19 March 2009

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000
By email: aerinquiry@aer.gov.au

Dear Mr Pattas,

SERVICE TARGET PERFORMANCE INCENTIVE SCHEME: PROPOSED AMENDMENT

Origin appreciates the opportunity to comment on the *Service Target Performance Incentive Scheme (STPIS): Proposed Amendment*. In principle, Origin supports measures that create incentives for improved service, provided rewards to Distribution Network Service Providers (DNSPs) are proportionate to improvements experienced.

As outlined on page 8 of the Australian Energy Regulator's (AER) *Explanatory Statement*, the current and revised schemes differ from each other in complex ways. The former relies not only on the rate of change between targets to determine benefits, but also on the carry over mechanism, which has a significant impact associated with sustained periods of below (above) target performance.

Origin notes that the motivation cited foremost for removing the carry over mechanism in the STPIS is to remove a perverse incentive. In short, a DNSP might seek to reduce performance, after the cap on revenue at risk had become binding, with a view to then improving from a lower base in the following year. To the extent that this incentive was likely to arise and to influence the activities of DNPSs, Origin agrees it should be removed. It seems unlikely that many DNSPs would be in a position to manipulate performance so precisely, as to generate dramatic turnarounds coinciding with a year end. However, was this to occur, it would clearly not be in customers' interests.

Origin would note that an important result of the proposed revision is to reduce the overall potential revenue impact of the scheme in the final years from over ±10 percent to ±5 percent. It is not immediately clear how much of a concern this is. On the one hand, the AER is proposing to increase the limit of the revenue in each year from the current ±3 percent to ±5 percent to counter this balance somewhat – and scenarios where a DNSP changes performance so dramatically are likely to be rare. On the other hand, the fact that the scenario is unlikely does not make the structure of the underlying incentives unimportant.

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When DNSPs are consistently under or over target in the current scheme, the impact accumulates. While 'symmetry' in the revised scheme may allow a DNSP to be assessed afresh each year, this does not carry as strong an incentive for consistent performance. Furthermore, in the revised scheme there is no incentive to improve performance once the DNSP has reached the 5 percent cap in any given year.

In the abstract, the idea of allowing the impact of successive years to accumulate to some degree may be aligned with customer interests. A period of successive below standard performance is likely to be of growing concern, with the reverse also true of above standard performance. Entities in competitive markets face 'asymmetric' rewards as a result of iterative successes or failures. The scheme also includes a range of carve-outs for events beyond a DNSP's control. In this way, there may be some value in maintaining a limited element of 'carry over'. Could this be achieved while still adopting the revised structure where performance is measured against the target rather than as a rate of change? After a prior year's increment is reversed, the new increment could give weighting to the divergence from target in the most recent relevant year as well as smaller weighting to divergences in prior year(s).

Origin also recognises the need for simplicity. The STPIS is a means for promoting commercial outcomes in a monopoly environment, so some limitations in the model are unavoidable. Setting the maximum yearly revenue impact at ±5 percent rather than ±3 as a way to counterbalance the impact of removing the carry-over mechanism may be the simplest solution. However, an overview of the different results of the 5 percent target versus the accumulating scheme – drawn from the AER's analysis – would provide more confidence that 2 percent was an appropriate increase.

Lastly, while the fundamentals of the STPIS are a product of prior consultation and this review relates to a technical amendment, Origin would note that the STPIS is a primary means for maintaining service levels and, as such, its set of performance measures are quite narrow.

In summary, Origin would reiterate the importance of a robust STPIS as a primary means to ensure service levels are maintained for customers. Removing perverse incentives with the potential to distort customer outcomes is important, but the incentives maintained must also be meaningful.

Should you have any questions, or wish to discuss this response further, please contact Steven Macmillan (Regulatory Analyst) on (03) 8665 7155 in the first instance.

Yours sincerely

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