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Dear Sir/Madam

**DRAFT REPORT ON GLADSTONE AREA WATER BOARD: INVESTIGATION
OF PRICING PRACTICES – SUBMISSION BY GLADSTONE CITY COUNCIL**

Council has considered your draft report on the Gladstone Area Water Board's pricing practices and is extremely disappointed at the lack of consistency in the conclusions drawn and recommendations made in relation water pricing for Council customers. Council submits the following comments on your report.

Maintenance of a Pooled Price

Council's major concern in respect of the report relates to the decision of the Authority to retain an equalised (non-differentiated) pricing arrangement for the two Councils:

The Authority considers that a pooled price be maintained for Gladstone City Council and Calliope Shire Council. (p. 43)

The basis for this decision is seriously questioned against a backdrop of efficient pricing under National Competition Policy (NCP) and COAG water reforms. Even the draft report highlights that differential pricing is the most economically efficient means of setting prices for GAWB's customers:

Where there are differences in the cost of providing services, differential prices provide appropriate incentives to users and service providers to use resources and services in a cost-effective manner...The Authority recognises that GAWB's water supply system has a number of clearly defined network components which result in significant differences in costs for servicing customers according to their location. Consistent with cost-reflective pricing principles, geographically differentiated prices should continue to be applied by GAWB. (pp. 39-40)

Further:

The Authority proposes that prices be differentiated for all customers according to their utilisation of specific components of GAWB's infrastructure network. (p. 41)

It is noted that the QCA's preferred treatment of Gladstone City Council and Calliope Shire Council would be as two separate customers levied two separate prices on the basis of their geographic location and different infrastructure requirements (as per the above pricing principles). In fact, the draft report indicates the following when commenting on the pooled price issue:

The Authority is generally predisposed to prices reflecting cost differences necessary to service different customer groups where these can be clearly identified. Differential pricing meets the objective of economic efficiency by providing appropriate pricing signals to different groups. (p. 43)

Differential or nodal pricing for each Council, with separate prices for CSC according to its major geographic residential precincts, would be consistent with the cost-reflective pricing principles recommended for GAWB by the Authority. (p. 42)

Differential pricing under current supply arrangements and assuming no change to infrastructure would be likely to result in a substantial price rise for CSC and its domestic customers, while delivering slightly lower prices to GCC. (p. 42)

If it is so important to differentiate prices on the basis of the type of product or service supplied and the geographic location of the customer, then it is questioned why the two Council customers are not priced in accordance with this decision rule. For some reason, economic efficiency, regulatory pricing principles and the intent of the NCP and COAG water reforms are all ignored when a decision is made on whether or not the pooled price should continue.

The reality is that there are **two separate Councils** - that is, **two separate customers**, with **two very separate budgets and very different cost structures**. The two Councils (customer groups) **can be clearly identified**, and clearly have dramatic differences in geographical landscape and size. The irony is that within our neighbouring shire there are arguments being developed for price differentiation (e.g. Mt Larcom) and yet an alternate argument is being presented for non-differentiation between the two Councils. In the executive summary of the draft report, *Geographic Differentiation* is mentioned, but in the very next paragraph, the QCA makes an exception for Councils. This is, in fact, a complete contradiction and makes a mockery of the pricing model.

The basis for the decision to continue with pooled prices is summarised in the draft report as follows:

...the Authority considers that pooled pricing should be maintained in this instance on the basis that past government policy was designed to provide a least cost solution for the regional community as a whole. There is no evidence that this intention was to only apply for a limited period of time, although the issue may be revisited once the installed assets require replacement. (p. 43)

Council is amazed that pooled prices are to continue for the foreseeable future on the basis of what are labelled "*historical arrangements*". This outcome is in direct contradiction to the thrust of all other sections of the report. Council read with disbelief, statements like "*to avoid embedding past inefficiencies*" and yet in this single instance, Gladstone City Council ratepayers are being penalised (and the pricing model is being distorted) for arrangements dating back 30 years; even though the environment that we are now working in has

completely changed. Either differential pricing should apply or differential pricing shouldn't apply for **ALL** types of customers. It should not matter whether a customer is a Council customer or an industrial customer; otherwise the regulatory decision will result in cross subsidies between a Council customer in one location and another bulk water customer in that same location. In Gladstone's case, as with our neighbouring shire we have major industrial consumers *as the Councils' customers?* It is imperative that the final report give clear guidance on how this is to be addressed.

When discussing the historical arrangements, the QCA notes comments by the Co-ordinator General in 1971 when proposing to increase the storage capacity of the dam and the establishment of a water authority to manage augmentation for the Gladstone-Calliope area:

The Calliope Shire Council has expressed its anxiety at the fact it has not been permitted to investigate its own independent source of water for supplying water to the newly developing areas in its shire...the scheme envisaged to supply water to the Gladstone-Calliope Area is an integrated one, developing initially the full potential of the Boyne River Catchment. (p. 42)

On the basis of these extracts, which do not directly indicate any agreement on pooled prices between the two Councils in perpetuity, the QCA makes the following conclusions:

It seems clear that, in establishing GAWB and its treated water distribution network, it was the Government's intention to adopt a regional approach for the supply of treated water for domestic consumers in both Councils...There has been no departure from a common pricing policy for the two Councils since the inception of the Board. (p. 42)

From the information provided it is not certain that the original intent of the scheme was to provide treated water to both Council customers at a price based on average cost of supply, and that this intent was formalised in any agreement between the government and the two Councils.

Gladstone City Council believes that in this instance, it would be more appropriate for the two Councils to be treated as separate customers of GAWB to ensure consistency in the application of pricing principles across ALL customer groups.

Even if the QCA believes that an implicit or explicit agreement was reached, the pricing principles utilised at that time must now be deemed irrelevant in light of the adoption of NCP and COAG water reforms. Even the QCA recognises the impact of the shift in government policy since the establishment of GAWB, particularly towards full cost recovery, more cost reflective pricing and the removal of cross subsidies:

It is evident, however, that when GAWB was established in 1976, water pricing was based on recovery of direct operational costs for water treatment and delivery only. Following commercialisation of GAWB and adoption of full-cost pricing including a return on capital and return of capital, the cost differentials between the two Councils have become more marked. (p. 42)

Given a significant shift in government policy over the past 30 years, how can the supposed historical arrangements still be considered appropriate? Just as it is appropriate to now earn a return of capital and return on capital on GAWB assets, it is appropriate to adopt cost

reflective pricing across ALL customers regardless of type; and appropriate to remove cross-subsidies that may have existed as a result of historic pricing arrangements pre-NCP and COAG water reforms. The decision to continue with a pooled price for Gladstone City Council and Calliope Shire Council directly conflicts with state-wide and nation-wide adopted reform principles and maintains the inefficiencies present during the previous pricing regime.

Further, it is important to highlight that the previous pricing regime was based on operating costs only, most of which were likely to be attributable to the operation of the Water Treatment Plant. Now that return of capital and return on capital are required to be recovered for the distribution network (the main cost differential between the two Councils), the old pricing regime is obviously no longer valid and should be reviewed. Treatment costs would obviously still be shared on a relative consumption and/or reserved allocation basis.

It is not clear if the QCA has made this contradictive decision on the basis of an explicit pricing agreement at the time of the Board's inception. It is also unclear as to why Council customers (and domestic customers supplied within the two Council areas) have been singled out in terms of the supposed historical arrangements. Instead, it seems as though the QCA has taken an easy option by accepting Calliope Shire Council's argument that a single price should be retained without a significant basis for making that decision. Some comments dating back to July 1971 have been referred to, (when the Water Board was first established in 1976) but there is very little discussion on whether this represents an effective pricing agreement, or whether such comments are still relevant in light of the adoption of NCP and COAG water reforms.

Surely if there are government policy issues with respect to past decisions, these should be handled directly between the government and the particular customer. It is not disputed that Government subsidies have been provided, but not specifically because of the regional infrastructure. The benefits of these subsidies have been passed onto the individual customers; and in fact, across the state, subsidies for water and sewerage infrastructure are provided to individual Councils when these services are provided. The historical subsidies were not linked in any way to the maintenance of a pooled price between Gladstone City Council and Calliope Shire Council.

It is ludicrous to believe that on one hand Council is facing a huge change in the pricing regime due to the adoption of such reforms, but supposed historic arrangements relating to the previous method of pricing are still relevant. Nor was it ever historic practice that return of capital and return on capital were incorporated into the price of water. Such issues have been discussed by the QCA and other regulatory agencies in previous decisions, with the general consensus being that government policy should change in response to the identification of additional costs to be recovered (i.e. return of capital and return on capital) and the need to establish pricing signals that are economically efficient and cost-reflective. In addition, are other water authorities required to provide water at the same price across local governments, regardless of distribution costs? If not, then why should supply to Gladstone City Council and Calliope Shire Council be any different?

Other commercialised water businesses in Queensland that had historically charged certain customers or certain groups of customers at a rate below full cost have been urged, through the adoption of NCP and COAG water reforms and changes to the relevant legislation, to remove such price discrimination or cross-subsidisation between customer groups to enhance efficiency. Why should a different rule apply to GAWB?

Alternatively, if the local government responsible for the operation of the commercialised water business wishes to continue to subsidise a particular customer or customer group, then they are generally required to establish a community service obligation (CSO) to fund the pricing subsidy. Translating this to the pooled price situation under assessment by the QCA, the State Government, as the supposed party making the decision on continuing to subsidise supply to Calliope Shire Council, should provide a CSO payment to GAWB that reflects the price differential between Gladstone City Council's non-equalised price and Calliope Shire Council's non-equalised price? This would be more appropriate and reflective of NCP and COAG water reforms than maintaining an historic pricing arrangement that inhibits economic efficiency. At least it would maintain a consistent approach to the pricing principles endorsed by the QCA.

Gladstone City Council itself, in meeting the requirements of NCP and COAG water reform has removed all cross-subsidies from its own two part tariff for water and yet now it is being told to take on one huge cross-subsidy for a neighbouring customer. This makes a mockery of the reform process. Effectively, the recommended pooled pricing by the QCA breeds inefficient resource allocation by not providing a pricing signal that it is more costly from a water supply perspective to locate in Calliope Shire than it is in Gladstone City. Such a decision essentially places the burden of higher costs on the existing and future residents and businesses of Gladstone City. A cross-subsidy, or at best significant price discrimination, will therefore always exist between residential, commercial and industrial water consumers in Gladstone City and residential, commercial and industrial water consumers in Calliope Shire.

There are other implications underlying this double standard that is proposed to be applied to Council customers versus all other customers. The report uses the argument that differential pricing **could** induce CSC to put in place alternative arrangements to bypass GAWB's treated water supply as part of the reason underlying the decision to maintain a pooled price:

Differential pricing could induce CSC to put in place alternative arrangements to bypass GAWB's treated water supply.

Were CSC to actually adopt a bypass option, GAWB would likely have some redundant assets (such as the Gladstone Calliope pipeline and some water treatment capacity) and GCC (and other treated water customers) would be required to meet some of the cost of spare treatment plant capacity. However, CSC would also incur costs involving treatment costs and trunk mains to supply Calliope and Tannum Sands.

Hence, overall regional supply efficiencies sought by the Queensland Government may not be achieved. (pp. 42-43)

Once again, the whole basis of NCP is to ensure an economic use of resources and to set prices such that customers can make informed decisions about the use of scarce resources and that prices are set in accordance with a commercial environment. By taking this threat of alternative arrangements on board, the QCA is developing a pricing model which is effectively placing protections on GAWB as a Government owned monopoly.

Government interest in competition reflects a general acceptance in most quarters that free and open competition can be a powerful inducement to economic efficiency and the advancement of consumer welfare through the market price mechanism, the forces of competition can be powerful instruments for ensuring that the needs of consumers and industry are satisfied in the least costly and most effective manner possible. In turn, such spurs to efficiency can contribute to economic growth and the sustenance of the nation's level of material well-being.

(<http://parlinfoweb.aph.gov.au/piweb/repository1/library/prspub/ws6461.pdf>)

Optimisation should occur on the installed assets, given current demand requirements of existing customers, to determine whether a more efficient supply solution could be provided. If not, then all customers should either be levied the same price for each product, or differentiated prices depending on their supply/distribution costs. Every customer may argue that there is a more efficient solution to supplying its demand, but if the system as a whole is constructed appropriately it should provide each customer with the lowest cost scenario. If not, then third party access may become an issue, regardless of the type of customer. Just because such an event may occur, it should not preclude the QCA from applying its accepted pricing principles to GAWB when establishing prices. To prevent third party access, the alternative supply option under consideration to bypass the existing supply possibly should be investigated by GAWB rather than by a customer. GAWB is in the best position to determine the most efficient means of supplying the demands of the region and to ensure resources are provided in the most efficient manner.

Whether or not a customer wishes to proceed with an alternative solution is a separate issue and should not be considered when determining whether a pooled price should exist. The investigation into whether the alternative solution would be more viable for a particular customer should be between the government and that customer, taking into account how much the government wishes to contribute to that scheme (if anything) based on the principles of regional efficiency. If a bypass option is in fact requested, it is appropriate at the time of investigation, that third party access provisions be reviewed and taken into account rather than basing the maintenance of inefficient pricing practices on a threat of third party. Even if a pooled price was to continue to exist, there is no guarantee that such a bypass option would not be requested.

It would seem that the decision to maintain a pooled price for Gladstone City Council and Calliope Shire Council is more of a political decision; or has been made as a preventative measure against potential third party access rather than being based on regulatory pricing principles and industry efficiency. It is totally inappropriate for political influences to impact upon the decision regarding a pooled price or the equalisation of charges across all customers and the QCA must ensure that its determination is independent of any such influences. If past government policy such as the pooled price leads to inefficient outcomes, then why is it appropriate for it to continue? Isn't the basis for NCP and COAG water

reforms to promote the most efficient resource allocation? All other customers have seen significant changes in the charging methodology deriving their prices, and it is inappropriate to consider the two Council customers as special cases in the pricing review.

If the pricing model is to have any sort of credibility, Gladstone City Council would expect the QCA to apply its principles consistently and accept price differentiation for each customer group including each separate local government. Further, why should the user pays philosophy apply to industry and not to Gladstone City Council, particularly given the significant policy shifts evident in the water industry, the recognition of the additional costs that Calliope Shire Council imposes on the system relative to Gladstone City Council, and the ambiguity of the historical arrangements supposedly setting an equalised price for Council customers in perpetuity?

NCP and COAG water reforms are based on creating a level playing field and ensuring government owned monopolies act commercially – surely no customer of a commercial enterprise could be expected to be held to any sort of arrangement commencing 30 years ago when the critical terms of that agreement or arrangement have changed so substantially.

Should the State Government decide to continue to subsidise the ratepayers of Calliope Shire, then it should consider the application of a community service obligation payment to GAWB to fund the pricing shortfall rather than burden the ratepayers of Gladstone City and potentially impact upon existing and future development within the City. At worst, the decision over whether this subsidy should continue to apply should be a matter for the government and the particular customers in question.

State Government as a Bulk Water Customer

The report recognises that a key issue is:

...who should bear the costs of the augmentation – users of existing capacity (existing users), users of new capacity (new users), all users, the shareholders of GAWB or other sponsoring authorities (such as the Queensland Government which may wish reserve capacity to be held for development purposes). (p. 43)

As with other customers, if the Queensland Government wishes to ensure there is sufficient reserve capacity available for development purposes, it must pay access charges to secure or reserve an allocation of water from GAWB. As a business, GAWB indicates that:

...it will not commit to providing future water availability or delivery capacity without compensation for: the development costs of providing the additional resource; and/or the opportunity costs of not selling the water availability or delivery capacity to other customers. (p. 44)

This issue is confirmed by the QCA, which states that:

Should the Queensland Government require greater capacity to be available for regional development purposes than GAWB would wish to install for commercial reasons, then it is open to the Queensland Government to fund such an arrangement through a CSO or some alternative arrangement. (p. 45)

Council would like confirmation that this decision will in fact be implemented in practice. In addition, Council is gravely concerned that its bulk water prices will continue to increase as more expensive supply sources are required to meet projected demand of new customers, particularly if the additional demand relates to a Queensland Government policy to promote industrial development in the region.

The Queensland Government should contribute additional funds to provide such alternative supply sources to ensure that average cost does not significantly increase, particularly for Council customers. It would be inappropriate for domestic ratepayers to face increasing water costs resulting from the infrastructure and resource implications of Queensland Government policy for continued industrial development in the region. It would be more appropriate for a contribution to be made from the Queensland Government, acting on behalf of the taxpayers of the State rather than the burden be localised to the Gladstone-Calliope region, particularly when the economic benefits flow to the state and nation.

Differential Pricing on the Basis of Reliability of Supply

With regards to drought implications for the tariff structure and customers, the report indicates that:

Drought risk is best allocated to GAWB as it is in the best position to manage overall supply options and any relevant restrictions (p. 18)

Further:

Drought risks appear best managed by GAWB as these typically require management of overall demand and prioritisation of supply, and any required differentiation of water reliability. These issues are being addressed by GAWB under its forthcoming Drought Management Plan (DMP). (p. 22)

It is essential that GAWB incorporate differentiation of water reliability into pricing mechanisms to ensure that those customers requiring or obtaining greater reliability or proportionate allocations during drought periods pay a premium for their water. It is evident that reliability of supply is a significant issue, with Councils having to reduce consumption by 35% in the first instance and a further 15% in the second instance during the last drought. That compared with just 10% in the first instance and a further 15% in the second instance for industrial customers.

As indicated in the original submission from Council in response to the Issues Paper:

The current Drought Management Plan and the restrictions on customers implemented during the recent severe drought suggest that industrial customers benefit from a higher level of reliability of bulk water supply than Council customers. In fact, Council customers seem to face earlier and more severe restrictions during periods of drought than industrial customers. In order to be equitable, those customers who demand higher reliability should pay a premium for bulk water supply.

Despite industrial customers benefiting from higher levels of reliability, no premium has been levied on their water charges. Council proposes that those customers with lower levels of reliability during drought periods should benefit from lower charges when reference

tariffs are set. Any customer or class of customer that desires a higher level of reliability should pay a premium for water on an ongoing basis.

It may not be appropriate for the status quo to be maintained for another five years, and it is recommended that the QCA be involved in the regulatory approval of pricing differentials based on different levels of reliability of supply.

Differential Pricing on the Basis of Contract Period

The draft report indicates that contract periods of less than 20 years would attract a price premium. Is there a recommended method by which such a premium is to be levied? Further, will the additional revenue collected through such price premiums be retained by GAWB for accepting a risk of withdrawal within the 20-year period, above the maximum revenue requirement?

Optimisation Approach

Given the current consideration of a bypass option by Calliope Shire Council if a non-equalised price was adopted, it is questioned whether a greenfields approach to optimisation would be more appropriate for pricing when such an issue is raised by a customer. Obviously, a greenfields assessment in meeting the demands of Calliope Shire would produce the same result as if Calliope Shire Council were to actually construct and operate a separate treatment and distribution scheme. Further comment in relation to this issue, and the implications of third party access when determining relevant optimisation adjustments, are requested.

Adoption of Price Cap Approach

The draft report indicates that:

A regulatory framework based on price caps is considered to remain the appropriate form of regulation for GAWB...a price cap approach provides the best means of ensuring that GAWB manages its key risks, especially demand risk as it relates to future expansion.

Price caps will ensure that GAWB will not expand its infrastructure unless there is corresponding demand and/or unless there are contracted arrangements in place to offset the risks. (p. 8)

Given the above, it is vital that demand estimates are accurate. Otherwise, GAWB may either 'undercharge' or 'overcharge' customers. It is recommended that a minor regulatory review be triggered if actual demand significantly differs from projected demand adopted in the immediately preceding formal regulatory review (in line with the +/- 15% indicated in the draft report).

Need for Transition Period

Given the significant jump in prices anticipated, a transition period should be considered, particularly for Council customers. This is because Council is unable to immediately

increase prices to the general community via rate increases due to the broad-scale impact on households. It would be most likely that Council would have to phase-in the charges.

Tariff Structure

The volumetric charge is set in accordance with a revised measure of LRMC. Council accepts the new measure of LRMC as appropriate. With regards to the Water Storage charge, it is evident that the majority of costs are fixed in the long run, with less than 10% of costs recovered via the volumetric charge. However, there is some concern over the level of revenue collected in the form of volumetric charges in the Water Delivery charge at 96.4%. This may be related to the potential underestimation of demand growth likely to be achieved during the assessment period, as outlined in an earlier section of this submission. Given the potential sensitivity of the tariff structure to demand projections, it is essential that the validity of such projections be tested.

With regards to the fixed charge, it is set in accordance with a contracted amount, and where actual demand exceeds the contracted volume for Council customers, unless otherwise negotiated with GAWB, a load factor of 10% is to be applied to the access charge where actual consumption exceeds 125% of the contracted amount. Given the identified "*greater inherent difficulties*" associated with estimating Councils' demands, it is important that GAWB retain some control over the demand estimation process or monitor whether actual demands significantly differ from contracted amounts on an ongoing basis. Under the proposed tariff structure, it may be beneficial for Council customers to continually underestimate their demand to reduce their relative fixed charge. Whatever is adopted, it is important that a clear decision rule exists as Council may need to adopt a similar pricing policy for its larger industrial customers given the potential flow-on effect from their demand into overall bulk water charges incurred.

Further, it is questioned as to how Council customers are able to commit to demand projections outlined in a five-year contract or 20-year contract given the "*greater inherent difficulties*" associated with estimating Councils' demands. It would be hoped that the Council customers enjoy some level of flexibility in relation to demand projections given this uncertainty, with projections able to be revisited each year.

Demand Projections

The QCA's demand projections for Gladstone City advised to Council under separate cover to the report are believed to be conservative. Council has examined the City's annual consumption figures prior to the recent drought (ie, pre-water restrictions in 2002/03) and considered these higher consumptions in conjunction with post-restriction (current) consumption. A more realistic estimate of consumption has been determined and the same 2% pa growth factor applied. These amended demand projections are included below and have also been forwarded to the QCA under separate cover.

Year	QCA Projections (MI)	GCC Projections (ML)
2005-06	5386	5695
06-07	5495	5809
07-08	5607	5925
08-09	5721	6044
09-10	5837	6164
10-11	5956	6288
11-12	6077	6413
12-13	6200	6542
13-14	6326	6673
14-15	6454	6806
15-16	6585	6942
16-17	6718	7081
17-18	6854	7223
18-19	6993	7367
19-20	7135	7514
20-21	7279	7665
21-22	7426	7818
22-23	7576	7974
23-24	7729	8134
24-25	7885	8297

Conclusion

A new pricing regime has been imposed upon water service providers – a regime which requires user-pays cost-reflective pricing for water. The QCA has both fully endorsed and recommended the adoption of this pricing principle for all Gladstone Area Water Board's customers; unless where the customer is a Council.

In the case of the Councils, this **principle is completely ignored** in favour of the old methodology, which was a pooled or equalised pricing; and is in direct contravention of the NCP and COAG water reform principles. The implication for Gladstone City residents of this contradiction of, and disregard for QCA's own recommendation, is that Gladstone City residents are subsidising the cost of water supply to residents of Calliope Shire.

Gladstone City Council does not want water prices to rise disproportionately in Calliope Shire – that is not our intent. But it is our intent that Gladstone City residents don't pay for another customer's privilege of cheaper water. We didn't change the rules. Why should we bear the consequences of these new rules? The State Government is enforcing the changes; they should subsidise the anomalies created by past government policy by providing appropriate *Community Service Obligations* rather than opting for an artificial equalisation of prices between two customers.

If the final recommendations remain contradictory and the anomalous equalised pricing principle is retained for Councils, it is essential that recommendations for appropriate *Community Service Obligations* are included to compensate the adversely impacted residents. We certainly would also require clear guidance on how each Council is to price

water to its own major industrial customers (eg NRG in Gladstone City's case). Is it QCA's intention that major industry gets a benefit that our domestic consumers don't?

Should you have any queries in relation to this submission please do not hesitate to contact me on 4970 0702 or Council's Director, Infrastructure Services, Mr Stuart Doak on 4970 0744.

Yours faithfully



PETER CORONES
MAYOR



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