GLADSTONE
REGIONAL COUNCIL

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Reference: WS1.2/mdh

8 November 2019

Chair
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Attn: Flavio Menezes

Gladstone Area Water Board – Price Monitoring 1 July 2020 to 30 June 2025

I refer to your correspondence received on 1 October 2019 advising of receipt of the proposal by Gladstone Area Water Board (GAWB) for pricing for 2020-2025 and formally submit below Gladstone Regional Council's comments with respect to the Part A and Part B proposals.

Further, Council is appreciative of the opportunity afforded by the Queensland Competition Authority (QCA) to formally consider the proposal at its meeting on 5 November 2019, and the subsequent extension of time for submission to 8 November 2019.

Council acknowledges that as an essential service provider, GAWB is obliged to ensure that it delivers bulk water services that are safe, secure, reliable and appropriately priced for the approximately 56,000 residents to whom GAWB is the bulk water provider.

At the last price reset in 2015, the effective price increase to Council was 2.3%. The concern to Council is that the sum impact of the proposed pricing to residents is a 37% increase per ML by 2025, under Part A and Part B submissions, with increased costs to the community proposed over this period of $26.8m, despite only a total 2.1% increase in forecast demand over the five year forecast period in total.

Council is being asked to provide comments on the GAWB submission, however only part of the information has been received to inform a response. With more detailed information as to the cost structure and capital investments, Council, as the regional retail water provider, would have been better placed to make more directed comments to ensure that there is an optimal investment of public resources (capital and operating expenditure) with respect to both bulk and retail water providers and we trust that the QCA will now perform this role on behalf of both Council and the community.

Whilst not relative to the Pricing Submission, Council acknowledges and welcomes bipartisan support confirmed through correspondence for the return of 50% of the Dividend and Tax Equivalent Payments (DTEP) to the community. Council seeks assistance to gain visibility of forecasting of future returns to our community. Should this visibility be obtained, Council will be better placed to pass through returns relative to residential usage from the State to the Community, as an offset to the bulk water charges paid to Gladstone Area Water Board.

Over the period from 1 July 2016 to 30 June 2019 Council has received $17.7m in dividend and tax equivalent payments, with this funding being utilised to fund water and sewerage capital infrastructure.

Governance

Council appreciates that GAWB has been preparing the extensive piece of work that comprises the 2020-2025 price reset for a period of in excess of two years. It is worth noting though that an entirely new board was appointed on 22 August 2019. Council does question whether appropriate governance and oversight of GAWB's pricing submission and impact on all 56,000 residents and industrial customers was possible given the short timeframe between appointment and lodgment of GAWB's pricing submission on 30 September 2019.

Extent of Price Increase

GAWB's proposal indicates an overall price increase of 9% in real terms, with different price impacts to be felt by different customers. The extent of the price increase for Council is much higher at 21% in 2020/21, and by CPI each year thereafter within the regulatory price period under the Part A Submission and with Part B factored in, the total increase is 37% by 2025. GAWB indicates that the increase is due to:

- The fact that 76% of water services are potable and a significant proportion of GAWB's capital program is on the potable network.
- The large number of connections – 7 pricing zones.
- The cumulative impact of expenditure in prior pricing zones.

Approximately $8 million in customer-initiated expenditure to connect two reservoirs (which will result in a reduction in demand in some pricing zones).

The cumulative impact of both the Part A and Part B submission, if adopted as is , would result in a per kilolitre cost to residents of $2.51 per kilolitre by 2025 that would make the Gladstone Regional Council resident subject to the highest per kilolitre charge in a major urban water service provider outside of South East Queensland.

The extent of the proposed price increase is significant and therefore all aspects of GAWB's submission need to be appropriately evaluated by the QCA to ensure household and business impacts are minimised within the Gladstone region's community.

Expenditure in 2015-20

As occurred during the previous regulatory period, GAWB's operating and capital expenditure has significantly exceeded that outlined in the QCA's 2015 final report. The QCA needs to consider the appropriateness of this additional expenditure, given the cumulative and compounding effect it has across regulatory periods on the Gladstone region community.

There also needs to be some sort of ex post assessment undertaken of GAWB's historic projections which appear to be inaccurate or deficient if actual expenditure is consistently underestimated. Alternatively, the efficacy of GAWB's expenditure within regulatory periods vs the QCA's recommended expenditure needs to be questioned.

It is important to note that one of GAWB's justifications for significantly exceeding the QCA's staff numbers and costs in the last regulatory submission was that it was insourcing maintenance which would lead to enhanced asset management strategies and lower reactive maintenance costs beyond 2020. The level of expenditure, staffing costs and contractor costs included in the current submission directly contradicts the previous submission, questioning the basis for the justifications provided to the previous review. A detailed ex post analysis is required to ensure that cumulative overspending is not occurring at the expense of the Gladstone region community as there appears to be a systemic environment of overspending by GAWB relative to the QCA recommendations.

At the time of the last review, GAWB indicated that it would not further increase staffing levels over 2015-2020. An evaluation of GAWB's performance in this regard is recommended, in addition to the overall resourcing effort of the organisation (i.e. including the use of contractors which appears to have increased considerably despite the insourcing strategy specifically noted at the time of the last review to justify the steep jump in staffing levels).

Council agrees with the QCA that the Contingent Supply Strategy works should continue to be excluded from the Regulated Asset Base (RAB), as should any expenditure on supply options that are clearly required to meet GAWB's industrial demand and not residential.

GAWB has included costs associated with the offline storage on the basis that they were necessary to overcome key risks with respect to potential failure of the Awoonga Dam Pump Station. The full costs, including that portion which the QCA considered to be above the efficient cost of managing this risk has been included in bulk water prices. Consistent with Council's previous view, residents should only pay a share of costs in excess of four days storage. That is, Council systems provide up to a four-day storage capacity to meet demand. Therefore, the project will provide the council with an additional level of service in the event of a failure that would take the system offline for a period of between 4 and 14 days. It is reasonable that Council does not pay for services it does not need. GAWB should consider some pricing discount that reflects Council's ability to manage its storage for up to 4 days.

Expenditure in 2020-25

The expenditure proposed by GAWB in 2020-25 considerably exceeds prior projections, despite demand projections not being higher.

For example, in GAWB's submission in the previous review it was indicated that capital expenditure for the entire period 2020-2035 was expected to total $121 million. In the 2020-25 five-year period alone in the current submission, GAWB now indicates that capital expenditure is expected to be considerably higher than that 15-year period at $179 million (including $60.7 million in dam safety upgrades) despite no significant growth in demands. Council has obvious concerns over the implications of this projected expenditure on the charges levied on its ratepayers and questions the necessity of the proposed timing of the dam safety upgrades relative to compliance requirements.

Further, as per the preceding section the justification for the increased operating expenditure conflicts with the assertions in GAWB's previous submission that increased staffing occurred to reduce the reliance on contractors to insource asset management strategies to reduce future maintenance obligations and no expectations of further increases in staffing levels with an increase in both staffing costs and contractor costs – the latter now justified on the basis of increased maintenance costs.

It is noted that GAWB has expanded its administrative and office overheads during the pricing period, with two offices in Gladstone and one in Brisbane, residents should only be responsible for funding prudent administrative overheads and as such the current office overheads appear excessive for the size of the business.

The proposed cost escalation factors also appear excessive given the current economic environment, implied inflation factors and the economic outlook.

It is acknowledged that GAWB has included a 1% efficiency target on its controllable operating expenditure (not specifically defined). Council questions what will happen at the time of the next review if this target is not met, given history has shown GAWB to overspend relative to cost projections with pricing restarting at new, higher cost levels at each review point.

Weighted Average Cost of Capital (WACC)

While GAWB's submission highlights a reduction in the WACC from 5.77% in 2015-20 to 4.57% in 2020-25, certain aspects of the WACC are questioned:

- Capital Structure – A capital structure of 50% is justified on the basis of the concentrated nature of its customer base and associated demand risk, rather than the 60% applied to Seqwater. The resulting impact for Council and its community is that it faces a higher cost than would otherwise apply. Council believes that in order for its community to be treated equitably, the capital structure input should be increased to 60%.
- Market Risk Premium – GAWB (via Synergies) suggest the MRP should be increased from 6.5% to 7%. Council considers that an MRP of no greater than 6.5% should apply to ensure consistency in treatment with the MRP's adopted in other jurisdictions for water supply.

Form of Regulation and Regulatory Pricing Period

GAWB has applied a +/- 10% dead-band approach, which means GAWB is exposed to revenue risk of 10% (above or below ARR) on all of its water services. Any over recovery of total revenue above the dead band of 10% will be returned to customers in the following regulatory period. The converse will occur if total revenue is more than 10% lower. Council agrees that the existence of the dead band provides GAWB with an incentive to increase take-up of excess capacity, which is to the benefit of all customers as fixed costs are allocated to a larger customer base. As such, Council agrees with GAWB's proposal in this regard.

However, one of the most significant changes in the GAWB pricing submission is the use of a 5-year price smoothing period as opposed to the 20-year price smoothing period as applied since the inception of QCA's monitoring of GAWB's price setting practices. GAWB has adopted this approach in response to the referral requesting a means by which the level of under-recovery in revenues is not further increased and preferably reduced in ensuring regulatory periods.

The most significant issue from Council's perspective is that this approach conflicts with the QCA's stated principle from prior reviews that the costs of spare capacity are to be shared between current and future users. Under GAWB's proposed approach, the carrying cost of spare (or excess) capacity would become a burden on current users rather than future users. Amongst other things, the 20-year price smoothing approach was adopted to ensure current customers were not paying for capacity required for future customers as well as the need to avoid significant price shocks associated with the need to install infrastructure to meet projected future demands.

Awoonga Dam Capacity Expansion and the Cost to Serve Council vs Industrial Customers

The GAWB submission refers to QCA's view in the 2015 report that it had "previously found that efficient excess capacity that was generated through the expansion of capacity at Awoonga Dam should be recovered across current and future users".

Under GAWB's proposal, the carrying cost of spare/excess capacity is no longer proposed to be shared between current and future users, with current users having to fund spare/excess capacity in the dam since its construction and continuing to carry these costs until demand grows to more reasonable levels. GAWB now indicates that it expects demands to reach dam capacity at 2035 – previously, expectations for demands to reach dam capacity were much earlier.

At many points within its submission, GAWB explicitly states that its operations and cost base are different from urban water suppliers in that industrial customers account for the majority of its demands and have greater demands and risks associated with their water supply. These comments imply that Council is being disadvantaged through the application of a higher WACC and higher operating and capital costs (e.g. "our cost base differs from urban water service providers", page 88) than would otherwise exist if Council was serviced through an urban bulk water supplier. It is questioned whether costs are being appropriately allocated to industrial customers vs Council – including common costs via the 'effort' ratios – given these assertions.

Further, GAWB indicates that its demand outlook is more uncertain than other urban water service providers with a high degree of demand and revenue risk attached to its operation and forecasting. It would appear that the delivery of capacity expansion was primarily established to service anticipated growing industry demands rather than any significant growth in residential demands, yet ratepayers – as the stable demand base in the region – are responsible for funding the establishment of this spare/excess capacity even when not utilised. Council queries what the potential implications would be for its community in terms of water charges should GAWB lose a significant existing industrial customer (which it identifies on page 68 of its submission as something that "cannot be ruled out").

GAWB must find a way to separate the portion of costs attributable to unused excess capacity over the regulatory period. Customers should not have to pay for capacity they do not need. As customer needs increase, the cost of raising the dam wall (and associated costs) should be included in the charges. Historic 'under-recoveries' should also be adjusted to account for unused excess capacity.

MDQ Charges

At the time of the last review, the QCA accepted the MDQ charging method for delivery services on the basis that it provides an effective pricing signal. It is agreed that this approach may be effective in theory on economic efficiency grounds for common infrastructure shared by multiple customers placing different demands on the system. In fact, GAWB indicates that many customers have introduced permanent water efficiency measures and operational processes and procedures to ensure 'over-runs' do not occur.

However, residential demands are reasonably certain and primarily fluctuate from year to year as a result of weather and rainfall patterns. As such, it is queried whether the MDQ approach is relevant for an urban supply environment where the majority of the infrastructure utilised by Council is customer-specific infrastructure. Any spike in MDQ is likely to be temporary due to an event such as a mains leak and not representative of a shift in peak usage patterns that may need to be subject to a punitive charging structure.

Further, Council manages its supply on a whole-of-network basis which may mean some temporary shifts in demand across the various supply points/charge nodes. Council has previously argued that Mean Day Maximum Month (MDMM), which is the highest 30–day moving average daily water demand during a year, is more appropriate than MDQ, particularly given council reservoirs act as both emergency storage and a peak demand buffer.

Should MDQ charging be retained, Council agrees with the feedback provided to GAWB that the MDQ ratcheting up mechanism is inappropriate and at a minimum requires amending as customers should not be penalised for many years as a result of an infrequent incident (e.g. a mains leak). Any amended mechanism should provide the customer with the ability to amend their MDQ in consultation with GAWB to ensure charges appropriately reflect the demands placed on the system.

Prevention of Future Under-Recovery and Proposed Recovery of Historic Under-Recovered Revenue

The Minister's referral requires the QCA provide advice on measures which will prevent the further accumulation of under recovered revenue, reduce the existing balance of under recovered revenue, and manage the impacts on customers of any proposed measures. GAWB has advised that its accumulated under-recovered revenue is $124.7 million.

The under recovery partially results from a rolling 20-year price smoothing mechanism designed to defer GAWB's recovery of costs such as the raising of the dam wall until increased capacity is needed, essentially sharing the cost across both current and future users. In order to prevent the further accumulation of under recovered revenue GAWB has proposed that from 1 July 2020, GAWB be allowed to fully recover its approved annual revenue requirement for each year of the regulatory period. That is, instead of prices being smoothed over a 20-year period, the price smoothing period should be aligned with the length of the regulatory period (currently 5 years).

However, Council believes that it should not have to pay for capacity that is not needed – particularly given its demands are fairly predictable and low risk for GAWB (i.e. Council should not have to fund GAWB costs associated with industrial demand risk). As customer needs increase, the cost of raising the dam wall and associated costs can be included in the charges. Spare/excess capacity exists due to demand forecasts at the time of construction being considerably higher than what has actually occurred. Consequently, GAWB must find a way to separate the portion of costs attributable to unused excess capacity and either write off or carry forward the cost of spare/excess capacity until demand increases sufficiently for it to be taken up.

GAWB proposes to recover each customer's portion of the outstanding under-recovery balance through an annual annuity payment, which would be a separate payment to GAWB's other charges (i.e. storage, delivery and administration) and will only apply to existing customers on the basis that the under recovery reflects the costs of servicing their demand, along with a proportion that contributes towards the costs of the most recent Awoonga Dam augmentation. GAWB needs to demonstrate the value customers have received (security of supply, deferring on-site augmentations, deferring water demand efficiencies etc.) as any historic under-recovery associated with unused excess capacity should not be recouped from current customers.

A 'default repayment term' of 100 years has been suggested by GAWB for GRC, which is greater than the term applied to commercial customers in recognition of the different risk factors associated with the supply of water for residential compared to industrial purposes. It also recognises that Council is effectively the 'customer of last resort' for recovering any residual outstanding amounts not recovered from other customers.

Council is unable to comment on the appropriateness of the allocation methodology adopted by GAWB for accumulated revenue under-recovery given it has not been made available for comment. However, on face value the percentage of the total under-recovery allocated to Council appears inconsistent with Council's share of total customer demands and relative utilisation of dam yield.

Council also wishes to confirm that GAWB is not attempting to capture under-recovered revenue attributable to historic customers that are no longer connected from Council as the customer of last resort. GAWB should not be recouping under-recovered revenue attributable to excess or spare capacity resulting from the dam augmentation given demand forecasts have not met expectations set at the time of investment given the shortfall in demands relative to expectations largely is a result of industrial customers rather than Council as a customer.

If Council was to accept an appropriate portion of under-recovered revenue, once all necessary information has been reviewed and agreed upon, then it may be more beneficial for it to consider how the overall cost to the public can be minimised, either through guarantee or annuity set at current borrowing rates, rather than the proposed WACC rate, ensuring that the net cost to the community and State is achieved.

There is approximately a 2.56% p.a. difference between current borrowing rates and the proposed annuity rate by GAWB. The premium rate of return proposed relative to applicable borrowing rates, means that a debt that GAWB is seeking to recover over 100 years can be repaid through debt in only 27 years, at a net saving to the community on a Net Present Value basis of over $43m.

Review Triggers

Review triggers are events that would allow GAWB to adjust water prices during the regulatory period to take account of unforeseen changes or material variations in revenue resulting from changes in demand. In its submission, GAWB proposes eligible review events to include:

- Adjustments to demand
- Drought response measures
- Force majeure.

If one or more of the above events occurs and the costs incurred exceed the materiality threshold (which GAWB proposes to reduce to 10% variation in aggregate revenue), they may be recovered through a mid-period adjustment to bulk water prices.

More information is needed regarding the method for determining a trigger event, the make-up of aggregate revenue and the timeframes around which the trigger event can be identified and adjustments to pricing made. The addition of 'adjustments to demand' as an eligible review trigger requires further clarification.

In summary, Council acknowledges that GAWB needs to be appropriately funded to manage its assets and provide a vital service to the residents and industrial customers of Gladstone, however Council does have some specific areas of concern as raised above around the size, scale and method of the proposed price increase to apply from 1 July 2020.

Gladstone Regional Council looks forward to working with all parties to a mutually agreed outcome that minimises the impact to all customers whilst ensuring continuity of service. Should you seek further information with respect to any of these issues please contact Council's General Manager Finance Governance and Risk, Mark Holmes on 07 4976 6919.

Yours sincerely

L A. Dowling

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