Supplementary submission on SKM's Service Standards report

1 Introduction

This document represents additional comments on SKM's report to the ACCC on Transmission Network Service Provider (TNSP) Service Standards dated November 2002.

Our previous submission focussed on issues of appropriateness and adequacy of the recommended framework.

SKM's report does not document the 'whys' of some of the design decisions and the features built into the performance incentive (PI) scheme. These aspects, however, are important when it comes to developing targets and caps and collars, etc.

It is our understanding that the ACCC intends to use this report as a basis for future service standards work (eg. during revenue resets). This is a brief supplementary submission to provide further information which, in our opinion, needs to be included in the final report if it is to be used as a guide in the future.

2 Design parameters used to balance risk

The values chosen for the scheme parameters such as the target, caps and collars and the "ramping factor"[1] directly affect the amount of risk placed on the TNSP.

For example, a TNSP can be given more or less risk by making the target tougher or easier to achieve. A TNSP can also be given more or less risk by

[1] The "ramping factor" is the term used by SKM to denote the amount of bonus or penalty that applies per unit change away from the "target" value – eg. the dollars bonus for each per cent higher availability than the target. When plotting the bonus/penalties against the KPI, the "ramping factor" is the slope of the curve.

exposing the TNSP to more or less total dollars. And a TNSP can be given more or less risk by applying large or small incentives for a small improvement or reduction in service standards around the target.

Powerlink engaged KPMG to provide advice on features of a PI scheme that could minimise the impact of the scheme on Powerlink's existing revenue cap arrangements.[2] However, the study resulted in a number of general observations. Powerlink submitted a summary of the findings in June 2002.[3]

Briefly, the following sections outline some of the conclusions.

2.1 The target value

If the intention of the PI scheme is to have a balanced upside and downside risk, then an appropriate target needs to be chosen such that the ability to improve on the target equals the risk of under-performing. This is not the same as the average of past performance, however. A firm that operates near best practice has a very limited scope for out-performing (as this is raising the frontier) but a high risk of under performing. To balance upside and downside risk for this firm, the target would need to be chosen considerably below past performance.

In fact, it is Powerlink's view that it should be chosen such that operating at near best practice is rewarded and penalties are only applied when performance falls below an 'acceptable' benchmark.

2.2 Asymmetry in caps and collars and "ramping factors"

SKM's framework allows for scheme design parameters, such as the caps and collars and the "ramping factors", to be asymmetric with respect to bonuses or penalties. That is, the total potential bonus is allowed to be different to the total potential penalty. Likewise, for performance on either side of target, the rate at which a bonus accumulates is allowed to be different to the rate at which a penalty accumulates.

[2] KPMG Assurance and Advisory, *Powerlink Queensland: Minimising the Impact of a Service Standards Incentive Scheme on Powerlink's Existing Revenue Cap*, May 2002.

[3] Powerlink Queensland, *Impact of the Performance Incentive Scheme on the Revenue Cap of TNSPs,* June 2002.

In all cases, asymmetry would be used to adjust the risk profile to the TNSP.

The choice of parameters would be directly related to the target chosen for the measure. A TNSP that is operating at or near 'best practice' levels has a very limited opportunities for improvement. In this case, it would be appropriate to provide a slow penalty arrangement, where penalties only become significant when performance falls below an 'acceptable' level, and a faster bonus arrangement. This would provide positive incentives for the TNSP to raise performance even further and also address the increasing costs associated with raising the 'frontier'.