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29 October 2004

Mr Gary Henry  
Director  
Queensland Competition Authority  
Level 19, 12 Creek Street  
Brisbane QLD 4000

Dear Sir

**Efficiency Gains and Efficiency Carryover Mechanisms**

Please find enclosed our comments in relation to your issues paper. Please contact me if you have any queries in relation to this matter.

Yours sincerely

Rod Hayes  
Chief Executive Officer



## *Summary*

In principle GAWB supports the inclusion of an efficiency carryover mechanism in the regulatory regime. Such mechanisms mitigate investment distortions by three-yearly or five-yearly pricing re-sets associated with regulatory determinations.

However, in the specific case of the water industry, changes in regulatory framework and underlying cost levels associated with national reform of the industry would diminish the value of introducing an efficiency carryover mechanism at the present time. GAWB would support deferment of the introduction of an efficiency carryover mechanism for water businesses until the regulatory regime is stable and inherent incentives better understood.

If a mechanism is introduced, it is important to consider the administration costs involved in calculating the efficiency carryover. For this reason GAWB supports a simple mechanism. GAWB proposes an efficiency carryover comprising:

- a high-level assessment of 'efficiencies' based on the difference between forecast and outturn costs; and
- no attempt made to distinguish between cost variances arising from management initiative and windfall events.

It is also important to consider the incentives created by an efficiency carryover in the context of other aspects of the regime. In particular, where a 'building block' approach is used to derive allowed revenues (or prices) for a regulated business, it is common to set the operating cost building block with reference to industry best practice rather than relying solely on the business' own cost estimates. This treatment of building blocks is consistent with positive efficiency carryovers. However, if negative carryovers are to be applied then a higher building block cost is required lest the regulated business be penalised twice.

For simplicity, if a building block approach is retained with best-practice review of forecast operating expenditure, then GAWB submits that an asymmetric carryover mechanism be adopted.

For capital intensive businesses such as GAWB (and most regulated utilities) incentives for efficient investment are very important. A regime that only provides incentives for operating efficiencies ignores the major component of customers' bills and may provide incentives to distort the operations/investment balance away from the lowest lifecycle economic cost. GAWB therefore submits that any efficiency carryover mechanism must consider capital efficiencies to be meaningful.

GAWB supports a rolling annual assessment of efficiencies provided:

- net efficiency losses are discarded (or at least reviewed) at the end of the regulatory period; and
- a low cost methodology for calculating annual efficiency gains is adopted.

GAWB submits that a 5 year retention period be adopted for operating efficiencies. However given the long life of many infrastructure assets and mature nature of the water supply industry, GAWB argues that a retention period of at least 10 years should be adopted for capital efficiencies.

Finally, GAWB submits that businesses should see incentives to at least maintain service levels and the service potential of the infrastructure. That is, the efficiency carryover mechanism should not weaken a regulated business' incentives to deliver appropriate quality products and services to its customers.

### ***Introduction***

In principle GAWB supports the inclusion of an efficiency carryover mechanism in the regulatory regime. Such mechanisms mitigate investment distortions by three-yearly or five-yearly pricing re-sets associated with regulatory determinations.

In the specific case of the water industry, the current national water reform initiatives are likely to materially affect cost structure over the next few years<sup>1</sup>. Moreover GAWB is proposing significant changes to the regulatory framework for the next regulatory period<sup>2</sup>. The State is also moving to ensure that the charges paid for water reflect its true value. *"The debate today is therefore not about whether charges should increase but what charges should recover and the practical considerations of setting and implementing future charges"*<sup>3</sup>. We therefore have some reservations about the ability to drive efficiencies and, more importantly, the ability to measure efficiencies in an environment of 'shifting goalposts'.

GAWB would support deferment of the introduction of an efficiency carryover mechanism for water businesses until the regulatory regime is stable and inherent incentives better understood.

If an efficiency carryover mechanism is introduced, GAWB submits that particular attention should be paid to:

- cost of administering the mechanism; and
- the effect of any efficiency carryover to weaken incentives for maintaining service levels and the service potential of the infrastructure.

The following sections outline GAWB's position on specific issues raised by the QCA.

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<sup>1</sup> <http://www.pmc.gov.au/nwi/index.cfm#agree>

<sup>2</sup> Refer GAWB's submission to the current QCA price oversight investigation.

<sup>3</sup> Water Resource Charges Discussion Paper – July 2004  
Department of Natural Resources, Mines and Energy

### *Variations Caused by Exogenous Events*

In both Victoria and South Australia recent regulatory practice has been not to differentiate between management-induced and external 'efficiencies'. Farrant Consultancy concluded that this approach is appropriate<sup>4</sup>:

Unearned variances in return that result from exogenous events should be included along with earned variances in return that result from endogenous management actions since:

- exogenous events need to be harnessed by the Service Provider;
- the financial impact of an exogenous event may be influenced by the prior commercial positioning of the Service Provider;
- some exogenous and endogenous impacts will be assumed in framing the price path;
- in a competitive environment a pipeline owner would sustain for at least a period the impacts of both endogenous and exogenous events; and
- making a distinction would invite an intrusive and costly case-by-case assessment approach by the Relevant Regulator.

GAWB agrees with this assessment. The first and last of the above points are most important.

Firstly, the regulated business must take advantage of any opportunity for windfall gain (restructure debt portfolio if interest rates fall, adopt some new technology, etc.). It is in the customers' interest for the regulated business to be rewarded for harnessing exogenous events.

Lastly, the administration cost associated with case-by-case analysis of the factors contributing to each difference between forecast and outcome expenditure (including the continuous trade-offs between capital and operating treatment) would appear to be prohibitive.

### *Capital Efficiencies*

Under the heading 'Expenditure Neutrality', the issues paper considers the need to ensure that the regulatory regime provides incentives for both operating and capital efficiencies. The QCA states that it has only contemplated the carryover of operating cost efficiency gains. It characterises the potential problem of considering only operating efficiencies as one of inefficient reclassifying of operating costs as capital expenditure<sup>5</sup>:

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<sup>4</sup> Farrant Consultancy Pty Ltd (prepared for the Economic Regulatory Authority of Western Australia), "Incentives Mechanisms for Code Regulated Gas Pipelines" Discussion Paper, March 2004, p26

<sup>5</sup> QCA, Efficiency Carryover Mechanism Discussion Paper, September 2004, p10

In the absence of such equal treatment, a business could be encouraged to capitalise operating costs through the reclassification of operating and maintenance expenditure as a capital cost or by undertaking capital expenditure when operating expenditure might represent the most efficient option.

GAWB submits that the implications of not considering capital expenditure efficiencies are much more significant: operating costs comprise only a small proportion of the bill.

For GAWB, total operating expenses represent about 20% of customers' bills. The capital-related components represent 80% of cost-reflective prices. The key to obtaining efficient outcomes in the long run (and the lowest sustainable price for customers) is to incentivise efficient investment.

GAWB therefore submits that the QCA should extend the carryover mechanism to consider capital expenditure. The regimes in place for electricity distributors in Victoria and South Australia provide a carryover based on difference between forecast and outcome expenditure impact on the return on investment building block (i.e. capital expenditure saving multiplied by regulated WACC). GAWB can see no reason why this incentive should not also apply to the depreciation building block.

#### *Cumulative Negative Efficiency Carryover*

It is hard to conceive of a circumstance where management initiatives would deliberately result in negative efficiency gains. However, depending on how the 'efficiency gain' is measured, negative efficiencies may result from:

- exogenous events (e.g. changes to work and safety legislation may increase cost of maintaining networks);
- failed management initiatives;
- inappropriate cost estimates and/or excessively ambitious efficiency targets included in previous determination; and
- volume effects (that is, higher than forecast growth may drive higher operating costs).

It is reasonable for the business to bear the cost of failed management initiatives. Similarly it is reasonable that the regulated business be incentivised to minimise the impact of unfavourable exogenous events.

However GAWB submits that it is not reasonable to penalise businesses on an ongoing basis where the inputs into the regulatory determination (which are generally either developed by, or at least approved by, the regulatory authority after consultation with experts and customers) turn out to be unachievable or optimistic.

The reasonableness of including negative efficiency carryovers depends on other aspects of the regime. If pricing is set based on forecast/benchmark costs and not altered during the regulatory period then customers are not impacted by a cost overrun. Similarly if prices for the next regulatory regime are based on benchmarks (rather than the particular business' higher cost) then customers are not impacted.