Background paper
QCA review of irrigation prices

Application of QCA Efficiency Savings to Non-direct Costs

April 2012

Application of QCA Efficiency Savings to Non-direct Costs

SunWater is concerned that the QCA has proposed efficiency savings in SunWater's forecast non-direct costs but plans to apply these savings to the recovered non-directs rather than to the total non-directs.

The QCA appointed Nera Economic Consulting (Nera) to review the SunWater financial model and the Authority's add-on pricing model. It became clear to SunWater during this review that the QCA has applied the efficiency and productivity savings identified in the QCA's draft report to SunWater's recovered non-direct costs rather than applying these savings correctly to the total non-direct costs.

We raised this point with Brendan Quach at Nera in a telephone conversation on 14th March 2012 and he agreed that applying the efficiency savings to the recovered non-directs is an error given that the savings themselves were determined against the total non-direct cost. We presume that Nera has covered this point in their report and that this report will be published on the QCA's website.

This issue was raised in an email on the 15th March 2012 from SunWater's Peter McGahan to the Authority's Les Godfrey and Angus MacDonald. The following is extracted from the email:

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- *It appears to SunWater that the Authority has made a fundamental error in the way in which it has applied the so-called efficiency gains to non-direct costs*
- *Deloitte's analysis of efficiency gains was made against total non-directs, not recovered non-directs, however the Authority has applied the efficiencies to recovered non-directs*
- *Similarly, the Authority applied its arbitrary "productivity gain" to recovered non-direct costs, rather than total non-directs*
- *This has resulted in the wrong total amount of non-directs being applied to service contracts and also the wrong proportions of non-directs being allocated to each service contract*
- *The only correct way to apply these imposed efficiencies is to apply them at the resource centre level in the SFM*
  - *Specific FTE savings should be applied to the relevant resource centre*
  - *Generic savings should be applied to all resource centres*
  - *This would then have an impact on the calculated overhead rates in the SFM, which would in turn affect the under-recoveries*
- *The Deloitte report in Appendix B illustrates the correct manner in which non-direct efficiency gains should be adjusted.*
- *Only when the savings are applied correctly through the SFM are the correct costs allocated to each individual service contract according to SunWater's proposed CAM .....*"

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We believe that the QCA must have regard to the basis on which the savings were determined and to apply the savings in a manner that is consistent with that basis. In this case, the non-direct savings for efficiency and productivity have been determined with regard to total cost, therefore the savings must be applied to total cost. The QCA has determined through their analysis that the total non-direct costs less the efficiency and productivity savings will result in efficient costs for SunWater's non-directs. However, the QCA has proposed to apply the savings to recovered non-direct forecast costs rather than total non-direct forecast costs. By the QCA's own analysis, this would reduce non-direct costs to below efficient levels. Given that SunWater operates in a lower bound environment, any efficiency target set below efficient cost will threaten SunWater's viability. We therefore urge the QCA to be consistent in the identification and application of the non-direct savings when determining SunWater's final pricing.