Australian Gas Networks

Attachment 12.2

Incentives

Response to AER Draft Decision

January 2023

Contents

1 Incentives

Opex and capex efficiency will continue to be incentivised in the next AA period under the ECM and contingent CESS.

1.1 Overview

This attachment sets out our revised Final Plan incentives proposal for the Victoria and Albury gas distribution networks over the next (2023/24 to 2027/28) Access Arrangement (AA) period in response to the AER's Draft Decision.

Our proposal is to maintain both the opex efficiency carryover mechanism (ECM) and the contingent capital expenditure sharing scheme (Contingent CESS) in our revised Final Plan. We have included some updated inputs in the calculation of carryovers from the schemes in the current AA period, and reproposed the exclusion of augmentation capex in the Contingent CESS, which is consistent with our GSR Response, but was not addressed in the AER's Draft Decision.

The AER’s Draft Decision on our incentives proposal:

- Accepted the continuation of the ECM, but modified its application in the current AA period to remove ECM exclusions that are no longer applicable and exclude Ancillary Reference Services (ARS) from the opex used to calculate carryovers;
- Accepted the continuation of the contingent CESS, with a modification in the next AA period to exclude connections capex from the calculation of efficiency gains, but did not address our proposal that the scheme in the next AA period also exclude augmentation capex from the calculation of efficiency gains; and
- Updated the calculation of efficiency gains under each of the schemes in the current AA period to include more recent inflation forecasts.

The focus of our response to the Draft Decision therefore relates to those few areas where the AER has modified or not accepted our proposal.

The key revisions in our revised Final Plan are:

- We have not accepted the exclusion of ARS from total opex when determining the carryover amount from the current AA period to apply in the next AA period. For the current AA period, ARS were forecast using a single year revealed cost approach, and therefore it is not clear they should be excluded from the calculation of carryovers for that period. We agree with the AER’s proposed approach for the next AA period as we have forecast ARS separately and therefore agree that ARS should be a specified exclusion from the ECM in the next AA period;
- We have updated the calculation of carryovers from the contingent CESS in the current AA period for draft actual capex in 2022; and
- We have re-proposed that augmentation capex be excluded from the calculation of efficiency gains under the contingent CESS in the next AA period.

The sections below discuss the changes from our Final Plan.

1.2 Customer and Stakeholder Feedback

In preparing our revised Final Plan we have continued to engage with stakeholders, including through our Reference Groups and consideration of public submissions to the AER on our Final Plan and GSR Response.

A summary of customer and stakeholder feedback is provided in Table 1.1 below.

Table 1.1: Summary of submissions on incentives

What we heard	Our response
Public submissions on our Final Plan and GSR Response	
We did not receive any feedback through stakeholder submissions on the ECM.	Our revised Final Plan ECM proposal responds to the AER's Draft Decision. See 1.4.1 below.
On the contingent CESS: • BSL was not supportive of removing augmentation from the CESS stating "Finding efficient ways to deliver safe and efficient services while avoiding unnecessary capex is particularly important in the current access arrangement, given the stranding risk identified".[1] • EUAA agrees with excluding certain capex from the CESS noting the relatively low level of this capex means the incentive for networks to incur efficient capex is not materially dampened.[2] • TRAC Partners disagrees with exclusion of augmentation capex from the CESS arguing we can in fact control factors of our augmentation spend including options for how to configure the network and unit rates for engaging contractors.[3]	Our revised Final Plan maintains our position for the exclusion of augmentation capex from the Contingent CESS. We consider the same arguments made by the AER in relation to connections capex apply to augmentation capex where higher or lower volumes of growth can trigger or defer augmentation which may lead to large windfall gains or losses that are unrelated to the incentive mechanism. This is discussed further at 1.4.2 below.

1.3 AER Draft Decision

The AER’s Draft Decision on our incentives proposal:

- Accepted the continuation of the ECM;
- Applied a lower ECM carryover amount from the current AA period due to the following adjustments;
  - removing ECM exclusions approved for the 2013–17 access arrangement period (2013–17 period) which were not applicable to the 2018–22 period from the 2016 and 2017 opex which is used to calculate the efficiency gain in 2018 (+$0.9 million);
  - excluding ancillary reference services from total opex (-$3.6 million); and

[1] Brotherhood of St Laurence, 2022 Victorian gas access arrangements, September 2022, p 29 (BSL Submission).
[2] EUAA, Submission to Victorian Gas Access Arrangements Proposal 2023-28, September 2022, p 7 (EUAA Submission).
[3] TRAC Partners for BSL, Response to Vic DBs’ 2023-28 Access Arrangement Proposals, September 2022, p 51 (TRAC for BSL Submission).

  - updating actual inflation for calendar year 2022 and forecast inflation for 2022–23 (-$0.8 million);
- Accepted the continuation of the contingent CESS;
- Accepted the exclusion of connections capex from the contingent CESS in the next AA period;
- Did not comment on our proposal to also exclude augmentation capex from the contingent CESS in the next AA period for similar reasons as the exclusion of connections capex;
- Applied a marginally higher CESS penalty from the current AA period following updates to inflation and real vanilla WACC; and
- Included amendments to our AA document to give effect to its Draft Decision.

We have provided a summary of the AER's Draft Decision on incentives for the next AA period in Table 1.2 below.

Table 1.2: Summary of the AER's Draft Decision on incentives

	AER Draft Decision	AER Comment
ECM	Modify	The AER approved the continuation of the ECM. The AER made adjustments to the calculation of carryovers from the current AA period to remove ECM exclusions that are no longer applicable, exclude ARS from total opex and update for more recent inflation.
Contingent CESS	Accept	The AER approved the continuation of the Contingent CESS. The AER updated for more recent inflation and rate of return in the calculation of carryovers from the current AA period.
CESS exclusions	Accept	The AER approved modification of the Contingent CESS in the next AA period to exclude connections capex consistent with similar recent decisions in NSW and SA. The AER did not comment on our proposal to also exclude augmentation capex from the Contingent CESS in the next AA period.
AA document	Modify	The AER made a number of modifications to the wording in our AA document to give effect to its Draft Decision on incentives.

Note: In this 'traffic light' table, green shading represents the AER's acceptance of our GSR Response, orange represents the AER's modification of our GSR Response and red shading represents the AER's rejection of our GSR Response.

The following sections outline the reasons for the AER's Draft Decision on incentives.

1.3.1 ECM carryovers from the current AA period

The AER made three adjustments to the ECM calculation of carryovers from the current AA period:

- Removal of ECM exclusions approved for the 2013–17 access arrangement period (2013–17 period) which were not applicable to the 2018–22 period from the 2016 and 2017 opex which is used to calculate the efficiency gain in 2018 (+$0.9 million);
- Exclusion of ancillary reference services from total opex (-$3.6 million); and
- Update of actual inflation for calendar year 2022 and forecast inflation for 2022–23 (-$0.8 million).

The following summarises the reasons for these adjustments in the Draft Decision.

Remove ECM exclusions that are no longer applicable

To calculate the efficiency gain/loss in 2018, the efficiency gain/loss from the final year of the previous AA period (2017) and the base year (2016) must be subtracted to ensure any efficiency gains or losses between the final year and the base year are only held for five years. The AER notes to account for true efficiency gains or losses, the 2016 and 2017 opex used to calculate this must be on the same basis (i.e. include the same exclusions) as applicable to the current AA period.[4]

Exclude ARS from total opex

The AER agrees ARS should be excluded from total opex in the 2023–28 period as they are not forecast using a single year revealed cost approach. The AER considers ARS should also be excluded from total opex for the 2018–22 period for the same reason.[5]

The AER adds that ARS are subject to a separate form of control (separate price cap) compared to the haulage reference services it determines opex for and are only recovered from customers who request these services. For this reason, the AER considers it would not be appropriate to share cost efficiencies due to ancillary reference services across all customers when the cost of ancillary reference services is not shared across all customers.[6]

Inflation

The AER has used inflation forecasts in the Reserve Bank of Australia's (RBA) November 2022 Statement on Monetary Policy, which was published after we submitted our proposal. The AER also notes it will update its inflation forecasts and December 2022 actuals to reflect the latest available inflation figures from the RBA and Australian Bureau of Statistics in its Final Decision.[7]

1.3.2 CESS carryovers from the current AA period

The AER updated for more recent inflation and rate of return in the calculation of CESS carryovers from the current AA period which saw the penalty increase from $21.5 million to $21.7 million.

1.3.3 Exclusions from the contingent CESS

The AER agrees there are benefits of updating the Contingent CESS to remove connections capex, which will avoid windfall gains or losses that are related to higher or lower volumes of new connections and unrelated to the incentive mechanism.[8]

1.4 Our revised Final Plan

Our revised Final Plan on incentives:

- Applies a higher ECM carryover amount from the current AA period than the AER on account of:

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[4] AER, Attachment 8: Efficiency carryover mechanism | Draft decision – Australian Gas Networks (VIC & Albury) Access Arrangement 2023–28, p 5 (AER Attachment 8: Efficiency carryover mechanism).
[5] AER, Attachment 8: Efficiency carryover mechanism, p 5.
[6] AER, Attachment 8: Efficiency carryover mechanism, pp 5-6.
[7] AER, Attachment 8: Efficiency carryover mechanism, pp 4-5.
[8] AER, Attachment 13: Capital expenditure sharing scheme | Draft decision – Australian Gas Networks (VIC & Albury) Access Arrangement 2023–28, pp 3-4.

  - Accepting the removal of ECM exclusions approved for the 2013–17 access arrangement period (2013–17 period) which were not applicable to the 2018–22 period from the 2016 and 2017 opex which is used to calculate the efficiency gain in 2018 (no change); but
  - Not accepting the exclusion of ARS from total opex, on the basis that ARS were forecast using a single year revealed cost approach in the current AA period, and therefore it is not clear they should be excluded from the calculation of carryovers for that period (+$3.6 million).
- Accepts the use of most recent inflation and rate of return estimates in the calculation of carryovers under both the ECM and the contingent CESS;
- Updates the calculation of carryovers from the contingent CESS in the current AA period for draft actual capex in 2022;
- Re-proposes that augmentation capex also be excluded from the calculation of efficiency gains under the contingent CESS in the next AA period; and
- Includes the majority of the AER's amendments to our AA document to give effect to its Draft Decision.

A summary of our response to the AER's Draft Decision is provided in Table 1.3 below.

Table 1.3: Summary of our response to the AER's Draft Decision on incentives

	AER Draft Decision	Our response	Our comment
ECM	Modify	Modify	We have modified the calculation of carryovers from the ECM for the current AA period, specifically; • We accept the AER's adjustment to 2016 and 2017 opex to remove exclusions that are no longer applicable; but • We have included ARS in total opex as it was forecast using a single year revealed approach in the current AA period. We accept the ECM to be applied to the next AA period. More information on our positions is provided at 1.4.1 below.
Contingent CESS	Accept	Accept	We accept the continuation of the contingent CESS in the next AA period and comment on the CESS exclusions below. We have updated the calculation of carryovers from the contingent CESS in the current AA period for draft actual capex in 2022.
CESS exclusions	Accept	Modify	We welcome the AER's decisions to accept the exclusion of connections capex from the CESS in the next AA period. We have reproposed the exclusion of augmentation capex from the CESS in the next AA period. More information on our positions is provided at 1.4.2 below.
AA document	Modify	Accept	We accept the majority of the AER's amendments to our AA document to give effect to its Draft Decision.

Note: In this 'traffic light' table, green shading represents the AER's acceptance of our GSR Response, orange represents the AER's modification of our GSR Response and red shading represents the AER's rejection of our GSR Response.

The following sections outline the reasons for our response to the AER's Draft Decision in our revised Final Plan.

1.4.1 ECM carryovers from the current AA period

Remove ECM exclusions that are no longer applicable

We agree with the AER that is it appropriate to remove ECM exclusions approved for the 2013–17 access arrangement period (2013–17 period) which were not applicable to the 2018–22 period from the 2016 and 2017 opex which is used to calculate the efficiency gain in 2018 and have maintained this in our revised Final Plan ECM calculation.

Exclude ARS from total opex

We do not agree that ARS should be excluded from the calculation of ECM carryovers in the current AA period under clause 5.1(iii)(g)(ii) of the AA. Clause 5.1(iii)(g)(ii) states:

> g The following costs will be excluded from the operation of the efficiency carryover mechanism:
>
> …
>
> ii any cost category that is not forecast using a single year revealed cost approach in the access arrangement period following this Access Arrangement Period (intended to commence 1 January 2023). These costs may include, debt raising costs and unaccounted for gas expenses

We have reviewed opex modelling and the AA document for the current AA period and consider it is not appropriate to exclude ARS from total opex when calculating carryovers because:

- Clause 5.1(iii)(h)(i) of the AA sets out the forecast expenditure amounts that are used as the basis for measuring efficiencies and exclude the costs listed in clause 5.1([g])(i)–(iii). The amounts set out in the table that follows are inclusive of ARS and exclusive of debt raising costs; and
- The forecast ARS for the current AA period was forecast using a single year revealed cost approach.

Inflation

We agree with the AER that it is appropriate to update actual inflation for calendar year 2022 and forecast inflation for 2022–23 for the latest information from the ABS and RBA. We note there will be further updates available for calendar year 2022 and forecast inflation for 2022–23 after submission of our revised Final Plan that can be considered when the AER is making its Final Decision.

1.4.2 CESS carryovers from the current AA period

We have updated the calculation of CESS carryovers from the current AA period for draft actual capex in 2022. Draft actual capex in 2022 is $27 million lower than our estimate submitted in our Final Plan and that accepted by the AER in its Draft Decision. This sees the business share of the capex overspend (which is 30%) reduce by $9 million to $13 million.

Table 1.4 below outlines the CESS carryovers from the current AA period in our revised Final Plan and in the AER's Draft Decision.

Table 1.4: CESS carryovers from the current AA period

$m 2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	Total AA
AER Draft Decision	(4.3)	(4.3)	(4.3)	(4.3)	(4.3)	(21.7)
Revised Final Plan	**(2.5)**	**(2.5)**	**(2.5)**	**(2.5)**	**(2.5)**	**(12.5)**

The variance in draft actual capex for 2022 compared to our Final Plan estimate is explained in Attachment 9.16 Response on Capital Expenditure.

1.4.3 Exclusions from the contingent CESS

We welcome the AER's Draft Decision to update the Contingent CESS in the next AA period to remove connections capex.

We also repropose that augmentation capex be excluded from the contingent CESS in the next AA period. The exclusion of augmentation capex from the CESS was not addressed in the AER's Draft Decision.

Augmentation capex is largely out of our control for the same reasons as connections capex. It is also heavily influenced by volumes of new customer connections in our network, as well as existing customer disconnections.

Our GSR Response on forecast augmentation capex (see Attachment 9.11A to our Revisions to Final Plan – GSR Response) shows the sensitivity of network augmentation to new customer connections and existing customer disconnections over the next AA period. If we see higher volumes of new customer connections or lower volumes of existing customer disconnections compared to our forecast, we are likely to need to undertake augmentation work that we said could be deferred in our GSR Response. Likewise, if we see lower volumes of new customer connections or higher volumes of existing customer disconnections compared to our forecast, we are likely able to defer augmentation work that we have said would still need to occur in our GSR Response.

While we can control the cost of each augmentation to some extent, we cannot control whether the volume of new customer connections or existing customer disconnections is higher or lower than forecast. This may lead to large windfall gains or losses that are not related to the incentive mechanism. Therefore, we consider it is appropriate for augmentation capex to be excluded from the contingent CESS in the next AA period.

1.4.4 AA document

We have accepted the majority of the AER's proposed revisions to the ECM in our AA document. Each of the proposed revisions are addressed in Appendix A.

1.5 Summary

In summary, our revised Final Plan on incentives:

- Accepts the continuation of the ECM in the next AA period;
- Applies a higher ECM carryover amount from the current AA period than the AER on account of;
    - Accepting the removal of ECM exclusions approved for the 2013–17 access arrangement period (2013–17 period) which were not applicable to the 2018–22 period from the 2016 and 2017 opex which is used to calculate the efficiency gain in 2018 (no change); but
    - Not accepting the exclusion of ARS from total opex, on the basis that ARS were forecast using a single year revealed cost approach in the current AA period, and therefore it is not clear they should be excluded from the calculation of carryovers for that period (+$3.6 million).
- Accepts the use of most recent inflation and rate of return estimates in the calculation of carryovers under both the ECM and the contingent CESS;
- Accepts the continuation of the contingent CESS in the next AA period, with connections capex to be excluded;
- Reproposes that augmentation capex also be excluded from the contingent CESS in the next AA period; and
- Includes the majority of the AER's amendments to our AA document to give effect to its Draft Decision.

Summary of revisions to ECM provisions in AA document

Table 1.5 below outlines the AER's proposed revisions and our response on the ECM in our AA document.

Table 1.5: Summary of revisions to ECM provisions in AA document

Revision	AER Draft Decision	Our revised Final Plan
8.1	Amend clause 5.1(iii)(a) so that it reads: a) The incremental efficiency gain (loss) for 2023/24 will be calculated using: $I_{2023/24} = (F_{2023/24} - A_{2023/24}) - 2 \times (F_{HY2023} - A_{HY2023}) + (F_{2021} - A_{2021})$ where: $I_{2023/24}$ is the incremental efficiency gain (loss) for Regulatory Year 2023–24. $F_{2023/24}$ is the approved forecast operating expenditure for Regulatory Year 2023–24. $A_{2023/24}$ is the actual operating expenditure for Regulatory Year 2023–24. F_{HY2023} is the approved forecast operating expenditure for the six-month extension period from 1 January 2023 to 30 June 2023. A_{HY2023} is the actual operating expenditure for the six-month extension period from 1 January 2023 to 30 June 2023. F_{2021} is the approved forecast operating expenditure for Regulatory Year 2021. A_{2021} is the actual operating expenditure for Regulatory Year 2021.	Accept

Revision	AER Draft Decision	Our revised Final Plan
8.2	Include a new clause which reads: Prior to the submission date for the Access Arrangement Period commencing 1 July 2028, actual operating expenditure data will be available for the regulatory year 2022. Where the Service Provider's actual operating expenditure differs from the operating expenditure estimate used to calculate the efficiency carryover mechanism, a true-up will be made to account for the difference. The true-up for regulatory year 2022 will be: $T_{2022} = -0.5 \times [(F_{2022} - A_{2022}) - (F_{2021} - A_{2021})]$ where: T_{2022} is the true-up for Regulatory Year 2022 F_{2022} is the forecast operating expenditure for Regulatory Year 2022 A_{2022} is the actual operating expenditure for Regulatory Year 2022 F_{2021} is the forecast operating expenditure Regulatory Year 2021 A_{2021} is the actual operating expenditure for Regulatory Year 2021	Accept
8.3	Include a new clause which reads: Prior to the submission date for the Access Arrangement Period commencing 1 July 2028, actual operating expenditure data will be available for the six-month extension period from 1 January 2023 to 30 June 2023. Where the Service Provider's actual operating expenditure differs from the operating expenditure estimate used to calculate the efficiency carryover mechanism, a true-up will be made to account for the difference. The true-up for the six-month extension period from 1 January 2023 to 30 June 2023 will be: $T_{HY2023} = (F_{HY2023} - A_{HY2023}) - 0.5 \times (F_{2022} - A_{2022})$ where: T_{HY2023} is the true-up for the six-month extension period from 1 January 2023 to 30 June 2023 F_{HY2023} is the forecast operating expenditure for the six-month extension period from 1 January 2023 to 30 June 2023 A_{HY2023} is the actual operating expenditure for the six-month extension period from 1 January 2023 to 30 June 2023 F_{2022} is the forecast operating expenditure Regulatory Year 2022 A_{2022} is the actual operating expenditure for Regulatory Year 2022 The T_{HY2023} true-up amount will be applied as a revenue adjustment to Regulatory Year 2028–29 of the Access Arrangement Period commencing 1 July 2028.	Accept. We note that we understand our proposed clause 5.1(iii)(a) and the AER's Draft Decision clause 5.1(iii)(a) to already incorporate this true-up.
8.4	Amend clause 5.1(iii)(g)(i) so that it reads: (i) movements in provisions related to opex.	Accept

Revision	AER Draft Decision	Our revised Final Plan
8.5	Amend clause 5.1(iii)(g)(ii) so that it reads: (ii) any cost category that is not forecast using a single year revealed cost approach in the access arrangement period following this Access Arrangement Period (intended to commence 1 July 2028). These costs may include, debt raising costs, unaccounted for gas and priority service program expenses.	Accept
8.6	Amend clause 5.1(iii)(g)(iii) so that it reads: (iii) any cost that the Regulator determines to exclude from the operation of the efficiency carryover mechanism in the 2023–28 period, which would not promote the National Gas Objective.	Accept
8.7	Include a new clause, clause 5.1 (iii)(g)(iv), which reads: (iv) ancillary reference services.	Accept
8.8	Include a new clause which reads: Where the Service Provider changes its approach to classifying costs as either capital expenditure or operating expenditure during the Access Arrangement Period, the Service Provider will report the actual operating expenditure, to align the accounting treatment of expenditure within a period with that in the approved expenditure for that period (reflecting the AER's final decision on this access arrangement).	Accept
8.9	Delete clause 5.1(iii)(i)	Reject. We consider this table is useful in the preparation and external review of Regulatory Information Notices (RINs) and therefore should be maintained.