Ref: B/D/14/34289

20 November 2014

Attention: Matt Bradbury
Queensland Competition Authority
GPO Box 2257
Brisbane Q 4001
water@qca.org.au

Dear Mr Bradbury

Gladstone Area Water Board – Price Monitoring 2015-2020

We thank you for making us aware that the Treasurer and Minister for Trade directed the Queensland Competition Authority (QCA) to monitor the prices of the Gladstone Area Water Board (GAWB) for the period from 1 July 2015 to 30 June 2020 (2015-2020). We understand a draft report is due from the QCA by 28 February 2015 and a final report by 31 May 2015. To assist in this process we welcome the opportunity to comment on GAWB's initial submission.

CS Energy Ltd (CS Energy) is a GAWB customer through the wholly owned Callide B Power Station and the joint venture in the Callide C Power Station. CS Energy is providing comments on behalf of Callide B Power Station. Callide Power Management (CPM) will submit a response to the GAWB proposal on behalf of the Callide C Power Station owners to which we give in-principle support.

Whilst GAWB is proposing a decrease in expenditure of 11% (which is an improvement given the significant increase in the previous pricing period), CS Energy does not believe GAWB has provided sufficient information to allow us to make a fully informed decision on whether the prices submitted reflect efficient and prudent operation.

CS Energy's key concerns regarding the GAWB submission focus on:

- Efficiency and appropriate inclusion of capital expenditure (CAPEX);
- Operating expenditure methodology (OPEX);
- Commentary on the relevance of the CSS project;
- Questions relating to pricing and the proposed form of regulation; and
- The WACC methodology proposed by GAWB.

These areas are discussed below in detail.

CAPEX

Historical impact on the RAB

The proposal to include $8 million of CAPEX overspend (compared to that forecast for 2010-15) into the Regulated Asset Base (RAB) is of concern given the majority of

Brisbane Office
PO Box 2227
Fortitude Valley BC Qld 4006
Phone 07 3854 7777
Fax 07 3854 7300

Callide Power Station
PO Box 392
Biloela Qld 4715
Phone 07 4992 9329
Fax 07 4992 9328

Kogan Creek Power Station
PO Box 41
Brigalow Qld 4412
Phone 07 4665 2500
Fax 07 4665 2599

Wivenhoe Power Station
PO Box 38
Fernvale Qld 4306
Phone 07 5427 1100
Fax 07 5426 7800

CS Energy Ltd ABN 54 078 848 745 **www.csenergy.com.au**

expenditure was not on projects determined to be efficient by the QCA in 2010. The initial submission by GAWB does not fully account for the CAPEX overspend and highlights instead how GAWB underspent $13 million on the $22 million Awoonga Dam Spillway Upgrade that constituted 34% of the QCA reviewed forecast CAPEX for 2010-2015.

We question whether the 2010-2015 CAPEX overspend was efficient and request the QCA seek further information from GAWB on the reasons for the change and increase to the CAPEX program compared to the projects identified as efficient in 2010 review.

Forecast
The capital expenditure forecast for 2015-2020 is significant at $77 million, yet only $33 million (43%) has been deemed to be efficient by GAWB consultant CARDNO. The greater proportion of the CAPEX forecast appears unaccounted for which mirrors the 2010-2015 overspend. This reduces our confidence that GAWB's forecast prices are prudent and efficient.

Review of the GAWB submission has identified that the majority of CAPEX for 2015-2020 pricing period appears to relate to downstream customers and not the Awoonga pricing zone. As the GAWB submission does not clearly identify all the CAPEX or the relevant pricing zone, CS Energy requests the QCA critically assess the forecast to ensure the CAPEX clearly and efficiently meets demand and/or service requirements for each of the pricing zones.

OPEX

CS Energy's principle concerns relating to OPEX are as follows:

- GAWB has moved to a forecast operating cost model that reflects increased historical costs rather than the previous used, and QCA approved, benchmark efficient cost model; and
- The expenses in the 2015-2020 submission for GAWB's Opex budget are up to 1.36 times greater than those incurred in the previous pricing period.

CS Energy is concerned with the significant increase in OPEX as there appears to be no significant change in operating regime or consideration of cost impacts given recent macro-economic changes, including the slow down in the regional economy post the gas investment boom. CS Energy requests that QCA consider reviewing the methodology utilised by GAWB in determining the OPEX cost structure to ensure the proposed expenditure is both prudent and efficient.

CSS Project

The CSS is a transformative project for GAWB effectively enlarging the RAB and affecting all customers. CS Energy believes there may be other options for managing water demand rather than increasing supply by 30GL through the CCS project.

The key areas of concern with the reintroduction of the CSS project include:
- The purpose of the project is to mange future supply shortages during drought periods or anticipated future demand;
- There is no indication of future demand growth and current demand for the 5 year period is expected to be well within the current and expected sustainable dam yield;

- The total project CAPEX is considered to be significant and if the project does eventuate will result in significant cost increases for all users;
- The QCA in the previous pricing period rejected the $14 million already spent on the CSS preparatory works and there are no compelling reasons to change this assessment;
- The inflation of the expenditure by the WACC from $14 million to $22 million effectively back dates the asset into the RAB from the period that it was rejected which is not consistent with CAPEX recognition; and
- In the 2010-2015 submission the QCA had allowed for $1.33 million to be spent to mothball the CSS project, yet GAWB has forecast a further expenditure of $5.6 million on elements of the CSS preparatory works.

The GAWB submission discusses risk mitigation and understanding of drought impacts however does not identify alternatives available to mitigate water consumption or manage water supply, other than the CSS project. There is also no clear indication of demand growth to support the CSS project which is supported by GAWB's commentary in the submission.

CS Energy is of the opinion that GAWB should seek to understand current customer demand/risk profiles and the opportunities to develop a stronger risk mitigation and supply strategy. These strategies may include changes in contractual volumes to reflect variability, recognition of water saving technologies introduced and changes in risk appetite. CS Energy ***does not support*** *the inclusion of the CSS project in the RAB and requests the QCA examine the implications of the inclusion of the CSS project.*

Regulation and Pricing

Regulation

The proposed changes to a hybrid price/revenue cap effectively changes the risk allocation for customers and ultimately results in customers bearing costs for spare capacity that may remain unused. Current contractual arrangements and pricing should adequately reflect the volume risk and protection required by GAWB without imposing additional costs to consumers.

CS Energy would not support a change to the regulation without due consideration given to reflecting the change in risk allocation through contractual arrangements, including increasing the variability of supply/pricing, appropriate inclusion/renegotiation of take or pay arrangements and recognition of GAWB's reduced risk profile through a change in the return (WACC).

Pricing

The Maximum Daily Quantity (MDQ) pricing appears to be founded on an equity principle as to who pays for the downstream pumping and piping to consumers. CS Energy understands that the MDQ will principally affect down-stream customers and Awoonga Dam customers will be largely unaffected.

Based on the above assumption CS Energy has no further comment on MDQ pricing as long as there is no significant change to the current storage and volume pricing for the Awoonga Dam customers.

WACC

From discussions with GAWB we understand the proposed change to the trailing average cost of debt, as recommended by Queensland Treasury Corporation, is to mimic the actual costs of raising debt rather than an 'on the day' rate. We understand the QCA has a preference for using the 'on the day' rate for establishing the cost of debt.

CS Energy understands both the rationale proposed by GAWB and the QCA's historic acceptance of the 'on the day' rate methodology. Should the QCA agree to GAWB's proposed change in methodology, CS Energy requests the QCA explore whether there is an opportunity for GAWB to refinance earlier (e.g. the beginning of the period) and effectively crystallise an immediate windfall gain. This would be contrary to the spirit of change in methodology and not acceptable to CS Energy.

CS Energy is pleased to have this opportunity to participate in the QCA's price monitoring process for the 2015-2020 GAWB submission. Should you require clarification on any of these issues please do not hesitate to contact me on 07 3854 7402.

Yours sincerely

Jason Mahoney
Group Manager – Commercial