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Dear Chris

RE: Service Target Performance Incentive Scheme Review Issues Paper

AEMO welcomes the opportunity to provide feedback on the AER's Issues Paper on the review of the Service Target Performance Incentive Scheme (STPIS).

AEMO supports the AER's objectives to improve the service standard component of the STPIS through regulatory consistency and transparency. In Victoria the incentive arrangements compliment AEMO's planning approach delivering an efficient price-service balance.

While the AER's review is focused on the detail of the STPIS elements, it needs to be considered within the broader transmission framework. Any changes to the STPIS in the short-term must be consistent with the direction of transmission frameworks in the longer term.

This submission discusses the STPIS in the context of the transmission framework as well as the questions raised by the AER in its Issues Paper.

The transmission framework

The STPIS is the only element of the revenue setting arrangements that rewards the delivery of services. The other element, the building block, rewards the construction of assets. The building block approach, coupled with an asset-focused redundancy standard applied in most regions, have driven significant increases in network expenditure. While the majority of these increases have been in the distribution network, transmission network charges have increased in many states considerably over the past decade.

As a result, under the current framework, any incentives which reward the provision of services are welcome but will be outweighed by the incentive to construct assets.

While we acknowledge that the AER's Chapter 6A rule change proposal will improve elements of the current revenue setting approach, we do not believe that it addresses the inherent design flaws of the current approach. Namely, consumers do not receive an appropriate price-service balance.

AEMO suggests that the AER takes the opportunity to develop a longer term position on how a more encompassing service based approach to regulation, guided by incentives that reward service provision. To the extent that an incentive cannot be developed at this stage the AER can commence its process of gathering information with the aim of implementing a service obligation in the future.

One such approach might be for the AER to develop a detailed regulatory contract with the TNSPs which sets out performance measures on each flowpath. Under this arrangement the TNSP would be rewarded for meeting or exceeding pre-defined service levels with respect to the transfer capacity delivered. Revenue could be informed by the value that consumers place on reliable transfer capacity on each flowpath.

Ability of TNSPs to amend the scheme

An objective of the incentive regime is to encourage TNSPs to build and operate their systems efficiently and to improve the value of the services they supply to network users. Currently, TNSPs are able to propose amendments to the STPIS to apply for a regulatory control period as part of their transmission determination. This allows the TNSP to adjust their benchmarks more favourably and therefore their ability to exercise market power is increased. In order to complement the building block revenue determination, an incentives regime should not provide the opportunity for TNSPs to influence their performance targets. This would also ensure that the regime is non-biased and more reflective of improving service performance and reliability to customers.

Consistency on parameter weightings and definition of exclusions

AEMO notes that the AER has asked for stakeholder views on parameter weightings or thresholds and the approach to the definition of exclusions. AEMO believes that in order to promote regulatory consistency and transparency, parameter weightings and the approach to defining exclusions should be the same across TNSPs.

In terms of the approach to be adopted for exclusion events, out of the three options presented in the Issues Paper, Option 3 (service performance threshold based approach) appears to be the most appropriate as it has more flexibility than Option 1's definitional based approach and would cater for rare or irregular events more than both Option 1 and 2. In developing the threshold as part of Option 3, AEMO believes Ofgem's method based on historical performance as being reasonable.

Value of Customer Reliability (VCR) for the measurement of economic cost of outages

AEMO notes that the AER has proposed the '...VCR produced by AEMO could be used as a proxy measure of economic harm'. AEMO supports the AER's proposal to use the VCR as a measurement of the economic cost of outages. AEMO also suggests that other factors may need to be used in conjunction with the VCR in determining this measurement, such as the cost of network congestion.

Additional service component parameters

In the Issues Paper, the AER has suggested a number of additional service component parameters be included as 'near miss' indicators which would provide information on the

effectiveness of the TNSP's maintenance, operations and training practices. AEMO considers the inclusion of these parameters would provide limited value to the current STPIS framework and therefore should be left out.

A financial incentive and level of revenue at risk for the service component and market impact component

The Issues Paper has asked for comment on the appropriate levels of revenue at risk for TNSPs under the service component.

The Rules currently allow for a maximum level of revenue at risk of +/- 5%. Given the current building block approach and to ensure TNSPs attempt to improve service performance and reliability to customers, AEMO believes that the financial incentives for both the service component and market impact component should have the same level of revenue at risk and be penalty-only schemes if the minimum standard of reliability is not maintained. This is consistent with international practice. A penalty-only scheme for the market impact component would also minimise the potential for strategic behaviour of TNSPs. However, if a more encompassing framework is developed as discussed above, AEMO would support a rewards-based incentive.

The AER has asked for comment on the timing of measuring performance of the market impact component. AEMO suggests that the performance be measured over a financial year for consistency with the revenue determination period.

In the longer term, AEMO proposes that the AER consider Rule changes to allow for a higher level of revenue at risk; which could be nominated by the TNSP at the regulatory reset. A suggested level would be in the range of 10% and have their targets measured over a longer period of time, such as 5 or 10 years. These parameters should link with the risk of not being able to supply electricity to their customers to capture both shorter and longer term performance for reliability. AEMO also proposes that a more customer focused approach could be to move towards the TNSP being required to supply a certain level of reliability at each of their connection points.

AEMO also believes that factors which impact the market affect generator behaviour, and therefore the AER may want to consider incorporating the market impact component into a future access regime rather than being part of the STPIS.

If you have any questions please do not hesitate to contact me on (08) 8201 7371.

Yours sincerely



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