Australian Gas Networks

Final Plan Attachment 11.4

Written Stakeholder Submissions on Incentives Issues Paper and Workshop

July/August 2016

29 July 2016

Via email: Jai.mcdermott@ue.com.au

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Jai McDermott
General Manager Corporate Affairs
United Energy and Multinet Gas

Dear Jai,

Incentive mechanisms for the Victorian Gas Distribution Businesses – Jemena submission on issues paper

Jemena welcomes the opportunity to comment on the issues paper on incentive mechanisms for the Victorian gas distribution businesses.

Jemena Gas Networks (**JGN**) delivers gas to over 1.3 million homes, businesses and industrial customers in New South Wales. While not directly impacted by incentive mechanisms applied to Victorian gas businesses, any changes to the regulatory framework adopted by the Australian Energy Regulator (**AER**) for the Victorian gas businesses may set a precedent for future Access Arrangement reviews. Accordingly, we have a strong interest in the issues paper, and the introduction of new incentive mechanisms into the gas regulatory framework.

It is encouraging that the Victorian gas distribution businesses are thinking about incentive mechanisms to promote efficiency for the long-term interests of customers with respect to price, quality, safety and reliability of gas distribution services.

The AER recently approved the introduction of an Efficiency Benefits Sharing Scheme (**EBSS**) for operating expenditure for JGN's 2015-20 Access Arrangement period. Prior to proposing the EBSS, we discussed the intent of the scheme with our Customer Council, and confirmed that it supported the application of the EBSS to JGN's operating expenditure. We consider that the EBSS is consistent with the revenue and pricing principles because it encourages efficient investment in operating expenditure programs, while providing JGN with a reasonable opportunity to recover at least its efficient operating costs.

We support the introduction of incentive schemes to the regulatory framework where it is consistent with the revenue and pricing principles and in the long term interests of customers. We remain open to the prospect of proposing additional incentive schemes for capital expenditure, service performance and innovation in future Access Arrangement reviews.

We believe that any assessment of incentives schemes aimed at improving or maintaining service performance should be informed by the value customers place on the service attribute that is being incentivised. As this is likely to vary between distribution businesses, we expect that the design and application of such incentive schemes may also vary between distribution businesses. We agree that customer feedback is a key input into decisions on whether introducing a customer service incentive scheme would be beneficial in promoting the National Gas Objective.

We await with interest the outcomes of the Victorian gas distribution price reviews and proposals by the businesses to implement new incentives schemes.

Yours faithfully

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28 July 2016

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Submitted via email: jai.mcdermott@ue.com.au

Dear Mr McDermott,

Re: Incentive mechanisms for the Victorian Gas Distribution Businesses

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to make a submission to the Farrrier Swier Issues Paper (the Issues Paper) on the Incentive Mechanisms for the Victorian Gas Distribution Businesses (Victorian DBs).

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland to over 1 million customers.

Red and Lumo do not support the introduction of a Capital Expenditure Sharing Scheme (CESS) on the Victorian DBs.

At a recent public forum in Melbourne the AER argued the capital expenditure arrangements that apply to the Victorian DBs deliver efficient outcomes. As such, the Victorian DBs operate very close to the efficient Production Possibility Frontier (PPF).

Any changes to the current arrangements risks threatening this outcome. Hence, we do not support them.

The Victorian DBs do not receive a carryover value on capital expenditure for efficiencies achieved in the current regulatory period. But efficiencies achieved by underspending their actual capital expenditure relative to forecast benchmarks are kept.

This approach has delivered efficient investment in capital expenditure in the Victorian gas distribution system with correspondingly high service levels. We have not seen any evidence that suggests that Victorian DBs are inhibited from providing efficient solutions under the current model.

Absent of an incentive scheme on capital expenditure, the Victorian DBs argue that they have no incentive to improve efficiency. More specifically, they argue the current incentive arrangements on capital expenditure fail to encourage dynamic efficiency. As a result they explore the option of implementing a high powered incentive regime.[1]

[1] Farrier Swier Issues paper – Incentive mechanisms for the Victorian gas Distribution Businesses" – 2018-to 2022 Gas Access Arrangement Review – 10 June 2016 p. 25 " The argument for higher-powered incentives may be more cogent where a business is operating at or close to the efficiency frontier where achieving further efficiencies gains are more challenging, and greater managerial effort and investment in innovation may be required.

If the AER decides to introduce a CESS on gas distribution in Victoria, it needs to be convinced that it will deliver improvements in dynamic efficiency before implementing such a scheme. It must also be convinced that a CESS will not threaten the current high levels of reliability.

Should you have any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager on 03 9976 5701.

Yours sincerely

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29 July 2016

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Response to Issues Paper - Incentive Mechanisms for the Victorian Gas Distribution Businesses

Dear Mr McDermott,

The Energy Networks Association (ENA) welcomes the opportunity to provide its comments in relation to the Issues Paper *Incentive Mechanisms for the Victorian Gas Distribution Businesses* (the Issues Paper).

The Issues Paper was released for consultation by Victorian gas distribution businesses Multinet Gas, Australian Gas Networks and AusNet Services (the businesses). The goal of the Issues Paper is to examine potential changes to incentive arrangements that the businesses could propose to the Australian Energy Regulator (the AER) for the forthcoming (2018 to 2022) access arrangement period.

This consultation process demonstrates that network businesses are making genuine efforts to effectively engage with their customers and to increase stakeholder transparency in the development of their access arrangements proposals.

Given that the existing incentive arrangements for gas businesses lack both a service incentive mechanism and a Capital Expenditure Sharing Scheme (CESS) that currently apply in electricity; the ENA considers that there is a clear opportunity to promote the long-term interests of gas customers by improving the existing incentive arrangements in gas.

As such, members of the ENA support the use of incentive-based mechanisms to promote continuous, effective and stable financial incentives for efficient expenditure.

Section 98 of the *National Gas Rules* (NGR) provides the AER with broad power with respect to the implementation of incentive schemes for individual gas distribution businesses. The inclusion of new incentive schemes in the businesses access arrangement proposals is consistent with the requirements of the rules and this matter deserves a detailed assessment by the AER.

The AER indicated in the recent decision for AGN's South Australian network that the lack of an industry wide consideration was a factor that meant it was not sufficiently confident to approve a strengthening of the incentive arrangements. The AER's Statement of Intent 2016-17 states that the AER will consider extending the CESS to gas throughout 2016-17.[1] This represents a positive step by the AER towards enhancing the incentive arrangements in gas. However, the timing of this upcoming review does not align with the businesses' access arrangement process. The ENA is concerned that the potential five-year delay in the introduction of the strengthened incentive arrangements for Multinet Gas, Australian Gas Networks and AusNet Services may result in significant potential customer benefits being delayed in their realisation.

The ENA supports the specific proposals explored by the businesses on the basis that:

- The NGR clearly contemplate that the businesses may propose incentive mechanisms to the AER and the rules were specifically intended as a flexible and adaptive framework allowing innovation in the development and proposal of incentive mechanisms.

[1] AER, Statement of Intent 2016-17, p.8.

- The proposed incentive arrangements are informed by the incentive arrangements that currently apply to electricity distribution businesses in the National Electricity Market. The AER undertook significant industry consultation through its Better Regulation program in 2013 and it would seem appropriate to adopt common approaches for gas and electricity.
- Taking an industry wide approach reduces the administrative costs of regulation lower and provides for consistent cost-efficiency signal across infrastructure types.

In this submission, the ENA does not address the individual questions posed in the Issues Paper.

Comments on Issues Paper

Incentives for efficient expenditure

The ENA supports the use of incentive-based mechanisms to promote continuous, effective and stable financial incentives for efficient expenditure.

During the 2012 rule change process, the Australian Energy Market Commission (AEMC) identified the following potential benefits of a CESS:

> *"The Commission identified the following benefits with capex sharing schemes in the draft rule determination:*
>
> - *they encourage appropriate network investment;*
> - *they encourage NSPs [Network Service Providers] to look for efficiencies, such as by innovation;*
> - *they provide an incentive for NSPs to reveal their efficient costs; and*
> - *they can be designed to provide for a continuous incentive, that is, the incentives could be set so that the incentive power is the same no matter in which year of a regulatory control period an investment is made."*[2]

Subsequently, changes to the *National Electricity Rules* (NER) were introduced to provide the AER with the discretion to develop a capital expenditure sharing scheme, so that the regulator can incentivise network service providers to invest capital efficiently.

The AER currently applies the following incentive mechanisms to electricity distribution and transmission businesses:

- Efficiency Benefit Sharing Scheme;
- Service Target Performance Incentive Scheme; and
- Capital Expenditure Efficiency Sharing Scheme.

The mechanisms listed above complement and reinforce each other to ensure that that incentives for capital and operating expenditure efficiencies are:

- Constant through the duration of a regulatory period;
- Balanced so that cost reduction does not compromise appropriate service quality; and
- Neutral in terms of which expenditure to incur (capex or opex).

The same incentive arrangements currently do not apply to gas distribution businesses. The AER's approach to gas is consistent with its approach to electricity prior to the rule changes, i.e. the AER applies an operating

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[2] AEMC 2012, "Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper", November 2012, p.121.

expenditure benefits sharing scheme only. This results in an unbalanced incentive framework in operation for regulated gas distribution businesses across Australia.

To this end, the ENA considers that the development and implementation of a capital expenditure sharing scheme in gas would be desirable.

Balancing incentives for cost reduction and service quality

The ENA recognises that the CESS that applies under the NER is balanced by a Service Target Performance Incentive Scheme (STPIS), which provides a balancing incentive to maintain or improve service quality against incentives for cost reduction. There is no comparable balancing STPIS for gas distribution businesses, although jurisdiction Guaranteed Service Level (GSL) exists in Victoria.

It may be argued that incentive measures relating to reliability are required in order to balance strengthened expenditure incentives (i.e. the CESS) and reduce the scope for inefficient deferrals. However, the incentive problem only applies where businesses have substantial discretion over the timing of investment. Given that the businesses are subject to the GSL obligations under the Victorian Gas Distribution System Code and the licensing and reporting frameworks, the discretion for investment projects to be deferred is limited.

To the extent that the incentive problem exists, the ENA considers that there are practical solutions available to fix this issue. For example, the AER has developed a deferred capex adjustment mechanism for electricity businesses, which is designed to deter network firms from inefficient deferral between regulatory periods.

Customer Service Incentive Scheme

The businesses have proposed a new Customer Service Incentive Scheme (CSIS). The scheme draws on some of the features of the current electricity distribution Service Target Performance Incentive Scheme, including setting revenue at risk, parameters, performance targets, incentive rates and exclusions.[3]

The ENA understands the detailed design of the potential scheme will require considered development, with a key focus being ongoing engagement with stakeholders and the AER on performance measures possible for inclusion, particularly measures around safety, reliability and service.

The ENA considers that the CSIS can provide benefits to consumers by encouraging a strong focus on improving performance and better aligning the incentives for the businesses with outcomes that are desirable for customers.

Network Innovation Scheme

It is widely accepted that the incentive for a regulated monopoly to invest in innovative projects is materially different to an unregulated business. Therefore, the ENA considers that specific measures, such as the proposed Network Innovation Scheme (NIS), are desirable to ensure that optimal levels of investment in network innovation can be delivered.

Gas is often referred to as 'a fuel of choice' because practical substitutes such as LPG and electricity are available. Gas networks' pricing decisions are, therefore, constrained by the risk of declining demand as customers may choose to substitute gas for alternative fuels. It can be argued that this provides gas businesses with greater incentives to innovate. However, gas distributors are still regulated monopolies under the existing regime to which the CPI-X form of regulation is applied. There are a number of aspects unique to the existing regulatory regime that hinder investment in innovation by gas networks:

- an allowance for innovation is not included in the regulated forecasts;
- revenues are reset shortly after the innovation (such that the benefits of that innovation are also passed through to consumers after a short period); and[4]

[3] Farrier Swier, Issues Paper, Incentive Mechanisms for the Victorian Gas Distribution Businesses, p.37.
[4] AGN, Access Arrangement Information for Australian Gas Networks' South Australian Natural Gas Distribution Network. July 2015, p.201.

» due to the uncertainty of outcomes with innovation initiatives, it is often hard to demonstrate that the spend will satisfy the expenditure tests, and is therefore unlikely to be allowed by the regulator.

The ENA notes that the proposed NIS also reflects reforms occurring overseas. In the UK, Ofgem's framework for price controls, known as RIIO (Revenue = Incentives + Innovation + Outputs), includes an Innovation Stimulus Package that applies to gas distributors. It seeks to encourage innovation that contributes to low carbon economy objectives through innovation funding mechanisms, which provide an upfront partial funding of innovation projects.

If further information is sought on this matter, please contact Garth Crawford, Executive Director, Economic Regulation, on 02 6272 1555.

Yours sincerely,

John Bradley

Chief Executive Officer

3 August 2016

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RE: Incentive Mechanisms position paper

Dear Mr McDermott,

Thank you for the opportunity to comment on the incentives mechanisms position paper.

The Consumer Utilities Advocacy Centre Ltd (CUAC) is a specialist consumer organisation established in 2002 to represent Victorian energy and water consumers in policy and regulatory processes. As Australia's only consumer organisation focused specifically on the energy and water sectors, CUAC has developed an in-depth knowledge of the interests, experiences and needs of energy and water consumers.

CUAC's advocacy maintains a focus on the principles of affordability, accessibility, fairness, and empowerment through information and education. We believe that consumer interests – particularly those of low income, disadvantaged and rural and regional consumers – must be a primary consideration in the development and implementation of energy and water policy and in service provision. CUAC supports informed consumer participation in energy and water markets.

CUAC is open to the idea of new incentives for the gas distribution businesses in Victoria to encourage more efficient investment in the long term interest of consumers, as articulated in the National Gas Law. However, we would like to see a greater reliance on empirical evidence as the basis for the proposed incentive mechanisms, rather than a dependence on theoretical economic arguments which often cannot predict unintended consequences. The gas businesses might also provide a clearer description of the problems with the current incentive regime, and explain these issues together with simple substantive positions. Further, it would be particularly useful to assess impact of the proposed incentive mechanisms - distributors should clearly outline the costs and benefits to consumers and could model the potential impact of incentive schemes on consumers' bills including likely scenarios for different user profiles.

Context in Victoria

For the vast majority of Victorians, gas is currently an essential part their energy mix, with both a high penetration of gas mains connections and high usage among consumers. As outlined in CUAC's research report, *Our Gas Challenge,* 83 percent of Victorian households have a gas mains connection.[1] CUAC's research found that a 'low usage' Victorian household – the bottom

[1] Martin Jones, 'Our Gas Challenge: The Role of Gas in Victorian Households' (Melbourne: Consumer Utilities Advocacy Centre Ltd., 2014), 3.

third of mains gas usage in Victoria - exceeds middle usage for households in NSW or SA, and is roughly equivalent to an upper usage household in QLD.[2] For many consumers, utility bills can be one of the primary causes of financial stress. According to the ESC, gas disconnections in Victoria remain high by recent historical standards, with 22,322 disconnections in 2014-15 due to a non-payment of an outstanding amount - roughly equivalent to two thirds of the absolute number of electricity disconnections over the same period.[3]

This can be explained to some extent by the increase in the cost of gas bills. According to the most recent DHHS Victorian Utility Consumption Household Survey, gas bills have increased approximately 40.0 percent between 2007 – 2014, despite a reduction in gas consumption of 25.1% over the same period.[4] While distribution accounts for approximately a third of the average gas bill in Victoria, reducing prices should be a key aim of the new incentive mechanisms, without compromising safety and reliability. This objective is clearly outlined in the National Gas Law:

*"… to promote efficient investment in, and efficient operation and use of, natural gas services for the **long term interests of consumers** of natural gas with respect to **price**, quality, safety, reliability and security of supply of natural gas".*[5]

CUAC recommends that the distributors clarify the total cumulative increase (or decrease) in return on equity, based on the incentive mechanisms proposed. It would also be particularly helpful to model the impact of this increase (or decrease) on consumers' bills.

It is also worth considering to what degree gas is a fuel of choice. According to ACIL Allen, there is "scant information on cross-price elasticity relevant to eastern Australian gas and electricity markets".[6] In our view, low-income consumers and renters have virtually no ability to switch their gas appliances, hot water and heating systems for electric substitutes in the short term. This group's ability to switch fuel and appliances is likely to remain unchanged in the longer term in the absence of a significant changes in government policy or incentives. Higher income customers may have a somewhat higher elasticity of demand should gas prices increase, though they are more likely to consider switching only at the point it becomes financially viable – for example when a hot water heating system breaks down or needs replacing, during a significant renovation or when planning a new build.[7] This means that the majority of Victorians will be directly impacted by price changes but have limited capacity to respond, other than through reduced usage.

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[2] ibid., 8.

[3] Essential Services Commission 2016, 'Energy Retailers Comparative Performance Report – Customer Service', May 2016, viii.

[4] Roy Morgan Research Ltd, 'Victorian Utility Consumption Household Survey 2015' (Department of Health and Human Services, 2015), 109.

[5] Section 23 National Gas Law

[6] ACIL Allen Consulting, 'Report to the Australian Energy Regulator - Review of Demand Forecasts for the AGN South Australia Gas Networks for the Access Arrangement Period Commencing 1 July 2016 – Public Version', 11 November 2015, 34.

[7] Alternative Technology Association, 'Are we still Cooking with Gas?', November 2014.

Capital Expenditure Sharing Scheme (CESS)

CUAC believes there is merit in a mechanism to incentivise gas distributors to invest efficiently across all years of the revenue period. While the proposed CESS incentive mechanism does in theory deliver this outcome, we have concerns about the potential for unintended consequences. A high powered incentive for gas businesses to underspend their capex allowances potentially creates the perverse incentive for the deferral of capex to future revenue periods. This potentially creates additional future costs for consumers, and could cause a decline in service levels to the detriment of customers.

Capex incentive schemes have previously been administered in Victoria in both the 2003-2007 and 2008-2012 gas access arrangement periods. During these periods, the ESC noted that distribution businesses underspent their capex allowance, received the incentive payment through the incentive mechanisms, but sought higher capex allowances in subsequent regulatory periods (referred to elsewhere as 'inter-period capex deferral').[8] We therefore encourage the AER to review the empirical evidence of distributor's spending during these periods and consider whether there is a risk of deferred capex as a result of the introduction of such a mechanism. It may also be useful to review the efficacy of the CESS mechanism for the electricity distribution regulatory period 2014-2019 in NSW/ACT to determine whether the incentive was effective and whether the power of expenditure sharing ratios is appropriate.

A further concern in regulating a CESS scheme is the increased complexity for the regulator to identify where and when distribution businesses defer capex. This is particularly problematic given the information asymmetry between regulator and business, and the significant time-lag between deferred capex and potentially adverse consequences in service quality.

Should the AER determine that a CESS is appropriate, we suggest an asymmetrical expenditure sharing scheme be introduced. Gas distributors could retain up to 30 percent of any underspend of their capex allowance. In our view, a higher powered incentive to underspend is inappropriate and may lead to gas distribution business pursuing excess cost reduction at the expense of service quality. A higher powered disincentive should be adopted for any overspend of a distributor's capex allowance - whereby gas distributors would be penalised 50 percent of any efficient overspend and the remaining 50 percent is borne by consumers. As argued elsewhere, there are a number of reasons for a higher powered disincentive for overspend, including;

- capex forecasts are likely to be biased upwards due to information asymmetry between regulator and distribution businesses,[9]
- consumers are not best placed to manage the forecast risks, while gas distributors have access to a variety of regulatory mechanisms to address significant forecast risks,[10]

[8] Public interest Advocacy Centre, 'Having the desired effect: submission to the AER's Draft Expenditure Incentive Guideline', 20 September 2013, 26; Joskow, Paul L., 'Incentive Regulation in Theory and Practice: Electricity Distribution and Transmission Networks.', in *In Economic Regulation and Its Reform: What Have We Learned?* (University of Chicago Press, 2014), 321.

[9] PIAC, 'Having the desired effect', 19.

[10] ibid., 8; Australian Energy Regulator, 'Explanatory Statement, Draft Expenditure Forecast Assessment Guideline', 2013, 16.

- mechanisms such as pass through arrangements protect distributors from unforeseen efficient overspends,[11]
- an efficient overspend increases the Regulated Asset Base (RAB) of a distribution business, resulting in a reduced penalty through the long term benefit to a distributor through the return of capital.[12]

Further, we suggest that any inefficient overspend should be borne entirely by the gas distributors and monitored through the conforming capex assessment process.

We consider it inappropriate for distribution businesses to receive different sharing ratios. This would add a further complexity and increase the burden on the AER to determine whether businesses receive particular ratios and develop a consistent basis for these decisions. The option of different sharing ratios potentially provides gas businesses with the opportunity to pursue higher ratios when they can deliver larger efficiencies and windfall profits, and avoid larger penalties when they expect their efficient costs might exceed their approved revenue to avoid windfall losses.

Customer Service Incentive Scheme

The introduction of the CESS incentive should be contingent on an effective complementary scheme to ensure a capex underspend does not result in compromised service standards. The metrics proposed in the incentive mechanism position paper may not be the most appropriate metrics to address compromised reliability, safety and quality of supply standards resulting from capex underspend. The proposed metrics consider customer service outcomes which appear more closely linked to opex than capex. The distributors should reconsider revising the incentive metrics as part of this proposed mechanism so that they are more closely linked to capex. It may be the case that a revised and strengthened Guaranteed Service Level scheme could provide a more appropriate check on capex underspend than a customer service incentive.

In considering the merit of the proposed Customer Service Incentive Scheme as a standalone proposition, recent research conducted by AGN found that customers "value the current standard of reliability".[13] This suggests that this proposed incentive mechanism may be unwarranted, particularly given the proposed link between the customer service incentive and ±1 percent of revenue. Distributors could consider a stronger empirical basis for this incentive, developed through transparent customer satisfaction research that examining willingness to pay for varying levels of service quality, or a rigorous value of customer reliability study. Consumers need to be properly equipped to participate in these surveys and questions need to be framed appropriately to ensure consumers can provide an informed and meaningful response.

The AER might consider whether a further financial incentive is warranted if this mechanism was introduced as a complementary scheme to a CESS incentive with a reasonably powered ratio.

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[11] PIAC, 'Having the desired effect', 14.

[12] ibid., 16; Uniting Care Australia, 'Response to the Expenditure Incentive Draft Guidelines', September 2013, 3; CHOICE, 'Submission to the AER on the Draft Capital Expenditure Incentive Guidelines', September 2013, 3.

[13] Deloitte, 'Australian Gas Network Customer Insights Report: Victorian and Albury Stakeholder Engagement Program', (Australian Gas Network, May 2016), 16.

Network Innovation Scheme

CUAC recognises the value of innovation to discover further efficiencies to deliver benefits for distributors and their customers through lower prices. However, it is unclear from the position paper how networks would financially account for the Network Innovation Scheme incentive. It is also unclear how the efficiencies that distributors uncover through innovation would be shared between the distributors and their customers.

Efficient savings delivered through a CESS or EBSS might provide an adequate mechanism to finance innovation, which then provides the opportunity for a business to discover further efficiencies, realise these efficiencies in subsequent periods and benefit through underspending their revenue allowance.

Concluding remarks

We would like to thank the networks for taking a collaborative approach to consultation through the Incentive Mechanism forum. We strongly suggest that the distributors give further consideration to their engagement strategies with their consumers in exploring these complex scenarios, providing simple explanations and examples to assist understanding and shifting from theoretical to more empirically based discussion about the merits of the different incentive mechanisms. The best case for the proposed incentive mechanisms is for the distribution businesses to demonstrate the costs and benefits to consumers, and better articulate the price and service quality mix on offer. Without this information it is difficult for consumers and consumer advocates to meaningfully engage with the proposed mechanisms and provide a more definitive judgement on the value proposition of new incentive mechanisms.

Thank you for the opportunity to submit feedback and should you have any questions, please do not hesitate to contact Ben Martin Hobbs on ben.martinhobbs@cuac.org.au or 03 9639 7600.

Yours sincerely,

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