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Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
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Dear Mr Hall

Efficiency Carryover Mechanism Issues Paper

Thank you for your letter of 24 September 2004 providing a copy of the "Efficiency Carryover Mechanism Issues Paper" for comment by the Department of Natural Resources and Mines (NR&M).

In my view, it is important that the framework encourage service providers to become more efficient by incorporating ongoing cost saving incentives in addition to allowing the service provider to achieve a weighted average cost of capital (WACC) return. In this regard it appears that an incremental rolling carryover of efficiency gains may represent the most appropriate approach to encourage efficiency improvements as it shares the benefits between the consumer and the service provider. It is noted that the rolling carryover mechanism may require a significant level of detail in order to trade efficiency gains across years, and this methodology may introduce volatility due to unpredictable annual adjustments. Further investigation into whether or not price smoothing (including a consideration of weighted price smoothing, passing through less of the gains to customers in the initial years of the regulated price period) would actually overcome this volatility is encouraged, otherwise there is potential risk that the disadvantages of the carryover mechanism could be significant.

It is suggested that an incremental approach to measuring efficiency gains may be more appropriate than a cumulative method. The incremental approach is preferred as it does not

retrospectively 'claw back' all of the efficiency gains achieved by the service provider over the regulated price period but rather takes into account the level of efficiency reached by the end of the regulated price period.

To encourage service providers to actively seek opportunities to improve efficiency, it is considered essential to implement a cost sharing arrangement, whereby both the service provider and the consumer benefit from efficiency improvements in future regulated periods. Such sharing arrangements should be consistent with those established by regulators in other Australian jurisdictions, provided that the rate of return on any infrastructure investment undertaken to enhance efficiency continues to be achieved.

In relation to windfall gains (however achieved), it is agreed that any such cost savings, should not be passed on to consumers as they are not ongoing in nature.

Enabling service providers to pass-through the cost of regulatory compliance, and unforeseen and unavoidable costs to customers in a timely manner is considered important, to ensure that essential services can continue to be supplied in future. As these costs are unavoidable for the service provider, it may be necessary to pass such costs through within regulated price periods to ensure the continued viability of the service provider's business.

Although NR&M do not necessarily support carrying forward efficiency losses, if such losses are to be carried forward, they should be limited to quantifiable losses as a result of the service provider being unable to continue to provide the same quality service at the same cost (indexed). Should efficiency losses be taken into account in future regulatory periods, any such carry over should be limited to a netting off to zero of efficiency gains and efficiency losses. Therefore it is suggested that there should not be a negative carry over where efficiency losses are larger than efficiency gains over any regulatory period.

In determining efficiency losses, it is also suggested that foregone efficiency improvement opportunities should be excluded from being carried forward, as these are not realisable efficiency losses for consumers in a monetary sense. It is also suggested that any increased costs associated with enhancing the service should be excluded, as these costs are not associated with a loss of efficiency but rather the improvement of the service provided to the consumer. Costs of enhancing the service provided may need to be passed straight through to the consumer to ensure the service provider's ability to continue providing the service in future.

It is also agreed that there may be a need to encourage service providers to improve both efficiency and reliability through the provision of new infrastructure works. In particular, it is considered important to allow service providers to appropriately estimate costs and set prices (that include an appropriate rate of return) to fully compensate them for proceeding with new infrastructure works. To encourage the service provider to investigate infrastructure solutions that may increase reliability, service quality and/or efficiency, it is necessary for the price regulator to agree to be bound by any contractual agreements entered into by the service provider and its customers. As such it is suggested that these customer supported infrastructure investment initiatives should not be optimised out of the entity's asset base by the price regulator at a later time.

Should you have any queries in relation to the matters raised in this letter, please contact Ms Ann Taylor, Financial Analyst, on 3224 7789.

Yours sincerely

A handwritten signature in cursive script that reads "Robert Reilly".

R. W. Reilly
General Manager
Water Industry Compliance