

First Proposed

Electricity Transmission Network Service Providers

Service Target Performance Incentive Scheme

EXPLANATORY STATEMENT AND ISSUES PAPER

January 2007



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1 Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of transmission network service providers (TNSPs) in the National Electricity Market in accordance with the National Electricity Rules (NER).

This Explanatory Statement accompanies the First Proposed Service Target Performance Incentive Scheme (proposed scheme) and provides the AER's reasons for the proposed scheme. It has been prepared to satisfy the AER's obligations under clauses 11.6.17(c) and 6A.20(b)(2) and (3) of the NER.

The AER has also prepared an Issues Paper, which forms part of this Explanatory Statement, which provides additional information and requests written submissions on specific issues.

2 Rule requirements

Clause 6A.7.4 of the NER requires the AER to publish the Service Target Performance Incentive Scheme (the scheme) by 28 September 2007. The scheme must comply with the principles prescribed in the NER at clause 6A.7.4(b).

Under clause 11.6.17 the AER must also publish a proposed scheme on or before 31 January 2007 that will apply to SP AusNet, VENCORP and ElectraNet for any transmission determination made in 2008. This scheme will form the basis for consultation to develop the scheme that will apply to all other TNSPs in future regulatory periods.

3 Purpose and objectives of the proposed scheme

The proposed scheme outlines the approach to setting a service target performance incentive within the transmission determination framework. The objectives of the proposed scheme are to:

- contribute to the national electricity market objective
- be consistent with the principles in the NER
- promote transparency in the information provided by a TNSP and the decisions made by the AER and
- assist in the setting of efficient capital and operating expenditure allowances.

The scheme will be a stand alone document. All substantive service standards provisions will, as far as possible, be included in the scheme rather than some other guideline. The exceptions to this general rule are that the general information that must be included in a TNSP's revenue proposal are specified in the Submission Guidelines and the service standards related reporting requirements for annual compliance are contained within the Information Guidelines.

4 The nature and reasons for the proposed scheme

The revenue cap form of regulation allows TNSPs to earn up to a maximum allowed revenue (MAR) within a regulatory year. The MAR is based on forecast efficient costs. During the regulatory control period a TNSP can maximise its profits by reducing its costs below the forecast levels. While cost reductions could occur because of improved efficiency, it could

also result from reduced service quality. A TNSP may have an incentive to maximise its profits at the expense of service quality delivered to customers and the market.

The proposed scheme uses an economic incentive mechanism to address this incentive and affect TNSP behaviour to improve customer and market outcomes relating to service performance. The scheme provides financial rewards for improvements in performance standards and penalties when performance standards decline against an historical performance target.

The proposed scheme promotes the national electricity market objective and principles set out in the NER by encouraging TNSPs to consider how their actions are valued by customers and how their investment and operational decisions may affect market outcomes. TNSPs are particularly encouraged to improve reliability of the transmission system at times which are most valued by transmission network users and on those elements of the transmission system that are most important to determining spot prices.

This is achieved through the suite of performance parameters applied to TNSPs, the relative weighting of parameters, the level of revenue placed at risk, and the performance targets established for each parameter. These factors in the proposed scheme interact to give incentives to TNSPs to improve service performance.

5 Consultation process

The AER anticipates that the following consultation process will apply to developing the scheme:

- publish the proposed scheme, this Explanatory Statement and additional material inviting written submissions
- consider comments received on the proposed scheme by 1 May 2007
- publish the final scheme in September 2007

6 Invitation for written submissions

Interested parties are invited to make written submissions to the AER on the proposed scheme, having regard to the issues outlined in the attached Issues Paper. The requirements for submission are outlined in the Issues Paper.

ATTACHMENT:

ISSUES PAPER

FIRST PROPOSED SERVICE TARGET PERFORMANCE INCENTIVE SCHEME

1 Introduction

This Issues Paper accompanies the Explanatory Statement and provides an overview of the key concepts contained in the proposed scheme.

2 Development of the scheme

In 2003 the Australian Competition and Consumer Commission (ACCC) released its *Statement of principles for the regulation of transmission revenues—service standards guidelines* (the existing guidelines), and in 2005 the AER adopted the existing guidelines as part of its compendium of regulatory guidelines.

The AER has developed the proposed scheme by reviewing the existing guidelines and making adjustments to allow for recent amendments to the NER. Broadly the proposed scheme departs from the existing guidelines by:

- adopting the new terminology used in the NER
- including many aspects of each TNSP's specific performance incentive scheme parameter definitions
- including additional requirements for targets, caps and collars, and
- moving the general information and reporting requirements to other guidelines.

3 Timing and process

3.1 Matters set out in the scheme

The existing guidelines anticipate that many aspects of a TNSP's service standards regime will be included in each TNSP's transmission determination. In response to the amendments to the NER the AER has drafted the proposed scheme so that the following aspects are now included in the scheme:

- the performance incentive scheme parameters (parameters) that apply to each TNSP
- the process for determining the adjustments to the MAR (including the level of the financial incentive) and
- the requirements with which values for the parameters must comply.

The only matters that will be included in a transmission determination are:

- the values for targets, caps and collars
- the weighting of the TNSP's parameters and
- for ElectraNet and SP AusNet some other elements of the parameter definitions.

3.2 Process for requesting an amendment to the scheme

Under the NER an amendment to the scheme cannot apply to a TNSP for a regulatory control period unless it takes effect at least 15 months before the commencement of that regulatory control period. Given this constraint the AER considers that it is appropriate to include a process for a TNSP to propose amendments to the scheme.

The proposed scheme includes a mechanism for a TNSP to propose amendments to the scheme which add, remove or vary a parameter or vary the level of the revenue at risk. The TNSP must submit the proposed amendment to the AER at least 22 months before the commencement of the next regulatory control period. This time period is required to allow the AER to consider the amendment and comply with the transmission consultation procedures prescribed in the NER. This mechanism does not prevent TNSPs proposing other amendments to the scheme.

Q.1. Is the process for requesting an amendment to the scheme suitable?

4 Performance incentive scheme parameters

4.1 Changes to terminology

As noted above, the proposed scheme has adopted the terminology used in the NER so that what were previously called measures and measure definitions are now called performance incentive scheme parameters (parameters).

4.2 Parameters

The proposed scheme applies the following network based parameters:

- transmission circuit availability
- loss of supply event frequency
- average outage duration

Appendix A of the proposed scheme lists the standard definitions for each of these parameters and shows how the performance data for those parameters should be calculated. Subject to some amendments to the definitions, these parameters are substantially the same as those applied across TNSPs under the existing guidelines.

The AER is considering including a definition of system minute in the loss of supply event frequency parameter. The AER is interested in whether there is a definition which can be applied across TNSPs.

Q.2. What is the current definition of system minute applied by TNSPs?

Q.3. Is the definition of system minute included in ElectraNet's definition of loss of supply event frequency (Appendix B) used by other TNSPs?

4.3 Market impact of transmission constraints

Market impact parameters have not been included in the proposed scheme due to their ongoing development by the AER. In June 2006 the AER released its final decision

Indicators of the market impact of transmission congestion and has since released data reports for 2003–2004 and 2004–05. The AER will release the data report for 2005–06 in the first quarter of 2007.

Work on the market impact of transmission constraints is continuing with the intent of devising one or more economic incentive parameters. The AER is currently developing an issues paper and will consult with its working group and industry on the development of these parameters.

The AER is aiming to incorporate any necessary amendments or additional parameters into the scheme as a result of this work before 30 September 2007. However given the complexity involved in developing parameters this may prove a significant challenge. In the event that it is not possible to include these parameters by 30 September 2007, the AER may begin amending the final scheme after this date. These amendments will be finalised before April 2008 so that they can apply to Transend, EnergyAustralia and TransGrid for their next regulatory periods.

4.4 TNSP specific parameter definitions

In response to the amendments to the NER the AER has included many aspects of a TNSP's specific parameter definitions in the proposed scheme (see Appendix B). The TNSP specific definitions have generally been drawn from each TNSP's existing transmission determination.

Q.4. Should any amendments be made to the TNSP specific parameter definitions in Appendix B?

As the proposed scheme will apply to ElectraNet and SP AusNet during their next regulatory control period, the AER has consulted with these businesses in developing the proposed scheme. The AER has reviewed the parameter definitions that apply to ElectraNet and SP AusNet and due to the limited time these businesses have been given to comment on the proposed scheme, the AER has permitted some aspects of these businesses specific parameter definitions to be finalised in the transmission determination.

5 Values

The NER require TNSPs to submit values in their revenue proposal for the parameters that apply to it under the scheme and the proposed scheme must include the requirements with which the values must comply.

The AER has included the requirements for values in clause 2.5 of the proposed scheme. These requirements include an obligation on a TNSP to propose a performance target, a cap and a collar for each of its parameters. The AER must be satisfied that all proposed values are consistent with the scheme's objectives.

5.1 Targets

The AER considers that the actual service performance outcomes of each TNSP is the most appropriate basis on which to set performance targets. Under the proposed scheme a performance target must be based on the TNSP's performance history over the previous five years and is subject to adjustments to allow for statistical outliers, increases in planned capital

works and material changes to regulatory obligations. Where this service performance data is unavailable the AER may accept a proposed performance target that is based on an appropriate benchmark or methodology.

Service performance targets must be set using data which is recent, accurate, reliable, consistent, auditable and repeatable. The AER considers that data over a period of the most recent five years aligns with the regulatory period and will provide a robust and reasonable basis on which to set service performance targets. In addition average performance over five years is an optimal period of time to establish targets as it encourages continual service performance improvements.

5.2 Caps and collars

The proposed scheme provides that the caps and collars proposed by a TNSP must be calculated by reference to the performance targets using a sound methodology.

Q.5. Should there be any additional requirements for setting values?

6 The revenue at risk and financial incentive

6.1 Revenue at risk

The NER provide that the maximum revenue increment or decrement that a TNSP may receive as a result of the operation of the scheme must be in a range of 1 and 5 per cent of MAR. The proposed scheme provides that the maximum revenue at risk is 1 per cent of a TNSP's MAR.

The AER recognises that this level of revenue at risk may be conservative over the long term. However as the operation of the service standards regime and parameters applied under the existing guidelines has not undergone any review, the AER is cautious about exposing TNSPs to additional risk or uncertainty by revising the revenue at risk upwards.

6.2 Weightings

The proposed scheme allows TNSPs to propose weightings to be applied to parameters in their revenue proposal. The AER must be satisfied that the proposed weightings are consistent with the objectives in clause 1.4. These objectives include the customer and market focussed principles in clause 6A.7.4(b)(1) of the NER.

This requirement will weight more heavily those parameters which encourage TNSP's to improve reliability at times which are highly valued by customers or on those network elements that impact on spot prices.

6.3 Timing of the financial incentives

The AER has included additional provisions in Appendix C which clarify the timing of the adjustment to the MAR. As with the existing guidelines, TNSPs measure and report their performance against established parameter definitions on a calendar year basis within a regulatory control period. This results in a six-month lag between when a TNSP's performance is measured and when the financial incentive adjustment is made to a TNSP's

MAR.

7 Reporting

The NER require the AER to publish Information Guidelines and Submission Guidelines. The annual service standards reporting requirements and guidance on the information to be included in a Revenue Proposal will be included in those guidelines. These forthcoming guidelines should be read in conjunction with the proposed scheme.

The proposed scheme includes new requirements on TNSPs to report to the AER when a TNSP's data collection methods materially change. This provision is necessary to ensure that the AER is able to assess those changes and determine whether amendments are required to the scheme.

8 Issues for comment

Interested parties are invited to make written submissions to the AER on the proposed scheme and provide any comments in response to the following:

- Q.1 Is the process for requesting an amendment to the scheme suitable?
- Q.2 What is the current definition of system minute applied by TNSPs?
- Q.3 Is the definition of system minute included in ElectraNet's definition of loss of supply event frequency used by other TNSPs?
- Q.4 Should any amendments be made to the TNSP specific parameter definitions in Appendix B?
- Q.5 Should there be any additional requirements for setting values?

Any submissions must be received by close of business 1 May 2007 and should be addressed to:

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