

SA Water
Regulatory
Business
Proposal
2016-2020

Attachment N
Review of the RBP 2016
technology submission,
KPMG



cutting through complexity

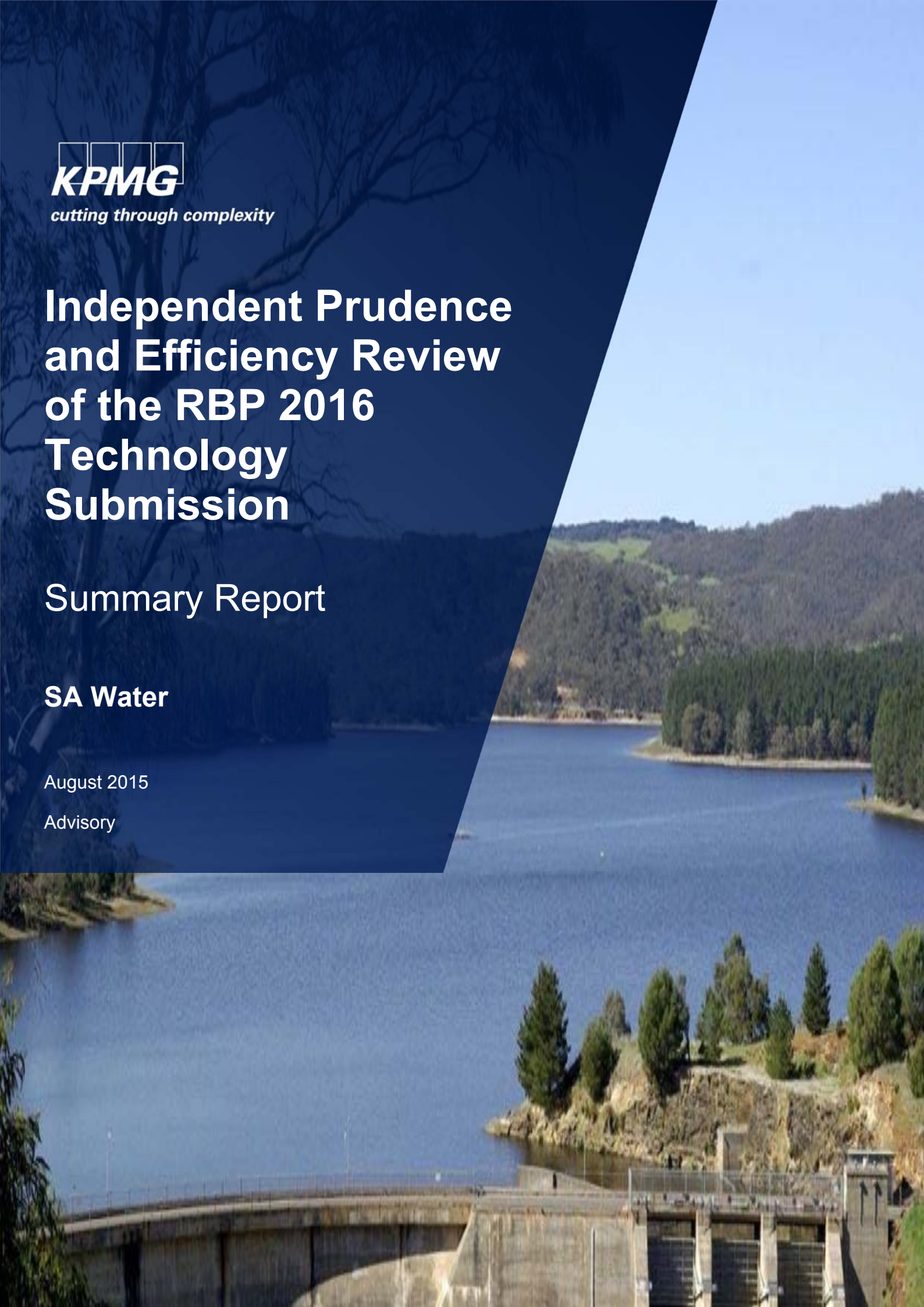
Independent Prudence and Efficiency Review of the RBP 2016 Technology Submission

Summary Report

SA Water

August 2015

Advisory



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Summary report

This report is delivered subject to the agreed written terms of KPMG's engagement.

This report provides a summary of KPMG's findings during the course of the work undertaken for SA Water under the terms of Standing Offer SO6176 and your letter of acceptance CS8016 dated 28 January 2015]. The contents of this report do not represent our conclusive findings, which will only be contained in our final detailed report.

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No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by SA Water management and personnel consulted as part of the process.

KPMG have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

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The findings in this report have been formed on the above basis.

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This report has been prepared at the request of SA Water in accordance with the terms of Standing Offer SO6176 and your letter of acceptance CS8016 dated 28 January 2015. Other than our responsibility to SA Water, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.

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Abbreviations

Abbreviations	
Term	Definition
Capex	Capital expenditure
CPI	Consumer Price Index
FTE	Full time Equivalent - Unit that measures the workload of an employed person
IRR	Internal Rate of Return
IS	Information Systems
NPV	Net Present Value
Opex	Operating Expenditure
Price escalators	Factor applied to current/actual cost to consider expected changes in the cost or price of specific goods or services brought about by factors such as CPI.
PI	Profitability Index
ROI	Return on Investment
SA	South Australia
SAW	South Australian Water Corporation (SA Water)
SCADA	Supervisory Control and Data Acquisition
Totex	Total Expenditure - Capital plus Operating Expenditure

1 Introduction

This report is a summary report and provides an overview of the findings from our work. Further observations and detailed discussion on the matters summarised in this report are contained in our full report.

This section provides an overview of the project objectives, scope and approach.

1.1 Background

On 5 April 2012, The State Parliament of South Australia adopted the Water Industry Act that gives the Essential Services Commission of South Australia (ESCOSA) the power to regulate pricing and standards for water and sewerage services in South Australia, thereby regulating SA Water’s pricing from 1 July 2013. The first regulatory period was set for three years to end on 30 June 2016 and SA Water are now preparing for their submission for the second regulatory period of four years, from 1 July 2016 to 30 June 2020.

As input to the price setting process, SA Water will submit a Regulatory Business Proposal (RBP 2016) containing its planned operating and capital expenditure (Opex and Capex) forecasts and the supporting analysis to support the provision of future revenue requirements in providing drinking water and sewerage services. Contained within the RBP will be details of planned IS Capex and Opex forecasts. SA Water has requested an independent review of the prudence and efficiency of the proposed IS Capex and Opex to support the RBP 2016.

In its document “SA Water Price Determination 1 July 2016 – 30 June 2020 – Final Framework and Approach November 2014” (‘The ESCOSA Framework’), ESCOSA is adopting the same approach to assessing SA Water’s expenditure as it did for the RBP 2013. That is using the Prudent and Efficient tests and the associated factors as follows:

Table 1: ESCOSA Prudent and Efficient tests and Factors

ESCOSA Tests and Factors	
Principle Tests	Factors
<p>ESCOSA is adopting the same approach to assessing SA Water’s expenditure as it did for the RBP2013. That is using the Prudent and Efficient tests as follow:</p> <ul style="list-style-type: none"> • Prudence: The benefits of the proposed expenditure outweigh the costs (i.e. should the project be done at all?). • Efficiency: The proposed expenditure is the least cost solution to achieve the intended outcome. 	<p>In addition to the stated tests, ESCOSA has stated that the following factors will be considered in assessing the expenditure forecasts:</p> <p><i>Capex</i></p> <ul style="list-style-type: none"> • The benefits of, and need for, the proposed project/program • The proposed timing and delivery of the project/program • The alternative options considered in developing the project/program • The forecast costs of the planned project/program, and • Any further relevant considerations. <p><i>Opex</i></p>

ESCOSA Tests and Factors	
Principle Tests	Factors
	<ul style="list-style-type: none"> ● Efficiency of current level of costs ● Movements in recurring expenditure ● Consideration of opportunities for further efficiency and any likely new business costs, and ● Benchmarking expenditure to utilities. <p>Additionally, consideration of expenditure for</p> <ul style="list-style-type: none"> ● Other regulatory obligations, and ● Customer consultations.

In addition to taking into account the above guidance, we have also been guided by the published requirements of water and energy economic regulations in other jurisdictions including:

- Independent Pricing and Regulatory Tribunal (IPaRT) – NSW regulator for water, transport and energy retail and local government services, and
- Australian Energy Regulator (AER) – National regulator for electricity and natural gas services and markets operation.

Based on these considerations we have formulated a set of criteria (“the assessment criteria”) that encompasses ESCOSA’s requirements enhanced by those of the AER and IPaRT. These are described below.

1.2 Approach

The purpose of this engagement is to provide a comprehensive independent report based on the consideration of SA Water’s methodology and approach to technology capital and operating expenditure forecasting for the 2016-20 period through the following:

- Review of key methodology documentation and assumptions
- Understanding and confirmation of SA Water’s approach and methodology through interviews with key stakeholders
- Consideration of the completeness, consistency, prudence and efficiency of the methodology relative to ESCOSA’s factors noted above and relevant AER capital and operating expenditure objectives
- Analysis of the IS Capex business cases and consideration of their completeness, consistency, prudence and efficiency relative to the criteria
- Analysis of technology operating expenditure forecasts
- Comparison of cost base and technology initiatives to relevant sector KPMG benchmarking data and provision of market insights, and
- Challenging the key risks and assumptions inherent in the forecasts.

Evaluation

As part of KPMG’s independent assessment of SA Water’s methodology and approach to IS capital and operating expenditure forecasting, assessment criteria were developed utilising the NER criteria and factors to practically apply the ESCOSA objectives.

Table 2: KPMG Assessment Criteria

Criteria Heading	Description
Investment context	
A concise economic rationale justifying the proposed expenditure in alignment with ESCOSA principles for prudent and efficient expenditure.	<ul style="list-style-type: none"> The rationale for the proposed expenditure plan for the forthcoming period is clearly articulated and justified The proposed expenditure supports the business strategy Reconciliation of previous submission to current spend with linkages to how current spend is justified Benchmarking analysis against peers have been performed and considered with major discrepancies understood and justifiable
Governance / Process	
Robust governance practices and models are applied to the production of the submission, as well as the processes followed	<ul style="list-style-type: none"> Appropriate and comprehensive process and policies are in place for the development of the IS Strategy and IS capital program Key inputs include business strategy and capital management plans Robust risk management processes are implemented Robust processes implemented for assessing cost drivers and needs analysis
Forecasting Methodology	
A reasonable and justifiable methodology for forecasting the technology initiatives which support the submission.	<ul style="list-style-type: none"> Reasonable and justifiable methodology according to good management practices Consistent application of methodology throughout the submission Where relevant, made use of external data points to justify large non recurrent spend where appropriate
IS Capital Expenditure	
A concise economic rational justifying the IS capital expenditure program(s) of work in alignment to the principles for prudent and efficient expenditure.	<ul style="list-style-type: none"> The rationale for the proposed capital expenditure for the forthcoming period is clearly articulated, justified and consistent with the Investment Context Assessment of options before determining preferred option including identification of efficient costs Compelling investment cases clearly articulating the business benefits, risks, options considered and alignment to the principles for prudent and efficient expenditure management and planning
IS Operating Expenditure	
A concise economic rational justifying the IS operating	<ul style="list-style-type: none"> The rationale for the proposed operational expenditure for the forthcoming period is clearly articulated, justified and consistent with the Investment Context

Criteria Heading	Description
expenditure program(s) of work in alignment to the principles for prudent and efficient expenditure.	<ul style="list-style-type: none"> • The organisation is actively seeking to reduce the cost to serve • Incremental operating expenditure increases are reasonable and align with the IS capital program • Recurrent operating expenditure are assessed against industry benchmarks and differences are explained and justifiable

Analysis approach

To analyse the IS program we performed the following key activities:

- Reviewed documentation supporting the regulatory proposal and IS program
- Conducted interviews with business and IS staff to further confirm our understanding of the IS program
- Assessed the IS program against our assessment criteria
- Assessed the basis of SA Water’s IS forecasts and estimates, including:
 - The overall approach for developing the IS program, forecasts and estimates
 - Stakeholder involvement in developing the IS program
 - Inputs and calculations used to arrive at forecasts and estimates
 - Processes followed to test the necessity of proposed IS initiatives - identify supporting assumptions, manage risk, evaluate investment options, and assess sensitivity of cost drivers, and
 - Alignment to industry good practices;
- Assessed the IS capital and operating expenditure for prudence and efficiency of individual initiatives in the IS program to evaluate:
 - Alignment of IS capital initiatives to business needs, priorities and risks
 - The reasonableness of the scope and costs of the technology capital initiatives compared to other utility companies
 - The reasonableness of SA Water’s performance relative to selected industry benchmarks
 - The reasonableness of forecast determination methods and application of forecast determination methods in the proposed forecast, and
 - How individual initiatives meet the criteria.
- Referenced IS investment practices of similar companies as well as industry better practices.

In our analysis we have utilised selected benchmark results, compiled by KPMG, from 13 electricity, natural gas and water services providers across five states in Australia.

Scope Exclusion

This review of the Technology Capital Plan includes all IS capital expenditure before the application of SA Water’s cost allocation methodology. The following are matters that were not covered by our assessment:

- Any IS expenditure that is not included in SA Water’s IS submission documentation provided, e.g. technology expenditure relating to the physical infrastructure for operational control systems, e.g. SCADA infrastructure

- Application of escalators to applied Capex and Opex forecasts. Except where specified, all expenditure forecasts as provided by SA Water have been presented in \$Real FY 2015 being mid-year as at 31 December 2014, and
- Validation of the accuracy and appropriateness of the benefits identified by SA Water for both its current period and forecast investments.

Information sources

The assessment relied on a number of information sources, including (sample only):

- SA Water Regulatory Business Proposal 2016
- IS Technology Capital Planning Approach and Summary – RBP 2016
- IS Cost Estimation Approach for Technology Plan; Regulatory Business Proposal 2016
- RBP2016 Technology Plan (Spreadsheet)
- Financial Planning and Budgeting Guide, and
- IS Capex Business Cases.

See Appendix A within the full report for a list of documentation inspected and personnel interviewed.

2 Summary

SA Water is preparing its proposal (2016 Regulatory Business Proposal - RBP 2016) to the Essential Services Commission of South Australia (ESCOSA) for the water and sewerage retail services price determination in South Australia, for its second regulatory period from 1 July 2016 to 30 June 2020. As part of this proposal submission, SA Water is proposing a four-year program of work in its Technology Capital Plan to the value of \$115 million (Dec 14 Real \$) and associated operating expenditure of \$124.5 million (Dec 14 Real \$). KPMG was engaged to assess SA Water's submission documentation and comment on the efficiency and prudence of the forecasts in accordance with the assessment principles outlined in the Final Framework and Approach for SA Water Price Determination 1 July 2016 – 30 June 2020, as pursuant to section 35(1) of the Water Industry Act 2012.

Note: unless otherwise noted, all \$ amounts in this report are expressed as Real December 2014.

Table 3: ESCOSA Prudent and Efficient Tests and Factors

ESCOSA Tests and Factors	
Principle Tests	Factors
<p>ESCOSA is adopting the same approach to assessing SA Water's expenditure as it did for the RBP2013. That is using the Prudence and Efficiency tests as follows:</p> <ul style="list-style-type: none"> • Prudence: The benefits of the proposed expenditure outweigh the costs (i.e. should the project be done at all?) • Efficiency: The proposed expenditure is the least cost solution to achieve the intended outcome. 	<p>In addition to the stated tests, ESCOSA has stated that the following factors will be considered in assessing the expenditure forecasts:</p> <p><i>Capex</i></p> <ul style="list-style-type: none"> • The benefits of, and need for, the proposed project/program • The proposed timing and delivery of the project/program • The alternative options considered in developing the project/program • The forecast costs of the planned project/program, and • Any further relevant considerations. <p><i>Opex</i></p> <ul style="list-style-type: none"> • Efficiency of current level of costs • Movements in recurring expenditure • Consideration of opportunities for further efficiency and any likely new business costs, and • Benchmarking expenditure to utilities. <p>Additionally, consideration of expenditure for</p> <ul style="list-style-type: none"> • Other regulatory obligations, and • Customer consultations.

The purpose of this report is to provide a summary of the key findings relating to SA Water's RBP 2016 expenditure forecast.

SA Water Information Technology

SA Water entered the current regulatory period with a largely risk mitigation focussed capital program. This was reflected in the RBP 2013 Technology Capital Plan that categorised the total planned capital expenditure by category of risk – Business Application, Infrastructure and Business Process of which asset lifecycle projects were approximately 62%. A change in business strategy and direction from ESCOSA in the first year of the current regulatory period resulted in a refocusing of IT Capex towards facilitating business efficiencies and improving customer service levels resulting in a reduced 49% being spent on IT Asset Lifecycle activities. This trend is continuing into the RBP 2016 period with only 41% of the total Technology Capital Plan being devoted to asset lifecycle projects and the majority being driven by a focus on improved efficiency and customer service levels.

Feedback from SA Water’s customer engagement program has highlighted the relative lack of past investment in modernising its customer facing systems that has left the business behind the expected level for the industry. Indicative of this is the ageing customer information and billing system (CSIS) that is recognised as incapable in its current form of providing the level of service expected by the business and today’s consumers. This, in addition to the strong focus on achieving operational cost savings through efficiency, is driving an increase in the technology capital program for the 2016-20 regulatory period.

For the RBP 2013 Technology submission, KPMG undertook a similar assessment of the prudence and efficiency of the IS Capex and Opex forecasts. Whilst considered at the time to be both prudent and efficient, a number of recommendations were made for SA Water to improve the documentation developed as part of the submission and to improve various operational and governance processes within the business to ensure the expenditure remained prudent and efficient. We have noted a number of initiatives both within IS and across the business that have reflected these observations and have improved the internal governance processes being applied, particularly to IS capital expenditure. Being only two years into the current period, work is continuing within SA Water’s IS group to further refine and improve its processes in order that the increased capital plan for RBP 2016 can be delivered in a similarly efficient and prudent manner.

SA Water IT Investment Plan 2016-2020 Submission

For the current three year regulatory period (2013-2016), SA Water has forecast an IS Totex (Total Expenditure) of \$146 million (\$48.7 million average p.a.) comprising of \$60.9 million IS Capex and \$85.4 million IS Opex.

For the next four year regulatory period (2016-2020), SA Water has planned IS Totex of \$239.5 million (\$59.9 million average p.a.) made up of \$115.0 million IS Capex and \$124.5 million IS Opex.

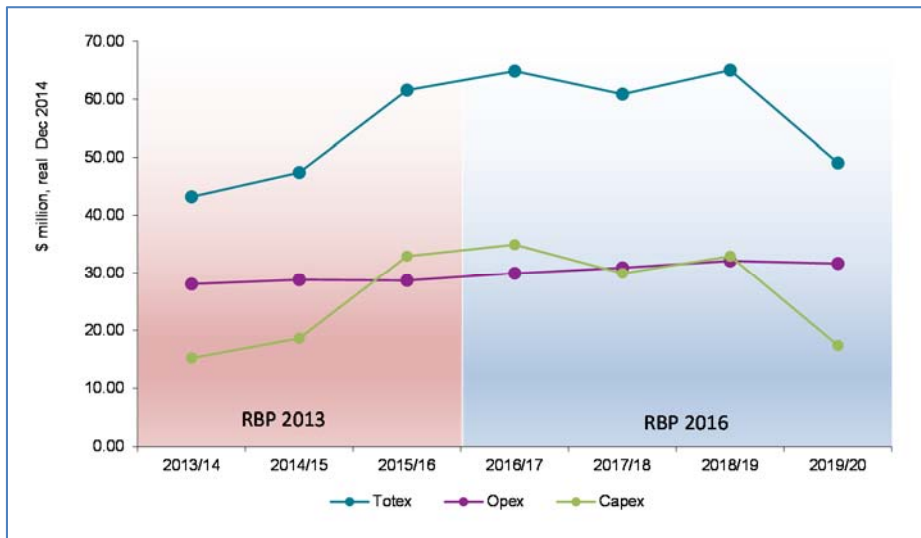
The breakdown of the total IS expenditure for 2016/17 to 2019/20 is provided in the table below:

Table 4: Total IS planned expenditure FY2017-20 (\$ million, Real Dec 14)

Cost Category	2016/17	2017/18	2018/19	2019/20	Total
Capex	34.9	29.9	32.9	17.3	115.0
Opex	29.9	30.9	32.1	31.6	124.5
Total	64.8	60.8	64.0	48.9	239.5

The chart below illustrates the actual and forecast IS Totex, Capex and Opex from 2013/14 to 2015/16 and the planned expenditure forecasts from 2015/16 to 2019/20.

Chart 1: IS Total Expenditure: 2013/14 to 2019/20 (\$ million, Real Dec 14)



IS Capital Expenditure

For the current regulatory period, SA Water’s IS Capex approved determination is \$56.2m. Compared to the current forecast total IS Capex for the period of \$60.9m, SA Water is planning to overspend its allocation by \$4.7m (approximately 8.3%).

SA Water’s results for a number of key metrics in the KPMG Utilities IT Benchmarking survey for 2012/13 show it on or below the industry mean indicating it is generally in line with its industry peers.

The RBP 2016 IT Capex forecast of \$115.0 shows a per annum increase over the current period of approximately 41%. The Technology Capital Plan has been split into two major programs of work – Business Change and IT Asset Lifecycle with each program being further categorised by the key driver for change. This is shown in the table below.

Table 5: Breakdown of RBP 2016 IT Capex Programs and Key Drivers (\$ million, Real Dec 14)

Cost Category/Driver	4 year Capex
Business Change Program	
Business Efficiencies	32.5
Improved Customer Services	13.5
Planning for the Future / Risk	22.0
IT Asset Lifecycle Program	
Planning for the Future / Risk	47.0
Total	115.0

This total program of work is intended to provide cost savings in the business of approximately \$30.7 million across the four year period and a recurrent p.a. saving of approximately \$11.4 million¹.

IT Operating Expenditure

For the current regulatory period, SA Water’s allocated Opex determination is \$102.8 million. The current forecast for actual expenditure for the same period is \$85.4 million, a forecast underspend of 16.9%.

Analysis of SA Water’s operating costs against KPMG’s Utilities IT Benchmarking Survey results (2012/13) show they are generally on or below the mean for the industry indicating they are more efficient than the benchmark group.

SA Water has forecast a total IS Opex for the next four year regulatory period of \$124.5 million, an approximately 9.3% p.a. increase over the current period. This forecast is made up of base IS Opex of \$118.2 million and a step increase due to the impact of the Capex program, of \$6.3 million. In line with the corporate efficiency targets, SA Water’s Base IS Opex is forecast to fall over the four year period to realise a 10% saving by the end of the four years.

Key Observations

The SA Water document “IS Technology Capital Planning Approach and Summary – RBP2016” broadly covers key information that provides the rationale for the proposed investments. The table below provides a summary of our key observations, findings and recommendations. SA Water has advised that it will continue to strengthen its support for the planned IS expenditure forecasts and to address the observations made below through appropriate prudent management and expenditure governance processes as it progresses through the regulatory determination.

Table 6: Summary of Key Observations

Assessment area and criteria rating	Positive indicators	Key observations
Investment context		
<p>G</p> <p>The rationale for the proposed expenditure plan for the forthcoming period is clearly articulated and economically justified</p> <p>The proposed expenditure supports the business strategy</p> <p>Benchmarking analysis against peers have been performed and considered with major discrepancies understood and justifiable</p>	<ul style="list-style-type: none"> There is a strong alignment to the business strategies through a business lead prudent and efficient process of identifying investment initiatives. Significant cost savings as a result of the IS Capital Program are identified in, and accepted by the business. Consideration is given to the results of the SA Water customer engagement program in relation to customer expectations on communication channels, online experience and willingness to pay. Individual initiatives in the Technology Capital Plan are justified against the business drivers of efficiencies, customer and risk. 	<ul style="list-style-type: none"> SA Water should articulate the internal process followed to allocate where and how the benefits from IS Capex are aligned to other business units outside of IS.

¹ SA Water submission – Chapter 13 Investment in Technology

Assessment area and criteria rating	Positive indicators	Key observations
	<ul style="list-style-type: none"> ● Risk analyses are performed to inform the prioritisation process. ● The context for the increase in IS capital expenditure has been reasonably articulated in the supporting regulatory documents. ● A demonstrated process of prudent deferral and re-assessment of the capital program for the current period has been undertaken as a result of the business wide Business Transformation Program. ● Benchmarking analysis indicates that the proposed expenditure continues to be in line with comparable industry organisations noting the broad scope and individual complexities of SA Water's range of services. ● Base IS Opex is forecast to reduce in line with corporate efficiency targets with increases only due to the effects of the IS Capital program. 	
Governance		
<p>G Appropriate and comprehensive process and policies are in place for the development of Technology Strategy and Capital program</p> <p>Key inputs include Business strategy and capital management plans</p> <p>Robust risk management processes are implemented</p> <p>Robust processes implemented for assessing cost drivers and needs analysis</p>	<ul style="list-style-type: none"> ● A formally defined governance mechanism exists for review, challenge and approval of the IS Capital Program. ● The Business Change Program within the Technology Capex Plan is driven wholly by the business and is prioritised by the Business Leadership according to the three Technology Investment Themes: <ul style="list-style-type: none"> ➢ Business efficiencies ➢ Improved customer services ➢ Planning for the future/risk. ● Corporate risk management team facilitate risk assessments for relevant projects using the SA Water risk management methodology. ● Rigorous challenge process by Senior Leadership Team before approval of projects added to the capital plan. ● IS Opex forecasts development process aligned and integrated with that for the rest of the business ensuring recognition of business area savings resulting from increased IS Capex. 	<ul style="list-style-type: none"> ● SA Water should articulate the options considered and the reason for the final investment choice within the relevant business case documents.

Assessment area and criteria rating	Positive indicators	Key observations
Forecasting methodology		
<p>G Reasonable and justifiable methodology according to good management practices.</p> <p>Consistent application of methodology throughout the submission</p> <p>Where relevant, made use of external data points to justify and demonstrate confidence in large non recurrent spend where appropriate</p>	<ul style="list-style-type: none"> • The forecasting methodology applied for the SA Water planned RBP2016 IS Capex forecasts follows good industry practices. • The methodology provides robust, consistent and transparent bottom-up cost estimations, appropriate for the purpose of IS projects, with comparable market rates applied to labour and infrastructure costs. • The methodology aligns with SA Water’s corporate approach to forecasting future expenditure with linkages between Capex investments and associated IS Opex and business Opex requirements. • SA Water has demonstrated prudent management expenditure forecasting planning with combined IS and Business Management involvement in defining project business needs, confirmation of project scope and estimation forecasting as an integral part of the IS expenditure planning process. 	<ul style="list-style-type: none"> • N/A
IS Capex		
<p>A The rationale for the proposed capital expenditure for the forthcoming period is clearly articulated, justified and consistent with the Investment Context</p> <p>Assessment of options before determining preferred option including identification of efficient costs</p> <p>Compelling investment cases clearly articulating that the business benefits outweigh the forecast costs, risks, and selection of the least cost option</p>	<ul style="list-style-type: none"> • For the business cases reviewed, SA Water has articulated the qualitative benefits which will be achieved. • SA Water’s benchmarks are in-line with the industry mean. Additionally, the types of projects are in-line with its peers in the utility industry. • The IS Capex program includes investments that are dedicated to meeting its customer expectations. This is evidence through references to SA Water’s “Your Say” program in the IS Capex documents and business cases. 	<ul style="list-style-type: none"> • SA Water has forecast an overspend for IS Capex within the first regulatory period. Management has advised that the overspend will be included in the RAB, however this is yet to be documented and explained within the IS Capex documentation. • During the first regulatory period, SA Water undertook a transformation program. This program is continuing into the second regulatory period, and SA Water should ensure it demonstrates all benefits that will result from this program. • We note that the business case documents are currently in draft. Management has advised that additional sections will be drafted prior to submission which will aim to address the issues identified within Section 5.3 of this report.

Assessment area and criteria rating	Positive indicators	Key observations
IS Opex		
<p>G The rationale for the proposed operational expenditure for the forthcoming period is clearly articulated, justified and consistent with the Investment Context</p> <p>The organisation is actively seeking to reduce the cost to serve</p> <p>Incremental operating expenditure increases are reasonable and align with the technology capital program</p> <p>Recurrent operating expenditure are assessed against industry benchmarks and differences are explained and justifiable</p>	<ul style="list-style-type: none"> SA Water has demonstrated prudent management practices in its budget planning process. This is evidenced by SA Water not including Incremental Opex in the IT budgets until the project is complete and benefits being realised within the business SA Water is forecasting an underspend in IS Opex for the first regulatory period as a result of the Business Transformation and Cost Optimisation initiatives. Benchmarking results indicated that SA Water's IS Opex is generally in-line with industry mean and its peers and in the case of Opex per user and per device, is below the industry benchmark. It is therefore considered to be comparably efficient. SA Water has articulated and quantified the business Opex benefits which are expected to be achieved as a result of the IS Capex program. It is noted that these business benefits outweigh the IS Opex increases that would result from the same IS Capex projects. SA Water is planning to maintain a flat IS Opex trend (in dollar value) from the first to second regulatory period. This indicates that SA Water is proposing to deliver additional IS operating activities without a significant increase in cost. This demonstrates that SA Water is prudent in its planning approach. 	<ul style="list-style-type: none"> N/A

Key: **G** = Reasonably satisfies the acceptance criteria, **A** = Minor issues identified, **R** = Major issues identified.

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