Attachment 12.1

Response to Draft Decision:
Incentive Arrangements

2016/17 to 2020/21 Access Arrangement Information Response to Draft Decision

Australian Gas Networks

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1 Response to the Draft Decision on Proposed Incentive Arrangements

1.1 Introduction

This attachment sets out Australian Gas Networks Limited's (AGN's) response to the Australian Energy Regulator's (AER's) Draft Decision on the incentive arrangements that are to apply over the next (2016/17 to 2020/21) Access Arrangement (AA) period. It also provides an update of the carry over amount arising from the current (2011/12 to 2015/16) AA period to apply in the next AA period, incorporating the use of actual 2014/15 operating expenditure (opex) which is now available.

Over the next AA period, AGN had proposed to retain and strengthen the Efficiency Benefits Sharing Scheme (EBSS) and introduce three new schemes: the Capital Expenditure Sharing Scheme (CESS), a Customer Service Incentive Scheme (CSIS) and a Network Innovation Scheme (NIS). AGN proposed strengthening the incentive framework as a way of promoting the long-term interests of consumers (and therefore better promoting the National Gas Objective (NGO)).

1.2 AER Draft Decision

The AER did not accept AGN's proposals to strengthen the incentive framework to apply in South Australia for the next AA period. The AER did however decide to maintain the application of an opex efficiency sharing scheme (the EBSS) over the next AA period, albeit a different scheme to that proposed by AGN. In not accepting AGN's proposed strengthened incentive arrangements, the AER stated:

> *Where we have developed and introduced new incentive schemes under the NER [National Electricity Rules]—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.*[1]

The AER Draft Decision in respect of our proposed incentive arrangements is summarised in the Table 1.1.

[1] AER 2015, "*Attachment 14 – Other incentive schemes | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 14-6.

TABLE 1.1: SUMMARY OF AER'S DRAFT DECISION ON INCENTIVE MECHANISMS

	AER Draft Decision	AER Comment
EBSS	Modify AGN proposal	Accepted application of an efficiency sharing scheme to opex but considered the AER's EBSS to be preferable to AGN's proposed scheme. Given this, the AER did not accept AGN's proposal for an equal sharing of efficiency gains between AGN and consumers citing that evidence suggests the current scheme, which requires AGN to retain a 30% efficiency gain or loss, is providing sufficient incentive to pursue opex efficiencies.
CESS	Reject AGN proposal	Sufficient incentive currently exists for AGN to be efficient due to the capital expenditure (capex) ex-post review provisions under the National Gas Rules (NGR) and given that gas is a fuel of choice. No evidence of AGN overspending its allowance over the past 10 years and therefore a CESS is not required to promote further efficiencies. The absence of a complementary service incentive scheme means that capital efficiency improvements may occur at the expense of service quality.
CSIS	Reject AGN proposal	AGN is currently providing high levels of customer service; therefore the benefits of introducing the CSIS may not outweigh the costs.
NIS	Reject AGN proposal	Sufficient incentives currently exist for AGN to undertake innovative efficiency enhancements without the need for a new scheme.

1.3 AGN Response to Draft Decision

AGN accepts the AER's Draft Decision in respect of all matters other than the introduction of a CESS. While AGN considers its proposed changes to sharing ratios for the EBSS and CESS, and the introduction of the CSIS and NIS are in the long-term interests of consumers, AGN accepts that these changes should preferably be subject to an industry wide consultation process.

In respect of the CESS, AGN does not accept the AER's Draft Decision not to apply the scheme as AGN considers the requisite industry consultation to have already occurred. The CESS is currently applied to electricity distributors, and as such, should also be applied to gas distributors. Table 1.2 provides a summary of AGN's response to the AER Draft Decision.

TABLE 1.2: SUMMARY OF AGN'S RESPONSE TO THE AER DRAFT DECISION ON INCENTIVE MECHANISMS

	AER Draft Decision	AGN Response	AGN Comment
EBSS	Modify AGN proposal	Accept Draft Decision	AGN also accepts the need for industry wide consultation to consider strengthening the power of the scheme.
CESS	Reject AGN proposal	Respond to Draft Decision	AGN considers it appropriate to apply the AER's CESS for the next AA period as the mechanism has already undergone extensive industry consultation. AGN notes the AER, in justifying the application of its preferred EBSS and opex forecasting approach (base-step-trend) in the next AA period, relied upon the fact each mechanism had undergone extensive industry consultation, despite this consultation being specific to the electricity distribution sector.
CSIS	Reject AGN proposal	Accept Draft Decision	Accept the need for industry wide consultation to consider the introduction of the new scheme.
NIS	Reject AGN proposal	Accept Draft Decision	Accept the need for industry wide consultation to consider the introduction of the new scheme.

The remainder of this attachment therefore focuses on reasons for not accepting the AER's decision is respect of application of the CESS.

1.3.1 Capital Efficiency Sharing Scheme (CESS)

AGN proposes that a CESS apply to the South Australian natural gas distribution network (the Network) over the next AA period, which CESS is identical to that currently applied to the electricity distributors[2]. AGN considers the CESS to be an appropriate mechanism by which to provide a continuous incentive to achieve capex efficiencies in the next AA period. Application of the CESS is therefore consistent with section 24(3) of the National Gas Law, which law requires

> *"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."*[3]

AGN also does not accept the key premise of the AER's decision not to allow the CESS on the basis of an industry wide consultation (which is also inconsistent with its application of the base-step-trend approach to forecast opex).

1.3.1.1 Application of the AER's opex forecast approach and EBSS to AGN

In rejecting the application of the CESS in the next AA period, the AER advised that an extensive industry wide consultation would be required prior to its introduction:

> *"For the electricity CESS, there was an extensive consultation period in the lead up to its introduction. This included consultation on the AEMC's [Australian Energy Market Commission'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."*[4]

The AER's position in respect of the CESS however is contradictory to its justification for its application of its preferred approach to developing opex forecasts (the base-step-trend approach) and the EBSS; each of which were developed through an electricity industry consultation program. That is, both the base-step-trend approach to forecasting opex and the EBSS have been applied by the AER to gas distributors despite there having been no industry wide consultation process.

AGN in its proposal had not used the base-step-trend approach to forecast opex and had proposed a different EBSS. In rejecting AGN's opex forecast methodology in favour of the base-step-trend approach[5] the AER noted:

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2 Refer section 5.2 of the AA for CESS formula.

3 National Gas Law 2015, Section 24 (3), 30 January 2015.

4 AER 2015, "*Attachment 14 – Other Incentive Schemes | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 14-13.

5 It is worth noting that the AER found that "*AGN's forecasting method is not the key driver of the difference (with the AER's forecast)*". That is to say the methodology applied by the AGN delivered a similar forecast to the AER's preferred base-step-trend approach.

> *"In the Expenditure Guideline, we developed an opex forecast method incorporating a rate of change in total opex..."*[6]

The guideline referred to by the AER is the "*Expenditure Forecast Assessment Guideline for Electricity Distribution"*, which guideline was developed in consultation with the electricity industry. No such equivalent guideline exists for gas. Despite this, AGN has accepted the application of the AER's preferred base-step-trend approach to forecasting opex as providing reasonable forecasts.

In respect of the EBSS, the AER have also deferred to that scheme developed for electricity distributors:

> *"Our efficiency carryover mechanism is consistent with Efficient Benefit Sharing Scheme we published for electricity distributors in November 2013."*[7]

Both the opex base-step-trend approach and the EBSS, as well as the CESS, were developed through an electricity based consultation process. The focus on the electricity industry in the development of those schemes has not however prevented the AER from applying these approaches to AGN in respect of opex and the EBSS. AGN therefore considers it to be inconsistent for the AER to use the lack of specific consultation in the gas industry as a barrier to the introduction of the CESS for AGN, when it has not done so in respect of the opex base-step-trend approach and the EBSS.

AGN considers that, as the AER does in respect of the opex forecast approach and EBSS, sufficient industry consultation has occurred for the CESS in order for it to be applied to AGN for the next AA period. AGN considers the opex base-step-trend approach, the EBSS and the CESS are equally applicable to electricity and gas businesses due to the similarity of the respective regulatory frameworks. AGN notes:

- the NGO and National Electricity Objective are in effect identical;
- the Revenue and Pricing Principles (RPP) set out in the National Gas Law (NGL) and National Electricity Law (NEL) are also in effect identical; and
- both the NGL and NEL require the use of the building block approach to setting revenue on a nominal post tax basis.

The AER also considered it inappropriate to introduce a scheme as part of an individual gas business's AA review and gave weight to the fact other gas businesses, including ActewAGL, had not proposed a CESS:

> *"While AGN has proposed a CESS, other gas NSPs [Network Service Providers] do not support introduction of a capex efficiency incentive scheme."*[8]

AGN notes that the NGR provides that an AA *may* include incentive mechanisms and one of those incentive mechanisms may provide for carrying over increments for efficiency gains or decrements for efficiency losses from one period to the next. The implication is that it is open to service providers to propose an incentive scheme and the AER is required to consider the merits of that scheme for the network under review, having regard to the RPP and the NGO.

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6 AER 2015, "*Attachment 7 – Operating Expenditure | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 7-31.

7 AER 2015, "*Attachment 9 – Efficiency Carryover Mechanism | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 9-11.

8 AER 2015, "*Attachment 14 – Other Incentive Schemes* | Draft decision: Australian Gas Networks Access Arrangement 2016-21", November 2015, pg. 14-13

1.3.1.2 Complimentary Schemes – Reliability, Safety and Customer Service

The AER has indicated some concern for introducing the CESS for capex absent a counterbalancing reliability and service incentive scheme.

> *"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)."* [9]

When considering the need for a complimentary reliability and service scheme, the AER should assess the current reporting requirements imposed on AGN. Clause 5.1 of AGN's Gas Distribution License requires AGN to conduct its operations to[10]

> *(a) prevent death or injury to, persons or damage to property;*
>
> *(b) minimize leakage of gas; and*
>
> *(c) account for the total amount of gas lost from the distribution system as a result of leakage or an activity…*

AGN's Asset Management Plan (AMP) (Attachment 8.1 to the Initial Access Arrangement Information submitted in July 2015 (Initial AAI)) provides the overarching plan explaining our strategy for ensuring both public and employee safety to meet the above obligations. The AMP provides a consolidated view of a number of technical and operational plans, including:

- the Leakage Management Procedure (LMP) – which outlines the process for managing natural gas leaks on the Network; and
- the Mains Replacement Plan (MRP) – which outlines the process for managing the replacement of ageing mains.

The key targets in the LMP for managing gas leaks include:

- the maintenance of a 24-hour, seven day a week facility for the public reporting of natural gas leaks;
- setting the time for the repair of a natural gas leak, which time depends on the severity or risk associated with the leak; and
- setting the time periods for undertaking routine surveys of mains to check for natural gas leaks.

The performance of AGN against these measures must be reported to the Essential Services Commission of South Australia (ESCOSA) and the South Australian Office of the Technical Regulator (OTR), whose role it is to ensure AGN is meeting its obligations. AGN considers therefore that a quantifiable, independent scheme already exists by which AGN's safety and reliability performance can be measured. This scheme will enable the AER, ESCOSA and the OTR to quickly determine if safety and reliability are being comprised by AGN in order to maximise a CESS reward.

Further, in chapter of its Initial AA Proposal, AGN noted it will be (voluntarily) reporting to stakeholders and the general public the performance of all AGN networks against measures of safety, reliability and customer

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9 AER 2015, "*Attachment 14 – Other Incentive Schemes | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 14-11

10 ESCOSA 2014 "AGN Gas Distribution Licence" December 2014, clause 5.1, pg. 2

service set out in its Vision Statement. As an example, AGN will be publically reporting its performance against the following measures:

- answer 90% of all calls to our emergency call centre within 10 seconds of receiving the call;
- attend to 95% of all publicly reported natural gas leaks within two hours (those leaks considered to be higher risk are prioritised as per the procedures set out in our LMP);
- repair all network leaks within the required time periods set out in the LMP; and
- complete routine natural gas leak surveys in the required time periods set out in the LMP.

Finally, as outlined in Chapter 3 of AGN's Initial Access Arrangement Information, ESCOSA is responsible for developing the customer service and reliability standards that are to apply over the next AA period. In 2015, ESCOSA undertook a review of these standards and found that whilst there were no areas of AGN's service that required improvement through the introduction of performance targets, there was a need to enhance the public reporting framework to facilitate the provision of additional data to monitor AGN's service levels.

ESCOSA's Final Decision on these standards requires AGN to periodically report on *"…its responsiveness to public reports of potential gas leaks and customers experiencing poor reliability outcomes*".[11] Importantly, ESCOSA also note that "*The revised reporting framework will provide the necessary data to monitor any material changes in current service levels that may require service standards with performance targets in the future.*"[12]

AGN therefore considers a quantifiable safety and reliability scheme already exists to complement the introduction of a CESS in the next AA period. AGN must report to ESCOSA and the OTR on its performance against the targets set in the LMP in order to meet gas Distribution Licence obligations for safety and reliability. Further, AGN will be publically reporting its performance against measures of safety, reliability and customer service driven by its Vison Statement.

AGN therefore considers sufficient safety, reliability and customer service performance reporting will occur in the next AA period to complement the introduction of a CESS. This performance reporting will enable the AER to quickly identify inefficient deferral of capex by AGN to maximise a CESS outcome. Not meeting these targets leaves AGN exposed to losing its gas Distribution Licence or, at the least, have its customers disconnect from the network due to it being unreliable and unsafe.

1.3.1.3 Complimentary Schemes – EBSS

The most important complimentary scheme to the CESS is the EBSS. This is because the two schemes work in tandem to ensure businesses apply the most efficient expenditure, whether it be capex or opex. The AER's Draft Decision to apply the EBSS without the complimentary CESS incentivises AGN to incur capex instead of opex to maximise the EBSS outcome, even if an opex solution is the most efficient. This was recognized by the Consumer Challenge Panel in their advice to the AER on AGN's AA proposal:

> *"We consider that the EBSS and the CESS work together to ensure that there no bias towards one form of expenditure over another."*[13]

The AER Draft Decision therefore does not provide a balanced incentive framework as it encourages AGN to pursue capex solutions at the expense of opex solutions. AGN considers it good regulatory practice for

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11 ESCOSA 2015, *"Australian Gas Networks Jurisdictional Service Standards for the 2016-2021 Regulatory Period"*, June 2015, pg. 1.

12 ESCOSA 2015, *"Australian Gas Networks Jurisdictional Service Standards for the 2016-2021 Regulatory Period"*, June 2015, pg. 1.

13 Consumer Challenge Panel subpanel 8, "*Advice to AER from CCCP8 regarding AGN's (SA) Access Arrangement 2016-21*", August 2015, pg. 15

the AER to apply the CESS and EBSS in combination to incentivise businesses to seek the most efficient expenditure – whether that be capex or opex. Other Factors

The AER also cites three other reasons why additional capex incentives are not required for AGN, which are that:

- gas is a fuel of choice so service providers should already be motivated to minimise costs;
- an ex-post capex test applies that also constrains inefficiency; and
- AGN's historic capex underspends suggest further incentives are not required.

While being a fuel of choice does create incentives to pursue cost efficiencies for AGN, given AGN nevertheless remains a regulated business and so responds to the incentives within such a framework, it is still the case the CESS would promote the NGO and the RPP for the reasons articulated in our Initial AA Proposal. This is indeed consistent with the AER's own view in respect of opex, as the AER has chosen to apply the EBSS to incentivise AGN to seek opex efficiencies and thus promote the NGO.

In respective of the ex-post review providing sufficient incentive on AGN to pursue efficient capex, it is notable that in its proposed changes to the rules for the economic regulation of electricity networks that the AER acknowledged the failings and limitations of an ex-post review of capex. It further stated that a sharing mechanism delivers superior incentives to invest efficiently. Specifically, the AER stated:

> *"However, the AER is concerned that by requiring an assessment of the efficiency of investment decisions after they have been made, ex post reviews may add to regulatory risk by creating potential for investment write downs. In addition, the evidentiary burden that the regulator must satisfy before it could disallow an investment is so high that ex post reviews may offer limited protection against inefficient expenditure.*
>
> *Given this background, the AER considers that a sharing mechanism generates more effective incentives to invest efficiently with less impact on regulatory risk."* [14]

The AER considered increased incentives on AGN through the CESS was not required due to AGN's historic underspend of capex against regulatory benchmark. The AER noted in its Draft Decision:

> *"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."* [15]

Further, the AER claims the CESS was introduced for electricity largely based on over-spending by the businesses.

AGN considers best practice incentive regulation should be focussed on providing the right incentives for businesses to reveal efficient outcomes. This has seen regulatory frameworks in the United Kingdom, for example, becoming increasingly reliant on incentives to drive performance. This is the direction that AGN considers regulatory frameworks should be heading.

AGN also notes the AER applied the CESS to electricity businesses with a similar history of underspend of capex to AGN (and not to have only applied the CESS to those electricity businesses with a history of overspend). AGN considers the AER to have appropriately applied the principle of incentive regulation in respect of its application of the CESS to those electricity businesses already achieving capex efficiencies. By extension, AGN therefore also considers the AER should apply the CESS in the next AA period, irrespective of the historic performance against benchmark.

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14 AER, Eco reg rule change, pp. 43-44.

15 AER 2015, "*Attachment 14 – Other Incentive Schemes | Draft decision: Australian Gas Networks Access Arrangement 2016-21*", November 2015, pg. 14-11.

1.3.2 Additional Benefits of the CESS

Other than removing the inherent bias to favour one form of expenditure over another by complementing the EBSS, the other key benefit is to rectify the key deficiency of the current capex incentive regime, which reflects that the incentive of the business to seek further efficiency declines as a regulatory period progresses. As the Productivity Commission identified in their inquiry report into electricity networks:

> *"Developing a well-designed EBSS for capex depends on a clear understanding of why such as scheme is necessary. In the absence of an EBSS, network businesses face weaker incentives to minimise costs as the regulatory period advances."* [16]

The business faces a declining incentive because the implied penalty from incurring an additional dollar at the end of the AA period is lower than at the start of the five year AA period. This problem exists irrespective of where the business sits relative to the expenditure forecast. The CESS, however, provides a continuous incentive such that businesses are motivated to undertake prudent and efficient capital investments when it is efficient to do so. The CESS adjusts for differences in the timing of actual capex incurred relative to that assumed in setting the benchmarks.

1.4 Carry Over Amounts for the Next AA Period

AGN has updated the carry over amount to apply in the next AA period to account for the actual 2014/15 opex. This results in the carry over amount to apply in the next AA period falling from $5 million to $0.3 million. Table 12.3 shows the revised calculation of the carry over amount.

TABLE 12.3: DETERMINATION OF OPEX EFFICIENCY CARRYOVER AMOUNTS

	Current AA Period					Next AA Period				
	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Opex Benchmark										
$ million real 2010/11	68.6	67.5	66.8	65.3	62.9	–	–	–	–	–
$ million real 2015/16	77.0	75.7	74.9	73.3	70.6	–	–	–	–	–
Opex Actual										
Money of the day	62.4	62.1	66.0	65.8	–	–	–	–	–	–
$ million real 2015/16	68.9	66.9	69.7	67.7	65.0	–	–	–	–	–
Opex Underspend ($ million real 2015/16)	8.1	8.9	5.2	5.6	5.6	–	–	–	–	–
Opex Incremental Gain ($ million real 2015/16)	8.1	0.8	-3.6	0.4	–	–	–	–	–	–
Carry-Over										
Year 2016/17	–	8.1	8.1	8.1	8.1	8.1				–
Year 2017/18	–		0.8	0.8	0.8	0.8	0.8			–
Year 2018/19	–			-3.6	-3.6	-3.6	-3.6	-3.6		–
Year 2019/20	–				0.4	0.4	0.4	0.4	0.4	–
Year 2020/21	–	–	–	–	–	–	–	–	–	–

[16] Productivity Commission. "Electricity Network Regulatory Frameworks – Inquiry Report Volume 1 April 2013, pg. 202.

Opex Efficiency Carry-Over ($ million real 2015/16)	–	–	–	–	5.6	-2.5	-3.2	0.4	0.0	

1.5 Summary

AGN accepts the AER's Draft Decision in respect of the EBSS, CSIS and NIS. AGN has also updated for the carry over amount to apply in the next AA period for actual opex incurred in 2014/15. The updated carry over amount is a benefit of $0.3 million compared to the draft decision carry over amount of $5 million.

AGN does not however accept the AER's Draft Decision in respect of the application of a CESS. AGN's proposal is for the CESS currently applied in electricity to also be applied to AGN for the next AA period. AGN considers the application of a CESS is in the long term interests of consumers and therefore better promotes the NGO. This is mainly because the combination of the EBSS and CESS provide the correct incentives in order for AGN to incur the most efficient form of expenditure – whether it be opex or capex.

Further, the application of the CESS will also provide AGN with a continual incentive to incur efficient capex over the next AA period. Under the current regulatory framework AGN is incentivised to seek capex efficiencies at the beginning of the period, which incentive diminishes as the period progresses. The proposed CESS removes this deficiency and provides AGN with the appropriate incentive to continually seek efficiencies throughout the period.

AGN considers the application of both the CESS and EBSS together, as opposed to the EBSS in isolation as proposed by the AER in the Draft Decision, best meets the requirement of section 24 (3) of the NGL, which requirement is that the AER should provide AGN

> *"…with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides."*

The AER's concern in respect of the CESS promoting behaviour which will negatively impact reliability, safety and service is allayed by the fact AGN is subject to independent regulatory oversight from ESCOSA and the OTR. Further, AGN will be publically reporting against measures for safety, reliability and service. Each of these measures will enable the AER to observe if AGN is deferring capex inefficiently in order to maximise the CESS outcome.

AGN also considers sufficient industry consultation has occurred for the CESS applied in electricity to also apply in gas. The AER has seen it appropriate to apply its preferred approach to opex forecasting (base-step-trend) as well as the EBSS to AGN on the basis that sufficient industry consultation has occurred, despite that consultation having been for the electricity industry. AGN agrees with the AER and has accepted the application of the AER's preferred approach in opex. As a result, AGN also considers sufficient industry consultation has occurred for the CESS applied in electricity to also apply to the Network.