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Mr J Hall
Chief Executive
Queensland Competition Authority
Level 19, 12 Creek Street
Brisbane QLD 4000

Dear Mr Hall

Origin Energy (Origin) would like to thank the Queensland Competition Authority (QCA) for providing the opportunity to present our views on efficiency carryover mechanisms for regulated entities. Please see the accompanying submission.

Origin is a leading Australian energy company that supplies natural gas, electricity and liquid petroleum gas (LPG) to more than 2 million business and residential customers in Australia, New Zealand and the Pacific. Origin is a participant in most segments of the energy supply chain including exploration and production, power generation, energy retailing and trading and asset management services. Origin employs almost 3,000 employees and has more than 140 years experience meeting the energy needs of Australians. Origin sold about 196 PJ of energy to customers in 2003/04.

The comments expressed in this paper are based upon experience in the energy industry and hence only directly apply to energy regulation. The QCA, with its inter-industry perspective, may wish to assess the relevance of Origin's comments to other industries.

The energy market reforms initiated by the Australian Government and led by the Ministerial Council of Energy (MCE) took shape during 2003/04 with the establishment of the AER and AEMC. As you will be aware, one of the main objectives for developing a national regulatory framework is to improve consistency in regulatory arrangements and approaches used by jurisdictions in order to reduce regulatory costs. As the Issues Paper indicates, there is substantial variation across jurisdictions in relation to the efficiency carryover mechanism. The AER will seek to harmonise arrangements where net benefits can be harnessed.

Since the QCA cannot second guess the outcomes of MCE's future deliberations on the appropriate national efficiency carryover mechanism and the QCA should not delay implementing improvements to Queensland's regulatory framework, Origin encourages the QCA to adopt carryover arrangements that are not substantially different from those of Victoria and South Australia (which are relatively similar). In this way QCA is likely to avoid substantial changes to its regulatory framework in the future.

Please feel free to contact myself or Patricia Cameron on (03) 9652 5878 if you wish to discuss any comments in this submission in further detail.

Yours sincerely



Tony Wood
General Manager Public and Government Affairs

Issues Paper: Efficiency Carryover Mechanism

Definition of Efficiency Gains

Is an efficiency carryover mechanism desirable?

Origin supports the introduction of an efficiency carryover mechanism which brings the regulatory framework more closely aligned with the incentives of competitive markets by creating a longer timeframe for accumulating efficiency savings. The detailed arrangements for the carryover mechanism should be developed within the context of interrelationships between other incentive mechanisms such as service level incentives. Whilst it is convenient to administer the one model of an efficiency carryover for each industry, effectiveness of the incentive mechanism may be diminished. Therefore Origin supports tailoring the arrangements to suit the nature of each industry.

What is the appropriate means of identifying efficiency gains? Is it desirable to restrict the carryover to explicitly identified efficiency gains as opposed to a broader approach?

Origin considers that a high level approach to regulating efficiency carryovers is more efficient in terms of use of resources, both of the regulators and regulated businesses, compared to specifically identifying sources of efficiencies and assessing each efficiency gain. Whilst a high level approach may include exogenous efficiency gains, it will eliminate concerns about the efficiency framework deterring investment. Comparison of actual expenditure against benchmarks, adjusted for actual demand growth is preferred to detailed, regulatory appraisal of business' decision-making.

What proportion of cost savings should be subject to carryover, if a more broad recognition of savings is adopted? Would this vary depending on the particular industry?

The proportion of cost savings that should be subject to carryover may vary depending on the particular industry. The QCA may wish to establish some guidelines for determining the appropriate proportion. Some suggested factors are:

- the capital/labour ratio;
- the rate of change in technological development;
- the extent to which exogenous factors, such as interest rate changes, influence efficiency of the industry; and
- the impact of any reduction from the total carryover on the strength of the efficiency incentive and the investment requirements of the industry.

Efficiency Carryover Gains

The most appropriate basis for measuring efficiency gains

Efficiency gains should be measured incrementally rather than cumulatively because efficiency savings achieved each year ought to be sustainable, so only additional gains should be rewarded. In contrast, by carrying-over the cumulative gain (the difference between the total regulatory period's benchmark and actual spend), the company is rewarded each year for each efficiency achieved in the past, which is excessive.

The most appropriate form of efficiency carryover mechanism

The rolling carryover mechanism is superior to the glide path mechanism because it is unbiased towards the timing of when efficiency savings are achieved.

The appropriate sharing ratio of efficiency gains between entities and consumers

Considering the results, cited by the QCA, of market surveys showing that above normal profits are generally retained for less than 5 years in competitive markets, then carrying over efficiency gains from regulated entities for 5 years is commensurate with competitive market outcomes. This implies a ratio of 30%:70% share of gains in favour of customers.

The symmetrical treatment of efficiency gains and losses in the context of any proposed efficiency mechanism.

Origin supports the Victorian Essential Services Commission's (ESC) treatment of efficiency losses where negative values are set to zero for that year but accrued annually to be offset against future gains within the control period. At the end of the control period, any negative carryover is taken into account in resetting the benchmark.

Are there merits in establishing expenditure neutrality as part of an efficiency carryover mechanism? To what extent is it practical?

Theoretically, operating (including maintenance) and capital expenditures should be combined before being subject to efficiency carryovers to remove incentives to shift expenditure between the two. The difference between the actual and benchmark capital expenditure can be used to ascertain that the expenditure was prudent. Therefore no detailed examination of each capital expenditure decision to judge if it was prudent, is required before additions are rolled into the regulatory asset base.

Origin supports the approach used by the Victorian ESC where the calculation of the amount to be carried over for capital expenditure is based on the difference between the actual and benchmark expenditure multiplied by the WACC.

What is the appropriate treatment of changes in service quality in the calculation of an efficiency carryover amount?

The size of the service quality incentive will need to be aligned with the size of the efficiency carryover mechanism to avoid trade-offs between the two incentives which could otherwise result in efficiencies derived from cost cutting to reduce service quality.