



Draft Report

**SEQ Interim Price Monitoring for
2011-12**

Part A - Overview

January 2012

Level 19, 12 Creek Street Brisbane Queensland 4000
GPO Box 2257 Brisbane Qld 4001
Telephone (07) 3222 0555
Facsimile (07) 3222 0599

general.enquiries@qca.org.au
www.qca.org.au

The Authority wishes to acknowledge the contribution of the following staff to this report

Catherine Barker, Fifi Gosali, Keith Hutchinson, Rick Stankiewicz and Roslyn Wood

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This report is a draft only and is subject to revision. Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). Therefore submissions are invited from interested parties. The Authority will take account of all submissions received.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by e-mail. Submissions, comments or inquiries regarding this paper should be directed to:

Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001
Telephone: (07) 3222 0547
Fax: (07) 3222 0599
Email: seqwater@qca.org.au

The **closing date** for submissions is **29 February 2012**.

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PREAMBLE

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

In this second year of the three-year price monitoring period, the Authority's role has been amended to, amongst other things, monitor:

- (a) for distribution and retail water and wastewater services for households and small business customers, the change in prices between 2010-11 and 2011-12 against a CPI cap (of 3.6%); and
- (b) for water and wastewater services not subject to the CPI cap, the change in prices between 2010-11 and 2011-12 having regard to the change in revenue from these services as against the change in the total prudent and efficient costs of the relevant activity.

Changes in the prices of distribution and retail water and wastewater services for households and small businesses differ across SEQ but do not exceed the CPI cap of 3.6%. The total prices paid by customers have increased by more than this when the increase in bulk water prices is taken to account.

For QUU and Unitywater, changes in the revenues of non-capped services (trade waste and recycled water) do not exceed the change in prudent and efficient costs. For Allconnex, the Authority was unable to make a valid comparison, due to changes in methodology and a lack of robust data on connections and volumes. Nevertheless, the Authority notes that Allconnex's trade waste and recycled water prices were only increased by 3.6% in 2011-12.

The entities have made progress in providing required information as identified by the Authority in last year's review. Also, all entities now include capital expenditure into the asset base only when it is commissioned and provides productive capacity.

The Authority's review of a sample of capital projects and programs across SEQ has generally confirmed their prudence and efficiency. Furthermore, the Authority's estimates of the efficient cost of providing services in 2011-12 (the Authority's maximum allowable revenue or MAR) were not significantly different from those of the entities.

With respect to revenues, the Authority has found that, for 2011-12:

- (a) QUU's forecast total water and wastewater revenues of \$775.9 million are below the Authority's MAR of \$807.9 million;
- (b) Allconnex's forecast total water and wastewater revenues of \$629.0 million are well below the Authority's MAR of \$804.6 million; and
- (c) Unitywater's forecast total water and wastewater revenues of \$398.4 million are below the Authority's MAR of \$455.3 million.

The Authority found no evidence of an exercise of monopoly power in 2011-12.

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.

Submissions on this Draft Report are due by **29 February 2012**.

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1. OVERVIEW

1.1 Introduction

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

The Authority's role in 2011-12 has been amended following significant legislative changes made in 2011 affecting retail and distribution water and wastewater pricing.

Amongst other things, these legislative changes imposed a consumer price index (CPI) price cap on the retail and distribution component of certain water and wastewater prices for 2011-12 and 2012-13. In addition, the Authority's deterministic role from 1 July 2013 was removed.

Furthermore, participating councils were permitted to opt out of their distributor/retailer business and revert to council provision of retail and distribution water and wastewater activities from 1 July 2012. Allconnex's participating councils have decided to do so.

1.2 Ministerial Direction

The Treasurer and Minister for State Development, and the Minister for Finance and Minister for The Arts, (the Ministers) have referred the water and wastewater monopoly business activities of Queensland Urban Utilities (QUU), Allconnex Water (Allconnex) and Unitywater (the entities) to the Authority for price monitoring until 30 June 2013. Under the Ministerial Direction (see **Appendix A to Part B**), the Authority must, amongst other things:

- (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 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 three entities. Under the amendments to 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 2011-12 and 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 2011-12 is 3.6%.

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).

The Authority has also 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 last year's report, the Authority has also noted changes in residential bills and average prices.

The entities have provided their estimated actual costs for 2010-11 (their first year of operation) and their forecasts for 2011-12 onwards, as at the time of setting 2011-12 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 operational constraints imposed by the *SEQ Urban Water Arrangements Reform Workforce Framework* and the prices charged by the SEQ Water Grid Manager (WGM) for bulk water storage, treatment and delivery.

Given the CPI price cap imposed by Government, costs were not the sole drivers of prices in 2011-12.

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

Under section 26 of the *Queensland Competition Authority Act 1997* (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.

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);
- (c) consulted with the entities and reviewed its information requirements, resulting in revised information requirements for 2011-12 (*SEQ Interim Price Monitoring Information Requirements for 2011-12* (August 2011));
- (d) met with the entities to identify and address relevant issues;
- (e) invited submissions from interested parties;
- (f) commissioned independent consultants to review aspects of the entities' submissions;

- (g) published all public submissions on its website; and
- (h) considered all submissions received in preparing this Draft Report.

As in 2010-11, this Draft Report has two parts. Part A presents an overview of key findings. Part B details the Authority's assessment of the entities' proposed costs.

Submissions on this Draft Report are due by **29 February 2012**.

1.5 Prices

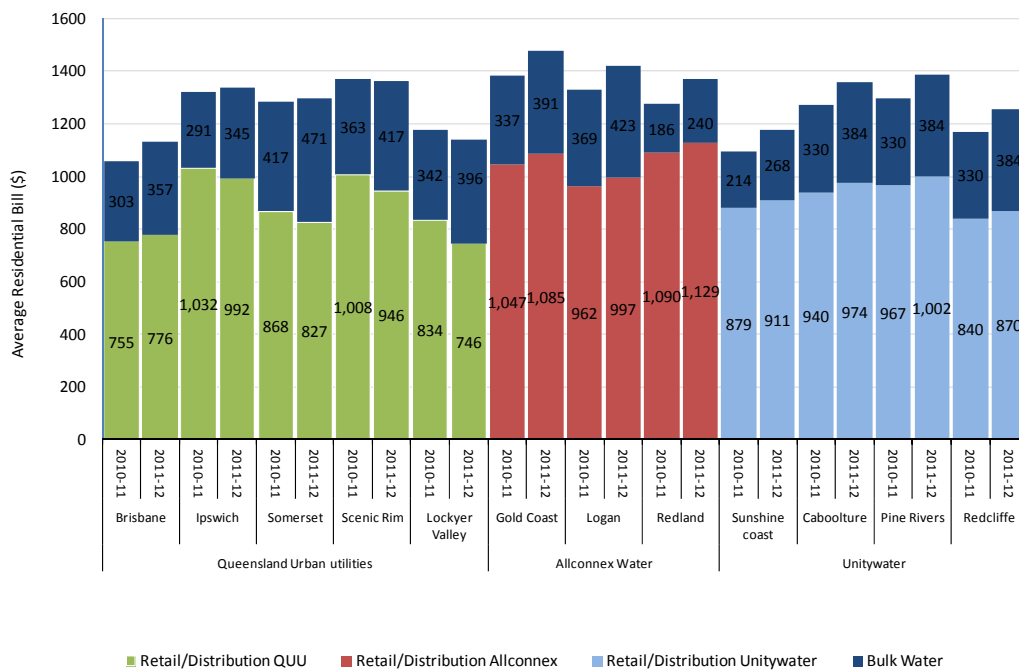
There is a wide range of prices set by the entities as a result of the wide range of services provided to each of the previous council areas and customer groups in SEQ.

Capped Prices

Changes in the prices of distribution and retail water and wastewater services for households and small businesses differ across SEQ, but do not exceed the CPI cap of 3.6%. The total prices paid by customers have however increased by more than this when the increase in bulk water prices is taken to account.

Residential bills (which include water and wastewater, and the bulk water component) increased across all SEQ council areas, with increases ranging from \$14 to \$94 per household, except in Scenic Rim and Lockyer Valley where bills fell by \$7 and \$35, respectively (Chart 1.1). In terms of percentages, residential bills changed by between -0.5% (Scenic Rim) and 7.2% (Brisbane and Redcliffe).

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 (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 one pedestal (where relevant). Source: QUU (2011) Allconnex (2011) Unitywater (2011)

Non-Capped Prices

For QUU and Unitywater, the Authority found that the change in revenue of non-capped services (trade waste and recycled water) did not exceed the change in the prudent and efficient costs of the relevant activity.

For Allconnex, the Authority was unable to make a valid comparison due to a change in the methodology adopted for forecasting revenues and the lack of robust data on connections and volumes. Nevertheless, the Authority notes that Allconnex's trade waste and recycled water prices were increased by 3.6% in 2011-12.¹ Further, wastewater revenues do not exceed costs for the activity as a whole.

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 (and encompass services which are both capped and non-capped under current arrangements as well both retail and distribution prices and bulk prices (which are outside the entities' control).

Average water prices in 2011-12 were between 9.9% and 14.9% higher than those in 2010-11. Average wastewater prices changed by between -0.4% and 6.7%. Charts 1.2 and 1.3 and Table 1.1 refer.

¹ Except for an increase of 13.96% in the sale of recycled water access key tags in the Gold Coast from \$51.50 to \$58.69. This is permitted under the legislation as these services are not capped.

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).

Table 1.1: Average Prices^{ab}

	<i>QUU 2011-12</i>	<i>Allconnex 2011-12</i>	<i>Unitywater 2011-12</i>
Water (\$/kl)	\$3.72	\$4.17	\$4.25
% increase from 2010-11, attributable to:	9.92%	11.73%	14.85%
Bulk water price increases	7.98%	7.37%	7.27%
Distribution and retail price increases	1.94%	4.36%*	7.57%*
Wastewater (\$/connection)	\$750.67	\$769.45	\$693.15
% increase from 2010-11	3.11%	-0.38%	6.66%

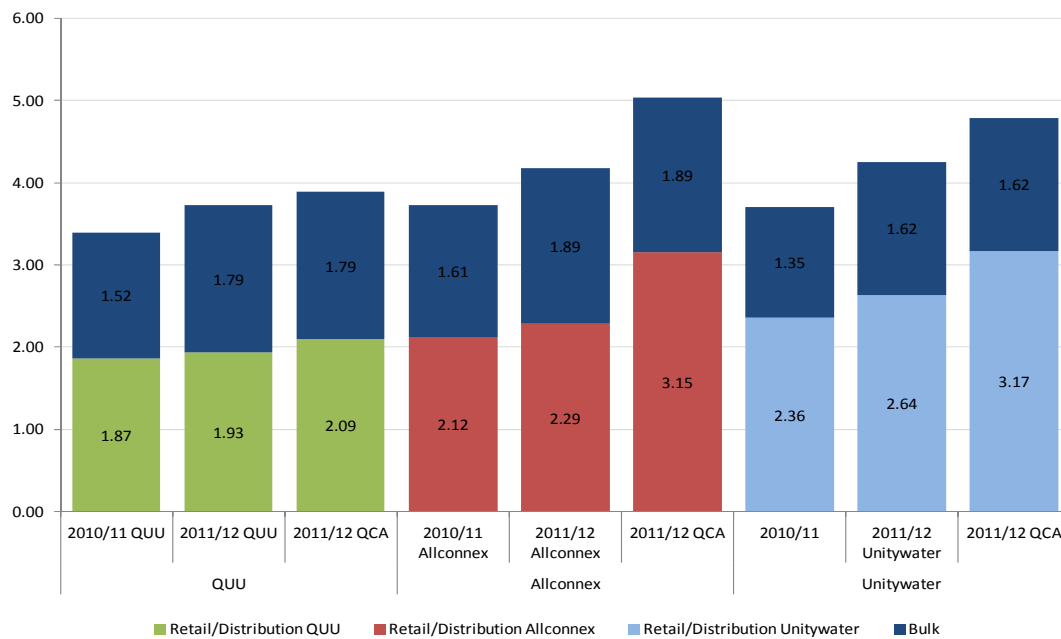
^a Average water price = Annual water revenue (\$) / total kl sold . ^bAverage wastewater price = Annual wastewater revenue (\$) / total connections. * greater than 3.6% as all non-bulk revenue from sales and connections (including fixed access charges) is included in the numerator, and only water sales volumes are included in the denominator. Allconnex and Unitywater have forecast a decrease in water sales and an increase in total connections. Source: QUU (2011), Allconnex (2011), Unitywater (2011), QCA calculations.

While all three entities complied with the CPI cap of 3.6% for the distribution/retail component of water prices, the increase in the average distribution/retail price per kl exceeded 3.6% for Allconnex and Unitywater. This is the result of the substantial fixed component of water prices (and costs) having to be spread over a forecast fall in the volume of water sold.

Bulk water charges represent around half (48.1%) of the average water price estimated by the Authority for QUU, while being slightly lower for Allconnex (45.2%) and Unitywater (38.0%). The bulk water charge is set by the State Government to recoup some of the costs of the State-owned bulk water providers.

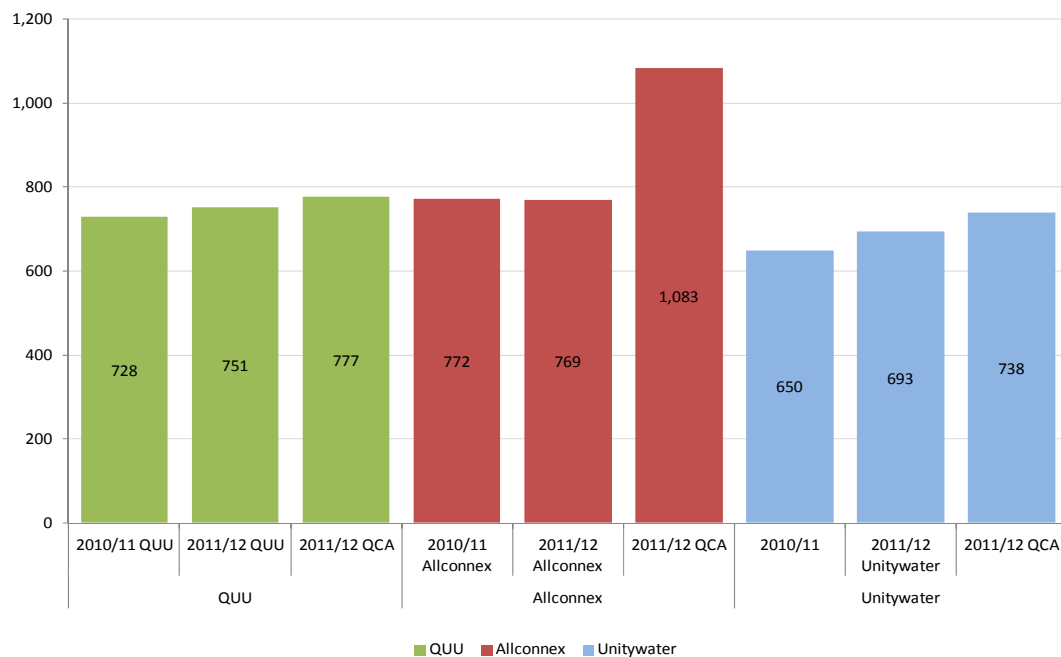
The average price charged by the entities is below that implied by the Authority's analysis of costs and demand for 2011-12. See subsequent sections and Part B.

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



Source: QUU (2011), Allconnex (2011), Unitywater (2011), QCA calculations (see Part B)

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



Source: QUU (2011), Allconnex (2011), Unitywater (2011), QCA calculations (see Part B)

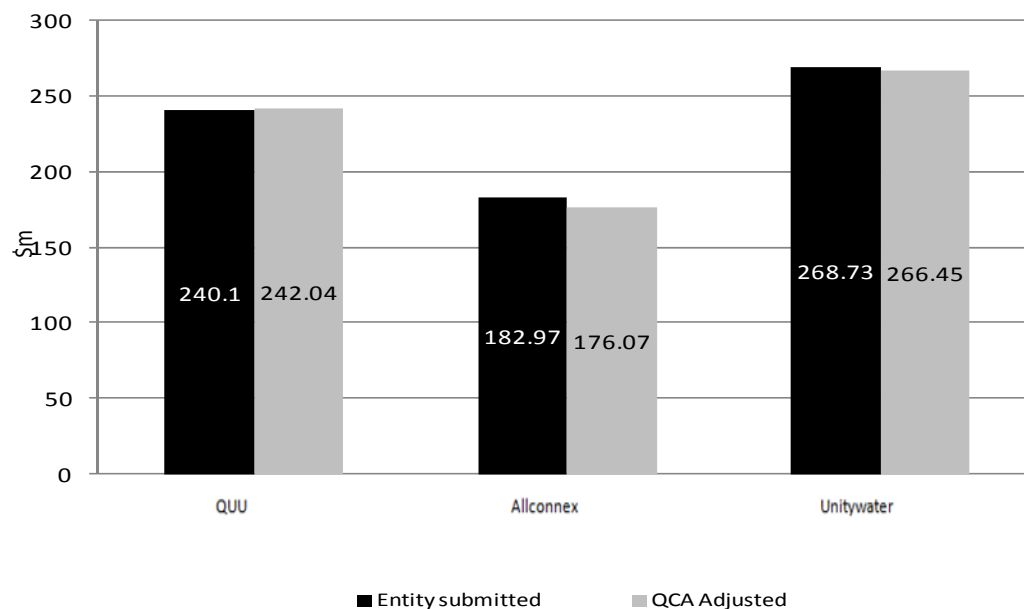
1.6 Costs

For 2011-12, SEQ water and wastewater prices were generally set with regard to the CPI cap. Costs were not a key factor in pricing decisions, except for QUU, given it was at cost recovery in 2010-11, and for Unitywater in relation to non-capped services.

The Authority’s estimate of the prudent and efficient costs forms the Authority’s MAR.

The Authority conducted an independent review of the prudence and efficiency of the entities' available capital expenditure forecasts (Chart 1.4). The Authority's review of a sample of capital projects and programs across SEQ has generally confirmed their prudence and efficiency, with only minor adjustments proposed for 2011-12. The entities have made savings in proposed capital expenditure by adopting a regional perspective.

Chart 1.4: Prudence and Efficiency Review of Capital Expenditure in 2011-12



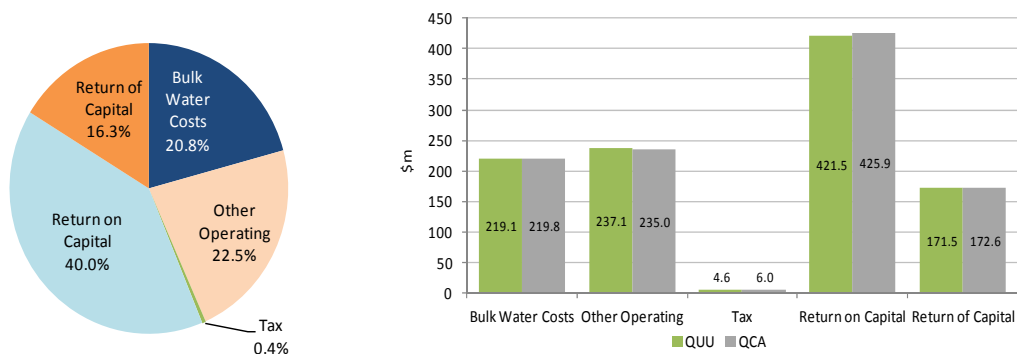
Source: QUU (2011), Allconnex (2011), Unitywater (2011), QCA calculation (see Part B)

The Authority also conducted an independent review of the reasonableness of the entities' operating costs. Charts 1.5 to 1.7 outline the entities' initially proposed costs and a comparison of the entities' and the Authority's estimate of costs for 2011-12. Part B provides more detail.

In assessing the reasonableness of proposed operating costs, the Authority reviewed the entities' estimates against the efficiency targets for 2011-12 that were identified by the Authority in its 2010-11 price monitoring review. These efficiency targets represent the cost savings considered achievable from the consolidation of the water businesses.

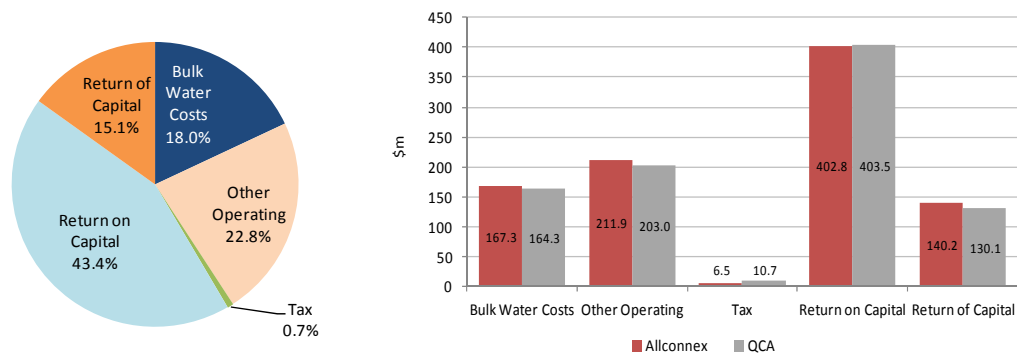
Both QUU and Unitywater made efficiencies in their forecasts of operating costs for 2011-12 that met the Authority's targets. However, while Allconnex identified some savings in operating costs, it was unable to demonstrate its forecasts met the Authority's target. The Authority has therefore included a 4% cost saving in its estimate of prudent and efficient non-bulk operating costs for Allconnex in this Draft Report.

Chart 1.5: QUU Components of Proposed and Estimated Costs (2011-12)



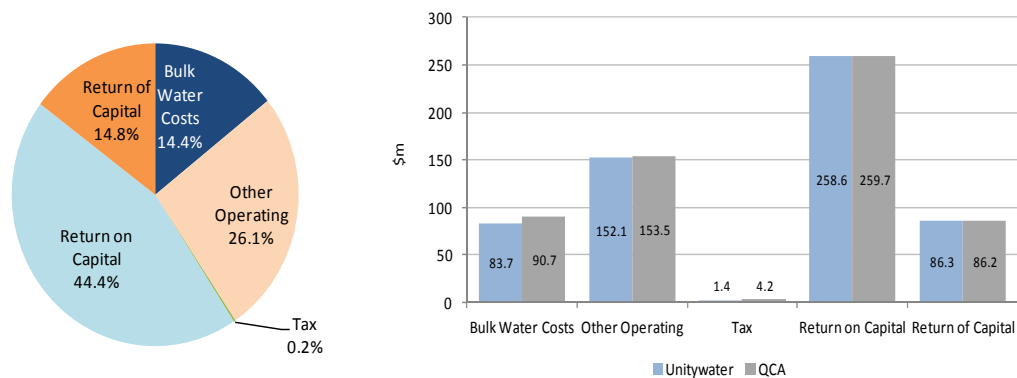
Source: QUU (2011), QCA calculation (see Part B).

Chart 1.6: Allconnex Components of Proposed Costs and Estimated Costs (2011-12)



Source: Allconnex (2011), QCA calculation (see Part B).

Chart 1.7: Unitywater Components of Proposed Costs and Estimated Costs (2011-12)



Source: Unitywater (2011), QCA calculation (see Part B).

In the main, the differences between the entities proposed costs for 2011-12 and the Authority’s arise from:

- (a) bulk water costs – the Authority has different estimates of bulk water costs due to the Authority’s revised demand volumes – the same bulk water prices have been assumed; and

- (b) distribution and retail operating costs – the Authority has derived alternative estimates for some costs and included an efficiency target for Allconnex. In general, these differences have not been significant.

Under the Direction, the entities have a choice of approaches to the treatment of capital contributions and the Authority has recognised their choice in its calculations. The entities have adopted the Authority’s advised weighted average cost of capital (WACC) benchmark of 9.35% in their cost estimates for 2011-12.

Estimates of costs cannot be directly compared between entities, as they reflect differences in data and methodology. For example, the MAR for QUU and Unitywater reflects the revenue offset approach to the treatment of capital contributions. In contrast, the MAR for Allconnex reflects the asset offset approach to the treatment of capital contributions which has a lesser immediate impact than the revenue offset approach.

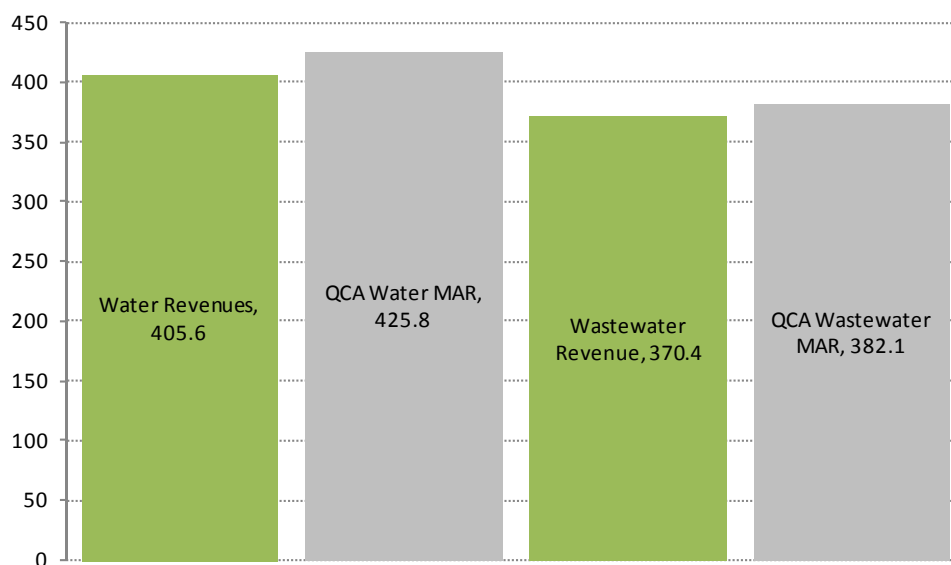
1.7 Revenues

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.

For QUU for 2011-12:

- (a) forecast water revenue of \$405.6 million is below the Authority’s MAR of \$425.8 million;
- (b) forecast wastewater revenue of \$370.4 million is below the Authority’s MAR of \$382.1 million; and
- (c) as a whole, QUU’s forecast revenue of \$775.9 million is below the Authority’s MAR of \$807.9 million.

Chart 1.8: QUU Revenues and QCA MAR (\$ 2011-12)

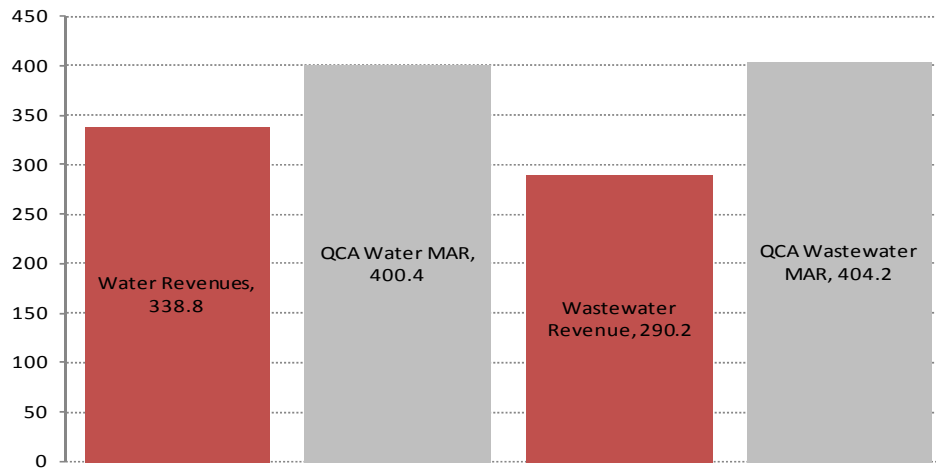


Source: QUU (2011), QCA calculation (see Part B).

For Allconnex for 2011-12:

- (a) forecast water revenue of \$338.8 million is below the Authority’s MAR of \$400.4 million;
- (b) forecast wastewater revenue of \$290.2 million is below the Authority’s MAR of \$404.2 million; and
- (c) as a whole, Allconnex’s forecast revenue of \$629 million falls well below the Authority’s MAR of \$804.6 million.

Chart 1.9: Allconnex Revenues and QCA MAR (\$ 2011-12)

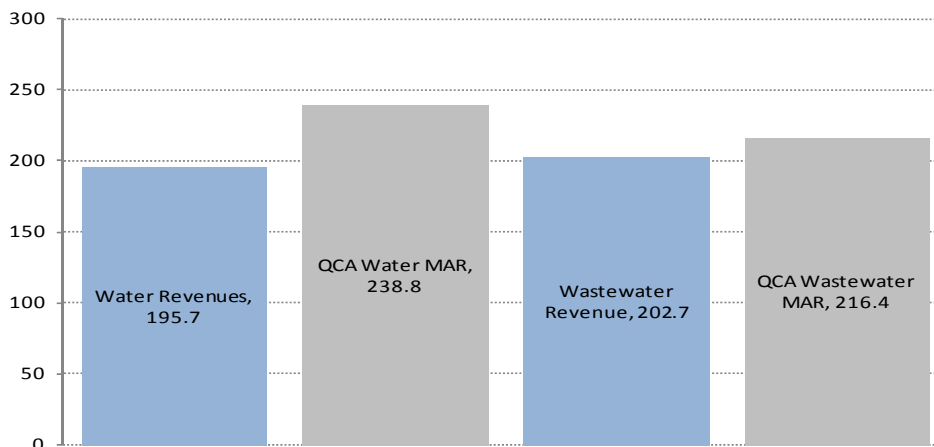


Source: Allconnex (2011), QCA calculation (see Part B).

For Unitywater for 2011-12:

- (a) forecast water revenue of \$195.7 million is below the Authority’s MAR of \$238.8 million;
- (b) forecast wastewater revenue of \$202.7 million is below the Authority’s MAR of \$216.4 million; and
- (c) as a whole, Unitywater’s forecast revenue of \$398.4 million falls below the Authority’s MAR of \$455.3 million calculated by the Authority.

Chart 1.10: Unitywater Revenues and QCA MAR (\$ 2011-12)



Source: Unitywater (2011), QCA calculation (see Part B).

Some of the differences between the entities' forecast revenues and the Authority's MAR arise from differences in estimates of costs. Other factors have also been noted by the entities in their submissions, in particular Allconnex and Unitywater. These other factors include the inability to review tariff levels and structures in 2011-12 under the CPI price cap, and a legacy of past under-recovery in pricing.

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 2011-12 are below the MAR, there is no evidence of an exercise of monopoly power in 2011-12.

Both Allconnex and Unitywater proposed to recover under-recoveries in future years. However, they did not provide a specific price path for consideration by the Authority.

Unitywater proposed a maximum allowable revenue adjustment transition (MAT) scheme, incorporating a balancing adjustment to capture an annual indexation of expected under-recoveries, a medium to long term price path to clear this balance, and an unders and overs mechanism to apply once the MAR has been achieved on a sustainable basis.

As noted in its SEQ Price Monitoring Framework Report, the Authority considers it is appropriate to recover prudent and efficient costs on a net present value (NPV) neutral basis, wherever possible. However, this is not always possible, particularly in the context of significant price increases.

1.8 Future Reviews

As in last year's report, the Authority notes that a substantial amount of capital expenditure is proposed by the entities in future years. At the same time, the Authority notes that the entities are developing their processes and systems to ensure that the prudence and efficiency of all projects can be demonstrated over time. Further, the Authority notes that, since providing their first (2010-11) submissions to the Authority, the entities have deferred and adjusted their capital expenditure programs due to efficiencies being identified as they consolidate their businesses.

In its 2010-11 price monitoring report, the Authority identified a range of initiatives that would improve the entities' internal processes:

- (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 to be included in the 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 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;

- (g) a 'toll gate' or 'gateway' review process to be implemented so that appropriate reviews are undertaken at milestone stages for selected projects; and
- (h) pricing to be demonstrably based on costs and other relevant factors.

The Authority notes there is evidence of progress against these initiatives. However, only partial evidence of progress is available in relation to establishing: a standardised approach to cost estimating (item d); a summary document for major projects (item e); an implementation strategy for the development of major projects (item f); and, gateway review processes (item g). In some cases, the evidence relates to projects originated by councils prior to 1 July 2010.

The Authority considers that the entities and their participating councils should continue to refine their forecasting and cost estimation approaches.