 'safety' works would amount to approximately 50 percent of the total cost. QUU has now provided a breakdown of costs, including an indication as to whether each cost component relates to safety or operational requirements.

QUU also contends that internal repair and coating of the tank was required from a safety viewpoint. Whilst it has not reviewed any reports of the inspection referenced in QUU's Response, Halcrow accepts that internal repair and coating of the steel tank was required for structural integrity (and therefore safety) reasons.

Halcrow has reviewed the breakdown of costs provided by QUU; on the basis of the item descriptions (ie. in the absence of specific detail of the scope of work involved), the cost estimates and allocation generally appear reasonable. Halcrow does, however, anticipate that a proportion of cost associated with Site Establishment and Demobilisation; Preparation of the Contract Management Plan; and Design would also be attributable to the operational requirements.

Assuming an allocation based on the proportion of the remaining costs (ie. 9 percent), \$9,913 of the total \$110,200 associated with these items should be allocated to operational requirements. Accordingly, \$87,990 of the total contract cost is attributable to operational requirements. This will attract proportional (9 percent) allocations of the contingency (\$5,629) and internal costs (\$17,990), bringing the total cost attributable to operational requirements to \$111,600, which should be removed from the 2012/13 expenditure forecast in respect of the Manly Elevated Steel Tank. This compares to the previously recommended reduction of \$620,000.

5.4 Sewer Pump Reliability Improvement Program

Halcrow acknowledges that the Brisbane Sewer Pump Station Reliability Program was initiated as a result of a dry weather overflow event at the Heroes Avenue Sewage Pumping Station. Halcrow was not, however, previously aware of the specific action taken by the Environment Protection Agency or the Enforcement Order by the Planning and Environment Court⁵² referred to in QUU's Response.

Assuming that the Court Order reflects the requirements set out in the EPA's Application,⁵³ it is noted that the requirements are (in summary) that QUU:⁵⁴

⁵¹ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page A-10.

⁵² Court Order not sighted.

⁵³ EPA Application to the Planning and Environment Court, Reference BD 2472/05 dated 8 July 2005.

⁵⁴ The Application was made in respect of Brisbane City Council, QUU's predecessor in respect of the provision of water and wastewater services; QUU took on the responsibilities from July 2010.

- Commission an independent consultant to provide a report with respect to practical measures which it might be taken to provide additional safeguards to minimise sewage overflows from its sewage pumping stations.
- Request that the independent consultant adopt a risk based approach in addressing matters including but not limited to:
 - Improving the reliability of sewage pump station control systems; and
 - Preventing dry weather overflows from pump stations by considering backup power and storage options, where applicable and appropriate.
- Formulate (and action) an implementation plan which responds to the reasonable and practicable recommendations of the independent consultant's report.

QUU engaged an independent consultant as required. As noted in QUU's Response, the consultant's report:⁵⁵

- concluded that "...Councils current and proposed initiatives to improve its management of its dry weather overflow capability are considered practical and generally appropriate for an organisation such as Brisbane Water";⁵⁶ and
- commented in respect of the Pump Station Telemetry and Control Systems initiative, "Projects need to be managed to completion".⁵⁷

Halcrow further notes the consultant's observations as follows:

- "Council has undertaken a spreadsheet-based risk assessment which ranks all sewerage pump stations against a range of performance indicators. The approach used by Council appears robust and is considered reasonable. ... Risk assessments need to be undertaken for those sewerage pump stations which have not been subjected to the analysis."⁵⁸
- In respect of the Pump Station Telemetry and Control Systems program:
 - "...the business has embarked on a comprehensive program for upgrade of the network Supervisory Control and Data Acquisition (SCADA) and Remote Telemetry Unit (RTU) systems. The objective of this upgrade is to improve the operational capability and accountability of the business";⁵⁹ and
 - "The scope of these projects should ensure that Brisbane Waters Dry Weather Overflow events should be better managed in future. The above suite of projects is largely underway or committed and is considered to be appropriate for an organisation of the size and capability of Brisbane Water. It is our experience that many other large SEQ authorities have either embarked on similar strategies or are currently considering such."⁶⁰

⁵⁵ Integran, *Review of Practical Measures for Minimising Dry Weather Overflows from Sewerage Pumping Stations*, April 2006.

⁵⁶ Ibid, page 37.

⁵⁷ Ibid, Table 5, page 35.

⁵⁸ Ibid, page 33.

⁵⁹ Ibid, page 18.

⁶⁰ Ibid, page 21.

- “Council has a range of programs in place to assist in minimising the occurrence of dry weather overflow events. Several of these projects are in progress. The business is demonstrating its commitment to the management of dry weather overflow events by: ... Completion of the Pump Stations Telemetry and control systems upgrade projects.”⁶¹

Whilst the independent consultant’s report supports the implementation of the Pump Station Telemetry and Control Systems initiative as a whole, Halcrow remains concerned that the project is being (has been) implemented across the full portfolio of QUU’s sewage pumping stations without assessment of condition/performance. Furthermore, as noted above, the independent consultant indicated that whilst Council was implementing a robust risk assessment process, such assessments had not been undertaken in respect of all sewage pumping stations.

Halcrow acknowledges the prudence of this project in principle, however, given that it has not seen evidence that condition/performance or risk assessments have been undertaken across the full portfolio of sewage pumping stations, is of the view that the need for upgrade/replacement works at all pumping stations has not been shown to be prudent.

In respect of the assessed efficiency of expenditure, Halcrow acknowledges that there will be specific challenges at individual sites. It is, however, of the view that such challenges will not be removed as a result of work packaging; contractors will factor risk into pricing regardless, and may be prepared to reduce ‘risk allowances’ when there is a greater cost base against which to do so. Risk allowances will only be removed when work can be better defined at tender stage.

Halcrow maintains the view that appropriate longer term packaging has the potential to reduce the cost of implementing programs of works, and again notes QUU’s advice (as noted in Halcrow’s report to the QCA)⁶² that it is “*reviewing and revising its procurement and packaging arrangement to achieve improved efficiencies with regard to this project*”.

5.5 Brisbane Meter Replacement Program

In Halcrow’s report to the QCA,⁶³ it recommended adjustment of the forecast expenditure in respect of the Brisbane Meter Replacement Program “... to reflect the difference between the unit cost shown in the Business Case and the actual unit cost incurred in the renewals program list.” In QUU’s Response, it advises that the differences in unit cost arise as follows:

- Business Case – \$170 is the estimated unit cost per meter replacement over the period of time covered in the Business Case (ie. 2011-2014) and the work identified in the Business Case consists of a number of meter groups.

⁶¹ Ibid, page 37.

⁶² Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page A-33.

⁶³ Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page A-17.

- Program List – \$150 is the unit cost of meter replacement based on the specific characteristics of the meter groupings planned to be replaced in the 2012/13 financial year.

On this basis, Halcrow acknowledges that a unit cost rate of \$150 may not be appropriate for future years, however, maintains that the portion of the adjustment (which reflects the difference in the two rates) to the forecast expenditure in 2012/13 should be applied.

QUU's comments in respect of meter acquisition by its installation contractor, including those in respect of the two (2) preferred meter suppliers,⁶⁴ are noted. Notwithstanding, in the absence of details of the installation contractor's approach to procurement, Halcrow remains of the view that term contracts with a small number of suppliers has the potential to deliver improved cost efficiencies.

Accordingly, Halcrow maintains that recommended adjustment to the forecast expenditure in 2012/13 (ie. a reduction of \$314,000)⁶⁵ is appropriate. It does, however, acknowledge that the adjustment on the basis of unit cost in future years may not be appropriate (costs will be dependent upon meter groupings to be replaced in those years).

⁶⁴ The fact that two (2) suppliers have become 'suppliers of choice was acknowledged in Halcrow's report to the QCA (Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, page A-15).

⁶⁵ Adjustment of \$314,000 actually equates to the difference between the computed cost of meter replacement (42,452 meters @ \$150 per unit = \$6,378,800 (number of meters and rate from Program List)) and the allowance reported in the Program List (\$6,693,000) (refer: Halcrow, *SEQ Water and Wastewater Price Monitoring 2012-13; Queensland Urban Utilities; Assessment of Operating and Capital Expenditure – Review Report (460502-32-001 Version 2.2)*, January 2013, Table A.3, page A-16). No adjustment was made in respect of procurement efficiencies in 2012/13.