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Queensland Government

Natural Resources and Mines

Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

Dear Mr Hall

Gladstone Area Water Board: Investigation of Pricing Practices – Draft for Comment

Thank you for your letter of 23 December 2004 inviting comment on the Queensland Competition Authority's draft *Gladstone Area Water Board: Investigation of Pricing Practices Paper (December 2004).* In relation to the draft report, a number of issues are discussed below for the QCA's consideration.

Regulatory Framework
I understand that the QCA has recommended that it should commence annual monitoring of Gladstone Area Water Board's (GAWB) prices, contractual arrangements and service standards. NRM is of the opinion that the jurisdiction of the QCA should not be extended to cover the ongoing management of the GAWB in relation to these issues, as this is more appropriately a job undertaken by the water authority's senior managers with the endorsement of the Board of Directors. The draft paper seems to recommend that the QCA acquire a level of micromanagement of the commercialised water service provider's business that would severely hinder the ability of the entity to effectively perform its functions. It would seem to be more appropriate to preserve the current management autonomy of the GAWB and the regulatory review function of the QCA at the direction of QCA Ministers.

Pricing Framework
It is agreed that charging higher water delivery charges during drought periods promotes efficient water use, at least to some extent depending on the price elasticity of demand of the customer. However, the effectiveness of such a demand management measure is likely to be substantially reduced should this revenue be returned to users through reduced access charges in the years following the drought as suggested by the QCA. Should GAWB be required to return additional charges to customers in future through a reduced access charge, it is likely that customers may merely view the increased water charges as a prepayment of rates in the short term and therefore not curtail their water usage habits in dry periods.

The imposition of such a requirement on GAWB is also likely to impact heavily on its future financial viability, as the access charge levied on customers on an annual basis essentially covers a large proportion of the Board's fixed costs.

Therefore, whilst it is agreed that a pricing signal can be, for some customers, an effective mechanism to ensure that there is an incentive for customers to reduce their water consumption during drought periods, it is suggested that the QCA give further consideration to the impact that reducing future water delivery charges may have on the effectiveness of such a measure.

In relation to charging customers a commercial price for water delivery where infrastructure has spare capacity, it is agreed that where the spare capacity reflects the least cost option, the cost should be passed through to existing customers based on the current level of demand. Although, it is acknowledged that the situation may differ when excess capacity is built into infrastructure for regional development purposes, the QCA should also differentiate this with a situation where customers desire considerable excess capacity to be built into the infrastructure to increase the reliability of supply. In such circumstances, it is envisaged that the cost of water delivered through the infrastructure system should continue to reflect a commercial return on the full capital outlay.

Water Demand

In relation to the discussion on assumed customer usage, I have been advised that GAWB currently base their water demand estimates on usage projections provided to the Board by customers. As mentioned in the draft paper, it is agreed that "*customers are best placed to assess their own demand for water from GAWB*", therefore any estimation error made by customers should not penalise the Board in a financial sense. Whilst the QCA's point in relation to underestimation of demand possibly being in GAWB's best interests for pricing purposes is noted, it is suggested that to some extent the effect of underestimation of water usage will be offset by delaying future augmentations, whereas, the effect of overestimation of usage will be offset by bringing future augmentations forward. It is also noted that the consultant, Marsden Jacobs and Associates (MJA) produced lower customer demand estimates than those supplied by the Board.

Rate of Return – Methodological Issues

- <u>Risk free rate</u>

The continued use of a twenty day average of the ten year Government bond rate is generally considered appropriate, as it is consistent with the accepted methodology used by regulators in other jurisdictions. However, in the present circumstance (that appears to be an anomaly) it is suggested that some smoothing of this twenty day average over a longer time frame may be required, as the point estimate taken in December appears to have occurred at a time when this ten year bond rate was considerably lower than the risk free rate in the previous month and the following month (i.e., November and January). Therefore, in order to overcome this difficulty when determining the risk free rate to apply over a five year regulatory period, it may be necessary to examine whether the data collected appears to have come from a particular point estimate that differs significantly from normal rate behaviour (i.e., determined by examining available end of day ten year Government bond rate data one month before and after the point estimate). Where such unusual behaviour occurs, it is suggested that a number of twenty day averages may be calculated, and the median figure be used as the risk free rate estimate for pricing purposes.

- Equity Beta

In relation to the equity beta it is also suggested that the QCA not depart from the methodology provided in the previous pricing investigation, being the Brealey-Myers formula. The QCA's point in relation to consistency with other aspects of the cost of capital method is noted, however, in relation to the value of gamma, it is contended that in a Public Sector environment, as the Qld Government does not receive any benefit from dividend imputation a more appropriate gamma may actually be zero. I have been advised that as a result of the contention and uncertainty surrounding the gamma assumption, a rate of 0.5 has historically been used as a compromise, thereby recognising some benefits from imputation whether these exist under the governance/ownership structure or not. As a result of this uncertainty surrounding the appropriate gamma rate, it is suggested that the previously endorsed Brealey-Myers formula should continue to be used by the QCA.

Asset Base

The QCA's recommended use of market value for land assets (as opposed to indexed historic cost) is noted. However, given the recent appreciation of land values across Australia, it is suggested that it would be more appropriate for a recent valuation of land value to be used rather than an outdated estimate of market value from the previous investigation that is now some three to four years old.

In relation to the issue of working capital, it is suggested that the QCA further explain their position in the final report, as the current discussion and recommendation is a little unclear. Intuitively, as noted in the report, where accounts receivable are less than accounts payable and there are no material inventories, then a working capital facility is more likely to be required, as expected short term future cash inflows are less than expected cash outflows.

Review period

The continued use of a five year review period would seem appropriate to provide some planning certainty for customers without unduly affecting GAWB's ability to change prices should their cost structure vary markedly over the five year period. Triggers for an early price review (within the five year period) are still considered appropriate, however it is suggested that the proposed trigger for variations in revenue should continue to be based on actual rather than forecast variations of greater than 15%. This is then consistent with the QCA's current review role based on actual rather than hypothetical situations.

Efficiency carryover mechanism

As noted in a previous Departmental submission on the QCA's *Efficiency Carryover Mechanism Issues Paper*, it is considered important that the regulatory pricing framework encourage service providers to become more efficient by allowing the entity to retain cost saving incentives in addition to allowing the service provider to achieve a weighted average cost of capital (WACC) return for a reasonable period of time. It is suggested that an incremental rolling carryover of efficiency gains may represent the most appropriate approach to encourage efficiency improvements as it shares the benefits between the consumer and the service provider. However, it is acknowledged that the introduction of such a scheme may need to be delayed until the next price review given the difficulties involved in identifying the savings achieved over the last five year period within the current time constraints.

Pooled pricing for council customers
It is noted in the draft report that the QCA considers that a pooled pricing arrangement be maintained for Gladstone City Council and Calliope Shire Council. It is suggested that the QCA should investigate this matter in more detail for the final report, clearly identifying the benefits and costs associated for each customer with regard to maintaining pooled pricing arrangements. It is suggested that an option including Mt Larcom within the pooling arrangements should also be assessed.

Mt Larcom indicative maximum price
The Department is aware that the QCA has re-engaged SMEC to consider whether or not part of the delivery network to Mt Larcom (i.e. pipeline section from the Boat Creek Pump Station to the East End Reservoir) should be optimised and the GAWB asset base adjusted if required. The Department understands the potential price implication this could have for Mt Larcom and considers that the appropriate technical treatment of such assets needs to be addressed.

Should you have any queries in relation to the matters raised in this letter, please contact Ms Ann Taylor, Financial Analyst, on 3224 7789.

Yours sincerely

Bob Reilly

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