Jemena Gas Networks (NSW) Ltd

2025-30 Access Arrangement Proposal

Attachment 7.11

Incentive schemes

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Abbreviations

AA	Access Arrangement
CP	Contingent Payment Index
Capex	Capital Expenditure
CESS	Capital Expenditure Sharing Scheme
ECM	Efficiency Carryover Mechanism
NGL	National Gas Law
NGR	National Gas Rules
Opex	Operating expenditure
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index

Overview

This document sets out the incentives schemes that we are proposing for the 2020-25 Access Arrangement (**AA**) period. This includes proposed changes to the incentive schemes.

The regulatory framework incentivises us to find more efficient ways of delivering our services, which ultimately benefits customers in the form of lower bills. Incentive schemes give us temporary rewards—increases in revenue for performing well—and penalties—reduction in revenue—if we don't. The schemes are designed to pass the benefits of improved efficiency to customers, over time. In this way, incentive schemes are an effective mechanism for promoting the long-term interests of customers.

The National Gas Rules (**NGR**) allow network businesses such as JGN to propose incentive mechanisms to encourage efficiency in the provision of services. The AER may also impose such schemes of network businesses. The incentives schemes must be consistent with the revenue and pricing principles in the NGR.[1]

The AER in its 2023 final decision on Review of incentives schemes for networks noted[2] -

> *Our assessment of the available data shows that the incentive schemes have driven significant improvements in performance through efficiency gains, which reduces prices over time, and reduces outages. For electricity distribution:*
>
> - *opex is down 30 per cent per customer since 2011/12*
> - *capex is down around 50 per cent per customer since 2011/12*
> - *these efficiency gains have contributed to the 35 per cent reduction in revenues per customer since 2014/15*
> - *in 2021 we also had a record low frequency and duration of outages, with improvements of 20 to 30 per cent* in those measures over the past 10 years.
>
> *While NSPs have been rewarded for the efficiency gains, the majority of benefits have gone to consumers. We therefore propose to retain the schemes with modifications.*

Both incentive schemes have delivered efficiencies for gas network businesses as well. Therefore, as part of the 2025-30 AA, we are proposing to:

- retain the Efficiency Carryover Mechanism (**ECM**), but modified to account for changes in our reference service classifications; and
- retain the Capital Expenditure Sharing Scheme (**CESS**), but modified to exclude renewable gas connection related capital expenditure (**capex**) in addition to the standard customer initiated connection capex.

These schemes will contribute to plans to improve JGN's long term cost-competitiveness, and will facilitate us in delivering a safe and reliable gas service at an affordable price that our customers expect.

1 Rule 98, NGR.

2 *AER - Final decision - Review of incentive schemes for networks - 28 April 2023*, Pg. 4

1. Efficiency Carryover Mechanism

1.1 ECM under the 2020-25 Access Arrangement

We are currently subject to an operating expenditure (**opex**) incentive scheme, which is commonly referred to as an ECM. The scheme provides us with a continuous incentive to identify and deliver improvements to operating expenditure efficiency. Any savings that we make are shared with our customers in a ratio of approximately 70% (customers): 30% (JGN).

As a result of our performance against this incentive scheme, we will either receive a reward or penalty in our revenue for the following regulatory period. In other words, our performance in the current regulatory period impacts the amount of revenue we receive in the next regulatory period.

We are forecasting additional revenue of $4M over the 2025-30 regulatory period under this incentive scheme as our share of improvements made in the current regulatory period.

Adjustments for SaaS implementation costs

We have made adjustments in our reported opex to exclude Software as a Service (**SaaS**) implementation costs from opex and instead reclassified them as capex for the current regulatory period.

Historically, SaaS implementation costs were treated as capex and included within our capex allowance in the current regulatory period. In April 2021, the International Financial Reporting Interpretations Committee (**IFRIC**) released an agenda decision classifying SaaS implementation costs as opex. Following the AER's guidance, we began reporting these costs as opex from 2021-22 in our annual RIN submissions and documenting the amount of SaaS costs reported in opex in the Basis of Preparation.

For the purpose of calculating efficiency gains or losses in the ECM and CESS, it is crucial to compare allowances and actuals on a like-for-like basis. The AER stated in its recent NSW decisions[3] –

> *… we consider our August 2022 advice, to align the accounting treatment of expenditure within a period with the approved expenditure treatment for that period, represents the appropriate approach for regulatory purposes. Under this approach there would be no opportunity for networks to incur windfall gains or losses that have resulted purely from movement of expenditure between opex and capex due to mid-period accounting changes.*

For JGN, SaaS implementation costs are included in the capex allowance in the current regulatory period. Therefore, we have adjusted our actual expenditure to reallocate these costs from opex to capex. This ensures that the cost classification of actuals is comparable to allowances. We have transparently shown this adjustment in our opex model (*JGN-Att 6.3M-Operating expenditure forecasting model*) to remove SaaS costs and in our capex model (*JGN-Att 5.2M-Capital expenditure forecast model*) to include SaaS costs. The expenditure, after the SaaS cost adjustment, is then used in the ECM (*JGN - Att 7.9M - ECM model*) and CESS (*JGN - Att 7.12M - CESS model*).

1.2 What we have heard from our customers

Affordability was one the key themes that arose throughout our customer engagement program. We believe that retaining the ECM for the 2025-30 regulatory period is consistent with the feedback from our customers, and in their long-term interests as it will incentivise us to deliver ongoing operating cost efficiencies, and remain cost competitive.

[3] AER, *Draft Decision Attachment 6 - Operating expenditure - Ausgrid - 2024-29 Distribution revenue proposal - September 2023*, Pg. 18

1.3 ECM for the 2025-30 Access Arrangement Period

We believe that retaining the ECM is consistent with the revenue and pricing principles in the NGR. It incentivises efficient investment in opex programs while providing JGN with a reasonable opportunity to recover at least its efficient operating costs through the adjustment for specified uncontrollable costs.

In the current regulatory period, our opex allowance and the ECM encompass reference services which includes both haulage and ancillary reference services. From 1 July 2025, our existing reference service will be split into Transportation Reference Service (**Transportation RS**) and Ancillary Reference Services (**Ancillary RS**). Consequently, opex forecasts for Transportation and Ancillary RS will be treated separately for the 2025-2030 regulatory period. Transportation RS opex will be forecasted using a base-step-trend approach[4], while Ancillary RS will be forecasted based on a bottom-up cost build-up for each individual service[5].

The ECM, also known as EBSS (efficiency benefit sharing scheme) in electricity determinations, is designed to work together with the AER's 'base-step-trend' opex forecasting approach to deliver cost savings to customers. The AER highlighted in its efficiency benefit sharing scheme guidelines that –

'The EBSS is intrinsically linked to the forecasting approach for opex… known as the revealed cost base-step-trend forecasting approach.' [6]

The revealed base year opex in the ECM is used as the 'base' to forecast future opex using the AER's base-step-trend approach. As networks respond to the incentive scheme by reducing revealed opex over time, opex forecasts decrease from one period to the next, resulting in lower revenue to be recovered from customers and delivering long-term savings to customers.

In the current regulatory period, our Transportation and Ancillary RS are treated as a single reference service. Opex for both services are forecasted together using the base-step-trend approach and are included as part of the ECM. For the next regulatory period, only Transportation RS will be forecasted using the base-step-trend approach, while Ancillary RS will no longer be included. To maintain consistency between the opex forecasting approach and ECM, we propose to modify the opex assessed under the ECM by excluding Ancillary RS opex.

In accordance with this proposal, we make the following amendments to our AA:

- include an additional line item 'Ancillary Reference Services' in paragraph 12.1 (h) in relation to the costs to be excluded from the operation of the ECM.

4 Our TRS opex forecast is provided in *JGN-Att 6.1-Operating expenditure*.

5 Our ARS forecast of costs is provided in *JGN-Att 7.2M-Ancillary services model*.

6 AER, *Efficiency Benefit Sharing Scheme for Electricity Network Service Providers - November 2013*, Pg. 4

2. Capital Expenditure Sharing Scheme

2.1 CESS under the 2020-25 Access Arrangement

We are currently subject to a capex incentive scheme, which is commonly referred to as CESS. The scheme provides us with a continuous incentive to identify and deliver improvements to capex efficiency. The savings we make are shared with our customers in a ratio of 70% (customers): 30% (JGN) in line with ECM.

Our capex performance in the current regulatory period under this incentive scheme directly impacts the allowed revenues in the subsequent regulatory period. The allowed revenue may be increased to reward capex underspends or decreased to penalise capex overspends. Additionally, to ensure lower capex does not compromise service standards, the reward amounts are modified by a contingent payment index (**CP**) set out in the AA. If our service performance fall below target levels, reward amounts are reduced. If our contingent payment index fall below a set threshold, we do not receive any rewards. Conversely, the contingent payment index does not apply to penalties, so if a penalty is incurred, it will not be reduced.

The current regulatory period is the first period we operated under a CESS. We have achieved our performance targets in delivering safe and reliable services to our customers while underspending our capex allowances. As a result, we are forecasting additional revenue of $30M over the 2025-30 regulatory period for our capex underspent in the current period.

Our service performance in 2019-24

We compared our actual and estimate service performance over 2019-24 against the targets set in our 2020-25 AA and calculated the contingent payment index for the current regulatory period. This is summarised in Table 2–1below. We have achieved our overall service performance targets with a contingent payment index of 108.9, above the required threshold of 100. It indicates that we are entitled to receive 100% of the CESS rewards for our efficient capex underspent in the current regulatory period.

Table 2–1: Contingent Payment Index 2019-24

Service performance measures	Unit	Target	Actual/ Estimate[7]	Index	Weight	Contribution to Index
Unplanned SAIFI	outages per 1000 customers	3.33	3.67	89.8	10%	9.0
Unplanned SAIDI	hours per 1000 customers	13.07	17.03	69.7	10%	7.0
Mains and services leaks	leaks per km of main	0.16	0.13	117.7	30%	35.3
Meter leaks	leaks per 1000 customers	8.15	7.36	109.7	10%	11.0
Poor quality supply	events per 1000 customers	0.92	0.70	124.0	30%	37.2
Meter read estimation rate	% of reads estimated	5.93%	6.24%	94.9	10%	9.5
Contingent Payment Index (CP)						**108.9**

Capex deferrals

The CESS payments need to be adjusted where we defer capex projects in the current AA period to the next AA period, as defined in paragraph 13.1(m)(i) of our 2020-25 AA. It requires the following three criteria to be satisfied before applying a CESS adjustment to account for the deferred capex:

1. the amount of the deferred capital expenditure in the Access Arrangement Period is material; and

[7] This includes actuals for 2018-19 to 2022-23 and estimates for 2023-24. 2023-24 will be updated to actuals in our revised proposal when the data becomes available. We provide the data sources and calculations of the service performance measures in *JGN - Att 7.12M - CESS model - 20240628*.

2. the amount of the estimated underspend in capital expenditure in the Access Arrangement Period is material; and

3. total approved forecast capital expenditure in the subsequent access arrangement period is materially higher than it is likely to have been if a material amount of capital expenditure was not deferred in the Access Arrangement Period.

We have assessed the projects in the 2020-25 period that are partially or fully deferred into the 2025-30 period against the criteria set out above. The deferred projects represent 2% of the capex allowance in the 2020-25 period. The re-proposed capex accounts for 2% of our total capex proposal for the 2025-30 period. We do not believe it meets criteria 1 and 3, and therefore have not proposed a CESS adjustment for deferred capex.

2.2 What we have heard from our customers

Affordability was one the key themes that arose throughout our customer engagement program. We believe that retaining the CESS for the 2025-30 AA period is consistent with the feedback from our customers, and in their long-term interests as it will incentivise us to deliver ongoing cost efficiencies, and remain cost competitive.

2.3 CESS for the 2025-30 Access Arrangement Period

We believe that retaining the CESS is consistent with the revenue and pricing principles in the NGR as it incentivises efficient investment in capex programs. When operating together with ECM, it ensures that all of our expenditure is covered by incentive schemes. We propose to continue the CESS in the 2025-30 regulatory period, with modifications to capex exclusions and updates to service performance targets.

Scope of capex included in efficiency measurement

In the 2020-25 regulatory period, the capex assessed under the CESS excludes costs associated with new connections. This exclusion was proposed and accepted by the AER based on strong customer support, recognising that such capex is driven by customer-initiated connection volumes beyond JGN's control. We, as a network business, should not be rewarded or penalised through CESS due to externally driven connection volumes being lower or higher than expected.

Since the implementation of CESS for JGN in the 2020-25 period, a new emissions reduction objective has been integrated into the National Gas Objective (**NGO**). This acknowledges that the long term interest of consumers now includes the achievement of Commonwealth, State and Territory targets for reducing Australian's greenhouse gas emissions. Additionally, the regulatory framework has evolved to recognise biomethane and hydrogen blends in gas networks, effective from early 2024. These changes will mean that we must allow renewable gas facilities to connect into our network, provided that it is technically feasible and safe to do so. As a result, in the 2025-30 regulatory period, we are expecting to connect renewable gas suppliers to our network. These connections in some instances require us to make investments in accommodating the interconnection of these new facilities and extend our network to the production site.

Similar to capex associated with customer-initiated connections, the investments we make in connecting renewable gas facilities are initiated by parties developing and constructing these facilities within our network. The number of facilities seeking connections to our network are beyond our control. Therefore, we propose to exclude capex for renewable gas connections from the CESS. This ensures that our performance is not unduly influenced by the number of facilities seeking connection. By doing so, the capex categories covered under the CESS can accurately reflect controllable expenditure, and that rewards and penalties genuinely reflect efficiency improvements we achieve.

Contingent Payment Index

For the 2025-30 regulatory period, we propose to retain the CESS and its operation with the contingent payment index. The service performance targets under the contingent payment index in the 2020-25 regulatory period were set based on five years of historical data from 2014 to 2018. We propose to update the targets based on the latest five years of data from 2019 to 2023, as shown in Table 2–2 below. We provide the calculations of our proposed targets in *JGN - Att 7.12M - CESS model - 20240628*.

Table 2–2: Service performance targets[8]

Measure	Basis	Target
Unplanned SAIFI	Outages per 1,000 customers	3.57
Unplanned SAIDI	Hours per 1,000 customers	34.50
Mains and services leaks	Leaks per km of main	0.15
Meter leaks	Leaks per 1,000 customers	8.32
Poor quality supply	Events per 1,000 customers	0.58
Estimated meter reads	% estimates	5.41%

[8] These targets may be updated at the time of revised proposal when the actual data for 2023-24 is available