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DEPARTMENT OF PRIMARY INDUSTRIES

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TO: Eugene Henry	FROM: Raif Sarcich
COMPANY: Australian Energy Regulator	DATE: 27/03/2009
FAX NUMBER: 03 9290 1457	TOTAL NO. OF PAGES INCLUDING COVER: 7
PHONE NUMBER:	SENDER'S REFERENCE NUMBER:
RE: STPIS proposed amendments	YOUR REFERENCE NUMBER:

- URGENT
 FOR REVIEW
 PLEASE COMMENT
 PLEASE REPLY
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NOTES/COMMENTS:

Eugene/To whom it otherwise concerns,

With apologies for the late delivery, please see the attached submission re: proposed amendments to the service target performance incentive scheme.

Regards,

Raif Sarcich - Senior Policy Officer - Energy Sector Development Division

(CLICK HERE AND TYPE RETURN ADDRESS)



Department of Primary Industries

23 March 2009

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Our Ref: PD/02/0088

Your Ref: M2008/622

Dear Chris,

Proposed amendments to the service target performance incentive scheme

Thank you for your letter of 9 February 2009 inviting the Department of Primary Industries (DPI) to comment on the Australian Energy Regulator's (AER) proposed amendments to the service target performance incentive scheme (STPIS). As you know, DPI has already commented on some aspects of the STPIS in its submission on the AER's framework and approach issues paper for Victorian distribution businesses.

DPI considers that many useful lessons have been learned in development of the current Victorian service performance scheme, and that these should inform the AER's approach to the STPIS. The submission attached outlines DPI's views on where the STPIS might usefully be improved to send the right signal to distribution businesses to make efficient improvements to network reliability and other service levels to customers.

If you wish to discuss this submission further, please contact Peter Clements on (03) 9658 4927 or Raif Sarcich on (03) 9658 4160.

Yours sincerely

for Marianne Lourey
Executive Director
Energy Sector Development Division

Att.



Submission – Review of Service Target Performance Incentive Scheme

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1 Introduction

This submission is in response to the consultation document “Proposed amendment – Service target performance incentive scheme” released by the Australian Energy Regulator (AER) in February 2009. The submission outlines the views of the Department of Primary Industries (DPI) based on our experience with development and evolution of the regulatory regime in Victoria over the past 15 years.

DPI understands the purpose of the Service Target Performance Incentive Scheme (STPIS) is to fulfil the AER’s functions under clause 6.6.2 of the National Electricity Rules (NER) to implement a scheme that incentivises electricity distribution businesses to maintain and improve levels of service at efficient cost to customers.

The AER proposes the following changes to the original STPIS (Australian Energy Regulator 2008a):

- Amended S-factor calculation:** The AER proposes to amend the method by which the S-factor is calculated. The S-factor calculation in version 1.0 of the STPIS was computed primarily on changes in performance from one year to the next (rather than on performance relative to the target). The S-factor was also applied cumulatively – that is, the allowed revenues (and prices) were altered by the S-factor and continued at the altered level until the end of the regulatory control period. The AER [proposes to change] the S-factor equation so that a Distribution Network Service Provider (DNSP)’s target is now computed primarily on the basis of deviations in performance from the underlying targets.

- **Amended cap on revenue at risk:** The AER also proposes to increase the amount of revenue at risk under the scheme from ± 3 per cent to ± 5 per cent. This amendment is designed to counter the decrease in the power of the incentive that occurs under some circumstances due to the amended S-factor formula.
- **Amended major event day calculation:** The AER proposes to amend how it calculates the major event day threshold which applies to events excluded from the scheme. (Australian Energy Regulator 2009, p. 1)

DPI has previously commented on some of the issues surrounding the STPIS in its submission to the AER's Framework and Approach process for Victorian Distribution Network Service Providers (DNSPs) (Issues Paper)¹ on 10 March 2009. In summary, DPI considers:

- that the AER should specify the length of period that the DNSPs will retain the benefit (penalty) of the S-factor at 6 years, as currently in place, in order to align with the incentives under the Efficiency Benefits Sharing Scheme (EBSS);
- that the cap on the S-factor scheme should be removed in its application to the Victorian distribution businesses, and in the STPIS generally;
- that the AER should make explicit the basis on which it arrived at the conclusion that Victorian customers value any potential improvement in average reliability levels that might arise because of the way the S-factor targets are set based on average performance in the preceding five years (rather than based on a fixed level) in the STPIS;
- that the AER provide information as to the basis of its decisions to adopt new forms and reject previously applicable forms of Guaranteed Service Level (GSL) payments in the STPIS; and
- that incentive rates set in 2005 based on VENCORP's 2002 valuation of customer reliability report should be re-evaluated in line with VENCORP's most recent report².

2 Comment on proposed amendments

DPI would like to comment broadly that the AER's proposed amendments to the STPIS are not minor changes. Indeed, they are fundamental changes to the operation of the S-factor scheme within the STPIS. Because of this, DPI would be concerned if the proposed changes were to be incorporated into the S-factor scheme to be applied to the Victorian DNSPs at this stage, as the effect would need to be thoroughly tested with stakeholders. Instead, amendments to the framework and approach for Victorian DNSPs should stand on the merits of arguments raised and responded to in the framework and approach consultation process.

¹(Australian Energy Regulator 2008b)

²(VENCORP 2008)

2.1 Amended S-factor calculation

DPI has a number of concerns with the significant alterations to the S-factor scheme. Of most concern is that DNSPs will only be able to retain any reward or penalty earned under the scheme for one regulatory year. This contrasts with the existing arrangements in Victoria where the DNSPs retain any reward or penalty for a period of 6 regulatory years.

As highlighted in DPI's submission to the framework and approach issues paper (Australian Energy Regulator 2008b), the retention period was set at six years in the Essential Services Commission (Victoria) (ESC)'s 2006-10 Electricity Distribution Price Review (EDPR) to offset the power of the incentive created by the efficiency carryover mechanism.

Setting the payment period to 6 years was achieved by setting the denominator for the calculation of S_t equal to $(1 + S'_{t-6})$. Thus, the formula was:

$$S_t = (1 + S'_t) / (1 + S'_{t-6})$$

The AER is proposing in the framework and approach issues paper that the DNSPs should retain the benefits (penalty) achieved under the EBSS for a period of five years after the year in which the gain is made. This means that the DNSPs will retain the benefit (penalty) for close to six years in total.

To effectively offset the incentives created by the EBSS, the DNSPs must also be allowed to retain the benefit (penalty) earned under the S-factor scheme for 6 years.

However, the AER is not proposing to make any commensurate change to the efficiency carryover scheme. The potential outcome of this is that the DNSPs will have the incentive to achieve efficiency gains at the expense of service levels.

2.2 Amended cap on revenue at risk

The AER believes that the cap on the S-factor maintains a consistent incentive effect with the efficiency carryover mechanism. DPI does not consider that the AER has made the case sufficiently to demonstrate this view, and should do so if it intends to balance the incentive schemes utilising this method. As noted, the ESC managed the balancing of the efficiency carryover and service incentive schemes through the retention period for S-factor gains. DPI believes that the AER should demonstrate why there is a need to move away from this method.

Indeed, the ESC was of a view that *no* cap on S-factor penalties was necessary to achieve a necessary and sufficient incentive power to maintain service levels.

Furthermore, imposition of a cap on the S-factor scheme potentially reduces the incentives that the DNSPs have to improve performance even though the incentive rates established may suggest that customers are willing to pay for improvements that extend beyond the cap. It effectively places a ceiling on the service improvements that customers can receive even though they may be willing to pay for those improvements.

Despite the proposed widening of the revenue-at-risk band to $\pm 5\%$, DPI remains of the view that no S-factor revenue-at-risk cap should be incorporated into the scheme applying to electricity distributors.

DPI understands that a cap on the S-factor scheme was introduced to achieve a degree of consistency with the arrangements established for transmission. However, generally, the dispersed nature of distribution networks means that the risk of extreme under-performance under the S-factor scheme due to events beyond the distributors' control is limited. Typically, fewer customers are affected by each outage, and (non-natural disaster related) unplanned outages generally occur over shorter time frames than with transmission.

Of further concern is the change in the way that rewards/penalties are calculated and the way the service targets are set. The Victorian S-factor scheme set in place in the 2006-10 EDPR rewarded the DNSPs for incremental improvements in actual performance. The targets for the scheme were set at the 2005 targets as no information had been received that Victorian customers valued further improvements in average reliability. As a result, the scheme operated on the change in actual performance from one year to the next.

The AER is now proposing to calculate improvements using the difference between the actual performance and the target that has been set for that year with the target being calculated as the average of the actual performance for the previous five years.

This second change to the scheme means that DNSPs may be insulated from the penalties that would otherwise be incurred if service levels deteriorate. As actual service outcomes deteriorate, the targets will become easier because targets are set based on the average of past performance. With the penalty calculated as target-minus-actual in one year, the easier target minimises the penalty that the distributors receive for allowing service to deteriorate.

2.3 Amended major event day calculation

DPI appreciates the AER's intention to adopt industry standards, where possible, to delimit major event days. To the extent that the AER adopts measures to improve the accuracy of these definitions, they will be of benefit to the energy sector. DPI is concerned, however, that the AER's intention is "...[to clarify] that it will exclude the entire duration of those outages originating within the midnight to midnight period of a major event day" (Australian Energy Regulator 2009, p. 15).

The ESC has in the past exercised regulatory discretion over the extent to which the duration of these outages will be excluded from an S-factor penalty calculation. It is appropriate that distributors only have the benefit of an exclusion for a reasonable time to rectify the resulting outages. An open ended exclusion from the time of a major event may not give distributors an adequate incentive to take strong measures to re-establish supply, especially where there may be a need for interstate personnel and other extraordinary measures.

Furthermore, the cost to consumers of outages tends to increase geometrically with the duration of an outage, with consequences initially minor for less than 1 day outages, moving through to significant financial cost for a few days and

complete displacement of homes and businesses for longer outages. The costs to consumers can quickly exceed the cost to distributors of restoring supply.

DPI suggests that the AER instead retain discretion over the duration of exclusions taking into account the reasonable measures distributors may take to rectify outages in major event scenarios.

2.4 Other matters

2.4.1 Value of customer reliability

DPI welcomes the integration of the 2008 VENCORP/Charles River Associates Value of Customer Reliability (VCR) study (VENCORP 2008) into the STPIS. Notwithstanding the comments made in Section 2 of this submission, it would be beneficial and prudent to incorporate this updated information into the inputs to the upcoming Victorian electricity distribution price determination, as there is no benefit to relying on outdated information.

2.4.2 Other changes

DPI has no specific comments on the other changes proposed to the STPIS by the AER.

References

- Australian Energy Regulator (2008a), 'Final decision: Electricity distribution network service providers – service target performance incentive scheme', AER Website.
- Australian Energy Regulator (2008b), 'Framework and approach paper: Citipower, Powercor, Jemena, SP AusNet and United Energy regulatory control period commencing 1 January 2011. (preliminary positions)', AER Website.
- Australian Energy Regulator (2009), 'Proposed amendment – service target performance incentive scheme', AER Website.
- VENCORP (2008), 'The value of customer reliability used by VENCORP for electricity transmission planning (consultation paper)', VENCORP Website.