



SUBMISSION

TO THE

QUEENSLAND COMPETITION AUTHORITY:

EFFICIENCY CARRYOVER MECHANISM

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1. EXECUTIVE SUMMARY

ENERGEX appreciates the opportunity to provide a submission to the Queensland Competition Authority (QCA) Issues Paper *Efficiency Carryover Mechanism* dated September 2004. The paper calls for submissions from interested parties to be made as part of a consultative process for the consideration of an appropriate efficiency carryover mechanism.

ENERGEX Limited is making this submission on behalf of all subsidiaries including Allgas Energy Pty Ltd.

ENERGEX believes that efficiency carryover mechanisms are an important part of an effective, incentive-based regulatory regime. Customers ultimately benefit if the regulated business is incentivised to deliver its service obligations at the lowest possible cost. The incentive to the business arises if the business can deliver the service for a lower cost than allowed in the regulatory revenue determination. Efficiency carryover mechanisms seek to ensure that such cost savings are retained by the business for a reasonable period and are not distorted in terms of the timing of delivery of efficiency gains.

ENERGEX strongly supports the establishment of an efficiency carryover mechanism for regulated electricity and gas networks, in particular on the grounds that such a mechanism:

- is consistent with the respective Electricity and Gas Codes;
- is consistent with good regulatory practice;
- provides a good balance to service quality incentive mechanisms;
- avoids distortions in regards to any market rationalisation; and
- is consistent with the existing QCA commitment in its 2001 *Final Determination: Regulation of Electricity Distribution*.

In terms of the actual form of the mechanism, ENERGENX supports a carryover mechanism applying an incremental approach for measuring efficiency.

ENERGEX also supports the extension of an efficiency carryover mechanism to all similarly regulated infrastructure industries.

ENERGEX would be happy to discuss its submission further with the QCA .

1. INTRODUCTION

ENERGEX operate electricity and gas distribution networks throughout south-east Queensland regulated by the QCA under the National Electricity Code and the National Third Party Access Code for Natural Gas Pipeline Systems respectively.

A key objective in both regulatory regimes is the adoption of incentive-based regulation, to encourage service providers to increase the efficiency of their operations.

While ENERGENX strongly supports the establishment of an efficiency carryover mechanism, given the challenges of establishing a mechanism in practice, ENERGENX encourages the QCA to adopt a pragmatic approach to deliver a carryover mechanism that is simple, effective and provides clear incentives.

2. DEFINITION OF EFFICIENCY GAINS

The Authority invites comments on:

- *whether an efficiency carryover mechanism is seen as desirable;*
- *an appropriate means of identifying efficiency gains;*
- *the desirability of restricting consideration of any carryover to explicitly identified efficiency gains as opposed to some more broad approach; and*
- *the 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?*

ENERGEX strongly supports the establishment of an efficiency carryover mechanism for regulated electricity and gas networks, on the grounds that:

- it provides an efficient service provider with an opportunity to increase shareholder value while consumers ultimately benefit in the medium term through return of those efficiencies through lower prices;
- such a mechanism is consistent with the Electricity and Gas Codes;
- such a mechanism is consistent with good regulatory practice;
- it provides a good counter-balance to service quality incentive mechanisms; and
- it is consistent with the existing QCA commitment in its 2001 *Final Determination: Regulation of Electricity Distribution*.

ENERGEX also considers that the establishment of an efficiency carryover mechanism should avoid distortions in regard to any market rationalisations. For example, a merger of two regulated businesses would largely be driven by the synergy benefits. If these benefits cannot be retained for a reasonable period of time, such rationalisation could be discouraged, to the long-term detriment of customers.

While ENERGEX accepts the principle that businesses should only be rewarded for the efficiencies that they achieve through improved business practices, ENERGEX believes the difficulties and costs involved in attempting to differentiate management-induced gains from external efficiency gains make such a task impractical.

ENERGEX notes the Essential Services Commission of South Australia (ESCOSA) concluded in its *Electricity Distribution Price Review: Efficiency Carryover Mechanism Working Conclusions* that:

ESCOSA is keen to ensure that the incentive mechanisms it establishes are simple and can be easily implemented. As such, ESCOSA will not differentiate between management and external efficiencies. (page 13)

In its *Electricity Distribution Price Determination 2001-05: Volume I Statement of Purpose and Reasons*, the Essential Services Commission, in light of concerns raised over the costs associated with trying to identify the potential sources of efficiency, proposed:

a simple rule of thumb which presumes that any underspending of operating or capital expenditure against the original forecasts used to set the price caps for the first regulatory period is the result of management induced efficiency improvements. (page xxiii)

ENERGEX supports the position developed in South Australia and Victoria that in the interests of a simple and easy to administer regime, the QCA should not differentiate between management induced and external efficiency gains due to the difficulty and cost involved in such an exercise.

Attempts to isolate external efficiency gains also raise issues of symmetrical treatment by the regulator of external efficiencies and disefficiencies. The isolation of external efficiency gains would, on equity grounds, require the regulator to provide the regulated business with full “pass through” of all externally-imposed “disefficiencies”. Clearly, this is problematic in practice, and reinforces the approaches cited above.

3. EFFICIENCY CARRYOVER DESIGN

3.1 Measuring efficiency gains

The Authority seeks comments on the most appropriate basis for measuring efficiency gains.

ENERGEX accepts that the incremental approach to measuring efficiency gains canvassed by the QCA paper effectively captures additional improvement in efficiency in a given year, over and above the improvements that have been achieved in previous years, whereas the cumulative approach detailed in the paper appears to double count one-off gains.

However, ENERGEX is concerned that the incremental approach may be seen to assume that any efficiency savings made by the business are permanent savings.

On balance, ENERGEX supports the incremental approach to measuring efficiency on the grounds that it provides a reward for retained efficiencies over one-off gains.

3.2 Types of carryover mechanism

The Authority seeks comments on the most appropriate form of efficiency carryover mechanism.

Under a rolling carryover mechanism, efficiency gains are calculated by comparing actual expenditure against set benchmarks for each year of a regulatory period with resulting gains or losses carried over for the duration provided by the sharing ratio.

Under a glide path approach, efficiency gains are calculated by comparing actual expenditure achieved in the last year of a regulatory period with the benchmark level of expenditure for that year. Benchmarks for the subsequent regulatory period are then adjusted to reflect the efficient expenditure achieved for the last year of the previous period, with the resulting efficiency gain or loss being phased out over the duration provided by the sharing ratio.

ENERGEX believes that the rolling carryover approach provides a continuous incentive for businesses to improve, whereas the glide path approach provides incentives to “front-end” efficiency improvements rather than sustain improvements throughout the regulatory period.

In this regard, ENERGEX believes the benefits of eliminating timing issues are an attribute of an efficiency mechanism that should be pursued and that the level of detail in order to track efficiency gains across years, relative to the glide path approach explained in the Issues Paper, would only be minor.

3.3 Sharing ratio

The Authority seeks comments on what might be an appropriate sharing ratio of efficiency gains and hence an appropriate retention period for distributors to retain the benefits of efficiency gains.

Regulated prices set on the basis of estimates of efficient costs leave investors uncertain as to whether those prices will recover actual costs for an efficient operator. In addition, by setting prices on the basis of regulator estimates of forward looking “efficient costs”, including an X-factor representing expected efficiency gains, regulators are awarding 100 per cent of what they consider to be achievable efficiencies to customers. Investors get no share in these efficiencies at all. If regulators over-estimate the potential for these efficiencies, then they will transfer to customers the benefits of efficiencies that have not been realised. In this case, the share to investors is negative.

On this basis, the sharing of efficiency gains favours customers, prior to the introduction of any sharing ratio.

Notwithstanding this fact, ENERGEX considers that the selection of a sharing ratio should be made by balancing consumer and investor needs. Moreover, provided that a carryover mechanism adopts the pragmatic approach of not differentiating between management induced and external efficiency gains a sharing ratio of 5 years would be a reasonable balance.

3.4 Symmetrical treatment of gains and losses

The Authority seeks comments on the symmetrical treatment of efficiency gains and losses in the context of any proposed efficiency carryover mechanism.

While ENERGEX agrees in principle that it is appropriate to treat efficiency gains and losses symmetrically within a regulatory period, negative carryover can have material effects on a regulated business, especially when the overspend is a result of excessive demand growth or factors beyond the control of the regulated business.

While ENERGEX believes that negative out-performance should be carried over and accrued each year until the end of the regulatory period, they should not be held over to offset gains made in any subsequent regulatory periods on the basis that carrying over an accrued negative carryover from one regulatory period to the next will dampen incentives to achieve efficiencies in the new regulatory period.

3.5 Expenditure neutrality

The Authority seeks comments on the merits of, and extent to which it is practical to establish, expenditure neutrality as part of an efficiency carryover mechanism.

ENERGEX accepts that if a firm can easily substitute between opex and capex, it will be important that the incentives are balanced. In this regard, ENERGEX supports mechanisms which are

neutral in recognising efficiencies in total expenditure, while acknowledging that there may be several avenues through which this balancing of incentives can be achieved.

3.6 Service quality

The Authority seeks comments on the appropriate treatment of changes in service quality in the calculation of an efficiency carryover amount.

ENERGEX considers that where incentives to reduce costs exist, there should be arrangements in place to ensure that service standards are safeguarded.

Where there are multiple objectives a firm must pursue, the power of the incentives to pursue these different objectives will be important. For example, if the incentive to maintain service standards is weak, introducing high-powered efficiency incentives greatly increases the risk the firm will reduce service standards in order to cut expenditure. Conversely, if the incentive to improve service standards is strong and incentives to reduce expenditure are weak, the firm may increase expenditure in order to increase service standards.

ENERGEX supports a regulatory regime where the incentives to pursue different objectives are balanced.

REFERENCES

Essential Services Commission 2000, *Electricity Distribution Price Determination 2001-05: Volume I Statement of Purpose and Reasons*, Victoria.

Essential Services Commission of South Australia 2003, *Electricity Distribution Price Review: Efficiency Carryover Mechanism: Working Conclusions*, South Australia.

Queensland Competition Authority 2004, *Efficiency Carryover Mechanism: Issues Paper*, Queensland