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Craig Oakeshott
Director
Wholesale Markets Branch
Australian Energy Regulator

AERinquiry@aer.gov.au

Locked Bag 14051
Melbourne City Mail Centre
Victoria 8001 Australia
T: 1300 360 795
www.ausnetservices.com.au

Dear Craig,

AusNet Services Submission – Draft Service Target Performance Incentive Scheme

AusNet Services welcomes the opportunity to make this submission in response to the AER's Draft Service Target Performance Incentive Scheme (STPIS). This submission outlines AusNet Services' views on the proposed amendments to the STPIS, and sets out a number of other proposed changes to the scheme.

AusNet Services strongly supports the use of incentives to efficiently improve the reliability of TNSPs to the benefit of customers and expects the AER's draft STPIS will generally provide effective incentives to align the performance of TNSPs with the public interest during the forthcoming regulatory periods. However the attached submission provides comments and suggestions in areas where we think it can be improved to be made more effective.

AusNet Services was the first TNSP to which version 4 of the STPIS has applied in its 2014-17 regulatory period. This includes the new Network Capability Component. Under version 4, AusNet Services has successfully delivered six projects in 2014.

Under Victoria's transmission arrangements, AusNet Services does not plan the transmission network. Therefore this submission considers the draft scheme in the context of the Victorian arrangements.

AusNet Services also supports the submission made by Grid Australia.

If you have further questions regarding this submission, please contact Charlotte Coster on 9695 6309.

Yours sincerely,

Tom Hallam
Manager Regulation and Network Strategy

AusNet Services' Submission on the Draft Service Target Performance Incentive Scheme

1. Introduction and Background

This submission responds to the AER's proposed amendments to the Service Target Performance Incentive Scheme ('the scheme'). AusNet Services supports the scheme's objectives and the need for it to be refined over time if it is to continue to provide incentives to businesses to improve aspects of network performance that are most valued by consumers.

Many of the AER's proposed changes should enhance these incentives, although there is a need for some further refinement and clarification of the scheme's arrangements. These proposed refinements and clarifications are set out in the sections below.

AusNet Services has participated in the Service Component of the AER's STPIS since the scheme's inception, and has achieved significant improvements in reliability. AusNet Services requested early application of the Market Impact Component, which has applied since August 2011. Since that time, AusNet Services' dispatch interval count has decreased markedly.

AusNet Services was the first TNSP to have the Network Capability Component applied to it during its 2014-17 regulatory control period, and has taken steps to implement the priority projects set out in its Network Capability Incentive Parameter Action Plan, including the successful delivery of six projects in 2014.

AusNet Services supports Grid Australia's submission on the draft scheme.

2. Service Component

AusNet Services supports the AER's proposal to assign a non-zero weight to the forced outage sub-parameters of the average circuit outage rate parameter (hereafter referred to as the unplanned outage circuit event rate parameter in line with the AER's proposed name change).

In addition to this, AusNet Services is proposing changes to the weightings of the loss of supply event frequency and proper operation of equipment sub-parameters. These changes are discussed below.

2.1 Unplanned outage circuit event rate parameter

Now that TNSPs have had sufficient time to collect consistent data on forced outages, AusNet Services is supportive of the AER's proposal to assign a weight of 0.25% to the forced outage parameters of the unplanned outage circuit event rate parameter.

By increasing the Service Component revenue at risk to + / - 1.25% to accommodate a non-zero weight on forced outages, the proposed change avoids diluting the incentive value of the unplanned outage circuit event rate parameter. AusNet Services strongly supports the strengthening of incentives as a means of encouraging continued performance improvements.

AusNet Services also supports the AER's proposal to maintain the separation of forced and fault sub-parameters to reflect the relative impact of the two types of outages on customers.

2.2 Loss of supply event frequency

AusNet Services considers that the recent change to the Value of Customer Reliability (VCR) warrants a reduction in the weight assigned to the loss of supply event frequency parameter. AEMO's *Value of Customer Reliability Review*, which was released in September 2014, concluded that the

weighted average VCR for the National Electricity Market (NEM) has reduced significantly from \$48/kWh (\$2014)[1] to \$33/kWh (\$2007).[2]

The VCR is a key input to the framework used by AusNet Services to determine whether asset replacement is economically justified. AEMO (as the planner of the Victorian transmission network) also uses the VCR to assess whether it is economic to augment the network. The reduced VCR will result in the deferral of capital expenditure projects. This will be reflected in AusNet Services' revenue proposal for the 2017-22 regulatory period, which will be lodged by 31 October 2015.

The deferral of capital expenditure will result in lower costs to Victorian electricity consumers. However, the efficient trade-off reflected in the VCR estimate is that reliability will be expected to fall.

The reduction in reliability resulting from the decrease in the VCR is expected to be gradual at a whole of network level. However, because targets are set using a fixed five-year average of historical performance, the target setting process will not address a gradual decline in reliability, resulting in a perpetual penalty for TNSPs.

Further, AusNet Services is approaching the performance frontier for this parameter, recording zero events in three of the last five years for one of the two sub-parameters. This has resulted in extremely low targets for these sub-parameters. In the current regulatory period, the target for the number of loss of supply events exceeding 0.30 system minutes is a single event. Based on 2010-2014 performance, this target will decline to 0.4 in the forthcoming regulatory period. AusNet Services will consider in further detail how this issue will be addressed in its Regulatory Proposal.

To respond to the change in consumer preferences reflected in the revised VCR and its position relative to the performance frontier, AusNet Services proposes that the loss of supply event frequency parameter weight be reduced from 0.30% to 0.15% of MAR. This approach will offset the downside risk of declining reliability driven by changing customer preferences, while ensuring businesses remain incentivised to improve performance. Adjusting targets to reflect the revised VCR is not considered practicable because of the challenges involved in accurately forecasting its impact on reliability, particularly given the low targets applying to this parameter.

It is noted that transmission networks have a strong incentive to reduce the frequency of loss of supply events because of the adverse reputational impact that may occur as a consequence of these events. Accordingly, the revised weighting on the loss of supply event frequency parameter will not result in less effort by AusNet Services to avoid loss of supply events on its network.

2.3 Proper operation of equipment

The proper operation of equipment parameter was introduced in the current version (v4) of the STPIS on a reporting only basis (i.e. assigned a zero weighting). This parameter comprises:

- Failure of protection systems;
- Material failure of SCADA; and
- Incorrect operational isolation of primary or secondary equipment.

In its final decision for STPIS v4, the AER considered that a reporting only parameter provided sufficient incentives and that it would consider the effectiveness of the parameter in the future, including whether to have a financial incentive in future versions of the scheme.[3] AusNet Services understands that this decision was in part due to concerns regarding the availability of robust and accurate data.

[1] AEMO (2014) *Value of Customer Reliability Review, Final Report*, September 2014, p.31
[2] VENCorp (2008) *Assessment of the Value of Customer Reliability (VCR)*, August 2008, p.6
[3] AER (2012) *Final decision - Service Target Performance Incentive Scheme - electricity transmission network service providers*, December 2012, p.20

As there is the potential for these incidents to impact supply, it is appropriate for the parameter to evolve to incentivise the reduction of these events. Consistent with its position in the previous STPIS review, AusNet Services supports the application of a financial incentive to this parameter. This weighting could be set equal to 0.15% of the MAR, which would offset the reduction to the loss of supply event parameter proposed above. This would leave the proposed total incentive value of the Service Component unchanged at 1.25%. However, AusNet Services would consider a higher weighting potentially being applied to this parameter should the AER consider it appropriate.

AusNet Services has reliable historic data on the number of events that have occurred for each of the three sub-parameters proposed. Where data sufficient to set a target exists, it is appropriate to link the parameter to a financial incentive straight away. This will create a stronger incentive for improvement during the next regulatory period than maintaining a reporting only parameter.

However, we recognise that not all TNSPs have consistent and robust data to allow them to participate. Accordingly, AusNet Services considers that TNSPs could be given the option to adopt this parameter from the start of their next regulatory period.

3. Market Impact Component

AusNet Services has achieved steady improvement in its MIC performance in recent years, reporting a count of over 3,000 in 2011, and less than 1,000 in 2014, with customers receiving substantial benefits from the operation of this scheme. AusNet Services intends to continue to improve its outage management practices and is therefore supportive of the continuation of the MIC.

The AER has proposed a number of substantial changes to the design of the Market Impact Component (MIC). Principally, the AER is proposing a scheme with the following features:

- A financial incentive equal to + / - 1% of MAR, for which a performance measure:
    - Of zero delivers a 1% reward;
    - Of double the performance target delivers a 1% penalty;
- The number of dispatch interval (DI) counts from an individual event is capped at a maximum of 17% of the performance target, with the capped results used in the calculation of targets and performance measures; and
- A minimum performance target of 100 counts.

The AER has also proposed to:

- Reintroduce the exclusion of planned third party outages; and
- Introduce a statistical outlier adjustment to remove the impact of abnormal events from performance targets and measures.

While many of the changes being proposed by the AER are appropriate, there is a need for some important refinements to the draft scheme's design and clarification of some key matters. These refinements and matters are discussed below.

3.1 Proposed penalty/reward scheme

At this point in time it is premature to apply a penalty/reward scheme. A number of TNSPs are yet to have the current scheme applied to them given its introduction in late 2012, limiting the opportunity to assess its impact on TNSP behaviour and overall effectiveness across the transmission sector.

A number of factors represent material downside risk to TNSPs going forward which suggest that the continuation of an asymmetrical scheme is warranted. These include:

- **The impact of generator behaviour.** Generator behaviour, after an outage has begun, can influence a TNSP's MIC performance if this behaviour results in prices above the $10MWh threshold during the outage; and
- **Future energy policy developments.** Future energy policy developments, including policies that impact the generation mix and wholesale electricity prices, may result in market conditions that are detrimental to TNSP performance. For example, all else equal, the future application of a carbon price would be likely to increase the number of DI's exceeding the $10MWh threshold;

Given generator behaviour and energy policy are outside the control of TNSPs, fully exposing TNSP to these downside risks through a reward/penalty scheme does not align with the STPIS objectives, and would distort the incentive properties of the scheme.

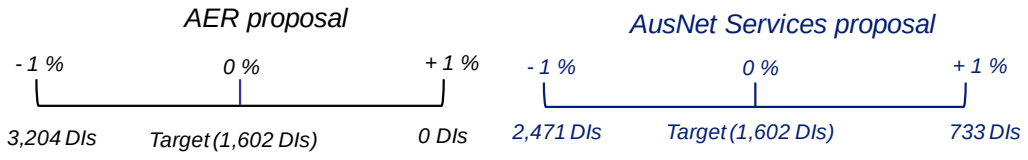
Further, under the proposed scheme, TNSPs are more likely to receive a penalty of -1% (by having a count of twice their target) than a reward of +1% (by having a count of zero). This is because achieving a count of zero is essentially impossible given the range of circumstances that can cause a single DI. By reducing the maximum reward to +1%, the AER's proposal also halves the value of each DI. This would therefore result in the scheme being asymmetric in practice.

AusNet Services recognises that the AER's proposed per event cap and statistical outlier adjustment are intended to mitigate the impact of single large events, and reduce the volatility of performance measures and targets. For these reasons, AusNet Services is supportive of these proposed changes, subject to the clarification of the statistical outlier adjustment (discussed below in section 3.2).

However, to create a more symmetrical scheme, AusNet Services proposes that caps and collars should be established using a statistical approach that takes into account the past performance of individual TNSPs. This could be achieved by setting caps and collars based on the statistical distribution that best fits each TNSP's long-term historical performance (e.g. using one standard deviation of historical performance data either side of the target). The best fit distribution and number of standard deviations would be set out in TNSP Revenue Proposals, with targets automatically updated for actual performance as part of the annual STPIS audit process.

For example, a performance target of 1,602 will apply to AusNet Services in 2015 (the average of 2012-14). Assuming one standard deviation of actual performance from 2006-14 under STPIS version 4– equal to 869 – is used to set caps and collars, the below figure compares caps/collars under the AER's and AusNet Services' proposed approaches:

Figure 1: AER and AusNet Services' proposed MIC design (illustrative example)



Note: Under AusNet Services' proposed approach, caps and collars would be determined using the best fit distribution. This may result in caps/collars that are not necessarily symmetrical, consistent with the Service Component. This analysis is based on historical performance under version 4 of the STPIS and therefore does not adjust for the impact of the cap proposed in draft version 5.

This proposed approach provides TNSPS with more symmetrical incentives than the caps and collars proposed by the AER. The approach set out here will also increase the incentive value of each DI, which is halved under the AER's proposal.

By setting caps and collars using a statistical method, AusNet Services' proposed approach would also improve consistency between the design of the Market Impact and the Service Components of the scheme. Regarding the setting of caps and collars, section 3.2(e) of the draft scheme states that:

> *"The proposed [Service Component] floors and caps must be calculated by reference to the proposed performance targets and using a sound methodology."*

While this requirement relates to the Service Component, the soundness of the methodology used to set caps and collars should be a key consideration when establishing values for these parameters. Given the shortcomings identified above with respect to the AER's proposal, AusNet Services considers its proposed scheme design is a better basis to set caps and collars.

AusNet Services would welcome the opportunity to discuss its proposed approach in greater detail with the AER.

Definitional issues

While AusNet Services recognises the merits of the per event cap of 17%, the current definition of a 'single outage event' is unlikely to capture all DIs associated with a single major event because AEMO can invoke multiple constraint sets over time in response to a single event.

Accordingly, given the stated intent of the cap is to "mitigate the risk of unforseen events, significant capex projects or major outages dramatically changing the measure and target"[4], the following, alternative definition is proposed:

> *"A network outage event includes all constraints invoked by AEMO to manage network outages initiated by a common event".*

AusNet Services would welcome the opportunity to discuss this issue in detail.

3.2 Statistical outlier adjustment

AusNet Services recognises that the AER's proposed statistical outlier adjustment is intended to mitigate the impact of single large events, and reduce the volatility of performance measures and targets. It understands that in practice it is unlikely to be applied to a non-interconnector TNSP.

However, greater clarity is required with respect to the circumstances in which the AER will remove the impact of an event (i.e. make an adjustment for a statistical outlier) in place of allowing the cap to apply. Under the electricity distribution STPIS, outliers are automatically excluded from performance measures and targets through the application of a major event day boundary, which is set based on a multiple of standard deviations from the mean of the distribution of a DNSP's historical data.[5]

Clarification on this adjustment will strengthen the incentive properties of the scheme by providing regulatory certainty to TNSPs regarding which events can be included or excluded from their performance measures and targets.

3.3 Planned third party outages

AusNet Services supports the exclusion of third party planned outages. The inclusion of these events, which are largely outside of the control of TNSPs, introduces significant volatility to the scheme and adds unnecessary complexity to contract negotiations with third parties.

[4] AER (2015) *Explanatory statement: Draft Decision, Service Target Performance Incentive Scheme version 5*, June 2015, p.16
[5] AER (2009) *Electricity distribution network service providers, Service target performance incentive scheme,* November 2009, Appendix D: Major event days

AusNet Services wishes to clarify the AER's position on the treatment of outages required by projects initiated by third parties in Victoria. As the considerations above are equally as relevant to these types of outages, these should also be excluded. However, in previous annual STPIS audits the AER has included outages that AusNet Services was obliged to take due to third parties (e.g. wind farms) connecting to the network in its MIC performance count. This is despite the exclusion of third party planned outages being included under the applicable version of the STPIS (v2). We would welcome further engagement with the AER on this matter.

4. Network capability component

AusNet Services supports the continuation of the network capability component (NCC) of the scheme, which provides an allowance for TNSPs to implement low-cost projects to increase the capability of existing network assets.

AusNet Services supports most of the changes proposed by the AER. These changes are discussed in more detail below.

4.1 Proposed ex-post review

AusNet Services does not support the AER's proposed introduction of an ex-post review of project benefits. These proposed changes would allow the AER to deem a project to have not met its priority project improvement target if, because of a material change in circumstances, the project's implementation no longer has a material benefit. This change would allow a TNSP to be penalised despite having successfully delivered a network improvement project that has achieved its initial target.

Network improvement projects are evaluated, proposed and delivered based on the best available forecasts and estimates of project benefits at the time. Penalising a TNSP if these forecasts and estimates change due to circumstances outside of its control will substantially weaken the incentive to propose and deliver network improvement projects, given the increased uncertainty over whether it will be funded for delivering these projects.

The proposed ex-poste review would equate to the AER assessing performance with hindsight, which is inconsistent with the ex-ante approach to incentive regulation under the current regulatory framework. This would also breach principles of good regulatory practice as the AER would no longer be required to 'stand in the shoes' of the TNSP making the initial decision as it could take into account information not available to the TNSP at the time of the investment decision.

This importance of providing strong incentives was recognised by the AER in its final decision for the current STPIS:

> *"Further, given the low cost of projects under the network capability component, the AER considers it is not necessary that the assessment of benefits be as rigorous or prescriptive as the RIT-T. This would also likely reduce the incentive on TNSPs to propose innovative and creative projects."*[6]

Accordingly, the proposed changes run counter to the original intent of the NCC, which was to incentive TNSPs to carry out low-cost projects offering high customer benefit through a "light-handed" incentive regime.

Further, to apply its proposed changes, the AER would assume the role of judging what information the TNSP was aware of, or ought to be aware of, at the time it proceeded with the project, having already scrutinised the assumptions and forecasts underpinning project benefits and approving a

[6] AER (2012) *Final Decision: Electricity network service providers, Service Target Performance Incentive Scheme version,* December 2012, pp.28-29

NCIPAP project. The proposed changes are tantamount to a second round of scrutiny of this information once the project has been delivered. This is unreasonably onerous, particularly given the relatively low cost of NCIPAP projects. Further, a continuous assessment of real-time project benefits would add a substantial administrative burden to the AER, AEMO and TNSPs, creating an unnecessary cost which would ultimately be funded by customers.

Importantly, the AER's proposed changes would be not be practicable in Victoria, where AEMO estimates project benefits as part of its role as the network planner. AusNet Services does not have oversight of changes in the benefits estimated by AEMO nor the requisite information to be able to routinely re-assess project benefits. In these circumstances, penalising AusNet Services for changes in benefits would be inconsistent with the objectives of the STPIS.

For the above reasons, AusNet Services does not support the introduction of an ex-post review, and considers that the proposed clause 5.3(d)(2) should be deleted from the draft scheme.

If the AER is to retain its proposed changes, provisions should be added to clause 5.3(d) that address the unique circumstances in Victoria. These amendments should outline that unless written communication is received from AEMO regarding changes in project benefits prior to the commencement of the project, AusNet Services will not be penalised for implementing a network improvement project where doing so no longer has a material benefit due to a material change in circumstances.

AusNet Services also notes that the current drafting of clause 5.3(d)(2) does not make clear that all three conditions must be met before a TNSP may be taken to not have achieved the priority improvement target.

4.2 Penalty for overspend

Clause 5.3(d) of STPIS v4 allows the AER to deem a project to not have met its priority project improvement target if this target has been achieved at a greater cost than the proposed amount. The practical application of this provision is that, should a TNSP overspend by $1 but still achieve the project's target, the AER is able to apply the full penalty provisions of the scheme.

In these circumstances, the penalty should be limited to the overspend amount. This would ensure that situations do not arise where customers receive the benefits of improvement projects but do not bear any of the costs. Further, this change would align with the ex-post review provisions of the NER which apply to general capex incurred by TNSPs. Under these provisions, the value of capex that can potentially be excluded from the RAB if found to not have been prudent and efficient is limited to the overspend amount, rather than the aggregate capex allowance determined by the AER.

Accordingly, AusNet Services considers that clause 5.3(d)(ii) of the draft scheme should be deleted, with appropriate amendments made to clause 5.3(b) to limit the penalty for project overspend to the overspend amount.

4.3 Other changes

AusNet Services considers that pro-rating the incentive allowance to proposed expenditure is an appropriate amendment. This change will ensure customers continue to receive value out of the scheme, and ensure that TSNPs are adequately incentivised to identify and carry out network improvement projects.

In addition, allowing TNSPs to propose NCIPAP projects within-period will provide greater flexibility and increased scope for projects, maximising the potential benefits of the scheme.

The change in the role for AEMO to enable it to identify priority projects will not impact AusNet Services as AEMO is currently responsible for identifying all priority projects. This is due to the unique planning arrangements that apply in Victoria. Under these arrangements, AEMO identifies and estimates the market benefits of priority projects, while AusNet Services is responsible for costing and delivering projects.

5. Minor drafting changes

AusNet Services notes the following minor drafting changes for the AER's consideration:

- Page 20 – Clause 6.5(b) should refer to clause 6.5(a) instead of 6.4(a); and
- Page 32 – The sentence "the failure of one piece of protection or control equipment where there is a backup or duplicate protection or control equipment for the relevant element" should be amended to remove references to control equipment as this is not included in the scope of this parameter.