



FINAL DECISION
Ergon Energy determination
2015–16 to 2019–20

**Attachment 11 – Service target
performance incentive scheme**

October 2015

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Note

This attachment forms part of the AER's final decision on Ergon Energy's 2015–20 distribution determination. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model

Shortened form	Extended form
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

11 Service target performance incentive scheme

Under clause 6.3.2 of the NER our regulatory determination must specify how any applicable service target performance incentive (STPIS) is to apply in the 2015–20 regulatory control period.

This attachment sets out how we will apply the STPIS to Ergon Energy for the 2015–20 regulatory control period.

AER's service target performance incentive scheme

We published the current version of our national STPIS in November 2009.¹ 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.

11.1 Final decision

We will apply the STPIS to Ergon Energy for the 2015–20 regulatory control period. In applying the STPIS, we will:

- set revenue at risk for Ergon Energy at the range ± 2.0 per cent
- segment Ergon Energy's network according to feeder categories urban, short and long rural
- set applicable reliability of supply (system average interruption duration index or SAIDI and system average interruption frequency index or SAIFI) and customer service (telephone answering) parameters
- set performance targets based on the Ergon Energy's average performance over the past five regulatory years
- apply the methodology indicated in the national STPIS for excluding specific events from the calculation of annual performance targets
- apply the methodology and value of customer reliability (VCR) values to the calculation of incentive rates using the latest VCR for Queensland
- not apply the GSL component as Ergon Energy is subject to a jurisdictional GSL scheme.

In making our final decision on the STPIS, we have taken into account our preliminary decision, our framework and approach (F&A) paper, Ergon Energy's initial and revised regulatory proposals, our information requests to Ergon Energy and a submission from

¹ AER, *Electricity distribution network service providers—service target performance incentive scheme*, 1 November 2009. (AER, *STPIS*, November 2009).

the Alliance of Electricity Consumers of Queensland. Our responses to the matters raised by Ergon Energy and the Alliance of Electricity Consumers of Queensland about the application of the STPIS are also discussed in this final decision.

Tables 11.2 and 11.3 present our final decision on the applicable incentives rates and targets that will be applied to Ergon Energy's STPIS for the 2015–20 regulatory control period.

The incentive rate for the customer service component will be –0.040 per cent per unit of the telephone answering parameter.

Table 11.1 AER final decision on STPIS incentive rates for Ergon Energy for the 2015–20 regulatory control period

	Urban	Rural short	Rural long
SAIDI	0.0159	0.0159	0.0034
SAIFI	1.3823	1.8113	0.5167

Source: AER Analysis.

Table 11-2 AER final decision on STPIS reliability targets for Ergon Energy for the 2015–20 regulatory control period

	value
Urban	
SAIDI	126.73
SAIFI	1.503
Rural short	
SAIDI	317.06
SAIFI	3.019
Rural long	
SAIDI	742.47
SAIFI	5.348
Telephone answering	
Percentage of calls will be answered within 30 seconds	77.3

Source: AER analysis.

11.2 Ergon Energy's revised proposal

Ergon Energy's revised regulatory proposal accepted most of our preliminary decision on the STPIS. However, it considered that we should not have capped the reliability of supply component of the STPIS in our preliminary decision for 2015–20 at ± 1.8 per cent.²

11.3 AER's assessment approach

We are required to make a decision on how the STPIS is to apply to Ergon Energy.³ When making a distribution determination, the STPIS requires us to determine all performance targets, incentive rates, revenue at risk and other parameters required to apply the scheme.⁴

We outlined our proposed approach to, and justification for, the application of the STPIS in our F&A for Ergon Energy.⁵ Our preliminary decision and final decision have adopted the same positions, unless new information has become available or new arguments have been put forward which warrant a reconsideration of this position. We have considered material submitted to us by stakeholders and Ergon Energy. In each instance, we considered the relative merits of the alternative against the objectives of the STPIS.⁶

11.3.1 Interrelationships

In applying the STPIS we must consider any other incentives available to the distributor under the NER or relevant distribution determination.⁷ 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 2015–20 regulatory control period, the STPIS will interact with the Capital Expenditure Sharing Scheme (CESS) and the opex Expenditure Benefit Sharing Scheme (EBSS).⁸

The rewards and penalties amounts under 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.

² Ergon Energy, *03.01.03 Revised Application of Incentive Schemes*, 3 July 2015, p. 8.

³ NER, cl. 6.12.1(9).

⁴ AER, STPIS, cl. 2.1(d).

⁵ AER, *Final Framework and approach for Ergon Energy an Ergon Energy Regulatory control period commencing 1 July 2015*, April 2014, p. 70-71.

⁶ AER, STPIS, November 2009, cl. 1.8(f).

⁷ NER, cl. 6.6.2(b)(3)(iv).

⁸ AER, STPIS, November 2009, cl. 1.5(b)(5).

Our 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, on the other hand, 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 CESS and EBSS, the STPIS will ensure that:

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

11.4 Reasons for final decision

The following section sets out our detailed consideration on:

- applying the STPIS to Ergon Energy for the 2015–20 regulatory control period
- how we will apply the STPIS between regulatory control periods and our response to submissions
- how we will apply the STPIS to Ergon Energy.

11.5 Applying the STPIS

We will apply the STPIS in accordance with our F&A to Ergon Energy.⁹

We have, however, updated Ergon Energy incentive rates to reflect the expected revenue (smoothed) in this final decision.

11.5.1 Revenue at risk

Ergon Energy's revenue at risk for each regulatory year of the 2015–20 regulatory control period will be capped at ± 2.0 per cent.

Our F&A paper capped the revenue at risk on the STPIS at ± 2.0 per cent of revenue. We did not apply a cap to the reliability of supply or the telephone answering component that Ergon Energy may earn on these parameters (so long as they do not exceed the ± 2.0 per cent revenue at risk).

⁹ AER, *Final Framework and approach for Ergon Energy an Ergon Energy Regulatory control period commencing 1 July 2015*, April 2014, p. 70-71; AER, *Preliminary decision Ergon Energy determination 2015–16 to 2019–20 Attachment 11 – Service target performance incentive scheme*, April 2015.

In its revised regulatory proposal, Ergon Energy disagreed with our preliminary decision to introduce a cap of ± 1.8 per cent on the reliability of supply component of the STPIS. In particular, Ergon Energy stated the introduction of the cap was inconsistent with our F&A paper.¹⁰

We agree with Ergon Energy and amended our final decision to remove the cap on the reliability of supply component of the STPIS. The removal of the reliability cap does not alter its revenue at risk (capped at ± 2.0 per cent), its performance targets or the incentive rates.

11.5.2 Reliability of supply component

Applicable components and parameters

We will apply unplanned SAIDI and unplanned SAIFI parameters under the reliability of supply component to Ergon Energy's Urban, Short and Long rural feeders for the 2015–20 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.

Exclusions

The STPIS allows certain events to be excluded from the calculation of the S-factor revenue adjustment. These exclusions include the events that are beyond the control of Ergon Energy, 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 Ergon Energy's STPIS performance.

Ergon Energy proposed to calculate the major event day (MED) threshold using the 2.5 beta method in accordance the STPIS. Since we have not received any submissions that we should depart from our F&A, we accept Ergon Energy's proposal to apply the STPIS to calculate the MED.

11.5.3 Customer service component

The national STPIS customer service target applicable to Ergon Energy is telephone response measured as the number of telephone calls answered within 30 seconds. This measure is referred to as the telephone Grade of Service (GOS).

In accordance with our preliminary decision, we accept Ergon Energy's customer service targets as it has applied a 5 year historical average to derive them for the 2015–20 regulatory control period. This is consistent with our National STPIS.

¹⁰ Ergon Energy, *03.01.03 Revised Application of Incentive Schemes*, 3 July 2015, p. 8.

11.5.4 Performance targets

The STPIS specifies that the performance targets should be based on the average performance over the past five regulatory years. It also states that the performance target must be modified for any reliability improvements completed or planned where the planned reliability improvements are:¹¹

- included in the expenditure program proposed by the distributor in its regulatory proposal, or
- proposed by the distributor, and the cost of the improvements is allowed by the relevant regulator, in the distributor's previous regulatory proposal or regulatory submission, and
- expected to result in a material improvement in supply reliability.

Ergon Energy accepted our preliminary decision on the performance targets and the incentive rates. In accordance with our preliminary decision, our calculated performance targets for Ergon Energy are presented in table 11.2 above.

11.5.5 Incentive rates

The incentive rates applicable to Ergon Energy for the reliability of supply performance parameters of the STPIS have been calculated in accordance with clause 3.2.2 and using the formulae provided as appendix B of the National STPIS.

Ergon Energy accepted our preliminary decision on the VCR for setting the incentive rates.¹² Consequently, this final decision adopted the VCR outlined in the preliminary decision in setting Ergon Energy's incentive rates for the 2015–20 regulatory control period.

The final incentive rates based on the VCR and expected revenue (smoothed) are found in table 11.3. The incentive rate for the customer service component will be –0.04 per cent per unit of the telephone answering parameter.¹³

Table 11.3 AER final decision on STPIS incentive rates for Ergon Energy for the 2015–20 regulatory period

	Urban	Rural short	Rural long
SAIDI	0.0159	0.0159	0.0034
SAIFI	1.3823	1.8113	0.5167

Source: AER Analysis.

¹¹ AER, *STPIS*, November 2009, cl. 3.2.1.

¹² Ergon Energy, *03.01.03 Revised Application of Incentive Schemes*, 3 July 2015, p. 7.

¹³ AER, *STPIS*, November 2009, cl. 5.3.2 (a).

11.6 Other issues in applying the STPIS

11.6.1 Accounting for step change between regulatory periods

A distributor's performance in the last regulatory year of its regulatory control period will affect its revenue in the second regulatory year in the next regulatory control period.

For example, if a distributor has a regulatory control period of 5 regulatory years between 1 July 2007 and 30 June 2012, its performance in the 2011–12 financial year will affect its revenues in the second regulatory year of the next regulatory control period (that is from 1 July 2014).¹⁴

The STPIS provides a mechanism to account for any step change in revenues (or prices), via X_0 , from one regulatory control period to the next. For Ergon Energy, the 'raw' s-factor calculated for the last and second last regulatory years of the regulatory control period (which is applied in the first and second regulatory years of the next regulatory control period) is adjusted in accordance with the following formula:¹⁵

$$S_t''' = \frac{S_t'}{1-X_0}$$

Where:

- $X_0 = \frac{AR_{2014-15} - AR_{2015-16}}{AR_{2014-15}}$
- $AR_{2014-15}$ is Ergon Energy's approved revenue in the 2014–15 pricing proposal
 $AR_{2015-16}$ is Ergon Energy's allowable revenue in the final determination for 2015–20.

11.6.2 Submissions

We received a submission from the Alliance of Electricity Consumers of Queensland regarding Ergon Energy's STPIS proposal.

The Consumer Challenge Panel did not provide a submission on the STPIS.

The Alliance of Electricity Consumers re-submitted that Ergon Energy should not be rewarded for meeting its legislative level of service. As such, we should revoke the STPIS payments Ergon Energy is seeking to recover in the next regulatory control period.¹⁶

¹⁴ AER, *STPIS*, November 2009, appendix C.

¹⁵ AER, *STPIS*, November 2009, Appendix C, pp. 33–34.

¹⁶ Alliance of Electricity Consumers, *Submission to the Australian Energy Regulator's preliminary decision (Queensland)*, 3 July 2015, p.30.

The Alliance of Electricity Consumers may be referring to the deterministic "N-1" planning standard for supply security.¹⁷ The deterministic "N-1" planning standard is no longer enforced and has been replaced with cost/benefit trade-off "probabilistic" planning approach. Both deterministic and probabilistic planning standards mainly address capacity shortfalls rather than reliability outcomes.

The STPIS on the other hand has a different purpose. It is an outcome focused mechanism intended to balance incentives to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to electricity distributors maintain and improve service performance where customers are willing to pay for these improvements.

Ergon Energy was rewarded under the STPIS in the current regulatory control period because it met its reliability targets or the intended outcome which was set above the reliability standard.

11.7 Revenue reduction and future reliability levels

Ergon Energy's regulatory proposal submitted a reliability impact assessment by Jacobs. The report contends that our preliminary decision to reduce Ergon Energy's capex and opex over historical levels may have an impact on the reliability of its network in subsequent years.¹⁸

This issue is addressed in our capex and opex attachments (attachments 6 and 7) because Ergon Energy has not applied for a departure for its STPIS.

¹⁷ Alliance of Electricity Consumers, *Submission to the Australian Energy Regulator's preliminary decision (Queensland)*, 3 July 2015, p.30.

¹⁸ Jacobs, *AER Preliminary Decision Response Ergon Energy Reliability Impact Assessment*, 12 June 2015.