



**FINAL DECISION**  
**Jemena Gas Networks (NSW)**  
**Ltd**  
**Access Arrangement**

**2020 to 2025**

**Attachment 13**  
**Capital expenditure sharing**  
**scheme**

June 2020

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## Note

This attachment forms part of the AER's final decision on the access arrangement that will apply to Jemena Gas Networks (NSW) Ltd ('JGN') for the 2020–25 access arrangement period. It should be read with all other parts of our final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The final decision attachments have been numbered consistently with the equivalent attachments to our draft decision. In these circumstances, our draft decision reasons form part of this final decision.

Our final decision includes the following attachments:

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 7 – Corporate income tax

Attachment 11 – Non-tariff components

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

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## Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
CPF	Contingency payment factor
EBSS	Efficiency benefit sharing scheme
JGN	Jemena Gas Networks (NSW) Ltd
NGL	National Gas Law
NGR	National Gas Rules
NSW	New South Wales
Opex	Operating expenditure
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
WACC	Weighted average cost of capital

## 13 Capital expenditure sharing scheme

### 13.1 Final decision

Our final decision approves the application of a capital expenditure sharing scheme (CESS) in the 2020–25 access arrangement period. However, we require amendments to be made to JGN’s proposal that:

- remove clause 13.2 of the access arrangement, which provides that the CESS is a fixed principle for the 2020-25 access arrangement period and for the next two access arrangement periods
- remove the table from clause 13.1(l)(iv) of the access arrangement
- remove a clause requiring material events outside JGN’s control to be adjusted when measuring actual performance
- change drafting to ensure the correct operation of the CESS.

JGN’s proposed CESS is based on the CESS approved for the Victorian distribution businesses (2018–22), with some important adjustments. The most significant of these is that JGN’s CESS will not apply to connections capital expenditure (capex). As the CESS is new for JGN, it will not impact revenues in the upcoming access arrangement period, but rather, future access arrangement periods. Consequently, our final decision relates to the design of the scheme.

A full list of required amendments is provided in Table 13.3 at the end of this Attachment.

### 13.2 JGN’s revised proposal

We approved the introduction of a CESS in our draft decision, but required revisions to make it consistent with the CESS framework applied in the recent Victorian gas access arrangements. Table 13.1 sets out these revisions and JGN’s response. We discuss these in detail in Section 13.4, along with further revisions sought in this final decision.

**Table 13.1 AER’s draft decision and JGN’s revised proposal response**

Revision	AER’s draft decision	JGN’s revised proposal response
13.1	Remove clause 13.2 from the access arrangement, JGN’s NSW gas distribution network, 1 July 2020 – 30 June 2025	Retained the fixed principle, but varied the clause.
13.2	Revise capex forecasts in clause 13.1(h)(iv). JGN has included a table setting out the revised capex that a CESS would apply to.	Revisions have been made in line with JGN’s revised proposal.
13.3	Add clause 13.(i)(v)	After consulting with JGN, we agree that this clause already exists.
13.4	Schedule 9: JGN to propose revised targets at (g) by removing outliers and reviewing targets against internal targets.	Accepted the removal of outliers; but did not consider internal targets appropriate.
13.5	Review clause 13.1(g) and provide further rationale for the proposed contingent payment factor range, and why that range should not be 90-100.	Retained the 80-100 range for the contingent payment factor.
13.6	Revise CESS mathematical formulas in clause 13 to ensure they operate as intended and the drafting is consistent with the illustrative CESS model.	Made changes to the formulae for greater consistency with the mechanics of the CESS model.

Source: AER, *Draft decision: JGN access arrangement 2020 to 2025*, November 2019; JGN, *Revised 2020-25 access arrangement proposal, Attachment 11.1: Response to the AER’s draft decision – Capital Expenditure Sharing Scheme*, January 2020.

### 13.3 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.<sup>1</sup> Incentive mechanisms may provide for carrying over increments for efficiency gains, or decrements for efficiency losses, from one access arrangement period into the next.<sup>2</sup> An incentive mechanism must be consistent with the revenue and pricing principles.<sup>3</sup>

<sup>1</sup> NGR, r. 98(1).

<sup>2</sup> NGR, r. 98(2).

<sup>3</sup> NGR, r. 98(3).

We consider the following revenue and pricing principle is most relevant for assessing JGN'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.<sup>4</sup>

### 13.3.1 Interrelationships

The incentive scheme JGN proposes relates to various areas of the business covered by the 2020–25 access arrangement.<sup>5</sup> For example, the introduction of a CESS will affect the size of the capital base and may alter the balance of investment signals between operating expenditure (opex) and capex. We aim to incentivise service providers, such as JGN, to make efficient decisions on when and what type of expenditure to incur, and to balance expenditure efficiencies with service standards.

## 13.4 Reasons for final decision

### 13.4.1 Removal of fixed principle

JGN proposed to apply a fixed principle that applied to the CESS. A fixed principle extends an access arrangement clause into future access arrangement periods (up to two periods). If the AER accepts a fixed principle, it is bound to accept that clause in the future periods.<sup>6</sup>

In our draft decision, we required JGN to remove a clause from the access arrangement that made the CESS a fixed principle. In its revised proposal, JGN reworded the relevant clause to make it clearer that the fixed principle applies to incorporating the benefits or penalties from CESS in the 2020–25 access arrangement period into the next access arrangement period.

We do not consider there is a need to include the CESS as a fixed principle to facilitate the inclusion of increments or decrements in revenues in subsequent access arrangement periods. The National Gas Rules (NGR) already allow for the inclusions

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<sup>4</sup> NGL, s. 24(3).

<sup>5</sup> The efficiency carryover mechanism for opex is a related scheme.

<sup>6</sup> NGR, r. 99, a fixed principle can be revoked by consent with a service provider, or, if a fixed principle is inconsistent with a rule, the rule operates to the exclusion of the fixed principle.



of increments or decrements from the application of incentive schemes in previous access arrangement period.

Further, our decision to apply the CESS is consistent with our decision for gas networks in our 2017 Victorian distribution decisions. In the Victorian decisions, we noted that we will continue to consult on the operation, monitor the outcomes and address any issues that may arise at the time of the next access arrangement review. For this reason, we did not approve application of a fixed principle for 10 years in relation to the CESS. For the reasons outlined above, and as a matter of consistency with the Victorian access arrangements, we do not accept JGN's proposed fixed principle.<sup>7</sup>

### 13.4.2 Capex forecasts subject to CESS

JGN's access arrangement includes a table that sets out the capex the CESS will apply to. Our view is that the table at clause 13.1(l)(iv) is not needed and should be removed from the access arrangement. We raised this with JGN and it agreed to remove the table.

### 13.4.3 Contingent payment factor range

The CESS proposed by JGN contains a mechanism to vary CESS payments based on how JGN performs against certain service targets. This is known as the contingent payment factor. The contingent payment factor is in place to balance the incentive for JGN to make efficiency savings on capex and maintain its quality of service.

The contingent payment factor allows CESS payments to be made to JGN on a sliding scale. JGN has proposed the range for the contingent payment mechanism be set from 80 to 100 per cent. Under this arrangement, if JGN achieves 100 per cent of its performance targets, it will receive a full payment. The payment will then reduce if JGN does not achieve 100 per cent on a sliding scale, and JGN will not receive a CESS payment if its performance is less than 80 per cent.

In our draft decision, we asked JGN to provide a rationale for the proposed range for the contingent payment factor of 80–100, including why it should not be 90–100.

JGN stated that, because the AER accepted 80–100 for Victoria, a precedent has been made, and for consistency we need to accept this range. Further, JGN “do not see any compelling reason to use a different range to Victorian businesses”.<sup>8</sup>

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<sup>7</sup> AGN, *Access Arrangement for our Victorian and Albury natural gas distribution networks 1 January 2018 to 31 December 2022*, December 2016, p. 15.

[https://www.aer.gov.au/system/files/AER%20-%20Draft%20decision%20-%20AGN%20Victoria%20and%20Albury%20gas%20access%20arrangement%202018-22%20-%20Attachment%2014%20-%20Other%20incentive%20schemes\\_0.DOCX](https://www.aer.gov.au/system/files/AER%20-%20Draft%20decision%20-%20AGN%20Victoria%20and%20Albury%20gas%20access%20arrangement%202018-22%20-%20Attachment%2014%20-%20Other%20incentive%20schemes_0.DOCX)

<sup>8</sup> JGN, *Revised 2020-25 access arrangement proposal, Attachment 11.1: Response to the AER's draft decision – Capital Expenditure Sharing Scheme*, January 2020, p. 4.

While JGN does not operate in the same environment as the Victorian distribution businesses, our analysis of JGN's CESS proposal reveals that the performance measures and calculations used are broadly similar. On this basis, we have accepted a contingent payment factor range of 80–100 for the 2020–25 period.

### 13.4.4 Revised performance targets for the contingent payment factor

JGN's contingent payment factor includes a series of targets that JGN's performance is judged against.

In our draft decision, we proposed that JGN review the performance targets used in the contingent payment factors. JGN reviewed the historical targets, and adjusted the targets by removing outliers. We have considered the arguments put forward by JGN and at this time have accepted the historical targets, but propose to review these at the next access arrangement review.

**Table 13.2 Comparison and final position on targets**

Measure	2020–25 access arrangement proposal	Outlier-adjusted target	Internal target	AER position
Unplanned SAIFI	3.33	3.33	N/A	3.33
Unplanned SAIDI	40.95	13.07	11.3	13.07
Mains and services leaks	0.16	0.16	N/A	0.16
Meter leaks	8.15	8.15	N/A	8.15
Poor quality supply	0.92	0.92	1.40	0.92
Estimated meter reads	5.93%	5.93%	5.00%	5.93%

Source: JGN, *Revised 2020-25 access arrangement proposal, Attachment 11.1*, January 2020.

### 13.4.5 Removal of and replacement of uncontrollable events provision

JGN added a clause to its revised proposal regarding the treatment of events outside of its control. The clause allows JGN to adjust its performance measures to account for events outside of its control. That is, these events, once excluded, would not reduce JGN's performance against its targets, and would not cause it to receive a lower CESS payment through the contingent payment mechanism.

We do not accept this for the following reasons:

- when the CESS was first designed, we carried out a public consultation process and specifically ruled out exclusions of this kind<sup>9</sup> – JGN has not presented any new evidence to cause us to reconsider this position
- the contingent payment mechanism provides a range within which CESS can be obtained, and is designed to account for unforeseen factors.<sup>10</sup>

On this basis, we do not accept JGN's proposed revision to the access arrangement (Schedule 9(j)). JGN can seek an adjustment for unforeseen events in the next access arrangement review. The AER would consider the merits of this at the time of that review. We have included a revision to the access arrangement to reflect this.

In addition, at the next access arrangement review, we will do an ex-post review to inform our assessment of:

- what capex in the last period has been prudent and efficient
- any capex that has been deferred
- the case for any adjustments that JGN proposes.

#### 13.5.4 Minor drafting amendments

We also require three small drafting amendments to the access arrangement.

1. Remove the explicit cross references in clause 13.1(b)(iv) and change the drafting of clause 13.1(b)(iv) to:  

(iv) For the purpose of calculating the annual efficiency gain or loss, the approved capital expenditure allowance is to be adjusted to take into account a change in the scope of activities in accordance with the approach outlined below or for any approved Cost Pass Through Event.
2. Fix the hyperlink in clause 13.1(c) that should be linking to 13.1(e) but is currently going to a different clause.
3. References in clause 13 and Schedule 9 to *real WACC* be changed to *real vanilla WACC*.

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<sup>9</sup> See AER, *Better Regulation, Explanatory Statement, Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, Section 2.3.6, p. 36.

<sup>10</sup> The contingent payment factor allows CESS payments to be made to JGN on a sliding scale. If JGN achieves 100 per cent of its performance targets, it will receive a full payment. The payment will then reduce if JGN does not achieve 100 per cent on a sliding scale, and JGN will not receive a CESS payment if its performance is less than 80 per cent.

## 13.5 Revisions

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

**Table 13.3 Revisions**

Revision 13.1	Remove clauses 13.2 from the Access arrangement, JGN's NSW gas distribution network, 1 July 2020 – 30 June 2025.
Revision 13.2	Delete the table in clause 13.1(l)(iv)
Revision 13.3	Delete schedule 9, (j). Include new schedule 9(j) stating:  The service provider may seek, subject to AER approval, to exclude from arithmetic average calculated in paragraph (b), the impact of material events that are outside of the Service Provider's control.
Revision 13.4	Remove the explicit cross references in clause 13.1(b)(iv) and change the drafting of clause 13.1(b)(iv) to :  (iv) For the purpose of calculating the annual efficiency gain or loss, the approved capital expenditure allowance is to be adjusted to take into account a change in the scope of activities in accordance with the approach outlined below or for any approved Cost Pass Through Event.
Revision 13.5	Fix the hyperlink in clause 13.1(c) that should be linking to 13.1(e)
Revision 13.6	Change References in clause 13 and Schedule 9 from <i>real WACC</i> to <i>real vanilla WACC</i>