



Draft Decision

**Service Quality Incentive Scheme for
Electricity Distribution Services in
Queensland**

February 2004

SUBMISSIONS

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). It therefore invites submissions from interested parties concerning its review of incorporating service quality performance in to the regulatory arrangements for Queensland electricity distributors.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by e-mail. Submissions, comments or inquiries regarding this paper should be directed to:

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The **closing date** for submissions is 5 March 2004.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (that is, the complete version and another excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked “confidential”, the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997*, the Authority must take all reasonable steps to ensure the information is not disclosed without the person’s consent, provided the Authority is satisfied that the person’s belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of an FOI request.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact the Authority on (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority’s website.

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1. OVERVIEW

This document outlines the Authority's draft decision on the inclusion of service quality incentives in the next regulatory arrangements. It follows consideration of stakeholder comments in response to the service quality incentive scheme proposed by Meyrick and Associates and Pacific Economics Group titled *Development of an electricity distribution service quality regime to take effect in future regulatory periods* (Draft Report, August 2003).

The Authority's *Final Determination on the Regulation of Electricity Distribution* (QCA 2001) set the regulatory framework for the period 1 July 2001 to 30 June 2005. In its Final Determination, the Authority expressed its intention to consider the inclusion of some form of service quality incentive mechanism into the regulatory framework for the next regulatory period. During the current regulatory period, the Authority has put in place service quality monitoring arrangements, with the DNSPs required to collect and report data on a quarterly and annual basis against service quality measures and definitions established by the Authority.

The Authority commissioned a scoping paper by Meyrick/PEG to look at the characteristics of service quality incentive regimes, the most important measures to target, how service quality incentives might interact with other parts of the regulatory regime and the experience of other Australian jurisdictions and international regulators. The scoping paper was released publicly and Meyrick/PEG were subsequently engaged to develop a service quality incentive regime that could be incorporated into the revenue cap arrangements in the next regulatory period.

Following consultation with the distributors and their customers, Meyrick/PEG proposed a service quality incentive scheme of the form CPI-X+S for inclusion into the Authority's revenue cap arrangements in the next regulatory period. The proposed scheme would establish a number of indicators to measure performance, benchmarks against which performance could be assessed and an award mechanism to convert performance into rewards and penalties. A full description of the scheme is in Meyrick/PEG's Draft Report, which is available on the Authority's web site.

In releasing the Meyrick/PEG Draft Report for comment, the Authority flagged its concern that a broad service quality incentive scheme with rewards to improve reliability may not be warranted if customers were happy with current reliability levels. This concern was based on emerging evidence from other Australian jurisdictions and internationally that electricity customers may not be as concerned about reliability aspects of service quality as previously thought, or at least that customers were generally not prepared to pay much for improvements in reliability. However, the evidence also suggested that those customers on the worst performing parts of the electricity networks were likely to be willing to pay more for improved reliability. It also appeared that customer service aspects of service quality may be of more concern to most customers than reliability aspects.

2. RESPONSES TO THE SCHEME PROPOSED BY MEYRICK/PEG

Six submissions were received in response to the Meyrick/PEG Draft Report, from Energex, Ergon Energy, Energy Users Association of Australia, Incitec Pivot, Queensland Treasury, and the Queensland Mining Council (now the Queensland Resources Council – QRC).

In general, submissions supported the introduction of some form of service quality incentive scheme in the next regulatory period. In some cases, this support appeared to be driven by the view that current service quality levels on the distributors' networks were low and needed to be improved. For example, QRC indicated that there was a general feeling in the mining industry that service quality could be improved. Similarly, Incitec Pivot was of the view that Queensland has one of the lowest levels of distribution reliability performance across Australia and suggested that Australian best practice therefore presented an appropriate target level of performance for the Queensland distributors. This view was also supported by the EUAA, which argued that Energex and Ergon Energy should reasonably be expected to at least match the reliability performance of similar distributors in other states by the end of the next regulatory period. Energex also argued that Australian best practice should be pursued. However, the issues of who should pay for such improvements and whether it was appropriate that this should occur through a service quality incentive scheme were not addressed in submissions.

It may well be that the existing level of system-wide service quality on the distributors' networks is too low and that a material improvement in service quality performance may be warranted over the next regulatory period. However, service quality incentive schemes are not generally intended to address such fundamental issues. Rather, such schemes are usually implemented to offset the negative incentive inherent in CPI minus X regulation for distributors to neglect service quality in pursuit of cost savings. Allowing for material improvements in underlying system-wide service quality levels would more appropriately be addressed in the context of establishing the opex and capex building blocks used to set the distributors' revenue caps.

Other issues raised in submissions fell into six broad groups.

Choice of indicators

It was suggested that the incentive scheme should include additional measures, including the frequency of momentary interruptions, the number of times affected customers are interrupted each year and interruptions as observed by customers rather than as measured by the distributors.

In order to construct an incentive scheme that could be implemented as part of the next regulatory arrangements, Meyrick/PEG were limited in their choice of measures to those that the Authority already monitors according to the *Electricity Distribution: Service Quality Reporting Guidelines* (QCA 2001). These Guidelines had been subject to stakeholder input and were designed to achieve reasonable consistency with measures proposed by the Steering Committee on National Alignment of Regulatory Reporting Requirements.¹

The Guidelines do not include the additional measures proposed in submissions. To expand the set of measures would require significant changes to distributors' current information collection systems. For example, the frequency of momentary interruptions would be very costly for the distributors to monitor on a network-wide basis. As data on the proposed additional measures is

¹ The Steering Committee on National Alignment of Regulatory Reporting Requirements was established by the Utility Regulators Forum to oversight the development of nationally consistent measures for reporting the service and financial performance of electricity distributors and service performance of electricity retailers.

not currently collected by the Authority, it would also be some time before any useful information was accumulated to allow these measures to be utilised. Moreover, with disaggregation on a geographic basis as already required, the existing set of measures places a significant reporting requirement on the distributors.

Energex suggested that the quality of supply complaints measure should not be used because it reflected customers' perceptions of distributors' performance rather than actual performance. While the Authority concedes that there is a subjective element to quality of supply complaints, customer perceptions of service quality is nevertheless an important ingredient.

Overall, the Authority considers that the mix of indicators proposed by Meyrick/PEG represents an appropriate balance of the simplicity, feasibility and comprehensiveness concerns raised by stakeholders.

Relationship of the scheme to opex and capex in core revenue cap arrangements

The distributors questioned how the Meyrick/PEG scheme would interact with the setting of capex and opex to be included in the distributors' revenue caps for the next regulatory period.

In practice, the scheme would have rewarded the distributors for achieving service quality targets based on an historical average of their own performance (penalties would have applied if the targets were not met). However, there would always be difficulties in separating the service quality effects of the "normal" investment and maintenance activities of the distributors (as provided for in the building blocks) from that achieved due to any additional expenditure the distributors directed specifically towards improving service quality to gain a reward under the incentive scheme. For example, if the capex and opex building blocks resulted in an improvement in the base level of service quality above the historical average, the distributors would effectively be rewarded twice for undertaking capex and opex with a service quality dimension – first, through an allowed return on the capex and opex under the revenue caps and second, through the reward payments under the incentive scheme. In order to prevent this outcome, it would have been necessary to separately identify service quality improvements associated with allowed capex and opex and service quality improvements associated with additional expenditure aimed at achieving rewards under the incentive scheme.

Complexity and delayed implementation of the scheme

A common criticism of the scheme proposed by Meyrick/PEG related to its complexity, including the need to make annual adjustments to the distributors' revenue to reflect service quality outcomes and the suggestion that the scheme should commence with a three year paper trial which would delay the introduction of 'real' payments until 2008-09.

The Authority acknowledges that the scheme could be somewhat complex and unpredictable due to the annual changes that would be required. The Authority was also concerned that there would always be some uncertainty about the service quality outcomes that could be expected over the regulatory period. It was for these reasons that the paper trial was proposed. The period of the paper trial would provide all parties with an opportunity to better understand the incentives created by the scheme and the likely impact on actual service quality outcomes, while at the same time providing some recognition of distributors' efforts to address service quality issues. As observed in submissions, the downside of the paper trial would be the delay in achieving full operation.

The nature of penalties and rewards

The Energy Users Association of Australia (EUAA) strongly criticised the penalties and rewards proposed by Meyrick/PEG due to the reliance that had been placed on the study of

VoLL conducted by Monash University which EUAA believed to be flawed and that reliance on this study would yield rewards and penalties that were too large.

A key criticism at the time of the Monash study was that data from only 7 per cent of the questionnaires sent out was used. This issue was addressed by Charles Rivers Associates (CRA) who were engaged by VENCORP to estimate the VoLL that should be used in assessing transmission system augmentations. CRA arrived at a measure for the overall value of customer reliability that was very similar to the Monash study's overall VoLL, despite finding significantly different values across customer groups. Meyrick/PEG utilised this updated information. While customer valuation studies are seldom immune from some level of criticism, the valuations derived by Meyrick/PEG appear acceptable given the constraints on the current exercise and the relatively small penalties and rewards being considered.

There was some support in submissions for capping rewards and penalties at around 1% to 2% of the distributors' allowed revenue. (The potential impact on retail electricity prices would be significantly less than this amount.) However, it was suggested that limiting the incentives to 1% or 2% of revenues may not provide the distributors with sufficient incentive to pursue service quality improvements. Of the two distributors, only Energex directly addressed this issue, expressing its view that a 2% limit was reasonable.

There was general support for a symmetrical (rewards and penalties) scheme as opposed to a penalty only scheme. The EUAA qualified its support by suggesting that the distributors should not be rewarded for providing base levels of service. Under its proposed approach, there would be no rewards or penalties available to the distributors for maintaining current levels of service quality with these only becoming available for clear improvements in service quality.

There was also some support for the use of deadbands in order to prevent windfall gains or losses to the distributors, limit price volatility for customers and reduce the administrative cost of the scheme.

Needs of larger customers

Some concerns were expressed by EUAA, QRC and Incitec Pivot that the proposed scheme, aimed as it was at improving system-wide performance, offered little for large customers whose requirements were often for a level of reliability well above the average.

The Authority agrees that the specific needs of large customers may not be addressed through the incentive scheme. However, these customers would still benefit to some degree from any network-wide improvements in service quality that would result from the scheme.

For large customers it may be preferable for the Authority to consider other means to resolve their specific service quality requirements in establishing the broader regulatory arrangements to apply from 1 July 2005.

3. OTHER JURISDICTIONS

3.1 New South Wales

The Independent Pricing And Regulatory Tribunal (IPART) recently released its *Draft Determination for Electricity Distribution Pricing 2004/05 to 2008/09*, which proposes a service quality incentive mechanism (an ‘S’ factor) linked directly to the price cap formula. The S-factor would allow a DNSP’s price cap to be adjusted either upwards or downwards within a regulatory period to reflect its service level performance relative to pre-determined targets approved by IPART.

IPART’s approach includes an initial paper trial period of two years, after which monetary incentives will apply from July 2006 based on each distributor’s aggregate service reliability performance measured against SAIDI (average minutes off supply per customer). IPART noted that it may be appropriate to expand the S-factor to cover a wider range of service quality measures at the next review if data availability and accuracy have improved sufficiently.

The NSW scheme will involve annual price adjustments subject to a cap of 0.5% of the maximum amount of distribution use-of-system revenue exposed under the S-factor. The proposed service quality incentive scheme would be symmetric in design, with performance above the target being rewarded at the same rate as performance below the target is penalised. The incentive rates for distributors will be based on the marginal costs of improving reliability (rather than the value customers attach to service quality improvements), in a range from \$4,000-\$8,000 per MWh of unserved energy² across the distributors. There will be no rolling averages of service quality performance used in setting the service quality targets and no performance deadbands.

IPART elected to use the current Steering Committee on National Regulatory Reporting Requirements’ (SCNRRR) definition of unplanned SAIDI, and based on this definition, the following outages will be excluded from the scheme:

- transmission outages;
- direct load shedding;

and outages:

- which exceed a threshold SAIDI impact of 3 minutes; *and*
- are caused by exceptional natural or third party events; *and*
- where the distributor cannot be reasonably expected to mitigate the impact of the event on interruptions by prudent asset management.

Momentary and planned interruptions will be excluded.

IPART is also introducing a service quality monitoring and publication regime, where a range of distributor service quality performance statistics will be collected and published. These statistics will cover service reliability, quality of supply and customer service measures. The Tribunal also intends, subject to Ministerial approval, to introduce Guaranteed Customer Service Standards for these measures.

² Unserved energy is a DNSP’s best estimate of energy that may have been consumed in the period when supply was interrupted.

3.2 Victoria

In its *Electricity Distribution Price Determination 2001-05*, the Essential Services Commission (ESC) introduced a service quality incentive scheme into the price cap formula, with compensation payments also potentially available for customers affected by poor reliability.

The incentive scheme includes measures for the number of unplanned outages (SAIFI), average unplanned outage duration (CAIDI) and total planned minutes off supply (SAIDI) for CBD, urban and rural customers. These measures are weighted based on the relative importance placed on them by customers. System averages are used rather than including a worst performing feeder dimension, due to the absence of reliable data on worst performing feeders. The scheme only includes reliability measures as customer service issues were seen to be mostly retail-related and there was no reliable information on technical quality of supply. The service quality targets under the scheme were approved by the ESC and are linked to costs built into the DNSPs' X-factors.

The incentive scheme only rewards a distributor for marginal improvements in service level performance, that is, only if it continues to reduce the gap between actual performance and the target performance from one year to the next. This is designed to reduce gaming opportunities that may be present in a simpler year-by-year scheme and to encourage distributors to achieve long-term, sustainable improvements in service quality.

The ESC did not cap total incentives as it believed this might have led to the distributors not spending on improving service quality but rather paying the penalty each period, with the scheme having no effect. The scheme is symmetrical in design, with performance above the target being rewarded at the same rate as performance below the target is penalised. The incentive rates are based on the distributors' marginal costs of improving reliability (rather than estimates of customer value) and range from \$3,960-\$7,050 per MWh of unserved energy across the DNSPs.

The scheme has had a larger impact than envisaged on the DNSP's revenues, with up to a 4% increase in actual revenue, compared to the expected 1% increase in revenue anticipated at the commencement of the scheme. This has been attributed to a run of favourable weather conditions and a focus by DNSPs on improving service reliability, with performance targets consistently exceeded over the first few years of the scheme's operation.

Distributors must apply to the ESC to have exceptional events excluded from the incentive scheme. These may include:

- supply interruptions made at the request of customers;
- load shedding due to a generation shortfall;
- supply interruptions caused by a failure of the shared transmission network; and
- supply interruptions caused by the failure of transmission connection assets.

Natural disaster events that are rare, widespread in their effect and that the distributor could not have been reasonably expected to have mitigated were also excluded.

In addition to the service quality incentive scheme, distributors are required to make guaranteed service level payments of \$80 to urban customers who experience more than 9 supply interruptions in a year and to rural customers who experience more than 15 interruptions in a year. Urban and rural customers are also entitled to payments of \$80 if their power is off for more than 12 hours at any one time. These payments are intended to motivate distributors to

improve poorly performing parts of the system where the investment may not meet the distributors' usual investment hurdle requirements.

3.3 South Australia

The Essential Services Commission Of South Australia (ESCOSA) implemented the first operational electricity service quality incentive scheme in Australia for ETSA Utilities in 2000-01. Under the scheme, ETSA's maximum allowable distribution revenue under its revenue cap was increased or decreased depending on actual performance across a number of service quality indicators.

The service quality indicators used were: minutes off supply per customer (SAIDI); the number of supply interruptions per customer (SAIFI); the average duration of each supply interruption per customer (CAIDI); time to restore supply to not less than 80% of affected customers; and operating cost per customer. For the first four measures, an average was taken across the Adelaide Central, Metropolitan, Rural and Remote areas plus a category which includes the forty worst feeders in South Australia based on numbers of interruptions per customer.

The first three measures of network reliability include both planned and unplanned interruptions to supply. The impact of interruptions that are less than 30 seconds duration are excluded from these measures for the purpose of the incentive scheme. In addition, the scheme allows the impact of certain events that are not directly related to the distribution network (such as loss of the transmission network or insufficient generation) to be excluded from the measures of network reliability.

Under the scheme, ETSA received points for its performance relative to pre-determined targets and revenue adjustments are made at the rate of \$300,000 per point. However, ETSA can earn more points (three) for out-performing the targets than it can lose (two) for under-performing relative to the targets. For 2001-02, the maximum potential reward was worth around 0.7% of allowable revenue and the maximum potential penalty was worth around 0.5% of allowable revenue. The first adjustment to revenue was made in 2001-02 and reduced ETSA's allowed revenue by \$900,000, mainly due to average operating costs per customer exceeding the target and reliability measures falling short of targets in rural and remote areas. While the calculation of reward points is symmetric, the timing of rewards and penalties is not with price reductions being passed onto customers immediately but any increases in prices being delayed until the following year and then capped at 1.5% per annum.

ESCOSA is currently reviewing the coverage and operation of the scheme in the lead up to its price determination for 2005-10. In its *Initial Thoughts, Electricity Distribution Price Review: Service Standard Framework*, ESCOSA indicated that changes to the scheme will be focussed on the measures used and their weightings. In addition, the emphasis of the scheme will be changed from average reliability performance targets to reliability targets for those customers with the worst service levels. Targets will be set in terms of the percentage of customers who experience:

- more than a given number of interruptions in a year;
- more than a given number of minutes off supply in a year; and
- an interruption longer than a given number of minutes in a year.

These changes are based on a customer valuation survey that indicated only 15% of customers were unhappy with service quality levels and willing to pay for service quality improvements. ESCOSA does not intend to include momentary interruptions in the revised scheme as the survey indicated this was not sufficiently important to customers. ESCOSA has also flagged

that it intends to include several measures related to call centre performance as part of the incentive scheme.

Complementary changes are also being proposed to the guaranteed service levels (GSL) scheme which currently only applies to timeliness in making new connections, keeping appointments and repairing streetlights. ESCOSA is proposing to extend coverage to include the number of interruptions experienced in the last year and the longest interruption in the last year, while removing the GSL on timeliness in keeping appointments.

3.4 Tasmania

In its *Investigation of Prices for Electricity Distribution Services and Retail Tariffs*, the Office Of The Tasmanian Energy Regulator (OTTER) proposed a service quality incentive scheme for Aurora's distribution services, linked directly to Aurora's revenue cap and based on two service quality measures, minutes off supply per customer (SAIDI) and the number of supply interruptions per customer (SAIFI), both measured on a statewide basis. OTTER decided that, due to the immaturity of the scheme, the revenue at risk will be relatively small during the 2003-2007 regulatory period, with the maximum adjustment being +/- \$1.6 million in any one year (representing approximately 1.25% of Aurora's annual average revenue requirement). Of this figure, half will be attributable to each of the two service quality measures. Some major events (based on a mathematical formula) will be excluded from the incentive scheme.

The performance targets have been set to reduce SAIDI from 185 minutes in 2003 to 144 minutes by 2007 (excluding major event days) and to reduce SAIFI from an average of 2.15 interruptions in 2003 to an average of 1.82 interruptions by 2007. The starting values were calculated using 24 month historical rolling averages. Aurora is to be penalised or rewarded \$26,000 per minute (SAIDI) and \$26,000 per 0.01 average interruption, if its performance diverges from these base line targets. The reward/penalty payments were based on the marginal cost of improving reliability. Based on a customer study conducted by Aurora, OTTER noted that it appeared customers' willingness to pay for improvements in reliability (measured by SAIDI) was several times the cost of improving reliability, although it treated this conclusion cautiously.

Similar to the Victorian scheme, the Tasmanian scheme will include guaranteed service level (GSL) payments of \$80 to individual customers should they experience:

- more than 9 outages in a year if residing in an urban area, or 15 outages in a year if residing in a rural area; or
- an outage lasting longer than 12 hours.

3.5 Transmission

In its decisions for the NSW/ACT and Qld transmission systems in 2000 and 2001 respectively, the Australian Competition and Consumer Commission (ACCC) specified a number of service standards it expected the transmission companies to meet. However, explicit service quality incentives were not introduced at that stage due to insufficient data being available. In later decisions for SA and Victoria in 2002, the ACCC explicitly incorporated service quality incentives. It has also flagged that the incentive schemes will be progressively refined and application expanded to the other states.

The ACCC transmission service quality incentive scheme involves the inclusion of an 'S' factor in the revenue cap formula. Based on average performance over the past three years, targets are set for:

- circuit availability;
- loss of supply event frequency index;
- minutes constrained (inter-regional); and
- minutes constrained (intra-regional).

The incentive schemes' impact on revenue is generally limited to 1% of allowable revenue for the initial period. Incentives are applied asymmetrically for all indicators, with performance better than the target being rewarded at a higher rate than poor performance is penalised. This was based on benchmarking studies showing that Australian transmission companies were already operating at high levels of service quality. All outage duration and most frequency indicators have deadbands. However, indicators relating to circuit availability do not.

There is generally a six month gap between the measurement of annual performance and the regulatory year in which the subsequent S-factor is applied. The incentive scheme is applied as a separate 'add-on' to the revenue cap each year, and there is no compounding effect over time (that is, each year's penalty or reward will only effect revenue in one year of the regulatory period).

4. AN ALTERNATIVE APPROACH

The Authority acknowledges several of the concerns raised by stakeholders. Principal among these are the complexity and uncertainty inherent in the proposed scheme and the negative delays in achieving real improvements which may result from the extended paper trial period (a feature which the Authority agrees with Meyrick/PEG would be necessary if the proposed scheme were introduced).

In order to address these concerns, and to more directly link service quality incentives to the core regulatory arrangements, the Authority proposes a simpler incentive process based on a regulatory contract, to be agreed as part of (and tied to) the current review. This proposal would retain many of the features of the Meyrick/PEG approach but would reduce the complexity associated with implementing the scheme and increase the transparency of outcomes for both the distributors and customers.

The scheme would target specific service quality outcomes to be achieved by the end of the next regulatory period, rather than requiring annual assessments of service quality and corresponding financial adjustments to be made.

In establishing the capex and opex building blocks for the next regulatory period, the distributors would be required to submit forecasts associated with:

- a) maintaining the current service quality level (the Authority has not been presented with any evidence to suggest that current service quality levels are too high);
- b) improving service quality aimed at delivering an agreed average level of service (which may be somewhat higher than current service levels); and
- c) specific additional commitments aimed at improving service quality in specific parts of the network or addressing identified customer requirements and including clearly identified service quality outcomes.

The Authority would assess the distributors' arguments for each of these cases on their merits as part of the process of setting the opex and capex building blocks for the next regulatory period. Stakeholders would have an opportunity to comment on the proposals in response to the 2005 Draft Determination.

In simple terms, part (a) of the above scheme represents a scenario similar to that encompassed by the current regulatory arrangements. In its *Final Determination on the Regulation of Electricity Distribution* (2001), the Authority approved annual amounts for capex and opex to be included in the revenue caps for each year of the current regulatory period. The Authority took the view that, in the absence of any set service standards, it could only assume that the current level of service quality was appropriate and should at least be maintained. Service quality outcomes are now being monitored and reported but there is no other mechanism in the current arrangements to link allowed revenue to service quality outcomes.

Part (b) would take this approach a step further by recognising that the current service levels may not be appropriate. The distributors and customers may argue in the current review that the networks need to be strengthened in order to recover declining security levels and to enhance system performance (this would be additional to any augmentation necessary to accommodate growing demand which would normally be captured under (a)). What the appropriate level of service quality might be will have to be determined in consultation with stakeholders but, in the first instance, the distributors would present their case for what they believe would be necessary based on their understanding of their own networks and of the interests of the customers they

serve. Assessing and agreeing an outcome would include establishing agreed service quality targets that are to be delivered.

Part (c) would provide the distributors with the opportunity to present a case for agreed amounts to be included in the revenue caps to meet specific customer requirements or requests. Cases presented here would need to address the full range of service quality issues identified in the Meyrick/PEG paper, including, for example, proposals to address problems on the worst performing parts of the networks.

No penalties or rewards would apply with respect to achievement of service quality outcomes under (a). This mirrors the current arrangements where best estimates were used to determine reasonable capex and opex forecasts for the regulatory period with the aim of maintaining existing service quality. These forecasts were then built into the revenue caps for each year without any specific penalties should service quality levels deteriorate. However, under the new arrangements, to the extent that parts (b) and (c) build on attainment of basic service quality levels under (a), there would be a clear incentive created for these basic levels to be achieved.

Parts (b) and (c) would form the basis of a regulatory contract between the Authority and each of the distributors. The contract would identify what service quality outcomes were to be achieved by the end of the regulatory period and what rewards and penalties would apply to success and failure. Attaining (b) may not attract significant rewards beyond an assurance that the capital invested would be included in the capital base. To avoid a penalty for not achieving the agreed outcomes, an assessment would have to be made that the capital allowed had nonetheless been invested wisely before it was entered into the roll forward asset base. The outcomes for (c) would be subject to greater incentives as the risks involved are likely to be higher. Achieving the agreed outcomes here would result in some additional reward (beyond the normal return on capital) along the lines of the Meyrick/PEG proposal. Failure could incur equally expensive losses to the business.

To ensure that service quality improvements were delivered throughout the regulatory period, the contract would include annual milestones that had to be achieved within reasonable performance bands. Annual results falling outside those bands would trigger some form of action by the Authority, possibly including an adjustment to allowable annual revenue to reflect failure of the distributor to meet agreed requirements of the regulatory contract.

The detail of the scheme will need to be settled as part of the current review process and be ready to commence at the start of the next regulatory period in July 2005. However, the broad principles of the approach would be as outlined above.

The proposed scheme addresses many of the concerns raised in submissions while retaining much of the intellectual rigour of the Meyrick/PEG suggested measures and outcomes.

The proposed scheme would be simpler to administer for the Authority and provide greater certainty of outcomes for the distributors and customers because the potential costs and benefits to customers and distributors would be clearly defined at the outset. As a result, there would be no need for a paper trial period as previously proposed and generally criticised in submissions.

The Authority's established service quality monitoring and reporting scheme would be maintained and used to make annual assessments of service quality performance against the targets established in the regulatory contract. An audit of the robustness of the distributors' collection procedures for the chosen service quality indicators would be undertaken prior to the commencement of the next regulatory period.

While this new proposal does not specifically address concerns raised by large users, other opportunities to address aspects of service quality for these customers could be investigated in

constructing the regulatory contract and the broader regulatory arrangements, for example, by providing some form of support for negotiated outcomes for these customers.

5. SERVICE QUALITY AND THE 2005 DETERMINATION

The Authority will consider feedback from stakeholders on this draft decision and anticipates releasing a final decision on the preferred approach to including service quality incentives in the next regulatory arrangements in April 2004. If the Authority's revised proposal is adopted, the Authority would then develop the details of the scheme for inclusion in the draft determination on the regulatory arrangements to apply from 1 July 2005. The draft determination will be released in late 2004. Following consideration of stakeholders' comments on all matters including the service quality incentive arrangements, a final determination will be released in early 2005.