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By Email
Mr EJ Hall
Queensland Competition Authority
PO Box 2257
BRISBANE QLD 4001

25 February 2010

Our reference 100225 GAWB 2010 Price Review – Submission 2 Final
Your reference

Dear Mr Hall

Thank you for the opportunity for Rio Tinto Alcan (RTA) to review GAWB's Commercial Framework and Pricing Principles, and Expenditure Proposals for the 2010 price review. Our comments in response to GAWB's proposals are detailed in the attached submission.

We look forward to further participation in the QCA review process and appreciate the opportunity to provide this submission for your consideration.

Yours sincerely

[redacted]

Paul Arnold
General Manager - Energy

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Rio Tinto Alcan (RTA) Submission to the Queensland Competition Authority

Gladstone Area Water Board (GAWB) 2010 Price Review

1. Risk vs Return

As an overall observation, it should be noted that GAWB is proposing a number of measures to reduce revenue risk while also submitting a higher WACC. It is considered that if GAWB's suggested changes to the regulatory framework are adopted and GAWB faces lower risk as a result, then GAWB's new risk profile should be taken into account when determining an appropriate WACC. Any effective reduction in risk and its impact on the WACC is in addition to the comments made regarding the determination of WACC below.

2. WACC

Pre versus post-tax cost of debt
The pre-tax cost of debt appears to have been applied in determining post-tax nominal WACC by both GAWB and Synergies Economic Consulting. The tax saving on debt costs should either be captured in the WACC or the underlying cash flows.

Capital structure
International water businesses, a number of which are regulated businesses, and Australian regulated infrastructure businesses, demonstrated significantly higher gearing at the time of the analysis (60% to 70%). We consider there is substantial evidence to suggest that the appropriate optimal gearing should be significantly higher than the 50% suggested by GAWB.

Imputation credits
Potential purchasers of an interest in infrastructure assets will, in most cases, be able to utilise the benefit of imputation credits. It is commonly accepted in the industry that a value is attributed to the imputation credits. There are several studies which support this view (as set out in the paper drafted by Synergies Economic Consulting for GAWB) and there are numerous precedents of the recognition of imputation credits in comparable regulatory determinations of WACC across Australia as detailed in Table 1 below.

Table 1

State	Company	Decision	Gamma
Qld	GAWB	Investigation of pricing practices, March 2005	0.5
	Burdekin-Haughton Water supply scheme	Assessment of certain pricing matters relating to the Burdekin River Irrigation Area, April 2003	0.5
NSW	Sydney Catchment Authority	Review of prices for the Sydney Catchment Authority, Water determinations report June 2009	0.3 - 0.5
	Gosford City Council	Prices for water, sewerage and stormwater drainage services from 1 July 2009 to 30 June 2013 – Water determinations report May 2009	0.3 - 0.5
	Sydney Water Corporation	Review of prices for Sydney Water Corporation's water, sewerage, stormwater and other services – Water determinations report June 2008	0.3 - 0.5
Vic	Metropolitan ESC and regional water	Melbourne metropolitan water price review 2009 – final decision June 2009	0.5
SA	Essential Services Commission SA	Inquiry into the 2009-10 metropolitan and regional water and wastewater pricing process – final report August 2009	0.5
WA	AQWEST and Busselton Water	Inquiry into tariffs of the Water Corporation, Aqwest and Busselton Water – August 2009	0.65

Source: Various regulatory decisions

On the basis that the comparable regulatory determinations predominantly attribute a gamma of 0.5 to the WACC calculations, we consider a gamma of 0.5 to be more reasonable than GAWB's proposed gamma of 0.

Debt margin

We consider Bloomberg, which quotes actual traded prices and is widely used by the market, to be a more reliable source than CBA Spectrum, which is a private market data system that is not widely available to the general public. We understand CBA Spectrum quotes indicative prices only, which may explain why Synergies Economics Consulting has determined a higher debt margin than Bloomberg.

Proposed WACC

Our consideration of each of the above parameters results in a lower indicative WACC than proposed by GAWB. Based on our analysis, and before considering any impact of the proposed business initiatives to reduce revenue risk, we consider the WACC may be up to 280 basis points lower than what is currently proposed by the GAWB.

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3. Regulatory inputs

Demand forecast
GAWB is proposing to determine prices using 'base case' demand, which includes only certain or contracted demand. This represents a substantial change from the last regulatory period, and is inconsistent with the QCA's and GAWB's stated intentions of a 'neutral' demand forecast. [redacted]. It is recommended that the best unbiased estimate of demand (including all available information such as 'uncertain demand') be adopted for all aspects of regulatory pricing. As described by GAWB, "Demand scenario 2" appears to include all known information about demand increases, and is within 1 percent of start and end points of the QCA demand projections for 2009/10 to 2014/15.

Therefore, it is recommended that QCA maintain the 2005 demand forecasts in the absence of any independent assessment showing a different demand forecast (and associated price-path) is warranted. GAWB has not provided a robust case for a change to the status quo (i.e. the QCA's 2005 Final Report demand forecast) and therefore there should be no consequent adjustment to the current demand forecasts used to calculate future prices.

Should the QCA decide that their 2005 demand forecasts require updating, it is recommended the update be based on QCA-procured independent advice (i.e. similar to the MJA process undertaken in 2005). The impact of changed demand forecasts to equity between current and future customers should be considered and critically examined before any proposal is accepted that adopts more conservative approaches to future demand as proposed by GAWB.

Regulatory Asset Base (RAB)
GAWB is seeking to reset its RAB based on a 2005 SMEC valuation report. The re-opening of the RAB has not been justified by GAWB, and is inconsistent with the regulatory goals of consistency and price stability.

Indicative prices
RTA intends to make further comment, if necessary, on GAWB's indicative prices, when provided. Further information is requested relating to asset values and demand profiles of current and proposed pricing zones.

4. Form of regulation

Planning period
It is not considered that the attributes of GAWB's customers justify the introduction of increased price volatility through a shorter planning period. A transition from a 20 year to a 5 year planning period is also inconsistent with GAWB's proposal to incentivise customers to sign long-term contracts.

Price differentiation
As mentioned in RTA's first submission, a pricing structure including discounts for long-term customers rather than surcharges for short-term customers is preferable. Furthermore, GAWB has not explained how price differentiation may work under a price cap regulatory framework without causing an over-recovery of regulated revenue. More information on this topic is requested.

IFR pricing
There are some practical considerations of IFR pricing that have not been addressed in GAWB's submission, such as demand management, contract

structure and on-site storage. IFR pricing requires more detailed analysis before it can be supported.

Revenue cap
GAWB's proposal to transfer additional demand risk to customers through the introduction of a revenue cap is not supported. Customers such as RTA have no ability to manage average household water consumption or new industrial customer uptakes. As submitted previously by RTA, GAWB remains the inherently best placed organisation to manage demand risk, and that a price cap continues to be appropriate. It is also noted that the QCA has previously rejected GAWB's proposals for a revenue cap.

5. Operating expenditure

Staffing cost allocations
GAWB is seeking significant increases in staffing numbers as a proportion of operational expenditure over the planning period. Moreover, a high proportion of the increases are occurring in the GAWB Operational Business Unit FTEs to address issues in relation to the treatment of water. Major raw water customers do not directly benefit from this additional expenditure.

It is recommended that GAWB provide a detailed breakdown of the cost allocation methodology between service areas to confirm the growth (past and future) of operational staff costs required for water treatment activities is correctly allocated to treated water customers.

It is recommended that the QCA seek independent advice with regard to the benchmarking of current levels of staffing costs at GAWB, focusing investigations on:

- The appropriateness of the escalation factor for employment costs of 5%;
- Comparison of operating expenses as proportion of the RAB; and
- The impact of projected staffing cost increases on benchmarked performance.

6. Capital expenditure

Capital planning and renewals expenditure
GAWB proposes aged-based and condition-based asset replacement expenditure of $21 million over the five years from 2010-2011. Appendix 3 of the second submission identifies some concerns with renewals planning by GAWB.

In particular, the author of this report identifies problems including:

- robust planning and procurement processes are not utilised for some project types;
- the incorporation of asset data into management systems is sub-optimal;
- further work is required on condition and performance assessment to improve the accuracy of expenditure forecasts;
- much of forecast renewals expenditure is derived from replacement costs and assets lives from 2005 SMEC asset valuation and is not based on specific asset condition assessment and performance data; and
- average annual renewals expenditure of 30 other water utilities (identified for benchmarking purposes) averaged between 0.5% and 0.6% per annum compared to GAWB's proposed 0.79% for the 2009/10 to 2018/2019 period.

These problems clearly highlight the need for further independent examinations to be conducted. As part of this examination, the condition of relevant assets need to be inspected and the details within the asset database (including in relation to asset life assumptions) should be subjected to rigorous benchmarking analysis.

It is recommended that a suitable proportion of any proposed future allowable price increase is deferred until remedial action in relation to the abovementioned capital planning and renewals expenditure problems is completed by GAWB and certified by an independent and qualified person.

Contingency Supply Strategy (CSS)
Since a February 2008 rainfall event and the consolidating falls of recent weeks, the likelihood has been that this project will not be required for many years. The QCA stated in 2007 that preparatory expenditure (i.e. on the CSS project) is only appropriate if there is a high probability of project commencement in the next few years. By GAWB's own admission in its second submission, as at December 2009, there was very little probability that project construction will proceed in the next few years. There have been no material developments to affect the probability between February 2008 and December 2009.

It is recommended that CSS project expenditure after February 2008 not be allowed to be reflected in prices.

Dam safety regulatory requirements
It is recommended that, prior to allowing this project expenditure to be reflected in pricing, further evidence is provided in relation to the:

- details of the business case for the project, including the impact of the higher cost relative to the unspecified original business case;
- case for a subsidy to be provided for the project similar to those provided for other similar projects;
- relative priority of this project in the context of all required dam safety projects in Queensland;
- cost benefit analysis associated with deferring this project.

Proposed system storage and re-pump
A business case for a proposed system storage with re-pump station within GAWB's delivery network located between Awoonga Dam and Toolooa Reservoir is not provided.

It is recommended that the QCA conduct a review of the proposed additional system storage to consider the prudency of the proposed expenditure in terms of both the need for, and scale of, the investment. Moreover, any proposed off-line storage and pump station should be re-examined and tested with GAWB customers.

Land management expenditure
GAWB is seeking expenditure program to purchase and manage certain properties adjacent to the Awoonga dam storage to increase buffer zones around Awoonga. GAWB has not indicated the total cost of the land and catchment management activities that, according to section 4.2.5, commenced during 2007/08 and are proposed to conclude during 2011/2012.

It is understood that the expenditure has not previously been considered or approved by the QCA. In addition, GAWB has provided no evidence to:

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- support the assertions that the proposed buffer is optimal and may reduce water treatment costs; and
- support a view that the unspecified expenditure is prudent.

In relation to regulatory requirements, the reference to consistency with EIS commitments, as opposed to say resource operation or environmental licence requirements, suggests that there are no regulatory requirements relating to the expenditure.

As detailed in appendix 3 of the second submission, 80 percent of GAWB water supplied is untreated raw water for industry. The benefit of additional catchment management expenditure aimed at reducing water treatment costs is questionable.

Land and catchment management expenditure should not be reflected in GAWB prices unless further supporting evidence is provided.

Capital (and operating expenditure) escalation factors
GAWB's proposal to adopt short run historical averages for forecasting cost escalation factors is not supported for two reasons:

- historical data, when considered in isolation, does not necessarily contain useful information about likely future outcomes; and
- the 3 year timeframe chosen by GAWB to escalation factors displays a historically high level of price growth.

We suggest adopting an independent, defensible forecast for escalation factors where available is more appropriate. If historical averages are adopted, a longer term average is a more appropriate estimate.