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5th February 2010

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

Dear Mr Hall,

Submission to the Queensland Competition Authority (QCA) in response to Gladstone Area Water Boards Expenditure Proposals (for the 2010 review)

Callide Power Management Pty Ltd (CPM) is the Manager of the Callide C Power Station in Biloela, Queensland, and contracts for the supply of water from the Gladstone Area Water Board (GAWB) on behalf of the owners (Callide Energy Pty Ltd and IG Power (Callide) Limited).

CPM has been invited to respond to the expenditure proposals submitted by GAWB to the Queensland Competition Authority (QCA), which are intended by GAWB to form the basis of the 2010 price reset process.

Attached to this cover letter is CPM's submission to the QCA regarding GAWB's Expenditure Proposals.

Should you have any queries in relation to this submission, please contact Jamie Maione, Commercial Manager, Callide Power Management Pty Ltd on 07 3001 7153.

Yours Sincerely,

[redacted]
Commercial Manager
Callide Power Management

Submission to the Queensland Competition Authority (QCA)

Gladstone Area Water Board Expenditure Proposals

(2010 Price Review)

February 2010

Contents

1. Introduction

Callide Power Management Pty Ltd (CPM) is the Manager of the Callide C Power Station in Biloela, Queensland, and contracts for the supply of water from the Gladstone Area Water Board (GAWB) on behalf of the owners (Callide Energy Pty Ltd and IG Power (Callide) Limited).

CPM has been invited to respond to the expenditure proposals submitted by GAWB to the Queensland Competition Authority (QCA), which are intended by GAWB to form the basis of the 2010 price reset process.

2. Executive Summary

CPM submits that the recommendations contained in the GAWB expenditure proposal, prepared for the purposes of the 2010 Price Review (GAWB Expenditure Proposal) in its current form, should be rejected on the basis that it has no reasonable foundation and is inappropriate as the basis for pricing for a monopoly business.

The GAWB Expenditure Proposal represents a significant and fundamental departure from prior expenditure proposals, and if approved, this proposal will result in a significant 'price shock' for GAWB's current customer base.

For CPM specifically, a price increase of this nature and magnitude will have a substantial and material impact on the competitiveness of the Callide C Power Plant. This large operational cost increase will affect only a limited number of power stations and not the vast majority of the Queensland or national electricity generation market, which places the Callide C Power Plant at a competitive disadvantage relative to other market participants.

CPM is not in a position to recover any of this cost increase through the national electricity generation market. It is inappropriate for a monopoly service provider to be seeking to recover this level of price adjustment from its customers who are operating in a competitive market.

The following summarises the main objections by CPM regarding GAWB's Expenditure Proposal:

i) Unreasonable Impact on Legitimate Business Interests of Water Users – The expenditure proposal GAWB has tabled will lead to unacceptable price increases (potentially more than doubling in price) in what is effectively a "steady state" environment. No significant augmentation is being implemented and there is no forecast catastrophic change in terms of regulatory or customer landscapes during the planning period. The Callide C Power Station has a long term supply contract for water and investment and funding is provided on a long term basis with assumptions as to probable and realistic input price increases. No business can viably operate in a competitive market environment where its major costs can increase by such a significant amount with limited ability to recover the costs.

ii) Need for Stability and Protection against Abuse of Monopoly Power – The regulatory framework was meant to provide a level of certainty and price stability to customers and protect consumers against abuses of monopoly power. Customers accepted large price increases at the time of the last augmentation in 2002, within a framework that provided for relatively stable, CPI-linked pricing outcomes in future periods. CPM accepts that any price trajectory may need occasional resetting and adjustment, but the scale of proposed price increase is unacceptable.

iii) Insufficient Connection to Efficient Water Supply Activity – There is insufficient evidence in the Expenditure Proposal, or the accompanying appendices, of any significant benefit to customers from the proposed expenditures. Most activities/expenditure initiatives are presented as necessary to meet certain regulatory or other requirements or 'correct' past practices (such as operational inefficiencies and poor demand forecasting). There appears to be little reference back to enhanced efficiencies in water supply, customer service standards or lower risk outcomes for the customer. CPM would expect for a price rise of this magnitude that these issues would be addressed.

iv) Prior Investigations – The proposal shows a disregard for the direction of preceding QCA investigations. GAWB has proceeded to incur significant Contingent Supply Strategy (CSS) costs without customer approval and despite augmentation works not being required in the near term. This has resulted in a price increase from CSS-related expenditures significantly in excess of the range initially indicated by GAWB.

v) Fundamental and inappropriate risk transfer while providing for a price adjustment for such risk – GAWB is seeking to reduce its risk by employing a revenue cap approach, which in principle may be acceptable, yet at the same time increasing the rate of return (which implicitly provides for compensation for risk) and incorporating direct compensation for 'self insurance' costs without any offsetting risk adjustment.

3. Demand Forecasts

The Base Case Demand scenario represents the lowest risk profile to GAWB. If the QCA are to endorse this demand scenario, which CPM does not support, the benefit of this lower risk (i.e. risk premium reduction) needs to be articulated/quantified, and passed through to major customers. It is apparent from the expenditure proposal that this is not the case.

In the past decade GAWB proposed and undertook a significant storage augmentation, at a time when demand growth was very uncertain and indeed some customers were cautioning that smaller, lesser cost augmentation options should have been considered given the substantial spare capacity that would result from the expansion. Since raising Awoonga Dam in 2002, GAWB's demand forecasts have repeatedly been shown to be overly optimistic. This is supported by the QCA's final report investigating GAWB's Pricing Practices - September 2002[1]. At one point it time, GAWB was forecasting demand for 2009/2010 to be 81,425ML[2].

[1] Chapter 4 – Demand Projections for GAWB, QCA Final Report Gladstone Area Water Board: Investigation of Pricing Practices, September 2002.
[2] QCA's March 2001 report "Gladstone Area Water Board: Projected Demand for Water - 2000/01 to 2019/20" (Appendix B)

Having completed this storage augmentation for Awoonga Dam and following the capitalisation of the related project costs in the Regulated Asset Base (RAB), GAWB are now proposing to adopt a more conservative, certain demand forecast, with an allowance only for very limited future growth.

This, together with proposed future changes to the length of the pricing horizon, will result in existing customers paying for spare capacity which will benefit future users should they materialise.

CPM considers this outcome fundamentally unacceptable. In a competitive environment the costs of investment in over-capacity cannot be recovered from users. Knowledge of this risk of capital stranding provides a discipline to sound investment decisions. GAWB effectively wants its customers to pay for its over-investment, past inefficiencies and poor demand forecasting as well as provide GAWB with a 'commercial' rate of return.

It is inappropriate that the risk of demand should be allocated to fixed long term customers whom have no control over the forecasting or the regional development initiatives that will drive that demand. That risk appropriately sits with the party best able to control or mitigate that risk, undertake the analysis and derive the forecast (i.e. GAWB). GAWB is also the party capable of undertaking demand management initiatives to address demand issues.

Furthermore, in assessing the merits of the revenue cap approach, CPM is urging the QCA to pay close attention to GAWB's allocation of risk between the business and users and also if GAWB encourages efficiency and cost reductions over time.[3]

4. Capital Expenditure

A significant capital expenditure program has been proposed by GAWB for the next planning period. GAWB has obviously gone to great lengths to support the capital expenditure proposal with a number of reviews commissioned, particularly on the 2 key areas of expenditure in Contingent Supply Strategy (CSS) and Saddle Dam works.

CPM has limited its comments principally to those cost initiatives with a direct impact on raw water customers, though notes that GAWB has proposed significant expenditures for its treatment/reticulation networks, also.

Contingent Supply Strategy (CSS)

Whilst the submitted reviews are informative in nature, in our view, there is no real test as to whether CSS expenditures **now** generate benefits for customers versus as an alternative strategy of deferring work to future periods. This is particularly important now that the augmentation (for either drought or demand growth reasons) is likely to be well outside the next planning period 2010-2015.

GAWB initially suggested that its CSS preparatory works would add between $18-27/ML to water prices.[4] The QCA subsequently limited the categories of activities to be undertaken that could be

[3] p.26 QCA Statement of Regulatory Pricing Principles for the Water Sector 2000

considered preparatory works, which therefore should have reduced the $/ML impact from CSS. However, recent presentations made by GAWB to CPM indicate that CSS costs contribute in excess of $30/ML to the proposed price increase, excluding demand and WACC impacts. CPM strongly believes that the expenditure on CSS allowed by the QCA to be recovered through prices in this next planning period needs to be significantly reduced to come into line with the QCA's previously determined principles, and to have regard to the core issue of whether the expenditures have delivered a benefit to customers.

Recent substantial inflows into Awoonga Dam in early February 2010 have elevated the dam to > 60% capacity as at 4 February 2010. This provides a compelling argument for GAWB, as a matter of urgency, to re-assess their forecast contingent supply strategy and look to reduce costs for the next planning period as a direct result of this inflow.

Storage

The largest component on capital expenditure proposed ($27.2M) relates to the construction of a new embankment at Saddle Dam No. 3 and the raising of the left abutment of Awoonga Dam in order to comply with dam safety / flood management obligations. It is imperative that the veracity and necessity of this level of investment is challenged. What, if any, alternative and potentially lower cost strategies have been investigated and what would be the likelihood of the Queensland Dam Safety Regulator accepting that a lower cost strategy would still meet regulatory requirements?

The QCA needs to look closely at these concerns. Significant cost was incurred when the dam was raised in 2002. What is the nature of the new safety requirements which were not apparent for a large infrastructure project completed only 8 years ago?

General Comment

All capital expenditure should yield benefits, either direct productivity, reduced risk (safety etc) or reduced contingent liabilities. If it is GAWB's intention to include increased capital expenditures in the cost base then the corresponding benefits should be included any price adjustment and/or through improved (and contractually defined) levels of service or reduced risk profiles to customers.

Furthermore, CPM should not be penalised for past inefficiencies or past revenue shortfalls from poor demand forecasting practices.

CPM would like to submit the following case study examples for the Authority to take into account when reviewing the appropriateness of the levels proposed for GAWB's capital expenditure program:

i) Growth related capital expenditure

CPM asks that the QCA take note of a recent Independent Pricing and Regulatory Tribunal of NSW (IPART) review in NSW of water pricing where the appropriateness of imposing

[4] This range of price increases was calculated by the QCA, based on GAWB's own contingent supply strategy cost estimates, as reported in *Gladstone Area Water Board: 2007 Investigation of Contingent Supply Strategy Pricing Practices – Stage A*, December.

significant price increases on current users versus future users for growth related capital expenditure was considered.

In May 2009, IPART completed an investigation of urban water prices for Gosford and Wyong Council's, and as part of this considered the appropriate treatment of capital expenditure relating to future growth.

IPART's report[5] noted:

"There is a significant amount of capital investment being undertaken over the 2009 determination period. Much of this investment is necessitated by development in the growth centre of Warnervale and redevelopment of other centres in Wyong Shire. While the infrastructure needs to be built now in order to accommodate a large increase in the population, increases in the population will occur incrementally over a long period of time.

As a general rule, costs should be recovered from those who benefit from particular items of capital expenditure. In the case of Wyong Council's growth related assets these are required to service future rather than current residents of Wyong. However, the application of IPART's normal building block approach would result in a substantial price increase for current customers who are not the main beneficiaries.

IPART has therefore developed an alternative approach that enables more of the costs of the growth assets to be recovered in future periodic charges and developer contributions rather than in the current periodic charges. This approach will apply to all of Wyong Council's growth assets other than those constructed under the joint water scheme with Gosford Council."

In effect, IPART's approach provides for "deferred recovery" of costs relating to capital expenditure incurred now, but principally for the benefit of future users. IPART noted further:

"If IPART did not introduce this scheme the current customers would pay significantly higher prices now which would subsidise relatively lower prices for all customers in the future."

CPM believes a similar methodology is appropriate for GAWB to ensure that the costs of current spare capacity developed by GAWB for the benefit of future users are not transferred to current users through higher water prices. This is achieved by maintaining a planning/pricing horizon of sufficiently long duration, to capture anticipated demand growth and the take-up of spare capacity.

It should be noted that future commercial water users of GAWB's will have the opportunity to assess their proposed investments factoring in such cost for capacity and will have the ability to make a commercial decision on whether or not to proceed with their investment. That option is not available for CPM. The owners committed the required capital funds several years ago and obtained project finance based on long term assumptions that included appropriate and realistic price movements in vital inputs such as water.

[5] IPART, *Gosford City Council Wyong Shire Council: Prices for water, sewerage and stormwater drainage services from 1 July 2009 to 30 June 2013 Water — Determinations and Final Report*, May 2009

ii) Justification of customer benefit in capital expenditure programs

One of the benefits that CPM can see in a regulatory process such as this is that the QCA can review and challenge the basis for operating costs and capital expenditure proposals of regulated utilities. Commonly, these reviews identify scope for efficiency in terms of the appropriate scale or timing of projects, or challenge the prudence of cost estimates overall.

In the UK, the Water Services Regulation Authority (Ofwat) has recently undertaken a review[6] of regulated water companies' draft business plans, of which capital expenditure proposals form a significant component. Collectively, the regulated water companies proposed a capital program over 2010-2015 of £24 billion, covering capital maintenance, supply/demand management, quality enhancements and service level enhancements. Ofwat reviewed these projects and determined to allow £19 billion of capital expenditure in the current regulatory period.

The reasons put forward by Ofwat for reducing the allowable capital programs included:

a) Water quality initiatives not justified on cost/benefit grounds

A number of capital projects were put forward by companies to meet water quality standards. Ofwat reported it would:

"... ask water companies and quality regulators to review those schemes which have a material cost impact and which appear not cost beneficial. In such cases, we will be working with the quality regulators to assist with a further challenge on the basis of a number of questions. These include whether the statutory driver has been correctly interpreted, and in particular whether:

- *alternative interpretations have been considered;*
- *there is any scope for flexibility in the driver;*
- *the company has considered different options for delivering the statutory driver; or*
- *the company has demonstrated that it has selected the best value option."(p.24)*

These principles could be applied by the QCA to GAWB's proposed dam safety expenditures, where significant expenditures are proposed but little consideration appears to have been directed to alternative ways in which the regulatory standard may be satisfied.

b) Water supply security projects not matched to customer needs

Ofwat rejected a number of capital projects where companies had failed to *"demonstrate that they needed to invest to deliver the service that customer want." (p.28)*

CPM is seeking a similar level of review by the Authority, to test GAWB's proposed capital expenditures against the benefit expected to be realised by users. Moreover, where projects

[6] Ofwat, *Capital expenditure for 2010-2015: Ofwat's view on companies' draft business plans*, December 2008

are justified by expected future benefits, then CPM would expect the QCA to consider whether these projects should be paid for by today's customers who receive marginal, if any benefit. Furthermore, CPM would like Authority to ensure that there are post investment reviews to demonstrate that the benefits are actually realised. Customers should not bear the risk of poor investments proposed on account of future benefits which are not realised.

5. Operating Expenditure

General Comments

It is CPM's view that the Operational Expenditure proposed should be benchmarked against key indicators such as current market conditions, similar utilities businesses with comparable risk profiles, geographical coverage and levels of recent augmentation works completed. Operating expenditure should be supported by strategies and programs that provide incentives to reduce cost over time, improve efficiencies and operating capabilities.

GAWB's submission refers to an accompanying analysis of operating expenditure efficiency and productivity undertaken by Marchment Hill Consulting. In CPM's view, this report does not provide a relevant and meaningful basis on which to assess GAWB's productivity or efficiency. It makes simplistic comparisons of various cost ratios (opex to total water sales revenue etc), but no meaningful analysis of the nature of the results.

For example, the ratios are biased by the fact that GAWB has just completed a significant augmentation, which increased significantly its RAB and has flowed directly through to a large increase in water sales revenue. Therefore, what the cost ratios are really showing is that GAWB's capital costs include significant spare capacity, meaning that opex (or capex) as a proportion of total costs/water sales revenue/RAB is low relative to other water businesses. This does not measure efficiency. All it shows is that GAWB's capital base is comparatively 'newer' and higher cost than the other water businesses examined. The QCA policy for operating costs is that operating costs are to be evaluated on an individual basis, and usually this would include benchmarking against other relevant organisations.[7] CPM contends that the relevance of the benchmarking and comparison undertaken is questionable for the very reasons noted above.

GAWB submits that the increase in opex is close to inflation[8], however, this comparison is drawn off an expenditure base that has more than doubled in the previous 4 years. Maintenance costs have more than tripled over the same time and entirely new cost categories have been added (for example self insurance costs at $590k pa) with no apparent pay-off to customers in terms of enhanced levels of service or reduced risk.

CPM would like the QCA to pay close attention to the following:

- Section 5.2.1 (p.37) Escalation: The concept of selecting 2007-2009 indicators and carrying this forward into the next 5 year period is flawed. 2007-2008 represents the tail end of what

[7] p.5 QCA Statement of Regulatory Pricing Principles for the Water Sector 2000
[8] p.35 Expenditure Proposals for the 2010 price review: A submission to the Queensland Competition Authority, December 2009

could be described as the economic boom in Queensland. The economy moved remarkably downwards in 2009 and recovery will take time. Resources became and are currently more readily available and the competition for firms to gain / continue business is much more aggressive. The AUD-USD has also improved dramatically.

- Section 5.2.2 (p.38) Maintenance: In accordance with GAWB's expenditure proposals maintenance costs have escalated dramatically since the last planning period (Table 9, p.37). Section 5.2.2 elaborates on the benefits of preventative maintenance programs. These programs will reduce the risk exposure to GAWB. CPM would like to know how this is to be reflected in subsequent pricing and/or contractual levels of service. Capital programs and asset replacement programs (which have also increased) should also work to keep maintenance costs down. Preventative maintenance programs should reduce the need for administration and other operational cost activity because there should be fewer instances of emergent repairs and reactive maintenance. CPM is expecting the QCA to rigorously investigate and challenge the step change and 'cost versus benefit' in the forecast maintenance costs and programs.

- Section 5.3.2 Organisational resourcing review: CPM would like the QCA to rigorously review GAWB's organisational structure proposed to execute the services in the next 5 years.

6. Regulated Asset Base (RAB)

CPM's position on preparatory costs for augmentation being included in RAB and depreciated over the economic life of the preparatory works remains unchanged and is consistent with previous QCA statements – that is, such adjustments to RAB are to be generally affected in the period which the new investment is bought in to use[9]. GAWB's plan to include preparatory costs for augmentation into the RAB prior to that augmentation being commissioned contradicts prior QCA directives.

Separately, GAWB appears to be proposing an increase the starting RAB by $16M, evidently to get a 'clean' opening valuation for 2010 price review consistent with its most recent detailed asset valuation. GAWB's submission suggests that it is unable to reconcile the starting asset value for its existing assets to a roll-forward of the previous QCA valuation, given information provided to it by the QCA.

This valuation uplift is inappropriate. It essentially represents an attempt to double-dip in customer charges; once through a nominal rate of return amount, which already includes an allowance for asset indexation, and secondly through an upwards revaluation to the RAB.

This revaluation should be disallowed, or if it is allowed then the $16.04M uplift should be offset against any revenue target for the coming regulatory period.

[9] p.4 QCA Statement of Regulatory Pricing Principles for the Water Sector 2000.

7. Weighted Average Cost of Capital (WACC) Parameters

CPM does not support the WACC value as proposed by GAWB. Having reviewed recent QCA decisions, and other relevant benchmarks, CPM believes GAWB's proposals are inconsistent with the QCA's most recently applied approach to WACC.

Table 1 in Appendix A of this submission demonstrates CPM's position and compares GAWB's proposal with the QCA 2005 view and the recent QCA findings on WACC related matters on Queensland Rail (QR) submissions as an example.

8. Other Issues

In prior submissions to the QCA, GAWB has suggested the implementation of a price transition process to assist major customers overcoming or 'smoothing' the impact of substantial price increases, but, GAWB indicated that this would be limited to a single planning period (i.e. 5 years)[10]. CPM is supportive of a transition approach, but firmly believes a price transition of 5 years is far too short. A period that is consistent with the customer's current contract or remaining contract term is the appropriate timeframe that a price transition should take place.

9. Conclusion

CPM considers that GAWB's Expenditure Proposals submitted to the QCA as part of the 2010 price review process are fundamentally inappropriate and will result in a significant 'price shock' if implemented.

The owners of the Callide C Power Plant operate in a competitive market with no ability to recover or pass through such an increase to the national electricity market. It is therefore unacceptable for a monopoly service provider, with minimal competitive market pressures, to propose expenditure and seek price increases of this nature and magnitude.

CPM is asking that the QCA thoroughly review and compare GAWB's submission with QCA policy and pricing principles for the Water Sector and relevant QCA precedents to ensure the consistency with those requirements.

[10] QCA Submission: GAWB – Submission 1 – Commercial Framework and Pricing Principles (Sept 09)

Appendix A: WACC Comparative Table

Parameter	QCA GAWB 2005	GAWB Proposed	QCA QR 2009	CPM Comment
Risk free rate	5.45%	5.61%	5.29%	Variance reflects mostly the different timing of relevant decisions. The risk free rate could be based on current market data at the time of the relevant pricing determination. CPM notes that the QCA changed its approach to estimating a risk free rate from a 5 year Commonwealth Bond yield, and would expect a similar approach would be applied for GAWB.
Gearing	50%	50%	55%	GAWB has proposed no change to gearing.
Debt margin	1.32%	4.34%	3.43%	The variance between the QCA's previous decision for GAWB and GAWB's proposal reflects mostly the different timing of relevant decisions. The debt margin should be based on market data at the time of the relevant pricing determination, though CPM expects that the QCA would assure itself as to the reliability and appropriateness of any market data, given recent volatility in financial markets.
Debt raising costs	0.125%	0.125%	0.125%	No change proposed by GAWB.
Market risk premium	6.0%	6.5%	6.0%	GAWB has proposed an increase in the MRP. The QCA's most recent determination provides a comprehensive consideration of this factor and determined to retain a MRP of 6.0%. Consistent with the QCA's established approach, CPM does not support any change to MRP for GAWB.
Gamma	0.5	0	0.5	GAWB has proposed a reduction in gamma to zero. Again, this is inconsistent with the QCA's established approach. The effect of GAWB's proposal is to double the impact of tax in customers pricing. CPM does not support this change.
Tax rate	30%	30%	30%	No change proposed by GAWB.
Asset beta	0.4	0.4	0.45	No change proposed by GAWB. CPM notes that for Queensland Rail, the Authority adopted a lower asset beta than its original 2005 decision. CPM would expect the QCA to reassess the relative systematic risk exposure of GAWB compared to other regulated utilities, and to re-determine the asset beta parameter as necessary.
Debt beta	0.11	0	0.11	The QCA's Queensland Rail determination considered a similar proposal from QR to apply a zero debt beta, though the QCA determined to maintain its previous approach of a debt beta of 0.11, the effect of which is to lower the equity beta given unchanged asset beta and gearing.
Equity beta	0.65	0.68	0.80	GAWB's proposed higher equity beta is a result of other proposed parameter changes, which are inconsistent with the QCA's established benchmarks/approach.
WACC	8.05%	10.05%	9.41%	

Table 1 – WACC Parameter Comparatives