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Mr E J Hall
Chief Executive
Queensland Competition Authority
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Dear Mr Hall

Efficiency Carryover Mechanism

Thank you for the copy of your Issues Paper which summarises the key matters relating to the design and implementation of an efficiency carryover mechanism (ECM) for the entities which the Queensland Competition Authority (QCA) regulates.

As you are aware, these businesses own and manage a considerable share of the Queensland economy's most important economic and social infrastructure. The commercial decisions taken by these organisations within the regulated environment have far-reaching service delivery implications, which impact upon the welfare of the population and the national and international competitiveness of state-based industries.

In your deliberations regarding the development of an ECM, Treasury encourages the QCA to consider the following comments in relation to specific aspects of the design and implementation of such a mechanism.

Desirability of an Efficiency Carryover Mechanism

Treasury is supportive of the need to reinforce the incentives for regulated businesses to create operational efficiencies and believes that this principle should remain a central element of the regulatory framework. In this context, while the benefits associated with efficiencies need to be ultimately passed on to customers in the form of lower prices, for the incentive to be effective, the regulated entity needs to be permitted to retain its management-induced cost savings for a sufficient period of time. Such an approach is consistent with the incentives afforded to businesses in a non-regulated marketplace, where superior performance yields financial rewards, which are subsequently eroded by competitive forces over time.

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Accordingly, Treasury endorses the application of an ECM in the regulatory framework, whereby the efficiency gains attained in one regulatory period may be carried forward to the next period.

Identification of Efficiency Gains

Treasury notes the Authority's concern that there are difficulties in distinguishing true efficiency gains from externally-generated windfall gains, short-term cost savings and simple underspends on particular activities. However, these difficulties should not unnecessarily prohibit the development of an ECM.

Regulated entities themselves should be in the best position to substantiate claims of efficiency gains, given the informational advantage which they clearly possess. To minimise the extent of regulatory intrusion, the regulator could publish a set of clear guidelines against which each cost saving may be reasonably assessed on a case-by-case basis. Such an approach would be transparent, minimise the burden of proof on the businesses and reduce uncertainty in the regulatory arrangements.

Measurement of Efficiency Gains

The incremental approach to measuring efficiency gains is preferred on the basis that it is forward-looking, having regard for the level of efficiency reached by the entity at the end of the regulatory period.

Form of the Carryover Mechanism

The rolling carry-forward form of the ECM is preferred to the alternative glide path approach, because of its time-insensitive qualities. By establishing that benefits may be retained for the same period of time, irrespective of the year in which they were earned, the organisation is provided with a continuous incentive to pursue efficiencies throughout the entire regulatory period. In contrast, the glide path method provides an incentive for a business to strategically move expenditure around during the regulatory period, thereby maximising benefits to be carried forward, potentially without achieving any lasting savings.

Sharing Ratio

On the basis of empirical evidence from competitive markets, Treasury considers regulated businesses should be permitted to retain the benefits of an efficiency gain for a five-year period.

Symmetrical Treatment of Gains and Losses

While efficiency gains and losses should be treated symmetrically within a regulatory period, given the potentially adverse impacts on consumers and businesses associated with the carry-forward of accumulated losses, Treasury is of the view that any net negative carryover amount should be set to zero.

Expenditure Neutrality

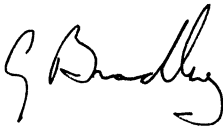
Treasury considers that the ECM should ideally treat any cost savings made in relation to either operating or capital expenditure in the same way. In this context, an ECM for operating cost savings should be extended to incorporate efficiencies realised in the capital expenditure program. A failure to do so may well distort the incentives facing regulated businesses to adopt the most efficient combination of operating and capital expenditure.

Service Quality

The recent Electricity Distribution and Service Delivery Review (the ESDS Review) highlighted the importance of regulated businesses ensuring the quality of the services they provide to customers. Accordingly, Treasury is of the view the ECM must not reward an organisation for pursuing efficiencies at the expense of service quality.

Thank you for providing Treasury with the opportunity to provide input into the Authority's consideration of the efficiency carryover mechanism. If you have any further queries, or require further information, please contact Mr Steve Williams on (07) 3234 1277.

Yours sincerely



Gerard Bradley
Under Treasurer