



24 October 2003

Mr John Hall
Chief Executive
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear John

**ELECTRICITY DISTRIBUTION – SERVICE QUALITY INCENTIVE MECHANISM
Summary and Introduction**

Please accept this submission from the Queensland Mining Council (Council) in response to your request for comments on the draft Service Quality Incentive Mechanism proposal prepared by Meyrick / PEG which was circulated under your letter of 16 September. Council had the opportunity to meet with QCA and the consultants Meyrick / PEG during the formulation of the proposed mechanism. This allowed the consultants to discuss with a number of our members issues of particular importance to the mining industry in relation to service quality in electricity distribution.

The mining industry is a large consumer of electricity with customers typically being large load, often demonstrating large load swings, and often in relatively remote locations. Electricity is a significant cost factor and the quality of service, particularly reliability of supply is of importance to the industry.

Council's response to the proposed mechanism is detailed below with the key points being:-

- The mechanism appears to be formulated to address issues relating to the small customer – residential, small business rather than the large customers of the type council represents. Council's interpretation is that this is likely to be driven by the assumption that large customers are able to enter into direct distribution contracts which will contain specific service quality incentive mechanisms. Council does not believe that its members have the ability to achieve such an outcome at this point in time.
- The mechanism is described as 'CPI-X+S' but the report does not explain what is meant by this. Council understands that the S represents the quality penalty / reward while the X is a factor to be imposed by QCA to drive the distributors to achieve efficient practice. Particularly in the light of the timeframe proposed, before rewards / penalties are a reality, the X factor and its relationship with base performance is considered important and the lack of discussion on this point is a deficiency of this report in Council's view.

- The proposed mechanisms and reward/ penalty proposals are a 'one size fits all' approach. The Queensland distribution system is far from uniform with a relatively dense population of relatively small customers in the SE corner and a dispersed population of customers in the region with load demand being dominated by a relatively small population of customers. Service quality values and costs are acknowledged to be different between these groups in the report and Council suggests that greater consideration be given to recognising the differences through the introduction of a tailored mechanism say between urban and long rural feeders.
- Council notes the intention to exclude outages of a short duration from performance assessment. As was specifically outlined in discussions between council and the consultants all outages are very disruptive to the mining industry and all outages should be included in performance assessment.
- Council has previously acknowledged that performance regimes of this type are complex and if not implemented properly can result in perverse behavioural response and / or impose an administrative cost burden on both service provider, regulator and customer that more than offsets any benefits. Nevertheless Council is surprised and concerned at the timetable proposed for the introduction of the scheme. The apparent lack of reliable data, including the number of customers, is disconcerting as is the time frame of 5 years before actual accountability is to be introduced. QCA should satisfy itself that such a time frame is unavoidable and does not reflect an overstatement of the shortfall in data availability by distributors unwilling to embrace the concept of a service quality mechanism.

Council appreciates the opportunity to comment on this matter and welcomes the opportunity for further consultation as any proposed mechanism are refined and move to a trial and implementation phase.

DISCUSSION

Application of the mechanism

The report proposes that the coverage of the scheme will be for all distribution services except for those where customers have entered into direct contracts with the distributors and for higher than basic price / service offerings, should they be offered. While council agrees with the principle of this proposal it is concerned that the current reality of large customer / distributor negotiation dynamics are not conducive to achievement of an outcome that is satisfactory to the customer. The assertion that 'large industrial customers who have special needs are in a position to enter into direct contracts with distributors for the supply of higher than standard quality power supply' (draft report page 25) does not reflect the experience of Council's members. It must be recognised that the distributors are monopoly service providers. The report notes that the distributor ultimately controls the terms of the Price – Service Offering (PSO) and that customers have no ability to opt out or change distributors. It is the mining industry's experience that there has been a reluctance on the distributors' behalf to seek to explore service quality differentiation and incentive arrangements for performance in contractual arrangements.

It is also noted in the report that the setting of terms for the minimum service package can clearly influence customer behaviour and terms and penalties can be set to induce customers to accept higher quality options than they would otherwise accept.

The mechanism as proposed is considered to be very much targeted for the smaller end of the customer scale – the residential and small business population as opposed to the large customers Council's membership represent. Such an emphasis is only valid if large customers have the opportunity to explore alternative PSO's with the distributor in a truly open negotiating environment with real alternative supply options available. Unless and until such an environment is created, and Council considers that QCA has a role to play in this regard, Council considers that there will be few instances where distribution services can be excluded from coverage by the mechanism. The concept of achieving this through individual contracts was raised by Meyrick and Council members emphasised at the time that for such a concept to be successful would require a change of culture within the distributors.

As a consequence the 'one size fits all' mechanism proposed would be a compromise between the costs and values for service quality in the relatively dense networks in the SE corner of the state and those for the regional networks which have significantly different customer bases and delivery cost characteristics. The need to differentiate between the service quality needs and values of large industry and smaller customers was discussed in the consultations forums.

The discussion in Chapter 6 regarding the penalty reward mechanism highlights the difference in both cost and value of alternative service quality outcomes between residential and industrial customers. Adopting a standard set of quality parameters and associated reward penalties represents a compromise which is unlikely to satisfy any party although it is acknowledged that any mechanism should avoid complexity.

Until there is a change in approach from the monopolistic distributors which sees an increased willingness to explore individual customer's service quality requirements and to adopt a meaningful incentive arrangement, Council suggests that some differentiation be introduced in the proposed mechanism to reflect the different customer characteristics. One possibility may be to differentiate between urban and long rural feeders with each having their own quality criteria and reward / penalty mechanism.

Quality Indicators - Reliability

During our discussions it was clearly stated by the industry that their principal quality criteria concern was that of reliability. Whether it be from a safety or continuity of production viewpoint the cost of supply interruption can be high particularly unplanned interruption. To a limited extent the industry is able to accommodate planned interruptions. One of the major load items in the mining industry is that of the processing plant whether it is a minerals concentrator or coal washery. These operations typically comprise high volume continuous processes which are run in series. An unplanned interruption of any duration can have significant consequences in terms of production time lost due to the requirement that the series processes have to firstly recover from the consequences of the interruption and then be restarted through a sequential process which often requires staged and gradual ramp up. The fixed time of any restart results in the cost of interruption being largely insensitive to the duration of the interruption.

Council therefore does not support the proposal that momentary interruptions (defined as less than one minute) be excluded from reliability data. While it is acknowledged that the mining industry can accommodate to some extent planned outages and there could be merit in distinguishing between planned and unplanned outage, as noted in the report if greater weight is placed on unplanned outages there will be a tendency for the supplier to increase the number of planned outages as a precaution. Therefore if planned outages are to be excluded or downgraded in importance an overall system availability indicator would need to be introduced.

Council suggests that the need for planned outages be recognised in the setting of the benchmark and that all outages whether planned or unplanned be included equally in any reliability indicator.

Exclusions

In relation to outages caused by transmission of generator failures which are out of the direct control of the distributor an alternative to simply excluding such events from the data is to have back to back quality mechanisms with the transmission provider and generator. The final customer is seeking delivery of a product at a certain quality and if this is not delivered is not really interested in having to attribute and apportion blame.

In relation to making an allowance for exceptional circumstances Council is wary of such an allowance being too generous and events which should have been able to have been accommodated by the service provider are able to be excluded on the grounds of being exceptional. Our discussions with the consultants considered the issue of lightning strikes as an example of this issue. Lightning itself is not an unusual event in Queensland and lightning strikes are often the cause of interruptions in regional Queensland. It is a debateable point as to whether a lightning strike, bush fire, or flood as examples are extraordinary. The infrastructure can be installed to minimise if not eliminate exposure to these factors. As noted in Council's submission on the issue of Infrastructure Investment in Extraordinary Circumstances (QMC - QCA correspondence 15 October) it is important that customers and service providers have a clear understanding of the level of service being offered. Council would be concerned for example that regulated prices for distribution are set on the basis of the cost of infrastructure that includes lightning strike protection yet interruptions due to lightning strikes are excluded from reliability data.

The suggested use of a '5% of customers' trigger to determine if an event is extraordinary needs to be considered with caution particularly in regional Queensland where if based on a demand weighting 5% could be triggered frequently.

Quality Indicators – Technical Quality

The nature of some of the equipment used in the mining industry can result in the customer having quite different technical quality requirements to the general community which often means that certain aspects of quality expected by the community is not required by the mining customers. Council acknowledges that ascertaining customer requirements and supply data is complex and may be difficult to incorporate in a generic mechanism. As reported technological improvements in data collection may allow specific technical quality parameters to be introduced but from the mining industry's perspective Council considers it is more appropriate that these parameters be subject to individual agreements.

Benchmarks

It is recognised that external business conditions can affect quality performance and that in establishing benchmarks specific conditions need to be taken into consideration. Nevertheless to establish a regime incorporating rewards and penalties legitimate benchmarks must be established if behaviour is to be changed and performance appropriately rewarded or penalised and customer satisfaction (and business performance) increased. External influences have to be accommodated in the setting of the benchmark but should not be used as an excuse for subsequent performance.

Given the length of time the distribution companies, under various guises, have been in operation in Queensland, Council is surprised to learn that there is a general lack of data available and believes that QCA should verify that this is the case and is not an excuse to delay the introduction of a quality regime.

The conclusion that the only feasible quality benchmark for Queensland is past distributor performance is disappointing to Council as there is a general feeling within the mining industry that the quality of service could be improved. However, because the current level of service is what the mines have been used to for so long it does not necessarily imply that it is an appropriate level of service. Such sentiments were expressed during discussions with the consultants. There is a danger that basing benchmarks on historic and future performance of the service provider there is a reward for moving from inefficiency to slightly less inefficiency.

If the approach recommended by the report is adopted then it is important that the introduction of a performance incentive (a CPI-X mechanism) is also introduced. The report refers to the notion that the scheme being introduced is a 'CPI-X+S' mechanism without explicit definition of what this means. Council assumes the 'S' represents the quality reward / penalty component but there is no discussion of the 'X'.

Council understands that, in a similar fashion to the incentive mechanism applied to QR in the Rail Access Undertaking to encourage efficiencies, it is intended that a CPI-X mechanism will be applied to the regulated revenue stream of the distributors. While adoption of a rolling average benchmark would capture (all be it with a lag) the 'easy' gains were benchmarks set too low to begin with, Council considers it important that an independent view of current efficiency be encapsulated in the setting of benchmarks.

Council believes this aspect to be of particular importance if the recommendation of a paper trial for 3 years is adopted. With no tangible repercussions to a fall off in quality there is a possibility of the distributors' reducing quality performance over this period, thus lowering the benchmark only to improve performance back to previous levels once tangible rewards are introduced and for which they will be rewarded.

The imposition of sound benchmarks and an underlying continual improvement mechanism must be included in any regime.

The proposal not to include deadbands in regime, at least initially, is surprising to Council. It would appear that the principle reason is due to the lack of data. The introduction of deadbands recognises the random fluctuations that occur and may avoid unnecessary administrative cost.

Proposed Time Frame

The report outlines a time frame for the implementation of a quality regime commencing with a data collection period from now until July 2005 followed by a three year paper trial with the first rewards and penalties applied for the year 2008/9 which means actual revenue will not be affected until 2009/10 due to the lag between actual performance and application of the consequences.

Such a timeframe appears to Council to be an inordinately long period and as a result it is likely to be difficult to get meaningful engagement from stakeholders at this point in time. Council acknowledges that the introduction of performance regimes needs to be approached cautiously so as to avoid the establishment of incorrect price signals. One of the factors behind the recommended time frame is the assessed lack of robust data.

Council reiterates that it is surprised at the apparent lack of data for what it would regard as basic information such as frequency of interruptions.

While moving firstly to a paper trial is consistent with the approach currently being adopted for the introduction of a KPI regime in rail Council questions the merit of conducting a trial over three years. While a paper trial can highlight deficiencies with data collection and analysis it is unlikely to significantly alter behaviours and result in actual implementation of alternative service quality approaches. As noted above it is possible that such long period could result in deterioration in performance in order to influence the starting benchmark for the real commencement of the regime.

If some information is not available at this point in time then perhaps it is appropriate to wait for this data to be collected and / or systems introduced to do so but this should not preclude the use of whatever data is available to commence the introduction of at least part of the regime in a much shorter time period.

Overall structure

Council acknowledges that any regime needs to be based on a small number of consistently reliable data sets, they need to be unambiguous in their collection and application, the mechanism should be simple, significant enough to actually change service delivery and requirements but not so significant as to become an end in itself. The proposed regime appears to meet these criteria. Provided the benchmarks are appropriately established Council considers it appropriate to introduce a symmetrical scheme with both reward and penalty. Establishing the quantum of the rewards / penalty on the basis of value to the customer is likely to be very difficult. The examples provided in the report demonstrate there is an apparent large range of customer value. Basing the rewards on the basis of cost is likely to be easier to establish but will require rigorous independent analysis. The proposal to cap the total rewards / penalties as stated in the proposal based on precedent and is a matter of judgement rather than economic reasoning. Capping at this level should ensure that the regime does not become an end in itself. Whether the rewards / penalties will be sufficient to encourage consumers and service providers to seek to change requirements /quality is unclear at this stage but needs to be assessed as the regime is first trialled and then implemented.

Council would welcome the opportunity to participate in any further consultation on this matter and is willing to continue to be involved in the development of the service quality regime. Should you wish to discuss any of the matters raised in this submission please contact me.

Yours sincerely

Keith Barker
Industry Policy Adviser