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JR

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Dear Sir/Madam

**Gladstone Area Water Board: 2004 Investigation of Pricing Practices**

Thank-you for the opportunity to provide comment on the current Issues Paper. The items that Council wishes to raise fall into two categories:

- Issues of mutual interest and concern to both Gladstone City Council and Calliope Shire Council.  
*In reading through this submission and that of Calliope Shire Council, you will notice that a joint approach has been taken to identifying and raising these issues.*
- Issues of concern that Gladstone City Council would like to raise on its own behalf.

**PART A - Joint Issues (Gladstone City Council and Calliope Shire Council)**

We request that the following items be taken into consideration as part of the 2004 investigation particularly as they impact both Councils quite significantly.

**(i) Reductions in the Dam Yield**

The previous yield of the dam with existing infrastructure was estimated at 87,900ML per annum, but that was subsequently reduced to 78,000ML per annum by the Department of Natural Resources, Mines and Energy (DNRME) in July 2003 following the drought, and then to 67,000ML per annum by DNRME until the Awoonga Dam has filled to its new full supply level of 40 metres.

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The lower the yield of the dam, the higher the unit cost of bulk water (should sufficient demand exist to take up the yield). As such, the implications for Councils of recent reductions in the dam yield and potential further reductions in the future may include:

- Lower availability of bulk water for purchase via existing infrastructure; and/or
- A higher price for bulk water through the medium to long term due to higher unit costs or the need for alternative supply sources.

Alterations to the dam yield obviously impact upon GAWB's financial and planning decisions, and therefore to bulk water prices. As such, it is vital that the following impacts also be considered:

- The community impacts of frequent adjustments to the dam yield (e.g. reliability of supply and the management of supply during drought with respect to minimum requirements for public health); and
- The financial and environmental costs associated with decisions regarding alternative supply options to meet projected long-term demand under different yield scenarios.

Continually changing the goal posts may significantly impact on decisions regarding supply options and associated capital expenditure, and therefore on the commercial viability of GAWB and its customers. As such, recent adjustments to the dam yield should be considered and incorporated into the optimisation assessment of the asset base and the structure of supply to the region.

## **(ii) Impact of Drought on Demand Patterns**

There is little doubt that there will likely be a permanent or semi-permanent impact on demand from many customers in response to the recent drought. Industrial customers may have investigated or introduced more efficient processes or alternative processes to reduce their reliance on water availability and Council customers may have also altered their demand patterns due to water saving devices, shifts in household irrigation patterns, etc. It is therefore vital that the demand estimates are developed via detailed discussions with each customer during the pricing review with some consideration for this potential impact to ensure that demand is not overstated.

### ***Pricing Issues***

## **(iii) Long-Run Marginal Cost**

In regulatory pricing, the Turvey Method and the Average Incremental Cost Approach are generally employed to derive the long-run marginal cost of water supply. Given that the estimation of long-run marginal cost can often differ markedly depending on the methodology employed, it is proposed that the financial and pricing assessment review a number of different methods of deriving marginal cost and average cost prior to making a final decision on the level of the volumetric charge.

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As such, both the Turvey method and the AIC approach should at least be considered when setting prices, and perhaps an average taken of the two methods when setting actual pricing levels to prevent significant changes between regulatory reviews.

**(iv) Customer Specific Risk**

The QCA notes that the extent of industrial demand, lumpy growth in supply to industrial customers and uncertainty relating to the establishment of new industrial projects and ongoing demand from industrial projects (e.g. due to possible process changes or business closure/relocation) all contribute to an uncertain planning capacity for GAWB when undertaking financial and pricing assessments. As such, it may be argued that industrial customers are a higher risk customer group relative to Councils and should be priced accordingly. Council customers, outside of drought periods where restrictions are enforced, provide a much more stable and predictable revenue stream for GAWB.

A higher risk customer or group of customers (e.g. industrial) should possibly be levied higher charges, in line with the greater risk of investing funds to supply that customer or group of customers. Conversely, a lower risk customer or group of customers (e.g. Council) should possibly be levied lower charges, in line with the lesser risk of investing funds to supply that customer or group of customers. It is proposed that the higher financial/investment risk to GAWB from industrial customers be considered when prices are formulated, possibly through a higher rate of return on capital (via specific customer group betas in the WACC equation).

**(v) Reliability of Supply During Drought Periods**

The current drought management plan and the restrictions on customers implemented during the recent severe drought suggest that industrial customers benefit from a higher level of reliability of bulk water supply than Council customers. In fact, Council customers seem to face earlier and more severe restrictions during periods of drought than industrial customers. In order to be equitable, those customers who demand higher reliability should pay a premium for bulk water supply.

***Revenue Requirement Issues***

**(vi) Asset Valuation**

The approach to asset valuation is extremely important in the GAWB pricing review as the size of the asset base can significantly impact on the overall revenue requirement. Due to recent shifts in both demand and supply, it is proposed that the QCA undertake a new optimisation assessment of the asset base rather than simply roll forward the asset valuation from the previous assessment using indexation.

The assessment should take into account at least the following:

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- Based on current demand and supply information, would an alternative supply network provide for greater supply efficiency and reliability in sourcing water for a similar or cheaper price? For example, under a greenfields scenario, would the money spent on the previous dam raising be better spent funding an alternative supply at greater reliability from Rockhampton or another source?
  - Impact on capacity utilisation in the treatment and distribution network from the permanent demand management impacts following the recent drought, and optimising out any excess capacity due to such a shock to the market.

#### **(vii) Treatment of Contributed Assets**

Contributed assets, government grants and subsidies should continue to reduce the net price for Council customers by reducing the regulatory asset base to which the rate of return on capital is applied, or by reducing bulk water charges paid by Council over the relevant assessment period for cash flows.

#### **(viii) Excess Capacity Held for Potential Industrial Demand**

Of concern to Gladstone City Council (as a bulk water customer) is the need for GAWB to ensure sufficient capacity in infrastructure for anticipated or potential new industrial projects. There is a real cost to GAWB from holding sufficient capacity to cater for significant lumpy jumps in demand from either expansions by industrial customers or new industrial customers that possibly should not be passed on to existing customers.

It is proposed that the pricing assessment be undertaken on the following basis:

1. Undertake a financial and pricing evaluation with infrastructure requirements relating to demand from existing customers only (i.e. remove any excess capacity in the system via optimisation and ignore any new projects).
2. Undertake a financial and pricing evaluation with infrastructure requirements relating to demand from both new and existing customers.

Compare 1 with 2 to determine whether existing customers are better off with or without the new customers. If so, then the same price may be charged on the new customers versus the existing customers. If not, a number of options could be considered, including:

- Levy prices derived in 1 (i.e. optimise out excess capacity) on existing customers until the new customers are established, and then alter prices thereafter; or
- Levy prices derived in 1 (i.e. optimise out excess capacity) on existing customers and new customers, with any difference between 1 and 2 (i.e. marginal cost of supplying the new customers) paid by the new customers via once-off headworks charges to GAWB when operations are established.

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**(ix) Treatment of Capital Gains Through Asset Revaluations**

It is understood that the QCA develops pricing estimates based on the incorporation of a net return on capital component as part of the revenue requirement. Net return on capital is equal to gross return on capital (the nominal WACC times the regulatory asset base), less any capital gains made on assets due to indexation/revaluation in each year.

Given the sharp increases in unit costs for water assets in recent years, it may be more appropriate to revalue the assets by a level of indexation more reflective of reality in the industry (e.g. the average increase in the unit cost of water assets over the past five to ten years) rather than by a more general measure of inflation.

**(x) Use of Renewals Annuities**

It is believed that the renewals annuity approach would provide a more accurate estimation of the asset consumption charge than the straight-line method of depreciation, particularly for long-lived infrastructure such as dams and pipelines. Such assets generally feature lives well in excess of traditional useful lives, subject to the refurbishment or replacement of selected components of the supply network.

Given that GAWB is presently finalising an asset management plan, it is important that the QCA assessment at least consider applying the renewals annuity approach for long-lived infrastructure such as the dam and pipelines. This would be more reflective of the full cost of bulk water supply in the region and would ensure that overcharging of customers does not occur.

**(xi) Allocation of Administration Costs**

While the existing allocation method seems reasonable, some consideration may be given to the administrative effort provided to certain customers in areas such as financial evaluations, planning and the collection of bulk water charges. For example, it may be argued that industrial customers place a greater burden on planning than Council customers due to the issues outlined in a previous comment. A simple list of cost drivers should be established to allocate selected costs to customers, as well as identified system components.

**(xii) Operating Cost Efficiency**

It is important that the performance of GAWB in meeting previous efficiency estimates be carried forward to any new regulatory decision. If GAWB is unable to meet the specified operating efficiency targets, then the new assessment should assess whether there were valid reasons for GAWB failing to meet the efficiency targets. If valid reasons are not evident, then the operating cost base for the new assessment should begin at a lower level than actual operating costs. Otherwise, there is no decent incentive for GAWB to achieve efficiency gains during the regulatory period.

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Conversely, if GAWB is able to achieve greater efficiency gains than originally anticipated, then it may be appropriate for a mechanism to be introduced that allows such efficiency gains to be shared between GAWB and customers over a certain timeframe.

**(xiii) Monitoring Framework**

In order to ensure the ongoing viability of GAWB and equity between bulk water customers, it is important that contractual arrangements are based on full cost pricing principles.

Given that contract terms can often tie a supplier to a certain price for a reasonably long period, it is important that some formal review process occur for each of GAWB's contracts, whether they be renewals of existing contracts or the establishment of new contracts, prior to them being entered into.

At the end of the day, such monitoring would ensure that pricing for Council customers is on the same basis as pricing for industrial customers, with the exceptions of the issues outlined in previous comments. Council customers wish to ensure that they do not pay more than their fair share of total system costs by covering any pricing shortfalls resulting from poor contract negotiation or subsidised industries (if relevant).

**PART B - Individual Submission for Gladstone City Council**

The key issue from a Gladstone City Council perspective that we are seeking to be reviewed/reconsidered as part of this current investigation, is that of equalised pricing between the two Councils. The Issues Paper makes reference to this in the following section:

*4.4 Pricing for Council Customers*

*In its Final Report, the Authority recommended that, given GAWB's infrastructure layout, its clearly defined products and geographically separated off-take points, that differentiated prices be applied to distinct classes of customer, but with treated water to Gladstone City Council and Calliope Shire Council to be priced as one class.*

*In making this recommendation, the Authority noted that, while there were significant differences in the cost of providing services to the two Council customers (Calliope Shire and Gladstone City), it had accepted the Councils' proposal for a single treated water price as a matter of equity and to reflect historical arrangements for the supply of water on a regional basis. The greater focus upon commercial management of risks associated with the supply of these may warrant a reconsideration of this approach.*

The Authority invites comment on the appropriateness of treating Gladstone City Council and Calliope Shire Council as one customer class.
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Whilst we appreciate that Council has previously been asked the question, and agreement was given at the time that the historical practice of equalising prices between the City and Shire would continue, the extent of 'cross-subsidisation' that was/is occurring was not fully appreciated.

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Other than the obvious pricing differential, the other key concern is that Council too is having to adhere to national competition policy (NCP) pricing principles and has gone to significant lengths to ensure that there is no cross-subsidisation between the different classes of consumers within the City. By agreeing to an equalised price, Council would be building into its two-part tariff, cross subsidisation of Calliope Shire residents. Further, we would be placing our commercial and industrial ratepayers at a possible disadvantage when compared to other centres.

Calliope Council has advised that they may have made different investment decisions had there not been equalised pricing when the Board was first established. Planning and investment decisions made by the Gladstone Area Water Board at the time were no doubt made based on population concentrations, distributions and projections undertaken at that time. Hence, it is conceivable that establishing an independent potable water treatment and distribution facility (or facilities) better geographically suited for the substantially smaller Calliope and Boyne/Tannum populations at that time, may have resulted in those Calliope residents paying a significantly higher price for their water than what they have since their water supply was established. It is also conceivable that the establishment of a reticulated potable water supply to the Calliope and Boyne/Tannum communities may not have eventuated for some period of time after its actual inception, due to politically unfavourable pricing.

Further, it is important to note that the 'playing field' has certainly changed, and the issue of national competition policy and its impacts need to be considered as part of this decision making process, similar to Council's own issues with respect to the implementation of COAG reforms including a two-part tariff in recent years.

It was agreed at a recent Council meeting that it is in the interests of the City's ratepayers to make representations to you, as part of this current investigation, for non-equalised pricing to be reconsidered and that Gladstone City Council's support for this approach be expressed.

Whilst there is not able to be agreement between the Councils on this issue, please be assured that we have briefed Calliope Shire Council and the Gladstone Area Water Board about this request for the issue to be re-examined.

At a recent Council meeting it was resolved that:

- 1. Council advise Calliope Shire Council that Gladstone City intends to make a submission to Queensland Competition Authority (QCA) by the due date of 2<sup>nd</sup> July 2004 in favour of non-equalised pricing and that GAWB also be advised of Gladstone City Council's intentions;*
- 2. Council advise Calliope Shire Council that the equalised price has been used as the basis for calculations in the draft 2004/05 budget - allowing time for the results of the QCA's current investigation to be known during the year;*
- 3. Council commence informal discussions with all interested parties as soon as practicable in relation to the above matters.*

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## **Closing Comments**

We trust that this letter will be sufficient to re-examine the matter of equalised vs non-equalised pricing having regard to Council's resolution as reproduced above and further that the QCA will consider the earlier issues raised (in Part A) as part of this current review.

The resolution of GAWB's water pricing practices is one of the most critical issues facing our community. We have already been faced with framing a number of budgets without any certainty of one of the City's key costs (bulk water). Without firm direction on GAWB's pricing directions, Council is unable to undertake its own financial planning and establish a pricing path that is politically palatable, and justifiable to our residents.

Council looks forward to receiving the Draft Report. In the interim though, should the QCA have any further queries in relation to this submission, please do not hesitate to contact me on 49700 702 or Council's Director-Technical Services (Mr Stuart Doak) on 49700 744.

Yours faithfully

Julie Reitano  
**CHIEF EXECUTIVE OFFICER**