FINAL DECISION
Australian Gas Networks (SA) Access Arrangement

2021 to 2026

Attachment 8
Efficiency carryover mechanism

April 2021

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the access arrangement that will apply to Australian Gas Networks (SA) ('AGN') for the 2021–26 access arrangement period. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

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

Attachment 11 – Non-tariff components

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Attachment 13 – Capital expenditure sharing scheme

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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 final 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 Final decision

8.1.1 ECM carryover amounts

Our final decision is to approve ECM carryover amounts totalling $6.6 million ($2020–21) from the application of the ECM in the 2016–21 access arrangement period. This is $1.3 million ($2020–21) higher than the $5.3 million ($2020–21) AGN submitted in its revised proposal.[1]

Our calculated carryover amounts differ from AGN's carryover amounts because:

- we updated for actual inflation and forecast inflation for the year to June 2021 using the latest Reserve Bank of Australia's (RBA) February 2021 *Statement on Monetary Policy*[2]
- we corrected the unaccounted for gas (UAFG) allowance to reflect the amounts we approved for the 2016–21 access arrangement.[3]

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

1 AGN, *Revised Final Plan 2021–26, Attachment 11.2 - Response to Draft Decision on Incentives,* 13 January 2021, p. 3.

2 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2021.

3 AER, *Final decision, Australian Gas Networks access arrangement, Attachment 7 - Operating expenditure,* May 2016, pp. 24–27.

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

	2021–22	2022–23	2023–24	2024–25	2025–26	Total
AGN's proposed carryover	4.4	0.1	4.0	–3.2	–	**5.3**
AER's final decision	4.6	0.8	4.4	–3.2	–	**6.6**
Difference	**0.2**	**0.7**	**0.4**	**0.0**	–	**1.3**

Source: AGN, *Revised Final Plan 2021–26, Attachment 11.3 - Revised ECM Model,* 13 January 2021; AER analysis.

Note: Numbers may not add up due to rounding. Differences of '0.0' and '–0.0' represent small variances and '–' represents no variance.

8.1.2 Application of the ECM for the 2021–26 period

Our final decision is to approve the application of an ECM for AGN in the 2021–26 access arrangement period. Consistent with AGN's proposal, we will exclude:

- 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 out the forecast opex we will use to calculate efficiency gains and losses for the 2021–26 period.

Table 8.2 Forecast opex for the ECM ($million, 2020–21)

	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26
Total forecast opex	80.7	80.9	70.0	70.6	71.1	71.6	72.3
Less UAFG costs	–13.2	–12.6	–8.1	–8.1	–8.1	–8.1	–8.1
Less debt raising costs	–0.9	–0.9	–0.9	–0.9	–0.9	–0.9	–0.9
Forecast opex for the ECM	**66.6**	**67.4**	**61.1**	**61.6**	**62.1**	**62.7**	**63.3**

Source: AER, *Final decision, AGN access arrangement, Post tax revenue model*, April 2021; AER, *Final decision, AGN access arrangement - ECM model*, April 2021; AER analysis.

Note: Numbers may not add up due to rounding.

8.2 AGN's revised proposal

8.2.1 ECM carryover amounts

AGN accepted our draft decision on the efficiency carryovers accrued from the application of the ECM in the 2016–21 access arrangement period. It updated its carryover calculation to include audited actuals for 2019–20 opex and aligned earlier year actuals with its recently submitted Annual RIN.[4]

8.2.2 Application in the 2021–26 period

AGN accepted our draft decision relating to the application of the ECM in the 2021–26 access arrangement period.[5]

8.2.3 Stakeholder submissions

We received submissions from eleven stakeholders on AGN's 2021–26 revised access arrangement proposal. There were no comments made relating to the ECM.

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.[6] An incentive mechanism must be consistent with the revenue and pricing principles.[7]

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4 AGN, *Revised Final Plan 2021–26, Attachment 11.2 - Response to Draft Decision on Incentives,* 13 January 2021, p. 3.

5 AGN, *Revised Final Plan 2021–26, Attachment 11.2 - Response to Draft Decision on Incentives,* 13 January 2021, p. 3.

6 NGR, r. 98(1).

7 NGR, r. 98(3).

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; and
>
> (c) the efficient use of the pipeline.[8]

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

[8] NGL, s. 24(3).

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 final decision

8.4.1 Carryover amounts from the 2016–21 period

Our final decision is to approve carryover amounts totalling $6.6 million (2020–21).

AGN accepted our draft decision and proposed a revised carryover amount of $5.3 million (2020–21). It updated its carryover calculation to include audited actuals for 2019–20 opex and aligned earlier year actuals with its recently submitted Annual RIN.[9]

Our assessment of AGN's carryover amount calculations found that AGN had not removed the unaccounted for gas (UAFG) costs that we had approved for the 2016–21 access arrangement period. AGN stated that it had applied a scaling factor to forecast UAFG costs. We consider that the UAFG costs removed from total opex should be the amount included in total opex. AGN agreed we should subtract the UAFG benchmarks reported in the 2016–21 final decision from total opex.[10]

The only other change we made to AGN's carryover amount calculations was to update actual inflation and forecast inflation using the RBA's February 2021 *Statement on Monetary Policy*.[11]

Applying these changes, we have calculated a total ECM carryover amount of $6.6 million (2020–21).

We consider that the ECM carryover amounts we have calculated, as set out in Table 8.1, provide for a fair sharing of efficiency gains and losses between AGN and its network users. It both rewards AGN for the efficiency gains it has made and penalises it for its efficiency losses. Further, we consider that the benefit to networks users, through lower forecast opex, is sufficient to warrant the ECM carryover amounts we have determined.

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9 AGN, *Attachment 11.2, Response to draft decisions on incentives,* 13 January 2021, p. 3.

10 AGN, *Information Request 029 – ECM Calculations,* February 2021.

11 Reserve Bank of Australia, *Statement on monetary policy*, February 2021.

8.4.2 Application in the 2021–26 period

Our final decision is to approve the application of an ECM to AGN in the 2021–26 access arrangement period. This is consistent with our draft decision[12] and AGN's revised proposal.[13]

We consider applying the scheme will benefit long-term gas customers because it will provide continuous incentives for AGN to reduce opex. Provided that we forecast AGN's future opex using its revealed costs in the 2021–26 period, any efficiency gains that AGN achieves will lead to lower opex forecasts, and thus lower network tariffs.

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 access arrangement period commencing in July 2026. We expect this will be five years.

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 revised proposal[14] and our draft decision,[15] 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, and 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.

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12 AER, Draft Decision, *AGN(SA) access arrangement 2021–26, Attachment 8 - Efficiency Carryover Mechanism*, November 2020, p. 4.

13 AGN, *Attachment 11.2, Response to draft decisions on incentives,* 13 January 2021, p. 3.

14 AGN, *Attachment 11.2, Response to draft decisions on incentives,* 13 January 2021, p. 3.

15 AER, *Draft Decision, AGN(SA) access arrangement 2021–26 Attachment 8 Efficiency Carryover Mechanism,* November 2020, p. 5.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
AGN	Australian Gas Networks South Australia
ECM	Efficiency Carryover Mechanism
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
opex	operating expenditure
UAFG	unaccounted for gas