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20 June 2003

Dr Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal
Level 2, 44 Market Street
PO Box Q290
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Dear Dr Parry

Response to Issues Paper 'Providing Incentives for Service Quality in NSW Electricity Distribution'

Country Energy welcomes the opportunity to comment on the Tribunal's Issues Paper.

The attachment documents Country Energy's position on a number of important issues raised by the Tribunal relating to the development of reliability incentive schemes for New South Wales electricity distributors.

Country Energy looks forward to further consultation in relation to incentive approaches. If you have any questions or wish to discuss this response, please do not hesitate to contact Mr Lawrence Zulli on 6883 4547.

Yours sincerely

Terri Benson
General Manager Regulatory Affairs

Country Energy's

submission to the
Independent Pricing and
Regulatory Tribunal



countryenergy

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Providing Incentives for Service Quality in NSW Electricity Distribution
20 June 2003



Providing Incentives for Service Quality

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1. Introduction

This submission outlines Country Energy's response to the Tribunal's Issues Paper 'Providing Incentives for Service Quality in NSW Electricity Distribution'. Country Energy believes that the consultation process in relation to service incentive schemes as outlined in the Issues Paper will be an informative and beneficial process for all stakeholders.

2. DNSP Views

The Tribunal seeks views from stakeholders on the DNSP proposals that an S factor with monetary incentives should not be introduced as part of the 2004 Network Review determination. Views are also sought on the proposals of some DNSPs that a 'paper trial' of an S factor be conducted during the 2004 regulatory period, allowing the possibility to introduce full monetary incentives at the next review, should the paper trial be successful.

A key issue for consideration during the current price review process is whether or not it is feasible to design and implement a financial incentive mechanism for service quality.

Country Energy has previously indicated in the April 2003 submission that it is generally not supportive of the introduction of an S factor adjustment to price controls for reliability. The efficient level of service is one where the customer value equals the cost of providing an incremental improvement in service. To 'artificially' replicate this concept practically in a financial incentive mechanism will be difficult.

There is little justification for the introduction of an S factor financial incentive scheme at this stage. There are practical difficulties in the development and implementation of an incentive scheme, and in those jurisdictions where incentive schemes have been introduced it is our view that it has added little value to rural distribution. Given the effective operation of present regulatory arrangements and the presence of commercial incentives for the distributors to maintain and improve service performance, we believe it would be difficult to justify a complex 'artificial' incentive for reliability.

The best approach to incentive regulation to achieve supply reliability outcomes is to set performance targets and the public disclosure of comparative performance. The current comparative reporting process is simple and a very effective form of regulation. It provides the necessary commercial discipline on the distributor to maintain and improve service levels, particularly for poorer performing parts of the network. The latter is a prime focus of Country Energy's expenditure plans for the forthcoming regulatory period.

While the current consultation process will be a productive and informative exercise, we have some concerns with the limited timeframe available to develop an effective and robust incentive mechanism. It is our belief that the development of an effective incentive mechanism requires a much more lengthy consultation and development process than that available in the present 2004 price review. The development work occurring in South Australia provides clear evidence of the research, development and time needed to fully develop an effective mechanism. Significant consultation must be undertaken to ensure an agreed upon set of performance measures, inclusions, targets, dead-bands, financial incentives and cap limits, price cap formulation, and processes for annual reporting and compliance. More importantly there is a real need for customer preferences to be fully established and integrated into the framework. There will be numerous other 2004 network determination processes occurring in parallel with this incentive scheme review.

We believe the Tribunal should create arrangements in the 2004 determination that provide the genesis for the future development of a workable robust mechanism and the establishment of appropriate performance targets over the forthcoming regulatory period. This would send a signal to the distributors of the Tribunal's future intent and process in this area. A robust incentive scheme in the price control providing appropriate incentives to the distributor could be effectively developed as part of the consultation process leading up to the 2009 regulatory reset.

In this respect there are a number of important implementation aspects that must be dealt with. As previously mentioned, a comprehensive study into customer preferences must be completed. Equally important, Country Energy believes that an incentive regime, including the proposal to conduct a 'paper trial', must be based on robust, consistent, accurate data for it to work effectively and reflect the true state of the network. Establishing an incentive mechanism using incomplete reliability measurement systems and data has the potential to create an unfair allocation of risk to the distributors or establish unrealistic performance targets and expectations for customers. Performance targets that do not accurately reflect the state of the network, but rather the state of reliability measurement systems, will not provide the correct incentives to the distributor.

The development of an incentive scheme requires three to five years of validated and high quality data to smooth out data inaccuracies and operational variations occurring from year to year. In this respect the regulatory framework in NSW has not matured sufficiently to accommodate monetary incentives given the current deficiencies. The Tribunal has previously accepted that there is an absence of sufficient and accurate time series data to assess the extent to which reliability performance has tended to vary over time. This was confirmed by PB Associates, in their recent report to the Tribunal, which clearly indicated that there is not sufficient quality or quantity of data on past performance to enable an effective incentive regime to be put in place. In our opinion, monetary incentives should only be adopted in those jurisdictions where the reliability measurement and reporting reforms are well advanced and comprehensive customer preference studies have been completed.

The current data issues can be worked through in the forthcoming regulatory period once clear guidance is provided by the Tribunal on the selected performance measures that would be integrated into this form of incentive scheme.

In Country Energy's case, it may take three years into the forthcoming regulatory period to develop the systems and collect data that would produce meaningful data for an incentive scheme. The implementation of the system proposed by Country Energy is detailed in the PB Associates report and in our April submission to the Tribunal. A considerable amount of work will be needed to achieve this objective given the issues identified. This limits the extent to which regulatory incentive schemes and accurate reliability performance targets can be developed and implemented for Country Energy in the forthcoming regulatory period.

Country Energy has previously raised concerns about the possibility that a scheme designed around inaccurate data can lead to an unfair shift in risk allocation and negative revenue impacts, not because of poorer performance but rather due to statistical inaccuracies. If a monetary incentive scheme were implemented, this risk allocation would need to be accompanied by a commensurate change in the weighted average cost of capital in order to ensure economic neutrality.

The forthcoming regulatory period would also allow the Tribunal to take into account the lessons learned from other jurisdictions. At the same time the distributors would commence their expenditure programs and commence collecting and reporting service quality performance data on an agreed range of performance measures. During this period of data

consolidation, the Tribunal could continue to monitor comparative performance to ensure that distributors are not achieving cost savings at the expense of service reliability.

3. Alternatives for Consideration

The Tribunal seeks views from stakeholders on each of the options outlined above.

The Tribunal has listed four alternatives for consideration in relation to the S factor. In deciding on an appropriate option moving forward, the Tribunal must ensure that the distributors are not exposed to unnecessary uncertainty and risk.

Option 1

Option 1 provides for the introduction of an S factor with full monetary incentives using data that is already available and switch/expand to incorporate other data as these become available (either part-way through the regulatory period or at the next regulatory reset).

A financial incentive scheme introduced in this manner will be strongly asymmetric for Country Energy where the value at risk will greatly exceed any potential gain that they may receive as a result of achieving improvements in reliability. It will provide inappropriate incentive signals and unfairly penalise Country Energy for a 'statistical deterioration' in performance. That is, the expected improvements to Country Energy's measurement and reporting systems over the next regulatory period are likely to increase the number of reported interruption events that are collected implying a degradation in service performance. This can only lead to an inappropriate balance of risk and reward.

Revising targets mid-stream or switching from one set of measures to another would only lead to an increase in complexity, uncertainty and regulatory risk. This reinforces the need to consider its implementation at the next reset.

Country Energy is therefore strongly opposed to this option.

Option 2

Option 2 provides for the introduction of an S factor with reduced monetary incentives with the possibility of increasing these incentives in the future as data improves.

Country Energy has a desire to limit the financial risk that it may be exposed to under a financial incentive scheme until more is known about the practical outcomes of its operation. However the issue of reliable and accurate performance data being used to set performance targets and risk issues apply equally to this reduced monetary option. As with option 1, any impacts would be driven by statistics rather than network performance. This could have a 'statistical' negative impact on revenue for Country Energy, which may reduce our ability to deliver services to customers over the forthcoming regulatory period.

Country Energy is therefore not supportive of this option.

Option 3

Option 3 proposes the introduction of a 'paper trial' S factor with no monetary incentives.

Country Energy provides some support for a 'paper trial'. The trial would enable the Tribunal and the distributors to understand the workings of an incentive mechanism better in its early inception, without financial risk. However for the 'paper trial' to work as intended and reflect

the true state of the network, there still remains the need to determine meaningful service performance targets for each of the proposed performance measures to be integrated into the trial incentive scheme.

One of the key principles in setting target levels of service is that it must be based on a consistent time series of historical accurate standardised data. Country Energy is opposed to using actual performance for the previous years to develop the targets. As identified in the PB Associates report, data has generally been collected in a fragmented manner, is incomplete and inaccurate. It is not of a standard that would allow adequate assessment of the statistical significance of variances in reliability and confidence in the accuracy of the resulting targets. As referred to earlier, this information may provide an incorrect picture of the actual service performance of the Country Energy network and therefore could not be relied upon in the setting of realistic targets for certain measures. Adjustments would therefore need to be made to past performance statistics to account for the under counting of outages, customers affected, and minutes of outage. In our opinion the modified data would not be good enough to form the basis of a 'paper trial'.

Country Energy believes that the trial of an initial pilot scheme could provide the basis for the future development and implementation of a more comprehensive scheme, if required, at a future regulatory reset.

Option 4

Option 4 proposes to lag the introduction of any S factor, postponing the start date until robust data is available at the levels of aggregation or the next regulatory period.

Given the effectiveness of present regulatory arrangements in providing commercial incentives for the maintenance of reliability standards, Country Energy's position continues to be that 'artificial' incentive schemes should not be introduced.

Nevertheless, should the Tribunal introduce such a scheme, Country Energy proposes that its implementation be delayed to some future regulatory reset, as proposed in Option 4, when more comprehensive information on reliability performance and customer preferences are available that could be used to set meaningful performance targets and incentives that underlie the true state of the network.

4. Choices of Measures

4.1 Types of Service Quality

The Tribunal seeks comment on the choice of reliability measures for inclusion in any incentive scheme, and on whether MAIFI data should be collected, with the option to add it to any service quality incentive scheme in the future.

Views are also invited on whether it would be desirable to collect data on other aspects of service quality (and if so, which aspects) so that these elements could potentially be included in future regulatory reviews.

Country Energy continues to provide support for the use of the three widely accepted measures of supply reliability, namely SAIDI, SAIFI and CAIDI should a service incentive mechanism be implemented. As detailed in our April submission these reliability measures have become industry standard in reporting network wide reliability performance and represent appropriate measures. Country Energy currently reports annually to the Ministry of Energy and Utilities using these indicators.

SAIDI should be the primary choice as it is a derivative of the other two indicators. That is, a distributor can take actions to reduce the frequency of interruptions (SAIFI) and/or reduce the time to restore supply following an outage (CAIDI), both of which result in a reduction in SAIDI.

For MAIFI data to be routinely and accurately captured by Country Energy, significant investment, resources and time will be required to record the transient interruptions. It would be prudent to delay the introduction of MAIFI as a performance measure in an incentive mechanism, until the benefits and costs associated with its collection are carefully examined.

Country Energy provided limited support in the April submission for the inclusion of other measures of service quality such as quality of supply and customer service, as there are difficulties and significant costs in obtaining data and it would be complex to implement in an S factor. Customer preferences should be analysed prior to the inclusion of these measures into an incentive scheme.

4.2 Customer Preferences and Priorities

The Tribunal seeks views on the ways in which customer preferences and priorities can best be reflected in any service quality incentive mechanism introduced.

The selection of service performance measures must reflect those key aspects of service delivery performance that are meaningful and most valued by customers. Customer preferences and priorities can be best demonstrated by willingness to pay customer research. A comprehensive study to determine customers' priorities for distribution network service performance improvement has not yet been completed in NSW. A pilot study has been completed. It is noted that the ESCOSA engaged a consultant to conduct a survey of customer preferences in South Australia.

The selection of performance measures for the incentive mechanism also needs to be efficient and practical, reflecting:

- Aspects of performance that can be influenced by the distributor;
- Data that is reliable and not excessively costly to obtain;
- As few measures as possible that would give a good understanding of the business performance and service performance trends; and
- Commonality with other jurisdictions where possible.

4.3 Data Quality and Availability: Creating Incentives for Improvements

The Tribunal seeks comment on the most appropriate options for creating incentives for the delivery of data quality improvements.

Starting from a position of three separate organisations with different systems, methodologies, and assumptions for providing reliability data, Country Energy has been in the process of implementing a common platform to enable outage data collection and detailed reporting and analysis to be conducted on a consistent basis. The identification of this need was established following our formation in July 2001 well before the Tribunal engaged PB Associates to review the necessary requirements to improve the collection and reporting of service performance data. Country Energy is in the process of purchasing management systems to assist us to achieve our objectives in this area.

The Tribunal should also recognise that there is considerable motivation for Country Energy to improve internal management reporting of quality reliability data, including:

- Analysis of system performance including identifying weak sections of the network;
- Enhancing customer satisfaction particularly in poorer performing sectors of the network where improvements are made;
- Aiding system planning and asset maintenance scheduling; and
- More efficient processes for regulatory reporting.

In our opinion there is no need for any further regulatory intervention in this respect as Country Energy has considerable commercial incentives to improve data quality as outlined above.

4.4 Excludable Events

The Tribunal seeks comment on whether certain events should be excluded from data used in any service quality incentive regime, and if so, what criteria for exclusion would be most appropriate. Comments are also sought on alternative ways to address the impact of exogenous events, including the possibility of having caps on the proportion of revenue that can be exposed to any service quality incentive scheme.

Adjustments must be made for events beyond the distributor's control. It would be inappropriate to hold the distributor 'financially' responsible for certain events that are beyond their control and not related to the distribution network. This would create inappropriate incentives. To be efficient, incentives should only be introduced with respect to interruption events that are 'endogenous' to the distributor. On this basis, Country Energy continues to believe that the key criteria should be to determine whether the supply interruption is attributed to an event that reflects a failure of the distributor to implement prudent 'distribution network' asset management practices or the interruption event is beyond the control of the distributor.

As outlined in our April submission, events that should be excluded include:

- Force majeure events such as extreme storms, bushfires and other natural disasters;
- Other major impact events on system performance where, for example, design limits of the distribution network are exceeded;
- Other rare events that the distributors would not reasonably be able to foresee or mitigate the impact thereof such as supply interruptions requested by emergency service organisations or NEMMCO;
- Interruptions resulting from within the individual customer's premise due to the failure of customer owned equipment;
- Interruptions resulting from safety related problems associated with the customer owned equipment;
- Incidents affecting electricity supply caused by third parties where distributors could not reasonably mitigate these;
- Interruption events resulting from the transmission network or from another distributor where inter-distributor arrangements are in place;
- Interruptions resulting from failure of transmission connected and distribution connected generation.

Country Energy believes that the impact of these events should be excluded from reliability measures on the basis that the distributor has no effective control over them.

Country Energy accepts that distributors may be better placed to manage performance and risk associated with their distribution networks where this can be managed through the implementation of prudent asset management practices. However we do not accept as fair or reasonable that there be no exclusions for external events beyond our control. It would be difficult to understand how a distributor could be able to fully or partially mitigate 'exogenous' events reinforcing the need for their exclusion in performance targets. Our published reliability standards do not fully reflect these events.

Additionally, adjustments should also be made for the following circumstances:

- Planned interruptions made with the prior agreement of the customer, or requested by the customer;
- Individual faults where the customer agrees to remain without supply for an extended period; and
- Interruptions lasting less than 1 minute.

In relation to the options proposed by the Tribunal for dealing with excludable events. The favoured process is for the distributor to claim for exclusion of events over which it has no reasonable control (as listed above). The Tribunal would then evaluate and verify these claims. However the complex and time consuming regulatory administration process that has enveloped the regulatory regime in Victoria for these types of applications should not be replicated in NSW. The process should therefore be simple, clear and transparent.

The following comments are provided in relation to the other options proposed:

- "Limiting the scope for companies to apply for exclusion" as proposed by the ESCOSA or "allowing companies to exclude a certain, pre-specified proportion of the impact of an event" as adopted by Ofgem represents an unfair imposition of financial risk onto the distributor. It would be inefficient to impose a penalty on the distributor where they are not in a position to respond to the "incentive" created. This would unjustly penalise the distributor who would face asymmetric risks and unfair revenue loss, impacting on the ability of the distributor to improve service levels.
- Country Energy has previously made comment on the SCNRRR approach to exclude events with a pre-determined reliability magnitude of more than three minutes when measured on an overall system basis. A severe storm that impacts on a regional centre in country NSW that results in an interruption of more than 24 hours for that regional centre may, when considered on an overall Country Energy system basis, lead to a SAIDI impact of less than three minutes. These storm events have a material impact on our reliability performance for that regional area. The present definition would not result in the exclusion of the storm event. This approach would be unacceptable to Country Energy as a result.
- The use of rolling averages would be suitable for smoothing out the variability that arises in performance outcomes over a set period of time, rather than relying on actual levels of performance at some point in time, however uncontrollable events must be removed in order to establish an underlying level of performance. This is a favoured approach to setting reliability performance targets, once accurate and robust data is available. Any other methodology would provide incorrect incentive signals to the distributor. This comment applies equally to the use of 'steps' (deadbands) in performance levels.

Country Energy provides in principle support for the use of caps on the proportion of revenue that can be exposed to the incentive scheme. Further comments in this respect are provided in our response to section 7 of the Tribunal's Issues Paper.

5. Mechanisms

5.1 Creating Incentives via Service Quality Expenditure Schemes

The Tribunal seeks views on the scope for creating incentives for service quality through its monitoring of service quality expenditure schemes. The Tribunal notes its commitment to avoiding micro-management of the DNSPs, and comments should be made within this context.

Country Energy's service-price offering as detailed in our April submission is predicated on maintaining the current level of service reliability across the network, and to deliver service improvement to poorer performing pockets of the network through a targeted expenditure program. Country Energy agrees with the Tribunal's view that the regulatory framework must not micro-manage the distributors as they have detailed knowledge of their networks and must be provided with responsibility to plan and efficiently allocate resources on service performance improvement programs.

In this respect the published standards of service relating to average system wide and remote area performance could be used as the benchmark for determining whether Country Energy has met its commitments in terms of delivering service quality expenditure programs. Additionally, as discussed in our April submission, Country Energy believes that the following measure for the identification of the worst performing circuits may be appropriate in the rural context:

- The implementation of a feeder performance indicator expressed in terms of SAIDI, SAIFI and CAIDI as a multiple of the average value for the feeder category, with weighting factors applied to reflect the degree of importance of each factor, noting that SAIDI is an outcome of SAIFI and CAIDI.
- On an annual basis, Country Energy would select the 20 worst performing circuits in the service territory on the basis of the feeder performance indicator.
- Corrective action would be taken within an agreed timeframe to reduce the feeder performance indicator of these worst performing circuits.
- The length of time a feeder is identified as a worst performer would be a measure of the effectiveness of the improvement strategies.

We see an opportunity to work with the Tribunal to develop a framework to overcome the limitation of whole system wide reporting and identifying and reporting on worst performing feeders to align with the aims of our expenditure program. The approach for identifying worst feeder performers as with other measures should be consistent with those applied by other jurisdictional regulators. This will enable Country Energy to be better compared with similar distributors in other jurisdictions. In this respect the approach proposed by ESCOSA for ETSA Utilities provides some interest to Country Energy.

5.2 Data Collection/Monitoring/Publication

The Tribunal seeks views on the extent to which incentives for service quality can be created through the collection and publication of performance data.

There are several avenues to provide incentives for distributors to meet their service performance obligations, including:

- Mandatory obligations imposed through relevant instruments;
- Public performance monitoring and reporting;
- Incentive mechanisms designed to reward (or penalise) performance that exceeds (falls short of) pre-determined performance targets; or
- A combination of these.

As supported in our April submission, the public reporting of comparative performance currently plays an important role by:

- Informing customers, regulators and other stakeholders of performance outcomes, and exposing distributors to critical assessment;
- Creating pressure on the distributors to both maintain and improve performance over time and relative to each other;
- Providing a commercial driver for distributors to prudently invest in their networks so as to improve service offerings and meet customer expectations;
- Facilitating informed negotiations between the distributor and customers on local or generalised quality improvements; and
- Providing an approach that is relatively straightforward to implement and a pre-requisite for other forms of incentives.

It is our belief that public reporting of performance has worked effectively in NSW. There needs to be a clear case made to justify the introduction of more complex 'artificial' incentives for reliability improvements, given the strong commercial incentives that the public reporting mechanism creates and the effective operation of present arrangements.

As detailed earlier, Country Energy is of the view that the most appropriate mechanism for service quality incentives in the forthcoming regulatory period should be comparative reporting and then potentially moving to service incentives at some future price reset provided it can be justified.

The current customer service GSLs and licence conditions, and any other voluntary minimum standards offered by the distributors would supplement this transitional arrangement. Performance monitored in this way over the forthcoming regulatory period will ensure that distributors do not achieve efficiency savings at the expense of service reliability.

5.3.1 What form should the S-factor take?

The Tribunal seeks comment on the form that the S factor should take, and on the extent to which features of the S factors discussed above are applicable in the NSW context. Comments are also sought on any alternative forms that the S factor might take.

The allocation of financial risk and uncertainty arising from data inaccuracies that may impact on the distributors from the implementation of the alternative incentive forms would need to be fully analysed by the Tribunal and clearly understood by all stakeholders prior to implementation. Irrespective, if an incentive scheme is adopted, provision should be made for

the costs associated with administering the scheme and estimates of financial losses to be included in the annual revenue requirement.

Brief comments in relation to each of the alternatives are provided below.

Victorian ESC Approach

Country Energy has previously outlined some key principles that should underpin the design of the financial incentive scheme. An important principle is that the incentive scheme should be a simple design for ease of understanding by all stakeholders. The Victorian S factor is a complex regulatory intervention with respect to the price control. The formula is cumbersome, features a complex array and interaction of terms, is data intensive and would be prone to errors of calculation.

Country Energy questions the need for multiple reliability performance indicators. If multiple indicators are to be used in NSW then appropriate weightings and incentive rates must be assigned to each indicator. The determination of these parameters can only be established through customer preference studies.

The Victorian 'summary' price control formula is expressed as $(1+CPI)(1-X)(1+S_t)/(1+S_{t-6})$. The term $1/(1+S_{t-6})$ would appear to give effect to and align with the efficiency carryover mechanism that has been implemented in Victoria. The Tribunal has previously indicated that it is not in favour of implementing this mechanism in NSW due to its complexity.

The formula could be better defined and more easily explained to customers if expressed as a simple $CPI-X+S$ form. A simple 'pilot' S factor in this form could be implemented to reflect the performance gap for the SAIDI indicator only for each of the standard network types. The performance gap would be the difference between actual SAIDI performance and a company specific target SAIDI performance set by the distributors for urban, short rural and long rural. Our preference for the use of the SAIDI indicator is outlined in our response to section 4.1.

Another disadvantage of the Victorian S factor approach is that it appears to provide weak incentive effects for improvements to poorer performing parts of the rural network, being based primarily on average performance improvement.

South Australian ESC Approach

The reliability improvement incentive model being developed in South Australia is of particular interest to Country Energy as it has as its prime focus an improvement to those parts of the network delivering the lowest service levels, rather than those parts of the network where customers are already satisfied with their current level of reliability. As detailed in our April submission, the specific targeting of reliability improvement in poorer performing remote areas of the network is a key theme for our service-price proposal given that a large proportion of our customers are generally satisfied with the service level provided. The ESCOSA proposal has a similar theme to the proposed performance measure as outlined in our response to section 5.1.

As emphasised in this submission, reliability performance measures that are chosen for this or any form of incentive scheme must reflect historical data that is robust and accurately reflects the current state of the network. In this respect there needs to be a considerable improvement in our ability to record outages at the customer level for the ESCOSA proposal to work effectively.

In place of performance measures based on the percentage of customers that experience levels of service worse than a pre-defined threshold, an alternative approach could be to base the measure on the percentage of feeders performing worse than a threshold. The latter would be simpler to measure.

A similar scheme implemented in NSW for reliability should be determined by reference to customer research. A call centre service initiative should be tested against willingness to pay customer preferences before it is introduced into NSW. It is noted that the ESCOSA has rejected the use of a quality of supply measures.

The ESCOSA is proposing to limit excluded events. As discussed in section 4.4, the inclusion of uncontrollable events in performance measures has the potential for unreasonable 'negative' revenue outcomes and the unfair allocation of risk to the distributors.

One issue that needs to be resolved in the design of the incentive scheme based on the ESCOSA model is the process implemented for the approval of annual price changes. For new network prices to be applied on 1 July each year, the monetary value for the incentive factor to be added to or subtracted from the price cap and the annual performance being measured would need to be calculated prior to the end of the financial year and prior to the distributor's annual price revision application. Alternative approaches could be to include unaudited estimates of reliability performance for the 't-1' financial year, or using reliability performance from the 't-2' financial year with a lag effect in terms of financial rewards/penalties, or using 'annual' reliability data that is not aligned with the financial year. Irrespective, the process followed would only increase the complexity of the incentive scheme and require additional regulatory reporting requirements and related compliance issues.

Country Energy agrees with the ESCOSA approach that momentary interruptions should be excluded from the incentive scheme. Country Energy has previously detailed the significant measurement difficulties with MAIFI. Additionally placing incentives on MAIFI would provide a perverse incentive for distributors to delay the implementation of improved measuring and reporting that the Tribunal has indicated in its Issues Paper that it is seeking to promote. It would also require significant time and expense to administer.

The Ofgem Approach

The Ofgem proposals have been designed to operate in the UK context with the UK business in mind with different business and operating environments and should only be adopted in NSW if supported by customer preference research.

5.3.2 Should Mechanisms be Symmetric

The Tribunal seeks views on whether any mechanism adopted should reward as well as penalise companies depending on service quality performance, and if so, should the incentive rates for rewards be of the same magnitude as the incentive rates for penalties?

The price control adjustment requires a good understanding of the value that the customer places on reliability and how much they are prepared to pay for increased (or reduced) supply quality. If there is to be an increase in network charges as a reward for out-performance or penalties for under-performance then this must be measured against customers' willingness to pay for the improvements or willingness to accept.

Whilst we recognise the importance of achieving a fair balance in risk exposure if any incentive mechanism were to be introduced, Country Energy believes that the scheme introduced should reward distributors for out-performance only, or asymmetric in favour of

rewards, until more is known about the operation of the scheme and more importantly, until performance data is accurate. The Tribunal could then set a symmetric scheme in the future when data has confidently improved or where this is warranted based on customer research. In relation to the last point, rewarding distributors only in our opinion is consistent with past customer research and the preliminary findings of the pilot willingness to pay study which revealed that customers place value on maintenance of existing reliability, or a small improvement in reliability of services, rather than paying less for worsening services. Therefore a service incentive scheme should be designed to provide a reward for a distributor to improve performance only.

Penalties are also not economically sound as the effect of 'negative' revenue arising from the operation of an S factor would restrict the distributors from receiving the full amount of allowed network revenue, as determined by the Tribunal as being required to facilitate the efficient operation and maintenance of the network. This may reduce their ability to improve or maintain system performance where it is needed. While this may benefit customers in the short term through lower prices, there are no service benefits to customers in the short or long term as a consequence.

An alternative approach could be to offset any 'negative' revenue outcome for any single year with any 'positive' revenue outcomes for any single year arising from the operation of the S factor during the regulatory period as outlined in our response to section 5.3.3 of the Tribunal's Issues Paper.

5.3.3 When should Price Adjustments be made?

The Tribunal seeks views on the relative advantages of a system that provides incentives for companies to meet/exceed service quality targets in every year of the control period, as opposed to for the period as a whole. Views are sought as to whether applying monetary penalties on an annual, as opposed to five-yearly basis would further strengthen these incentives.

If any incentive mechanism were to be introduced, Country Energy believes that price adjustments should be made at the end of the regulatory period rather than on an annual basis. This approach would enable the distributor to collect through the term of the regulatory period the level of revenue that the Tribunal has determined to be efficient to operate and maintain the network. In this respect any 'negative' amount calculated in a single year would be accrued to offset any 'positive' amount in a following year. At the end of the regulatory period, any accumulated 'negative carryover' should be set to zero in the transition from one regulatory period to the next.

This approach would also reduce the potential risk to the distributors associated with implementing an incentive scheme in the forthcoming regulatory period that has been based on inaccurate reliability data.

5.3.4 Use of Dead Bands

The Tribunal seeks views on whether the incentive and complexity disadvantages of deadbands exceed the advantages.

As indicated in our April submission, there is a need to take account of differences that arise in performance or data inaccuracies, even after excludable events have been taken into account. An appropriate approach for dealing with this small volatility is to introduce 'steps' of performance such that performance would need to move from one range to another before any financial rewards or penalties are incurred in any one given year. The use of three-year

rolling averages would also assist to remove volatility from one year to the next and smooth out the underlying system performance.

6. Target Setting

6.1 Alternative Approaches to Target Setting

The Tribunal seeks views on the most appropriate approach to target setting, and particularly on the following:

- *Do the pros and cons of alternative approaches to target setting detailed above suggest that the most appropriate approach might involve a combination of information sources?*
- *Do the fact that companies operate in significantly different operating environments mean that company-specific, rather than relative targets are appropriate for NSW DNSPs, particularly with current information levels?*

Clear and unambiguous service targets are important to customers, distributors and the Tribunal to ensure a common understanding of the basis for the delivery performance of electricity distribution services. For any incentive scheme to work as intended there is a need to determine agreed upon service performance targets for each of the proposed performance measures that reflects the true state of the network for each distributor.

As provided in our April submission, we believe the following principles must be taken into account in setting performance targets:

- The process should be clear, transparent and minimise any potential uncertainty;
- It must be based on a robust time series of historical data collected using the same definition for each measure (this is currently not available);
- Reliability of the network from one year to the next involves the impact of randomly occurring events outside the control of the distributor. There must be appropriate exclusions for exceptional circumstances as discussed in our response to section 4.4;
- Reliability indicators are randomly distributed about a mean so there is a real need to guard against any apparent 'sense of precision' when setting targets;
- It would not be appropriate to simply adopt the actual levels of performance at some point in time. It must be recognised that there will be years when the performance is worse than the average and years when the performance is better than average due to cyclical variations due to factors such as weather, hence an average using at least three years of data should be used;
- It should ideally reflect relative performance against like peers nationally, while still recognising individual operating conditions; and
- Targets should be set according to geographical location, rather than for specific customer groups, as there are practical issues in establishing the latter.

Country Energy is opposed to using actual performance for previous years to develop the target levels for the forthcoming regulatory period. As referred to earlier, this information may provide an incorrect picture of the actual service performance of the Country Energy network and therefore could not be relied upon in the setting of realistic targets for certain

measures. In its Issues Paper, the Tribunal has acknowledged that historical data may overstate the actual performance experienced by customers. That is, the performance is worse than the historical data has shown due to inaccurate measurement and reporting systems.

If service performance targets are to be set using inaccurate performance statistics, adjustments must be made to account for any under counting of the number of outages and customers affected. It is difficult to estimate the potential impact on historic reported performance. The PB Associates report provided a conservative variation range for Country Energy. Equally adjustments for changes in definitions of performance measures, which have been implemented in recent times due to the introduction of nationally consistent approach, would need to be taken into account.

The adjustment process would need to be transparent and consistent. Distributors should be given the opportunity to demonstrate that the change in reported performance is (or will be) directly attributed to changes in measurement systems and/or the impact of the changes in the measurement systems was not taken into account in the way that targets were originally set. This exercise would not be precise and would only lead to an increase in complexity and regulatory risk emphasising the need to consider the implementation of a service incentive scheme at a future price reset when more robust data is available.

It is noted that the ESCOSA has recently revised the performance targets applicable to the rural network operated by ETSA Utilities for both average number of interruptions and average number of minutes of supply to correct for data errors in previously reported rural reliability performance.

Country Energy believes that specific targets should be adopted for each NSW distributor to take into account the unique characteristics of each network. In this respect, Country Energy's preferred approach is for the Tribunal to collect quality standardised data for each distributor over the course of the forthcoming regulatory period, which could then be used to establish company specific targets at a future price reset. A rolling average could then be applied after three years and onwards to smooth out any variability, and uncontrolled events would be removed in order to establish an underlying level of performance that is under the direct control of the distributor.

In the interim, published standards of service could be used as the benchmark for determining whether Country Energy has met its commitments to improve performance through its expenditure program and in particular the poorer performing feeders. These company specific standards could be tested by the Tribunal against other 'like' electricity distributors operating in Australia to demonstrate their reasonableness and prudence. As indicated earlier, Country Energy is willing to be publicly measured and held accountable against our published objectives through a comparative-reporting regime. This mechanism provides the necessary commercial incentives to achieve planned objectives.

In setting target levels of performance, it must be recognised that for some rural feeders the high cost of improving the reliability of supply to meet targets might be prohibitive.

6.2 How ambitious should targets be?

The Tribunal seeks views on what the appropriate levels for targets should be, and whether/how these should move during the regulatory period. Views are also sought on ways in which any disincentives to conduct maintenance and improvement work can be avoided.

Country Energy believes that service targets should be set at fixed levels for the duration of the regulatory period. Our expenditure program for the forthcoming regulatory period has

been planned and structured based on maintaining reliability standards across the network, with a particular focus on improving areas with the lowest service levels, and the level of expected resource availability.

Any revision of targets during the course of the forthcoming regulatory period would need to be based on a rigorous evaluation of the costs and benefits of moving from the present level to a higher level and the availability of resources to undertake the improvement works. Given the increasingly ageing network infrastructure, we believe that substantial costs and resources will be incurred in maintaining the current service standards, through an extensive replacement/renewal and maintenance program over the forthcoming regulatory period, apart from any attempt to move these standards to a higher level. The additional costs and resources requirement associated with higher targets would need to be recognised in the revenue building blocks.

It would be inappropriate to expect distributors to restructure their medium to long term asset management plans to meet increasing standards of service provided by an 'artificial' incentive factor. Expenditure programs must be based on prudent economic network planning and customer willingness to pay.

Planned interruptions should not be included in performance targets. This would avoid penalising planned maintenance work to improve supply reliability. While a distributor will not interrupt a customer unnecessarily, it is vital for it to be able to take a customer off supply to perform essential maintenance work. While Country Energy plans to gradually increase the proportion of maintenance work carried out using live line techniques over the forthcoming regulatory period, there are maintenance activities that can only be carried out using dead line techniques, or are uneconomical to undertake using live line techniques. The distributor should not be penalised in this respect.

The incentive scheme should reward a reduction in unplanned interruptions only.

7. Penalty/Reward Setting

The Tribunal invites comment on the appropriate basis for the setting of any penalties and rewards. In particular, views are sought on the attractiveness of having a percentage cap on the amount of revenue exposed to any penalties/rewards, and if such a cap is favoured, views on the appropriate size (especially given the current data robustness).

To be effective, the S factor should reflect at least the marginal cost of reliability improvement. However estimating the marginal cost of reliability improvement is very subjective and impractical, particularly once differences in network type and the variable nature of improvement costs are taken into account. The significant diversity in Country Energy's network at all voltage levels and asset categories would make this exercise extremely difficult, if not almost impossible.

A preferred method is to base financial incentives on the results of a yet to be completed customer willingness to pay research.

Notwithstanding the above, if an incentive package were to be introduced by the Tribunal at the 2004 regulatory reset it must reflect an appropriate balance of the risk and reward for the distributors. Country Energy has a desire to limit the financial risk that it may be exposed to until more is known about the financial and practical outcomes of the scheme. Equally the Tribunal should ensure that incentives provide to the distributor must be offset against the potential for higher volatility in prices to customers and higher volatility in revenue to distributors.

The incentive scheme must be implemented in a manner that preserves the economic value of a business continuing to meet its service targets at a network wide level. To be economically neutral would involve providing an additional revenue allowance to the distributor to cover any expected costs of financial risks and losses under the scheme.

As indicated earlier, the incentives should be based on reliable and verifiable performance data. Due to the uncertainties regarding the robustness of data, Country Energy believes that the amount of revenue exposed to the incentive scheme should be set to zero for at least the first three years of the scheme if not for the full regulatory period. Alternatively, a scheme whereby negative outcomes in a single year are offset by positive outcomes in any subsequent years, with a zero negative carryover from the 2004 regulatory period to the next would also minimise risk due to data inaccuracies.

Equally it may be prudent to impose a cap on the level of price adjustments provided under the scheme. The impact of the S factor should be capped at a relatively low level to mitigate the impact of unforeseen and uncontrollable events and current data inaccuracies, limiting the financial exposure of the distributor. The cap should be set at no more than 0.5% of annual network revenue for the potential reward or penalty at the end of the regulatory period. The need for caps would be reinforced if the events listed in our response to section 4.4 were not excluded.

A 'rewards' incentive would need to be accompanied by greater flexibility in current side constraints to provide the distributor with the ability to recover the additional revenue.