



# **FINAL DECISION**

## **United Energy Distribution Determination 2021 to 2026**

### **Attachment 10 Service target performance incentive scheme**

April 2021

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## Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to United Energy for the 2021–26 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

### Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

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Attachment 10 – Service target performance incentive scheme

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# 10 Service target performance incentive scheme

Under clauses 6.3.2 and 6.12.1(9) of the National Electricity Rules (NER) our regulatory determination must specify how any applicable service target performance incentive scheme (STPIS) is to apply in the next regulatory control period.

This attachment sets out our final decision on how we will apply the STPIS to United Energy for the 2021–26 regulatory control period.

## AER's service target performance incentive scheme

We published the current version (version 2.0) of our national STPIS in November 2018.<sup>1</sup> The STPIS is intended to balance incentives to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to distributors to maintain and improve service performance where customers are willing to pay for these improvements.

## AER draft decision on the approach to the application of STPIS

Our draft decision was to apply the STPIS version 2.0 as it is to United Energy for the 2021–26 regulatory control period. United Energy is also required to submit the 2019–20 STPIS actual performance data in its revised revenue proposal in order for the targets to be calculated in our final decision.

Specifically, we proposed to:

- set revenue at risk at  $\pm 5.0$  per cent
- segment the network according to the urban and rural short feeder categories
- apply the System Average Interruption Duration Index (SAIDI), the System Average Interruption Frequency Index (SAIFI), and the Momentary Average Interruption Frequency Index (MAIFI)
- set performance targets based on the distributor's average performance over the past five regulatory control years
- apply the telephone answering parameter in the STPIS, but will consider replacing this component with the new Customer Service Incentive Scheme (CSIS) should United Energy choose to apply CSIS instead
- apply the method in the STPIS for excluding specific events from the calculation of annual performance and performance targets and 2.5 beta method to calculate the major event day (MED)

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<sup>1</sup> AER, *Electricity distribution network service providers—service target performance incentive scheme version 2.0*, November 2018.

- apply the method and values of customer reliability (VCR) as indicated in our Values of Customer Reliability Review published in December 2019<sup>2</sup>
- not apply the guaranteed service level (GSL) component of the STPIS, as the Victorian distributors remain subject to a jurisdictional GSL scheme.<sup>3</sup>

## 10.1 Final decision

Our final decision is to apply the STPIS 2.0 to United Energy for the 2021–26 regulatory control period. This is consistent with our draft decision on the application of the STPIS.

We will not apply the STPIS telephone answering target and incentive rate to United Energy in the next regulatory control period because the distributor has opted to apply the CSIS in its revised proposal. However, United Energy will continue to report on the telephone answering parameter in the upcoming regulatory control period via the STPIS.

We have taken into account United Energy's revised revenue proposal, submissions raised by stakeholders and our draft decision in reaching our final decision.<sup>4</sup> Our response to the matters raised by United Energy about the application of STPIS is discussed below.

Table 10.1 and Table 10.2 present our final decision on the applicable incentive rates and targets that will apply to United Energy for the 2021–26 regulatory control period.

**Table 10.1 Final decision – STPIS incentive rates for United Energy for the 2021–26 regulatory control period**

	Urban	Rural short
SAIDI	0.0860	0.0081
SAIFI	3.5564	0.3666
MAIFI	0.2845	0.0293
Telephone answering	.	Not applicable

Source: AER analysis. Note: Telephone answering parameter will not be applied to United Energy for the 2021–26 regulatory control period, given that the CSIS will be applied.

<sup>2</sup> AER, *Values of Customer Reliability Review - Final Report*, December 2019.

<sup>3</sup> AER, *Draft decision, United Energy Distribution Determination 2021 to 2026*, Attachment 10, *Service target performance incentive scheme*, September 2020.

<sup>4</sup> United Energy, *2021–26 Revised Regulatory Proposal*, December 2020; United Energy, *2021–26 Revised Regulatory Proposal, Attachments 10.11 and 10.12*, December 2020; AER, *Draft Decision United Energy Distribution Determination 2021 to 2026 Attachment 10 Service target performance incentive scheme*, September 2020.

**Table 10.2 Final decision – STPIS reliability targets for United Energy for the 2021–26 regulatory control period**

	Value
<b>Urban</b>	
SAIDI	42.700
SAIFI	0.688
MAIFI	0.956
<b>Rural short</b>	
SAIDI	131.068
SAIFI	1.926
MAIFI	4.288
Telephone answering	Not applicable

Source: AER analysis. Note: Telephone answering parameter will not be applied to United Energy for the 2021–26 regulatory control period, given that the CSIS will be applied.

## 10.2 United Energy's revised revenue proposal

United Energy's revised proposal accepted our draft decision on how the STPIS will apply to calculate its targets, incentive rates and MED.<sup>5</sup> United Energy proposed to remove the telephone answering target and the associated incentive rate, and to replace it with its proposed CSIS.<sup>6</sup>

## 10.3 Assessment approach

We are required to make a decision on how the STPIS is to apply to United Energy.<sup>7</sup> When making a distribution determination, the STPIS requires us to determine all performance targets, incentive rates, revenue at risk and other parameters under the scheme.<sup>8</sup>

We outlined our proposed approach to, and reasons for, the application of the STPIS in our framework and approach and draft decision for United Energy. Our final decision has adopted the position in the draft decision (except for the telephone answering

<sup>5</sup> United Energy, *Revised Proposal 2021–26*, December 2020.

<sup>6</sup> United Energy, *Revised Proposal 2021–26*, December 2020.

<sup>7</sup> NER, cl. 6.12.1(9).

<sup>8</sup> AER, Final decision, Electricity distribution network service providers, Service target performance incentive scheme, November 2018, cl. 2.1(d).

target). We have considered materials submitted to us by United Energy and by stakeholders.

### 10.3.1 Interrelationships

In implementing the STPIS we must take into account any other incentives available to the distributor under the NER or relevant distribution determination.<sup>9</sup> One of the objectives of the STPIS is to ensure that the incentives are sufficient to offset any financial incentives the distributor may have to reduce costs at the expense of service levels. For the 2021–26 regulatory control period, the STPIS will interact with the Capital Expenditure Sharing Scheme (CESS) and the operating expenditure (opex) Efficiency Benefit Sharing Scheme (EBSS).

The reward and penalty mechanism under the STPIS (the incentive rates) are determined based on the average customer value for the improvement or otherwise to supply reliability (the VCR). This is aimed at ensuring that the distributor's operational and investment strategies are consistent with customers' value for the services that are offered to them.

Our capital expenditure (capex) and opex allowances are set to reasonably reflect the expenditures required by a prudent and efficient business to achieve the capex and opex objectives. These include complying with all applicable regulatory obligations and requirements and, in the absence of such obligations, maintaining quality, reliability, and security outcomes.

The STPIS provides an incentive for distributors to invest in further reliability improvements (via additional STPIS rewards) where customers are willing to pay for it. Conversely, the STPIS penalises distributors where they let reliability deteriorate. Importantly, the distributor will only receive a financial reward after actual improvements are delivered to the customers.

In conjunction with the CESS and the EBSS, the STPIS will ensure that:

- any additional investments to improve reliability are based on prudent economic decisions
- any reduction in capex and opex are achieved efficiently, rather than at the expense of service levels to customers.

## 10.4 Submissions

The Consumer Challenge Panel, sub-panel 17 (CCP17) supported the introduction of the CSIS for AusNet Services, CitiPower, Powercor and United Energy for the 2021–26 regulatory control period, and Jemena's choice not to adopt a CSIS for

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<sup>9</sup> NER, cl. 6.6.2(b)(3)(iv).



2021–26 regulatory control period.<sup>10</sup> The CCP17 also supported our draft decision on STPIS that United Energy should continue to report on the telephone answering parameter in the upcoming regulatory control period for transparency purposes.<sup>11</sup>

As discussed in section 10.5.3, we will not apply the STPIS telephone answering target and incentive rate to United Energy in the next regulatory control period because the distributor has opted to apply the CSIS in its revised proposal. However, United Energy should continue to report on the telephone answering parameter in the next regulatory control period.

We received submissions about distributors historical under-spend on capex and opex allowance, as well as customers' willingness to pay for reliability improvements.

Red Energy/Lumo Energy submitted that it did not support any of the resubmissions that apply to the incentive schemes other than the CESS and the EBSS. It stated that the STPIS is not required to be applied to United Energy, because:<sup>12</sup>

The STPIS was introduced to address the risk that DNSPs would under-spend relative to their benchmark expenditure allowances over the regulatory period improving their profitability at the expense of reliability. In our view, it is not clear that a DNSP would erode the reliability of its network for short term profits. Such a strategy would risk the loss of its license in the long run.

The joint submission from the Victorian Community Organisations stated that:<sup>13</sup>

In its response to the initial proposals, the sponsors (i.e. Victorian Community Organisations) noted that the current version of the STPIS (version 2.0) has some shortcomings, particularly that

- There was a continual reliability improvement which, because consumers were paying the DBs a bonus, they are effectively paying for improved reliability.
- There is an unwillingness to pay for increased reliability.
- The STPIS targets for the next period are based on performance that was achieved well into the past and a rolling average target based on the previous 3-4 years is a better incentive for performance and provides a better outcome for consumers.

The AER draft decision states that the current STPIS (version 2.0) is to be applied to the next regulatory period without change, meaning that the current detriments observed will continue. This is disappointing.

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<sup>10</sup> CCP17, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 96–97.

<sup>11</sup> CCP17, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 96–97.

<sup>12</sup> Red Energy Lumo Energy, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26*, January 2021, pp. 3–4.

<sup>13</sup> Victorian Community Organisation, *Submission on the Victorian EDPR Revised Proposal and draft decision 2021–26 – Headberry Partners - Report to the Sponsoring Organisations* January 2021, p. 59.

The AER also observes that the unwillingness to pay for increased reliability is addressed within the Value of Customer Reliability (VCR). While the provision of the VCR does provide guidance as to the willingness of consumers to pay it is pointed out that consumers have been quite clear that they do not want to pay at all for improved reliability so the application of the VCR should refer more to the price consumers are prepared to pay for maintaining or avoiding reductions in reliability rather than them paying to further increase reliability.

The AER also commented that it does not consider that there is a relationship between reliability of supply and the development of the opex and capex allowances as any proposal by the DBs to improve reliability has to demonstrate a clear relationship between the cost of the improvement and the change in reliability to be achieved. This is not the point.

The commentary by the sponsors was that the amount of capex and opex do have a relationship with the reliability achieved and if the opex and capex allowance is higher than needed to maintain reliability then there will be improved reliability. Effectively, if reliability is improving over time, then it is because the AER has provided more capex and opex than were needed. This is what is being observed – that reliability is improving implying that the opex and capex allowances are higher than necessary.

With this in mind, the allowances for opex and capex should include recognition of the trend of reliability performance.

We would like to clarify that the STPIS provides an incentive for distributors to invest in further reliability improvements (via additional STPIS rewards) where customers are willing to pay for it. Conversely, the STPIS penalises distributors where they let reliability deteriorate. Importantly, the distributor will only receive a financial reward after actual improvements are delivered to the customers.

More importantly, a distributor can only retain its rewards if it can maintain the reliability improvements on an ongoing basis. Once an improvement is made, the benchmark performance targets will be tightened in future years, resulting in ongoing benefits to consumers while the business only receives a one-off reward.

Customers will only pay for sustained reliability improvements. One-off improvement will only result in the business receiving a temporary one-off reward. But, the reward will be refunded to customers in future years when performance returns to normal.

Consequently, in conjunction with the CESS and the EBSS, the STPIS ensures that:

- any additional investments to improve reliability are based on prudent economic decisions
- reductions in capex and opex are achieved efficiently, rather than at the expense of service levels to customers.

United Energy's revised revenue proposal has not included capex nor opex allowances for reliability improvement; therefore no adjustments to its reliability targets are required. Please refer to Attachment 5 – Capital expenditure and Attachment 6 – Operating expenditure of the final decision for further details.

The NER requires that we provide adequate funding for a distributor to maintain its current level of reliability. Any underspend in the past is likely the result of efficiency improvements.

Our VCR survey found that:

- Residential customers continue to value reliability and have a preference to avoid longer outages, and outages which occur at peak times (defined as 7am to 10am and 5pm to 8pm).<sup>14</sup>
- Industrial customers also indicated their value for supply reliability.<sup>15</sup>
- While there is no measure of the willingness to pay for widespread long duration outages that lasted three, six or twelve times longer than a one hour outage, for outages of longer duration, and/or covering wider areas, the VCR could begin to increase again beyond a certain threshold as different types of costs are incurred that would not arise in the surveyed 'standard' localised outages.<sup>16</sup>

The incentive rates under the scheme for the forthcoming regulatory control period are based on the latest VCR survey findings. Hence, we consider that the scheme incentive mechanism is reflective of customers' value in terms of reliability outcomes.

We would not expect that a distributor will allow its reliability level to deteriorate significantly due to the operational and business risks it would face in the long run. In the short term, the STPIS off-sets a distributor's attempts to cut cost and reduce service levels by imposing a penalty, operating as an early indicator of business practices.

In the coming months, we will be undertaking a broad review of our incentive schemes and how they are operating. We will look into various issues that have been raised by both consumers and businesses about aspects of individual schemes and their interrelationships. We encourage stakeholders to participate in this process.

## 10.5 Reasons for final decision

We will apply the STPIS to United Energy in accordance with the scheme. This includes using the latest 2019-20 reliability data to calculate United Energy's performance targets for the next regulatory control period.

The following section sets out our detailed considerations on applying the STPIS to United Energy for the 2021–26 regulatory control period.

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<sup>14</sup> AER, *Values of Customer Reliability Review - Factsheet*, December 2019.

<sup>15</sup> AER, *Values of Customer Reliability Review - Factsheet*, December 2019. The higher industrial VCR value has driven a small increase in the National Electricity Market and state VCR values compared to 2014. This is because, proportionally, industrial customers use more energy relative to other customer segments and so have a greater influence on load weighted VCR numbers.

<sup>16</sup> AER, *Final Conclusions, Widespread and Long Duration Outages - Values of Customer Reliability*, September 2020, p.17.

## 10.5.1 Revenue at risk

Revenue at risk caps the potential reward or penalty for United Energy under the STPIS. We determine that the cap on revenue at risk under the STPIS be reduced to 4.5 per cent from 5 per cent, taking into consideration the application of the CSIS with a revenue at risk of 0.5 per cent. The CSIS is intended to replace the telephone service component of the STPIS, which has a revenue cap of 0.5 per cent. The total revenue placed at risk under both schemes will remain at 5 per cent as per the design of the STPIS. Please see attachment 12 regarding the CSIS.

## 10.5.2 Reliability of supply component

### Applicable components and parameters

We will apply unplanned SAIDI, unplanned SAIFI and unplanned MAIFI parameters under the reliability of supply component to United Energy's feeders for the 2021–26 regulatory control period. Unplanned SAIDI measures the sum of the duration of each unplanned sustained customer interruption (in minutes) divided by the total number of distribution customers. Unplanned SAIFI measures the total number of unplanned sustained customer interruptions divided by the total number of distribution customers. Unplanned MAIFI measures the total momentary interruptions divided by the total number of distribution customers.<sup>17</sup>

### Exclusions

The STPIS allows certain events to be excluded from the calculation of the s-factor revenue adjustment. These exclusions include the events specified in the STPIS, such as the effects of transmission network outages and other upstream events. They also exclude the effects of extreme weather events that have the potential to significantly affect United Energy's underlying STPIS performance.

United Energy proposed to calculate the MED threshold using the 2.5 beta method in accordance with our draft decision.

### Performance targets

The STPIS specifies that the performance targets should be based on the average performance over the past five regulatory control years. It also states that the performance targets must be modified:

- for any reliability improvements completed or planned where the planned reliability improvements are included in the expenditure program proposed by the network

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<sup>17</sup> Sustained interruption means supply interruption longer than three minutes. Momentary interruptions are those supply interruptions lasting less than three minutes.

service provider and expected to result in a material improvement in supply reliability;<sup>18</sup> and

- where the actual performance outcome exceeds the revenue at risk cap.<sup>19</sup>

Our final decision has not included capex for programs to improve reliability. As a result, we have not made adjustments to United Energy's reliability targets.

Our calculated performance targets for United Energy for the 2021–26 regulatory control period are presented in Table 10.2.

### 10.5.3 Customer service component

Our draft decision was to apply the STPIS telephone answering parameter to United Energy in the next regulatory control period because its revenue proposal did not apply to use the CSIS.

For the final decision, we will not apply the STPIS telephone answering target and incentive rate to United Energy in the next regulatory control period because the distributor has opted to apply the CSIS in its revised proposal.

As discussed in the draft decision, we agreed with the submission from the CCP17 acknowledging telephone answering as an important service for many consumers.<sup>20</sup> For the final decision, we consider that United Energy should continue to report on the telephone answering parameter in the next regulatory control period.

### 10.5.4 Incentive rates

The incentive rates applicable to United Energy for the reliability of supply performance parameters of the STPIS have been calculated in accordance with clause 3.2.2, using the formulae provided as Appendix B of the STPIS 2.0 and our VCR review published in December 2019.<sup>21</sup>

Our final decision on United Energy's incentive rates is at Table 10.1.

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<sup>18</sup> AER, *Electricity distribution network service providers, Service target performance incentive scheme, Version 2.0*, November 2018, cl. 3.2.1(a)(1A).

<sup>19</sup> AER, *Electricity distribution network service providers, Service target performance incentive scheme, Version 2.0*, November 2018, cl. 3.2.1(a)(1B).

<sup>20</sup> AER Consumer Challenge Panel, *CCP17 Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, 10 June 2020, p. 36.

<sup>21</sup> AER, *Electricity distribution network service providers, Service target performance incentive scheme, Version 2.0*, November 2018.

### 10.5.5 Value of customer reliability to calculate the incentive rates

Consistent with our draft decision, we have calculated United Energy's incentive rates by using our Values of Customer Reliability Review published in December 2019.<sup>22</sup>

The VCR for network segments outlined in Table 10.3 were applied to calculate United Energy's incentives rates for the 2021–26 regulatory control period.

**Table 10.3 Value of customer reliability (\$/MWh)**

	Urban	Rural short
VCR	41,210	41,210

Source: AER, *Value of customer reliability review, final report*, December 2019, pp. 17 and p. 71.

## 10.6 Transitional arrangements for the STPIS

This section addresses the transitional issues relating to the STPIS and how we intend to adjust the s-factor between regulatory control periods under STPIS 2.0.

The STPIS operates as part of the building block determination and is applied via the control mechanism. Through the s-factor component of the STPIS, distributors are penalised or rewarded for diminished or improved service performance compared to predetermined targets. Distributors are either rewarded or penalised via network charges two years after the end of each regulatory control year because audited performance data is only available after the regulatory year is completed—hence, the earliest time the s-factor can apply is the year following audited performance data availability.

Consequently, the s-factor outcomes for 2019 and 2020 will apply to prices in the 2021–22 and 2022–23 regulatory control years respectively.

A key amendment under STPIS 2.0 is to simplify the scheme by specifying STPIS outcomes as a fixed monetary amount, rather than as a percentage adjustment to the maximum allowable revenue as set out in Appendix C.<sup>23</sup> This appendix also sets out the s-factor calculation formula and the operation of the s-bank mechanism under this approach.

To transition to STPIS 2.0, United Energy's s-factor outcomes for 2019, 2020 and the determination extension period will be converted to a dollar value before being applied

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<sup>22</sup> AER, *Values of Customer Reliability Review - Final Report*, December 2019.

<sup>23</sup> AER, *Electricity distribution network service providers, Service target performance incentive scheme, Version 2.0, Appendix C - Adjustments to allowed revenue*, November 2018.

in the price control formula in the next regulatory control period. Please refer to Attachment 14 – Control mechanisms of the final decision for details.

We have had ongoing correspondence, typically via email, with Victorian distributors on our proposed transition to STPIS 2.0. We considered, as a principle, the STPIS revenue should be neutral under either STPIS 1.0 or STPIS 2.0. Nonetheless, an earlier transition to STPIS 2.0 will likely provide more clarity and certainty. Victorian distributors did not raise an objection to our proposed methodology.

## Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CCP17	Consumer Challenge Panel, sub-panel 17
CESS	capital expenditure sharing scheme
CSIS	Customer Service Incentive Scheme
DB	distribution network service provider
distributor	distribution network service provider
DNSP	distribution network service provider
EBSS	efficiency benefit sharing scheme
GSL	guaranteed service levels
MAIFI	Momentary Average Interruption Frequency Index
MED	major event day
NER	National Electricity Rules
opex	operating expenditure
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
STPIS	service target performance incentive scheme
VCR	values of customer reliability