Mr Larney: TLS:WS1

YOUR REFERENCE

8 February 2005

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Community, Environment & Industry in Partnership

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PLEASE ADDRESS ALL CORRESPONDENCE TO THE CHIEF EXECUTIVE OFFICER

Mr E Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
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Dear Mr Hall

RE: GLADSTONE AREA WATER BOARD: 2004 INVESTIGATION OF PRICING PROCEDURES

I refer to your letter and the attached report of 23 December 2004. On behalf of Council I thank you for the opportunity to comment on this report.

As an overall comment, I would express Council's extreme disappointment that your report is suggesting a 23.3% increase in the price of urban treated water delivery simply because the two Councils have introduced demand management initiatives. NCP theory suggests that prices should reflect the true cost of the service thereby encouraging the efficient use of scarce resources. However, the reality is that if Council had encouraged our ratepayers to use more water the price of that water would have actually fallen. Your report states that price caps provide an incentive for customers to put effective demand management policies in place, as lower volumes purchased result in overall savings to users. This is obviously not the case for the Board's customers.

Council is also disappointed that the indicative maximum prices have been provided without supporting detail. Council is being asked to provide comments to the report, when in reality, it has only received part of the information. With a greater break up of the cost structure, as has been provided in the past, Council could understand why the price for water to Mt Larcom is over three and a half times more expensive than your last investigation. Silence or omission will not lead to a better outcome in this study.

Water Demand Estimates

Council is currently revising the Projected Demand figures contained in your letter. The demand figures contained in your letter for both the Pooled Price and Mt Larcom are likely to be close to any revised figure. Officers will need to assess the likely impact that changes to Council's pricing policy will have on demand, although the figures in your letter are low compared to actual consumption during the early months of this financial year, probably due in large part to the dry conditions.

The demand projections for the Northern Industrial Area are totally unrelated to actual consumption for this area. It may well be that these figures exclude the two largest customers in the Yarwun area, Orica and Comalco. Consumption in the Northern Area for the first four months of the financial year was approximately 500ml. This error could explain the 45% increase in the water price to this area of the Shire.

The issue of who should service industrial customers in this area is still very much up in the air. The related issue of who should own the infrastructure in the Yarwun Area and thereby service the customers in that area has been an ongoing issue for a number of years. It is hoped that this matter can finally be resolved in the coming months. Therefore, while we believe that the demand projections should probably be somewhere between 1,300 and 1,500ml, Council has not consulted either company at this stage. It is believed that GAWB has been having discussions with Comalco regarding its future consumption requirements.

<u>Mt Larcom Water Price</u>

The recommendation on page 43 states that the pooled price should be maintained for the two Councils. This has been the situation for the town of Mt Larcom prior to, and following the first QCA review. Your letter dated 23 December 2004 however, clearly distinguished the pooled price of $886 per megalitre from the Mt Larcom price of $8868 per megalitre. Accordingly, it appears that your letter is inconsistent with your report. The fact remains that even if Council assumes that the status quo (equalised price) for Mt Larcom will be maintained the balance of water consumers simply cannot afford to subsidize water at this price.

Council was genuinely shocked when it saw the maximum price for treated water to Mt Larcom. At $8,868 per mega litre this water must surely be the most expensive domestic water in the country, especially considering that this amount does not include additional Council costs including system losses. This price represents an increase of 356% in the bulk water price to this community. Any reasonable assessment would say that there is a fundamental flaw in both the theory and the model when water prices to Mt Larcom increase by this percentage. The reality is that nothing has changed for the residents of that community since the last review except the water bill. The Queensland Local Government Comparative Information book for 2002/03 states that the highest consumption charge in the state was $2.80 per kilolitre in Miriam Vale Shire. Water is critical to life and to charge such an exorbitant amount threatens the very viability of this community. Council will be left in the unenviable position of having to decide to either require the rest of the community to subsidise the residents of Mt Larcom, or set a water price that is too expensive for these residents.

Council would question what additional infrastructure has been added to the system in this area to arrive at such an extraordinary increase in the water price. This is an ideal example of customers being left in the dark as a direct result of a lack of supporting information. The provision of a more detailed break up of the Mt Larcom price would allow greater scrutiny and should help to ensure that any calculation errors do not go unnoticed. Without the supporting information, Council is left to try and hypothesis the reason for this outrageous increase.

Does the increase reflect the inclusion of the new Mt Miller pipeline? If it does, Council would question whether that pipeline currently supplies water to Mt Larcom. The existing infrastructure before the Mt Miller pipeline is and will remain adequate for the needs of the Board's customers in the Mt Larcom area. The Mt Miller pipeline was built to supply water to Comalco and future industry. Why should existing customers be forced to suffer water increases of 356% simply to subsidise a new industry? There would be no starker example of new customers being subsidised by existing customers.

The main that supplies water to Mt Larcom and the East End mine is a 300mm pipeline. This size is significantly larger than is required to meet the needs of Council and Cement Australia at East End. Council would question if the price in your letter includes the optimisation of this main to reflect the current needs of these customers. Optimisation has been used for the Dam and other major infrastructure and Council would trust that this practice has also been used for this infrastructure. The large reservoir at East End is also well in excess of the needs of these customers. If GAWB was deprived of either of these assets, they would be replaced with significantly smaller infrastructure. The appropriate replacement infrastructure should form the basis of the valuation for pricing purposes.

If the final price remains close to the indicative figure, Council will need to consider other options. Council is currently in negotiations with Cement Australia in regards to a disused slurry line which runs parallel to the water line. Council is also examining alternative water supplies such as Willmot lagoon and Raglan Creek to replace the water supply from GAWB. Council can not and will not accept the indicative maximum water price proposed in your letter.

<u>Differentiation Between Councils</u>

Calliope Shire Council agrees with the recommendation in your report in relation to maintaining the Pooled Councils Price for the two Councils, although Council would draw your attention to its comments in regard to the Mt Larcom water price.

Your comments in relation to the historical arrangements accurately reflect the long term nature of the agreement that exists between the two Councils.

It is hoped that this matter has now been finalised and we do not have to continually revisit this issue each and every review.

Risk Profiles and Reliability Tolerances

Council welcomes your comments in relation to this issue, however it is very disappointed that the issue was not comprehensively addressed in this review, and now has no faith that it will be fully investigated at any future review.

If pipelines, pumps etc are duplicated to ensure a continuous supply of water, then those customers who demand a continuous supply, because they have not invested in onsite storage etc, should be required to pay for a significant component of the cost of this duplication. Currently your pricing model appears to be allocating the full cost of the duplicated infrastructure over all customers including those that invested in on-site storage infrastructure, thereby giving them greater tolerances to water supply reliability. The QCA report appears to be saying to the Board's customers, do not provide onsite storage or other risk minimisation infrastructure because the other customers of the Board will subsidise your risk minimisation through the construction of duplicate Board infrastructure. One is left with the view that only the QCA would see this as an efficient use of resources and the equitable treatment of all customers.

Council would like to see the recommendation contained on page 47 implemented to fully reflect the issues raised in our earlier submission. It is not acceptable to say that duplication costs should be shared by all customers if the sole or predominate reason they exist is to minimise reliability risks for only one or a small proportion of the customers using that infrastructure.

Drought Management

Council is aware that Gladstone Area Water Board's Drought Management Plan is still being revised, however Council would expect that many of the components in the original plan, including the different treatment of domestic and industrial customers, will continue to exist in the new plan.

A significant component of that plan was that domestic consumers faced earlier and more severe restrictions than applied to all of the Board's other customers, namely the region's industries. Council has no argument with the logic of this policy because domestic consumers are better able to deal with restrictions than industry due to the fact that a significant percentage of domestic consumption goes straight onto gardens and lawns. As was often stated during the last drought, it is better to have a brown lawn and a job than a green lawn and no job.

I would reiterate previous comments Council has made relating to the fact that by accepting this lower level of supply, the two Councils ensure that the Board's industrial consumers are able to consume more water and for longer periods during times of drought. Your report needs to recognise the different levels of reliability provided to the various customers of the Board and implement a pricing model which reflects these differences. This pricing model must establish a cost premium and/or a discount which reflects these differing levels of certainty and consistency of supply levels.

<u>New verse Existing Customers</u>

Council notes that the authority is still recommending that new and existing users should pay the same price for the common infrastructure costs of providing water. In theory where each new customer consumes only a small percentage of either the total supply or spare capacity, it could be argued that new and existing customers should pay the same price without applying a headworks charge to each new entrant. However when you have major new industries consuming a large percentage of the spare capacity of the existing network, there is a legitimate argument for either a headworks charge or a different pricing regime for these new customers to reflect the impact they have on the other customers of the Board. The raising of the Awoonga Dam has had a significant financial impact on the water price paid by the existing customers. Clearly the customer who uses the last mega litre of spare capacity or needs the next mega litre shouldn't pay the full cost of the next augmentation, however there must be some recognition of the impact that major new customers have on existing customers.

The fact is that every council water business in this state charges developers a Headworks contribution to offset the impact that their subdivisions have on the capacity of the water infrastructure. These contributions are recognised by local government, the State Government and developers as the most equitable mechanism to minimise the effect that new entrants have on existing customers. The Integrated Planning Act actually requires councils to adopt Infrastructure Charging Plans covering water, sewerage and other infrastructure.

While economic theory in a perfectly competitive market states that new and existing customers should pay the same price for the same commodity, the reality is that the water business in this region is not a perfectly competitive market. There is currently only one seller and only a limited number of buyers. Each new buyer can have a significant impact on the availability of the commodity and this fact must be recognised in the adopted pricing model.

Council submits that some form of headworks charge would be a simple mechanism to recognise and mitigate the impact that new customers have on the capacity of the Board's infrastructure and the water price to existing customers.

Council notes your comments on page 45 in relation to the State Government funding excess capacity. Council agrees that if infrastructure is being built to attract new industries to this region, then the State Government should contribute towards this infrastructure so that current industries and residents are not required to solely carry the cost of attracting industry to this region. These industries benefit the whole state.

Depreciation Method

I would restate the comments that Council has previously made. Depreciation rates used in straight line depreciation are calculated utilising a combination of engineering and accounting theory. The difficulty is that both of these professions are conservative by nature, which generally leads to depreciation rates that are not realistic compared to the actual useful lives of these assets, particularly long-life assets. To use an example to demonstrate this fact: the rock wall of Wivenhoe Dam which was valued at approximately $40m in the mid 1990's was being depreciated over 150 years. Council would suggest that this wall will still be there in a 1,000 years. The difference in the annual depreciation expense between 150 and 1,000 years is very significant and the impact on the water price would also be significant.

It would appear absurd that anyone can seriously argue that Dam earthworks have a useful life of only 150 years.

The Water Act required the Gladstone Area Water Board to have a Strategic Asset Management Plan (SAMP) in place by 1 October 2002. Council would question why consultants have been engaged to calculate various Betas, Gammas, etc however you indicate that GAWB still does not have a SAMP in place. GAWB has over $350m in assets which are almost exclusively Infrastructure assets. The failure to have a SAMP in place over two years after it was required under the Water Act should not be an acceptable reason for excluding renewals annuity as the most appropriate method of depreciating long-life assets.

The other claim raised in your report in relation to this issue is the potential for substitutes such as sea water cooling to effect the economic life of these assets. There is no doubt that substitutes such as sea water cooling should be seriously considered when the next augmentation approaches, however it is doubtful that anyone would seriously believe that these substitutes will impact on the future economic viability of Awoonga Dam.

Figure 8.1 while accurate in theory perpetuates the myth that all three methods are fundamentally the same. As stated above, useful lives are conservative. Dam earthworks is a simple example which disproves your figure. This graph states that under renewals annuity GAWB's dam earthworks will be consumed over only 150 years. Even from a theoretical perspective this is clearly incorrect.

GAWB's Depreciation costs for the 2004 financial year totalled $5.7m. This is not an immaterial amount and I would therefore suggest that work needs to be undertaken to ensure that this cost is as accurate as possible so that current customers are not forced to subsidise both future generations and future customers, which unfortunately is the situation under your current recommendation.

Cost Allocation

Council was disappointed to read that the authority did not see any basis for the argument that industrial customers place a greater cost burden on the Board for network planning than Council customers. In reality all of the Board's planning work relates to its raw water distribution network, particularly in relation to new industries or industrial expansion. The fact is that planning for the region's domestic customers is undertaken by the two Councils covering their own distribution networks, while the distribution network for industrial customers is planned for and managed by GAWB.

Banking Water

CPM raises the issue of banking water. While Council does not have any fundamental problem with this issue, any proposal would need to include an amortisation or write down factor reflecting both the natural loss of water through evaporation etc as well as the holding cost of that water. Such a factor would ensure that no customer receives either a financial or water security advantage over the other customers of the Board.

Conclusion

While many of the recommendations in the report were positive from Council's perspective, Calliope Shire Council remains extremely frustrated with the whole pricing methodology for the region's water. The Mt Larcom water price is the most obvious example. $8,898 a mega litre is not an acceptable water price to this Council. To a pensioner in Mt Larcom using 312 kilolitres of water a year, this is not some adjustment to their bottom line, it represents 23% of their annual pension (excluding council costs to get the water to the household).

The existing customers of the Board have seen only one thing since these pricing reviews started and that has been massive increases in their water prices, especially those further away by pipeline from the dam. The long term result of this water pricing methodology may be a desire by water intensive industries to locate close to the dam to cut production costs, despite the fact that the State Government has established the State Development Area for future industry.

While great effort has been spent on analysing each segment of the network to say who is using it to arrive at a price, the equally important issues such as the impact of new customers, duplication of infrastructure to minimise individual customer risks have been put in the too hard basket. The impact on the Board's costs of duplicating the water main into Gladstone, additional pumps etc have been more significant than the pipeline to Calliope or the network supplying Mt Larcom. However the QCA recommendations are significantly different in determining who should pay these different costs.

Council would therefore suggest that the whole pricing methodology needs to be reviewed. The electricity industry does not charge progressively higher electricity rates the further one is from the power station. Is the Government planning to change the way it charges for electricity? No, because it would disadvantage those customers who are further from the power station. The Government would also not want industries to relocate closer to power stations just to cut their electricity costs.

Similarly, does Telstra charge higher prices the further you are away from the capital cities? Clearly the cost of the service in rural Australia is higher than the capitals, however the community would not accept a telecommunications price that would deprive a percentage of the community of that service.

While we charge a so-called postage stamp price for electricity, telecommunications and other services, the QCA says that this option is not acceptable for water. Water is certainly just as essential for life as electricity and the telephone, however this is not reflected in the price. This closed view to different pricing methods for water is not acceptable to the residents of this region. As is currently being demonstrated in Mt Larcom, this community is no longer prepared to sit back and accept this economic rationalist ideology.

If you have any questions in relation to this response please do not hesitate to contact Mr Mark Larney, Council's Director of Corporate and Community Services or myself.

Yours faithfully

GI KANOFSKI
CHIEF EXECUTIVE OFFICER