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Your reference Paul Bilik
Our reference BNE2004/2917

Environmental Protection Agency

Incorporating the
Queensland Parks and Wildlife Service

2 April 2004

Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Hall

Technical Review of the Authority's Cost of Capital Methodology

The Environmental Protection Agency (EPA) generally agrees with the use of the Capital Asset Pricing Model (CAPM) as articulated in the report but notes the following areas where it is considered further development is needed.

Regulated entities provide goods and services that have public good characteristics. This should affect how the returns to capital invested by these entities are estimated. For instance, if demand-side management on water consumption was to be successful at a given output price obtained under the current CAPM or the modified CAPM recommended by the report, then the financial or equity capital invested would not be returned during the life of investment. However, the returns to society through more sustainable irrigation practices and uses by consumers would certainly have benefits for the state, for example decrease in salinity, deferral of infrastructure costs and higher productivity in agriculture. This also suggests that estimation of risk for 'public goods' should take into account broader community issues beyond financial market issues. It is recognized that significant research is occurring and is still needed in this area.

The EPA's experience with price regulation for 'essential services' products such as water and energy is that CAPM drives organizations to adopt supply-side, asset-based options. A least cost-planning approach that seeks outcomes based on a review of all options including supply-side, demand-side and alternatives would provide a better basis for investment decisions. Investment in least-cost planning options adopted should be able to be recovered through pricing arrangements.

Supply-side emphasis also leads to perverse effects from contractual and pricing methods such as 'take or pay' contracts. These provide no incentives for water conservation. The recent water

crisis in Gladstone may have been prevented if investment recovery had been allowed for water demand management.

Thank you for the opportunity to provide input on this issue. Should you have any questions, the contact officer for the EPA is Mr Tad Bagdon (Email: tad.bagdon@epa.qld.gov.au or telephone Tel. 322 48438).

Yours sincerely

A handwritten signature in black ink, appearing to read 'James Purtill', written in a cursive style.

James Purtill
Director-General