DRAFT DECISION
Australian Gas Networks (SA)
Access Arrangement

2021 to 2026

Attachment 8
Efficiency carryover mechanism

November 2020

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Australian Gas Networks (SA) ('AGN') for the 2021–2026 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 – Efficiency carryover mechanism

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Attachment 11 – Non-tariff components

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8 Efficiency carryover mechanism

An efficiency carryover mechanism (ECM) 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 service providers and network users.

This attachment sets out our draft decision on the ECM carryover amounts AGN accrued over the 2016–21 access arrangement period, and the ECM we will apply in the 2021–26 period.

8.1 Draft decision

8.1.1 ECM carryover amounts

Our draft decision is to approve carryover amounts totalling $8.2 million ($2020–21) from the application of the ECM in the 2016–21 access arrangement period. This is $4.2 million ($2020–21) lower than AGN's proposed $12.4 million ($2020–21) submitted in its proposal.[1]

Our calculated carryover amounts differ from AGN's carryover amounts because we have used different inflation figures to convert amounts into 2020–21 dollars.

We set out our draft decision on the carryover amounts AGN accrued from the operation of the ECM during the 2016–21 access arrangement period in Table 8.1.

Table 8.1 AER's draft decision on AGN's carryover amounts ($million, 2020–21)

	2021–22	2022–23	2023–24	2024–25	2025–26	Total
AGN's proposed carryover	6.5	1.8	5.8	–1.6	–	**12.4**
AER's draft decision	6.1	–0.4	4.7	–2.2	–	**8.2**
Difference	**–0.5**	**–2.1**	**–1.1**	**–0.6**	**–**	**–4.2**

Source: AGN , *Final Plan: Five year plan for our South Australian network, 2021–2026 – supporting document – Attachment 11 – Workbook – Efficiency Carryover Mechanism – Consolidated*, 20 July 2020; AER analysis.

Note: Numbers may not add up due to rounding.

Our draft decision takes into account AGN's 2019–20 opex which are an estimate comprised of three quarters of actuals and an estimate for the June quarter. In our final decision, we will update to reflect the full year of actuals for 2019–20 and also update our inflation forecast for 2020–21.

[1] AGN), *Final Plan: Five year plan for our South Australian network, 2021–2026 – Supporting document - Attachment 11 – Workbook – Efficiency Carryover Mechanism - Consolidated*, 20 July 2020;

8.1.2 Application of the ECM for the 2021–26 period

Our draft decision is to approve the application of an ECM for AGN in the 2021–26 access arrangement period, subject to minor amendments that we discuss in section 8.4.2 below. Our revisions to AGN's proposed ECM are set out in section 8.5.

In applying the ECM to AGN in the access arrangement period commencing on 1 July 2026, consistent with AGN's proposal, we will exclude:

- Unaccounted for gas (UAFG) costs
- Debt raising costs
- Movement in provisions
- Cost categories that are not forecast using a single year revealed cost approach in the access arrangement period commencing on 1 July 2026
- Any cost that we determine, as part of a decision on revisions to apply to this Access Arrangement, to exclude from the operation of the efficiency carryover mechanism because we are satisfied it would not promote the National Gas Objective.

Table 8.2 sets outtable 8.2 the forecast opex we will use to calculate efficiency gains and losses for the 2021–26 period.

Table 8.2 AER's draft decision on AGN's forecast opex for the ECM for the 2021–26 access arrangement period ($million, 2020–21)

	2021–22	2022–23	2023–24	2024–25	2025–26
Total forecast opex	66.3	66.4	66.6	66.9	67.6
Less UAFG costs	7.8	7.8	7.8	7.8	7.8
Less debt raising costs	0.9	0.9	0.9	0.9	0.9
Forecast opex for the ECM	**57.7**	**57.7**	**57.9**	**58.3**	**58.9**

Source: AER, *AGN draft decision – Post tax revenue model*, November 2020; AER analysis.

Note: Numbers may not add up due to rounding.

8.2 AGN's proposal

AGN's 2021–26 regulatory proposal calculated carryover amounts totalling $12.4 million ($2020–21) from the application of the ECM in the 2016–21 access arrangement period.

8.2.1 Application in the 2021–26 period

AGN stated that the only incentive scheme to date that has applied to the South Australian network is the opex efficiency benefit sharing scheme. It proposes that this scheme be continued into the next access arrangement period.[2]

8.2.2 Stakeholder submissions

We received submissions from ten stakeholders on AGN's 2021–26 access arrangement proposal. The following key points were made in relation to the ECM:

- CCP24 supported the continuation of ECM over the 2021–26 access arrangement period. [3]
- ECA noted the AER proposed modifications to the standard EBSS in the JGN 2020 Plan and asked if these were being incorporated into AGN's plan. [4]

8.3 Assessment approach

An ECM is a form of incentive mechanism. A full access arrangement may include (and we may require it to include) one or more incentive mechanisms to encourage efficiency in the provision of services by the service provider.[5] An incentive mechanism must be consistent with the revenue and pricing principles.[6]

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

> 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
>
> (b) the efficient provision of pipeline services
>
> (c) the efficient use of the pipeline.[7]

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2 AGN, *Final Plan:* Five year plan for our South Australian network, 2021–2026, July 2020, p. 118.

3 CCP24, *CCP24 Advice to Australian Energy Regulator on Australian Gas Networks Final Plan*, 10 August 2020, p. 33.

4 ECA, *Evoenergy and Australian Gas Networks (SA) Gas access arrangement proposals 2021-26 Submission,* August 2020, p. 24.

5 NGR, r. 98(1).

6 NGR, r. 98(3).

7 NGL, s. 24(3).

8.3.1 Interrelationships

The ECM 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 ECM 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 ECM 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 ECM.

When a business makes an incremental efficiency gain, it receives a reward through the ECM, 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 ECM that are not forecast using a revealed cost approach, a business would in theory receive a reward for efficiency gains through the ECM (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 costs forecasting approach.

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

8.4 Reasons for draft decision

8.4.1 Carryover amounts from the 2016–21 period

Our draft decision is to approve carryover amounts totalling $8.2 million ($2020–21) from the application of the ECM in the 2016–21 access arrangement period. This

difference is $4.2 million ($2020–21) lower than the carryover amounts in AGN's submitted proposal of $12.4 million ($2020–21).

We note that 2019–20 opex figures used in the calculation of the ECM for the draft decision are an estimate comprised of three quarters of actuals and an estimate for the June quarter. In our final decision, we will update our calculation of the carryover amounts using actual opex in that year. Under the framework, AGN is required to provide these to us on 30 November 2020.

The difference between our calculation of the carryovers and AGNs is due to using different inflation figures to convert amounts into 2020–21 dollars. We have used different inflation figures for 2019–20 and 2020–21. For 2019–20 we used the actual CPI figures published by the Australian Bureau of Statistics (ABS), which were released after AGN submitted its proposal.[8] For 2020–21 we used the latest inflation forecast published by the Reserve Bank of Australia (RBA) available at the time of our assessment.[9] This was also published after AGN submitted its proposal. In our final decision we will update our inflation forecast for 2019–20 to reflect the latest available forecast from the Reserve Bank of Australia.

8.4.2 Application in the 2021–26 period

Our draft decision is to approve the application of an ECM to AGN in the 2021–26 access arrangement period.

We have made minor amendments to AGN's proposed ECM in this draft decision to be consistent with version 2 of the EBSS for electricity service providers and other gas distribution business' equivalent incentive mechanisms.[10] Specifically, we have removed the reference to a non-recurrent efficiency gain in 2014–15 in the formula for calculating the incremental efficiency gain for 2021–22. This appears to be a reference to non-recurrent efficiency gain removed from the base opex used to forecast opex for the 2021–26 period. However, we note 2019–20 was used as the base year not 2014–15. Nonetheless, no such adjustment was made to base opex and thus the variable is not required. This also addresses ECA's concerns that AGN's ECM should be updated to remain consistent with our proposed modifications in the recent JGN 2020 decision.

Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2021–26 access arrangement period will be the same as the length of AGN's following access arrangement period. We expect AGN's next access arrangement period will be five years, starting from 1 July 2026.

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8 ABS, *Catalogue number 6401.0, Consumer price index* (ref 'A2325846C'), June 2020.

9 RBA, *Statement on monetary policy*, *Appendix: Forecasts*, August 2020.

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

Adjustments to forecast or actual opex when calculating carryover amounts

In applying the ECM to AGN in the 2021–26 access arrangement period, consistent with AGN's proposal, we will exclude:

- UAFG costs and debt raising costs
- Cost categories that are not forecast using a single year revealed cost approach in the access arrangement period commencing on 1 July 2026.

For avoidance of doubt, consistent with our standard approach, we will also adjust:

- Forecast opex to add (subtract) any approved revenue increments (decrements) made after our 2021–26 final decision, such as approved pass through amounts
- Actual opex to reverse any movements in provisions
- Forecast and actual opex for inflation
- Any cost that we determine, as part of a decision on revisions to apply to this Access Arrangement, to exclude from the operation of the efficiency carryover mechanism because we are satisfied it would not promote the National Gas Objective.

8.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Revision	Amendment
Revision 8.1	Amend clause 5.1(a) so that it reads: The incremental efficiency gain (loss) for financial year 2021–22 will be calculated using: $E_{2021–22} = (F_{2021–22} – A_{2021–22}) – (F_{2020–21} – A_{2020–21}) + (F_{2019–20} – A_{2019–20})$ where $E_{2021–22}$ is the incremental efficiency gain (loss) for financial year 2021–22. $F_{2021–22}$ is the forecast operating expenditure for financial year 2021–22. $A_{2021–22}$ is the actual operating expenditure for financial year 2021–22. $F_{2020–21}$ is the forecast operating expenditure for financial year 2020–21. $A_{2020–21}$ is the actual operating expenditure for financial year 2020–21. $F_{2019–20}$ is the forecast operating expenditure for financial year 2019–20. $A_{2019–20}$ is the actual operating expenditure for financial year 2019–20

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
EBSS	Efficiency Benefit Sharing Scheme
ECA	Energy Consumers Australia
ECM	Efficiency Carryover Mechanism
NGL	National Gas Law
NGR	National Gas Rules