Draft Decision

APA Victorian Transmission System

Access Arrangement 2023 to 2027

(1 January 2023 to 31 December 2027)

Attachment 8 Operating expenditure incentive mechanism

June 2022

AUSTRALIAN ENERGY REGULATOR

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Amendment record

Version	Date	Pages
1	30 June 2022	13

Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to APA's Victorian Transmission System (VTS) for the 2023–27 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Operating expenditure incentive mechanism

Attachment 9 – Reference tariff setting

Attachment 10 – Reference tariff variation mechanism

Attachment 11 – Non-tariff components

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8 Operating expenditure incentive mechanism

An operating expenditure incentive mechanism (OEIM) is intended to provide a continuous incentive for service providers to pursue efficiency improvements in operating expenditure (opex), and provide for a fair sharing of these between customers and the network business.

This attachment sets out our draft decision on the OEIM carryover amounts accrued over the 2018–22 access arrangement period (2018–22 period) for the Victorian Transmission System (VTS). It also sets out the OEIM that we will apply in the 2023–27 access arrangement period (2023–27 period).

8.1 Draft decision

Our draft decision is to approve carryover amounts totalling –$3.2 million ($2022) from the application of the OEIM in the 2018–22 access arrangement period. This is $1.7 million ($2022) higher than APA's proposal for VTS, which was –$5.0 million ($2022).[1] This difference reflects adjustments we have made to:

- reflect actual opex in 2021, which became available after APA submitted its initial proposal
- update actual and forecast inflation for the latest forecasts at the time of the draft decision
- remove the movement in provisions in actual to opex, which APA had not removed, consistent with the approach set out in the Access Arrangement
- remove category specific allowances for linepack and spares from forecast opex, consistent with the approach set out in the Access Arrangement.

We set out our draft decision on the carryover amounts APA accrued from the operation of the OEIM during the 2018–22 period in Table 8.1.

Table 8.1: AER's draft decision on OEIM carryover amounts ($million, 2022)

	2023	2024	2025	2026	2027	Total
APA's proposal	0.1	–1.5	–2.8	–	–0.7	–5.0
AER's draft decision	–2.3	–1.8	–2.0	–	2.9	–3.2
Difference	–2.4	–0.3	0.8	–	3.6	1.7

Source: APA VTS, *Access arrangement proposal 2023–27, ECM model*, 1 December 2021; AER analysis.

Note: Numbers may not add up to the total due to rounding. Amounts of '0.0' and '–0.0' represent small amounts and '–' represents no variance.

Our draft decision is to approve, subject to the amendments detailed below, the OEIM proposed by APA for the 2023–27 access arrangement period. This reflects the same OEIM that applied in the current access arrangement period, which is based on version 2 of the Efficiency Benefit Sharing Scheme (EBSS), which we use for electricity service providers.[2]

1 APA VTS, *Access arrangement proposal 2023–27, ECM model*, 1 December 2021.

2 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

We have made a minor amendment to the OEIM to revise the formula in 3.6(c) for calculating the incremental gain for 2023, to reflect that 2020 has been used as the base year to forecast opex for the 2023–27 period.

Consistent with past applications of the OEIM, we will exclude debt raising costs from the scheme, because we have forecast them on a category specific basis and expect to continue doing so in the 2028–32 access arrangement period. We will also make other adjustments as permitted by the Access Arrangement (e.g. see 3.6(g) in 2023–27 Access Arrangement), such as removing movements in provisions. For the avoidance of doubt, we have added a new clause 3.6(g)(iii) that details the exclusion of the movement in provisions from the OEIM calculations.[3] This clause is intended to provide additional clarity on the treatment of provisions. It is consistent with our past approach in other reset determinations,[4] and the 2016 Australian Competition Tribunal decision[5] that clarified this matter.

Table 8.2 sets out the opex forecast we will use to calculate efficiency gains in the 2023–27 period, subject to any further adjustments required by the OEIM.

Table 8.2: Approved forecast opex for the OEIM ($million, 2022)

	2023	2024	2025	2026	2027	Total
Forecast total opex	34.5	34.5	34.5	34.5	34.5	172.5
Less debt raising costs	0.6	0.7	0.6	0.6	0.6	3.2
Forecast opex for OEIM	**33.8**	**33.8**	**33.9**	**33.9**	**33.9**	**169.3**

Source: AER, *Draft decision, APA VTS transmission determination 2023–27, Post tax revenue model*, June 2022; AER analysis.

Note: Numbers may not add up due to rounding.

8.2 APA's proposal

8.2.1 Carryover amounts from the 2018–22 period

APA proposed carryover amounts totalling –$5.0 million ($2022) in its revenues from the application of the OEIM to the VTS in the 2018–22 period.[6] APA excluded debt raising costs in calculating its carryover amounts.[7]

8.2.2 Application in the 2023–27 period

APA proposed the same opex incentive mechanism would apply to the VTS in the 2023–27 period as applied in the current access arrangement period.[8]

3 And, as outlined below, renumbered the existing 3.6(g)(iii) to be 3.6(g)(iv).

4 AER, *Draft Decision, TransGrid transmission determination 2018 to 2023 EBSS model*, 17 September 2017.

5 Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, para 593-631

6 APA VTS, *Access arrangement proposal 2023–27, ECM model*, 1 December 2021.

7 APA VTS, *Access arrangement proposal 2023–27, ECM model*, 1 December 2021.

8 APA VTS, *APA VTS 2023–27 Access Arrangement Reset RIN Response – Public, Access Arrangement RIN response and Basis of Preparation*, 1 December 2021, p. 86.

8.2.3 Stakeholder submissions

We did not receive any submissions from stakeholders on APA's proposal in relation to the OEIM.

8.3 Assessment approach

An OEIM is a form of incentive mechanism. A full access arrangement may include one or more incentive mechanisms to encourage efficiency in the provision of services by the service provider.[9] An incentive mechanism must be consistent with the revenue and pricing principles.[10]

We consider the following revenue and pricing principle is most relevant for assessing APA's proposed efficiency carryover:

> A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides.
>
> The economic efficiency that should be promoted includes:
>
> a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and
>
> b) the efficient provision of pipeline services; and
>
> c) the efficient use of the pipeline.[11]

8.3.1 Interrelationships

The OEIM is intrinsically linked to our opex revealed cost forecasting approach.

Our opex forecasting method typically relies on using the 'revealed costs' of the service provider in a chosen base year to develop a total opex forecast if the chosen base year opex is not considered to be 'materially inefficient'. Under this approach, a service provider would have an incentive to spend more opex in the expected base year. Also, a service provider would have less incentive to reduce opex towards the end of the access arrangement period, where the benefit of any efficiency gains is retained for less time.

The application of the OEIM therefore serves two important functions:

1. It removes the incentive for a service provider to inflate opex in the expected base year in order to gain a higher opex forecast for the next access arrangement period.
2. It provides a continuous incentive for a service provider to pursue efficiency improvements across the access arrangement period.

The OEIM does this by allowing a service provider to retain efficiency gains (or losses) for a total of six years, regardless of the year in which the service provider makes them. Where we do not propose to rely on the single year revealed costs of a service provider in forecasting opex, this has consequences for the service provider's incentives and our decision on how we apply the OEIM.

9 National Gas Rules (NGR), r. 98(1).

10 NGR, r. 98(3).

11 NGL, s. 24(3).

When a business makes an incremental efficiency gain, it receives a reward through the OEIM, and consumers benefit through a lower revealed cost forecast for the subsequent access arrangement period. This is how efficiency improvements are shared between consumers and the business. If we subject costs to the OEIM that are not forecast using a revealed cost approach, a business would in theory receive a reward for efficiency gains through the OEIM (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast in the subsequent access arrangement period. Therefore, we typically exclude costs that we do not forecast using a single year revealed cost forecasting approach.

For these reasons, our decision on how we will apply the OEIM has a strong interrelationship with our decision on a business's opex (see Attachment 6). We have careful regard to the effect of our OEIM decision when making our opex decision, and our OEIM decision is made largely in consequence of (and takes careful account of) our past and current decisions on opex.

8.4 Reasons for the draft decision

8.4.1 Carryover amounts from the 2018–22 period

Our draft decision is to approve carryover amounts totalling –$3.2 million ($2022) from the application of the OEIM in the 2018–22 period. This is $1.7 million ($2022) higher than the carryover amounts APA proposed (–$5.0 million, $2022). This difference is due to us:

- updating actual opex for 2021, which resulted in an increase of $4.5 million ($2022)
- updating actual inflation for 2021 and forecast inflation for 2022, which resulted in a decrease of $0.6 million ($2022)
- removing movement of provisions from actual opex, which resulted in a decrease of $1.9 million ($2022).
- updating forecast opex by removing category specific allowances for linepack and spares, which resulted in a decrease of $0.3 million ($2022).

We discuss each of these reasons in more detail below.

8.4.1.1 Actual opex for 2021

APA's OEIM carryover proposal for the VTS included an estimate of opex in 2021 of $28.7 million ($nominal). Since APA submitted its proposal, it has reported actual opex for 2021 of $32.9 million ($nominal). We have used this amount (converted to a $2022 basis) to calculate the carryover amounts for the VTS..

This increase in actual opex in 2021, relative to the estimate APA used, has increased the total of OEIM carryovers.

This is because this higher opex occurred after the base year of 2020. This timing means that the increase in opex has no impact on the forecast opex for 2023–27, which is based on the level of opex in the base year. Importantly, in the absence of the OEIM, APA would incur 100% of this step up in opex, which is assumed to be non-recurrent. The OEIM shares this step up in opex with customers.

Specifically, every extra dollar that APA spent in 2021, results in an extra dollar of OEIM carryovers six years later. This reflects that APA incurs the full increase in opex, and

overspend relative to its allowance, in 2021 and the sharing under the OEIM with customers occurs in the sixth year when APA receives its carryover. When accounting for the time value of money, the same dollar spent will be worth less when the carryover is received six years later. The OEIM therefore ensures that APA is financially worse off, and creates a clear disincentive for APA to increase its opex.

8.4.1.2 Inflation

Consistent with our standard approach and opex forecast, we used unlagged inflation to convert opex amounts to 2022 real terms.

To do this, we used updated consumer price index (CPI) values that became available after APA submitted its proposal. For 2021, we used the actual headline December 2021 CPI figure published by the Australian Bureau of Statistics.[12] For 2022, we used the inflation forecast for the year to December 2022 in the Reserve Bank of Australia's May 2022 *Statement on monetary policy*.[13]

We will update for the most recent inflation forecasts in our final decision.

8.4.1.3 Provisions

APA did not remove movements in provisions from its actual opex its proposed calculations of the carryover amounts from the application of the OEIM in the 2018–22 period. APA has reported movements in provisions related to annual and long service leave, and defined benefit obligations. We have removed these from actual opex in our OEIM calculation. Consistent with our past approach, and as confirmed in the 2016 Australian Competition Tribunal decision,[14] movement in provisions should be excluded when calculating carryover amounts.

8.4.1.4 Category specific forecasts

The OEIM model APA submitted in its proposal for the VTS did not make adjustments for the category specific allowances received for linepack and spares. We have corrected the forecast opex by removing these category specific allowances. The requirement is specified in the following two clauses of the VTS 2018–22 access arrangement:

- 3.6(g)(i)[15], that actual expenditure be calculated on the same cost categories and methodology as the forecast expenditure, and
- 3.6(g)(iii)[16], exclude any cost category that is not forecast using a single year revealed cost approach

12 Australian Bureau of Statistics, *6401.0 Consumer Price Index, Australia*, March 2022.

13 RBA, *Statement on Monetary Policy, Forecast Table - May 2022*, 5 May 2022.

14 Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, para 598–630.

15 AER, *Victorian transmission system access arrangement, Effective 1 January 2018 to 31 December 2022*, 30 November 2017, pg. 11.

16 AER, *Victorian transmission system access arrangement, Effective 1 January 2018 to 31 December 2022*, 30 November 2017, pg. 11.

Full details of our OEIM calculations are set out in our draft decision OEIM model, which is available on our website.[17]

8.4.2 Application in the 2023–27 access arrangement period

Our draft decision is to approve the OEIM as proposed by APA for the 2023–27 access arrangement period, subject to the amendments detailed below. This reflects the same OEIM that applies in the current access arrangement period, which is based on version 2 of the EBSS which we use for electricity service providers,[18] with a small number of changes.

We consider applying the scheme will benefit the long term interests of gas consumers as it will provide continuous incentives to reduce opex. Provided we forecast APA's future opex using its revealed costs in the 2023–27 period, any efficiency gains that APA achieves will lead to lower opex forecasts, and thus lower network tariffs.

Version 2 of the EBSS, on which the OEIM is based, specifies our approach to adjusting forecast or actual opex when calculating carryover amounts.[19]

We have made minor amendments to APA's proposed OEIM in this draft decision to be consistent with version 2 of the EBSS. In particular, we have revised the formula in 3.6(c) for calculating the incremental gain for 2023 to reflect that 2020 has been used as the base year to forecast opex for the 2023–27 period. This is Revision 8.1 below.

8.4.2.1 Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2023–27 period will be the same as the length of the following access arrangement period. We expect the next APA access arrangement period will be five years, starting from 1 January 2028.

8.4.2.2 Adjustments to forecast or actual opex when calculating carryover amounts

The OEIM as proposed allows us to exclude categories of costs that we do not forecast using a single year revealed cost forecasting approach in the following access arrangement period.[20] We do this to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through the OEIM and consumers receive a benefit through lower forecast opex in the next access arrangement period. This is the way consumers and the service provider share in the benefits of an efficiency improvement.

As included in the proposed OEIM, which we are approving with a minor amendment as this will now become 3.6(g)(iv) (Revision 8.3 below), if we do not use a single year revealed cost forecasting approach, we may not pass the benefits of these revealed efficiency gains to consumers. It follows that consumers should not pay for OEIM rewards where they do not receive the benefits of a lower opex forecast.

We do not forecast debt-raising costs using a single year revealed cost forecasting approach. Instead, we provide a benchmark allowance. Accordingly, we have excluded these

17 AER, *Draft Decision, APA Victorian Transmission System Access Arrangement 2023-27, OEIM model*, June 2022

18 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

19 AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

20 AER, *Victorian transmission system access arrangement, Effective 1 January 2018 to 31 December 2022*, 30 November 2017, 3.6(g)(iii),pg. 11.

costs from the OEIM for the 2023–27 period, since any achieved efficiency gains (or losses) would not be passed on to network users.

In addition to excluding debt raising costs, consistent with the proposed OEIM, which we are approving, we will also make the following adjustments when we calculate the OEIM carryover amounts accrued during the 2023–27 period:

- adjust reported actual opex for the 2023–27 period to exclude any movements in provisions. Note that for the avoidance of doubt, we are proposing that a clause be included in the 2023–27 access arrangement to explicitly state this (Revision 8.2). This is consistent with our past approach in other reset determinations,[21] and the 2016 Australian Competition Tribunal decision[22] that clarified this matter.
- any cost that we determine to exclude from the operation of the OEIM because we are satisfied it would not promote the NGO (Revision 8.4).

8.5 Revisions

We require APA to make the following revisions to its access arrangement proposal consistent with the NGR and NGL.

Revision number	Detail
Revision 8.1	Amend clause 3.6 (c) so that it reads: The efficiency gain for 2023 is to be calculated in accordance with the following formula: $E_{2023} = (F_{2023} – A_{2023}) – (F_{2022} – A_{2022}) + (F_{2020} – A_{2020})$ where: E_{2023} is the Service Provider's efficiency gain in 2023 F_{2023} is the Service Provider's forecast operating costs for 2023 as specified in section 3.6(h) A_{2023} is the Service Provider's actual operating costs for 2023 as specified in section 3.6(g) F_{2022} is the Service Provider's forecast operating costs for 2022 as specified in section 3.6(h) A_{2022} is the Service Provider's actual operating costs for 2022 as specified in section 3.6(g) F_{2020} is the Service Provider's forecast operating costs for 2020 as specified in section 3.6(h) A_{2020} is the Service Provider's actual operating costs for 2020 as specified in section 3.6(g).
Revision 8.2	Insert clause 3.6(g)(iii) that reads: adjust reported actual opex for the 2023–27 period to exclude any movements in provisions.
Revision 8.3	Rename clause 3.6(g)(iii) to clause 3.6(g)(iv)
Revision 8.4	Insert clause 3.6(k) that reads:

21 AER, *Draft Decision, TransGrid transmission determination 2018 to 2023, EBSS model*, 17 September 2017.

22 Australian Competition Tribunal, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1*, 26 February 2016, paragraph 598 and 630.

<table>
<tr><th>Revision number</th><th>Detail</th></tr>
<tr><td></td><td>We will exclude any cost that we determine to exclude from the operation of the operating expenditure incentive mechanism because we are satisfied it would not promote the NGO.</td></tr>
<tr><td>Revision 8.5</td><td>Amend table on page 10 of Access Arrangement 2023–27 so that it contains the following:

Approved forecast operating expenditure for the incentive mechanism ($ million, 2022)
<table>
<tr><th></th><th>2020</th><th>2022</th><th>2023</th><th>2024</th><th>2025</th><th>2026</th><th>2027</th></tr>
<tr><td>Forecast total opex</td><td>29.9</td><td>31.2</td><td>34.5</td><td>34.5</td><td>34.5</td><td>34.5</td><td>34.5</td></tr>
<tr><td>Less debt raising costs</td><td>0.1</td><td>0.1</td><td>0.6</td><td>0.7</td><td>0.6</td><td>0.6</td><td>0.6</td></tr>
<tr><td>Less category specific forecast</td><td>0.3</td><td>0.3</td><td>–</td><td>–</td><td>–</td><td>–</td><td>–</td></tr>
<tr><td>Forecast opex for the OEIM</td><td>29.5</td><td>30.9</td><td>33.8</td><td>33.8</td><td>33.9</td><td>33.9</td><td>33.9</td></tr>
</table>
Note: may not add due to rounding</td></tr>
</table>

A Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
APA / APA VTS	APA VTS Australia (Operations) Pty Ltd and APA VTS Australia (NSW) Pty Ltd
CPI	Consumer Price Index
NGL	National Gas Law
EBSS	Efficiency benefit sharing scheme
NGO	National Gas Objective
NGR	National Gas Rules
OEIM	Operating expenditure incentive mechanism
Opex	Operating Expenditure
VTS	Victorian Transmission System