



**PRELIMINARY DECISION**  
**Ergon Energy determination**  
**2015–16 to 2019–20**

**Attachment 11 – Service target**  
**performance incentive scheme**

April 2015

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## Note

This attachment forms part of the AER's preliminary decision on Ergon Energy's 2015–20 distribution determination. It should be read with all other parts of the preliminary decision.

The preliminary decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators

Shortened form	Extended form
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

# 11 Service target performance incentive scheme

We published the current version of our national Service Target Performance Incentive Scheme for electricity distributors (STPIS) in November 2009.<sup>1</sup> The STPIS is intended to balance incentives to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to distributors to maintain and improve service performance where customers are willing to pay for these improvements.

The STPIS operates as part of the building block determination and is applied via the control mechanism. Through the S-factor component of the STPIS, distributors are penalised or rewarded for diminished or improved service performance compared to predetermined targets.

Our framework and approach paper for Energex and Ergon Energy proposed to continue to apply the national STPIS to the Queensland distributors. The framework and approach paper also proposed to:

1. apply a  $\pm 2$  per cent financial reward or penalty based on whether the Queensland distributors meet their STPIS targets, and
2. not to apply the guaranteed service level (GSL) component as the Queensland distributors are subject to a jurisdictional GSL scheme.<sup>2</sup>

## 11.1 Preliminary decision

Our preliminary decision is to apply the STPIS to Ergon Energy for the 2015-20 regulatory control period in the following way:

- set revenue at risk for Ergon Energy at the range  $\pm 2.0$  per cent
- segment Ergon's Energy's network according to feeder categories urban, short rural and long rural
- set applicable reliability of supply (system average interruption duration index or SAIDI and system average interruption frequency index or SAIFI) and customer service (telephone answering) parameters
- set performance targets based on the Ergon Energy's average performance over the past five regulatory years
- apply the methodology indicated in the national STPIS for excluding specific events from the calculation of annual performance targets

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<sup>1</sup> AER, *Electricity distribution network service providers—service target performance incentive scheme*, 1 November 2009. (AER, *STPIS*, November 2009).

<sup>2</sup> AER, *Final Framework and approach for Energex and Ergon Energy Regulatory control period commencing 1 July 2015*, April 2014, p. 70-71.

- apply the methodology and value of customer reliability (VCR) values to the calculation of incentive rates using the latest estimate of VCR for Queensland.

### 11.1.1 Revenue at risk<sup>3</sup>

The maximum level of penalty or reward under the STPIS is calculated as a percentage adjustment to Ergon Energy's total revenue (the S-factor adjustment). The S-factor adjustment is subject to the revenue at risk cap.

The revenue at risk for Ergon Energy for each regulatory year of the 2015–20 regulatory control period will be capped at  $\pm 2.0$  per cent. Within this cap, there will be a sub cap of  $\pm 1.8$  per cent for the reliability component and  $\pm 0.2$  per cent on the telephone answering parameter for performance.

### 11.1.2 Incentive rates<sup>4</sup>

Incentive rates are the penalty or reward that Ergon Energy receives for a single unit variation in performance. The incentive rates parameters are calculated with reference to the Value of Customer Reliability (VCR).<sup>5</sup> We consider the most recent VCR rates published by AEMO for Queensland should be applied in calculating the incentive rates because it better reflects customers' current value for reliability than our national STPIS values. AEMO's review process was comprehensive and included surveys of Queensland consumers and relies on more recent information compared to our national STPIS on the preferences of Queensland consumers.<sup>6</sup>

Table 11.1 presents our incentive rates to apply to Ergon Energy's SAIDI and SAIFI targets. The incentive rates for the telephone answering parameter will be -0.04 per cent per unit of the telephone answering parameter. Table 11.2 outline the VCR values that were used to derive the incentive rates.

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<sup>3</sup> AER, *STPIS*, November 2009, cl. 2.1(d)(2).

<sup>4</sup> AER, *STPIS*, November 2009, cl. 2.1(d)(3).

<sup>5</sup> The VCR represents, in dollar terms, the willingness of customers to pay for the reliable supply of electricity. The values produced are used as a proxy in this way, and can be applied for use in revenue regulation, planning and operational purposes in the NEM. In network planning, the VCR is used by AEMO to assess the economic merits of carrying out additional investment in the electricity network. It is therefore important the VCR figures accurately reflect the value of reliability across a range of customers.

<sup>6</sup> AEMO, *Value of customer reliability review final report*, September 2014.



**Table 11.1: Preliminary decision of incentive rates to apply to Ergon Energy's STPIS targets**

	Urban	Short rural	Long rural
SAIDI	0.01541	0.01538	0.00332
SAIFI	1.33964	1.75543	0.50072

Source: AER Analysis.

**Table 11.2: Value of customer reliability**

	Urban	Short rural	Long rural
VCR	\$40,206	\$40,206	\$40,206

Source: AEMO, Value of customer reliability review, final report, September 2014, p. 30. VCR values have been escalated to the March 2015 quarter.

### 11.1.3 Performance targets<sup>7</sup>

We will apply the System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) reliability of supply parameters. The targets will be set by reference to Ergon Energy's reliability performance in the previous regulatory control period.

We will also apply the telephone answering parameter, but not the STPIS Guaranteed Service Level (GSL) scheme. This is because Ergon Energy must comply with the existing jurisdictional GSL scheme.<sup>8</sup>

Our preliminary determination on the performance targets for Ergon Energy's STPIS parameters based on our calculation results are presented on Table 11.3.

**Table 11.3: Preliminary decision of Ergon Energy's SAIDI and SAIFI targets**

	SAIDI (Minutes p.a.)			SAIFI (Interruptions p.a.)		
	Urban	Short rural	Long rural	Urban	Short rural	Long rural
Preliminary decision	126.73	317.06	742.47	1.503	3.019	5.348

Source: AER analysis.

<sup>7</sup> AER, *STPIS*, November 2009, clause 2.1(d)(4).

<sup>8</sup> Ergon Energy, *Proposed Application of STPIS for the 2015/16 to 2019/20 Regulatory Control Period*, 22 October 2014, p. 6.

### ***Telephone answering***

We will apply the telephone answering parameter to Ergon Energy. We accept Ergon Energy's proposed performance target that 77.3 per cent of calls will be answered within 30 seconds.<sup>9</sup>

### ***Ergon Energy's historical performance against the AER's targets***

Figure 11.1 shows that Ergon Energy's network performance in the current regulatory period has been better than the STPIS targets. This has resulted in a net positive revenue adjustment under the STPIS. Ergon Energy stated that the favourable network performance is attributed to a sustained period of benign weather.<sup>10</sup>

The STPIS targets for the next regulatory period have been adjusted to reflect Ergon Energy's performance. That is, the STPIS targets have been tightened in accordance with the scheme to reflect Ergon Energy's historical performance.<sup>11</sup>

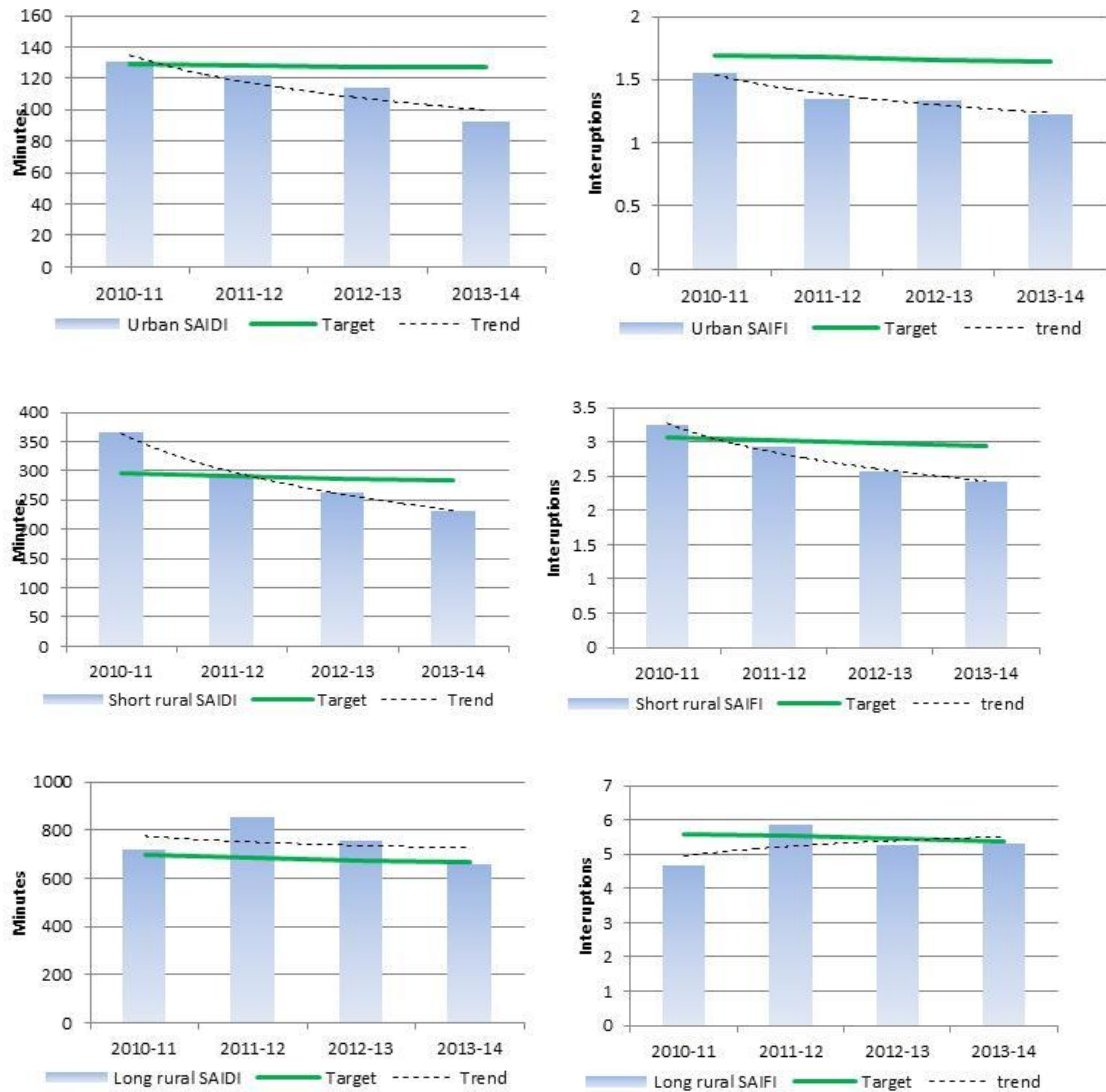
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<sup>9</sup> Ergon Energy, *Proposed Application of STPIS for the 2015/16 to 2019/20 Regulatory Control Period*, 22 October 2014, pp. 16–17.

<sup>10</sup> Ergon Energy, *Proposed Application of STPIS for the 2015/16 to 2019/20 Regulatory Control Period*, 22 October 2014, p. 11.

<sup>11</sup> AER, *STPIS*, cl. 3.2.1(a).

**Figure 11.1: Ergon Energy's historical outcomes against the performance**



Source: AER analysis.

## 11.2 Ergon Energy's proposal

Ergon Energy's regulatory proposal supported our framework and approach proposal to continue to apply the national STPIS for the 2015/16 to 2019/20 regulatory control period.<sup>12</sup>

Ergon Energy proposed to set its performance targets based on historical average performance. It initially proposed to adjust these performance targets to reflect the benefits that will be realised from its additional investment from reliability improvement

<sup>12</sup> Ergon Energy, *Proposed Application of STPIS for the 2015/16 to 2019/20 Regulatory Control Period*, 22 October 2014, p. 4.

capex. Ergon Energy subsequently withdrew its proposal to adjust the performance targets for the next regulatory control period because the STPIS does not require it to modify these targets for additional investment in reliability improvement capex. Our discussions about adjustments can be found in section 11.4.2 below.<sup>13</sup>

## 11.3 AER's assessment approach

We are required to make a decision on how the STPIS is to apply to Ergon Energy.<sup>14</sup> When making a distribution determination, the STPIS requires us to determine all performance targets, incentive rates, revenue at risk and other parameters required to apply the scheme.<sup>15</sup>

We outlined our proposed approach to, and justification for, the application of the STPIS in our framework and approach paper for Energex and Ergon Energy. Our preliminary decision has adopted the position in the framework and approach paper, unless new information has become available or new arguments have been put forward which warrant a reconsideration of this position. We have considered material submitted to us by Ergon Energy and by stakeholders.

### 11.3.1 Interrelationship with other incentive schemes

In applying the STPIS we must consider any other incentives available to the distributor under the NER or relevant distribution determination.<sup>16</sup> One of the objectives of the STPIS is to ensure that the incentives are sufficient to offset any financial incentives the distributor may have to reduce costs at the expense of service levels.<sup>17</sup> For the 2015–20 regulatory control period, the STPIS will interact with the Capital Expenditure Sharing Scheme (CESS). However, for this period we will not apply the opex Expenditure Benefit Sharing Scheme (EBSS).

The rewards and penalties amounts under STPIS are determined based on the average customer value for the improvement, or otherwise, to supply reliability (the VCR). This is aimed at ensuring that the distributor's operational and investment strategies are consistent with customers' value for the services that are offered to them.

Our capex and opex allowances are to be set so as to reasonably reflect the expenditures required by a prudent and efficient business to achieve the capex and opex objectives. These include complying with all applicable regulatory obligations and requirements and, in the absence of such obligations, maintaining quality, reliability, and security outcomes.

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<sup>13</sup> Ergon Energy, *Proposed Application of STPIS for the 2015/16 to 2019/20 Regulatory Control Period (revised)*, 9 April 2015.

<sup>14</sup> NER, cl. 6.12.1(a).

<sup>15</sup> AER, *STPIS*, November 2009, cl. 2.1(d).

<sup>16</sup> NER, cl. 6.6.2(b)(3)(iv).

<sup>17</sup> AER, *STPIS*, November, cl.1.5(b)(5).

The STPIS on the other hand provides an incentive for distributors to invest in further reliability improvements (via additional capex or opex) where customers are willing to pay for it. Conversely, the STPIS penalises distributors where they let reliability deteriorate. Importantly, the distributor will only receive a financial reward after actual improvements are delivered to the customers.

In conjunction with CESS, the STPIS will ensure that:

- any additional investments to improve reliability are based on prudent economic decisions
- reductions in capex are achieved efficiently, rather than at the expense of service levels to customers.

## 11.4 Reasons for preliminary decision

The following section sets out our detailed consideration in applying the STPIS to Ergon Energy for the 2015–20 regulatory control period.

### 11.4.1 Revenue at risk

Ergon Energy's revenue at risk for each regulatory year of the 2015–20 regulatory control period will be capped at  $\pm 2.0$  per cent. Within this there will be a cap of  $\pm 1.8$  per cent for the reliability of supply component and  $\pm 0.2$  per cent for the customer service component.

Revenue at risk caps the potential rewards and penalties for Ergon Energy under the STPIS. We consider an incentive of two per cent of maximum allowable revenue would balance the risk to both consumers and Ergon Energy and thus better meet the objectives of the STPIS. This rate is consistent with our framework and approach paper position.

#### *Revenue at risk for 2015-16 and 2016-17*

The STPIS operates as part of the building block determination and is applied via the control mechanism. Through the S-factor component of the STPIS, distributors are penalised or rewarded for diminished or improved service performance compared to predetermined targets. Distributors are either rewarded or penalised via network charges two years after the end of each regulatory year because audited performance data would only be available after the regulatory year is completed—hence, the earliest time that the S-factor can be applied is the year following the performance data availability.

Consequently, the S-factor outcomes of 2013-14 and 2015-14 will apply to prices for the 2015-16 and 2016-17 regulatory years respectively.

As stated above, the revenue at risk caps the risk of the STPIS to Ergon Energy at two per cent. However, distributors may exceed this cap where there are increases or decreases to the amount of maximum allowable revenue that they can recover between regulatory control periods. The STPIS scheme accounts for the differences to

maximum allowable revenue recoverable between regulatory control periods by making an adjustment to the "raw"<sup>18</sup> S-factor for the last and second last regulatory years of the current regulatory control period (which is applied in the first and second regulatory years of the next regulatory control period) by adjusting the raw S-factor value based on:

the percentage change between the annual revenue requirement in the last regulatory year of the previous regulatory control period and the annual revenue requirement for first regulatory year of the next regulatory control period taken from the post-tax revenue model.<sup>19</sup>

Hence, the revenue at risk cap for the first two years of the next regulatory control period should be adjusted based on the approved revenue at risk cap of the previous regulatory control period.

## 11.4.2 Reliability of supply component

### Applicable components and parameters

We will apply unplanned SAIDI and unplanned SAIFI parameters under the reliability of supply component to Ergon Energy's urban, short rural and long rural feeders for the 2015–20 regulatory control period. Unplanned SAIDI measures the sum of the duration of each unplanned sustained customer interruption (in minutes) divided by the total number of distribution customers. Unplanned SAIFI measures the total number of unplanned sustained customer interruptions divided by the total number of distribution customers.

### Exclusions

The STPIS allows certain events to be excluded from the calculation of the S-factor revenue adjustment. These exclusions include the events that are beyond the control of Ergon Energy, such as the effects of transmission network outages and other upstream events. They also exclude the effects of extreme weather events that have the potential to significantly affect Ergon Energy's STPIS performance.

Ergon Energy proposed to calculate the major event day (MED) thresholds using 2.5 beta method in accordance with appendix D of the STPIS and our framework and approach paper. We will apply the exclusions as proposed by Ergon Energy and have incorporated our calculation of exclusions into the setting of STPIS targets for this preliminary decision. Table 11.4 sets out our calculated MED thresholds calculated in accordance with Appendix D of the STPIS.<sup>20</sup>

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<sup>18</sup> "Raw" refers to the S-factor prior to any adjustments.

<sup>19</sup> AER, *STPIS*, November 2009, Appendix C, pp. 33–34.

<sup>20</sup> AER, *STPIS*, November 2009, Appendix D.

**Table 11.4: Our calculated MED thresholds ( $T_{MED}$ ) for Ergon Energy**

Regulatory year	$T_{MED}$
2010/11	8.27
2011/12	8.39
2012/13	8.53
2013/14	8.34
2014/15	8.25

Source: AER analysis.

## Performance targets

The STPIS specifies that the performance targets should be based on the average performance over the past five regulatory years. It also states that the performance target must be modified for any reliability improvements completed or planned where the planned reliability improvements are:<sup>21</sup>

- included in the expenditure program proposed by the distributor in its regulatory proposal, or
- proposed by the distributor, and the cost of the improvements is allowed by the relevant regulator, in the distributor's previous regulatory proposal or regulatory submission.

Ergon Energy proposed to set the performance targets based on historical averages as per the scheme guidelines. We accept this approach as the capex allowance under this decision does not result in any material increases in reliability performance.

### *Adjustments for historical reliability improvement expenditure*

Ergon Energy's regulatory proposal submitted performance targets that were based on its 5-year average historical performance. These targets were adjusted to account for the expected reliability outcomes of its automatic circuit reclosers and remote control switch capex programs in the current regulatory period. It subsequently withdrew this proposal to adjust the STPIS performance targets because the STPIS guideline only requires an adjustment if the expenditure was a part of the reliability improvement capex allowance.<sup>22</sup>

Ergon Energy's performance targets in the current regulatory control period have been established based on the previously approved capex. We consider further

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<sup>21</sup> AER, *STPIS*, November 2009, cl. 3.2.1.

<sup>22</sup> Ergon Energy, *Letter to the AER\_revised STPIS Targets*, 9 April 2015.

modifications to the next regulatory control period's performance targets are not required under the STPIS because they have already been adjusted for in the current performance target. Furthermore the STPIS does not require Ergon Energy to modify the performance targets to take into account additional reliability improvement capex in the current period. As explained in section 11.3.1, the STPIS rewards Ergon Energy for reliability improvements if it chose to invest beyond its quality improvement capex allowance to increase reliability; and Ergon Energy can only receive a return after actual improvement is delivered to customers.

Our final decision on the distributors service target performance incentive scheme in June 2008, also explained the intent the scheme. It states that:

In practice this means that where a distributor's actual cost of undertaking works to improve service performance is less than the reward provided through the scheme the distributor has an incentive to carry out the works and achieve the desired performance level. In this way the scheme can act as an additional cost-recovery mechanism for service performance improvements, where these improvements are over and above those being funded through the revenue allowed in a distribution determination.<sup>23</sup>

Having said this, the expected benefits from Ergon Energy's capex improvement programs in the next regulatory control period, may result in tighter performance targets being applied in the 2020–2025 regulatory period.

In essence, the STPIS is designed so that an improving performance trend will automatically tighten performance targets to ensure continuous reliability improvements. A further adjustment occurs where distributors are funded for reliability improvement capex that would lead to a material outcome in reliability improvement.

### ***Adjustment for new expenditures***

For the next regulatory period, this preliminary decision includes \$5.5 million capex to improve the reliability of worst performing feeders. We consider the impact on reliability outcome of these activities is small as \$5.5 million represents less than 0.05 per cent of Ergon Energy's regulatory asset base. The impact of this investment is essentially not material compared to the weather impact on historical performance. The STPIS requires performance targets to be modified by reliability improvement capex planned for the next regulatory period if it results in a material improvement in network reliability. Our above assessment is consistent with Ergon Energy's advice that:<sup>24</sup>

The distribution feeders that would be assessed for improvement opportunity under this investment category, supply approximately 1.4% of the Whole of Network customer base. The level of investment forecast is limited and as such will in most cases not make a significant change to the reliability of supply outcomes for the customers. From

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<sup>23</sup> AER, *Final decision, Electricity distribution network service providers Service target performance incentive scheme*, June 2008, p. 6.

<sup>24</sup> Ergon Energy, *AER Ergon 067 – worst performing feeder performance*, March 2015, pp. 1–2.



our past experience feeders that are consistently poor performing are so because achieving a significant change is impractical or cost prohibitive. Not all feeders will present a prudent opportunity to invest and those investments that are applied will impact on a very small portion of Ergon Energy's total customer base. It is therefore our expectation that this investment category will have a negligible impact on the reliability of supply performance under the STPIS.<sup>25</sup>

## 11.5 Customer service component

The national STPIS customer service target applicable to Ergon Energy is telephone response measured as the number of telephone calls answered within 30 seconds.<sup>26</sup> This measure is referred to as the telephone Grade of Service (GOS).

We accept Ergon Energy's proposed customer service targets as it has applied a 5 year's historical average to derived them for the next regulatory control period. This is consistent with our national STPIS.<sup>27</sup>

## 11.6 Incentive rates

The incentive rates applicable to Ergon Energy for the reliability of supply performance parameters of the STPIS have been calculated in accordance with clause 3.2.2 and using the formulae provided as Appendix B of the National STPIS. Our preliminary decision on Ergon Energy's incentive rates are at Table 11.5. The incentive rates for the customer service component will be -0.04 per cent per unit of the telephone answering parameter.<sup>28</sup>

**Table 11.5: Preliminary decision on incentive rates to apply to Ergon Energy's STPIS targets**

	Urban	Short rural	Long rural
SAIDI	0.01541	0.01538	0.00332
SAIFI	1.33964	1.75543	0.50072

Source: AER Analysis.

## 11.7 Stakeholders submissions on the STPIS

This section addresses stakeholders' submissions about the application of the STPIS to Ergon Energy.

<sup>25</sup> Ergon Energy, *Response to AER information request: AER Ergon 067 – worst performing feeder performance*, March 2015, p. 1.

<sup>26</sup> AER, *STPIS*, November 2009, cl 5.1(a) and (b); see also Appendix A: Performance incentive scheme parameters—standard definitions

<sup>27</sup> AER, *STPIS*, November 2009, cl 5.31(a).

<sup>28</sup> AER, *STPIS*, November 2009, cl. 5.3.2(a).

## ***The Alliance of Electricity Consumers***

The Alliance of Electricity Consumers submitted that Ergon Energy should not be rewarded for meeting its legislative level of service. As such, the AER should revoke the STPIS payments Ergon Energy is seeking to recover in the next regulatory control period.<sup>29</sup>

The Alliance of Electricity Consumers may be referring to the deterministic "N-1" planning standard for supply security. The deterministic "N-1" planning standard is no longer enforced and has been replaced with cost/benefit trade-off "probabilistic" planning approach. Both deterministic and probabilistic planning standards mainly address capacity shortfalls rather than reliability outcomes.<sup>30</sup>

The STPIS on the other hand has a different purpose. It is an outcome focused mechanism intended to balance incentives to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to Ergon Energy to maintain and improve service performance where customers are willing to pay for these improvements.

Ergon Energy was rewarded under the STPIS in the current regulatory control period because it met its reliability targets or the intended outcome which was set above the reliability standard.

## ***Cumming Economics***

Cumming Economics submitted that the STPIS is at a high level and does not take into account ground reliability levels. That is, businesses and households that experience reliability concerns are lost in state wide averages.<sup>31</sup>

We consider that the submission relates primarily to the design of the STPIS scheme and should be considered when we review the scheme.

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<sup>29</sup> Alliance of Electricity Consumers, *Submission on Ergon Energy's Regulatory Proposal 2015–2020*, 30 January 2015, p. 29.

<sup>30</sup> Alliance of Electricity Consumers, *Submission on Ergon Energy's Regulatory Proposal 2015–2020*, 30 January 2015, p. 29.

<sup>31</sup> Cummings Economics, *Submission to Australian Energy Regulator by Cummings Economics on behalf of a Network of Electricity Users in Far North Queensland*, 30 January 2015, pp. 23–25.