Draft decision

Jemena Gas Networks (NSW) access arrangement 2025 to 2030
(1 July 2025 to 30 June 2030)

Attachment 13 – Capital expenditure sharing scheme

November 2024

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
Email: aerinquiry@aer.gov.au
Tel: 1300 585 165

AER reference: AER22005460

Amendment record

Version	Date	Pages
1	29 November 2024	14

List of attachments

This attachment forms part of our draft decision on the access arrangement that will apply to Jemena Gas Networks (NSW) for the 2025–30 access arrangement period. It should be read with all other parts of this draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement (no attachment - covered in the Overview)

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency carryover mechanism

Attachment 9 – Reference tariff setting

Attachment 10 – Reference tariff variation mechanism

Attachment 11 – Non-tariff components

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

Contents

List of attachments .... **iii**

13 Capital expenditure sharing scheme **1**

13.1 Draft decision 1

13.2 JGN's proposal 2

13.3 Assessment approach 5

13.4 Reasons for draft decision 6

13.5 Revisions 9

Glossary **10**

13 Capital expenditure sharing scheme

This attachment outlines our assessment of Jemena Gas Networks' (JGN) proposal for a capital expenditure sharing scheme (CESS) for the 2025–30 access arrangement period (2025–30 period). This includes CESS rewards or penalties to be applied next period based on JGN's performance this period.

The CESS is designed to incentivise efficient spending on capital expenditure (capex) by rewarding Network Service Providers (NSP) for lowering their capex below the amount approved for the access arrangement period. The rewards are shared between the NSPs and consumers.

To ensure lower capex does not compromise service standards, the reward amounts are modified by a contingent payment factor (CPF). If service standards fall below target levels, reward amounts are reduced. Below a certain service standard threshold, rewards are reduced to 0. Conversely, the CESS will lead to a penalty if the NSP spends above its approved capex forecast. The CPF does not apply to penalties, so if a penalty is incurred, it will not be reduced.

JGN's proposed CESS design, and our draft decision, for the 2025-30 period is based on JGN's 2020-25 CESS design, but with adjustments. The most significant adjustment our draft decision requires is that the CESS' sharing factor will now be tiered, as per our update to the CESS mechanism in April 2023.[1]

13.1 Draft decision

JGN is expected to spend less capex in the 2020–25 access arrangement period than our forecast capex in the final decision for the 2020-25 access arrangement period. This results in a CESS reward being added to JGN's revenue in the 2025–30 access arrangement period. Our draft decision is to not approve JGN's proposed CESS revenue increment of $30.27 million ($2024-25), but our alternative CESS revenue increment of $30.61 million is broadly similar. Table 13.1 outlines JGN's proposal and our draft decision.

Table 13.1 Our draft decision on JGN's CESS increments ($ million, $2024/25)

	2023-24	2024–25	2025–26	2026–27	2027–28	Total
JGN's proposed increment	6.05	6.05	6.05	6.05	6.05	30.27
AER draft decision increment	6.12	6.12	6.12	6.12	6.12	30.61

Source: AER analysis. JGN, *JGN - Att 7.12M - CESS model - June 2024*, June 2024. Numbers may not add up due to rounding.

The difference between our decision and JGN's proposal is that we have updated the consumer price index (CPI) and real vanilla weighted average cost of capital (WACC)

1 AER, *Final decision - Review of incentive schemes for networks*, April 2023.

figures.[2] We are otherwise satisfied that JGN's application of the CESS is appropriate, and consistent with the CESS mechanism set out in its access arrangement.

We accept JGN's proposal to retain a CESS for the 2025–30 Access Arrangement period, including the exclusion of regular connections capex from the CESS.[3] JGN has sought to exclude renewables connection capex forecast from the calculation of the CESS. We note that, in our draft decision for capex, we have not accepted these projects. Consequently, they do not currently form part of forecast capex against which the CESS is calculated.

We have concerns about excluding renewable connections capex (if any) from the CESS. In particular, we consider that JGN can exert a greater degree of control over renewable connections capex than it can on regular connections spending. We give our reasoning in section 13.4.2.2. If, in its revised proposal, JGN proposes to exclude renewable connections capex from the CESS, we expect JGN to address these issues.

Separately, we require JGN to apply a tiered sharing factor to its CESS mechanism, as per the AER's update to the CESS mechanism in April 2023. The details of this update and our reasons are given in section 13.4.2.3.

13.2 JGN's proposal

13.2.1 CESS amounts from the 2020–25 access arrangement period

JGN proposed a $30.27 million ($2024/25) reward be added to its revenue in the 2025–30 access arrangement period.[4]

As part of its Consumer Performance Index, JGN has adopted measures to monitor service performance. The five target measures are:

- unplanned System Average Interruption Frequency Index (SAIFI) (weighting 10%)
- unplanned System Average Interruption Duration Index (SAIDI) (weighting 10%)
- mains and service leaks (weighting 30%)
- meter leaks (weighting 10%)
- poor quality supply (weighting 30%)

---

2 Attachment 2 on the capital base sets out our CPI draft decision, while Attachment 3 on rate of return details our vanilla WACC draft decision.

3 In this attachment, "regular connections" refers to all connections capex except renewable connections capex.

4 JGN, *JGN - Att 7.12M - CESS model - June 2024*, June 2024.

- meter read estimation rate (weighting 10%)

Performance targets for each measure were set in our final decision for 2020-25 using the previous five years of historical data. JGN's performance against all its targets is represented by the contingent payment index, which then informs the CPF. The contingent payment index measures performance and can have any value. The CPF adjusts JGN's CESS revenue reward. The CPF is equal to the contingent payment index only between the values of 80 and 100: when the CPI is above 100, the CPF equals 100; when the CPI is below 80, the CPF equals 0.

The CPF is used to scale down rewards if service performance is less than the target level. Consistent with the previous access arrangement period's CESS, the threshold of performance below which no reward is payable to JGN for an underspend is an index score of 80 (base is 100). As seen in Table 13.2, owing to strong performance against its most heavily weighted targets, JGN has a contingent payment index of 108.9, leading to a CPF of 100. JGN will receive 100% of its revenue increment as a reward.

Table 13.2 JGN's reported performance and CPF

Measures	Actual	Target	Index	Weight	Contribution
Unplanned SAIFI	3.7	3.3	89.9	10%	9.0
Unplanned SAIDI	17.0	13.1	69.7	10%	7.0
Mains and services leaks	0.1	0.2	117.7	30%	35.3
Meter leaks	7.4	8.2	109.7	10%	11.0
Poor quality supply	0.7	0.9	124.0	30%	37.2
Meter read estimation rate	6.2%	5.9%	94.9	10%	9.5
Contingent Payment Index	108.9				
CPF	100%				

Source: JGN, *JGN - Att 7.12M - CESS model - June 2024*, June 2024. Numbers may not sum due to rounding.

13.2.2 Application of CESS in the 2025–30 access arrangement period

JGN proposes to continue using a CESS into the 2025-30 access arrangement period. It proposes to update the CESS from how it was implemented in the 2020–25 access arrangement period by excluding renewable connections capex. JGN argues that renewable connections capex is analogous to regular connections capex, which we allowed JGN to exclude in its 2020-25 access arrangement.[5]

13.2.2.1 Contingent payment index targets

As part of its CPF, JGN has adopted measures to monitor service performance. JGN broadly proposes to maintain the measures and weightings it used during the 2020-25 access

[5] AER, *AER - Final decision - JGN access arrangement 2020-25 - Attachment 13 - Capital expenditure sharing scheme - June 2020*, June 2020. For our reasoning, see: AER, *AER - JGN 2020-25 - Draft decision - Attachment 13 - Capital expenditure sharing scheme - November 2019*, November 2019.

arrangement period. It has formulated its targets using the average of the past five years of actual data. Table 13.3 outlines JGN's proposed performance targets.

Table 13.3 JGN's proposed performance targets ($ million, $2024/25)

	2018-19	2019–20	2020–21	2021–22	2022–23	Target	Weighting
Unplanned SAIFI	3.8	3.2	2.9	4.1	3.8	**3.6**	10%
Unplanned SAIDI	37.3	85.0	15.9	28.1	6.3	**34.5**	10%
Mains and services leaks	0.2	0.2	0.1	0.1	0.1	**0.1**	30%
Meter leaks	10.1	9.8	7.8	6.4	7.6	**8.3**	10%
Poor quality supply	0.4	0.4	0.5	0.9	0.7	**0.6**	30%
Meter read estimation rate	4.0%	4.1%	6.5%	8.8%	3.6%	**5.4%**	10%

Source: JGN, *JGN - Att 7.12M - CESS model - June 2024*, June 2024; JGN*, JGN - 2025-2030 - Access Arrangement - June 2024*, June 2024, pp. 97-98. Numbers may not add up due to rounding.

JGN notes that it has slightly changed how it calculates its unplanned SAIFI, unplanned SAIDI, meter leaks, and poor quality supply measures compared to their application in the 2020-25 access arrangement period. Each of these 4 measures is calculated on a per 1000 customers basis. In JGN's calculation of its targets and its reported performance for the 2020-25 access arrangement period, JGN only included residential customers in these calculations. For the 2025-30 access arrangement period, JGN proposes to include all customers (residential, commercial, and industrial) in its calculations of its targets and reported performance.

In response to an information request, JGN noted that in its access arrangement for 2020-25, the given calculations for these measures specify the "total customer numbers on the Network at the end of the Financial Year". JGN states: [6]

> 'The current period inputs for Contingent Payment Index target setting and performance measurement reflects only residential customers. By including commercial and industrial customers, the measures and performance measurement will align better with the definitions in the Access Arrangement which requires use of all customers.
>
> For the current period, the targets were inadvertently set using residential customers only, even though the Access Arrangement specified all customers. If commercial and industrial customers were included in the current period (for targets and performance measurement), there would be no impact on the CESS outcome.'

JGN only wants to update the calculation of customer numbers for the 2025-30 period. For the 2020-25 access arrangement, the CPF targets were calculated using only residential numbers, and so JGN has calculated its actual performance using only residential numbers.

6 JGN, *Response to IR#015 [Public]*, 30 September 2024; AER, *AER - Final decision - JGN access arrangement 2020-25 - Approved Access Arrangement for JGN (NSW) Ltd 2020-25 - June 2020 - Clean*, June 2020, pp.82-84.

13.2.2.2 The sharing factor

The CESS includes a sharing factor or ratio, which determines how an efficiency gain/loss is shared between the NSP and its customers. That is, if the NSP underspends/overspends, it will only receive certain percentage of that underspend/overspend as a CESS reward/penalty. That percentage is the sharing factor.

Following a review in 2023, the CESS mechanism was updated, most relevantly the sharing factor. Previously, the sharing factor was 30% without variation for both underspends and overspends. The updated guideline introduces a tiered sharing factor for underspends. 30% will apply to any underspend amount up to and including 10% of the approved capex forecast; and 20% will apply to any underspend amount greater than 10% of the approved forecast. For overspends, the sharing factor remains a constant 30%. In short, the updated scheme reduces the rewards when a network business outperforms against its approved forecast by more than 10% but maintains the same penalties for underperformance. This asymmetry is intended to reduce the costs of the CESS to consumers while maintaining strong incentives for efficiency.[7]

JGN's initial proposal made no mention of the updated sharing factor. However, in response to an information request, JGN clarified its position. JGN states it did not include a tiered sharing factor in its proposal to align with the CESS mechanism applied in the recent Victorian gas access arrangement resets (VIC GAAR) for 2023-28. Nevertheless, JGN states it is open to the AER's suggestions regarding potential amendments to the CESS.[8]

13.2.2.3 Capex applicable to the CESS

JGN proposes to continue excluding capex related to regular new connections from the CESS. This exclusion was first proposed and accepted for JGN's 2020-25 access arrangement. This was on the basis that such capex is driven by customer-initiated connection volumes broadly beyond JGN's control. As the purpose of the CESS is to incentivise efficient spending, the CESS should ideally apply only to capex within JGN's control.

In addition to capex relating to regular connections, JGN proposes to exclude renewable connections capex from the CESS in the 2025-30 period. Renewable connections capex includes the 8 biomethane renewable connections projects (in total $80.8 million) JGN is proposing.[9] JGN argues that these connection projects are analogous to regular connections, as they are customer-initiated and therefore beyond JGN's control. JGN argues that excluding renewable connections capex would better allow rewards and penalties to reflect efficiency improvements.

13.3 Assessment approach

A full access arrangement may include (or we may require it to include) one or more incentive mechanisms to encourage efficiency in the provision of services by the service

7 AER, *AER - Final decision - Capital expenditure incentive guideline - 28 April 2023*, April 2023, pp. 4-5.

8 JGN, *Response to IR#006 [Public version]*, 6 September 2024.

9 These projects are discussed in more detail in Attachment 5 of this draft decision.

provider.[10] Incentive mechanisms may provide for carrying over increments for efficiency gains, or decrements for efficiency losses, from one access arrangement period into the next.[11] An incentive mechanism must be consistent with the revenue and pricing principles.[12]

We consider the following revenue and pricing principle is most relevant for assessing JGN's proposed incentive scheme:

> 'A scheme pipeline service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes—
>
> (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and
>
> (b) the efficient provision of pipeline services; and
>
> (c) the efficient use of the pipeline.'[13]

13.4 Reasons for draft decision

13.4.1 CESS amounts from the 2020–25 access arrangement period

We consider JGN's proposed reward of $6.05 million per year and $30.27 million overall is consistent with the CESS mechanism in its 2020-25 access arrangement. As JGN performed strongly against its CPF targets, its CPF is 100, meaning it will receive 100% of its reward. However, we have updated the CESS calculations to reflect our draft decision on CPI and WACC.

These updates lead to a CESS reward of $6.12 million per year and $30.61 million overall. For its revised proposal, we require JGN to use up-to-date data on CPI, WACC, reported performance measures, and reported capex.

13.4.2 Application of the CESS in the 2025–30 access arrangement period

We accept JGN's proposal to apply the CESS in the 2025-30 access arrangement period, but we require JGN to introduce a tiered sharing factor. While we have not accepted renewable connections capex, we consider there are reasons why renewable connections capex (if accepted as part of any capex decision) should be included in the CESS. If JGN

10 NGR, r. 98(1).

11 NGR, r. 98(2).

12 NGR, r. 98(3).

13 NGL, s. 24(3).

proposes to exclude renewable connections capex from the CESS in its revised proposal, it should address the issues raised in this draft decision.

13.4.2.1 Contingent payment index targets

We accept JGN's contingent payment index targets. We also accept its proposal to include residential, commercial, and industrial customers in its calculations of CPF targets for the 2025-30 period. This is in line with the wording of the access arrangement which we accepted for the 2020-25 period, and which covers all customers. and we currently do not require changes to this wording for the 2025-30 period. Table 13.4 outlines our draft decision targets.

Table 13.4 JGN's actual performance and AER's draft decision targets for 2025-30

	2018-19	2019–20	2020–21	2021–22	2022–23	Target	Weighting
Unplanned SAIFI	3.8	3.2	2.9	4.1	3.8	3.6	10%
Unplanned SAIDI	37.3	85.0	15.9	28.1	6.3	34.5	10%
Mains and services leaks	0.2	0.2	0.1	0.1	0.1	0.1	30%
Meter leaks	10.1	9.8	7.8	6.4	7.6	8.3	10%
Poor quality supply	0.4	0.4	0.5	0.9	0.7	0.6	30%
Meter read estimation rate	4.0%	4.1%	6.5%	8.8%	3.6%	5.4%	10%

Source: JGN, *JGN - Att 7.12M - CESS model - June 2024*, June 2024; JGN, *JGN - 2025-2030 - Access Arrangement - June 2024*, June 2024, pp. 97-98. Numbers may not add up due to rounding.

The value of unplanned SAIDI in 2019-20 is relatively high (85.0 compared to the next highest of 37.3 and the minimum of 6.3). Nevertheless, we do not consider it high enough to be an outlier. This is also because the target is an average of all 5 values, and we consider that this relatively high value is balanced by the relatively low value for 2022-23 of 6.3. We do not require adjustment to the calculation of JGN's unplanned SAIDI target.

13.4.2.2 The sharing factor

Following a review in 2023, the CESS mechanism was updated, most relevantly the sharing factor. The updated scheme reduces the rewards when a network business outperforms against its approved forecast by more than 10% but maintains the same penalties for underperformance. This asymmetry is intended to reduce the costs of the CESS to consumers while maintaining strong incentives for efficiency.[14]

JGN's proposed access arrangement does not include the updated sharing factor.[15] As mentioned above, JGN states it did not include an updated sharing factor so that its CESS mechanism would align with those we approved in the 2023-28 VIC GAAR. However, the timing of the Victorian gas access arrangement reset made it difficult to incorporate the updated CESS guidelines. The updated CESS guideline was published in April 2023. The VIC GAAR began in 2022, and the updated CESS guideline was published a few months after the NSPs submitted their revised proposals. As such, there was not enough time to

[14] AER, *Final decision - Review of incentive schemes for networks*, April 2023.

[15] JGN, *2025–30 - Access Arrangement*, June 2024, pp. 25-31.

engage with the businesses and stakeholders on the benefits and costs of applying the updated sharing factor.

JGN states it is open to the AER's suggestions regarding potential amendments to the CESS.[16] We require JGN to update its proposed access arrangement in its revised proposal to incorporate the new tiered sharing factor as described in the updated CESS guidelines.

If JGN does not wish to include the new tiered sharing factor, it should provide its reasoning in its revised proposal.

We have so far received only one stakeholder submission on this topic. Consumer Challenge Panel 31 (CCP31) is in favour of updating the CESS sharing factor in line with our updated guidance.[17]

13.4.2.3 Capex applicable to the CESS

We accept the continued exclusion of capex related to regular new connections from the CESS. Our reasoning is provided in the draft and final decision for JGN's 2020-25 access arrangement.[18]

However, we consider that there are good reasons why renewable connections capex, if accepted, should be included in the CESS calculations. We consider renewable connections projects are not analogous to regular connections, because we consider JGN has greater discretion to control its spending on these projects.

In general, we consider the CESS mechanism encourages businesses to identify the lowest cost and technically acceptable approach. The renewables gas projects are novel, and the capital expenditure is significant, therefore there is a positive benefit in providing incentives for prudent and efficient investment on behalf of customers.

Regular connections capex is excluded from the CESS because the volume is largely outside of JGN's control, and it may not represent a gain or loss of efficiency. If the volume is lower than forecast, JGN benefits. If it is higher, JGN is penalised. In our draft decision for the 2020-25 access arrangement, we noted stakeholder concern that connections capex is driven by market forces for both volumes and unit rates.[19] The reason why regular connections are outside of JGN's control is that JGN is obligated to connect a customer provided the customer pays a connection charge determined in accordance with the requirements of the National Gas Rules.

Part 12A of the NGR sets out obligations on distributors relating to retail customers. A 'retail customer' is defined in section 2 of the NGL as 'a person to whom covered gas is sold for premises by a retailer'. We note that a renewable gas supplier is not a retail customer in section 2 of the NGL and, therefore, Part 12A has no application to the connection of

---

16 JGN, *Response to IR#006 [Public version]*, 6 September 2024.

17 CCP31, *CCP31 - Advice to the AER - JGN 2025-30 Access Arrangement Proposal and Issues paper - September 2024*, September 2024.

18 AER, *JGN 2020-25 - Draft decision - Attachment 13 - Capital expenditure sharing scheme*, November 2019; AER, *Final decision - JGN access arrangement 2020-25 - Attachment 13 - Capital expenditure sharing scheme*, June 2020.

19 AER, *JGN 2020-25 - Draft decision - Attachment 13 - Capital expenditure sharing scheme*, November 2019.

renewable gas suppliers. Thus, the provisions of the NGR that govern connection charges do not apply to these connections.

For these reasons, we consider that:

- JGN should amend the wording of the CESS exclusion in its access arrangement to refer to connections that it is required to provide under Part 12A of the NGR.
- If JGN still wishes to exclude renewable connections capex from the CESS in its revised proposal, it should further explain why this expenditure is largely outside of its control, including whether it is required to connect those customers and whether it can require those customers to pay the full cost of those connections.

We have so far received only one stakeholder submission on this topic. CCP31 is in favour of the continued exclusion of regular new connections capex from the CESS, and it views the exclusion of renewables connections capex as consistent with this position.[20] We invite further stakeholder submissions on the matter, in light of our view on renewable connections.

13.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable as set out in Table 13.5.

Table 13.5 JGN's CESS revisions

Revision	Amendment
Revision 13.1	Make revisions necessary to update CPI, real vanilla WACC, reported performance inputs, and reported capex inputs in the calculation of the CESS revenue increment, in line with our draft decision.
Revision 13.2	Incorporate the tiered sharing factor as described in the updated CESS guidelines.
Revision 13.3	Revert clause 13.1(b)(v)(A) to how it appeared in JGN's 2020-25 access arrangement: A. exclude expenditure related to connecting customers (i.e. connections capex under Part 12A of the National Gas Rules);

[20] CCP31, *CCP31 - Advice to the AER - JGN 2025-30 Access Arrangement Proposal and Issues paper - September 2024*, September 2024.

Glossary

Term	Definition
capex	capital expenditure
CCP31	Consumer Challenge Panel, sub-panel 31
CESS	capital expenditure sharing scheme
CPF	contingent payment factor
CPI	consumer price index
JGN	Jemena Gas Networks
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
NSP	Network Service Provider
NSW	New South Wales
opex	operating expenditure
SADI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
VIC GAAR	Victorian gas access arrangement reset
WACC	weighted average cost of capital