



**Submission on the Queensland Competition Authority's
“Draft Decision Paper on Service Quality Incentive Scheme
for Electricity Distribution Services in Queensland”**

15 March 2004

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Introduction

The Queensland Competition Authority (QCA) is considering the inclusion of some form of service quality incentive mechanism into the regulatory framework governing the two Queensland Distribution Network Service Providers (DNSPs) for the next regulatory period starting from 1 July 2005. As part of the review process, the QCA has:

- Released a paper on service quality incentive scheme proposed by Meyrick Associates and Pacific Economics Group (*Meyrick/PEG Report*);
- Received and considered six stakeholder comments on the paper, including one by the Energy Users Association of Australia (EUAA);
- Released its Paper “Draft Decision - Service Quality Incentive Scheme for Electricity Distribution Services in Queensland” dated February 2004 (*Draft Decision paper*), and
- Invited submissions from interested parties on the Draft Decision paper.

In response to the above invitation, the EUAA is pleased to have the opportunity to comment on the Draft Decision paper. EUAA’s comments follow the structure of the Draft Decision paper, with the relevant sections of the Draft Decision paper used as paragraph headings.

As a general comment, we feel that the Draft Decision is welcome but that it is misconstrued in its general position questioning the importance of service standards to energy users and that it lacks detail on how the QCA’s proposals would be implemented.

Overview

(Page 1)

The last paragraph of Section 1 “Overview” refers to the QCA’s concern “based on emerging evidence” that:

- “Customers may not be as concerned about reliability aspects as previously thought;
- Those on the worst performing parts of the network were likely to be willing to pay more for improved reliability; and
- Customer service aspects may be of more concern to most customers than reliability aspects”.

EUAA’s comments:

- *These points had not been made in the original Meyrick/PEG Draft Report, and it would help if the QCA could provide more details of the “emerging evidence” to support those points, and whether such sentiments span across all customer classes.*

- *The EUAA notes that the QCA, in raising these points in the Draft Decision paper, has not recognised the points made by the EUAA in its submission on the Meyrick/PEG report that EUAA members operating in Queensland have concerns about reliability, quality of supply and customer service. The EUAA would like to re-iterate that the electricity supply reliability and quality are issues of major concern to EUAA members operating in Queensland. This has been emphasised time-and-again to the EUAA by its members in Queensland as was pointed out in our original submission. EUAA members in other jurisdictions also confirm this point.*
- *The EUAA is also worried that the Draft Decision could be (mis) interpreted to mean that the QCA does not consider supply reliability as a significant issue in Queensland, and would request the QCA to make a categorical statement that such is not the case.*
- *Generally, the point can be made that DNSP customers are vitally interested in both the price of distribution services and the service they receive for this price. Clearly, there are trade-offs involved in these matters, but users have an expectation that a certain level of service will be delivered for their distribution charges. Overall, they would expect their current service to beat least maintained and in some cases (the worst performing areas) could even expect some improvement for the same cost.*

QCA Responses to the Scheme proposed by Meyrick/PEG

(Page 2)

The QCA has noted some of the views put forward in the submissions in the first three paragraphs of Section 2, but does not clearly state QCA's final views on the issues raised herein. Furthermore the QCA appears to be doubtful about the appropriateness of service quality incentives schemes by casting them as steps to "offset disincentives inherent in CPI-X regulation for distributors to neglect service quality in pursuit of cost savings" and stating that "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 distributor's revenue caps".

EUAA's comments:

- *The QCA should clearly state its position on the broad issues raised in the first three paragraphs of Section 2, namely:*
 - *Whether Queensland should use Australian best practice as an appropriate target level of performance?*
 - *Who should pay for improvements in service quality?*
 - *What is the main reason for the service quality incentive scheme in Queensland?*
 - *How the QCA proposes to address service quality in the context of setting capex and opex and how this compares to regimes used elsewhere?*
- *Regarding the use of benchmarks, the EUAA would support the development of a comprehensive database that tracks the service quality performance of other distributors in Australia and overseas, with features "to control to the*

greatest extent possible for differences in external business conditions that may affect the measured quality” (Ref: Section 8, The Meyrick/PEG report). This is an essential precursor to the use of benchmarks in any service quality incentive scheme.

- *Whilst we appreciate the QCA’s concerns about the shortcomings of the present approaches to service standards in Australia and understand that sentiments behind its suggestion that network service levels may also be addressed (perhaps more effectively) in the context of setting capex and opex for DNSPs, we are concerned that such an approach not be used by DNSPs to ‘gold plate’ their networks or as an ‘excuse’ for higher expenditure. It is well known that regulated networks can use the incentives provided by regulatory regimes to the game the system as well as improve their performance.*
 - *This point needs to be appreciated by the QCA and understood in the development of any policies to address service levels.*
 - *A regime such as that outlined by the QCA would also need to consider (perhaps target) the areas of greatest need such as those with the poorest performance and regional areas.*
 - *The EUAA has seen evidence before where DNSPs in other jurisdictions have used dubious methods, such as flawed market surveys, to argue that their customers want better service and “are prepare to pay for it”, as part of a claim for higher expenditure.*

QCA’s Choice of Indicators

(Page 2)

While indicating its support for the Meyrick/PEG’s proposed indicators, the EUAA raised in its previous submission the issue that the mix of indicators, such as average SAIDI and that of the worst 10% of feeders, would still not cover the band of customers who are marginally better off (e.g. the next worst 10% feeders). The Draft Decision concludes that the Meyrick/PEG proposed indicators “represent an appropriate balance of simplicity, feasibility, and comprehensiveness”.

EUAA’s comments

- *The EUAA understands and supports the need for keeping the indicators simple, however, some recognition needs to be given to the distribution of service levels around the mean (average) level. The feasibility of statistical measures such as standard deviation could be considered to describe the dispersion of service levels around the mean. In the initial stages of the scheme, this could be a parameter that is monitored, but not necessarily included in the calculation of incentives.*
- *In addition, as we pointed out in our original submission, it is most often the quality of supply (eg, the frequency of interruptions) that is of more interest to business users than the duration.*

The Nature of Penalties and Rewards

(Pages 3-4)

The Draft Decision has specifically addressed EUAA's concerns about the use of the results from VoLL study conducted by Monash University. While conceding that customer valuation studies are seldom immune from some level of criticism, the Draft Decision paper has accepted the use of that study on the basis of "the relatively small penalties and rewards being considered."

In relation to penalties, it is worth noting that the Office of Gas and Electricity Markets (OFGEM) in the UK "has significant powers to fine companies up to 10 per cent of their turnover if they breach their licence conditions." (Ref: Statement by the OFGEM Chief Executive Alistair Buchanan, 10 March 2004, in response to the UK Trade and Industry Committee Report on the resilience of the national electricity network). While the OFGEM Statement does not refer to the positive incentives in place, it indicates the importance attributed to the deterrent effect arising from a high level of penalties in case of breaches of licence conditions.

EUAA's comments

- *The EUAA realises that further debate on the validity of the Monash VoLL study is not going to be fruitful in this context; however, QCA's implied justification of the Monash method on the basis of non-materiality of the amount of penalty and reward raises the inevitable questions such as:*
 - *If it is such a non-material amount, will it have any impact at all on the DNSPs at a macro level?*
 - *What would happen in a case where a large customer tries to negotiate a service level contract with a DNSP, and the penalty / rewards turns out to be a non-trivial percentage of the distribution charges paid by the customer as a result of applying the Monash VoLL study results?*
- *The controversial nature of the Monash VoLL study makes it a weak platform on which to base any computation of rewards / penalties, particularly in one-to-one negotiations between large customers and DNSPs.*
- *As the Meyrick/PEG report states, the values used in their report may not reflect precise preferences of Energex and Ergon customers and that "further work in estimating the value of service to customers in Queensland may be important". (Ref: Section 8 of Meyrick/PEG report). We support this and note its importance given the prospect of real service and revenue being involved.*

Needs of Larger Customers

(Page 4)

The Draft Decision report agrees that "the specific needs of large customers may not be addressed through the incentive scheme", and adds that "it may be preferable for

the Authority to consider other means to resolve their specific service quality requirements.”

The Meyrick/ PEG report also raised the prospect of a “role for the regulator” in monitoring compliance with (bilateral) service contracts and in any dispute resolution process arising from the contract. (Ref: Section 3.1.1 of Meyrick/PEG report).

The EUAA, in its submission on the Meyrick/PEG report, stated that “the larger electricity users are also in need of (regulatory) protection” in the area of service standards provided by the DNSPs.

EUAA’s comments

- *The EUAA welcomes QCA’s explicit recognition that the service quality needs of larger electricity customers should also come under some form of regulatory purview. However, it would request the QCA to go one step further and canvass the details of some options on the appropriate mode of regulatory involvement in the area of network service standards provided to larger customers. As stated in its submission on the Meyrick/PEG report, the EUAA would welcome an opportunity to work with the QCA and DNSPs on these options. The EUAA has provided in Attachment 1 additional points, for consideration by the QCA, on the possible scope of a regulatory role in the relationship between a large customer and a Queensland DNSP.*

Other Jurisdictions

(Pages 5 - 9)

The Draft Decision report succinctly summarises the service quality incentives arrangement prevailing in the other Eastern States. We welcome this inclusion.

While similar in intent and the underlying principles, there are distinct differences between the details of the incentive regimes proposed by different jurisdictions.

EUAA’s comments

- *The Draft Decision report does not specify which features, if any, of the other jurisdictions’ arrangements will be adopted in the Queensland regulatory framework. Does it support the CPI-X+S approach? What is an appropriate level of penalties and rewards cap for the Queensland DNSPs? What should be the value of unserved energy in Queensland?*
- *The EUAA would also support any on-going effort amongst the regulators to bring in greater level of uniformity and consistency as much as possible.*

Alternative Approach

(Pages 10 - 11)

The QCA proposes in Section 4 of the Draft Decision “a simpler incentive process based on a regulatory contract... that would retain many of the features of the

Meyrick / PEG approach”. Only the broad principles of the new approach have been outlined and the QCA proposes that the details will be finalised as part of the current review process.

EUAA’s comments:

- *The principles of the alternative approach require further elaboration so that they can provide clearer indication as to eventual details of the proposed regulatory contract between the QCA and the DNSPs. For example, the QCA should clearly specify which features of the Meyrick/PEG approach will be retained, and which will not.*
- *The practical aspects of implementing this approach would need to be considered. In particular, the categorisation of any augmentation works into one of categories (a), (b) or (c) would involve considerable subjectivity and may create some scope for disputes. For example, any improvement work done on the current worst 10% feeders may be argued as category (c), since it would be a case of more than maintaining current service standards which comes under category (a); and being part of category (c), such work could be claimed as eligible for service incentive benefits. The unintended consequences of the proposed alternative approach may well be a greater level of QCA oversight into DNSP’s operations than is currently the case.*
- *More comprehensive guidelines need to be provided as to how the categorisation of capex and opex into the three ‘boxes’ would occur.*
- *The EUAA is concerned about the lack of specific details in the Draft Decision. In our view, a Draft Decision should outline quite detailed aspects of what a regulator such as the QCA is proposing so that all affected parties can properly assess this and respond to the regulator in an informed way.*

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Attachment 1: Service Quality Requirements of Large Customers - Role of the Regulator

1. It is recognised that as the size of an electricity customer increases, the requirements of electricity supply reliability, quality and customer service tend to become more site and user specific. Therefore, there is a stronger need for service quality indicators measured at the general network level to be augmented by some site-specific service indicators as well.
2. Large customers, both commercial and industrial, place heavy emphasis on all the three classes of services from the DNSPs – Reliability, Supply quality, and Customer service- to meet their electricity needs.
3. In addition, large customers may have special requirements relating to connection of new (or additional) load to the network, connection of on-site generation, such as co-generation and standby generation to the network, continuous supply for some critical processes, etc.
4. While each large customer may have unique needs, it must be recognised that the monopoly DNSPs have a general commitment to an equitable treatment of all its customers.
5. Normally, these two positions are resolved by negotiations between the service provider and the large customer under the broad principle of “user pays” or “the causer pays” for services that are unique to that customer. However, there is limited use of this process in electricity distribution in Australia and DNSPs have generally displayed a reluctance to “negotiate” with larger customers, let alone on equal terms.
6. While large business customers have recourse to technical capability required to deal with DNSPs on these issues, the fact still remains that they will be dealing with a monopoly supplier. This already makes equal negotiation difficult even for the largest customers. The scope for cost effective ‘distribution bypass’ by a dissatisfied customer is non-existent in almost all cases.
7. There is also the case of information asymmetry at the negotiation table, with the DNSPs, not surprisingly, having much more data to support their positions on costs, the levels of quality indicators appropriate to that site etc, than the customer. This asymmetry needs to be redressed so that negotiations can take place on ‘a level playing field’. This problem can be compounded where DNSPs refuse to release certain information or delay its release.
8. There may also be instances when disagreements could arise between the large customer and the DNSP over alleged (non) delivery of agreed service standards. The information asymmetry problem is relevant here too.
9. All the above factors dictate the definite need for a role for the Regulator in such a bilateral relationship between the large customer and DNSP. This basic

principle needs to be explicitly recognised by the Regulator. EUAA's suggestions on the scope of the Regulator's role are outlined below to provide a starting point for discussion on the subject.

10. The Regulator's role needs to be carefully structured around broad principles such as:

- The Regulator has to be cognisant of the unique needs of larger customers, but not adopt an overly prescriptive process, as there should be genuine room to negotiate.
- The Regulator's intervention should normally be only at the request of either the DNSP or the large customer (more likely the latter), though the Regulator may retain the right of intervention without such a request, in exceptional cases involving public interest.
- The Regulator can provide a negotiation framework under which a large customer can directly negotiate on specific service standards with a DNSP from a position that replicates, as much as possible, that of a customer in an open, competitive market by spelling out, for example:
 - The rights and responsibilities of each party;
 - The extent of property rights that the customer can exercise over supply assets owned by them;
 - The process for arriving at benchmark service levels, penalties and rewards, including the background data needed to be supplied by the DNSP to support its preferred position; and
 - Dispute resolution procedure covering both the initial negotiation stage and during the on-going delivery of services, etc.
- The Regulator can go one step further, and provide a model (template) for network services agreement that covers the above and other points or requires that the DNSPs do so (subject to approval by the Regulator).
- The Regulator can provide a forum for dispute resolution through mediation or, as a last resort, arbitration.

The EUAA has, in the past, worked with other interested parties in arriving at a template document for contracting for connection and supply between a DNSP and large customers. Its view, based on such experience, is that such connection agreements are more likely to be effective (from a customer viewpoint) if there is some scope for regulatory intervention.

The EUAA would welcome an opportunity to work with the QCA and DNSPs on this issue in the ensuing months so as to assist the QCA "in establishing the broader regulatory arrangements to apply from 1 July 2005" to meet the needs of larger customer. (Ref: Page 4, Draft Decision)

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