

2013 – 2017 Gas Access Arrangements Review (GAAR)

SP AusNet's Revised Access Arrangement Proposal (RAAP)

RAAP Chapter 7: Incentive Arrangements

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RAAP Chapter 7: Incentive Arrangements

This chapter sets out SP AusNet’s response to the amendments required by the Draft Decision relating to SP AusNet’s proposed incentive mechanisms (Chapter 10 and Attachment 7 of the Draft Decision).

In the event of inconsistency between information contained in this chapter and SP AusNet’s Access Arrangement Information (AAI), the information contained in this attachment supersedes the AAI.

1. Introduction

In summary, SP AusNet:

- accepts the Draft Decision’s methodology with respect to the calculation of the efficiency carryover from the operation of the incentive mechanism during the 2008–12 Access Arrangement. However, the 2012 calculations have been updated with the latest available information.
- accepts the amendments required by the Draft Decision with respect to the opex efficiency carryover mechanism to apply during the forthcoming access arrangement period;
- does not accept the amendments required by the Draft Decision that remove the incentive mechanism from capex. SP AusNet proposes to retain the existing capex efficiency carryover mechanism.

The remainder of this chapter is structured as follows:

- Section 2 sets out SP AusNet’s revised calculation of the efficiency carryover from the 2008–12 Access Arrangement.
- Section 3 outlines the proposed efficiency carryover mechanisms to apply for 2013–17.

The information set out in this attachment accords with all of the applicable requirements of the NGR.

2. Efficiency Carryover from 2008–12 Access Arrangement

2.1 Draft Decision

The Draft Decision did not approve SP AusNet’s proposed carryover of \$23.7 million (2012) from the 2008–12 access arrangement period because the AER did not consider the carryover amount was calculated in accordance with the incentive mechanism in SP AusNet’s current access arrangement. The AER has calculated that SP AusNet accrued a total carryover of \$24.2 million (\$2012) during the 2008–12 access arrangement period.¹

¹ AER, *Access Arrangement Draft Decision SPI Networks (Gas) Pty Ltd 2013-17*, Part 1, p. 48 (pdf).

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2.2 SP AusNet Response

2.2.1 Opex efficiency incentive

SP AusNet accepts the methodologies used in the Draft Decision to calculate the opex efficiency carryover amount but does not accept the amount. SP AusNet has updated the calculation to reflect the revised base year opex (described in detail in section 2.2.3 of RAAP Chapter 3) and the output of growth estimate for total customer numbers and total delivery volumes for 2012 to be consistent with CIE model.

Table 7-1: Operating and maintenance expenditure

Description	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
O&M Benchmark \$m (1/7/06)	43.0	43.2	43.9	44.7	45.8					
O&M Benchmark \$m (2012)	51.5	51.7	52.6	53.5	54.8					
Adjustments to O&M \$m (2012)	0.1	0.3	0.4	0.6	0.7					
Adjusted O&M Benchmark \$m (2012)	51.6	52.0	53.0	54.1	55.6					
O&M Actual \$m (nominal)	37.3	45.0	37.6	41.0						
O&M Actual \$m (2012)	42.2	48.4	40.0	42.4	43.9					
O&M Underspend \$m (2012)	9.5	3.5	13.0	11.7	11.7					
O&M Incremental Gain \$m (2012)	9.5	(5.9)	9.4	(1.3)	-					
Carryover – Year 2008		9.5	9.5	9.5	9.5	9.5				
Carryover – Year 2009			(5.9)	(5.9)	(5.9)	(5.9)	(5.9)			
Carryover – Year 2010				9.4	9.4	9.4	9.4	9.4		
Carryover – Year 2011					(1.3)	(1.3)	(1.3)	(1.3)	(1.3)	
Carryover – Year 2012						-	-	-	-	-
O&M Efficiency Carryover \$m (2012)						11.65	2.19	8.10	(1.34)	-

Source: SP AusNet

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2.2.2 Capital efficiency incentive

SP AusNet accepts the methodologies used in the Draft Decision to calculate the capex efficiency carryover amount but does not accept the amount. SP AusNet has updated the calculation to take account of the most recent expenditure figures. Specifically, the capex incentive scheme has been updated to reflect more recent estimates of the number of kilometres replaced as part of the low pressure mains replacement program and the number of new connections for domestic and non-domestic customers.

Table 7-2: Capital expenditure

Description	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Capex Benchmark \$m (1/7/06)	66.0	73.3	62.7	59.8	58.4					
Capex Benchmark \$m (2012)	79.0	87.8	75.1	71.7	70.0					
Adjustments to Capex \$m (2012)	2.9	(1.5)	3.8	0.2	6.3					
Adjusted Capex Benchmark \$m (2012)	81.9	86.3	78.9	71.9	76.3					
Capex Actual \$m (nominal)	63.0	67.4	68.7	79.3						
Capex Actual \$m (2012)	71.3	72.6	73.2	82.1	76.3					
Capex Underspend \$m (2012)	10.6	13.7	5.8	(10.3)	-					
Capex Incremental Gain \$m (2012)	0.7	0.9	0.4	(0.6)	-					
Carryover – Year 2008		0.7	0.7	0.7	0.7	0.7				
Carryover – Year 2009			0.9	0.9	0.9	0.9	0.9			
Carryover – Year 2010				0.4	0.4	0.4	0.4	0.4		
Carryover – Year 2011					(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	
Carryover – Year 2012						-	-	-		
Capex Efficiency Carryover \$m (2012)						1.2	0.6	(0.3)	(0.6)	-

Note: Incremental gain = underspend * WACC of 0.062.

Source: SP AusNet

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2.2.3 Total Revenue Increment Carried Forward

SP AusNet has calculated the amounts which should be added to the revenue requirement, in accordance with the framework set in place for the Fourth Access Arrangement Period. Total numbers for capex and opex efficiency carryover has been adjusted for six months inflation to reflect end of 2012 dollars. These amounts are set out in the table below.

Table 7-3: Total efficiencies carried forward

Efficiency Carryover (Real 2012\$m)	2013	2014	2015	2016	2017
Opex efficiency carryover	11.8	2.2	8.2	-1.4	-
Capex efficiency carryover	1.3	0.6	-0.3	-0.6	-
Total efficiency carryover	13.0	2.8	7.9	-2.0	-

Source: SP AusNet

3. Proposed Efficiency Carryover Mechanisms for 2013–17

3.1 Draft Decision

The Draft Decision accepted SP AusNet’s proposal to apply an incentive mechanism to opex. However, the AER identified issues with SP AusNet’s proposed opex incentive mechanism. The AER considered that SP AusNet’s proposed opex incentive mechanism required amendment to make it consistent with r. 98 of the NGR and the revenue and pricing principles.²

The Draft Decision did not approve SP AusNet’s proposal to include an incentive mechanism applying to capex in the 2013–17 access arrangement period. The AER considered the proposed capex incentive scheme delivered an inappropriate incentive to inefficiently defer capex, which would be inconsistent with r. 98 of the NGR and the revenue and pricing principles.³

3.2 SP AusNet Response

3.2.1 Opex efficiency incentive mechanism

SP AusNet accepts the amendments required by the Draft Decision relating to operation of the opex incentive mechanism for the forthcoming access arrangement period but has not accepted the benchmarks outlined in Table 7.51 of the Draft Decision.⁴ SP AusNet has

² AER, *Access Arrangement Draft Decision SPI Networks (Gas) Pty Ltd 2013-17*, Part 2, p. 164.

³ *Ibid.*, p. 168.

⁴ *Ibid.*, p. 173.

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replaced clause 6.4 of its proposed Access Arrangement with the incentive mechanism set out in section 7.4.2 the Draft Decision⁵.

SP AusNet has inserted its alternative to Table 7.51, consistent with its proposed opex outlined in RAAP Chapter 3, in Part B of its Access Arrangements.

3.2.2 Capital efficiency incentive mechanism

SP AusNet does not accept the amendment required by the Draft Decision to remove the proposed capex incentive mechanism. SP AusNet’s detailed response to the AER’s concerns is set out below.

3.2.3 Deferral of capex

The AER’s main reason for rejecting the proposed capex incentive mechanism is that the mechanism would provide an incentive to defer capex inefficiently from one access arrangement period to the next. For example, the Draft Decision states:⁶

“The AER has previously noted that cumulative efficiency carryover schemes applied to capex can deliver incentives to defer capex to a later access arrangement period even when it is not efficient to do so. This is because the service provider receives a return on that deferred capital twice in the following access arrangement period (in addition to the return on capital provided in the preceding period) if the deferred capex is not removed from the capex forecast:

- *first in the ex ante capex allowance*
- *a second time in the return on the unspent capex provided by the capex incentive mechanism carryover.*

SP AusNet considers that the AER’s concerns are misplaced given that SP AusNet has proposed clear adjustment mechanisms to ensure that the benchmarks used in the calculation of the efficiency carryover amount reflect the actual volume of customer connections, mains replacement works and meter replacement capex undertaken. (The adjustments proposed by SP AusNet in the Initial Access Arrangement Proposal are reproduced in the box below). These adjustments, which were also applied in the 2008–12 Access Arrangement, ensure that SP AusNet is not over-rewarded if the actual volume of capital expenditure is below the benchmark allowances. Therefore, the assertion in the Draft Decision that the incentive mechanism gives rise to a double payment is in error.

⁵ Ibid, pp. 170-172.

⁶ Ibid, p. 173.

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Benchmark adjustments

For capital expenditure, benchmarks are adjusted for customer connections (domestic and non-domestic), mains replacement works (low pressure and medium pressure) and meter replacement works (domestic and non-domestic) as follows:

For the low and medium pressure mains replacement benchmarks:

- $(\text{Actual} / \text{Forecast km replaced} - \text{Benchmark km replaced}) \times \text{benchmark unit rate per km}$

For the domestic and commercial meter replacement benchmarks:

- $(\text{Actual} / \text{Forecast meters replaced} - \text{Benchmark meters replaced}) \times \text{benchmark unit rate meter replacement}$

For customer connections the benchmark will be revised as follows for commercial and domestic:

- $(\text{Actual} / \text{Forecast customer connections} - \text{Benchmark customer connections}) \times \text{benchmark unit rate per customer connection.}$

The Draft Decision also expresses a concern that instances of efficient expenditure deferral can be difficult to identify:⁷

“While many deferrals are efficient (by minimising the long term total cost of service provision), it can be difficult to determine whether a deferral is efficient or not and the AER considers the proposed capex incentive mechanism provides an incentive to defer some capex even when it is not efficient to do so.”

The available evidence does not support this conclusion since the major gas capex programs are defined in simple and clear terms. In particular, with respect to the majority of a gas networks’ capex associated with customer connections, pipe and meter replacement (over 80% of capex in the forthcoming period), it is easy to identify if deferral has taken place. This is because there are clear volume targets embedded in the forecasts and benchmarks (respectively, number of connections, km of pipe replaced or number of meters replaced). Thus, a benchmark is easily adjusted for deferred volumes.

Likewise, actual capex is easily measured in terms of completed volumes. Therefore, while other sectors such as electricity distribution may give rise to the challenges referred to in the Draft Decision, the gas distribution sector does not.

This was clearly recognised by the ESC, as highlighted by the AER:⁸

“The ESC considered this when it decided to continue to apply the capex incentive mechanism in its 2007 draft decision for the Victorian gas distribution networks. The ESC considered the nature of capex in the gas industry, and its ability to monitor volumes and unit rates better than in the electricity industry, provided it with the ability to adjust benchmarks to reflect the actual amount of capital works undertaken. With gas distribution, a large part of capex is recurrent

⁷ Ibid, p. 174.

⁸ Ibid, p. 173.

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in nature because a large proportion is ongoing projects such as replacements. The ESC considered there was scope for service providers to make efficiency gains that are achievable indefinitely into the future in such ongoing projects. This provided it with greater certainty that carryovers would not be generated due to inefficient deferral of capital expenditure.”

The Draft Decision also states that its analysis shows there was considerable deferral of non-volume related capex; that is, capex where there is no adjustment to benchmarks:⁹

“A comparison of the actual capex spend of the Victorian gas distribution service providers against forecast capex in the 2003–07 and 2008–12 access arrangement periods suggests service providers are increasingly deferring their capex programs. These deferrals are occurring in all capex categories, including significant deferral of non volume driven capex.

SP AusNet has earned positive capex carryovers in 2008, 2009 and 2010. The positive carryovers have been driven by significant underspending in the non-volume driven capex categories, in particular IT, SCADA and other capex. The forecast capex for 2012 and the 2013–17 access arrangement period in these categories is higher than the current benchmarks, suggesting that the underspending in these capex categories was due to deferral.”

This criticism is not sustainable. As the AER is aware, and accepts in the Draft Decision in relation to IT capex, that the timing of IT expenditure is largely determined by factors that are outside the direct control of the gas business. In particular, the scope and timing of shared IT platform investment has been driven largely by the AMI program in SP AusNet’s electricity distribution business. SP AusNet was not aware of this program when forecasting the IT program for the current gas access arrangement period. The materiality of this issue is also questionable as IT expenditure (the largest program identified above) made up just 10% of total capex and the level of underspending to the end of 2011 was just 4.8%. Across the entire capex program the level of underspending to the end of 2011 was just 3.6% and is expected to be an overspend by the end of 2012. In SP AusNet’s view, there is no evidence of widespread deferral occurring to the detriment of customers, noting that the benchmarks relating to the large expenditure programs are adjusted for deferral. It would, therefore, seem to be unnecessary and inappropriate for the presently strong efficiency incentives that apply to the major network capex programs to be weakened on these grounds.

3.2.4 AER’s recent Rule change proposal

The Draft Decision’s position on SP AusNet’s proposed capex incentives appears to be somewhat at odds with observations made recently by stakeholders in response to the AER’s administration of the capex efficiency regime under the National Electricity Rules. Specifically, the AER has been criticised for seeking Rule changes while not having pursued its existing powers to design and implement alternative capex efficiency schemes.¹⁰

Industry, consumers and the AEMC have highlighted the flaws in the existing capex efficiency regime in the electricity sector. The AER noted in its own Rule change proposal,

⁹ Ibid, pp. 173-4.

¹⁰ For example, ENA, *Response to Consultation Papers Proposed Energy Rules Changes: Economic Regulation of Network Service Providers Calculation of Return on Debt for Electricity Network Businesses*, p. 33 and Major Energy Users, *AER Network Regulation Rule Change Response to AEMC Consultation Paper*, p. 10.

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Economic regulation of transmission and distribution network service providers, that capex efficiency incentives in electricity may be insufficient. In particular, two areas of weakness were highlighted in the current electricity regime:

- the regulator’s inability to remove historic capex from the asset base on inefficiency grounds; and
- the low powered and distorted incentives provided by the capex efficiency scheme.

SP AusNet observes that implementing the AER’s Draft Decision would have the effect of dismantling a functioning scheme that successfully addresses both these issues. Specifically, the NGR allows the removal of historic capex from the capital base on inefficiency grounds and the scheme is designed to be higher powered than the electricity arrangements.

In this context, it is particularly noteworthy that the AEMC identified the current scheme for gas in Victoria as a possible alternative to the current electricity arrangements, stating in its Draft Determination:¹¹

“One problem with capex sharing schemes is that it may be difficult to identify whether reductions in capital expenditure are from efficiency gains or inefficient deferral. A capex sharing scheme should not encourage actions that would later lead to degradation of network quality and consequent reductions in service quality. In addition, NSPs are subject to service target performance incentive schemes and regulatory obligations which may affect their ability to respond to capex incentives in that way. The ESCV in respect of gas and Ofgem in Great Britain have both developed ways which attempt to address this problem. A lower powered incentive could also be adopted as a means of reducing the potential size of the problem. While there may be difficulties in applying these schemes, the benefits should outweigh these difficulties. There is room for further innovation in this area.”

3.2.5 Distorted incentives

By removing the proposed capex efficiency carryover mechanism, the AER introduces a distortion in the capex efficiency incentives into the scheme. In particular, it replaces a mechanism that provides continuous incentives with one that provides incentives which decline materially from the start to the end of the access arrangement period. This feature is recognised as a key flaw in the current electricity capex efficiency incentive regime.

In its Draft Determination, the AEMC stated that a continuous incentive is preferable to a declining incentive:¹²

“The Commission does not support a principle which provides that a capex sharing scheme should be continuous. A principle of this nature could discourage some schemes which are appropriate. At the same time, the Commission takes the view that in most cases a continuous incentive is preferable to a declining incentive. A constant incentive power is relevant in capex in order to provide an equal incentive to invest in each year of a regulatory period. Anything other than an equal incentive may provide

¹¹ AEMC, *DRAFT RULE DETERMINATIONS Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, p.130.

¹² AEMC, *DRAFT RULE DETERMINATIONS Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, p.131.

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incentives for NSPs to defer expenditure, even where it is not efficient to do so. The Commission agrees with the EUAA and UnitingCare Australia that a declining incentive in capex and a constant incentive in opex may encourage inefficient substitution between opex and capex.”

As the incentive to defer between periods is largely addressed by the benchmark adjustments included in SP AusNet’s capex incentive scheme design, the AER’s Draft Decision, if implemented, would introduce rather than remove the potential for distortions to arise in the incentives for efficient capex. As such, it would undermine the achievement of the National Gas Objective by failing to promote efficient investment in natural gas services.

3.2.6 Service standards

One of the reasons cited in the Draft Decision for rejecting SP AusNet’s proposed capex efficiency carryover mechanism related to service standards:¹³

“In addition, the incentive to maintain service standards must also be considered. Ideally capex incentives would be balanced with an equal incentive to maintain or improve service levels. This would encourage efficiency driven capex reductions without a fall in service standards. Because service standard obligations are only loosely defined for gas distribution businesses, and no service standard incentive mechanism is in place, the AER considers SP AusNet does not have a balanced incentive to maintain service levels.”

Service standards on a reticulated gas network are closely related to safety. Stringent safety standards apply to SP AusNet, and these are monitored closely by Energy Safe Victoria (ESV). ESV has approved SP AusNet’s gas safety case and the associated expenditure plans, and actively monitors its implementation. Any reduction in service standard performance would raise concerns about possible risks to safety, and would be subject to investigation by ESV. When SP AusNet’s actual service performance is examined there is no evidence of a decline in standards over the current access arrangement period, during which the existing capex incentive mechanism has been in operation.¹⁴

In view of this lack of evidence, SP AusNet considers that the AER’s concerns about the potential impact of the capex incentive scheme on service standards are unfounded, and do not provide a reasonable basis for the AER to reject the proposed capex incentive mechanism. Implementing the Draft Decision based on the AER’s flawed reasoning would undermine the achievement of the National Gas Objective.

3.2.7 Current performance

The current capex incentive mechanism has been in operation for two successive access arrangement periods. It has driven evident efficiencies and done so without rewarding inefficient deferral of capex. SP AusNet proposes the retention of the current arrangements

¹³ AER, *Access Arrangement Draft Decision SPI Networks (Gas) Pty Ltd 2013-17*, Part 2, p. 174.

¹⁴ SP AusNet, *2013-2017 Gas Access Arrangement Review – Access Arrangement Information*, 30 March 2012, Section 3.7 shows SP AusNet’s performance against a suite of service standard KPIs. In particular, USAIDI and USAIFI have been, and are expected to continue to be, stable.

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because they drive efficient outcomes while sharing the benefits of these outcomes between investors and those who receive pipeline services.

The current capex incentive mechanism has been an integral part of the package of measures that has delivered SP AusNet’s Victorian gas consumers stable real gas distribution prices since privatisation in 1998.

3.2.8 Conclusion

The AER’s reasoning in rejecting SP AusNet’s proposed capex incentive mechanism is, for the reasons set out above, unsound and inconsistent with the available evidence. The AER’s position in the Draft Decision seems at odds with statements it has made in the current Rule change process regarding the capex efficiency incentive regime that applies in the electricity sector. The AER’s position is also difficult to reconcile with the recommendations and guidance of the AEMC in this area, as well as the views of consumers and governments on the importance of strong capex efficiency incentives, which have been expressed in the various industry reviews being undertaken in 2012.

For these reasons, SP AusNet considers that the Draft Decision’s amendments requiring SP AusNet to remove its capex incentive mechanism are inconsistent with Rule 98 of the NGR and the Revenue and Pricing Principles of the NGL. Moreover, the Draft Decision would undermine achievement of the NGO, principally, by failing to promote efficient investment in natural gas services.

Therefore, SP AusNet proposes to retain the existing capex efficiency carryover mechanism as set out in Part B of the current access arrangement.

SP AusNet accepts the amendments required by the Draft Decision relating to the opex incentive mechanism for the forthcoming access arrangement period.

By encouraging efficiency improvements, SP AusNet’s proposed efficiency carry over mechanisms are consistent with Rule 98, the NGO, and the revenue and pricing principles in section 24(3) of the NGL.