

BURDEKIN RIVER IRRIGATION AREA COMMITTEE
ANNOTATED COMMENTARY ON SUNWATER SUBMISSION

Introduction

This commentary by way of reply to the submission put to the Queensland Competition Authority is made by the Burdekin River Irrigation Area Committee (BRIAC).

It is a public submission which has made no use of any confidential material and we request that it be placed on the QCA website, along with BRIAC's prior submissions.

Comments on the SunWater main submission and its two Appendices by the Burdekin River Irrigation Area Committee (BRIAC) are in italics.

General Comments on the SunWater Main Submission

It is apparent that there are fundamental differences between BRIAC and SunWater as to the appropriate methodologies to be used by the inquiry in determining a regulatory capital base and cost of capital for the Burdekin scheme. Computation of appropriate charges or refunds depends on resolving crucial points of principle.

*In general terms, SunWater seems to believe that costs chargeable to BRIA irrigators should be based on **hypothetical or notional** costs not on **actual** efficient costs. However, hypotheses used to derive notional costs are not always internally consistent, producing arguments which are self-contradictory and irrational in legal, economic and commercial terms.*

Such inconsistencies are noted in the detailed commentaries on the main submission and appendices, but some examples are noted here.

- *It is illogical (and contrary to commercial common sense and practice) not to treat land and water sales proceeds or capital contributions by users **collectively** as well as **individually** as part of the returns by way of capital recoupments on infrastructure investment by a land developer.*
- *It is illogical to claim tradeable water entitlements are intimately connected with storage and haulage infrastructure and simultaneously claim that payments for water rights should not be credited against the cost of providing such infrastructure.*
- *It is illogical to admit that irrigated land prices paid at auction included the value of servicing the blocks with roads but simultaneously assert such prices did not include the value of water infrastructure servicing the same blocks.*

- *It is illogical for SunWater to claim credit for non-SunWater assets contributed to shires as part of its asset base while trying to deny the same treatment to assets in its ownership which were financed by farmers and taxpayers.*
- *It is illogical to use a CAPM model of a required post-tax rate of return for new private sector investment, when the investment being priced is sunk investment, there is surplus capacity so no new investment is required, and the infrastructure owner is a tax-exempt body.*
- *It is illogical for SunWater to advocate use of a private sector CAPM model which includes capital gains and returns of capital in computing return on investment while SunWater tries to ignore such returns in its accounts for the purposes of setting regulated charges.*

It is economically irrational (and arbitrary as between users of various types of taxpayer-funded assets) to treat government grants or taxpayer funded assets as investments requiring a rate of return on "equity", since tax funding is involuntary and not a form of equity raising on capital markets. The cost of capital to the scheme is zero, since no equity has been issued in the scheme, the cost of taxpayer funds to a government is zero (whatever may be the efficiency costs elsewhere) and no debt is extant in relation to the scheme.

It is economically irrational to argue that higher prices for water storage and haulage services are a social benefit because they force water to be allocated to higher valued uses. That ignores the loss of production and output in other uses. The optimal pricing rule is short run marginal cost (SRMC), which is zero in the case of sunk capital. Further, higher valued uses may not exist and, if they did, would already be exploited by farmers eager to diversify from sugar cane. In any case, the Burdekin scheme has a surplus of unallocated water, so there is no need to ration water towards higher valued uses. With the "higher valued uses" argument, one might just as well argue that any price rise anywhere in the economy is a "good thing" because it limits use of a commodity to higher valued uses. The fallacy of the argument is obvious once it is realized that prices which kill off demand may also kill off suppliers who are left with unsold goods. That is why competitive markets adjust demand to marginal cost of supply – only a monopolist like SunWater can act on this sort of argument without fear of market repercussions.

In terms of tax analysis, to charge a rate of return on the notional value of assets which have been previously paid off is to impose a selective excise tax upon production. In terms of equity or social welfare considerations, BRIA farmers objecting to a selective excise tax are not seeking a subsidy (though they may well be owed a refund on a proper accounting).

BRIAC also notes that depreciated optimized replacement cost (DORC) is indeterminate as a concept of cost because, as noted in our previous submissions, there are varying hypotheses which may be chosen, with varying results (eg brownfields, greenfields, above or in-ground channels, ring tank alternatives etc).

Finally, we note that SunWater has relied in part on the results of other inquiries. BRIAC observes that the results of other inquiries are no form of precedent for this inquiry, especially where those participating in other inquiries may have mutually chosen to accept or not dispute certain methodologies. Given their importance to the outcome of this inquiry, BRIAC has no choice but to put fundamental points of methodology in issue and to insist that all the arguments be addressed on their merits, paying no regard to any lingering preconceptions formed elsewhere without the benefit of close scrutiny or argument.

Specific Comments on SunWater Main Submission

Page 1

1. Whether payments for land and water allocations and sugar mill levies should be treated as capital contributions, and the pricing effects of these transactions;

The Burdekin River Irrigation Area Committee (BRIAC) has previously argued that these should be treated as recoupments of capital and, to the extent they exceed a proper apportionment of the BRIA's costs of the whole scheme, surplus amounts should be credited towards reduction of opex charges.

2. Whether funds provided by the State and Federal governments constitute capital contributions, and the appropriate treatment of such payments for pricing purposes;

BRIAC has argued there is no basis for charging a rate of return on payments out of Consolidated Revenue, no more than for charging a rate of return on funds expended on public parks or roads. In particular, the Commonwealth contribution was a free grant and the State Treasury would be unjustly enriched by charging a return on capital which cost it nothing and which was given to promote North Queensland development.

3. Asset valuation issues and the relevant asset base; and

BRIAC has condemned the use of DORC as being inconsistent with normal commercial accounting and with genuine economic competition, and we refer the QCA to the works of professors Bob Walker and David Johnstone for further explanations as to the problems with DORC. In particular, to apply DORC to assets whose cost has already been recouped is to legitimate abusive monopoly pricing through double dipping.

4. The appropriate weighted average cost of capital for the Burdekin Scheme.

BRIAC has observed the CAPM model is quite inappropriate for public works programmes, since, inter alia, there is no equity issued and the only true cost of capital is the actual interest cost of earmarked project loans. As taxpayers do not charge a rate of return to government on their taxes applied to capital works through Consolidated Revenue, there is no cost of "equity" of any kind.

The Government issued a Direction to SunWater (6 October 2000) setting out the prices to be charged for the delivery of water entitlements to rural irrigation water users. SunWater has charged in accordance with this Direction.

BRIAC notes the gazetted charges are maximum prices only and SunWater is not obliged to charge the gazetted maxima. Nor should it, where, as BRIAC argues, there would be historical cost over-recovery.

Page 2

However, the Authority's investigation addresses significant commercial issues for SunWater, most notably the principles underpinning its regulatory asset base and its weighted average cost of capital used for commercial pricing. SunWater's submission is largely focussed on these issues, as they also have implications for SunWater's regulated business activities that fall outside the Pricing Direction.

BRIAC notes the QCA is obliged by administrative law to conduct this inquiry on its own merits, without regard to extraneous considerations, such as SunWater's other commercial interests. Fiat iustitia, ruat coelum - let justice be done, though the skies fall in - is the rule to be followed. It would be quite erroneous for an inquiry to reach a conclusion other than on the merits of the facts and arguments in the particular case.

The Authority's investigation also includes conceptual and historical consideration of the pricing and regulatory treatment of water entitlements. As an owner of water entitlements, SunWater wishes to put forward its views to ensure an orderly and rational development of a water entitlement market in accordance with Council of Australian Governments (COAG) principles.

BRIAC observes that these considerations may be outside the terms of reference of this inquiry and, in particular, that COAG principles have no force of law controlling the outcome of this inquiry. If, however, the QCA feels that these matters should be examined, BRIAC notes that, unlike other water entitlement holders - such as irrigators, SunWater has a privileged market position, similar to a gas wellhead and transmission pipeline owner who is also a gas retailer. As a vertically integrated water owning, storage and haulage business, SunWater has incentives to shift profits from competitive areas of its business to monopoly parts (such as storage and haulage). Extraction of monopoly rents by SunWater through high storage and haulage charges can diminish or destroy the value of other persons' tradeable water entitlements but this is of no concern to a profit-maximizing vertically integrated monopolist. If the QCA decides these issues are to be explored, BRIAC would like the opportunity to argue that SunWater's vertically integrated monopoly business should be broken up.

The IC recommended that when calculating capital charges, water authorities' asset bases should include assets provided by developers or funded through developer charges. However, the rate of return earned on those assets should be refunded to customers in new subdivisions

in the form of lower charges for water services.

*BRIAC notes the Industry Commission report on **Water Resources and Waste Water Disposal** (1992, p 3) acknowledged that cost recovery was complex and that "in future" all costs should be recovered. The IC also warned that urban customers should not be charged twice for development costs. The tenor of the IC's observations in this regard is quite consistent with BRIAC's central argument that BRIA irrigators are facing retrospective cost over-recovery. Nor, we note, would the IC's comments on cost recovery necessarily sanction over-recovery through valuations inflated by DORC over actual cost. BRIAC also notes the IC also recommended (No 10, p 13) that prices in existing schemes for irrigation water should cover irrigators' share of opex and maintenance only and that a return on capital should only be sought where there was excess demand for water. Given that there is still a large amount of unallocated water in the Burdekin and large amounts are reserved for non-BRIA users, appeal to the IC Report supports BRIAC's arguments rather than SunWater's.*

The report of the COAG Expert Group on Asset Valuation Methods and Cost-Recovery Definitions for the Australian Water Industry (1995) also assumed that all assets, including those paid for by customers, would be owned (that is, identified in their accounts) by the water authorities. Whilst the Expert Group supported the setting of such charges to fully recover all costs of water services to new customers, it did not make specific recommendations as to past contributions.

*SunWater's appeals to the authority both the IC and the COAG expert group (for what they are worth) actually assist BRIAC's case, rather than SunWater's. At page 55 of its report, the COAG Expert Group did **not** challenge the view of the IC that seeking a return on private contributions "would represent double charging". The IC (1992, p 75) was firm that no return should be sought on private capital contributions and declared "Despite contrary arguments, the Commission remains of the view that, in principle, it is unnecessary for authorities to seek a rate of return on developer provided or funded assets." (Incidentally, the term "Expert Group" is something of a misnomer as the Group's membership set out in its attachment A consisted almost completely of Treasury representatives and asset owners, who all had a vested interest. The Group did not include any academic experts and ignored the work of experts such as Professor Bob Walker. The nature of treasuries' vested interest in water pricing can be seen in the recent NSW controversy over a further NSW Treasury raid on Sydney Water – see "Egan in raid on cash cow billions" Sydney Morning Herald, June 15-16, 2002, p 1)*

The Authority's Draft Report of its investigation of Pricing Practices for the Gladstone Area Water Board recommends:

"That capital contributions be recognised where there is evidence that the contribution was made with the intent of obtaining future price benefits – unless there is evidence that the contribution was a pre-payment for services, returned through explicit pricing arrangements or, applies to assets that have since been consumed or replaced".

In its review of Queensland Rail's (QR) draft undertaking, the QCA took a legalistic approach to the issue of past contributions, determining that past contributions should only be recognised for a claimant who could demonstrate that recognition beyond the existing contractual arrangements was justified by way of documentary evidence, in which case specific adjustments would be made to access charges.

BRIAC begs to take issue with these remarks. First, we note that the law of unjust enrichment appears quite pertinent to situations where a monopolist demands a capital contribution to a scheme and then refuses to give credit to those who paid for the infrastructure. Why should it matter whether there was a specific contract in any individual case as opposed to a general understanding by a class of infrastructure users that their collective contributions would defray scheme capital costs? The law recognizes equity, unconscionable conduct, unjust enrichment and class actions as well as simple bilateral contracts. In this regard, we note the law, properly understood, is consistent with economic common sense. Why would any group of rational business people make capital contributions to a scheme unless it was taken for granted that this would cover scheme costs and be reflected in reduced collective charges?

Page 3

SunWater asks the Authority to provide a consistent approach in its treatment of contributed assets to its past decisions. To do otherwise would create regulatory uncertainty and confusion. If the Authority is considering moving away from these precedents in its investigation for the Burdekin Haughton Scheme, SunWater would be pleased to make a more detailed supplementary submission in relation to contributed assets.

There is no intellectual or moral virtue in being consistently wrong. Even the House of Lords is no longer bound by its precedents and since 1966 has corrected erroneous precedents, as does our High Court. In any case an administrative body such as the QCA, conducting an inquiry such as this, is not bound by "precedent" in any legal sense and, where arguments are put to it, must consider them on their merits. As the QCA itself has commented to BRIAC, its statement on water pricing principles is not set in stone. If other parties in other inquiries have failed to argue their cases comprehensively, that does not preclude BRIAC from doing so - and from insisting its arguments be dealt with properly by the QCA.

1.1. Land Purchase

Some 187 farms were sold by public auction or ballot, realising total revenue to Government of \$91.3 million.

BRIAC's adjusted census figures from auction sales with extrapolation for missing sales suggest a cumulative total of some \$150 million was effectively raised from land and water sales.

Purchasers of farms received in consideration for this payment:

Freehold land capable of irrigation;

"Capable of"? Or "to be irrigated"? Why would you pay cold, hard, cash for irrigated land only to be charged again?

A water entitlement;

Access to the farm via constructed roads;

SunWater here admits that a land price paid at auction includes the capitalized value of access to the farm arising from government capital works on roads. Why does it not equally include water access via constructed channels? A farmer needs and expects to bring water to his cane by channels as much as he brings fertilizer by roads. This commonsense understanding of what was paid for is reinforced by auction documentation which refers to "the construction of roads and irrigation infrastructure to service these farms." One would assume the developer was recouping all these construction costs from sale prices (which BRIAC notes were often well above reserve prices).

Concessional finance (for most lots offered); and

The value of this is capitalized in the auction prices.

Cane assignment (for some lots)

Cane assignment had no value as these were freely available at the time outside the auction process.

SunWater is of the view that money paid for the purchase of land was simply a commercial transaction to purchase tradeable assets (i.e. freehold land and a water entitlement).

Correction. What was purchased was irrigated land, not dry land. The purchase price was paid on the basis that the excess over dry land value was a capital contribution to defray costs of the scheme - the same understanding the State had in its land resumptions in the area.

In the context of the criteria for determining a contributed asset, the issue therefore becomes one of whether there was any documented intention or promise for future benefits from the purchase of land, in the way of reduced prices for the ongoing water delivery charges.

SunWater has reviewed the documentation and contracts surrounding the land auctions, and cannot find any basis to conclude there was any documented or implied intent or commitment for any particular set of water and drainage charges to apply **beyond the year in which the farms were purchased**. Given the construct of the regime for setting water charges over the

period, SunWater can see no legal constraint on future water charges arising from any auction documentation or contracts.

This is breathtaking. Is SunWater seriously arguing that anyone in their right mind would hand over their life savings and borrow from banks to buy the privilege of becoming an economic hostage to a legally unconstrained monopoly supplier? The rational explanation for what occurred is the historically accurate one. The State became a land developer and people paid for their farms on the assumption that the sale price defrayed development costs - an assumption not disabused by references in auction documents to being charged a minimum payment of 75% to meet the Department's "fixed costs of supplying water". The State took its chances on recovering capital costs from land and water sales and irrigators took it that they would only be charged for actual costs of scheme opex and maintenance in the future - the same way they are charged for servicing and maintenance of constructed roads, the same way public land development works have traditionally been charged for - a combination of land sale prices, rates and user charges to cover actual operating costs.

Page 4

Therefore, SunWater is of the view that the land sales for the scheme do not constitute **capital contributions** on the basis that there was no intention for a future benefit through reduced delivery charges.

"Therefore" is a non sequitur. In addition BRLAC notes that payments were described as capital contributions or as one off or once only capital contributions at the time and in later Government submissions to the IC.

This argument is supported by the fact that the same charging regime for water deliveries has applied to:

farms sold at auction;
farms retained by original landholders in the resumption process; and
farms supplied with granted water allocation with no land transaction (eg. farms in the "old" irrigation area, or extensions to the new scheme).

This is not true of charging for additional allocations to North and South Burdekin Water Boards or allocation to Townsville-Thuringowa. As for the older irrigation areas being charged the same price for no extra benefit, is SunWater arguing that "one bad turn deserves another"? It is no defence to a charge of theft or rape to argue that one has done it to others.

If a future benefit was intended to be derived from the purchase of land, SunWater believes the charging regime would have provided differentiated prices for the above group of people. In conclusion, SunWater believes the consideration for payment for land was the land itself,

not a future benefit in relation to ongoing delivery charges.

What was bought was irrigated land, expected to be serviced at cost - and the capital contributions did differ depending on the auction prices. This is hardly surprising. A suburban developer recoups his capital costs on water pipes without worrying whether the prices paid for the blocks are the same or whether this new development gives him extra value on retained blocks from a previous development.

The terminology used to explain the purchase of water entitlements forming part of resumption settlements, particularly in the 1980s, was "headworks contribution". Other descriptions for the payment to secure a water entitlement included capital charges and nominal allocation charges.

However, the terminology used to describe the payment should not be the sole basis upon which to decide whether such payments formed capital contributions in an economic and regulatory sense. SunWater believes the critical test, as indicated by past regulatory decisions, is whether there was any documented intent to provide any future price benefits from this payment.

BRIAC begs to differ. We note that this admission by SunWater that there were headworks contributions or capital charges contradicts its assertion to the contrary at the top of its page 4. The descriptions as headworks contributions or as once only capital contributions were precisely indicative of what was meant. The rational economic approach would have been to assume that these payments were capital contributions in an economic sense and should be accepted as such regulatory purposes. The case is no different to any other purchase of serviced land, such as suburban blocks with curbing guttering, electricity and water. One assumes in such cases that the capital costs are recouped in the land price at auction.

SunWater believes there is no evidence that such payments were made with the documented or implied intention in relation to future prices. If such indications were made, this would have created a policy dilemma at the time in relation to differential prices for those people who had purchased water, and those who had water entitlements granted to them. SunWater has only found contrary statements made at the time, that purchased water entitlements were to rank equally with granted water entitlements in all respects, including priority of supply and prices.

Differential prices have in effect been applied as regards the North and South Burdekin Water Boards and Townsville-Thuringowa. As for BRIA users, it was of course rational to grant water entitlements from the scheme where there were pre-existing riparian rights which had to be recognised. The argument here is in any case puzzling. Surely, irrigators can be treated equally by only charging efficient operational costs and ignoring sunk or recouped capital costs?

Furthermore, the consideration received for the payment of nominal allocation charges was an asset in the form of a water entitlement. This value of this asset was manifest in the value of the land to which it is attached (prior to a water trading environment) or in the entitlement itself (post water trading environment). As such, the consideration for this purchase was not future price benefits, but a specific asset in the form of a water entitlement.

The argument is specious. The value of a water allocation depends critically on the cost of exercising it. The value of a water allocation depends on the cost of getting the water onto the farm. The higher the charges SunWater is allowed to levy for storage and haulage of water allocations, the lower the value of a water entitlement. The price paid for water allocations would have assumed that the State would not charge more for the actual carriage of the water than its actual costs. The argument is like saying that the purchase of a suburban block of land does not carry with it the right to use the streets to get to it and that the government may accordingly erect boom gates at the end of every street and start charging suburban residents a toll each time they leave or return to their homes.

SunWater believes the Authority's deliberations in relation to treatment of water allocations may have a fundamental bearing on the way water entitlements are valued and traded into the future. It is critical that the value of water entitlements be separated from the water delivery charges to enable a robust and workable market in water entitlements to develop, and hence realise the economic benefits to be gained.

There will be no viable market for water entitlements if their value is liable to be destroyed by excessive storage and haulage charges levied by vertically integrated incumbent monopolists. Further, the economic benefits to be gained from public works depend on their being priced on the basis of optimal short run marginal cost and not being used as covert, surrogate, taxing mechanisms which lead to underutilisation and loss of export markets, national income and employment.

This analysis demonstrates that the TWE itself is of value irrespective of service delivery charges. This applies whether service delivery charges are zero (for example, in an unregulated system), at the Lower Bound, the Upper Bound or somewhere in between. There should be no confusion between the determination of infrastructure charges for service delivery in accordance with the pricing policy of the day, and the value of the water entitlement that is influenced by a range of issues, **of which infrastructure charges are but one factor.**

But high infrastructure charges can diminish or destroy the value of tradable water entitlements. In the case of the Burdekin, since there is an unallocated surplus in the dam one assumes the value of tradable water entitlement in a free competitive market would be zero. Just as the provision of infrastructure services can enhance land values, so their withdrawal or overcharging can lead to a collapse of resource values. Such negative externalities from an overcharging regime reflect the painful social cost of extraction of monopoly rents.

1.3. Sugar Mill Levies

Section 117 (2) of the *Act* states:

“Assessments made and levied ... must be applied towards the costs of operation, maintenance or administration and as a contribution **towards capital costs** with respect to the supply of water to or the drainage of the land in question from works constructed by the corporation....”

The legislation **does not contemplate the application of sugar mill levies as a capital contribution**, rather as contribution towards the basket of costs associated with the delivery.

BRIAC requests that SunWater be asked to please explain. The plain English of the Act seems to say the opposite.

Page 6

If the levy were intended to be a capital contribution and result in lower charges for water users, a differential pricing regime would have been established between:

- landholders growing cane under peak assignment;
- landholders growing cane under other assignment; and
- landholders growing crops other than cane.

Why? This seems to be a non-sequitur. A class of people may make general undissected capital contribution in aggregate to a scheme without requiring specific, individual, contractual quid pro quos in each one's charges, but nonetheless expecting as a class - and being led to expect - that capital costs so recouped would not be charged for again.

There has never been a differential pricing regime based on the above. Furthermore, when sugar mill levies were abolished through the Water Reform Unit's price path process, the revenue shortfall (or part thereof) was gathered through all water users rather than those customers growing cane.

BRIAC notes the sugar levies were abolished because of their apparent invalidity as excise taxes contrary to section 90 of the Commonwealth Constitution. BRIAC notes that excessive charges by State statutory authorities may be seen in due course as equally invalid excise taxes upon production.

2. STATE AND FEDERAL FUNDING

“The appropriate approach to regulatory recognition of capital subsidies, depends, largely on the purpose of the grant... In the absence of any specific agreement or

agreed purpose, or evidence to suggest that a particular outcome was intended, the treatment of past and future grants should be at the asset owner's discretion."

BRIAC does not believe it is either economically rational, historically sensible, or just to allow asset owners a free lunch by allowing them to charge for assets which they never paid for. We note that in income tax law, grants are required to be treated as revenue and that asset depreciation is based on actual cost, so that a gifted asset has no cost base for depreciation purposes. If A makes a gift to B for the benefit of C, why should B be allowed to charge C for it?

Consideration is therefore required as to the purpose of the Commonwealth Government grant provided to State for the purpose of developing Burdekin Falls Dam. SunWater has reviewed its records of documentation between the State and Federal Government for the funding of Burdekin Falls Dam, and can find no evidence that the purpose of the Federal Government grant under the *National Water Resources (Financial Assistance) Act 1978* was tied to any particular purpose other than construction of Burdekin Falls Dam and associated infrastructure.

We note that the Federal Government in comments made in Hansard appears to have taken it as given that the purpose of its grant was to promote regional development by helping to establish agricultural industry in the Burdekin. If the cost of a \$430 million scheme could be recouped from some 300 farmers, a grant would hardly have appeared necessary. Just as the Commonwealth does not expect its grants for roads to be charged for again in tolls, so it is reasonable to assert that the Commonwealth assumed regional development would be fostered by its provision of the dam at no cost to the State and irrigation users.

Page 7

Furthermore, SunWater has found no evidence from either State or Federal Government funding that a particular outcome in relation to ongoing water charges was intended in the provision of funding.

Perhaps it goes without saying that no one seriously expected that taxpayer-funded assets would be charged for again?

Further justification for this approach is provided by Australia's system of public finance under which there is a mismatch between the Federal Government's taxing powers and the State Government's spending responsibilities, known as vertical fiscal imbalance. Commonwealth Government grants provide a significant source of funding for all State Government programs.

Really? What has vertical fiscal imbalance got to do with anything? This is a wholly irrelevant consideration and one which is factually inaccurate in any case after the intergovernmental agreement associated with the goods and services tax.

In this light, it can be seen that Commonwealth grants for specific purposes merely form part of the State's overall funding base.

Specific purpose grants are, if we may be pardoned for saying so, for specific purposes. They are not part of a State's general funding base.

Indeed, if the Commonwealth had intended to confer a benefit directly upon particular users or a group of users in a region, it would have arguably chosen a different vehicle to that of State Government funding.

This does not follow. There are potential Constitutional restrictions on Commonwealth grants for matters not within a direct Commonwealth head of power. In any case, States have objected to Commonwealth grants to bodies such as local governments outside the scope of a Federal-State agreement. The fact that the Burdekin grant was processed through a State agreement in no way negates an intention on the part of the Commonwealth to benefit North Queensland through making a gift to the development of the Burdekin scheme.

Note 15 The 1980 Report to Parliament demonstrated to Parliament the robustness of the development proposal in financial terms, including that it would achieve some return on capital. The anticipated return on capital was used to highlight this point, **and was not a desired target for cost recovery.**

We agree. The 1980 Report anticipated much of the return would come from land rents and sales. We note that this concession by SunWater contradicts previous reliance by the Water Reform Unit and others on the 1980 Report to suggest that it justified charging to secure a return on capital.

Page 9

The QCA also noted a general move by Australian regulators to adopt DORC as the preferred method for valuing utility assets, and concluded that DORC should be used for establishing initial asset values for GAWB as it sets a maximum that a sustainable business would achieve in a competitive market.

A DORC valuation is higher often than that of a genuinely competitive market. BRIAC has set out in its first submission several reasons why DORC is inappropriate. We note that our views are shared by Professors Bob Walker and David Johnstone who have advanced similar criticisms of DORC which we expect the QCA to address. We further note that a general move by regulators to adopt DORC does not excuse the QCA from the need to address the arguments put to it by BRIAC on this question.

SunWater agrees with the QCA's approach, noting in addition that DORC has four main characteristics that commend it over other valuation approaches:

it supports operating capability maintenance, in that it allows the company just sufficient funds to maintain its operating capability;

This is not necessary for sunk capital with an infinite life where only renewals annuity and ongoing maintenance expenses are required. It also ignores the possibility of funding of new capital expenditure by debt finance to be amortized by rates over time.

setting DORC in respect of sunk assets reduces the scope for regulatory risk;

Shifting from actual depreciated cost to DORC for existing sunk assets represents a retrospective regulatory cost shock imposed on users.

provides a basis for a valuation of DORC that is compatible with future investment by the infrastructure owner; and

Well, if this is so, how does it come about that investment in the private sector goes ahead without DORC and companies use the normal commercial historical cost accounting conventions?

it provides a basis for prices that avoids inefficient bypass.

A cost which is not so outlandish as to provoke bypass can still impose heavy excess burdens as against once-only recovery of historical cost or optimal short run marginal cost pricing. Even the most grasping monopolist will not price so high as to trigger user bypass and loss of his monopoly, so this is not a particularly economically virtuous criterion for a pricing rule.

3.3. Third Party Assets

The development of the Burdekin scheme included expenditure on a number of assets and items that do not form part of SunWater's asset base. SunWater is of the view that there is an argument for including these expenditures where they were necessary when considering pricing issues. These costs to be considered include the road from Mingela to the Burdekin Falls Dam and the road network servicing the irrigation farms. These assets are now owned by Dalrymple Shire and Burdekin Shire respectively and do not appear in the asset valuation reviewed by Arthur Andersen. It should be noted that SunWater does not believe that Arthur Andersen took a particular view as to whether such assets *should* have been included in the DORC valuation, as their review was limited to assets on SunWater's asset register at the time.

In its previous regulatory decisions, the Authority has recognised that expenditure on assets owned by third parties should be incorporated into the asset base for pricing. For example, in its decision for QR's Access Undertaking, the Authority incorporated an allowance for costs

incurred by QR in altering assets owned by third parties in developing its rail network.

In its draft investigation of pricing practices for the Gladstone Area Water Board, the Authority recommended that relocation costs associated with third party assets (such as rail lines) be included in the asset base.

SunWater submits that the expenditure for the road from Mingela to Burdekin Falls Dam should be included in the asset base for pricing purposes. The expenditure on this road was essential for the construction of the Dam. Similarly, construction to bitumen standard was required to minimise the risk of delay in critical materials to site from adverse weather conditions, and for safety reasons for people living at the construction site. The costs associated with maintaining the road are borne by Dalrymple Shire.

BRIAC is astonished at the lack of logical symmetry (one might be tempted to say hypocrisy) in SunWater's approach here. SunWater wants credit for capital assets it contributed to other parties so it may get a regulated return on those assets, yet stoutly denies the same courtesy to irrigators who seek to have their contributions to its asset base properly recognized. What is good for the goose is sauce for the gander. If SunWater is determined to keep sunk capital contributed by others on its books and charge a rate of return on a DORC valuation, then let SunWater start to pay a dividend to irrigators for the share (at DORC) of its assets they financed! The absurdity of this SunWater argument demonstrates the essential soundness of BRIAC's argument that user-financed or gifted assets or recouped costs should be removed from the regulatory capital base.

In relation to the road network servicing irrigation farms, SunWater believes this expenditure should be accounted for and recognised, but does not form part of the asset base for the purposes of determining an Upper Bound price. These roads were essentially part of the land development and subdivision of farms, and should be viewed as an expense in that context to be offset against proceeds from the sale of land in the scheme.

As noted previously, SunWater is being astonishingly illogical. Why are road costs part of the scheme's capital costs to be recouped through land sales yet the same is not true of irrigation channels etc? Roads and channels were both built to service irrigated farms which are what was sold. The whole irrigation scheme was an integrated land development scheme as recognized by the Queensland Government in its submissions to the IC in 1992.

Page 12

4. WEIGHTED AVERAGE COST OF CAPITAL (WACC) CONSIDERATIONS

BRIAC has rejected the CAPM model in its second submission, to which we refer, along with comments on Appendix Two.

5. FACTORS TO BE CONSIDERED IN DETERMINING THE APPROPRIATENESS OF CHARGING A RATE OF RETURN

One of the most important objectives of the water reform process is to maximise the contribution of water to national income and welfare. This objective involves improving the net social surplus from the water industry's activities:

Short run marginal cost pricing is the rule to maximize social surplus from sunk assets.

in a productive sense – by encouraging efficient practices by water service providers;

Regulatory allowance of inflated capital costs on DORC valuations and cost over-recovery does nothing to stimulate efficiency - rather it imposes monopoly rents as a tax on the export competing productive sectors of the economy.

in an allocative sense – by ensuring water is allocated to its highest value uses; and

This may be seen as patronizingly offensive to farmers. Allocation of water to highest value uses occurs anyway if farmers are rational in choosing their crops. It is not as though farmers do not wish to maximize their returns - BRIA farmers would dearly love to find an alternative high valued irrigated crop to sugar. Further, allocation of water to higher valued uses will also occur with trading of water entitlements. Higher charges for storage and haulage of water does nothing but enrich the monopolist storage and haulage business - at the expense of all water users.

in a dynamic sense – by establishing an environment where new investment in water infrastructure is efficient and value-adding downstream investments are encouraged by the enhanced security afforded by water trading.

How do high charges above actual cost for storage and haulage of water do anything to attract investment in downstream water using industries?

Page 13

“The Authority considers that there is an economic case for, and the public interest is better served by, charging all users who place similar demands on the common infrastructure of the network system similar prices. Any differences between individuals' prices should only reflect differences in their use of the monopoly infrastructure (dams, pipelines and treatment plants) and any commercial differences (eg. quantity demanded, long-term vs. short-term contracts and the like).

Such an approach is consistent with the outcomes in competitive markets, the benchmark against which monopolists' activities are assessed. Furthermore,

the Authority considers that the community's interests are best served by diverting water resources to their highest valued use."

On this basis, BRIA farmers should only be charged on the basis of the proportion of scheme water allocated to them, that is 350/850.

"Water is a resource with few, if any, substitutes and, in any particular region, few alternative economic sources of supply and the community's interests are best served by directing resources to their most valued use."

BRIA cane farmers have no alternative to BRIA water supply. There is a surplus of unused water in the scheme. The real story is about survival now rather than rationing a scarce resource between competing higher valued uses - would that there were!

5.1.1.2. Charges for New Infrastructure

Clause 3(d)(iii) of the 1994 COAG Strategic Framework states in relation to rural water supply:

"That future investment in new schemes or extensions to existing schemes be undertaken only after appraisal indicates it is economically viable and ecologically sustainable."

This was after the Burdekin scheme was set in place. There should be no retrospectivity. In any case, the scheme has more than likely paid its way, as we demonstrated in our first submission, taking into account all external benefits and wet land sales.

Page 14

The National Competition Council has interpreted economic viability to mean that all new rural investments should have the potential to recover all direct costs, namely:

administration, operations and maintenance;

cost of capital;

externalities (e.g. contribution to salinity control programs);

taxes or tax equivalent regimes (TERs); and

provision for asset consumption.

Accordingly, the NCC's interpretation of the COAG 1994 Strategic Framework means that to comply, the services provided by new infrastructure, whether public or private, will be priced at upper bound rates (unless a fully disclosed Community Service Obligation arrangement is established with the service deliverer).

BRIAC has noted in our first submission how the Queensland Treasury scorned the NCC interpretation of economic viability. We also note credit should be given for beneficial externalities such as increased land values and fiscal external benefits.

5.2. Value of the Investment to the Community

The current replacement cost of SunWater's water storage and distribution infrastructure in Queensland is in the vicinity of \$2.7 billion. Accordingly, obtaining an appropriate level of economic benefit for Queensland taxpayers and the Queensland economy through charges, taxation or a mixture of both is a significant issue.

In economics bygones are bygones. The replacement cost of sunk capital in Queensland's irrigation systems is as relevant to pricing today as the cost of rebuilding Roman aqueducts still in use in Europe.

In the Australian context, estimates of the marginal (efficiency) costs of raising taxes have been estimated at approximately 20% of revenue raised. These estimates do not include an allowance for collection and compliance costs associated with the operation of the taxation system which is itself significant.

This argument supports BRIAC's position. The excess burden efficiency costs of taxation are precisely why those costs should not be added to by seeking equity returns on taxpayer-funded assets. A price above short run marginal cost is a tax. Sunk capital assets have no opportunity cost - their SRMC is zero. Narrow excise taxes are generally more distorting than low-rate broad based taxes. It is inefficient to impose selective excises on some 300 BRIA farmers in the guise of SunWater charges.

Footnote 35

Whilst it is true that the Commonwealth Government has been a significant contributor to various schemes, these contributions were paid to the State Government and hence form part of the Queensland Government's historical investment in the infrastructure.

Really? The Australian Taxation Office takes a rather different view to claims for an expenditure as an incurred cost where that expenditure has been recouped through other means (as has been seen in its denial of deductions for recouped costs in many investment schemes).

Page 15

To the extent that the State Budget has a requirement for a given level of revenue from the tax base, the choice of revenue source can affect the economy and the wellbeing of

Queenslanders. In particular, other things being equal, the economic wellbeing of Queenslanders as a whole will be advanced where revenue sources are utilised that impose minimum efficiency costs on the economy.

So why impose an inefficient selective excise tax on some 300 BRIA farmers, by seeking returns on sunk capital with no opportunity cost?

5.3. Need to Promote Competition

Approximately 50% of water utilised for consumptive purposes in this State is sourced using privately funded infrastructure – whether from bores or private dams used to harvest water under licence.

Any investment in privately funded infrastructure will be undertaken on the basis of securing an adequate return on the investment, after consideration of any subsidies for such infrastructure investment from Government. Accordingly, to the extent that infrastructure charges for one class of infrastructure do not incorporate such a return (after accounting for any explicit subsidies for private development), competition both in relation to the provision of infrastructure (as between public and private) as well as in downstream industries reliant upon water could be distorted.

SunWater believes that the QCA should have regard to the promotion of competition between private and public sources of water storage and distribution infrastructure as well as downstream industries reliant upon water in the context of charges for State-owned water assets.

Strange to say, some farmers in the Burdekin did want to set up private irrigation schemes. Yet the Queensland Government created a monopoly irrigation scheme with forcible land resumptions on the basis that this was a situation where normal market forces would lead to inefficiently small irrigation development. It saw the scheme as a natural monopoly, where a large scale development would allow many farms and deny windfall profits to a few larger farmers. Rightly or wrongly, that decision has been made. If the monopoly supplier can now supply foreseeable demand in the Burdekin more cheaply than any alternative, it is socially optimal that it do so at SRMC, rather than price above SRMC to induce unnecessary private sector investment. That would be a social waste like the Telstra-Optus dual cabling fiasco rightly denounced by Professor John Quiggin.

5.4. Protection of Consumers from Abuses of Monopoly Power and the Legitimate Business Interests of Users and Potential Users

5.4.1. Protection of Consumers From Abuses of Monopoly Power

In its draft report for the GAWB, the QCA indicated that the prices that would be expected to prevail in a competitive market were sufficient to protect the interests of consumers from abuses of monopoly power. These prices were set at a level consistent with the earning of a commercial return on an asset base determined in accordance with the DORC methodology.

SunWater believes that these considerations are also relevant to a consideration of the charges for the use of water storage and distribution infrastructure.

BRIAC considers pricing based on a DORC-valued asset base above net unrecovered depreciated actual cost is an abuse of monopoly power.

5.4.2. Legitimate Business Interests of Users and Potential Users

In practice, there are many factors that will influence the price paid in the market for a TWE and land use decisions regarding production. These factors are similar to those that determined the market price for land when water allocations were not separable from the land. One factor amidst many that is likely to affect business decisions by landholders relates to expectations about future infrastructure charges.

SunWater believes that the QCA should have regard to the desirability of certainty of future infrastructure charges for water users.

BRIAC considers water users are entitled to expect prices will be set on the basis of efficient unrecovered costs and SRMC wherever possible, not on hypothetical replacement costs.

Page 16

5.5. Legitimate Business Interests of Water Provider

The QCA, in its draft decision on the assessment of QR's draft undertaking provided the following guidance as to the interpretation of QR's legitimate business interests:³⁸

"The QCA's consideration of QR's legitimate business interests took account of QR's obligations to its shareholder, the Queensland Government, in relation to its financial performance. This included the need for QR to recover the efficient costs incurred in providing services over the expected lives of the assets employed and to earn a risk-adjusted rate of return on the value of those assets. Some of QR's financial obligations take the form of specific financial requirements, such as rate of return targets and prescribed dividend-payment ratios."

BRIAC believes it is absurd to treat a government as a shareholder when it has no cost of raising equity capital. All of SunWater's assets have been financed from taxpayer and irrigator funds. To take someone's money by force of law and then charge a return on the assets acquired with that money might be seen as double dipping.

5.6. Efficient Cost, Rate of Return and Inflation

SunWater notes that the effect of inflation is specifically factored into the QCA's methodology for ensuring revenue adequacy. SunWater also notes that efficient lower bound costs were addressed by the Water Reform Unit in developing price paths for rural irrigation

water. These elements must underpin any determination on rate of return issues.

Why? BRIAC notes that cane farmers cannot index the world sugar price to their satisfaction! What competitive industry can really index its future revenues?

5.7. Impact on the Environment and Demand Management

Infrastructure charges represent the cash cost of water to a user. As such, infrastructure costs may influence the incentives of users to pursue measures that improve water efficiency. SunWater believes that the QCA should have regard to the capacity of infrastructure charges to encourage water efficiency in considering future infrastructure charges for water users.

BRIAC suggests farmers have every incentive to maximize their net revenue by allocating water to its highest valued use. Restricting water use in a scheme where there is a surplus is not optimal economic policy. Nor is economic efficiency promoted within SunWater by granting monopoly infrastructure owners regulated revenue streams above their actual or efficient costs.

Page 17

5.8. Social Welfare and Equity Considerations

The way in which distributional objectives are pursued, whether through direct measures such as income support or through subsidised infrastructure charging, may materially affect efficient resource allocation and consequently economic wellbeing. Distortions to production and consumption may affect the capacity of the economy to achieve equity objectives being maximised. The Industry Commission (now Productivity Commission), explains:

“... the pursuit of economic efficiency is not an end in itself but a means to achieving a more productive economy. This means a greater capacity to do more about social justice, to alleviate poverty and disadvantage through income transfer payments and welfare services and to pursue other community objectives.”

BRIAC's submissions are based on both efficiency (the optimality of SRMC) and equity (unjust enrichment, anti-retrospectivity) grounds. "Equity" does not always mean "redistribution" or "handouts". We do not seek a subsidy - simply a recognition that we should not be forced to pay twice over for previously recouped or non-existent capital costs. Given the current crisis in the sugar industry, and our excessive past contributions we consider it would even be fair and equitable to grant BRIA farmers a refund or a water charges holiday in recognition of past excessive charges.

5.9. Socially Desirable Investment or Innovation

Page 18

5.10. Economic and Regional Development Issues

SunWater notes the QCA's comments in relation to economic and regional development issues made in the context of the GAWB:

"In addition, the Authority concluded that prices differentiated between existing and new users are potentially inconsistent with other matters which the Authority is required to consider under the QCA Act 1997. In particular, the application of differential pricing between existing and new users may have a detrimental impact on regional development to the extent that higher prices for new users would deter investments in the region in the future (when costs are expected to rise)."

SunWater believes that the QCA should have regard to these factors in the context of economic and regional development issues associated with setting prices for the use of its storage and distribution infrastructure.

BRIAC notes that there is already discriminatory pricing within the Burdekin scheme. Regional development is certainly not being assisted by water storage and haulage charges which are in excess of efficient SRMC costs. This is illustrated by the failure of the scheme to reach its full potential. Only the adoption of SRMC pricing principles and the abandonment of self-defeating attempts at cost over-recovery can ensure the scheme produces its maximum benefit for regional development.

ANNOTATED SUNWATER SUBMISSION - APPENDIX ONE
UNBUNDLING AND TRADEABLE WATER ENTITLEMENTS

General Comments

BRIAC notes that this Appendix appears to have limited relevance to the terms of reference of the QCA inquiry. It appears to be an a priori set piece of theoretical economic reasoning which overlooks certain key facts which distinguish the Burdekin scheme from other irrigation schemes; for example, that there is excess unallocated water in the Burdekin scheme and that North Queensland is not a dry inland area.

The central thesis of this appendix appears to be that excessive charges for the use of water storage infrastructure do not matter because irrigators will have a valuable asset in the form of a tradeable water entitlements in any event. Without the storage infrastructure, water entitlements would not exist and therefore irrigators should not complain about what they are charged.

Such a thesis is both commercial and economic nonsense.

From a commercial point of view, it is like saying that without the invention of barbed wire or the railway, agriculture would not have been possible in the American West and therefore American farmers should not have worried about railway rates or the cost of fencing their properties.

From the point of view economic theory, the argument implies that Ricardian resource rent should be treated as a return to capital or that the marginal productivity theory for dividing factor returns between land labour and capital is pointless. Orthodox neoclassical economics does not accept resource rents are a return to capital investment. If that were so, there would be no theoretical basis for resource rent taxes and one would never observe a price being paid for bare land or mining leases.

The plain fact is that the value of irrigators' water entitlements, whether traded or used on their own farms, is adversely affected by excessive charges for water storage infrastructure.

What is being argued for is a transfer of resource rents from irrigators as owners of water entitlements (which in many cases can be traced to pre-existing riparian rights) to monopoly rents to be levied by SunWater.

BRIAC sees no logical reason for the QCA to condone such an arbitrary asset expropriation, especially since its effect would be to diminish the total value of the water resource to the general community.

Specific Comments

Page 4

1 Introduction

The creation of tradeable water entitlements (TWEs), and with it, water markets, brings several significant economic benefits. **The most significant of these economic benefits is the more productive allocation of water.** The normal operation of the market will typically result in those users whose use of water has the highest marginal productivity securing TWEs on account of their preparedness to pay more for it.

This statement assumes that the existing owners of water entitlements, such as irrigators, have no interest in using it for the highest valued crop they can. An asset does not need to be traded to be put to its highest valued use, if its owner is rational.

.....

Accordingly, the process of trading in TWEs will enhance economic output and encourage socially desirable investment in industrial and agricultural as well as downstream commercial enterprises.

Moreover, those who hold TWEs but whose use of water is relatively less productive will benefit to the extent that they are able to sell their entitlements to others if doing so leaves them better off. **Of course, sellers will only relinquish their TWEs if the sale price is higher than their own valuation of the TWE.**

Given the current prices for sugar cane, BRIA farmers would be pleased for NECG to advise them of higher valued uses for their water for which they could either use their water entitlements themselves or sell their water to some other party.

Accordingly, the creation of TWEs overcomes the distortions that arise where holders of water allocations do not pay a market value for their allocation.

"Do" not pay or "did" not pay? BRIA water allocations were purchased at auction.

This is especially the case in **the previous environment where infrastructure charges were set at below incremental costs.** In such an environment, entitlement holders had strong incentives to use available water allocations irrespective of the productivity of that use.

The statement that infrastructure charges were set below incremental costs is asserted but not proved. It is wrong. BRIA irrigators take offence at the doctrinaire armchair suggestions that they did not pay the market value for the infrastructure that was provided or that they are so economically illiterate as not to be looking at all times for the most

productive use of their land and water.

Page 6

2 Role of storage infrastructure

2.1 Comparison with electricity or gas

Typically, regulated infrastructure, such as gas and electricity transmission and distribution facilities, provides a physical connection and as such is involved in the delivery of gas or electricity. Notice that the production and sale of the commodity that is conveyed through this infrastructure (be it electricity generation or gas extraction and processing) is generally unregulated.

In the water industry, the main transportation mechanism is provided by the existing river system. In some cases, channels have been constructed providing for the reticulation of water to irrigation farms. **Whilst the channel infrastructure performs a role analogous to electricity distribution infrastructure, it is the storage infrastructure that distinguishes water from other infrastructure industries.**

This is because the storage infrastructure, which will be the subject of economic regulation, is inextricably connected with the creation of the underlying product, the TWE, which is itself tradeable in a competitive market.

Is there really an economic difference between building a dam to harvest water, sinking a bore to pump water or drilling to extract oil or gas? In each case, capital investment is applied to unlock the latent value of a natural resource. In each case, the resource would be useless or non-existent with the capital investment but that in no way means the capital supplier can appropriate the entire value of the unlocked resource as a return to capital. BRIAC further notes that the dam in this case cost the Queensland Government precisely nothing.

Footnote 1

It is true that rivers are able to provide water for consumptive uses in the absence of storage infrastructure. However, if this were to occur, it would be almost impossible to accomplish development on the scale that occurs in the case of regulated streams. For example, it would be necessary for individual users to either individually or collectively build storage infrastructure and take water at designated times when environmental flows would not be compromised. The construction of this storage infrastructure would not benefit from the scale economies and natural locational advantages that exist for on-stream storage infrastructure. Moreover, such infrastructure would also involve significantly higher operating (and transaction) costs due to the complexities associated with regulating the harvesting of water from the river by numerous entitlement holders whilst constantly monitoring the flow of water in the river. In practice, these complexities would complicate water entitlement trading.

Pre-existing riparian rights were an important issue in the Burdekin, a river with significant and reliable annual flows. Where someone held riparian rights he may well argue that he has gained nothing much from a scheme water entitlement, so why should he pay the storage infrastructure supplier anything for it? This argument was relevant to the North and South Burdekin Water Boards, inter alios. Second, we note that this footnote implies the cost of ring tanks should set an upper bound to pricing in terms of bypass.

Page 7

2.2 Economic role of storage infrastructure

The regulation of natural river flow by water storage infrastructure **does not “create” water** but does create a set of water allocations which have more desirable attributes than allocations in unregulated rivers. ..

Precisely. Building a dam to catch water no more creates water than a fishing boat creates fish. In neither case, should the capital supplier expect to appropriate a resource rent as a return to capital. The values of a fishing licence or a water allocation are separate from the cost of the boat or dam.

.....

Footnote 2

Other benefits from water infrastructure **include recreational benefits and flood mitigation.**

BRIAC notes that these admitted external benefits should be credited against scheme costs charged to BRIA irrigators.

Page 8

.....

Accordingly, TWEs provide a form of insurance to water users as well as allowing users to optimise their water consumption patterns. The availability of this “insurance” encourages greater investment in downstream uses, and is no doing, tends to increase the value of TWEs.

While “insurance” may not be the best word to use at the present time, BRIAC does not disagree with the theoretical proposition that TWEs can be a good thing for flexible use of water allocations. However, BRIAC does not understand what this has to do with water storage and haulage charges levied by SunWater. The water allocations already belong to BRIA farmers and others.

....

However, it should be noted that a trading regime may operate in isolation of the existence of storage infrastructure. For example, the *Water Act 2000* (the Act) recognises the capacity for water harvesting rights and unregulated flow entitlements to be traded.

Precisely. So why should the existence of TWEs have any relevance to SunWater's storage and haulage charges? The dam cost the State nothing. The subtext of all this discussion seems to be that, regardless of its zero cost, ownership of the dam by SunWater ipso facto entitles SunWater to charge so much for its storage services as to expropriate the whole value of all water allocations - since these would not exist without the dam.

Page 10

3 Unbundling

The creation of tradeable rights associated with water entitlements necessitates the unbundling of complementary products, being the TWEs, from the associated infrastructure services that underpin the value ascribed to a TWE in the market. **Indeed, it is not even necessary for there to be infrastructure associated with an underlying water entitlement for that right to be traded.** For example, in the case of harvesting rights, the Act recognises the scope for trading to occur even in the absence of the existence of any storage or distribution infrastructure.

See previous comment.

The definition and realignment of property rights associated with the various inputs that were previously "bundled" has formed part of the reform processes in all of the infrastructure industries. In the context of the water industry, a TWE represents the right to a share in the available water from a storage facility and for that entitlement to be traded in the market.

In order for such an environment to operate effectively, it is critical that there be a separation between the TWE and the associated infrastructure charges. This is recognised in the Water Reform Unit's price paths. Notice, however, that the change that has occurred with the water reform process is less dramatic than some of the other industries (such as electricity).

For example, the separation between the water allocation (or entitlement) itself (being the right to take a quantity of water in a certain time, whether expressed as an allocation or a TWE) and the underlying provision of infrastructure has always existed in the Burdekin region (and, as noted above, complementary infrastructure services are not necessary for equivalent rights to be traded).

In the case of the Burdekin, the original sale of water allocations took place against a backdrop of separately determined water infrastructure charges. Hence, the concept of

unbundling existed even in the context of these original allocations. The nature of the property rights that were specified as part of that process involved the water allocation forming effectively “part of the land”.

Precisely. BRIA farmers have paid for their water rights as part of buying irrigated land. They own their water entitlements and are complaining that a monopolist which has recouped in land sales or been granted free the costs of its infrastructure has been charging them excessive prices for storage and haulage of their water. BRIAC also notes an apparent inconsistency between the argument in this Appendix that TWEs only exist because of the storage infrastructure and SunWater’s main submission that farmers paid for water rights but not for infrastructure. BRIAC’s view is that farmers paid for both, just as a suburban homebuyer pays one lump sum covering a land developer’s unimproved land value costs plus water, drainage, electricity, road servicing costs etc..

Page 11

.....

Indeed, the water reforms associated with the creation of TWEs have materially increased the value of the original water allocations because it substantially enhances the prospect of water being applied to higher value uses. At the same time, these reforms ought to increase the (unbundled) value of the land to which the water was previously attached, as a better allocation of water makes land more productive.

BRIAC finds these statements somewhat bizarre. First, are farmers so silly they would not already be using or leasing their land for higher valued uses than growing sugar cane, if there were any such uses? Second, if land is worth more denuded of water rights than with, why was the Burdekin scheme built?

For example, the value of the original water allocations purchased in the Burdekin can be expected to increase by virtue of the conferral of a right to trade those entitlements under the *Water Act 2000*. This is because the right to trade (be it to sell or purchase TWEs) can be expected to change the nature of water use in the region and with it the marginal productivity of water, and, in turn, the value of a TWE. This can be expected to become increasingly clear over time as the market evolves.

NCEG seem not to be aware that there is a surplus of unallocated water in the Burdekin scheme and therefore one might assume the marginal value of a new water entitlement should be zero. The Burdekin is not the same as Murray-Darling schemes where there is a scarcity rent for water.

A corollary of unbundling is that the market will determine the transfer price for a TWE between a buyer and a seller. In such an environment, a range of factors will determine that

transfer price (which are discussed in the following section). **It should therefore be noted that the charges for the use of storage and distribution infrastructure will only be one factor that affects the value of a TWE.**

But a crucial factor. Indeed, high water storage and haulage charges can destroy the entire value of TWEs and sterilize the whole value of the scheme by making it unprofitable for anyone to use!

Page 12

4 The value of water entitlements

The price that is paid for a TWE will be a reflection of supply and demand for TWEs in the competitive market. The following are the most significant factors affecting the market value of a water entitlement:

.....

It is strange no mention is made of the cost of exercising the TWE. Yet high infrastructure charges can diminish the value of natural resources or even render them worthless.

Page 13

4.2 Returns from the TWE

Just as is the case for any share, there are two distinct sources of return from a TWE:

\$ **yield** from the TWE over the period (equivalent to a dividend in the current year); and

\$ **growth** in the capital value of the TWE over time (equivalent to growth in the value of the share in future years).

BRIAC notes that SunWater is here displaying a remarkably irrational inconsistency. SunWater argues here for capital gains on TWEs to be treated as returns to irrigators holding water entitlements, yet it refuses to treat revaluations of its own assets as income in its own accounts to be taken into account for the purpose of looking at regulated returns. This is the same fundamental inconsistency as applying the CAPM (total returns) model to a regulatory regime where revaluations are excluded from the business income statement.

4.2.1 Yield within the period

.....

Over time, the nature of commercial activity in a region will adapt to the availability of reliable water (so that new investment will increasingly seek to exploit higher value opportunities for the water).

As both owners and users of water entitlements, BRIA farmers would be grateful if SunWater and NECG could interrupt this a priori theorizing for a moment and please tell BRIA farmers what are these high valued uses which would service their water storage and haulage charges and their mortgage payments? BRIA farmers have a very keen interest in gaining a return on their assets and would be happy to do so. What they find obnoxious is the idea that SunWater should be guaranteed a monopolist's return on its assets which it did not pay for or the cost of which has been recouped already while BRIA farmers are left staring at their assets which cannot generate any sort of a decent return on the millions they have personally invested.

Page 15

....

Table 4.1 Gross margins for a cross section of irrigated crops

.....

It should be noted however that the gross margins represented in table 4.1 **do not provide any allowance for the costs of on-farm infrastructure associated with the production of a crop**, including additional distribution works, development costs of crop establishment and on farm infrastructure. In practice, a major factor in the cost of production concerns the existence of this infrastructure to support the application of water.

How are these crops relevant to BRIA farmers and what are relevant net margins? Nothing here shows any latent capacity of BRIA farmers to pay water charges with embedded monopoly rents to SunWater because of some magical crop with hidden high net margins. Even if there were such a crop to rescue BRIA farmers from low sugar prices, the resource rents should belong to BRIA farmers as resource holders and not be diminished through counter-productive attempts at expropriation by an overcharging infrastructure monopolist. If resource rents are to be taxed, there should be a general land and resource tax on all Queenslanders, not inefficient and discriminatory infrastructure charges which operate as selective excise taxes against cane farmers trying to compete on world markets

Page 16

.....

In regions of Australia where tradeable water entitlements are well established, the pattern has consistently seen market values rise over time, in some cases, substantially. This is

indicated by figure 4.1 which illustrates the trading range and closing values of water entitlements in selected valleys of New South Wales over the last 3 years.

This is totally irrelevant to the Burdekin. The rising values may reflect infrastructure withdrawal or stinting of irrigation in favour of environmental flows or scarcity rents in the Murray-Darling basin. The Burdekin has a different climate, being in the North Queensland cyclone zone. The existence of unallocated water in the Burdekin scheme belies the notion that TWEs are some manna from heaven which will make up for BRIA farmers in property speculation profits what they are losing on their investments in their farms. There is no magic game of "pass the parcel" to the next mug investor, make your profits on TWEs and get out.

Page 17

The figures reported in the press by George Megalogenis relate to dry climates, as do the NCC's, and are quite irrelevant to the Burdekin.

Footnote 10

Or in economic terms, future expectations from the quasi-rent from scarcity values.

Scarcity rents are not desirable in themselves - most people do not applaud the OPEC cartel's attempts to maximize their oil rents through limits on supply. Competition and economic development policies should be about maximizing abundance and cheapness of output, not the creation of rents through artificial scarcity, where it is otherwise feasible to augment infrastructure use or supply. Other countries compete to expand cane production and their incomes, nor do they count it a blessing if they have a diminishing pool of producers able to pay higher and higher scarcity rents for critical inputs such as water.

Page 19

4.4 Income

Income affects the value of a TWE in several ways. The capacity of a user to separate ownership of land from the ownership of a water entitlement creates a wealth effect. This is because the ability to separate and transfer a water entitlement whilst retaining ownership of land increases the wealth of the holders of TWEs. All other things being equal, the greater the income of those seeking TWEs, the higher the likely price of TWEs.

This may be as naive as those people who thought demutualization of insurance companies such as the NRMA and AMP produced costless "unlocking the wealth" effects and now wonder why insurance is more expensive after a portion of revenues is diverted away from premium pools to pay dividends. You cannot have your cake and eat it too.

Taking water away from irrigated land may render the land worthless. Unless there is a shortage of available Burdekin water and uses sought by others valued more highly than growing cane, it is hard to see how TWEs can make BRIA farmers wealthy.

Another factor concerns the impact of infrastructure charges affecting the behaviour of the holder of an entitlement B for example, **the introduction of cost reflective infrastructure charges is likely to have the impact of water efficiency on farms B encouraging the more efficient use of water. In addition, income effects associated with higher infrastructure charges may well have the effect of encouraging water users to attempt to apply available water to higher value uses.**

These comments are disturbing for several reasons. First, it seems to be assumed (without any proof) that BRIA farmers are being under-charged for water storage and haulage. Second, it assumes incorrectly that efficiency in water use equates to less use of water as an end in itself, even if there is no marginal cost to more supply and there is surplus water in the dam. Third, it assumes owners of water entitlements are so foolish as to have no interest in higher valued uses for their water apart from that stimulated by the lash of exorbitant storage and haulage charges - a sort of Cromwellian economic puritanism which insists that Adam Smith's invisible hand does not work without the hard slap of government-decreed prices (an approach which might have found favour in the former Soviet bloc).

4.5 Scarcity

The physical limit of water availability and the need for environmental flow requirements to be observed in river systems impose a constraint on the amount of water that may be extracted for consumptive uses. This means that the supply (or availability) of TWEs is effectively fixed (or inelastic) and can be contrasted with most other markets where supply is itself responsive to price. Here it is largely fixed.

This constraint is critical to the assessment of market prices for TWEs as it will ultimately exert enormous influence on the market price of TWEs. This is because **the limited availability of water results in more marginal water users being displaced by others who can apply the limited amount of available water to higher value uses.**

But, as noted above, the Burdekin scheme has an excess of unallocated water. That water has now been vested by the State in SunWater, creating an apparent conflict of interest. Is SunWater now to behave like the historic De Beers diamond monopoly and control the price of water by locking up the surplus and keeping it off the market?

5 Role of scarcity values

There is a critical difference between water infrastructure and the other regulated infrastructure industries. Prices for the services provided by electricity and gas transmission and distribution infrastructure are typically regulated at prices that equate to the SCARM upper bound. Prices for the underlying commodity are set in a competitive market.

In the case of water and TWEs, it is the regulated infrastructure that creates the commodity (being the TWE) that is traded in a competitive market. As such, the value of the TWE in the market and the charges that are levied by the infrastructure provider are inextricably linked. This does not occur in the other markets involving regulated infrastructure.

Really? High charges for services of the capital sunk in infrastructure always affects resource rent valuations. Water storage and haulage infrastructure is not unique. How much would the value of the Mt Isa mine leases be worth if Queensland Rail increased its haulage charges to Townsville fivefold? Few farms in rural Australia would have any value at all if governments charged \$1 million per ton to move freight by rail, but does anyone see that as a reason for governments to charge exorbitant rail rates?

This linkage between the value of TWEs and infrastructure charges highlights a further issue that is unique to the water industry **B to the extent that infrastructure charges are below upper bound prices, there will be a transfer from the infrastructure provider to the holders of the TWEs.**

Or vice versa, where, as in the Burdekin, the holders of TWEs have already more than paid their fair share of infrastructure costs and this is not recognized. The proof of the pudding is in the eating. How may BRIA farmers can now re-sell their farms at a profit over what they paid, allowing for the time value of money and their additional on-farm investment? If there has been a wealth transfer to them, BRIA farmers are unable to see it.

The extent of this transfer will be equivalent to the capitalised value of the discount from the upper bound infrastructure charge (so long as the discount rate for the infrastructure provider and the holder of the TWE are equivalent). **Moreover, the capital value of this transfer is equivalent to the diminution of the infrastructure provider's asset base (relative to that which would be consistent with upper bound pricing).**

Nonsense. This ignores what has been contributed already towards paying for the infrastructure owner's asset (not "provider" - the provider was the taxpayer along with farmers). The diminution has been in the asset value of BRIA irrigators' farms.

A situation where the value of a TWE is positive with upper bound infrastructure charges applying suggests the existence of scarcity rents.

But a scarcity may be manufactured (as historically in the OPEC oil and De Beers diamond cases). The Burdekin has unallocated water which implies excess supply rather than excess demand.

This in turn suggests that the economic rent that arises from resource scarcity in water markets belongs with the licence to create TWEs which would normally be secured through the right to construct the water storage infrastructure. This is clearly seen when considered in the context of new infrastructure B to the extent that scarcity rents exist, **Governments, as grantors of the resource licence, are well placed to extract these rents when the infrastructure is first established (for example by tendering the right to build the storage infrastructure and sell the TWEs it creates).**

Which the Queensland Government did by selling land and water allocations in the Burdekin auctions to fund the infrastructure. What is being attempted now is a "double dip" by trying to re-define what irrigators paid for.

For existing storage facilities, scarcity rents will accrue to those who secure TWEs. It is submitted that in such a case there is no case for intervention B to do so would simply distort the market for TWEs. ...

Yes, the Burdekin is an existing storage which has already been paid for - unlike many - by an open auction process. So there is no case for intervention to set bogus "cost recovery" target prices to recover costs already recouped or never incurred.

....

Page 22

.....

Alternatively, a tax equivalent to the estimated scarcity rent could be levied on holders of TWEs. Where it is applied to all users, it results in a situation where holders of TWEs are taxed on an asset that they have acquired. It would also distort the trading in TWEs in the future B ultimately it could be expected to have the equivalent effect to requiring trades to occur at a zero price. **Again, where a tax is levied on a single market participant (such as the infrastructure owner) there will be, in addition to this retrospectivity, an additional distortion induced into the market.**

This is precisely what SunWater's excessive charges amount to - a selective disguised tax on Burdekin sugar cane growers, who have already paid for their water entitlements and are facing adverse world sugar prices. It is like charging heavily mortgaged suburban homebuyers again for the water pipes they paid for when they bought their blocks 10 years ago - at a time when they face retrenchment from downsizing corporations.

Accordingly, there would appear to be no case for regulatory intervention in relation to the possible existence of scarcity rents secured in association with the holding of TWEs.

But the gazetted price paths do represent regulatory intervention only partially

restraining a government-owned monopoly company.

The existence and, in turn, the ability of market participants to internalise scarcity rents is ultimately critical to the accomplishment of the objectives of establishing TWEs, being the efficient allocation of scarce water resources. **Equally fundamental to the accomplishment of these goals is the unbundling of the infrastructure charges from the TWEs.**

But not at inflated infrastructure charges.

ANNOTATED SUNWATER SUBMISSION - APPENDIX TWO

WEIGHTED AVERAGE COST OF CAPITAL

General Comments

As stressed in our second submission, BRIAC rejects completely the relevance of private finance CAPM pricing models to derive a so-called weighted average cost of capital for public finance projects where the funds are tax financed, not equity. We note that some of our criticisms are shared by experts such as Professor Bob Walker and Professor John Quiggin. Our specific comments below illustrate some of the inconsistencies created by trying to apply a CAPM model to a public sector project. In BRIAC's view what is required is not a hypothetical cost of capital, but the actual cost of any borrowed funds not since recouped or repaid. If a project has been built, the capital has been sunk and the cost was financed by taxes or grants and all debts have been paid off, then the cost of capital is, in truth, zero.

The only rational economic reason for using a private sector CAPM pricing model to determine SunWater's permitted charges would be if it is the State Government's intention to float SunWater as a public listed company enjoying a statutory monopoly franchise. It is disturbing to us, for example, that this Appendix speaks of hypothetical foreign equity investors. We note the sale of South Australian infrastructure assets to overseas billionaires. In our view, SunWater's capital costs should be dealt with on the basis of actual historical unrecovered costs and not manipulated on a hypothetical basis to attract an "investment" (more accurately, takeover) by foreign investors anxious to make profits at the expense of those BRIA farmers who contributed so much to the building of the Burdekin scheme in the first place.

Specific Comments

Page 5

When adopting a conservative bias to each of the parameters, the nominal **post-tax** "vanilla" WACC for SunWater as of 1 March 2002 is estimated to be 9.85% based on:

- \$ risk free rate based on the 20-day average yield on 10 year Commonwealth bonds;
- \$ **market risk premium (MRP)** of 6.5%;

There should be no allowance for taxes for a tax-exempt asset owner nor a market risk premium for a government asset owner which has funded its assets by grants or taxes. The only possible capital cost is the actual interest rate on any earmarked, undischarged, project loans.

Page 6

2 Non-contentious matters

In developing its submission, SunWater considers that the following issues are not contentious:

- \$ application of the weighted average cost of capital to be determined by **applying the capital asset pricing model (CAPM)**;
- \$ the WACC and the underlying cash flows to be based on a **post tax** nominal basis;
- \$ the **risk free rate** being determined on the basis of the 10 year Commonwealth bond rate with that rate being determined on the basis of the 20 day average yield.

These are all highly contentious issues. The private sector CAPM model does not make sense for a sunk, taxpayer-funded, public works investment. It does not make sense to ignore the tax-exempt status of an asset owner. Nor does it make sense to add a risk premium to actual borrowing costs.

Page 7

The market risk premium ("MRP") is the amount that an investor **expects to earn from a well diversified market portfolio** above the return that can be earned on a risk free investment.

Note that this means capital gains are treated as part of total return on investment (ROI). It also means returns of capital (eg as in property trusts) are taken into account in looking at return on investment (ROI). So why has SunWater not included its nominal revaluation gains in its business income statements? Why has SunWater not shown land and water sales as returns of capital? You cannot rationally plead for charges based on a cost of capital made up of components, type A, type B and type C, and then turn around and say only type A will be recognized as a return in your accounts. (Of course, there is no cost of "equity capital" for SunWater in any case.)

Page 9

The mean *ex post* MRP as measured **on the basis of stock market returns** appears to have been lower in the last decade than in previous decades.

See previous comment.

Page 12

During this year the shareholders will realise a return by dividend of \$100,000 **but a loss of value of the investment of \$9,901** (\$1,000,000 - \$990,099) for a net return of \$90,099 on the investment of \$1,000,000.

Again this confirms the lack of logic of SunWater's not declaring its nominal revaluation gains in its business income statements.

Page 15

Moreover, in a competitive market, marginal investors set security prices. For reasons set out in section 5 below, the **marginal investor in the Australian stock market is most likely to be an overseas investor**. It is therefore this shareholder group that is most likely to influence the *ex ante* MRP.

If there is a scheme to sell the Burdekin to a foreign investor, we should like to be apprised of the details, so as to defend our prior interest. If not, and it is to be retained as a publicly owned utility, the returns demanded by foreign investors from Australian shares are neither here nor there.

Page 16

There are no statistically robust estimates to support the proposition that the introduction of the dividend imputation system has resulted in a lower MRP. This was stated by the QCA in Appendix C of Working Paper 4:

There is no conclusive empirical evidence to support the argument that dividend imputation has had a systematic effect on the market risk premium in recent years.

These findings are not surprising. In a small open economy such as Australia, **international investors are likely to be the price setting investors**. As a result, domestic tax changes are likely to have little or no impact on the overall MRP, given that imputation credits have little or no value to international investors.

See previous comment. As points of technical correction, we also note that any competently advised foreign investor would seek to ensure franking credits were used domestically. We further note that franked dividends were made exempt from dividend withholding tax. But, stepping back, why is any of this relevant to a tax-exempt asset owner anyway?

Pages 18-19

The regulatory consequences of setting too low a MRP/WACC in the form of insufficient investment are greater than those of setting too high a WACC (short run super-normal profits), a point noted by the Productivity Commission.

The possible disincentives for investment in essential infrastructure services are the main concern. In essence, third party access over the longer term is only possible if there is investment to make these services available on a continuing basis. Such investment may be threatened if inappropriate provision of access, or regulated terms and conditions of

access, lead to insufficient returns for facility owners.

While the denial or monopoly pricing of access also impose costs on the community (see above), they do not threaten the continued availability of the essential services concerned. Thus, over the longer term, the costs of inappropriate intervention in this area are likely to be greater than the costs of not intervening when action is warranted. The substantial information and other difficulties that confront regulators in establishing access terms and conditions, make this asymmetry in the benefits and costs of access regulation even more important in a policy context.

We note that the argument that access regulation deters investment was roundly criticized in submissions to the Productivity Commission and it was exposed as a false antithesis to argue that monopoly rents should be tolerated as the price of infrastructure provision. Yet SunWater seems to be arguing on these lines by apparently implying that the quid pro quo for farmers' tradeable water entitlements should be higher than optimal prices payable by farmers to SunWater on sunk water storage and haulage infrastructure assets.

Page 26-28

it is submitted that the critical issue for resolution of the WACC, and with it the asset beta for SunWater is to attract capital to the sector for new investment. (Page 26)

.....

a relatively high asset beta is appropriate, mainly on account of the operating leverage and pricing risk that would be present were SunWater able to price the provision of its water infrastructure services in a manner that is consistent with the attraction of capital for new investment. (Page 28)

But this inquiry is not looking at the pricing of new investment! The Burdekin scheme has been built as a great publicly funded work, no private equity capital was involved, the capital has been sunk and there is no need for new investment since there is unallocated water in the dam. When, and if, new investment is required, then the questions of debt, equity or hybrid security or rate or land sales funding can be discussed but there is no logical reason to charge here and now more than optimal short run marginal cost on assets which already exist and which have been paid for.

Page 28

Currently, SunWater has no net debt.

In which case its Burdekin loans must have been paid off and its cost of debt is zero. As it also has no cost of equity capital (being given taxpayer financed assets), the WACC reduces to zero.

Accordingly, it is recommended that it be assumed that SunWater's capital structure be based on its current capital structure B i.e. be assumed to be 100% equity.

We note there is no such thing as "equity capital" raised by governments and this "100% equity" argument seems something of a ploy to maximize the revenue base on which to apply the hypothetical "market risk premium". However, note the elasticity of argumentation. When it suits, appeal is made to a hypothetical (foreign) investor in a hypothetical SunWater Corporation floated on the Australian Stock Exchange and no attention is paid to SunWater's actual tax-exempt government owner. But here appeal is made to SunWater's actual capital structure. In BRIAC's view such illogical shifts in reasoning show that in abandoning an examination of actual unrecouped Burdekin capital costs and embarking upon ahistorical a priori CAPM hypothesizing, one is left at sea without rudder or compass.

The market value of distributed franking credits **should be established at the market level, not the firm level. So for regulatory purposes, current shareholding should be irrelevant.** Therefore, we agree in principle with the QCA where it did not take into account the ownership structure of GAWB. Similarly, the gamma for SunWater should not be based on its current ownership structure.

Why? Franking credits could be used by a well informed private sector owner. Indeed, a properly-advised tax-exempt charitable or government owner would have set up SunWater as a trust (like the Queensland Coal Trust) and no corporate tax would be payable. Why should users be charged for tax costs which would not be incurred by a private owner and are not payable by government owner?

For publicly listed Australian companies, the marginal investor is likely to be an international investor. It is therefore clear that foreign investors exert substantial influence on Australian stock market prices. Indeed, once it is recognised that Australia is a net importer of capital and that Australian equities represent approximately 1% of the global market, it is difficult to avoid the conclusion that **the marginal shareholder is in fact a foreign shareholder who at best will experience considerable difficulty accessing imputation credits.** for companies with substantial foreign ownership, the market value of tax credits is close to zero.

As noted at the outset, if there is a proposal to sell the Burdekin to a foreign billionaire we wish to be advised. As a technical correction, we note franking credits can be used even where a company is majority foreign-owned, so the argument is as factually

incorrect as it is logically irrelevant, given the current public ownership of the Burdekin.

Page 35

Footnote 36

An extreme example of stranded asset risk would be if a water infrastructure facility could not sell any water for a positive price. The water infrastructure assets would be in place but stranded and the owner would not be able to recover its investment. **The stranding risk is, itself, dependent on the mode of asset valuation and depreciation used in price setting. Lower asset valuations and accelerated depreciation lead to reduce the firm's exposure to stranding risk.**

Yes, the stranding risk is increased by pricing above optimal short run marginal cost (SRMC) through devices such as DORC revaluations and a refusal to credit returns of capital outlays through land and water sales or attempts to charge on grants or taxpayer-funded assets. This is why the use of notional inflated CAPM WACCs instead of actual costs is so economically damaging - it can reduce great public works to uselessness. So far from being rewarded, asset owners should therefore be penalized for charging above SRMC and thereby preventing potentially productive fuller use of infrastructure.

Page 36

Thirdly, these are risks that cannot be diversified away by investors in the water infrastructure provider. This is a critical point. The reason that they cannot be effectively diversified away is that the counter-parties to the risks are water users rather than public companies in which investors can invest.

But the risks were diversified away - to the BRIA farmers who helped government recoup much of the costs of the scheme through land and water auctions. Just as gas pipeline developers diversify risk by signing up foundation shippers, so an irrigation scheme developer such as the Queensland Government can - and did - reduce its net investment by funding the scheme through land and water sales.

Page 38

.. the annualised cost to the firm of issuing the debt. These costs are called issuance (or flotation) costs and consist of underwriting and management fees and direct costs such as legal and accounting fees.

But if there is no debt in SunWater why are hypothetical debt issuance costs relevant?

Page 39

Failure to accommodate these costs represents a disincentive to invest in the industry. This is

because a possible developer would never be able to recover its costs in establishing an asset were it unable to recover its exit costs.

Successful land developers do recover their costs through land sales - as did the Queensland Government. Unsuccessful private sector developers do not - and go bankrupt. Unlike SunWater, they are not allowed to go back to those to whom they sold their lots and demand top-up payments on the pretence that the infrastructure was not paid for, only the land.

Page 40

Accordingly, consideration of the costs of issuing equity as a cash flow item represent a legitimate cost for a business in the same way as the costs of securing debt are considered.

But SunWater has no cost of issuing debt, equity or hybrid securities. It was taxpayer-funded and is publicly owned. Is it being suggested that BRIA farmers be charged in advance for the stockbroking profits to be made on a future Telstra-style float of SunWater? If stockbrokers are to be enriched through the sale of public assets, let it at least be after they have done the job of selling them!

Page 40

Indeed, for a developer such as SunWater,

So, at the last breath, it is admitted that SunWater is a land developer. So why is no credit being given for land and water sales proceeds in computing its unrecouped capital base?