



State Development and Innovation

Please quote: MN62429
Contact officer: Peter Jones
Contact telephone: 322 78373

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Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Hall

Thank you for your letter of 23 December 2004 forwarding the Queensland Competition Authority's (the Authority) Draft Report "Gladstone Area Water Board: 2004 Investigation of Pricing Practices" and inviting submissions on it.

Overall, the Department of State Development and Innovation is of the view that the model used in the review is consistent with current regulatory approaches around Australia. However, there are three issues on which this Department considers further consideration or clarification is necessary by the Authority.

- (a) Pricing for Exceptional Circumstances (including drought) - (pages 50 to 53 of the Draft Report) - The Authority states that higher prices are justifiable during droughts to promote efficient water use. However, where the higher prices are not cost related, and other resource rent arrangements are not applicable, the revenues should be returned to users at a later stage on the basis of a proportionate reduction in all customers' access charges.

It is not clear in practice as to how this approach may work. As it is proposed excess revenue would be returned to users at a later stage, the incentive to users to improve water efficiency could be significantly reduced. Indeed, it could see the burden of improving efficiencies falling on those users with the least capacity to carry the additional cost for a period.

Further, it is considered that penalty pricing in times of drought is not a substitute for an ongoing program to promote long term improvements in the efficiency of water use. A focus on drought periods may not produce long term improvements in water use, particularly as the Authority proposes that the revenues from higher pricing in drought periods be returned at some later stage to the users.

Executive Building
100 George Street
PO Box 168
Brisbane Albert Street Qld 4002

Telephone +61 7 3227 8373
Facsimile +61 7 3225 8158
Website www.sdi.qld.gov.au
ABN 97 406 359 732

Clarification is sought from the Authority as to how its support for higher pricing in drought periods (with subsequent return of revenues to users) would be applied in practice and the extent to which it could be a better approach than other programs aimed at achieving long term improvements in water use efficiency.

- (b) Optimisation of Assets (pages 71 to 73 of the Draft Report) – The Authority, in discussing its approach to determination of the Depreciated Optimised Replacement Cost, supports the approach proposed by Gladstone Area Water Board (the Board) that only infrastructure supported by supply contracts be put in place. The Authority considers this would not preclude the Board putting in place additional capacity but would require the existing users to be prepared to contract for the associated risk.

The Board has proposed that to reduce the risks associated with future regulatory treatment of investments, and therefore to achieve lower prices, an ex ante test be applied to investments by an Investment Review Panel. The Draft Report does not indicate any Authority support for this approach.

Given that additional infrastructure/capacity would be unlikely to be able to be sized to meet a particular new user's demand and the uncertainty that existing users would be prepared to carry the risk for the "over capacity" that would result, the practical effect could well be that potential major industrial developments with a significant water demand could not have their demand met in either a timely or cost effective way. The outcome could well be the loss of economic development opportunities for the State.

In effect, the framework encapsulated in the report will require the Government to take on any major augmentation costs/risks which the Board cannot pass directly on to existing or new customers via contracts.

This Department supports the use of an Investment Review Panel (as proposed by the Board) before an investment to remove the possibility of "optimisation" in the years after an investment.

- (c) Review of proposed prices and contracts prior to final completion (pages 126 and 127 of the Draft Report) – This section (Monitoring Framework) discusses the establishment of processes to monitor pricing practices of the Board. There is agreement between the Board and Authority that the Authority should have an opportunity to ensure appropriate application of the Ministerially approved pricing principles.

However, the Authority considers that this should be achieved by reviewing proposed prices and contracts prior to their final completion.

This seems to suggest that all new proposed contracts will need to be vetted by the Authority before they are finalized (and by implication any variations to existing supply contracts). This would appear to represent a heavy handed approach to regulation and has the potential to complicate contractual negotiations and delay any proposed arrangements between the Board and a customer(s) relating to, for example, measures to address security of supply issues.

This Department seeks a reversal of the proposal that the Authority review "prices and arrangements in contracts prior to their completion" (or at a minimum a clarification by the Authority as to how it may practically be applied). This Department is also of the view that the Authority should identify and consider alternatives to the approach proposed before a final determination is made on this issue.

I look forward to these issues receiving further consideration by the Authority prior to finalization of the Report. If you have any questions, please contact Mr Brett Garner (telephone 322 58023) or Mr Peter Jones (telephone 322 78373).

Yours sincerely



Paul Fennelly
Director-General