Queensland Alumina Ltd Submission in response to the Queensland Competition Authority Draft Investigation of Pricing Practices for the Gladstone Area Water Board (December 2004)

Tuesday, 15 February 2005

Key Issues

1. Asset base

QAL believes that the asset base used to derive the GAWB revenue requirements should not include all the capital for the full 2002 dam wall raising and associated water delivery infrastructure, as this capacity is not required in total for at least 20 years. QAL recommends that part of this capital be optimised out of the asset base until it is required on a "just-in-time" basis.

QAL recognises that there may be economies of scale in capital projects and that it may be cost-effective in some cases to add capacity in excess of immediate requirements, but with water demand in 2024-25 still about 10,000 ML below capacity, this appears to be a clear indication of too much capacity added too soon.

QAL considers that this issue may be the key reason for the proposed increase in water prices from 1 July 2005, yet it is given only token consideration in the draft report.

QAL also considers that failure to optimise the asset base in line with demand provides a disincentive to users to reduce water use – contrary to government objectives of creating incentives to improve water demand management.

QAL believes that to raise the dam wall the full ten metres in 2002 rather than incrementally may not be the most cost-effective option, and recommends that due to its significance, this issue be subject to rigorous further investigation and documented in detail. Due to the criticality of this issue, QAL recommends that the engineering data used to arrive at the proposed asset base be made publicly available to facilitate wider scrutiny, and to ensure that there is no asymmetry of information and negotiating power favouring GAWB in negotiations with customers.

2. QCA cash flow model

QAL recommends that the QCA use a 30-year cash flow model to determine the GAWB annual revenue requirement. This would be consistent with long-life, capital-intensive industry practice and would account for the fuller utilisation of assets over the asset life as well as annually.

Allowing for capital recovery over 30 years rather than 20 years is more efficient economically, is consistent with the planning horizons of GAWB's major customers, and should mean lower annual water charges.

QAL believes that this issue should be considered further and the impact on water prices of capital recovery over 30 years instead of 20 years be investigated and documented in detail.

3. Return of capital (depreciation)

QAL believes that financial annuity depreciation is a more economically efficient return of capital than straight-line depreciation. Defined as the annual payment earning the cost of capital that is required to replace the asset at the end of its useful life, financial annuity depreciation is consistent with the return of capital implicit in discounted cash flow analysis. It is a constant real annual number and is significantly lower than straight-line depreciation.

While it can be shown that the combined return of capital and return on capital can equalise over the cash flow period for straight line and financial annuity depreciation, straight-line depreciation results in much larger annual revenues for GAWB in the earlier years. QAL believes that this is inconsistent with a five-year regulatory period, as water users run the risk of not receiving the benefit of lower payments in latter years. For example, if the asset base is optimised downwards, users have paid higher up-front return of capital charges on the optimised assets under straight-line depreciation than if a financial annuity had been applied.

QAL therefore recommends that, in spite of regulatory precedent in favour of straight-line depreciation, a logical and compelling argument in favour of financial annuity depreciation can be mounted and therefore this issue should be given further serious investigation.

4. Market risk premium

QAL believes that the market risk premium in the rate of return calculation should use the geometric mean of equity returns rather than the arithmetic mean, as the latter may distort actual returns. The geometric mean takes into account continuous compounding and is lower than arithmetic averages. For example, a ten percent return in one year, followed by a five percent fall the next year, results in an arithmetic mean return of 2.5 percent, but a geometric mean of only 2.25 percent.

Clearly the arithmetic mean overstates the market risk premium and inflates the returns to GAWB. The QCA flagged this anomaly in its 2002 investigation but deferred to regulatory precedent to rule in favour of the arithmetic mean, in spite of its obvious problems. QAL considers that it would be disappointing if regulators place a greater weight on precedent than on rational practice, as continuous improvement to regulatory practice may be hindered.

QAL therefore recommends that this issue be investigated further with a view to resolving the inconsistency inherent is using the arithmetic mean for calculating the market risk premium.

5. Operating costs

The price of most, if not all commodities (including alumina) has been in long-term trend decline of two to three percent annually, meaning that QAL's costs must also fall by at least this amount in order to maintain international competitiveness. Globalisation is driving industry to be located in the most cost-effective regions.

QAL therefore questions why GAWB revenues should be allowed to increase in line with inflation and in this way shelter GAWB from stronger incentives to continually improve and reduce operating and maintenance costs. (QAL understands that cost reductions have been factored into GAWB's operating costs over the five-year regulatory period, but questions how this would work over the longer-term, particularly if GAWB were allowed to force customers into longer-term contracts.)

QAL also notes that the cost benchmarking analysis conducted for the QCA report is, at best inconclusive "due to a lack of comparative data" and cannot be used to conclude that GAWB is cost-competitive.

QAL therefore recommends that GAWB revenues not be allowed to increase with the CPI, in order to provide incentive for competent management of operating and maintenance costs.

6. Price differentiation based on contract length

QAL considers that it is uncompetitive behaviour to require customers, through threat of price penalties, to lock into long-term contracts with a commodity supplier; particularly considering allowance for ongoing improved competitiveness. QAL understands that allowance has been made for cost improvements over the first regulatory period but are unclear how this will flow through to further years.

Competitive markets are characterised by a variety of product sales channels – including sales to exchanges, that are often independent of the original investment decision of the supplier. If suppliers maintain their competitiveness there is little commercial risk. In GAWB's case the commercial risk should be even lower due to lack of apparent attractive alternatives (as confirmed by GAWB's recent work with local industry in

costing alternative water supply options). However, if customers are not constrained by long-term contracts, it will encourage GAWB to maintain service levels and competitiveness and not exploit its monopoly position.

QAL therefore recommends that GAWB not be allowed to differentiate prices based on contract length. Rather, QAL recommends that price concessions should be available for the benefit provided to GAWB by high-volume customers. Based on volume taken, high-volume users should be given credit for the sales security provided to GAWB as well as lower GAWB overhead and administration costs compared to having to service multiple customers. QAL recommends that this issue be investigated in detail further.

7. Contributed assets

QAL supports the QCA proposal that rebates for contributed assets should include both the return on and return of capital components.

8. "Banking" of water

QAL supports the QCA's comment that banking of water demand for future use is "a valid prospect", however QAL believes that there must be allowance between regulatory periods for a reduced access charge so that water users have the incentive to reduce demand and thereby conform with government policy of encouraging more efficient water usage.

9. Water trading

QAL believes that water users should have the right to trade water unfettered by GAWB as this would enhance competitive local water markets.

10. Differentiation between customers

QAL is concerned that there be no pricing differentiation or cross-subsidy between farmers, councils, government and industry and seek assurances from the QCA that this is not the case.