

## Callide Power – Response to QCA Draft Report

Callide Power Management has reviewed the QCA's draft report *Gladstone Area Water Board: Investigation of Pricing Practices*, December 2004, and wishes to submit the following comments for the Authority's consideration.

### Optimisation of Capacity Augmentation

Over the course of the Authority's previous prices investigation for GAWB, and in our response last year to the current prices investigation issues paper, CPM has repeatedly submitted that the Authority has a responsibility to ensure that GAWB's augmentation decisions were initially and remain 'optimal'. Without the discipline of a competitive, commercial market, and the threat of market entry by competitors, it is the regulator's duty to ensure that regulated prices reflect no more than the efficient, forward looking costs of delivering utility services. For capital-intensive utilities optimisation is critical to satisfying this responsibility.

#### *Is the current augmentation still optimal?*

The QCA's draft report maintains that the Authority is of the view that the augmentation of Awoonga Dam to FSL 40 was and still is the optimal capacity augmentation decision for GAWB. The Authority has reached this view based on the advice of its technical consultants, notwithstanding that the raised dam now has a safe yield of some 78,000ML per annum, yet demand over the nominated planning horizon (to 2024-25) is forecast to reach only 68,772ML per annum, a shortfall of some 12% in the final year.

Optimisation should seek to define the optimal capacity augmentation path, assessed in terms of the present value of augmentation costs, over the defined planning period. Applied to GAWB, optimisation should seek to identify the least cost means of meeting the assessed demand requirements of users, over the period to 2024-25. This might involve a combination of capacity increments, spaced over time, or one larger capacity expansion to meet the full demand requirement.

In CPM's view the QCA has not properly considered this matter. Even accepting the Authority's use of the more limited "brownfields" (or incremental) approach to optimisation, the Authority itself notes that this approach should "... *optimise out any over-capacity in assets, over-designed assets, and redundant or abandoned, but listed, assets*" (page 71, emphasis added).

The Authority's approach does not meet this requirement as it has not demonstrated that the present augmentation is the least cost means of satisfying forecast demand over the planning period. Based on the Authority's own projections, it remains that there is a substantial amount of spare capacity at the end of the planning period which has not been optimised out.

To the extent that the Authority has considered optimisation, it was only that a single capacity increment to 78,000ML supply yield was preferable, on cost grounds, to two (or more) smaller capacity augmentations to reach the same ultimate level of capacity. Ignored in either case was the extent of spare capacity that remains at the end of the planning period.

To address this fault the QCA should do one of two things:

1. establish the 'optimal' augmentation cost of a supply increment to 70,000ML, and permit only this amount to be capitalised in the regulatory asset value, or

2. incorporate in its cash flow modelling a residual amount for the future value of spare capacity that remains at the end of the modelling period, assuming it is exercised in the period immediately following the nominated planning horizon.

Given remaining timeframes for the Authority's review the latter approach is probably the most practicable option. Properly applied it should insulate customers from paying for spare capacity which they neither require nor demanded of GAWB.

It would involve including in the Authority's financial modelling a terminal value (positive cash inflow) equal to net revenue from water sales against a notional demand volume equal to Awoonga's capacity (78,000MLpa), for the remainder of Dam's useful life. Effectively this approach assumes that in the year following the planning period (the year beyond 2024-25) demand increases to exactly match supply capacity and remains at this level for the rest of the storage asset's functional life.

An advantage of this approach is that it is not actually writing down the value of GAWB's assets. It simply accepts that the cost of spare capacity should be borne by (as yet unidentified) future customers, not present users.

The alternative method – recalculating an asset value based on a 70,000ML dam – would require the Authority to revisit the entire asset valuation task, at least for the Awoonga Dam, as the method of construction may be different for a smaller storage.

The price impact of either approach is unclear at this point, though both *must* result in lower prices for dam-only customers. Looking at the first method, quite evidently the cost difference between a 78,000ML and 70,000ML yield storage will not be equal to the difference in annual yield (~12%), given fixed costs in any augmentation.

Yet the smaller storage *must* have a lower replacement cost by virtue of its lesser materials requirements, recognising that each extra ML of yield requires a proportionately greater increase in storage capacity and a proportionately greater quantity and cost of construction materials. Even a very small cost differential in percentage terms may have a material impact on prices for dam-only customers given the substantial DORC valuation of the storage infrastructure and the prime contribution of this asset value to the water charge at Awoonga Dam.

#### *Compensation for optimisation adjustments*

The notion that the service provider should be 'compensated' for optimisation adjustments (pp. 72-73) is ill-conceived. Such compensation does not exist in any competitive market, the outcomes and incentives of which are trying to be mimicked by regulatory processes. A commercial supplier ultimately 'pays' for errors of judgement (in demand forecasting, sizing of plant capacity etc) through a write-down in the value of its assets – it cannot pass to customers this cost. The return on assets is compensation for this risk.

The QCA's approach essentially allows GAWB unfettered recovery of its costs, irrespective of whether these costs can be shown to be reasonable for the particular market circumstances that arise. This approach is unacceptable to CPM, and in CPM's view represents a failure of the QCA to adequately balance the interests of customers against the legitimate business interest of the monopoly supply. GAWB should be permitted the *opportunity* to recover its costs, not *guaranteed* this outcome.

On the same issue, the idea that compensation mechanisms would be effected unless it was apparent that "the regulator had been misled in some way" (p. 72) is impractical. There were a number of submissions to the QCA's previous prices investigation cautioning against accepting GAWB's higher demand forecasts – forecasts which ultimately proved far too optimistic. The QCA itself reported that GAWB had a history of overestimating future demand. How would the QCA propose to differentiate between forecasting errors, which are now a matter of fact, and deliberate overstatement of demand by a supplier to support a capital expansion program?

### *The need for an Investment Review Panel*

CPM does not support the concept of an Investment Review Panel (IRP), as proposed by GAWB and referred to in the QCA report (refer page 72, for instance).

Responsibility for asset valuation, optimisation and any findings on the 'reasonableness' of capital investment decisions must remain with the Authority. CPM cannot see how the Authority to delegate a function so critical to its prices oversight role and fundamental to satisfying the statutory objectives set out in the Authority's enabling legislation.

CPM remains of the view that any major investment decisions made by GAWB should be underwritten by firm contracts with customers. This approach, which we note was supported by the QCA in its draft report, should ensure that capital is committed only where there is a firm need for capacity.

### **Water Quality Risk**

The Authority's draft report includes a discussion of various risks and an assessment of which party is considered best placed to manage these risks. This risk allocation framework then underpins the Authority's WACC assessment, amongst other things.

An observation CPM would make is that water quality risk, identified at page 15 of the draft report as one of GAWB's "key commercial risks" is, we understand, effectively transferred to customers via contractual provisions. CPM understands that GAWB's general contracting philosophy is to provide no warranties or indemnities for water quality. This essentially means that the risk of a deterioration or variance in water quality is borne by customers, not GAWB.

CPM would ask that the QCA reconsider this issue, and consider particularly whether this readjustment to risk allocation has a bearing on the cost of capital for GAWB or any other aspect of the prices investigation.

GAWB should be contacted directly to confirm CPM's understanding in this area.

#### **Forecast Tariff Increases**

A minor concern of CPM relates to the table of price increases shown at page 132 of the draft report. This table observes that the price increase "from previous recommendations" is 16.5% for Awoonga Dam users.

What the table does not make clear is that the percentage increase is from the previous tariff recommendations indexed forward at CPI to 1 July 2005. A reader might interpret this table as suggesting that prices for dam-only customers would increase by only 16.5% from 2002 (the date of the QCA's previous recommendations) to 1 July 2005. On an annualised basis this represents only a comparatively small tariff increase over this period.

In actuality the increase for customers on 1 July 2005 will be the cumulative impact of both CPI indexation and the 16.5% base tariff increase, for a total increase of nearly 20%, and a nominal (excluding inflation adjustment) increase of some 26% over the same period. This aggregate tariff impact should be made clearer in the Authority's report.