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Queensland Competition Authority
Level 19, 12 Creek Street
BRISBANE

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Dear Sirs

GLADSTONE AREA WATER BOARD

We refer to the invitation to provide comment to the Queensland Competition Authority's document on pricing for the Gladstone Area Water Board.

We attach our submission to this letter. Our commentary has been kept necessarily brief so as to retain a focus on matters of a substantive nature only.

We thank you for the opportunity of providing commentary and look forward to discussing these matters with you later in some greater detail.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Alan Hustwick', written over a horizontal line.

Alan Hustwick
General Manager - Procurement

1	<p>Comment</p> <p>The weighted average cost of capital (WACC) provided in QCA's pricing recommendations is not reflective of the underlying risk of service provision.</p> <p>The level recommended is very high and is not reflective of the business environment in which GAWB operates.</p>	<p>Recommendation</p> <p>The weighted average cost of capital should be realigned with the risk associated with service provision. Risk should be assessed based on a number of factors such as:</p> <ul style="list-style-type: none"> • Security and certainty of cash flow • Credit rating of individual customers • Price risk environment • Technological environment • Threat of competition • Debt levels • Service levels <p>A nominal WACC based on the market risk free rate (10 year bond) plus 1.2% reflecting an appropriate equity beta would be reasonable and commensurate with competitor infrastructure service providers in the global environment.</p>	<p>Support Reasoning</p> <p>The risk environment of GAWB is very low. This is evidenced by nature and quality of the assets (and its ongoing maintenance profile), its customer base, low complexity involved in service delivery and the effort required to guarantee and secure its revenue flows.</p> <p>For those customers who require greater supply security, then a compensating increase in the investment hurdle (WACC) rate over the proposed base rate can be determined.</p>
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<p>2</p>	<p>Comment</p>	<p>Recommendation</p>	<p>Support Reasoning</p>
<p>There is no recognition in QCA's pricing mechanism that allows for customers' efforts in managing/containing its own water demand from GAWB over time. Demand containment and consequent investment avoidance by GAWB may be sourced from:</p> <ul style="list-style-type: none"> • Dedicated capital by customers to ensure water supply security • In-house efforts to reduce demand from a critical strategic community resource. 	<p>We recommend that a framework for water trading be established:</p> <ul style="list-style-type: none"> • Within the user community in Gladstone, failing which • Amongst entities that are related through ownership. 	<p>If the user community is absorbing the risk of supply security in a responsible manner, then it should be compensated for its efforts (more than those who do not). There should be no disadvantage or disincentive provided in the pricing framework to prevent demand reduction initiatives as it strengthens the resource capacity of GAWB and defers any spending on augmentation. In addition, a pricing regime as suggested would reflect the community behaviours that should be encouraged to build a long-term sustainable future for the community.</p>	

3	<p>Comment</p> <p>QCA's pricing proposals do not give due recognition to the levels of capital contributed by its user/customer base over time to GAWB. As these assets now form part of the invested asset base to determine future revenue charges, established customers are penalised. This is particularly so as the pricing proposals recommended should be applied to the entire user community under a consistent framework.</p>	<p>Recommendation</p> <p>Whilst we have no objection to a pricing basis based on an installed capital base valued on an Optimised Depreciated Replacement Cost, it is unreasonable to give undue recognition to the levels of funding provided over many years by established users. We acknowledge past funding has been part directed to paying for GAWB's fixed overhead cost base, and not solely for invested capital base.</p> <p>So as to equalise the position for existing and future users, mechanisms should be established to fairly reflect past contributions made by users to the existing capital base.</p>	<p>Support Reasoning</p> <p>In order to encourage/incentivise users to move to a new commercial regime, the recognition of the strategic significance of capital contributions in pricing is essential. Precedence is well established in this area for supply contracts of a similar nature (monopolistic infrastructure service provision).</p>
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4	<p>Comment</p> <p>We remain neutral to the concept of GAWB trading under a regime of price cap or revenue cap. However, whichever model is adopted, there should be acknowledgement and recognition of some fundamental principles which support either regime. These do not appear to be adequately reflected in QCA's pricing proposals.</p>	<p>Recommendation</p> <p>If a revenue cap regime is preferred, this must be reflected in the discount rate that is built into the cost of capital flowing through to pricing calculations.</p> <p>If a price cap regime were proposed then greater risk lies with the service provider (ie GAWB). GAWB will be incentivised to sell more water to maximise its revenue base and potentially cause or exacerbate drought potential. This in turn will bring forward the need for augmentation and capital spending thereby placing current supply security at risk. This should therefore lead to a low consumer price environment, as they will bear the risk of supply in the near term.</p>	<p>Support Reasoning</p> <p>A revenue cap ensures GAWB will always be able to meet its ongoing service obligations and any annual surpluses can be returned to Government in the form of dividends. The risk to GAWB in this regime is low as it is similar to a 'take or pay' environment.</p> <p>A price cap may drive wrong behaviours as the consumer is placed at greater risk through lesser supply security; accordingly a low pricing regime will be required to compensate users.</p>
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5	<p>Comment</p> <p>The pricing framework does not provide adequate recognition of developments that may occur in the Gladstone Region over the next 20 years.</p> <p>The State Government actively promotes Gladstone as a centre of industrial development, which will place a constraint over water supply. This in turn may lead to a scenario of water augmentation and consequent capital expenditure. The role of State Government as a provider of essential services appears to be ignored in this scenario particularly as it impacts GAWB's strategic planning and pricing.</p> <p>The issue is compounded, as incentives will be provided to attract investment and funded by the existing users through the tax base albeit in a different form to the incentives themselves.</p>	<p>Recommendation</p> <p>Whilst we support present (and future) Government policy to provide Gladstone as a major regional industrial base to leverage off established infrastructure, it should not do so at the expense of generating risk to established and new users over essential supply items such as water.</p> <p>Government funding priority should be weighted equally to all essential infrastructure and support services (incl roads, port, etc) that will underpin economic growth for many years.</p> <p>Augmentation of existing water capacity should be paid for by existing users to the extent that it is required to sustain their own business through organic business growth.</p>	<p>Support Reasoning</p> <p>Government policy may drive GAWB to oversell its capacity and thereby potentially accentuating the impact of years of below average rainfall.</p> <p>The real winners in this scenario are new users, and the financial losers are those that have an established community presence.</p>
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<p>Comment</p>	<p>Recommendation</p>	<p>Support Reasoning</p>
<p>We support QCA's recommendation that there is a pricing review once every five years within a long-term contractual arrangement. Many circumstances can give rise to change (eg customer risk profile, technology, regional demand, Government policy), which necessitates the opportunity for review.</p>	<p>The framework for pricing should provide as much predictability and certainty as possible over the life of the contract. In addition the rules for pricing review should be clear (those element of pricing that will be subject to review and those which will not).</p> <p>In addition, the framework for pricing review should also be in the context that pricing should be allowed to fall over time and to define the circumstances that will give rise to this event. These in turn will incentivise the user community to structure their business in a manner that capitalises on this opportunity.</p>	<p>Major investment decisions are founded on security of core infrastructure services to underpin risk assumptions, capital returns and choice of investment location. The greater the certainty provided, the greater the opportunity to attract and retain business investment and future development.</p>

7	<p>Comment</p> <p>There is an underlying assumption to the QCA's pricing proposals that GAWB is an efficient provider of service.</p> <p>However, pricing mechanisms do not allow for a reduction in its overhead base over time and passing that benefit to its customers.</p> <p>If this environment existed, risks will be more evenly shared between customer and supplier as the pricing formulae proposed are based on GAWB's risk profile only.</p>	
	<p>Recommendation</p> <p>Users should have the confidence of the efficiency as GAWB as a service provider. Its minimum service levels should be articulated and performance monitored accordingly.</p> <p>Underpinning efficiency and continuous improvement, the recurrent overhead base should reduce over time and this benefit should be passed to users in the form of reduced charges or other rebates.</p>	
	<p>Support Reasoning</p> <p>Many of GAWB's customers work in a 'price taker' environment where there is no ability to pass an increase in its overhead base to its customers.</p> <p>These businesses need to constantly reduce its cost base in order to maintain continuity of business and compete as viable entities in the global environment.</p>	