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Subject: Public Submissions on Issues Paper - Efficiency Carryover Mechanism

Message:

Please find attached Rockhampton City Council's response to the issues paper.

My apologies for the lateness of my response.

Kind Regards,
Kerrie McDevitt
Financial Services

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Comments on QCA "Efficiency Carryover Mechanism" Issues Paper.

1. Introduction

In essence the 'Efficiency Carryover Mechanism' is a tool to gauge the effects of the efficiency gains made, by the application of full cost pricing, over more than 1 regulatory period. This issue is particularly relevant at present as a number of the QCA's determinations are due for review, and an element to be considered will be what efficiency gains were made, and how these gains can be shared between the service provider and the users.

2. Rationale for an efficiency carryover mechanism

Implicit in incentive regulation is the notion that there are gains to be made by all parties, by the introduction of measures to increase the efficiency and effectiveness of their operations. This is typically done by encouraging the regulated business to outperform pre-determined efficiency benchmarks, and allowing the business to retain all or part of the benefit over time.

A disincentive would avail, if the business believes it's efforts would be insufficiently rewarded. QCA argues, that unless an efficiency carryover mechanism is implemented, any savings generated by the business, would be passed onto customers (in the form of lower prices), and not retained by the regulated business. This would lead to a disincentive to the business to carry on with it's efficiency program. Another risk is in the absence of such a mechanism, the regulated business will target efficiency gains in the early years, and defer introducing cost savings towards the end of the regulatory period, with a view to maximise the period over which gains can be retained.

3. Definition of efficiency gains

Efficiency gains are calculated by using the efficiency benchmark set at the beginning of a regulatory period, to ascertain, improvements, if any over that period.

Gains can be categorised into the following:

- Windfall gains, which occur when factors outside the entities control, lead to reductions in a regulated business' cost. Examples of windfall gains are reductions in interest rates, which would lower operating costs. Windfall gains are likely to be passed onto customers rapidly, as these benefits will be available to all competitors.
- Efficiency gains, which occur as a direct result of a management induced initiative intended to achieve a cost saving. An example of an efficiency gain could be a management decision to introduce new labour saving methods, or improved asset management and maintenance practices.

The difficult issue is how to separately measure the quantum of each gain. One approach put forward is to disregard the source of savings, but allow a less than full carryover, acknowledging that part of the cost savings will not be efficiency gains.

One advantage of this method is in it's simplicity, but the disadvantage is that the business could not be guaranteed that it was properly rewarded for it's efforts. Another is that it could be easily manipulated. The cost savings to be carried forward would likely be arbitrary and difficult to justify.

Another approach may be the requirement for the business to establish what part of identified savings were the result of explicit management decisions. The advantage of this approach is that only efficiency gains would be rewarded, and there would be some certainty that these benefits would be passed on. The disadvantage is that the process would be intrusive, inasmuch as a clear case would need to be put forward, and supported by clear evidence.

QCA have put forward that a possible compromise, which would fall in between the two methods.

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4. Efficiency Carryover Design

If a carryover mechanism were to be included, a number of pertinent matters must be raised in design this model. Firstly the problem of measuring the efficiency gain needs to be addressed. Two methods of measurement have been put forward, name a cumulative or incremental method. These methods are discussed below, with reference to Table 1.

TABLE 1: Calculation of Operating Gains/Loss (\$M)

<i>YEAR</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>TOTAL</i>
Forecasted Expenditure	100	100	100	100	100	500
Actual Expenditure	100	90	95	80	70	435
Incremental Gain/Loss	0	10	(5)	15	10	30
Cumulative Gain/Loss	0	10	5	20	30	65

- The incremental method calculates gains on the basis of the difference between the current and previous years, and is clearly forward looking. It is for this reason that operating and maintenance expenditure efficiencies are generally calculated using this method.
- The cumulative method is backwards looking and has no regard for the level of efficiency reached at the end of the regulatory period.

Under both methods, the business will generally retain the full benefit of any savings made during the regulatory period, while customers continue to pay prices based on the higher forecast level of expenditure.

5. Types of Carryover Mechanisms

QCA have put forward two approaches to measure carry efficiency gains or losses, namely the glide path and rolling carryover methods. The essential difference between the two methods is one of timing.

- The glide path method allows for savings to be passed to consumers in a staged manner over a set time frame. For example if it was determined to set a time frame of 5 years, any savings would be passed on proportionately over this period.
- The rolling carryover method allows efficiency gains to be retained by the regulated business for a set period of time, irrespective of the year in which they occurred. Once the retention period had expired, gains would normally be passed on to consumers in a one-off price reduction, or phased in over a period of time. QCA have intimated that this method is their preferred method, as it eliminates the timing issue from the decision making process, and also provides a continuous incentive for business to seek efficiencies throughout the regulatory period

6. Sharing Ratio

A pivotal aspect of the efficiency carryover mechanism, is the time over which the regulated business will be able to retain the benefits it gained. The longer this period, the greater the delay before customers also enjoy the benefit. If the period is too short, there may be insufficient incentive to encourage business to seek efficiency gains. The choice of retention periods needs to be assessed in terms of this trade off, and determined so as to provide sufficient incentive for the business to continue to pursue sensible efficiency improvements for the business, while providing customers with reasonable access to the benefits of such activity.

Whilst there are no ideal or optimal sharing ratios, the following options have been put forward:

- A sharing ratio of 30/70 in favour of customers, believing that this would provided adequate incentive for further productivity improvements by the business. This ratio was put forward by the Essential Services Commission (ESC) and the Australian Competition and Consumer Commission (ACCC)
- A sharing ratio of 50/50 put forward a lobby group of regulated businesses. This ratio it is argued, will lead to benefits to consumers being maximised in the long run.

7 Symmetrical Treatment of gain and losses

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While a business can achieve efficiency gains over the regulated period, it is also possible for losses to occur and accumulate.

One issue is whether it is appropriate to treat efficiency gains and losses symmetrically in one regulatory period. The second issue is whether it is appropriate to carryover net losses in one regulatory period to a subsequent regulatory period.

8 Service Quality

Any consideration of efficiency carryover cannot be made in isolation from any number of other aspects of the business' performance. Cost cutting can have serious consequences for costs in other areas, and the quality of outputs.

Under the present regulatory regime, it is possible to trade off service quality in favour of short-term profitability.

It is therefore necessary to balance the need for efficiency gains, with the continuance of quality service.

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The Authority seeks comments on:

1. Whether an efficiency carryover mechanism is seen as desirable;
 2. An appropriate means of identify efficiency gains
 3. The most appropriate basis for measuring efficiency gains.
 4. The most appropriate form of efficiency carryover mechanism.
 5. The most appropriate sharing ratio of efficiency gains, and retention period for distributors to retain the benefits of efficiency gains.
 6. The most appropriate treatment of changes in service quality in the calculation of an efficiency carryover amount.
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1. An efficiency carryover mechanism would be seen as desirable, as Council's efforts in applying these reforms, would become more transparent. If appropriate and accurate figures could be produced, trends as to where the most considerable gains were being produced could be acted upon. Council's efforts could be directed to the areas where the biggest gains were to be made.
 2. Council feels that this particular area would be fraught with difficulties. One problem would be identifying whether gains were as a result of a windfall, or due to the fact that efficiency methods put in place were effective. As QCA would be aware, to ensure the validity of the quantum of gains, considerable resource would have to be set aside. Council feel that the cost/benefit ratio would not warrant such measures.
 3. Council feels that the incremental approach be used. As the paper points out, this method takes into account the level of efficiency that a regulating business reaches at the end of the period. Council asks whether an amalgam of these two methods be used? Another question Council raises is if both methods could be used in conjunction with each other.
 4. Council feels that the rolling carryover method would be best to use, but is hesitant as to the amount of resources needed for accurate and timely dissemination of information
 5. Council has no preference of one method over the other, as it is Council's opinion, that any gains **will** be passed onto it's ratepayers. This may come about by an improved bottom line, resulting in increased community equity, or by having more available cash to repay loans, resulting in less interest payments.
 6. Council feels that there should be no decrease in service quality, but exactly the opposite. Efficiency gains should result, as mentioned above in a better bottom line, and from this an increase in community equity, or more available cash.
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