

# Allconnex Water Submission: QCA Draft Report

SEQ Interim Price Monitoring for 2010/11



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# 1 Introduction

In early February 2011 the Queensland Competition Authority (QCA) released its draft report *SEQ Interim Price Monitoring for 2010/11 (the Report)*. The Report details findings of the QCA's review of the pricing and cost recovery practices of the three participating Council-owned distributor-retailer water authorities. The Report was provided in two volumes: Part A – Overview (Part A) and Part B – Detailed Assessment (Part B).

The QCA has invited submissions on the Report. The QCA must finalise its Report not later than 31 March 2011.

Allconnex Water generally accepts most of the QCA's findings and recommendations. There are some specific issues to which Allconnex Water provides comment for the consideration of the QCA. It is only these specific issues that frame Allconnex Water's submission.

The specific issues addressed within the submission should be considered by the QCA as part of the QCA's current and future role in prices oversight.

The Report confirms Allconnex Water is currently below the Maximum Allowable Revenue as determined by the QCA.<sup>1</sup> This current level of under-recovery is consistent with Allconnex Water's long-term approach to cost recovery in order to mitigate price shocks to customers.

The Report notes the QCA "...has not found evidence of an exercise of monopoly power in 2010/11".<sup>2</sup> Allconnex Water agrees with this assessment confirming Allconnex Water is not overcharging for water and wastewater services.

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<sup>1</sup> QCA *SEQ Interim Price Monitoring - Draft Report Part A – Overview*, February 2011, p. ii.

<sup>2</sup> *Ibid.*

## 2 Response to specific issues

### 2.1 RAB roll-forward

The Report generally accepts Allconnex Water's approach to determining the opening Regulatory Asset Base (RAB) for 1 July 2010, as consistent with the terms of the Minister's Direction Notice. The QCA's RAB as at 1 July 2010 does not differ materially from that calculated by Allconnex (\$4,087.39 million compared to Allconnex Water's \$4,079.95).

The difference in the opening RAB is a result of a minor variance in the indexation rate for 2008/09. Allconnex Water used an indexation rate of 2%, while the QCA adopted an indexation rate 2.02%. This difference is then carried forward to the 2009/10 calculations. Other minor variances such as timing assumptions and the valuation of disposals appear to account for the residual difference.

For the current period, the QCA has adopted the regulatory useful lives proposed by Allconnex Water, noting that a comprehensive review of individual asset lives would form part of any deterministic regulatory regime going forward. Allconnex Water looks forward to the opportunity to contribute to such a review, and in the absence of further guidance from the QCA will continue the current approach to calculating both depreciation (based on existing useful lives) and its RAB more broadly.

Allconnex Water has updated the QCA information requirement templates based on 2009/10 audited accounts and supporting information provided by participating Councils. Specifically, templates 5.1.1, 5.1.2, 5.1.3 and 5.6.1 have been amended. The participating Councils have also received advice from the Minister for Natural Resources, Mines and Energy and Minister for Trade finalising allowable establishment costs.

The templates include an additional \$6.3 million in capital expenditure for 2008/09. This reflects expenditure on drought assets not previously included in the market valuations performed by KPMG used to set the initial RAB. Supporting documentation concerning this issue and other issues associated with the information templates will be provided to the QCA on request.

The amended templates are provided as a separate Excel spreadsheet to this response.

Allconnex Water expects the amended templates will allow the QCA to finalise the initial 1 July 2010 RAB.

### 2.2 Capital expenditure

#### *Capital Expenditure Efficiency*

The Report determined most proposed capital expenditure for 2010/11 was prudent and efficient.

Allconnex Water's original submission included participating Councils' capital expenditure forecasts. Following the submission to the QCA, Allconnex Water undertook a comprehensive review of the capital program based on the regulatory principles of prudence and efficiency. As a consequence of this review, these forecasts were revised down by Allconnex Water. This revision included either the deferral or removal of approximately \$168m in capital expenditure for 2010/11.

The Report identifies a further reduction of \$2.5m for 2010/11, with larger reductions flagged for future years. Allconnex Water acknowledges that further review is required in relation to the timing of future capital projects, however, notes it has already

significantly reduced the original participating Council provided forecasts of expenditure by approximately \$500 million over three years.

In response to the capital expenditure project checklist detailed on page 91 of the Report, Allconnex Water has formalised internal business case requirements to demonstrate 'prudence and efficiency' for all future capital expenditure budget submissions. Processes for capital budgeting and planning were not uniform across the three former participating Council water businesses and these have also commenced standardisation.

Allconnex Water has committed to the establishment of a corporate Project Management Office (PMO) to provide clear governance and reporting for all projects. A key feature of the PMO is the implementation of a 'gateway review' process, independent of the project management methodology used. An external party has been engaged to facilitate the implementation of this process, expected to 'go live' by the end of the current financial year.

### ***Consistent Standards of Service and Capital Expenditure Processes***

Allconnex Water is currently working towards more consolidated, entity-wide, processes and business standards.

Allconnex Water agrees with the QCA that

*Allconnex should develop processes which take into account a regional perspective when developing future capital works programs.<sup>3</sup>*

This is already occurring within the business. Allconnex Water no longer develops capital and operating budgets based on local government boundaries. The business captures costs at a whole of business level and focuses on the prudent and efficient delivery of operating and capital expenditure across the entire service delivery area.

In relation to the consolidation of service standards across the region, Allconnex Water is close to finalising a comprehensive business-wide customer service standard. In addition, the delivery of a Water Network Services (NetServ) Plan is underway. This plan includes desired levels of service for infrastructure planning, with a consultation draft to be completed by 30 June 2012 (in order to meet the requirements of the *South-East Queensland Water (Distribution and Retail Restructuring) and Other Legislation Amendment Act 2010* by 1 July 2013).

### ***Provision of capital expenditure data***

Allconnex Water is committed to working with the QCA to provide detailed information on capital expenditure in the future. In particular, the Report requests that data on capital expenditure be captured and reported to allow for capitalisation of expenditure upon commissioning, as compared to the previous approach of reporting expenditure on an 'as-incurred' basis.

Allconnex Water agrees this is appropriate, and would allow the relevant asset to be included in the RAB only when it is able to contribute to the productive capacity of the system (though also notes that its previous approach is almost 'MAR-neutral' since Work in Progress expenditures attract interest-during-construction (at the relevant WACC rate) and Allconnex Water has elected a glide-path approach to cost

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<sup>3</sup> QCA *SEQ Interim Price Monitoring - Draft Report Part B – Detailed Assessment*, February 2011, p. 106.

recovery). The most significant difference being only the commencement of regulatory depreciation for inclusion in the MAR.

As part of its capital planning and budgeting process, Allconnex Water has already introduced a process to ensure, where possible, commissioning dates and other relevant information is captured. However, some data issues are likely to persist into the next prices monitoring period. Principally, these issues relate to the disaggregation of expenditure across the QCA's nominated asset categories.

As part of transitioning away from using participating Council systems under Service Level Agreements there have been difficulties capturing this information as participating Councils did not historically collect data in these categories. Allconnex Water has begun the implementation of an Enterprise Resource Planning system and development of supporting processes to improve processes for the collation of this information in future.

There also is significant complexity in unbundling the joint costs and cost drivers associated with wastewater services (e.g. treatment processes). Given this complexity, Allconnex Water requests further information as to how disaggregated information on costs will inform the development of pricing principles.

In relation to future forecasts for contributed assets and capital contributions across all districts, Allconnex Water draws the QCA's attention to the Infrastructure Charges Taskforce's current recommendations.<sup>4</sup> Any impacts of these recommendations will need to be incorporated in future regulatory processes.

### **Indexation**

The Report states Allconnex Water's capital expenditure indexation rate of 5% is reasonable, but notes that:

*a consistent indexation rate across SEQ will be investigated over the interim price monitoring period, taking into account further research and actual outcomes.<sup>5</sup>*

Allconnex Water looks forward to being involved in a consultative process with the QCA on indexation rates, with the opportunity to provide input.

In the absence of further direction from the QCA before the 2011/12 interim price monitoring submission and/or the early release of an issues paper on the subject of indexation for the 2013-14 deterministic submission, Allconnex Water will continue to adopt the same approach for capital indexation as used in the 2010-11 submission.

## **2.3 Depreciation**

The QCA's estimate of depreciation is broadly consistent with Allconnex Water's estimate, though reflecting adjustments to the capital base for a slight change in the opening RAB and lower re-forecast capital expenditure.

Allconnex Water intends to continue applying the same approach to calculating depreciation for the 2011/12 prices monitoring period.

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<sup>4</sup> Infrastructure Charges Taskforce, *Interim Consultation Report - Proposed reform of Local Government development infrastructure charges arrangements*, November 2010.

<sup>5</sup> QCA *SEQ Interim Price Monitoring - Draft Report Part B – Detailed Assessment*, February 2011, p. 90.

## 2.4 Operating costs

The QCA's estimate of operating costs is broadly in line with Allconnex Water's total operating budget, though with adjustments to various cost components. These adjustments include:

- additional assumed synergies of 2% across all non-bulk water operating costs from the consolidation of the three former businesses;
- adjustments to escalation rates;
- minor additional costs; and
- the QCA's revised demand forecasts that affect volume-related costs such as bulk water and chemical costs..

The Report also flags the potential for greater efficiency adjustments in future years.

While Allconnex Water accepts the concept of a reasonable efficiency target, it considers that the QCA's current target of 2% may not be achieved across *all* non-bulk cost categories in the short- to medium-term. This is due to certain costs being relatively fixed in this period.

For example, labour costs are relatively inflexible since the SEQ Urban Water Arrangements Reform Workforce Framework 2010 requires no forced redundancies or overall loss of employment, and Enterprise Bargaining Agreements include prescriptive wage escalation rates. The QCA's independent consultant noted these factors may limit Allconnex Water's ability to achieve full labour efficiency. The consultant concluded Allconnex Water's labour escalation rate (4%) was reasonable, since the labour escalation rate used by Allconnex Water was in line with both the Australian Energy Regulator forecast indices and the historic trends as derived from the Labour Price Index. The consultant also concluded the growth factors used to determine employee costs were reasonable.<sup>6</sup>

Allconnex Water considers electricity costs to be relatively uncontrollable in the short-term. The type of electricity purchase agreement will have a significant impact on electricity costs and Allconnex Water agrees with the QCA the most efficient option should be sought. However, Allconnex Water is bound by State Procurement Policy and considers to meet the requirements of this policy price negotiations with electricity suppliers are unlikely to be concluded in time for cost savings to accrue in the current financial year. Any resulting agreement is unlikely to affect electricity costs in the short-term. Therefore, efficiency gains in electricity costs will only occur in the medium- to long-run. In addition to the general 2% 'efficiency adjustment', the QCA also adjusted the escalation rate for electricity costs. Allconnex Water considers that this is a duplicate reduction, and that the generalised efficiency adjustment should therefore *not* apply to electricity costs.

Similar to the QCA's approach to electricity costs, the QCA's adjusted estimate of chemical costs includes a specific adjustment of 0.5% for potential efficiency gains and economies of scale.<sup>7</sup> Allconnex Water believes this is duplicated by the general efficiency adjustment for all non-bulk costs. Based on the QCA's cost estimates, to achieve the same operating cost adjustment to non-bulk costs (*excluding* labour,

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<sup>6</sup> *Ibid.*, p. 122.

<sup>7</sup> *Ibid.*, p. 124.



electricity and chemicals) would require a 3.3% reduction in wastewater operating costs and a 3.1% reduction in water operating costs – a total average reduction of 3.2%.

The integration of the three former participating Council businesses, and the adoption of various legacy participating Council arrangements, means it may be difficult to achieve the additional cost reductions proposed by the QCA in the short-term. Allconnex Water does, however, expect that efficiencies may be achieved by various future business initiatives and projects. Allconnex Water's own financial modelling has incorporated an efficiency adjustment after the initial integration period.

Allconnex Water is committed to delivering value for money for its customers, and is currently implementing a range of cost-reduction initiatives.

## **2.5 Return on capital**

Allconnex Water, along with the other distributor-retailers, has separately submitted a report by CEG addressing the WACC methodology and parameters proposed by the QCA.

## **2.6 Taxation**

The QCA's tax estimate is lower than Allconnex Water's estimate, due to the lower capital base and lower deductions for depreciation. The QCA notes that its approach is consistent with its interpretation of the LGTER. However, there is insufficient information in the Report to determine in detail the basis for the modelled reduction in tax costs.

At the time Allconnex Water formulated its pricing for the financial year 2010-11, the State Government had not provided guidance on the tax transition arrangement to apply under the Local Government Tax Equivalents Regime (LGTER). As a result, Allconnex Water's submission used the RAB as a proxy tax base. For future submissions, Allconnex Water's opening tax cost base is likely to change, although this issue may remain open for 2011/12 as it has not yet been formalised within the business.

Allconnex Water remains of the opinion that its 2010/11 submitted tax cost was relatively conservative given the likely variance between the RAB value and LGTER tax cost base (which is likely to be much lower, leading to lower deductions for depreciation and therefore a higher tax cost). This is despite the QCA's adjustments for the treatment of contributed and donated assets.

It is understood the QCA received advice on the updated Local Government Tax Equivalents Manual (released in September 2010), after the 30 August 2010 submission by Allconnex Water to the QCA. As the QCA indicates this advice validates the QCA's approach to modelling contributed and donated assets, Allconnex Water requests the QCA to provide a copy of the advice to the entities. This will enable the entities to internally validate the tax treatment of contributed and donated assets (in particular, those received by participating Councils prior to the 'acquisition' of the water businesses on 1 July 2010).

## **2.7 Demand**

Allconnex Water generally accepts the QCA's various refinements to its demand forecasts, however notes there are a number of additional issues that should be considered for future reviews.



The Report states residential connections should be based on the Queensland Government's Population Information and Forecasting Unit (PIFU) forecasts, therefore slightly increasing estimated water connections over the next three years as compared to Allconnex Water's original forecast. Allconnex Water is concerned that solely using PIFU forecasts may not fully reflect changing economic and demographic conditions, as PIFU data is updated at irregular intervals. Additionally, it is unclear how the PIFU data has been used in developing the connections forecasts adopted by the QCA. Allconnex Water is concerned the use of average cohorts may lead to inconsistencies and inaccuracies in growth projections.

Allconnex Water is currently developing a history of property data it believes should be used in conjunction with PIFU forecasts in determining future demand.

Allconnex Water agrees with the QCA that daily residential usage should be based on the connected population and not total population as originally adopted in Allconnex Water's submission.

Recent consumption data indicates demand has fallen significantly since prices and budgets were developed for the 2010-11 year and since the interim price submission. This reduction in demand is most likely due to the current wet weather being experienced within South East Queensland rather than pricing. This weather pattern significantly affects outdoor water use by consumers. Outdoor use is likely to be the most discretionary consumption for users. Water demand during recent summer months (a historically high consumption period) has been lower than expected, even with low levels of water restrictions. Water demand in January 2011 for the Gold Coast region was calculated at approximately 184 litres, per person, per day (L/p/d), compared to 215 L/p/d in the submission, and actual demand of 222 L/p/d in January 2010.

Allconnex Water believes water consumption will not return to pre-restriction/ pre-drought levels as quickly, or to the same magnitude as assumed by the QCA. Consumption patterns in other jurisdictions indicate limited "bounce-back" to original levels of demand following the removal of restrictions.

For example, Melbourne Water indicated that, despite moving from mandatory to voluntary water conservation measures, Melburnians continued to conserve water during 2009/10.<sup>8</sup>

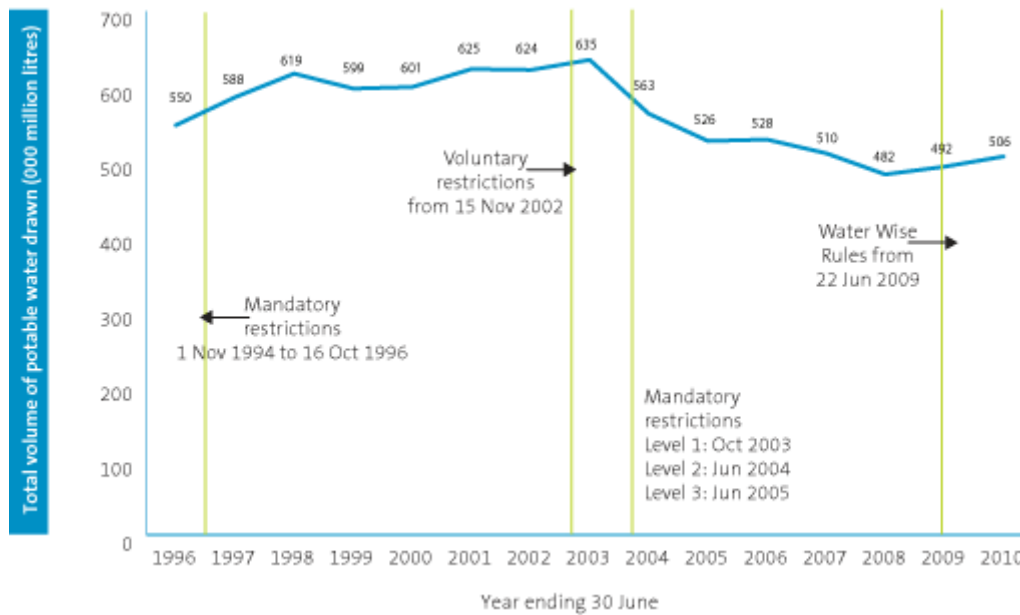
Similarly, Sydney Water indicated that, during 2009-10, customers maintained water use at levels achieved under level 3 drought restrictions, despite the introduction of Water Wise Rules (see Chart 1). In addition, Sydney Water stated that the low level of water use is anticipated to continue until at least 2015.<sup>9</sup> Sydney Water also indicated that, while per person demand increased in 2009-10, the increase was much less than anticipated given the lifting of restrictions.

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<sup>8</sup> Melbourne Water *Annual Report 2009/10*, August 2010, p. 6.

<sup>9</sup> Sydney Water, *Annual Report 2010*, 2010. available at [http://www.sydneywater.com.au/Publications/Reports/AnnualReport/2010/performance/sustainability/water\\_efficiency\\_si4.html](http://www.sydneywater.com.au/Publications/Reports/AnnualReport/2010/performance/sustainability/water_efficiency_si4.html)

**Chart 1: Total volume of water drawn by Sydney Water from all sources**



Source: Sydney Water *Annual Report 2010*.

In a recently released report for Sydney Water, Abrams et al indicated that a number of factors have contributed to the sustained reduction in water use, including:

- water conservation activities, including:
  - subsidised water efficiency programs; and
  - regulatory measures, planning requirements and promoting water efficient appliances;
- drought restrictions on outdoor water use;
- concerns over water security during severe and sustained drought; and
- increases in water usage prices from 1 October 2005.<sup>10</sup>

Allconnex Water expects similar factors to impact future demand in the Allconnex Water network.

Allconnex Water agrees with the QCA's recommendation to incorporate elasticity estimates into its demand forecasts. However, as suggested by the Water Services Association of Australia, significant step changes in consumption behaviours mean that previously observed relationships between price and demand are now untested and unreliable.<sup>11</sup>

<sup>10</sup> Abrams, B., Kumaradevan, S., Sarafidis, V. and Spaninks, F., *The Residential Price Elasticity of Demand for Water*, Joint Research Study, Sydney, February 2011, p. 18

<sup>11</sup> Water Services Association of Australia, *Submission to Productivity Commission Issues Paper: Australia's Urban Water Sector*, November 2010, p. 15.

Consistent with this conclusion, a recent study on the responsiveness of residential households to water usage prices in Sydney found elasticity estimates were generally lower than previous studies in Australia, and well below the commonly assumed constant elasticity of -0.3.<sup>12 13</sup> In addition, the study noted that it would be necessary to re-estimate the price elasticities should households increase their level of water use to pre-drought restrictions levels.<sup>14</sup>

As noted in the QCA's Report, a further complication is the large proportion of tenanted properties in the Allconnex Water network. It is estimated that tenant properties (that do not receive water bills) account for up to 40% of Gold Coast customers. Allconnex Water considers a comprehensive investigation into price elasticity of demand would need to be conducted over an extended period of time. However, given the possible introduction of tenant billing in the future, it would appear impractical to conduct such an investigation at this time.

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<sup>12</sup> Abrams, op. cit., p. 41.

<sup>13</sup> The differing estimates also reflect differences in model specification.

<sup>14</sup> Abrams, op. cit., p. 6.

## 3 Other matters

### 3.1 Glide path

Allconnex Water's prices for 2010/11 were set with reference to cost recovery over a longer-term glide path. While Allconnex Water was the only one of the three businesses to propose a glide path, it considers that this was essential in to avoid undue customer impacts in the short-term.

The Report acknowledges the Ministers' Direction Notice requires the QCA to take into account any revenue glide path submitted by the entity for the purpose of avoiding price shocks over the interim period. However, it does not comment on whether a glide path longer than the three-year interim price monitoring period will be recognised as part of any future deterministic pricing regime.

Allconnex Water considers that a longer-term glide path is appropriate and should be recognised by the QCA. Importantly, the current bulk water price path has been set over a 10-year period (extending beyond the 2010/11 to 2012/13 period). This impacts Allconnex Water's ability to pass on fully cost-reflective prices.

Allconnex Water requests further guidance in relation to the QCA's proposed treatment of its longer-term glide path, to assist it in determining prices for 2011/12 and 2012/13.

### 3.2 Provision of data

Allconnex Water notes the Report focuses on a comparative analysis of costs and revenues at a relatively high level. Cost recovery is reported only at the level of water and wastewater functions (for example, there is little information concerning costs or revenues for recycled water or trade waste services). Likewise there is little information in relation to the level of cost recovery at a district level, despite the Authority requiring the entities to report cost and other data at a very granular level by service (and sub-service) and by district.

Allconnex Water notes that it, and the other entities, were unable to provide cost and revenue data at the level required by the QCA for 2010/11, and acknowledges this is likely to be a continuing issue for 2011/12 given the difficulties associated with disaggregating some cost categories and notwithstanding the ongoing efforts to improve data-capture across the business.

Additionally, the Report directs Allconnex Water to apply a more 'regional' perspective to its capital planning. This implies the geographic location at which costs are incurred may be less relevant to future prices monitoring investigations. Allconnex Water agrees that a participating Council boundary determined approach to cost capture is not appropriate. As previously indicated, Allconnex Water no longer develops capital and operating budgets based on local government boundaries. The business captures costs at a whole of business level and focuses on the prudent and efficient delivery of operating and capital expenditure across the entire service delivery area.

Accordingly, Allconnex Water proposes to achieve the objective outlined by the QCA and not allocate costs at a participating Council boundary level for future submissions.

### 3.3 Pricing structure

The Report does not provide the entities with any guidance on the QCA's expectation in relation to future pricing structures. Allconnex Water and the other entities are

navigating difficult and complex price harmonisation and tariff reform issues without guidance from the regulator on key matters of principle.

In determining prices for 2010/11, Allconnex Water broadly retained the previous participating Council pricing structures, and determined a 'flat' percentage adjustment to prices based on the apparent level of cost recovery for each district and each major product. In future, Allconnex Water expects to move towards a more consolidated view of cost recovery across the whole business.

Allconnex Water is required to publish proposed prices for 2011/12 not later than 31 March 2011. These prices are being developed without pricing principles providing specific guidance on the Authority's views regarding pricing.

Allconnex Water acknowledges the QCA has not received a formal direction for future deterministic pricing, expected to commence in 2013. Allconnex Water considers (at least) broad guidance in relation to these structural matters associated with pricing should be provided.

### 3.4 Comparative prices and revenues

Part A of the Report provides a comparative analysis of costs and revenues across the three entities.

The QCA assessed that average water price increases ranged between 13.9% and 23.0% and average wastewater price increases ranged between 12.1% and 18.9%.<sup>15</sup> Allconnex Water's water and wastewater price increases for FY10/11 were at the upper end of this range.

Despite being at the upper end of the average prices increases, the QCA has assessed Allconnex Water as having the *lowest* level of cost recovery.

Allconnex Water asserts this difference in cost recovery may be attributable to methodological differences in the calculation of MAR for 2010/11. In particular, Allconnex Water adopted an asset-offset approach to calculate the RAB and MAR whereas the other two entities applied a revenue-offset approach.

In addition, Allconnex Water believes the comparison provided by the QCA should account for differences in bulk water prices set by State Government. Allconnex Water currently has the highest average bulk water price of the three distributor-retailers. Allconnex Water is paying around \$0.10/kL more for bulk water than Queensland Urban Utilities and \$0.29/kL more than UnityWater. The removal of the bulk water price contribution indicates Allconnex Water's FY10/11 revenue per kilolitre is lower than UnityWater, though remaining higher than Queensland Urban Utilities.

Allconnex Water also notes that cost comparisons at an aggregate level, as presented in Part A of the Report, should acknowledge:

- different levels of spare capacity that may be evident in the capital bases;
- differences in service standards; and
- other legacy operational arrangements.

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<sup>15</sup> QCA SEQ Interim Price Monitoring - Draft Report Part A – Overview, February 2011, p. ii

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