

11 November 2011

Mr Chris Pattas
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Dear Chris,

Transmission STPIS Issues Paper

SP AusNet welcomes the opportunity to make this submission in response to the AER's Issues Paper.

SP AusNet is the primary Victorian TNSP and its electricity transmission network interconnects generators, distributors, high voltage customers within the state and with the transmission systems of the neighbouring States of New South Wales, South Australia and Tasmania. This network serves all of Victoria, covering an area of approximately 227,600 square kilometres and a population of over 5.6 million people.

SP AusNet strongly supports the use of incentives as the most effective way to align a TNSP's interests with the public interest. SP AusNet has an additional two percent of revenue at risk under its jurisdictional scheme and two percent of revenue at risk on the MITC since 2011. Therefore SP AusNet has the largest amount of revenue at risk under performance schemes of any TNSP in the NEM.

This submission outlines the key features of Victorian transmission arrangements that should be considered in relation to any amendments to the existing scheme, as well as details of the Victorian jurisdictional performance incentive scheme that SP AusNet is also subject to.

If you have further questions regarding the information provided, please contact Katie Yates, on 9695 6622.

Yours Sincerely,



Alistair Parker
Director Regulation and Network Strategy

1. Background

Victorian Transmission arrangements are different to those that apply in other states in the National Electricity Market (NEM). Specifically, Victoria has a network structure in which asset ownership is separated from planning and investment decision making. SP AusNet owns Victoria's primary network of transmission assets, but the Australian Energy Market Operator (AEMO) plans and directs most network augmentation. The AEMO also buys bulk transmission network services from SP AusNet for sale to customers.

SP AusNet is responsible for replacement of assets on its transmission network. The AEMO, generators and distribution customers plan and direct network augmentation, with new transmission facilities and services open to contestability.

In other Australian states, planning and responsibility for augmentation is not separated from the incumbent transmission company (although independent planning oversight occurs in South Australia)

The separation of transmission planning and operation in Victoria affects the strength of performance incentives in Victoria, as the incentives only apply to SP AusNet as the network operator, who has a more limited 'toolkit' for responding to incentives than TNSPs in other states who may make planning as well as operational changes to improve network performance and reliability in response to the STPIS.

As the system stands, it is not possible to apply incentives to drive Victorian planning decisions to deliver the outcomes desired by customers. This highlights the major disadvantage to the Victorian arrangements which potentially stifle innovation in response to service standard incentive schemes.

Another important aspect of the Victorian arrangements that should be considered in relation to this review of the STPIS is that SP AusNet's transmission network is also subject to the Availability Incentive Scheme (AIS) which is applied by AEMO. There is considerable overlap between AIS and both the service and market components of the STPIS in terms of the performance measures and operational behaviours that are targeted.

2. Objectives of the scheme

Well designed incentives should link the incentives of the transmission businesses with what customers want out of their electricity network, and drive the improvement (or maintenance) of performance in those areas.

In the ACCC's 'Statement of Principles' regarding the development of the service standards scheme, they stated that¹:

The service standards should influence the revenue cap to ensure that TNSPs:

- *Are rewarded when performance standards increase and penalised when performance standards decline, thus providing incentives for continued performance improvement*
- *Consider how their operations are valued by the national electricity market (NEM).*

The recent rule change proposal lodged by the AER identified a need for a greater role for customers in the regulation of electricity and distribution networks. The STPIS is a key tool for aligning the interests of TNSPs with the interests of their customers. This is an important point to emphasise in reviewing the scheme – that the incentive scheme needs to be grounded in an understanding of what customers value, and any amendments to the scheme should reflect greater emphasis on those values.

In this context, it is important to recognise that where TNSPs have responded to the incentives that are in place, and where they have received payments under the scheme, that this is because they have delivered measurable improvements in areas of performance and reliability that customers value. That is to say, that the STPIS has successfully aligned the interests of TNSPs with their customers.

This idea that the incentive scheme should focus on those areas of performance of greatest interest to customers is relevant to the questions raised in the issues paper around what is the appropriate way to deal with incentives for parameters (measures of performance) that are approaching a 'natural limit' or 'efficiency frontier'. In particular, it would seem reasonable to assume that in such instances where customers are experiencing desired performance levels, they would not be overly concerned with strengthening the incentive regime on these measures.

Incentive mechanisms such as the STPIS can also provide an effective tool for identifying the efficient performance level for individual transmission networks. This can be hard to establish in the absence of incentives due to the significant differences that are present across transmission networks.

¹ ACCC, *Decision: Statement of principles for the regulation of transmission revenues – Service standards guidelines*, 12 November 2003

3. Performance of the scheme

In the operation of any performance incentive scheme, success would be measured by improved performance against the targets and (under a symmetric scheme such as STPIS) would be associated with positive incentive payments. Conversely, if the incentive scheme does not result in a change in performance, it could be a sign that the incentive is a failure in some way, possibly because the scheme was targeting performance measures that TNSPs did not have sufficient ability to control, or that the size of the incentive was insufficient relative to the costs of improving performance. However, it may also be that the historical performance was efficient.

The AER's most 2008-09 report on the performance of TNSPs reported on their historical performance under STPIS. The s-factor results reflect the share of revenue at risk that the TNSP earned (or, in the case of a negative result, the size of penalty they were required to pay) in each year.

Table 1: Performance results for Service Standards incentives²

	2005		2006		2007		2008		2009	
	s-factor*	\$m	s-factor*	\$m	s-factor*	\$m	s-factor*	\$m	s-factor*	\$m
	%		%		%		%		%	
Directlink	-	-	(0.54)	(0.1)	(0.62)	(0.1)	(1.0)	(0.1)	(1.0)	(0.1)
ElectraNet	0.71	1.2	0.59	1.0	0.28	0.5	0.29 ^(a) (0.4) ^(b)	(0.2)	0.6	1.4
Energy Australia	0.67	0.6	0.39	0.4	(0.14)	(0.2)	0.72	0.9	0.37	0.3
Murraylink	0.15	(0.0)	0.18	0.0	(0.32)	(0.0)	0.69	0.1	0.9	0.1
Powerlink	-	-	-	-	0.82	2.2	0.53	3.0	0.2	1.1
SP AusNet**	0.09	0.2	(0.17)	(0.5)	0.06	0.2	0.15 ^(a) 0.82 ^(b)	2.9	0.5	2.4
Transend	0.19	0.2	0.06	0.1	0.57	0.7	0.85	1.2	0.9 ^(a) 0.1 ^(b)	0.7
TransGrid	0.70	3.1	0.63	3.0	0.12	0.6	0.31	1.7	0.2 ^(a) (0.3) ^(b)	(0.3)

*Financial incentives are capped at ± 1.0 per cent of each TNSP's MAR for that year. For example, an s-factor of 0.50 would result in a financial incentive of 0.5 per cent of the TNSP's MAR, or half of the potential maximum financial incentive available under the service standards performance incentive scheme.

**SP AusNet's financial incentive in its previous regulatory control period was capped at +0.5 per cent of its MAR. In 2008, SP AusNet transitioned into a new regulatory period, and its financial incentive is now capped at +1.0 per cent.

(a) 2008 performance for the six months from January to June 2008.

(b) 2008 performance for the six months from July to December 2008.

Table reproduced from AER (2011), p.61

As the results indicate, TNSPs have on balance been outperforming their targets and delivering performance improvements against the parameters set out in the scheme.

A common feature of incentive schemes is that they often extract the greatest shift in performance in the initial years in which they apply, as the TNSPs collect the 'low hanging fruit', and then settle down to a pattern of more incremental improvement. This is a relevant consideration in light of the analysis of the response to the MITC and its implications for the future of that component of the scheme.

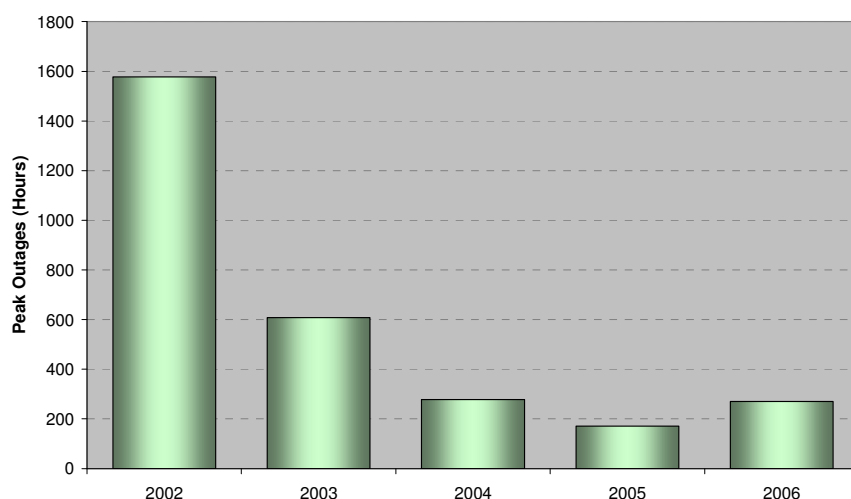
² AER, *Transmission Network Service Providers – Electricity Performance Report for 2008-09*, February 2011

This pattern should be expected. Moving from an environment of zero incentive to one with a positive incentive, while setting targets on historic performance, should be expected to produce improvements in most cases. Sizeable performance shifts should not be taken as an indication that the scheme incorrectly provides windfalls to businesses. Rather it is often an efficient delivery of the benefits valued by customers. While early TNSP benefits may appear large, customers usually get to reap the benefits for extended periods of better performance, including long after targets have adjusted and incentive payments has shrunk.

A relevant example of this was SP AusNet's peak outage performance following the initial introduction of the jurisdictional AIS scheme as reported in the TRR. SP AusNet was the first Transmission Network Service Provider (TNSP) to implement an incentive scheme on outage management in 1994 and was the first TNSP to be subject to the AER service standards scheme in 2003. The company responded to these incentives with improved outage management and planning, ensuring less disruption and risk to customers from maintenance and construction activities.

Since their introduction, the AER scheme and the more targeted AEMO (previously VENCORP) availability incentive scheme have driven desirable outcomes in operational performance. For example, peak outage hours (during the summer demand peak) have fallen dramatically since the introduction of both schemes in 2003 (refer Figure 1). This illustrates the importance SP AusNet places on ensuring the transmission system capacity is available during times that are most likely to be important to the National Electricity Market, therefore, helping minimise market prices at these times and greatly improving the security of supply to customers. Mirroring this, SP AusNet's financial benefit under the AIS has declined over time.

Figure 1: Peak Outages



Source: SP AusNet

4. SP AusNet View

SP AusNet supports the submission of Grid Australia to this review. This submission is intended to address the issues as they specifically concern SP AusNet's transmission network and the Victorian transmission arrangements.

SP AusNet is strongly supportive of the presence of service performance incentives as part of the regulatory framework for electricity transmission, and believes that well designed incentives play an important role in aligning business interests with customer interests.

Further, SP AusNet believes that on balance the current STPIS is working well, and has been responsible for driving improvement in service standards across a range of performance areas covered by the scheme that are valuable to customers.

Given this, it is reasonable to assume that any amendments made to the scheme will be focused on making refinements rather than wholesale changes. The fact that the MITC is still in its relatively early days further emphasises the need for this. SP AusNet notes that the issues paper for the review is broad ranging and that the scope of changes canvassed in the paper, if taken as a total package, are beyond what is warranted based on performance of the scheme to date. In this light it is important that the AER makes a case for any amendments – either that the current scheme is broken in some way or that there is a strong case that fundamental as opposed to incremental amendment is necessary.

This is particularly relevant with regards to whether the STPIS should be expanded to provide incentives targeted at capex decisions as this is currently being examined in the Transmission Frameworks Review.

MITC

In relation to the weightings of components of STPIS, SP AusNet agrees that well-designed incentives focused on the market impact of TNSP operational behaviour are, in principle, the best basis for performance incentives. In practice, SP AusNet has limited experience with the MITC, which was only introduced in 2011, and does not feel that it has sufficient understanding of the details and realities of the scheme to be able to judge if the AER has got all the elements of the scheme design right. In particular the scheme's volatility due to issues outside of TNSP control need to be assessed, as it may be that performance improvements against the MITC to date are due in some part to exogenous factors.

Flexibility

SP AusNet believes that it is essential to retain the current flexibility in the STPIS when applying the scheme across TNSPs. Specifically, any amendments made to the scheme through the process of this Review, need to acknowledge the unique planning relationship with AEMO that is in place in Victoria, and the impact that has on SP AusNet's ability to respond to incentives.

On the issue of the operation of incentives at the 'performance frontier,' which emerges as a significant concern of the issues paper, SP AusNet believes that the use of historical performance data to set performance targets provides an inherent self-correcting mechanism, and that there is no need for major changes in this area. However, flexibility is required in the application of incentives at the frontier, including being open to the

probability that the best likelihood distribution for performance parameters of TNSPs operating near the frontier may not be normal.

The key arguments for this approach to setting performance targets were identified when the initial service standards guidelines were adopted:

[T]he ACCC has chosen to use the actual performance outcomes of each Australian TNSP from the last three to five years as a guide to set achievable performance targets. The advantages to this approach are as follows.

- *- As with most forecasting, the best guide to future outcomes can be derived from past performance. A TNSP's most recent performance would take into account all available historical information, making it a reliable method of setting achievable targets.*
- *- Using actual performance data reduces complications arising from comparing companies with different operating environments. A TNSP with poor performance results may be operating very well given its local (difficult) conditions and hence an industry benchmark would be inappropriate. For example, it would not be appropriate to give two TNSPs the same industry benchmark, when one suffers many outages due to violent storms and the other does not.*
- *- Applying actual performance data provides a self-check mechanism. Once the performance target is set for the regulatory period the TNSP would report its performance annually. The ACCC would then reassess the performance targets based on reported results. This removes the incentive for the TNSP to exaggerate its performance in an attempt to seek higher financial rewards.³*

The following sections address some of the specific questions raised in the AER's issues paper.

Scheme objectives and evaluation criteria

SP AusNet supports the current objectives of the STPIS and the proposed evaluation criteria for the review. Noting however, that when it comes to a consistent treatment of TNSPs, a consistent impact of the STPIS will only be achieved with a flexible application of incentives that is mindful of the important differences between the transmission networks that make up the NEM. For example in Distribution, where a consistent VCR is applied, it does not result in identical targets, thresholds and exclusions under their incentive scheme.

Performance measures (parameters) and exclusions

Q.3 Should the transmission circuit availability parameter still be included as a measure of network reliability?

SP AusNet agrees with Grid Australia's response that availability is a meaningful measure of service performance.

³ ACCC, *Decision: Statement of principles for the regulation of transmission revenues – Service standards guidelines*, 12 November 2003

Q.4 Given the overlap between the circuit availability and the market impact component, should the circuit availability parameter focus on unplanned outages (with or without interruption to supply)?

Given the jurisdictional AIS scheme that SP AusNet is subject to, as well as the Market Impact component of the STPIS, SP AusNet believes that the planned availability parameters add little to the overall incentives that apply to its transmission network, and their removal could simplify the scheme.

It notes also that the current availability parameters that focus on static definitions of 'peak' and 'non peak' can constrain TNSPs from taking actions to reduce constraints under MITC. For example, in summer periods in Victoria where the 'peak availability' measure is applied there will be periods of cool weather and low energy demand, when taking outages would not cause significant constraints as measured by the MITC.

This highlights the need for the STPIS to take account of the jurisdictional differences between the TNSPs, for example through the weighting of parameters, because other TNSPs who are not subject to the AIS may consider that the availability parameter provides them with a meaningful and worthwhile incentive.

Q.5 Should the target for unplanned outages be zero rather than an average of past performance?

From a technical perspective this is an unreasonable target as networks are not designed to achieve this outcome nor is opex and capex allocated to achieve this outcome. This is not to say that it would not be the operational goal for TNSPs, but a zero target would in effect penalise TNSPs even if they had reached the efficient frontier for performance in this area. This cannot be consistent with the National Electricity Objective or revenue and pricing principles in the National Electricity Law.

Where the goal is to drive performance improvements, a zero target does not provide a stronger incentive than a historical performance target with a symmetrical incentive.

Q.6 What measure should be used to measure unplanned outages – should it be number of events or total duration (with individual events capped at say seven days)? Should the measure be normalised based on the number of transmission elements, to make comparison between TNSPs possible?

SP AusNet does not have a preference between measuring the number or the duration of events. It is noted however, that for businesses such as SP AusNet that have an infrequent number of events, expected total duration (with a cap for individual events) is a better duration measure than average duration. This limits the situation where one large event early in the period can blunt the incentive for the remainder of the period.

Q.7 Should the definitional thresholds for the loss of supply event frequency parameters differ across TNSPs? If so why?

This is in essence a statistical question, for the AER to establish. While TNSP performance and, therefore, targets will differ due to the inherent characteristics of their networks, in theory, consistent thresholds could be applied if there were a statistically significant sample for all TNSPs at the level the threshold is set.

From a practical measurement perspective harmonising the threshold is likely to result in some TNSPs not having a statistically significant sample upon which to base targets.

If a common threshold was applied that was too high, it could lead to a performance target of zero that is not meaningful for driving performance improvement (this could happen if the expected frequency of such events was less the historical period used to set the target).

Q.8 Is there merit in including these 'near miss' (or any other) additional parameters in the STPIS?

SP AusNet supports the development of incentives where they can be shown to deliver value to customers. If the AER wishes to develop an incentive around near miss parameters, they need to establish the case that an improvement in performance in this area is something that customers would value (e.g. because it is related to risk levels for the network), and that it is consistent with the STPIS objectives.

The development of near-miss or leading edge parameters would need to be more fully developed, before the merits of such parameters could be assessed.

Also, the scheme would need to be flexible enough to deal with the Victorian planning arrangements. Specifically, it would not be appropriate to apply near miss parameters related to failures to meet reliability standards or network transfer capability measures given that it does not have planning control.

Q.9 to Q.17 Exclusions

The current approach to dealing with exclusions under the STPIS has been effective and supports the Grid Australia response in relation to these matters.

If the AER wishes to develop an alternative approach, they must consistently apply the preferred approach to the setting performance targets (ie. the historical data must be filtered for the same exclusions before the targets are determined). For some of the approaches being considered this may present problems with obtaining appropriate data.

Q.18 to 19 Process for proposing amendments to STPIS.

SP AusNet supports the Grid Australia response to these issues. The current scheme is functioning well and there is no compelling reason advanced by the AER for removing the ability of a TNSP to propose amendments.

Setting of targets and weighting of performance measures

In relation to the setting of targets and performance weightings SP AusNet supports Grid Australia's response to specific questions. Further, there are a couple of general points that should be noted.

Firstly, performance under the existing scheme suggests that relatively small incentives have been effective in driving changes to service standards. Where performance has not responded strongly it is not necessarily the case that a higher parameter weighting is desirable (from a consumer value perspective) or that it would illicit a response (as performance improvement may not be achievable).

Secondly, the issue of the weighting of parameters is in large part a question of customer consultation regarding what aspects of service are most important. Further to this, however, the AER needs to ensure that TNSPs are not exposed to excessive or asymmetrical risk.

Thirdly, the AER may need to undertake further statistical analysis to establish what the appropriate period is for determining performance targets based on historical data. While in electricity distribution, a five year data set provides a relatively stable historical average, the inherent reliability of Transmission networks may make it more difficult to set reliable performance targets due to the small number of events that occur.

Setting of the financial incentive

Q.27 Should the AER increase the revenue at risk for TNSPs under the service component of the STPIS?

It is not clear that it is necessary to increase the revenue at risk based on the evidence that the current incentive level has been driving performance improvement.

Q.28 Should the financial incentive incorporate the economic cost of outages for parameters and sub-parameters which measure loss of supply?

The loss of supply parameter is too volatile to allow TNSPs to be exposed to the full value of the economic cost. As a first step, the success or otherwise of the MITC as an appropriate scheme for delivering incentives that are aligned with the value to customers needs to be assessed.

Q.31 Should the parameters which have reached the 'performance frontier' be subject to an asymmetric penalty-only scheme?

This is not necessary where targets are based on historical performance as there is a self-check built in. Further, the performance frontier is likely to be network specific and by removing the incentive for any further improvements, a penalty only scheme would risk locking in a level of performance that is actually below the true performance frontier if the frontier moves.

Q.34 Should the financial incentive of the market impact component of the STPIS be symmetrical?

SP AusNet supports Grid Australia's response to this question.

As explained above, the AER has highlighted the strong response of TNSPs to the MITC based on the data from those that have had the scheme in place for the longest. It should not come as a surprise that this is the case, given the advocacy for the introduction of such a scheme was rooted in the belief that there were large benefits to be achieved.

It is noted that this performance improvement against MITC has delivered substantial benefits to customers. Further, it can be expected that having 'picked the low hanging fruit' further improvements are likely to be incremental, yet customers are likely to retain much of the benefits of improved performance. However, it is also to be expected that high volatility will be an inherent feature of the MITC, as market constraints are affected by numerous factors that are not the intended target of the incentive (e.g. the investment cycle, value of energy).