Submission to the Queensland Competition Authority (QCA)

Gladstone Area Water Board 2015 Price Monitoring Investigation

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 2015 Price Monitoring Investigation submitted by GAWB to the Queensland Competition Authority (QCA), which is intended by GAWB to form the basis of the 2015 price reset process.

2. Executive Summary

CPM has reviewed GAWB's 2015 Price Monitoring Investigation submission to the QCA. CPM understands that its indicative 2016 price, as calculated by GAWB, is expected to be 11% (in real terms) lower than the current price. Whilst at face value, a real price decrease is a 'good' result for industry, CPM is seeking to ensure the QCA scrutinise and validate the key changes in approach and methodology proposed in GAWB's submission.

CPM wishes to impresses upon the QCA the need to ensure that it fully understands – and makes transparent to users – the underlying impact of the movements in each pricing parameter/assumption. CPM believes this is necessary because if the QCA accepts each of these changes, a precedent will be set for future pricing reviews. In particular, CPM notes the significant reduction in the GAWB indicative WACC (due to large and justifiable reductions in market parameters) and impact this will have on customer's pricing. CPM would like to understand how much of this price reduction has been eroded by offsetting changes in methodology that otherwise would contribute to a price increase.

CPM's key concerns regarding GAWB's submission and the QCA process include:

- CPM is concerned with the seemingly subtle **change in the form of price** review to be performed by the QCA and whether this has diminished the effectiveness of price regulation.
- GAWB has **changed the methodology used to determine the operating costs** included in pricing calculations. GAWB has moved away from prudent and efficient operating cost benchmarks previously determined by the QCA and instead are basing costs on GAWB's forecast of its actual costs, a methodology that has previously been rejected by the QCA.
- The **reintroduction of Contingent Supply Strategy (CSS)** into the GAWB's regulated asset base roll-forward, despite this capital expenditure previously being rejected by the QCA.
- GAWB's **proposal to introduce a hybrid price/revenue cap** for reservation and storage services, despite this approach previously being rejected by the

QCA. CPM notes that commercial agreements provide a great deal of revenue certainty for GAWB and modifying the form of regulation will change the risk allocation between GAWB and its customers.

3. Form of Price Review

For the 2010 GAWB price review, the Ministers directed the QCA to prepare an investigation of pricing practices under Section 24 of the Queensland Competition Authority Act 1997 (QCA Act). For this 2016 GAWB price review, the current Minister has directed the QCA to conduct a price monitoring investigation under Section 23 A of the QCA Act.

Generally, CPM understands the two mechanisms – investigation into pricing practices and prices monitoring investigation – are similar in that the QCA cannot determine charges to be applied by GAWB, only review the business' proposals and make recommendations.

CPM understands that one of the key changes as a result of this Price Monitoring Investigation, as opposed to the historic investigations of GAWB's pricing practices, is the agreement reached between GAWB and the QCA with respect to a materiality threshold. That is, '*… where expenditure (whether operational expenditure or capital expenditure) has an impact on any customer's price of more than 1%, then it will be subject to review by the Authority as part of the price monitoring investigation'*[1].

CPM would expect that the QCA would evaluate any individual cost assumption or input parameter that had a greater than 1% impact on customers pricing. However, we understand that for this pricing monitoring investigation where the impact of expenditure is minor or has less than a 1% impact on pricing then it will not be reviewed by the QCA.

CPM understands that the indicative 2016 price for the Awoonga pricing zone prepared by GAWB is expected to be 11% lower than the current price in real terms. Noting that GAWB's calculation of prices relies on a number of parameters, CPM submits that the QCA should ensure that it fully understands – and makes transparent to users – the underlying impact of the movements in each parameter/assumption to ensure the materiality threshold has effectively been applied. For example, there is a significant reduction in the indicative WACC applied by GAWB to determine the indicative 2016 pricing and CPM would like understand how this is offset by each of the other parameters movements, and whether each of these movements surpasses the materiality threshold.

The QCA has made previous recommendations on cost recoverability or pricing methodology and GAWB appears to have deviated from these decisions in preparing

[1] GAWB, *2015 Price Monitoring Investigation – Submission to the QCA*, September 2014, p2.

its pricing submission. CPM would like to understand the individual impact of each of these changes. CPM notes that GAWB is proposing the following changes to the pricing practices established by previous QCA recommendations:

- the basis of operating costs has moved away from prudent and efficient operating cost benchmarks previously determined by the QCA and instead are based on GAWB's actual forecast cost recovery, a methodology previously rejected by the QCA
- the re-introduction of $22m into the RAB for the Contingent Supply Strategy where these costs had previously been reviewed and purposefully excluded by the QCA
- the introduction of a hybrid price/revenue cap

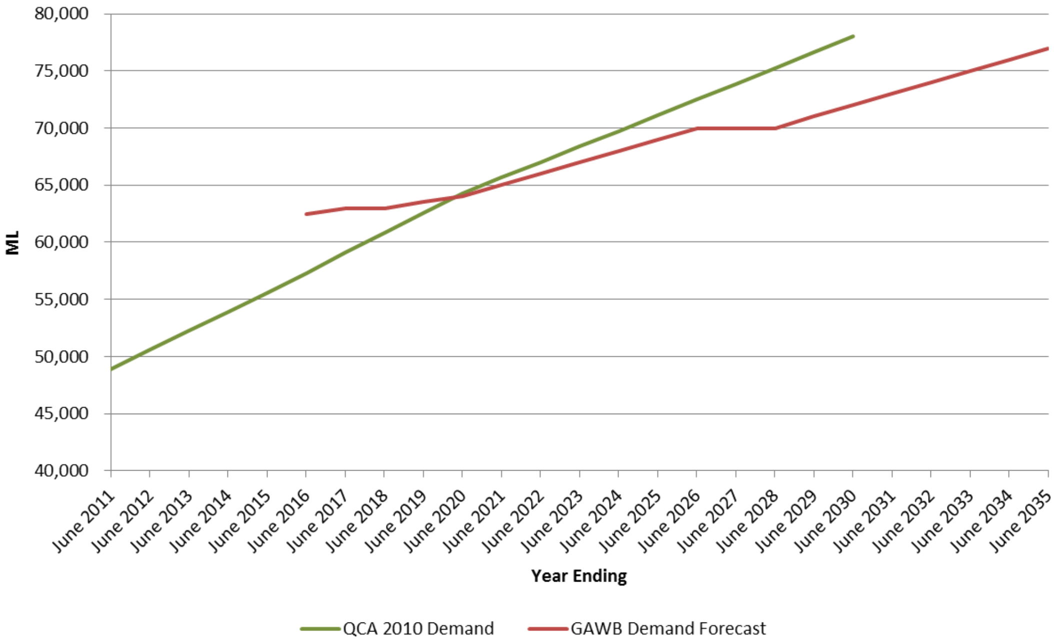
Despite charges decreasing, it is critical that the QCA reviews the full suite of changes proposed by GAWB in determining pricing for the next regulatory period. Whilst at face value, a price decrease in real terms is a 'good' result for industry, accepting these changes in approach and methodology will now result in a precedent being set for future pricing reviews.

4. Demand Forecasts

In its June 2010 Final Report, the QCA estimated that demand would increase from 55,600 ML for 2014-15 to 64,300 ML in 2019-20. The QCA demand forecast exceeded the GAWB forecasts developed for the 2010 investigation of pricing practices.

In its current submission to the QCA, GAWB has estimated a relatively flat total demand profile for the 2016-2020 regulatory period, with demand of 62,500 ML in 2016 increasing to approximately 64,000 ML in 2020 (estimated from the graph in GAWB's submission, p57). Thereafter, GAWB effectively assumes that demand will increase steadily until the supply capacity limit of 78,000 ML is reached in 2035.

Figure 1: Demand comparison



GAWB is now forecasting lower aggregate demand over the 20 year planning period. Even though demand is now expected to be higher in the initial years of the regulatory period, the forecasts increasingly diverge for the remainder of the planning period.

GAWB's current forecast suggests a further delay in demand reaching the capacity of the Awoonga system. Indeed, CPM notes that when the Awoonga Dam Raising Project was proposed, the additional capacity was then forecast to be exhausted by 2009/10[2] (with reference to the revised historic no failure yield of 78,000 ML). Existing customers are carrying the cost of this additional spare capacity for more than 20 years more than was originally anticipated.

CPM requests that QCA critically review GAWB's reduced demand forecast and verify the adjusted demand. CPM also requests that the QCA determine the extent to which current water prices are higher than they otherwise would have been, had the 2010 demand forecast been retained. This goes to the issue of whether customers are actually bearing the risk of future demand forecasts being achieved.

Further, CPM notes that GAWB has modified its demand forecast methodology in line with its intended change in the basis of charging. GAWB is proposing to move from annual volumes to a peak – maximum daily quantity (MDQ) – volume basis.

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[2] QCA, GAWB: Projected Demand for Water – 2000/01 to 2019/20, March 2001, p18.

5. Capital Expenditure

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 in any price adjustment and/or through improved (and contractually defined) levels of service or reduced risk profiles to customers.

GAWB has included a significant forecast capital expenditure program for the 2016-2020 regulatory period. Over the five year period 2016-2020, GAWB is proposing to spend $77.1 m in new capital expenditure, representing around 15% of its forecast opening RAB as at 30 June 2015 of $504.7 m.

The majority of this forecast capital expenditure relates to GAWB's downstream networks, and does not directly affect charges for dam-only customers, like CPM. However, CPM submits that the QCA should critically review the forecast capital expenditure to ensure that charges recover only expenditure that is absolutely necessary to meet demand and service requirements, and represents the most prudent and efficient response to these requirements.

CPM also notes that security and reliability of supply should be appropriately balanced with the level of required capital expenditure and also the customer's ability and desire to separately manage these risks.

6. Operating Expenditure

GAWB has proposed a significant change in approach to determining the base level of operating expenditure for the 2016-2020 regulatory period. GAWB has moved away from a benchmark efficient cost proxy, previously recommended by the QCA, to reflecting its own forecast operating costs for the purposes of determining charges. CPM notes that GAWB had previously proposed, and the QCA rejected, this methodology.

Based on a comparison of the 2014 QCA forecast and the actual costs incurred by GAWB, operating cost increases in the order of 20-30% would have been factored into customers' water charges had this 'actual cost' approach been accepted by the QCA at its last review. GAWB has commissioned an operational expenditure benchmarking review of its costs to assist in justifying this change in methodology. CPM requests that the QCA again review this change in methodology and the GAWB commissioned benchmarking review to determine whether the operating expenditure contained in the GAWB submission meets the prudent and efficient regulatory tests.

On the basis described above, GAWB has developed an operating expenditure estimate for 2016. Consistent with generally accepted practice, GAWB applies a

series of cost escalators to derive (nominal) forecast operating expenditure for the remaining planning period.
Some of the cost escalation rates/approaches proposed by GAWB appear to depart from methodologies accepted by the QCA, or otherwise appear high.

For instance, as part of the recent review of SEQ retail water pricing, the QCA recommended electricity prices be escalated in the first year by applying using the most recent retail electricity determination for small sites, and escalation rates included in current contracts held with electricity providers for large sites. For subsequent years, the QCA adopted a less uniform approach and a range of methodologies and benchmarks were accepted, including those based on estimates produced by consultants and regulatory bodies. We note that advice by Wedgewood White Limited was not one of the data sets adopted by the other water utilities and subsequently approved by the QCA.

CPM notes that earlier precedents of benchmark escalation rates would have included the impact of the former carbon pricing scheme, which has now been discontinued. Given the timing of the GAWB submission, CPM would expect that carbon pricing would have been removed from the base cost and that the escalation factor proposed by GAWB excluded any carbon pricing impact. However, we ask the QCA to ensure any comparison of cost escalation factors completed on a like for like basis.

7. Regulated Asset Base (RAB)

GAWB has proposed a significant increase in the forecast RAB to apply as at 30 June 2015. The main reason for this increase (ignoring the impacts of inflation and depreciation) is due to the inclusion of $67.38 million in ‘acquisitions’. GAWB’s total sum for acquisitions refers to a variety of capital expenditure projects for the period 1 July 2005 to 30 June 2015 and also includes $22.31 million for the Contingent Supply Strategy (CSS).

2010-2015 capital expenditure

CPM accepts that capital expenditure projects are allowed to be incorporated in the RAB. Although GAWB has commissioned various reviews of the various capital projects, CPM would expect the QCA to independently determine whether each of the capital expenditure projects and associated costs amounts have been delivered and incurred prudently and efficiently.

CSS preparatory works

CPM has previously challenged the inclusion of costs relating to the CSS in the RAB. In its 2010 Final Report the QCA also recommended that no expenditure related to the CSS be included for pricing purposes. CPM requests the QCA determine whether the arguments presented by GAWB justify the re-introduction of the CSS costs into the RAB.

GAWB purports that the CSS preparatory works provide an accelerated implementation timeframe in the event it needs to augment its water supply. GAWB states that CSS may be required in the event that there is an increase in demand or a supply shortage occurs due to drought.

Given that GAWB itself states that it 'has no current enquiries from potential customers that would require water supply within 5 years', CPM believes that the supply capacity augmentation argument is weak, particularly for the next regulatory period 2016-2020.

GAWB's website (as at 6 November 2014) states that the Awoonga Dam is currently at 93.9% of capacity. Demand is expected to be well below the sustainable dam yield, particularly for contracted volume over the next 5-year regulatory period, suggesting that even with low or minimal inflows, there is a significant period of time to progress any drought-response initiatives.

GAWB has argued that the CSS preparatory works reduces the implementation timeframe for an augmentation trigger event from 6-8 years to a period of 3 years. In its submission, GAWB refers to timeframes mandated by its own Drought Management Plan (DMP). GAWB appears to derive the 6-8 years implementation timeframe by the addition of two specific time frames:

- The GAWB DMP requires for the second water source to be supplying water while Awoonga Dam still has 2 years water supply remaining.
- GAWB states that *'…lead time to full operation of the second source can be up to 6 years…'*[3].

These assumptions are critical and the QCA needs specifically to validate the 6-year lead time nominated by GAWB, and the DMP requirement that supply of water from the second water source be available 2-years prior to it access actually being required.

Perhaps more important still, the CSS preparatory works relate to a *particular* augmentation project. Depending on the characteristics of any future required drought response, the current CSS project may or may not be optimal. If this is the case, then expenditure already incurred with respect to the CSS project would prove to be of no real value to customers.

CPM continues to hold a view that an 'opt in' arrangement is the most appropriate solution for supply reliability works, where customers that require higher reliability pay for that particular augmentation, rather than all customers being required to contribute to greater level of supply certainty that they may not require or need.

[3] GAWB, 2015 Price Monitoring Investigation – Submission to the QCA, September 2014, p77.

Capitalising CSS costs now effectively socialises the costs of these works, irrespective of whether there is little to no value to some customers.

On this basis, CPM believes that including CSS preparatory works is not warranted for the 2016-2020 regulatory period. The QCA should recommend that the CSS preparatory works not be included in the 2016-2020 regulatory period, consistent with its prior consideration and its 2010 recommendation.

8. Weighted Average Cost of Capital (WACC) Parameters

CPM has reviewed each of GAWB's indicative WACC parameters and compared this to the recommendations made by the QCA in its June 2010 Final Report. Appendix A contains a table comparing the individual parameters and identifies instances where GAWB has deviated away from the various historical benchmarks and also acknowledges QCA's recent publications with respect to estimating market parameters for regulated businesses.

9. Other Issues

Introduction of MDQ-based pricing

GAWB is proposing to change its pricing model for its delivery network from pricing based on annual quantities to a Maximum Daily Quantity (MDQ) approach. CPM does not use the GAWB network and therefore will not be directly impacted by this proposed change.

As long the methodology applied to allocate costs between the reservation and storage service and the delivery network remains unchanged, CPM has no concerns with MDQ based pricing.

Planned changes to regulatory framework

GAWB is proposing significant changes to the regulatory framework in the form of a hybrid price/revenue cap mechanism for the reservation and storage services, and a revenue cap for its delivery network.

The QCA has previously reviewed and rejected similar proposals by GAWB. In its 2010 Final Report, the QCA stated that 'a revenue cap as proposed by GAWB is inappropriate as it would pass on to existing customers the risk that the estimated take-up of spare capacity does not eventuate'.

CPM's concern is that the current framework already provides significant volume-risk protection for GAWB:

- at each successive regulatory price reset, GAWB has adjusted its demand forecast, extending further the period over which demand will reach system capacity – the effect of this is that GAWB is accruing a significant "revenue shortfall" amount, which feasibly could be recovered from existing users, if future demand forecasts are not realised.
- sitting behind the regulatory framework applied to set prices, there are agreements that have been struck on commercial terms at a particular point in time. The commercial agreements provide a great deal of revenue certainty for GAWB through a variety of charging mechanisms. This includes fixed charge components of two-part tariffs, penalty charges where customers understate proposed usage, and take-or-pay provisions.

These provisions provide GAWB with a significant level of revenue protection, beyond that implied by a conventional price-cap framework. The introduction of a revenue cap to protect GAWB further will effectively place an increased take-or-pay burden on customers.

If the QCA were to consider these proposals, it should recognise the impacts on the risk allocation previously negotiated in commercial agreements and ensure that any risk transfer in favour of GAWB is appropriately compensated for by a reduction in GAWB's rate of return.

Appendix A: WACC Comparison Table

Parameter	QCA GAWB 2010	GAWB Proposed	CPM Comment
Risk free rate	5.04%	3.53%	Variance reflects mostly the different timing of relevant decisions. The risk free rate will be based on current market data at the time of the relevant pricing determination. CPM notes that the QCA estimated a risk free rate for GAWB in its 2010 Final Report based on a 5 year Commonwealth Bond yield, matching the regulatory period. However, GAWB has based its estimate on a 10 year Commonwealth Bond yield.
Gearing	50%	50%	GAWB has proposed no change to gearing.
Debt margin	4.74%	2.45%	Variance reflects mostly the different timing of relevant decisions. The debt margin will be based on current market data at the time of the relevant pricing determination plus allowances for debt raising and refinancing costs. CPM notes that the QCA estimated the base debt margin for GAWB in its 2010 Final Report based on a 5 year Bond yield, matching the regulatory period. However, GAWB has based its estimate on the RBA 10 year BBB Bond yield.
Debt raising costs	0.125%	0.108%	GAWB has assumed a reduction in debt raising costs in line with the QCA's recent publication for SEQ water retailers.
Market risk premium	6.0%	6.5%	GAWB has proposed an increase in the MRP to 6.5%. CPM notes the QCA's recent publications with respect to estimating market parameters for regulated businesses, including adopting an increase from 6.0% to 6.5%.
Gamma	0.5	0.47	GAWB has proposed a reduction in gamma. CPM notes that this change is in line with the QCA's recent publications with respect to estimating market parameters for regulated businesses.
Tax rate	30%	30%	No change proposed by GAWB.
Asset beta	0.4	0.4	No change proposed by GAWB.
Debt beta	0.11	0.11	No change proposed by GAWB.
Equity beta	0.65	0.64	GAWB's lower equity beta is a direct result of a minor reduction in the Gamma parameter, as described above.
WACC	**9.35%**	**6.85%**	