

19 March 2009

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

aer inquiry@aer.gov.au

Dear Chris,

RE: STPIS Proposed Amendment

This letter details SP AusNet's response to the AER's Paper outlining a proposed amendment to the Service Target Performance Incentive Scheme (STPIS) to be applied nationally to DNSPs. These amendments make three key changes to the STPIS including:

- an amended s-factor calculation. The AER has altered the s-factor equation so that a DNSP's target is now computed primarily on the basis of deviations in performance from the underlying targets;
- an amended cap on revenue at risk. The AER proposes to increase the amount of revenue at risk under the scheme from $\pm 3\%$ (cumulative) to $\pm 5\%$ (absolute); and
- an 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.

SP AusNet addresses each of these proposed amendments below.

The amended S Factor calculation

SP AusNet supports the proposed amendments, subject to the comments in the following section. SP AusNet considers that the new scheme is well designed, increases transparency and can be more easily integrated with a DNSP's expenditure proposal.



CERTIFIED QUALITY
MANAGEMENT SYSTEM
ISO 9001



CERTIFIED SAFETY
MANAGEMENT SYSTEM
AS/NZS 4801



CERTIFIED
ENVIRONMENTAL
MANAGEMENT SYSTEM
ISO 14001

The amended revenue at risk

The AER's proposed amendment to the STPIS has replaced the original default 3% cumulative cap with an absolute 5% cap on revenue at risk under the scheme.

The key rationale for capping the revenue is risk mitigation. This becomes one of five options with which a DNSP can mitigate risk within the proposed scheme, the other four being:

- the exclusion regime which protects the DNSPs from large unforeseen events that impact on its network;
- the S Bank that allows the revenue to be smoothed by offsetting the effects of one off events in financial outcomes;
- the five year price/service proposals allows a DNSP to propose a modified exclusion regime, different reliability measures and changes to targets. This provides a further opportunity for a DNSP to justify individually tailored measures to control risk if their circumstances justify it; and
- the AER can suspend the scheme entirely in consultation with the affected DNSP.

SP AusNet believes the AER's proposed scheme provides a DNSP with adequate mechanisms to control risk without a cap, through the other four measures.

Concerns with a cap – asymmetry of the risk

Capping the revenue results in a distortion of the incentives outlined in the scheme. In particular, a business is disincentivised to dramatically improve performance, even if the technical analysis shows such improvement can be achieved, if the financial benefits are restricted through the application of a cap. Conversely, a DNSP could theoretically allow performance to decline dramatically knowing any penalty was capped.

In particular, SP AusNet questions the appropriateness of a cap on the bonus that can be earned from improvements to the underlying reliability for customers. Such a cap places a strong financial disincentive for substantial improvements to the network that may be possible for a DNSP to implement.

On the reasonable assumption that underlying revenue will be representative of underlying reliability performance, SP AusNet considers that, if it is going to be utilised as risk mitigation tool, any revenue cap should only be applied on the down side to protect a DNSP from a penalty received from a precipitous decline in performance.

This asymmetry is justified because large random effects occur only on the downside. It is natural disasters such as bushfires, cyclones, floods and wind storms that generate large (generally one off) declines in revenue and increase the revenue variability that DNSPs may wish to mitigate. There is no equivalent one off effects in the opposite direction, that is, only genuine improvements in underlying performance tend to increase revenue dramatically in the long run under the scheme. That is, there is very little

probability of random events increasing the revenue dramatically relative to decreasing it. Therefore, a cap on the upside is simply penalising consumers by preventing them from receiving efficient reliability improvements as opposed to protecting them from paying windfall gains to a DNSP from random events not related to the underlying reliability performance

This is, of course, the rationale for having an exemption regime which also inherently recognises this asymmetry.

Risk mitigation (cap or exclusion regime)

If the asymmetric approach to applying the cap is accepted, it then becomes clear that a downside revenue cap and an exclusion regime are substitutable. As such, SP AusNet believes that a DNSP should be able to propose an exclusion regime or a revenue cap as risk mitigation measure but not both.

Setting of the default cap

The AER noted its original 3% cumulative cap was unlikely to bind, even in Jurisdictions currently with an uncapped scheme:

... to date, the greatest change in annual revenue under a jurisdictional s-factor scheme has been 2.6 per cent. (page 16)

It is understood this was based on historic information that excluded consideration of results in the current Victorian Scheme. For example, SP AusNet's S Factor result for 2008 was a 7.3% increase in revenue (to be paid from 2010). Therefore, with consideration of more recent data, the AER's observation above no longer holds.

SP AusNet is not aware of any analysis for the proposed move to an absolute cap of 5%. SP AusNet considers this move increases the likelihood of the cap binding in the Victorian Jurisdiction. Assuming the application of the AER scheme in Victoria for the period from 2001 to 2010, the proposed 5% cap would have bound for SP AusNet in 2 of those years and, if performance remains stable, would bind for a further 6 years to 2016. SP AusNet also notes that revenue variation hit both the upper and lower bound in this period. This illustrates the material impact of the cap in Victoria, in relation to SP AusNet, and the significant potential impact to incentives introduced by a cap.

SP AusNet is also concerned that the proposed adjustment mechanism in Section 3.2.1 (a) 1A of the amended Scheme does not appear to remove the distortion on incentives. Even with such an adjustment in place, it denies business substantial benefits from investments that improve reliability.

The amended major event day calculation

SP AusNet supports the proposed amendments. SP AusNet considers that the new threshold definition increases clarity in this area.

Setting of the exclusion limit

SP AusNet believes that the IEEE standard using the 2.5β method is a significant step change relative to the current Victorian regime that reduces the risk to a distribution company but also potentially results in a greater disconnection between the reported network performance and the network performance that the customer experiences. The AER should be aware that adjustments may be necessary where a DNSP believes the geographic layout, past capital expenditure and network asset age dictates a change that would improve the exemption classification.

Should you have any questions in relation to this matter please contact me on 9695-6623, we would be happy to provide further information if required.

Yours sincerely,

[signed]

Patrick Murphy
Manager Economic Regulation