3 EFFICIENCY INCENTIVES

3.1 Introduction

The Commission's draft *Regulatory Principles* proposes a 'glide path' regime in which efficiency gains made by a regulated company are gradually phased out. This approach, sometimes referred to as an 'efficiency carry-over mechanism', has the effect of sharing efficiency gains between the regulated company and its customers.

The Commission has explained the rationale for adopting a glide path[1]:

> If the only benefits the TNSP is to receive from productivity gains are those available within a particular regulatory period, there may be an incentive to defer potential improvements (and not disclose them to the regulator) until the start of the next regulatory period. Of course, such gaming produces an economically inefficient outcome, although the benefit for the firm may be maximised. Glide pathing will significantly reduce the magnitude of this perverse incentive …

Transend supports the Commission's concept of a glide path because it provides strong incentives to the company to improve efficiency as quickly as possible, regardless of the timing of future regulatory reviews.

Ultimately, customers benefit from such a mechanism because it will deliver lower prices over the medium- to long-term than the prices that would prevail in the absence of the incentive mechanism.

3.2 Defining efficiency gains

Transend's view is that the glide path mechanism should address the following aspects of efficiency:

- cost efficiencies – the costs savings achieved in delivering a given level of output
- scope efficiencies – increased output (measured by volume and/or quality of output) for a given level of cost.

From a number of perspectives, it is important that the glide path mechanism takes due account of both these aspects of efficiency. In particular, customers should want assurance that apparent cost efficiencies do not reflect simply a reduced scope of activity (for instance, a deterioration in the reliability of the network). On the other hand, it is equally important that the company's increased output should also be properly recognised and rewarded.

In making these observations, Transend notes the findings of the Appeal Panel that reviewed the Office of the Regulator General's (ORG) price determination of the electricity distribution businesses in Victoria, published in September 2000. The ORG's subsequent re-determination on 1 December 2000 reported the Panel's findings in relation to measures of efficiency as follows[2]:

- The Panel notes that the Office [the ORG] measured efficiency by comparing actual total costs (including operating and maintenance costs, and capital costs) as achieved in 1999 with the benchmark forecasts, for the distribution business, for that year. The Panel recognised that this comparison does not make any allowance for changes in the size or scope of the business from those which were assumed in the benchmark forecast.
- In the Panel's view this results in a measure which does not reflect efficiency as normally understood, and which creates incentives for the distribution business to perform inefficiently.

[1] *ACCC, draft* Statement of Regulatory Principles, *May 1999, p 94.*

[2] *ORG* 2001 Electricity Distribution Review, Redetermination, *December 2000, p4.*

- The Panel decided that the use of a rule of thumb to measure efficiency which did not make allowance for changes in scale and scope of the business constituted an error of fact in a material respect. Accordingly, the Panel decided to set aside the Determination and remit it to the Office for amendment of the Determination to incorporate the effects on costs of the differences between forecast and actual demand in the measure of efficiency carry over.

While the Appeal Panel's findings are not binding on the Commission for the purposes of this revenue determination, Transend expects that the Commission will, nevertheless, wish to take account of the Appeal Panel's view. Transend therefore proposes a glide path mechanism that takes account of both scope changes and cost efficiencies.

3.3 Transend's efficiency gains

Transend's view is that the existing revenue determination established by OTTER significantly under-estimated Transend's scope of work. The increased scope has arisen in part from the evolving nature of the Tasmanian regulatory regime. In particular, Transend has incurred additional unforeseen resource costs in addressing a range of regulatory developments since 1999:

- compliance with ring-fencing and accounting guidelines
- development of guidelines for the regulatory test
- compliance with regulatory reporting guidelines
- participation in the Reliability and Network Planning Panel scope review
- compliance with the Reliability and Network Planning Panel guidelines.

Transend has also committed additional resources to monitor developments in the NEM. In particular, the following national market reviews raise issues that are core to Transend's business:

- the Productivity Commission's review of Part IIIA of the *Trade Practices Act 1974* (Commonwealth)
- the Council of Australian Governments' *Energy Market Review*
- the Commission's review of the regulatory test for network augmentations
- the Commission's review of service standards (including the introduction of financial incentives and penalties) for TNSPs
- the finalisation of the Commission's draft *Regulatory Principles* on the regulation of transmission revenues.

In addition to these reviews, the National Electricity Code Administrator (NECA) and the National Electricity Market Management Company (NEMMCO) have both conducted reviews and development activities that also have important implications for Transend. The key reviews that are either in progress, or have been recently completed include:

- Stage 2 of the *Review of the Integration of the Energy Market and Network Service Provider* in relation to market-based performance incentives
- Implementation of the Code changes associated with network planning, arising from the Network and Distributed Resources package. In particular NEMMCO's Inter Regional Planning Committee has to establish reliability criteria to be used to evaluate proposed network augmentation
- Development of an effective method for implementing the beneficiary pays principle in accordance with NECA's *Transmission and Distribution Pricing Review*.

Transend's existing revenue determination did not anticipate the extent and coverage of the regulatory reviews and developments that have occurred in this regulatory period. As a consequence, Transend's revenue control did not sufficiently provide for the costs of these activities. To ensure the company's effective participation in all of these activities, Transend has committed more resources to regulatory issues without receiving appropriate remuneration through its revenue control.

In addition to the increased scope of regulatory work, Transend has also incurred significant costs with respect to Tasmania's entry to the NEM. In particular, Transend initiated the Tasmanian Wholesale Electricity Market (TWEM) project to manage issues associated with NEM entry. OTTER did not anticipate the costs of this project during its 1999 revenue determination.

3.4 Calculating the efficiency bonus

Table 3.1 shows Transend's actual operating costs compared to OTTER's allowance in the 1999 determination. It shows that over the 4-year period to 30 June 2003 Transend's actual costs will exceed OTTER's allowance by an aggregate of $5.8m.

Table 3.1: Transend's O&M costs compared to OTTER revenue cap allowances (in 2002-03 $m)

	1999–00	2000–01	2001–02	2002-03
Total O&M cost	18.9	19.4	20.8	22.7
O&M allowance contained in 1999 Pricing Determination	19.3	19.1	18.7	18.7[1]
O&M allowance minus Transend's actual cost[2]	0.5	(0.3)	(2.0)	(4.0)

Sources: Transend annual reports and the Final Report of OTTER's Investigation into Electricity Supply Industry Pricing Policies, November 1999.

[1] *OTTER determined Transend 2003 revenue by rolling forward in real terms the 2002 revenue cap.*

[2] *Figures do not add due to rounding.*

Transend's view, however, is that given the increased scope of work described in Section 3.3 the company has significantly improved its efficiency and cost performance (compared to the O&M allowances in the 1999 revenue cap).

Theoretically, Transend's efficiency gain should be assessed against a cost allowance that fully recognises the actual scope of work in the first regulatory period. Unfortunately, such an approach would involve a degree of conjecture.

As a compromise position, Transend proposes that an efficiency bonus is calculated on the basis of the TWEM costs incurred during the current regulatory period. This is equivalent to assuming that OTTER would have allowed $5.8m for the additional non-TWEM scope increases for the period 1999-00 and 2002-03, or about $1.45m a year.[3]

Transend's view is that this approach almost certainly underestimates Transend's efficiency gain during the first regulatory period. However, given the difficulty of objectively verifying the efficiencies gained, the company has taken a pragmatic approach in framing this proposal.

[3] *In other words, it assumes that the actual operating costs, excluding TWEM costs, exactly matched OTTER's revised allowance. This would leave the TWEM costs as the efficiency gain.*

Transend has identified the TWEM costs as averaging about $0.5m a year over the current regulatory period. The proposed efficiency bonus 'glide paths' this gain over the next regulatory period, as summarised in Table 3.2. The glide path allows the full efficiency gain in the first year, reducing by 20% in each subsequent year.

Table 3.2: Transend's proposed glide-path for efficiency gains (in 2002-03 $m)

	2004–05	2005–06	2006–07	2007–08	2008–09
Efficiency bonus	0.5	0.4	0.3	0.2	0.1

3.5 Future regulatory periods

Transend recognises that a formal glide path mechanism should be established for the forthcoming and subsequent regulatory periods. This will ensure that Transend has clearly defined incentives to improve efficiency. In developing a glide path mechanism, Transend believes that the following four principles should be satisfied:

1. Scope and cost efficiencies are treated on an equivalent basis
2. Operating and capital expenditure efficiencies are treated on an equivalent basis
3. The early delivery of efficiency gains is encouraged rather than discouraged
4. There should be 'fair-sharing' of efficiency gains between the TNSP and its customers.

In Transend's view, the efficiency carry-over mechanism adopted by the Essential Services Commission in Victoria (the ESC) substantially satisfies the second and third principles. That mechanism therefore provides a reasonable basis for further development. Transend would welcome further discussion with the Commission about developing the ESC's approach for application in Transend's forthcoming regulatory period.