



Final Decision

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

April 2004

TABLE OF CONTENTS

	PAGE
1. OVERVIEW	1
1.1 Background	1
1.2 The Authority's Service Quality Incentive Scheme Draft Decision	1
2. RESPONSES TO THE DRAFT DECISION	4
2.1 Issues Associated with Linking the Scheme to Capex and Opex	4
2.2 Issues of Detail	5
3. SERVICE QUALITY INCENTIVE SCHEME FINAL DECISION	8

1. OVERVIEW

This document outlines the Authority's final 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 for Electricity Distribution Services in Queensland* Draft Decision (February 2004).

1.1 Background

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 distributors 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 & Associates/Pacific Economics Group (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, *Development of an Electricity Distribution Service Quality Regime to Take Effect in Future Regulatory Periods*, which is available on the Authority's web site.

Submissions in response to the Meyrick/PEG Draft Report raised a number of concerns. Principal among these were the complexity and uncertainty inherent in any such scheme and the negative delays in valuing real improvements which may result from the paper trial period.

1.2 The Authority's Service Quality Incentive Scheme Draft Decision

In order to address the concerns raised in submissions to the Meyrick/PEG Draft Report, and to more directly link service quality incentives to the core regulatory arrangements, the Authority proposed in its Draft Decision a simpler incentive process based on a regulatory contract, to be agreed as part of (and tied to) the current review. The proposed approach would involve targeting 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 annual 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 three sets of 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 may argue in the current review that the networks need to be augmented in order to improve system security and to enhance system performance (this would be additional to any augmentation necessary to accommodate growing demand which would normally be captured under (a)). The appropriate level of service quality 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 upon an outcome would include establishing 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 proposed 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 these would typically be projects with a low priority due to a range of factors such as the small number of customers who may benefit,

the low return that may attach to the project (relative to the cost) or simply that other projects are more urgent making these somewhat discretionary when funds are limited. Achieving the agreed outcomes here would be likely to 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 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.

2. RESPONSES TO THE DRAFT DECISION

Six submissions were received in response to the Draft Decision, from Energex, Energy Users Association of Australia (EUAA), Ergon Energy, International Power, Queensland Consumers Association and Transgrid.

Comments in submissions fell into two broad categories – those that related to the general approach of linking the incentive scheme to capex and opex in the revenue cap arrangements and those that related more to the detail of how the approach will be implemented. These are discussed below.

2.1 Issues Associated with Linking the Scheme to Capex and Opex

In general, submissions supported the approach proposed by the Authority in the Draft Decision for incorporating service quality incentives into the next regulatory arrangements. For example, the Queensland Consumers' Association, Energex and Ergon Energy all explicitly supported a regulatory contract based on three categories of capex and opex with related service quality targets. The Energy Users Association of Australia welcomed the Draft Decision and International Power was generally supportive of the proposed approach.

Both distributors noted that linking the incentive scheme to opex and capex in the core revenue cap arrangements would mean that they would have to submit forecasts of capex and opex to the Authority as part of the 2005 review before the Authority made its final decision on the service quality incentive scheme (Energex) or before it finalised the details of the scheme as part of the 2005 review (Ergon). Both distributors therefore indicated a desire to revise their forecasts in light of the Authority's final decision on the scheme (Energex) or finalisation of the details of the scheme (Ergon).

The Authority acknowledges the distributors' concerns. However, the Authority indicated in the Draft Decision that capex and opex forecasts associated with scenario (a) – maintaining the current level of service quality – would not attract any penalties or rewards, mirroring the current arrangements, where capex and opex forecasts for maintaining existing service quality were built into the revenue caps. The Authority maintains this position. As a result, the distributors do not require any further details on the incentive scheme in order to provide capex and opex forecasts to maintain service quality.

In the Draft Decision, the Authority stated that capex and opex forecasts associated with scenario (b) – improving service quality to an agreed average level of service (which may be somewhat higher than current service levels) – may not attract significant rewards beyond an assurance that the capital invested would be included in the capital base.

Energex suggested that capex and opex for scenarios (b) and (c) in the Draft Decision should be built into the distributors' revenue caps and that achievement of service quality targets for those scenarios should attract additional rewards or penalties.

All capex and opex will be incorporated into the revenue caps under the Authority's revised proposal. However, capex and opex agreed to under this proposal would be identified as being related to a particular category (either (b) or (c)).

There does not appear to be any good reason to attach significant rewards to achievement of service quality outcomes under scenario (b). Scenario (b) provides the opportunity for the distributors to make realistic, achievable improvements in the average level of service quality they provide to their customers. Achieving realistic improvements in average levels of service quality does not present Queensland distributors with material additional risks beyond those that would be compensated for in the core revenue cap arrangements.

Achieving the outcomes required under scenario (c) would involve the distributors undertaking projects which may traditionally have had a low priority due to the small number of customers affected, the lower returns (relative to costs) that may result from such projects, or simply that in the competition for funds and resources, such projects tend to be the last to be considered. The rewards attaching to proposals under scenario (c) would be intended to overcome such hurdles and result in these projects becoming high (rather than low) priority.

The Authority acknowledges that most of the detail of the penalties and rewards for outcomes under scenario (c) is yet to be developed. As indicated in the Draft Decision, this will occur as part of the current regulatory review and the outcome will be reported in the Authority's 2005 Draft Determination due to be released around November 2004. All interested parties will have an opportunity to comment on the service quality (and all other) components of the 2005 Draft Determination.

Stakeholders will also have an opportunity to respond to the proposed capex and opex for all three scenarios when the findings of the capex and opex review being undertaken by the Authority's consultants are released for comment.

2.2 Issues of Detail

Some submissions noted the lack of detail in the Draft Decision. For example, the Energy Users Association of Australia was concerned that the Draft Decision lacked detail and argued that it should have included detailed aspects of the approach so that all stakeholders could have properly assessed the proposal and responded to the Authority in an informed manner. The Authority agrees that stakeholders should be given the opportunity to provide fully informed comment on the proposed scheme. As noted above, the detail of the scheme is to be settled as part of the current review process. Stakeholders will have an opportunity to comment on the details of the proposed scheme, and all other aspects of the regulatory arrangements, in response to the 2005 Draft Determination.

Submissions identified a range of issues that the Authority should consider as it develops the detail of the scheme. Some of these issues, and the Authority's preliminary views, are discussed below.

The importance of service quality to customers

Some submissions raised concerns about the Authority's comments in the Draft Decision 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.

The Authority was not presenting its view but rather commenting on information being revealed in recent surveys of customer concerns. These particular comments reflected the results of a customer survey conducted in South Australia and anecdotal evidence emerging from other Australian jurisdictions and internationally which indicated that, for many customers, improvements in customer service aspects of the service they receive from distributors, for example, response times for fault reporting phone services, were more important than further improvements in reliability. It was also noted that this was not the case for those customers on the poorer performing parts of the networks. While the Authority acknowledges that customers value service reliability, it is yet to be convinced that Queensland customers (in general) would be willing to pay significantly more for what may well be small improvements in reliability, or for improved reliability ahead of improvements in other aspects of service quality, such as customer service. Consistent with the evidence from other jurisdictions, the Authority recognises that, for some customers, the priorities will be reversed and its proposal in relation to

scenario (c) is intended to encourage distributors to address the concerns of this group of customers.

Choice of indicators

A number of submissions explicitly addressed the choice of indicators proposed in the Draft Decision. Comments received generally endorsed the use of SAIDI and SAIFI to measure reliability for the distributors' entire networks and their worst performing feeders.

Energex, Ergon Energy and Transgrid emphasised the need to adjust reliability measures to account for interruptions due to extreme events. The Authority currently allows the distributors to exclude interruptions that arise in their networks which affect at least 5 per cent of customers and are due to widespread storms and flooding or other natural disaster. For the service quality incentive scheme, Energex recommended (and Ergon discussed) using the definition of excluded events adopted by the Steering Committee on National Regulatory Reporting Requirements (SCONRRR). This definition requires that the event has a SAIDI impact of at least 3 minutes and is due to a natural or third party event that the distributor could not reasonably be expected to have mitigated. Meyrick/PEG noted that this definition appeared to be too lenient and that the Authority's current definition appeared preferable. The Authority is reviewing the adoption of the SCONRRR definition for the sake of uniform national reporting.

Energex proposed that only reliability on the 10 worst performing feeders by network type should be targeted under the scheme. The Authority currently monitors service quality performance on this basis. Meyrick/PEG proposed that indicators of reliability for the worst 10 per cent of feeders on the distributors' networks should form part of the incentive scheme. The Authority will consider these alternatives in developing the finer detail of the scheme.

Most of the other comments regarding the choice of indicators re-iterated responses to the Meyrick/PEG report. For example, the Queensland Consumers' Association and Energex suggested the use of additional measures and expressed reservations about the reliability of complaints as an indicator of service quality. The Authority argued in its Draft Decision that, 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 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. However, reflecting stakeholder concerns, the Authority will consider applying a relatively low weighting to complaints about service quality in the basket of indicators used to measure service quality outcomes.

Energex suggested that the distributors target additional service quality measures that suit the needs of individual networks and customer bases. The Authority welcomes this suggestion because it would provide customers with an extra level of commitment to service quality outcomes by the distributors.

The nature of penalties and rewards

While Energex supported a symmetrical scheme (where payments and rewards are equivalent), Ergon argued that there was an inherent asymmetry to reliability performance because good performance was bounded by perfect reliability while poor performance (for example, due to bad weather) is virtually unbounded. Ergon suggested that one way of addressing this was to have rewards that were greater than penalties. However, while this may hold for the full range of possible service quality outcomes, the same asymmetry is unlikely to exist in the narrow band of performance around existing service quality levels over which the incentive scheme would operate.

The Queensland Consumers' Association recommended that Guaranteed Service Level (GSL) agreements should have a prominent place in the incentive scheme adopted by the Authority and that these, to be effective, need to include automatic payments and compensation, such that all breaches result in payments, rather than only those reported by customers, as is currently required by the distributors' voluntary GSL schemes. In addressing service quality outcomes, there is nothing in the Authority's proposal to prevent GSL schemes being part of the solution proposed by distributors. In particular, GSL schemes, which effectively reduce the price of services for affected customers, may be a more cost-effective means of addressing particularly poor service quality than costly network improvements. To be effective, any GSL scheme needs to be well publicised and easily accessed by customers.

Needs of larger customers

The EUAA offered its views on the role of the regulator in meeting the service quality needs of large customers. It suggested that the Authority provide for a negotiation framework under which large customers could negotiate directly on service standards with a distributor. The proposed framework would include the rights and responsibilities of each party, the extent of property rights, the process for arriving at benchmark service levels, penalties and rewards and a dispute resolution procedure. A forum for mediation and arbitration could also be provided for. In its Draft Decision, the Authority recognised that an essentially network-wide service quality incentive scheme was unlikely to meet the specific needs of large customers and that other measures may be more appropriate in this regard. The Authority will consider EUAA's proposal in preparing its 2005 Draft Determination.

Differences in the distributors' networks

Ergon Energy argued that its relatively large sub-transmission network has implications for its reliability performance and that capex it intended to allocate to this part of the network to improve its reliability should form part of scenarios (a) or (b) which address network-wide reliability, not scenario (c). The Authority has consistently acknowledged the different operating environments of the two distributors. In establishing the details of the service quality incentive scheme, including allowable capex and opex for the next regulatory period, such issues will be taken into account.

3. SERVICE QUALITY INCENTIVE SCHEME FINAL DECISION

The Authority's Final Decision is to develop a service quality incentive scheme based on a regulatory contract with each distributor, which will be incorporated into the regulatory arrangements commencing on 1 July 2005.

The details of the service quality incentive scheme will be presented in the 2005 Draft Determination, which will be released around November 2004. Stakeholders will have an opportunity to comment further on the service quality incentive scheme in the context of responding to the 2005 Draft Determination.