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SEQWATER

Wivenhoe, Somerset & North Pine Dams

Quality of water. Quality of life.

26 October 2004

Mr E J Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE Q 4000

Attention: Mr Gary Henry

Dear Mr Hall

Thank you for the opportunity to comment on your Issues Paper "Efficiency Carryover Mechanism."

Thank you also for allowing us to extend our time for response so that our Board had the opportunity to review our response.

Attached is our response, suitably referenced to the relevant parts of your Issues Paper.

If you have an enquiries on our response please contact Brian Hartnett on 3011-5128 or e-mail bhartnett @ seqwater.com.

Yours faithfully

PETER BORROWS
Chief Executive Officer

SOUTH EAST QUEENSLAND WATER CORPORATION LIMITED

RESPONSE TO QCA “Invitation for Public Submissions on Issues Paper – Efficiency Carryover Mechanism”.

Part 3.1 Windfall and Efficiency Gains

Desirability of an efficiency carryover mechanism.

A carry over of efficiency gains is equitable in that it shares the benefit of efficiency gains between the business and the customers. If the original benchmark resulted in an outcome for customers that was agreed or acceptable, then there can be no thought that customers are being deprived if not all of the gains against that benchmark are passed on.

Appropriate means of identifying efficiency gains.

A criteria for efficiency gains is that they should be ongoing gains, lasting at least to the end of the subsequent regulatory period. It is necessary to distinguish these from efficiency gains which are ephemeral. This approach also dispenses with the risk stated in the Paper that a business may bias its savings to the earlier years of the regulatory period. If they occur in the earlier period but not in the later period then they cannot be considered to be ongoing.

Desirability of restricting consideration of any carryover to explicitly identified efficiency gains as opposed to some more broad approach.

Following on from the above, our view is that the efficiency gains should be explicitly identified. Any other gains will be to the benefit of business. It is noted, however, that a new regulatory period will involve a new price determination using current price components, not the least being a possible revised WACC. In these circumstances, it is likely that efficiency gains, other than those specifically identified for carryover, will be taken into account in setting prices for the new regulatory period.

Proportion of cost savings that might reasonably be subject to carryover if a more broad recognition of savings is adopted. Would this vary depending on the particular industry?

A maximum of 50% to the customer is suggested.

It may vary according to the nature of the efficiency gain, which itself may be characteristic of certain industries. For example, industries have various degrees of capital intensiveness. An industry with a comparatively large proportion of its cost structure comprised of sunk costs in infrastructure, may achieve efficiency gains by producing greater volume of output without further investment in that infrastructure. The degree to which future customers benefit from a lower unit cost will depend on views as to compensation to the business for the risk borne by them in investing in infrastructure ahead of demand.

Part 4.1 Measuring Efficiency Gains

Most appropriate basis for measuring efficiency gains.

The incremental approach is favoured. This accords with what would intuitively be seen to be the gain. The gain carried forward on a per annum basis should relate to the annual gain achieved in the final year of the regulatory period. The gain should be permanent, as stated earlier.

Part 4.2 Type of Carryover Mechanism

Most appropriate form of efficiency carryover mechanism.

Our response to the paper is predicated around the concept that the efficiency gain is an ongoing gain that exists in the last year of the preceding regulatory period. This accords with the incremental approach to recognition, and dispenses with the issue that a business may bias its gains in the earlier years of the regulatory period.

On this basis a glide path is favoured for the carryover of the efficiency gains.

The case for a rolling carryover mechanism is acknowledged. However this does not fit so well with our view on the recognition of the efficiency gain. It would also be, as stated in the paper, more administratively complex to administer (and review?) than our favoured method.

Part 4.3 Sharing Ratio

Appropriate sharing ration of efficiency gains and hence an appropriate retention period for the distributors to retain the benefits of efficiency gains.

A 50/50 sharing seems reasonable as a broad approach.

It may be worthwhile considering whether the ratio should be different for various sources of efficiency gains.

Part 4.4 Symmetrical Treatment of Gains and Losses

Symmetrical treatment of efficiency gains and losses in the context of any proposed efficiency carryover mechanism.

The setoff of efficiency gains and losses in a regulatory period would not apply in our favoured option. Only the permanent gain in the final year of the regulatory period would be considered.

As regards the carryover of net losses into the next regulatory period, it is submitted that gains and losses should be separated. Gains will be carried over in accordance with the previous discussion. Losses, if they are not permanent, would be borne by the business. If permanent, consideration would need to be made as to the inclusion of them in the cost base for calculation of prices in the new regulatory period. This would particularly apply to a permanent increase in the cost structure of the business. If the loss in efficiency is the result of building too much capacity in the system to meet the demand, then the circumstances would need to be reviewed to determine the degree of management fault in not estimating future demand correctly. (In assessing management's performance in this regard consideration would need to be given to the long lead times involved in certain industries).

What our response points to is that gains and losses need to be assessed individually.

Part 4.5 Expenditure Neutrality

Merits of, and extent to which it is practical to establish, expenditure neutrality as part of an efficiency carryover mechanism.

Highly capital intensive industries have a large sunk cost in their cost structure. The quantum of money involved in their high investment affects pricing through the depreciation charge, and the asset base for calculation of return on assets.

Accordingly one of the best things such an industry can do is to ensure that the investment in infrastructure assets is optimal, and that they are constructed at the lowest possible cost. Once installed, there is no discretion to change the quantum of associated annual cost inputs into the pricing calculation.

On this basis it is our view that operating and capital expenditure should be treated the same.

However, consistent with our previous statements, each efficiency gain (or loss) needs to be assessed separately.

(Note that any physical valuation of assets should remove any of the cost effects of inefficiencies in construction. Also, if any expenditure is misallocated to capital it will be excluded from the asset base).

Part 4.6 Service Quality

Appropriate treatment of changes in service quality in the calculation of an efficiency carryover amount.

This issue supports our previously stated view that each efficiency gain (or loss) must be permanent (at least to the end of the subsequent regulatory period), and must be separately assessed. The degree of change in the standard of service delivery will be a key component as to whether the gain or loss can be carried forward, and to what extent it is shared between the business and the customer.

The correlation between changes in efficiency and changes in service standards could vary to such degrees that a general approach is not practical.