



DRAFT DECISION
Australian Gas Networks
Access Arrangement
2016 to 2021

Attachment 14 – Other
incentive schemes

November 2015

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Note

This attachment forms part of the AER's draft decision on Australian Gas Networks' access arrangement for 2016–21. 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 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

Attachment 9 - Efficiency carryover mechanism

Attachment 10 - Reference tariff setting

Attachment 11 - Reference tariff variation mechanism

Attachment 12 - Non-tariff components

Attachment 13 - Demand

Attachment 14 - Other incentive schemes

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Shortened forms

| Shortened form | Extended form |
|-----------------------|---|
| AA | Access Arrangement |
| AAI | Access Arrangement Information |
| AER | Australian Energy Regulator |
| ATO | Australian Tax Office |
| capex | capital expenditure |
| CAPM | capital asset pricing model |
| CCP | Consumer Challenge Panel |
| CESS | Capital Expenditure Sharing Scheme |
| CPI | consumer price index |
| CSIS | Customer Service Incentive Scheme |
| DRP | debt risk premium |
| EBSS | Efficiency Benefit Sharing Scheme |
| ERP | equity risk premium |
| Expenditure Guideline | Expenditure Forecast Assessment Guideline |
| gamma | Value of Imputation Credits |
| GSL | Guaranteed Service Level |
| MRP | market risk premium |
| NECF | National Energy Customer Framework |
| NERL | National Energy Retail Law |
| NERR | National Energy Retail Rules |
| NGL | national gas law |
| NGO | national gas objective |
| NGR | national gas rules |
| NIS | Network Incentive Scheme |
| NPV | net present value |
| opex | operating expenditure |
| PFP | partial factor productivity |
| PPI | partial performance indicators |
| PTRM | post-tax revenue model |
| RBA | Reserve Bank of Australia |

| Shortened form | Extended form |
|----------------|---|
| RFM | roll forward model |
| RIN | regulatory information notice |
| RoLR | retailer of last resort |
| RPP | revenue and pricing principles |
| SLCAPM | Sharpe-Lintner capital asset pricing model |
| STPIS | Service Target Performance Incentive Scheme |
| TAB | Tax asset base |
| UAFG | Unaccounted for gas |
| WACC | weighted average cost of capital |
| WPI | Wage Price Index |

14 Other incentive schemes

We aim to incentivise service providers such as AGN to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality. There are a number of incentives that already exist in the framework that applies to AGN's access arrangement. For example, the NGR allow AGN to retain the full value of its approved capex forecast, including any amount it saves through more efficient delivery of its capex program, until the end of the access arrangement period. In addition, we review the capex it actually spends at the end of the period so that only conforming capex is rolled into its capital base. AGN has also described gas as a 'fuel of choice'—as an alternative energy source, it must compete with electricity—creating further incentives to remain cost efficient, and competitive in price and the quality of service.

In addition to these inherent incentives, the NGR also allow the inclusion of one or more targeted incentive schemes in an access arrangement, to supplement the incentives under the regulatory regime and encourage efficiency in the provision of services.

14.1 Draft decision

AGN proposed three new incentive schemes apply for the 2016–21 access arrangement period: a Capital Expenditure Sharing Scheme, a Customer Service Incentive Scheme, and a Network Innovation Scheme. In this attachment we set out our reasoning and draft decision on these proposed schemes.

AGN also proposed alterations to its existing Efficiency Benefit Sharing Scheme (EBSS), to increase the sharing of benefits between AGN and its customers from the current 30:70 ratio to 50:50. Our reasoning and draft decision on AGN's proposed EBSS is set out in Attachment 9 – Efficiency Carryover Mechanism.

We applied a CESS for the first time in the electricity distribution and transmission determinations we made in April 2015 (for New South Wales and ACT distribution networks and New South Wales and Tasmanian transmission networks). However, to date we have not considered development or application of a CESS for gas service providers under the NGR. AGN's proposed CSIS and NIS are new schemes that we have not applied before in electricity or gas decisions.

Where we have developed and introduced new incentive schemes under the NER—including the CESS—we have done this in conjunction with consideration of related forecasting methodologies and complementary schemes, and as part of extended consultation with stakeholders, including other service providers. It is unusual for us to consider introduction of a new incentive scheme in the context of an individual access arrangement or service provider.

In this context we note that there are conflicting views on the benefits of these schemes in gas, which require further exploration through an appropriate consultation process. For example, while AGN has proposed a CESS, other gas service providers

who submitted their proposals at the same time as AGN have said that they do not support introduction of a CESS in their own access arrangements.¹ While supportive of a CESS in principle, the CCP does not support the CESS that AGN has proposed. Other stakeholders have also questioned the need for new incentive schemes in AGN's access arrangement, and the design of the schemes that AGN has proposed. These are discussed further below in sections 14.3, 14.4 and 14.5.

Our draft decision does not accept the introduction of these new schemes in AGN's access arrangement at this time. We consider it preferable that the development and implementation of any new incentive schemes under the NGR be subject to a consultative, informed and industry-wide process such as that undertaken as part of our 2013 Better regulation program.

14.2 AER's assessment approach

A full access arrangement may include (or we may require it to include) one or more incentive mechanisms to encourage efficiency in the provision of services by the service provider.² Incentive mechanisms may provide for carrying over increments for efficiency gains, or decrements for efficiency losses, from one access arrangement period into the next.³ An incentive mechanism must be consistent with the revenue and pricing principles.⁴

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

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.⁵

Under the NGR we have full discretion in our decision as to whether to approve the introduction of an incentive scheme.⁶

¹ ActewAGL, *Access arrangement information for the 2016–21 access arrangement, Attachment 10*, June 2015, p. 13; APTNT, *Amadeus gas pipeline, Access arrangement revision proposal, Submission*, August 2015, p. 169.

² NGR, r. 98(1).

³ NGR, r. 98(2).

⁴ NGR, r. 98(3).

⁵ NGL, s. 24(3).

⁶ NGR, r. 40(3).

14.2.1 Interrelationships

The incentive schemes AGN proposed relate to various areas of the business covered by the Access Arrangement.⁷ For example, introduction of an incentive scheme for capex would affect the size of the capital base and may alter the balance of investment signals between capital expenditure (capex) and operating expenditure (opex). Similarly, introduction of a service level incentive scheme may alter AGN's approach to capex and opex investment. We aim to incentivise service providers such as AGN to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service quality. We discuss these interrelationships where relevant as part of our reasons below and in other attachments to our draft decision.

14.3 Capital expenditure sharing scheme

14.3.1 AGN's proposal

AGN proposed to introduce a CESS for the 2016–21 access arrangement period.⁸

A CESS is part of the regulatory framework we administer for electricity network service providers (NSPs).⁹ A CESS is not currently a feature of the regulatory framework we administer for gas, though the NGR provides that such a scheme may be implemented via an approved access arrangement.

In the electricity context, the CESS provides financial rewards for NSPs whose capex becomes more efficient and financial penalties for those that become less efficient.¹⁰ Consumers benefit from improved efficiency through lower regulated prices. To date, the CESS has only been approved for electricity NSPs.

The CESS proposed by AGN would work as follows:

- We would calculate AGN's cumulative capex underspend or overspend for the current access arrangement period in net present value terms.
- We would apply a sharing ratio of 50 per cent (in the current electricity CESS this ratio is 30 per cent) to the cumulative underspend or overspend to work out what AGN's share of the underspend or overspend should be.
- We would calculate the CESS payments taking into account the financing benefit of the underspends or overspends.¹¹ We could also make further adjustments to

⁷ Related schemes are the efficiency benefit sharing scheme (EBSS) for opex, the demand management innovation allowance (DMIA), and the service target performance incentive scheme (STPIS) for service levels.

⁸ AGN, Access Arrangement Information for AGN's South Australian Gas Distribution Network, July 2015, p201.

⁹ NER, cl. 6.4A(b).

¹⁰ AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, pp. 5–9. (AER, Capex incentive *guideline*, November 2013).

¹¹ We calculate benefits as the benefits to the service provider of financing the underspend since the amount of the underspend can be put to some other income generating use during the period. Losses are similarly calculated as the financing cost to the service provider of the overspend.

account for deferral of capex and ex post exclusions of capex from the capital base.

- The CESS payments would be added or subtracted to AGN's forecast revenue requirement as a separate building block in the upcoming access arrangement period.

Under the electricity CESS, a NSP retains 30 per cent of an underspend or overspend, while consumers retain 70 per cent of the underspend or overspend. This means that for a one dollar saving in capex the NSP keeps 30 cents of the benefit while consumers keep 70 cents of the benefit. However, AGN has proposed a CESS with a 50 per cent benefit sharing ratio. That is, for a one dollar capex saving AGN would keep 50 cents and consumers keep 50 cents.

AGN proposed to limit scope to inefficiently or imprudently defer capex by permitting only a 10 per cent variation from the target volume of capex work. AGN referred to this as a ten per cent 'dead band'. That is, if AGN were to deliver 15 per cent less (more) capex volumes than our allowance provided for, AGN's CESS benefit would incorporate no more than 10 per cent less (more) volume. AGN proposed this approach would limit its revenue instability and therefore limit price instability for customers. However, AGN would retain an incentive to outperform volumes by allowing it to retain any outperformance up to a maximum of 10 per cent (and vice versa if above benchmark volumes are incurred).

AGN further proposed there would be no such constraint on its per unit costs. That is, AGN would retain the full amount of any cost efficiencies it is able to achieve in delivering its capex program.

14.3.2 Reasons for draft decision

We have assessed the proposal by AGN for the introduction of a CESS. A number of factors have influenced our draft decision to not approve the introduction of a CESS.

AGN provided the following reasons to introduce a CESS:

- to strengthen the incentive to incur prudent and efficient capex
- to strengthen the financial incentives that apply to, and efficient trade-off between both opex and capex
- to ensure the incentive for AGN to make efficient gains is the same irrespective of the year in which an investment is made.

In this section we address each of AGN's reasons, listed above, in turn. We consider that it would be preferable not to introduce a CESS at this time. We consider that without the CESS there would still be consistency with the revenue and pricing principles. In particular, we consider not introducing a CESS better promotes economic efficiency in the provision of AGN's reference services.

Strengthening the incentive to incur prudent and efficient capex

We consider AGN already has sufficient incentives to incur prudent and efficient capex. In the short term, AGN may retain capex underspends until the start of the next access arrangement period. In the longer term, to the extent gas is a fuel of choice,¹² it is in AGN's interests to supply gas efficiently in order to compete with electricity as an energy source. Further, the NGR require us to complete an ex post assessment of whether capex undertaken in an access arrangement is conforming at the time of the next review.

The South Australian Council of Social Services (SACOSS) suggested AGN has incentives to reduce its capex, including:¹³

- the ability to earn a return on forecast capex and depreciation as the forecast capex is assumed to be added to the RAB
- having the use of the allowed capex for the 2016–21 access arrangement period
- managing the risk of the RAB, and resulting revenue requirement, growing to the point where it risks asset stranding.

Related to this point, SACOSS submitted that difficulties forecasting efficient capex for the upcoming access arrangement period made introduction of a CESS unadvisable. This is because applying a CESS may give AGN a windfall gain if allowed capex is in excess of a reasonable amount.¹⁴

Similarly, Origin Energy submitted that a CESS should be carefully calibrated with the rest of the regulatory framework to avoid creating perverse incentives.¹⁵ AGL submitted that we should review the efficiency sharing schemes proposed by AGN and assess whether they are sufficiently transparent, enforceable and equitable to avoid consumers paying for a poorly designed framework.¹⁶

We also note that, currently, there do not appear to be concerns around AGN overspending capex relative to its approved forecasts. Rather, the opposite is the case. Our application of the CESS to electricity businesses was as a result of capex overspends over time by electricity NSPs.¹⁷ AGN is in a different situation.

¹² AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, pp. 1, 39, 70, 82, 88, 202, 212, 260.

¹³ SACOSS, *Submission on AGN's regulatory proposal for the 2016–2021 Access Arrangement (AA) period*, 8 August 2015, p. 8.

¹⁴ SACOSS, *Submission on AGN's regulatory proposal for the 2016–2021 Access Arrangement (AA) period*, 8 August 2015, p. 7.

¹⁵ Origin, *Australian Gas Networks 2016–21 Access Arrangement Proposal for its South Australia Gas Distribution Network*, 10 August 2015, p. 6.

¹⁶ AGL, *Australian Gas Networks (South Australia): Access Arrangement Proposal 2016–21*, 10 August 2015, p. 3.

¹⁷ AER, *Expenditure incentives guidelines for electricity network service providers – Issues paper*, March 2013, p. 18.

AGN underspent its capex allowance in the current access arrangement period in almost all capex categories.¹⁸ AGN's actual capex is around \$68.3 million (\$2014–15) or 12 per cent below the capex allowance we set in the last access arrangement review. AGN's capex performance in the current period is a continuation of a longer term trend. In the 2006–11 period AGN (then Envestra) underspent its capex allowance by around \$35.9 million (\$2009–10) or 15.4 per cent.¹⁹

AGN's history of underspending capex relative to approved forecasts suggests it already has an incentive to act efficiently and is doing so. We therefore question whether additional incentives under a CESS are required. Moreover, customers may question why we would approve a capex incentive providing AGN with a financial bonus for continuing, as it has in previous access arrangement periods, to underspend its capex allowances.

We also consider it preferable for capex incentive schemes to be introduced alongside quantifiable service reliability measures, which has not been proposed by AGN. Such measures monitor the service provider's delivery of services in a safe and reliable manner. This mitigates risk that, by achieving capex underspends, a service provider may also undermine its network reliability levels or network safety (this is discussed further below).

Strengthening the financial incentives that apply to, and efficient trade-off between, opex and capex

While we recognise an incentive scheme currently exists for AGN's opex (the Efficiency Benefits Sharing Scheme (EBSS)) but not for capex, the EBSS is linked to our opex assessment approach. The 'base step trend' approach for opex depends on the revealed cost in year four of an access arrangement period (the base year). The EBSS operates so the business reveals its actual costs. This differs from a capex assessment which does not exclusively rely on a revealed cost approach.

We further consider that any potential advantages from equivalent opex and capex incentive schemes must be balanced against other considerations.

In the electricity sector, the CESS is balanced by a complementary scheme providing incentives for NSPs to maintain or improve network reliability levels— the Service Target Performance Incentive Scheme (STPIS). Under the STPIS, electricity NSPs are rewarded (penalised) for achieving (not achieving) pre-determined network reliability standards. In some jurisdictions, state based guaranteed service levels (GSL) are applicable instead of the GSL component of the STPIS, but the effect is the same.

There is no scheme equivalent to the STPIS for gas NSPs currently. AGN has not proposed such a service reliability scheme for the 2016–21 access arrangement

¹⁸ AER - Draft decision Australian Gas Networks access arrangement - Attachment 6 - Capital expenditure - November 2015, p xx.

¹⁹ Envestra, *South Australia Access Arrangement Information*, September 2010, p. 37.

period. AGN's proposed Customer Service Incentive Scheme (CSIS), discussed in 14.4 below, would be premised on measures relating to customer interactions such as complaint responses and telephone call answering times.

The Essential Services Commission of South Australia (ESCOSA) is just beginning to measure and record AGN's network reliability performance. We consider the absence of an existing framework for service level (reliability) performance and a corresponding lack of time series data is a significant barrier to introducing a CESS for AGN at this time.

The Consumer Challenge Panel (CCP) supported a CESS aligned with the EBSS to balance incentives for efficient investment across capex and opex.²⁰ While we recognise the theoretical benefit of dual opex and capex schemes, AGN's history of capex underspending and lack of a countervailing service standards scheme mean we do not agree with the CCP on this issue. We further note the CCP and Government of South Australia did not support AGN's proposed move to a 50–50 sharing of benefits between consumers and AGN.²¹

Incentive for efficient capex throughout the regulatory period

AGN submitted that a CESS would provide a consistent incentive for efficient capex investment across the full five years of the access arrangement period.

As we note above, AGN already faces incentives to undertake efficient capex because it retains any capex underspend until the end of the access arrangement period. However, the relative strength of the incentive varies throughout the access arrangement period. The incentive for a NSP to achieve capex efficiencies, by 'beating the allowance', is strongest in year one of an access arrangement period when the benefit can be retained for the remaining four years. By year five, the incentive reduces to approximately zero.²² In absolute terms, the strength of the current incentive depends on factors such as the rate of return and asset life.²³

In contrast, under a CESS AGN would accrue a benefit (penalty) relative to forecast capex for each year. That is, were AGN to underspend (overspend) its capex allowance for a given year, it would accrue a benefit (penalty). The potential benefit (penalty) AGN may accrue would be the same regardless of which year it related to.

While we note the potential benefit described above from introduction of a CESS, it is not apparent that AGN requires a CESS to provide it a further incentive to incur efficient capex for the reasons outlined above. To the extent AGN considers it currently

²⁰ CCP sub-panel 8, *Advice to AER from CCP8 regarding AGN's (SA) Access Arrangement 2016–21 Proposal*, 25 August 2015, p. 15.

²¹ CCP sub-panel 8, *Advice to AER from CCP8 regarding AGN's (SA) Access Arrangement 2016–21 Proposal*, 25 August 2015, p. 15; A/Minister for Mineral Resources and Energy, *Submission on Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 6.

²² Regulatory control periods are usually five years in length.

²³ AER, *Issues paper - Expenditure incentives guidelines for electricity network service providers*, March 2013, p. 9.

has a problem scheduling its capex investment, it is within AGN's control to reschedule its capex to invest efficiently over the period. Moreover, any potential benefits from providing continuity in capex incentives must be balanced against the other potential effects of introducing a capex incentive scheme.

We consider these trade-offs are best considered as part of an industry-wide consultation process rather than through the review of an individual access arrangement. While AGN has proposed a CESS, other gas NSPs do not support introduction of a capex efficiency incentive scheme.²⁴ Before introducing such a scheme, a sector-wide process of policy development and consultation would ideally be undertaken.

The process for consultation on introduction of a CESS

For the electricity CESS, there was an extensive consultation period in the lead up to its introduction. This included consultation on the AEMC's rule change to facilitate an electricity CESS. We also consulted on the CESS as part of our better regulation program, and had considerable stakeholder engagement. We consider that development of a CESS for gas business should ideally occur through a similar consultative, informed and industry-wide process.

Importantly, the electricity CESS was developed in conjunction with our consultation on and development of the Expenditure Forecast Assessment Guideline. This process recognised that any incentive scheme design process must be compatible with the relevant forecasting approaches in order to promote outcomes consistent with the long terms interest of end-users. Implementing a CESS for gas NSPs has wide ranging implications requiring input from a wider group of stakeholders than we have in this access arrangement review.

14.4 Customer service incentive scheme

AGN proposed a Customer Service Incentive Scheme (CSIS) for the 2016–21 access arrangement period, to be implemented in 2017 following a consultation process.

14.4.1 AGN's Proposal

In its access arrangement proposal, AGN stated:

The purpose of the CSIS is to adjust tariffs (positively or negatively) by reference to target service levels, such that customers impacted by service below a set target are compensated and AGN is incentivised to provide improved service performance over time.

²⁴ ActewAGL, *Access arrangement information for the 2016–21 access arrangement, Attachment 10*, June 2015, p. 13; APTNT, *Amadeus gas pipeline, Access arrangement revision proposal, Submission*, August 2015, p. 169.

The details of the CSIS will be proposed by AGN following further stakeholder consultation, with a view to the CSIS commencing operation on 1 July 2017.²⁵

It suggested, as an example, an incentive of plus or minus one per cent of revenue.

Some of the areas proposed by AGN as possibly being included in the scheme are:

- telephone responsiveness – leaks and emergency line
- telephone responsiveness – general enquiry line
- number of complaints.²⁶

AGN cited stakeholder feedback as a supporting factor for the introduction of such a scheme, indicating that stakeholders are:

... supportive of the principle of having a formal scheme in place to compensate those customers impacted by service that is below an agreed standard and/or to incentivise the business to provide improved performance over time."²⁷

At the time of submitting its proposal AGN did not consider itself in a position to introduce a scheme for the entirety of the access arrangement period. Its proposal did not include a developed scheme. Rather, AGN asked us to approve the introduction of a CSIS, but to allow AGN to continue its own consultation to ensure any incentives best reflect customer values and provide a meaningful incentive to improve performance. AGN's proposal was that AGN would then develop and introduce a CSIS after the access arrangement period had commenced, on 1 July 2017.

AGN also indicated it intends to implement a program for ongoing measurement of customer satisfaction with the service it provides. AGN has indicated that this program will be implemented regardless of whether we approve a CSIS for the 2016–21 access arrangement period.

²⁵ AGN, *Access Arrangement for AGN's South Australian Gas Distribution Network*, July 2015, p. 18.

²⁶ AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, p. 201.

²⁷ AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, p. 201.

14.4.2 Reasons for draft decision

We accept that an incentive scheme designed to improve customer service for a regulated business, if it operated efficiently, could provide benefits to consumers. Such schemes are sometimes established by regulators where customer service is a problem. However, we question whether the potential benefits of such a scheme would justify the cost of its introduction to AGN's customers, given high levels of customer satisfaction with its current performance. Providing reasonable customer service is a core function of service providers such as AGN, which should not require further incentives to do so.

We note AGN is currently performing relatively well in terms of its customer service levels. AGN indicated that 90 per cent of emergency phone calls have been answered within 10 seconds. Also, that 95 per cent of leaks are attended within two hours.²⁸ ESCOSA, in its report of June 2015 regarding service standards, stated that AGN's own stakeholder engagement program has found that customers were generally satisfied with the current reliability of AGN's gas distribution service.²⁹ AGN further indicated that at current reliability levels the average customer would experience only one hour of outage every 40 years.³⁰

Business SA submitted it has no issue with the level of customer service AGN is currently providing. Business SA also submitted:

...there is no requirement for an additional incentive scheme specifically targeted at improving customer service to reward AGN for improving what is already a fundamental business imperative.³¹

SACOSS referred ESCOSA's report on service standards for AGN.³² In assessing the need for a Guaranteed Service Level (GSL) scheme, which would provide incentives for AGN to maintain a guaranteed level of service to its customers, ESCOSA said:

In the absence of a clear need to incentivise AGN to improve particular aspects of its service valued by customers where current performance is not meeting customer expectations, and data identifying customers experiencing poor service, the Commission will not introduce a GSL Scheme for AGN for the 2016–2021 regulatory period.³³

²⁸ AGN presentation to AER staff on 6 August 2015.

²⁹ Essential Services Commission of South Australia, *Australian Gas Networks Jurisdictional Service Standards for the 2016–2021 Regulatory Period – Final Decision*, June 2015, p 28.

³⁰ AGN presentation to AER staff on 6 August 2015.

³¹ Business SA, *Submission to AER on proposed Australian Gas Networks Access Arrangement (2016–21)*, 10 August 2015, p. 9.

³² SACOSS, *Submission on AGN's regulatory proposal for the 2016–2021 Access Arrangement (AA) period*, 8 August 2015, p. 9.

³³ Essential Services Commission of South Australia, *Australian Gas Networks Jurisdictional Service Standards for the 2016–2021 Regulatory Period – Final Decision*, June 2015, p. 3.

The CCP and the Government of South Australia also directed us to the ESCOSA report in their submissions.³⁴ The Government of South Australia noted that ESCOSA had specifically considered and consulted on a service standard and performance target for telephone service (one of AGN's suggested parameters) but concluded against their introduction.³⁵ The CCP submitted that, based on the ESCOSA report, it did not support the introduction of a CSIS.³⁶

It is difficult to assess the extent to which AGN's proposed CSIS would address these concerns when the scheme itself has yet to be developed. We do not consider it appropriate to approve the introduction of a CSIS 'in principle' before a scheme has been developed. On the information available to us we are not satisfied that the case for introduction of a CSIS has been made.

Our draft decision is therefore not to accept AGN's proposal for the introduction of a CSIS in the 2016–21 access arrangement period. This does not prevent AGN from proposing a fully developed CSIS proposal for a future access arrangement period.

It is open to AGN to bring forward the next access arrangement review submission date.³⁷ We note, however, that if AGN did seek to bring forward the next access arrangement review submission date, the access arrangement as a whole would be open to review, not only the incentive schemes component.

14.5 Network innovation scheme

AGN proposed the introduction of a Network Innovation Scheme (NIS) for the 2016–21 access arrangement period.

14.5.1 AGN's proposal

AGN proposed a NIS for recovery of costs for small scale research projects aimed at innovation. AGN proposed that the NIS include the following features:³⁸

- the ability to recover up to \$1 million per year of expenditure incurred
- a mechanism to seek prior approval for expenditure on innovation forecast to exceed \$1 million
- innovation expenditure AGN seeks to recover would be subject to independent review

³⁴ CCP8, *Advice to AER from Consumer Challenge Panel sub-panel 8 regarding Australian Gas Networks' (SA) Access Arrangement 2016–2021 Proposal*, 25 August 2015, p 15; A/Minister for Mineral Resources and Energy, *Submission on Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 6.

³⁵ A/Minister for Mineral Resources and Energy, *Submission on Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 6.

³⁶ CCP8, *Advice to AER from Consumer Challenge Panel sub-panel 8 regarding Australian Gas Networks' (SA) Access Arrangement 2016–2021 Proposal*, 25 August 2015, p. 15.

³⁷ NGR, r. 65(1).

³⁸ AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, p. 204.

- any approved expenditure to be excluded from the operation of the EBSS and the proposed CESS
- the AER would approve the recovery of innovation funding through the annual Reference Tariff Variation Mechanism.

AGN also proposed that, to qualify for funding under a NIS, it would be required to demonstrate the project must have potential to directly impact AGN's operations and:

- involve a piece of new equipment
- a novel arrangement or application of existing network infrastructure
- a novel operational practice directly related to the operation or safety of the network
- or an improvement in customer service, or a novel commercial arrangement.

It must also:

- have potential to develop learning that may be applied by other gas pipeline distributors
- have potential to deliver net financial benefits and/or improvements in customer service.

Finally, AGN proposed that any intellectual property developed via the proposed NIS must be made available to third parties.³⁹

In support of a NIS, AGN contended that gas is a “fuel of choice”. Further, that a lack of innovation may lead to a decrease in connections and ongoing customer support. AGN argued this would increase the risk of underutilised assets and also a “negative spiral” where declining volumes lead to higher prices which lead to declining volumes and so on.⁴⁰

AGN submitted two reports from Economic Insights on the productivity performance of AGN's South Australian network compared to its interstate peers. These reports indicate that, after a period of productivity growth in the gas distribution sector from 1999 to 2008, the sector has seen a period of flat productivity growth since 2008. The reports also indicate AGN's productivity performance is consistent with productivity growth across the sector over this time.⁴¹ AGN has relied heavily on precedent in the United Kingdom, where Ofgem has implemented an innovation scheme.⁴² The scheme administered by Ofgem includes an allowance for recovery of costs for small scale projects, an annual competition for funding larger projects and a mechanism to pass—

³⁹ AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, Pp. 204–205.

⁴⁰ AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, p. 202.

⁴¹ Economic Insights, Attachment 4.1, *The Productivity Performance of Australian Gas Networks' South Australian Gas Distribution System*, p. ii.

⁴² AGN, *Access Arrangement Information for AGN's South Australian Gas Distribution Network*, July 2015, p. 203.

through costs for the rollout of initiatives with demonstrable and cost effective benefits.⁴³

14.5.2 Reasons for draft decision

A scheme such as proposed by AGN may enable development of a new technology, process, or some other efficiency improvement that would otherwise not be considered and therefore developed. However, we consider AGN has sufficient incentives and opportunity to invest in innovative efficiency enhancements under its current regulatory framework.

Our revenue determinations provide total allowances for specific purposes, such as capex and opex investment. Service providers must then spend those allowances as they consider most appropriate. As discussed in 14.1.3 above, AGN has a history of underspending its capex allowances. In the current period AGN has also underspent its opex allowance, by around \$32 million (\$2014–15) or 9 per cent. This suggests AGN has had financial resources to invest in innovations in the last two access arrangement determinations. We further consider AGN has not made a case that modest productivity growth in the gas distribution sector can be successfully addressed through increasing revenue to NSPs.

While positives arising from an increase in revenue to a NSP through a NIS *may* be possible over the long term, consumers will certainly pay more in the short term. This may contribute to the “negative spiral” that AGN described in its proposal.⁴⁴ In this case, such a scheme as proposed by AGN runs the risk of being counterproductive.

The Alternative Technology Association (ATA) submitted that gas is economically uncompetitive as a “fuel of choice” because of higher gas prices and more efficient electrical appliances.⁴⁵ The ATA submitted on AGN’s argument about a “negative spiral” by stating:

ATA believes that declining demand for gas because of a more efficient competitor is better characterised as a business risk and “innovation incentives” are inappropriate.⁴⁶

More generally, the ATA submitted that any incentive payment to AGN would be inappropriate if AGN did not meet its demand forecasts.⁴⁷

The Government of South Australia saw benefit in the proposed NIS, but noted the importance of well-defined criteria and clear boundaries. It also suggested the scheme

⁴³ AGN, *Access Arrangement Information for AGN’s South Australian Gas Distribution Network*, July 2015, p 203.

⁴⁴ AGN, *Access Arrangement Information for AGN’s South Australian Gas Distribution Network*, July 2015, p 202.

⁴⁵ Alternative Technology Association, *Submission on Australian Gas Networks (SA) Access Arrangement Proposal*, 10 August 2015, p. 9.

⁴⁶ Alternative Technology Association, *Submission on Australian Gas Networks (SA) Access Arrangement Proposal*, 10 August 2015, p. 9.

⁴⁷ Alternative Technology Association, *Submission on Australian Gas Networks (SA) Access Arrangement Proposal*, 10 August 2015, p. 9.

be subject to a strict cap to provide certainty regarding the price path over the period.⁴⁸ In its submission, SACOSS was generally supportive of the scheme, but suggested an overall annual cap of \$2 million per year would be appropriate.⁴⁹

The CCP submitted that:

We consider that it is important for businesses to invest in innovation that is in the long term interest of consumers.⁵⁰

However, the CCP submitted that it supported the scheme if used for investment that would not have been made by AGN if the scheme was not in place.⁵¹ While we agree with the CCP that NSPs should undertake innovation investment in the long term interests of consumers, we consider the test proposed by the CCP is unable to be measured. Were we to approve AGN's proposed NIS, we would not be able to assess whether prospective or resulting innovations would have been developed without the NIS in place.

In light of the above considerations, we do not approve introduction of AGN's proposed NIS in the 2016–21 access arrangement period.

14.6 Revisions

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

Revision 14.1: Remove the CESS, CSIS and NIS from the proposed access arrangement.

⁴⁸ A/Minister for Mineral Resources and Energy, *Submission on Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 6.

⁴⁹ SACOSS, *Submission on AGN's regulatory proposal for the 2016–2021 Access Arrangement (AA) period*, 8 August 2015, p. 9.

⁵⁰ CCP8, *Advice to AER from Consumer Challenge Panel sub-panel 8 regarding Australian Gas Networks' (SA) Access Arrangement 2016–2021 Proposal*, 25 August 2015, p. 15.

⁵¹ CCP8, *Advice to AER from Consumer Challenge Panel sub-panel 8 regarding Australian Gas Networks' (SA) Access Arrangement 2016–2021 Proposal*, 25 August 2015, p. 15.