# Draft decision

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

## Attachment 8 – Efficiency carryover mechanism

**November 2024**

AUSTRALIAN ENERGY REGULATOR

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# 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:

# Contents

# 8 Efficiency carryover mechanism

An efficiency carryover mechanism (ECM) is intended to provide a continuous incentive for service providers to pursue efficiency improvements in operating expenditure (opex), and provide for a fair sharing of these between service providers and network users.

This attachment sets out our draft decision on the ECM carryover amounts accrued over the 2020–25 access arrangement period (2020–25 period) for Jemena Gas Networks (JGN) (NSW), and the ECM that we will apply in the 2025–30 access arrangement period (2025–30 period).

## 8.1 Draft decision

Our draft decision is to approve carryover amounts totalling $6.1 million ($2024–25) from the application of the ECM in the 2020–25 access arrangement period. This is $1.9 million ($2024–25) higher than JGN's proposal of $4.2 million ($2024–25).[1]

The difference between our draft decision and JGN's proposal reflects adjustments we have made to account for recent updates to actual and forecast inflation.

We set out the ECM carryover amounts JGN accrued during the operation of the 2020–25 period in Table 8.1, along with JGN's proposal and the difference.

**Table 8.1: AER's draft decision on JGN's carryover amounts ($million, 2024–25)**

| | 2025–26 | 2026–27 | 2027–28 | 2028–29 | 2029–30 | Total |
|---|---|---|---|---|---|---|
| JGN's proposed carryover | 29.6 | –2.2 | –22.0 | –1.2 | – | **4.2** |
| AER's draft decision | 30.2 | –1.7 | –21.6 | –0.8 | – | **6.1** |
| **Difference** | **0.5** | **0.5** | **0.4** | **0.5** | **–** | **1.9** |

Source: JGN, *Att 7.9M – ECM model,* June 2024; AER analysis.

Note: Numbers may not add up to total due to rounding. Amounts of '0.0' and '–0.0' represent small amounts and '–' represents zero.

In our final decision, we will update to reflect the full year of actuals for 2023–24, and update our inflation forecast for 2024–25.

Our draft decision is to continue to apply the ECM to JGN in the 2025–30 period, subject to amendments that we discuss in Section 8.4.2.1. These amendments are also reflected in the revisions to JGN's access arrangement, as set out in Section 8.5.

[1] JGN, *Att 7.9M – ECM model*, June 2024.

# 8.2 JGN's proposal

## 8.2.1 Carryover amounts from the 2020–25 period

JGN's proposal included ECM carryover amounts totalling $4.2 million ($2024–25), from the application of the ECM in the 2020–25 period.[2] JGN excluded the following cost categories in calculating its ECM carryover amounts:[3]

- debt raising costs
- unaccounted for gas
- licence fees
- movements in provisions
- carbon costs.

## 8.2.2 Application in the 2025–30 period

JGN proposed to continue applying the ECM in the 2025–30 period,[4] and proposed the following costs to be excluded from the operation of the ECM:[5]

- unaccounted for gas
- government and jurisdictional charges (including licence fee costs that are accounted for in the calculation of the licence fee factor amount in clause 2.1 of Schedule 4 of JGN's 2025–30 Access Arrangement)
- debt raising costs
- carbon costs
- the cost of any Relevant Tax
- any opex allocated or attributed to ancillary reference services
- movements in provisions related to opex
- 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 2030)
- any other cost that JGN and the AER agree to exclude from the operation of the efficiency carryover mechanism.

## 8.2.3 Stakeholder submissions

We have not received any submissions from stakeholders on JGN's proposed ECM.

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2 JGN, *Att 7.9M – ECM model*, June 2024.

3 JGN, *Att 7.9M – ECM model*, June 2024.

4 JGN, *2025 Plan*, June 2024, p. 110.

5 JGN, *2025–30 Access Arrangement*, June 2024, pp. 24–25.

# 8.3 Assessment approach

An ECM is a form of incentive mechanism. A full access arrangement may include (and we may require it to include) one or more incentive mechanisms to encourage efficiency in the provision of services by the service provider.[6] An incentive mechanism must be consistent with the revenue and pricing principles.[7]

We consider the following revenue and pricing principle is most relevant for assessing JGN's proposed efficiency carryover mechanism:

> 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; and
>
> b) the efficient provision of pipeline services; and
>
> c) the efficient use of the pipeline.[8]

## 8.3.1 Interrelationships

The ECM is intrinsically linked to our opex revealed cost forecasting approach.

Our opex forecasting method typically relies on using the 'revealed costs' of the service provider in a chosen base year to develop a total opex forecast, if the chosen base year opex is not considered to be 'materially inefficient'. Under this approach, a service provider would have an incentive to spend more opex in the expected base year. Also, a service provider would have less incentive to reduce opex towards the end of the access arrangement period, where the benefit of any efficiency gains is retained for less time.

The application of the ECM serves two important functions:

1. It removes the incentive for a service provider to inflate opex in the expected base year to gain a higher opex forecast for the next access arrangement period.
2. It provides a continuous incentive for a service provider to pursue efficiency improvements across the access arrangement period.

The ECM does this by allowing a service provider to retain efficiency gains (or losses) for a total of six years, regardless of the year in which the service provider makes them. Where we do not propose to rely on the single year revealed costs of a service provider in forecasting opex, this has consequences for the service provider's incentives and our decision on how we apply the ECM.

When a business makes an incremental efficiency gain, it receives a reward through the ECM, and consumers benefit through a lower revealed cost forecast for the subsequent

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6 National Gas Rules (NGR), r. 98(1).

7 NGR, r. 98(3).

8 National Gas Law, s. 24(3).

access arrangement period. This is how efficiency improvements are shared between consumers and the business. If we subject costs to the ECM that are not forecast using a revealed cost approach, a business would in theory receive a reward for efficiency gains through the ECM (at a cost to consumers), but consumers would not benefit through a lower revealed cost forecast in the subsequent access arrangement period. Therefore, we typically exclude costs that we do not forecast using a single year revealed cost forecasting approach.

For these reasons, our decision on how we will apply the ECM has a strong interrelationship with our decision on a business's opex (see Attachment 6). We have careful regard to the effect of our ECM decision when making our opex decision, and our ECM decision is made largely in consequence of (and takes careful account of) our past and current decisions on opex.

## 8.4 Reasons for draft decision

### 8.4.1 Carryover amounts from the 2020–25 period

We do not accept JGN's proposed carryover amounts totalling $4.2 million ($2024–25) from the application of the ECM in the 2020–25 period. Our draft decision is to approve carryover amounts totalling $6.1 million ($2024–25), which is $1.9 million ($2024–25) higher than JGN's proposal. This difference reflects our use of the most recent inflation figures to convert amounts into 2024–25 dollars. We discuss the impact of inflation below. Full details of our draft decision are set out in our ECM model, which is available on our website.

Consistent with JGN's proposal and our standard approach in calculating ECM carryover amounts, we have also made the same adjustments and exclusions as discussed in Section 8.2.1.

#### 8.4.1.1 Inflation

Consistent with our standard approach, and our opex forecast, we used unlagged inflation to convert amounts to 2024–25 dollars.[9] This approach is also consistent with the approach JGN adopted in its proposal.[10]

We have used the latest inflation forecasts available, which were not available at the time JGN submitted its proposal. This increased our draft decision ECM carryover amounts by $1.9 million ($2024–25), compared to JGN's proposal. For 2023–24, we used the actual headline Consumer Price Index figure published by the Australian Bureau of Statistics.[11] For 2024–25, we used the inflation forecast in the Reserve Bank of Australia's August 2024 Statement on monetary policy.[12]

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9 This ensures JGN is not accruing carryovers that are not being passed on to customers.

10 JGN, *Att 7.9M – ECM model*, June 2024.

11 Australian Bureau of Statistics, *Consumer Price Index, Australia, released on 31 July 2024 (accessed on 31 July 2024*: https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/jun-quarter-2024).

12 Reserve Bank of Australia, *Statement on monetary policy, August 2024, (accessed on 6 August 2024:* https://www.rba.gov.au/publications/smp/2024/aug/outlook.html#3-5-detailed-forecast-information).

### 8.4.2 Application in the 2025–30 period

Consistent with JGN's proposal, our draft decision is to continue to apply the ECM to JGN during the 2025–30 period to Transportation Reference Services.[13] We consider applying the scheme will benefit the long-term interests of gas consumers, as it will provide continuous incentives for JGN to reduce opex. Provided we forecast JGN's future opex using its revealed costs in the 2025–30 period, any efficiency gains it achieves will lead to lower opex forecasts, and thus lower network tariffs.

The ECM specifies our approach to adjusting forecast or actual opex when calculating carryover amounts. We provide details on this below.

#### 8.4.2.1 Adjustments to forecast or actual opex when calculating carryover amounts

The ECM allows us to exclude categories of costs that we do not forecast using a single year revealed cost forecasting approach in the following access arrangement period. We do this to fairly share efficiency gains and losses. For instance, where a service provider achieves efficiency improvements, it receives a benefit through lower forecast opex in the next access arrangement period. This is the way consumers and the service provider share in the benefits of an efficiency improvement. If we do not use a single year revealed cost forecasting approach, we may not pass the benefits of these revealed efficiency gains to consumers. It follows that consumers should not pay for ECM rewards where they do not receive the benefits of a lower opex forecast.

In applying the ECM to JGN in the 2025–30 period, we will adjust the following when we calculate the carryover amounts accrued during the period:

- remove any movements in provisions related to opex from actual opex
- remove cost categories that are not forecast using a single year revealed cost approach in the period commencing 1 July 2030 from forecast and actual opex, which include costs such as:
  - debt raising
  - unaccounted for gas
  - support for customers experiencing vulnerability
- remove any opex allocated or attributed to Ancillary Reference Services from forecast and actual opex
- remove forecast and actual opex for any cost that the AER determines to exclude from the operation of the ECM, which would not promote the National Gas Objective
- remove Safeguard Mechanism costs, consistent with the amounts recovered through the reference tariff variation mechanism
- add (subtract) any approved revenue increments (decrements) to forecast opex that occur during the access arrangement period, such as approved pass through amounts
- adjust forecast and actual opex for inflation.

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[13] JGN, *2025–30 Access Arrangement*, June 2024, p. 22.

In applying the ECM to JGN in the 2025–30 period, consistent with that set out above, we consider the following changes should be made in addition to the amendments JGN proposed in its access arrangement:[14]

- remove clause 12.1(h)(ii), which referred to JGN's proposed exclusion of government and jurisdictional charges from the operation of the ECM. JGN proposed that these costs be excluded on the basis that they were uncontrollable. However, we do not consider uncontrollable costs should be excluded from the ECM. We discuss our reasons for not excluding uncontrollable costs in our EBSS explanatory statement.[15] For similar reasons, and as discussed in Attachment 6, licence fee costs will be treated as a step change, rather than a category specific forecast. Previously, these costs were included as a category specific forecast to enable these costs to be trued-up through our reference tariff variation mechanism. However, we no longer consider these costs should be subject to a true-up and have thus not included a category specific forecast for them.
- amend clause 12.1(h)(iv), which related to JGN's proposed exclusion of carbon costs from the operation of the ECM, to instead refer to excluding trued-up Safeguard Mechanism costs that appear in opex. We consider that the costs, as captured by the definition of Carbon Costs and Carbon Scheme, are too broad and will include costs that should not be excluded when calculating the ECM carryover amounts. Instead, we consider a narrower focus on the actual costs incurred from the Safeguard Mechanism that may appear in opex, and recovered through the reference tariff variation mechanism, to be the appropriate exclusion.
- remove clause 12.1(h)(v), which related to JGN's proposed exclusion of the cost of any Relevant Tax from the operation of the ECM. As noted above, we do not generally exclude uncontrollable costs from the calculation of the ECM. We find no basis to change our position in this circumstance. We discuss our reasons in detail for not excluding uncontrollable costs in our EBSS explanatory statement.[16] We also note the JGN may apply for a Tax change pass through event, which we consider is sufficient to address the risk of a material change in these costs.
- amend clause 12.1(h)(ix), which related to JGN's proposed exclusion of 'any other costs that the Service Provider and the AER agree to exclude from the operation of the efficiency carryover mechanism', to instead read 'any cost that the AER determines to exclude from the operation of the efficiency carryover mechanism, which would not promote the National Gas Objective.' This amendment will ensure the operation of the ECM remains aligned with the National Gas Objective.
- amend clause 12.1(i) to instead refer to the latest post tax revenue model (PTRM). Specifically, we consider removing the table detailing the approved forecasts avoids unnecessary confusion on the correct amounts to be used when calculating the carryover amounts. We consider instead linking these forecasts to the PTRM provides enhanced transparency in the process. This will further ensure any approved forecast opex amounts approved after the final decision are included in the ECM calculations.

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14 JGN, *2025–30 Access Arrangement* – 20240628, June 2024, pp. 22–25.

15 AER, *Explanatory statement – efficiency benefit sharing scheme*, November 2013, pp. 21–23.

16 AER, *Explanatory statement – efficiency benefit sharing scheme*, November 2013, pp. 21–23.

- insert a new clause 12.1(h)(ii), to exclude support for customers experiencing vulnerability costs from the operation of the ECM. We have included these costs in our opex forecast as a category specific forecast, as opposed to JGN's proposal to include this as a step change. Consistent with our approach in calculating ECM carryover amounts, we will exclude these costs when calculating the ECM carryover amount.
- insert clause 12.1(j), related to ensuring that if JGN changes its approach to classifying costs as either capital expenditure or operating expenditure during the Access Arrangement Period, it will still align the accounting treatment of expenditure within a period with that in the approved expenditure for that period. We consider it is more appropriate to align the accounting treatment of expenditure within a period with that in the approved expenditure for that period, i.e. not to implement any mid-period accounting changes until the start of the new period. This is consistent with our recent decisions, and is intended to limit opportunities for windfall gains purely from movement of expenditure between opex and capital expenditure due to these mid-period accounting changes.[17]
- insert clause 12.1(k), related to adjustments to forecast opex to add (subtract) any approved revenue increments (decrements) that occur during the access arrangement period for approved pass through amounts
- insert clause 12.1(l), related to adjustments to expenditure for inflation.

## 8.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable as set out in Table 8.2.

**Table 8.2: JGN's ECM revisions**

| Revision | Amendment |
|---|---|
| Revision 8.1 | Delete clause 12.1(h)(ii) |
| Revision 8.2 | Delete clause 12.1(h)(v) |
| Revision 8.3 | Amend clause 12.1(h)(iv) to read:<br>the Safeguard Mechanism costs that appear in opex and are recovered through the reference tariff variation mechanism true-up |
| Revision 8.4 | Amend clause 12.1(h)(ix) to read:<br>any cost that the AER determines to exclude from the operation of the efficiency carryover mechanism in the relevant period, which would not promote the National Gas Objective. |
| Revision 8.5 | Amend clause 12.1(i) to instead read:<br>For the avoidance of doubt, the forecast expenditure amounts, that are used as the basis |

[17] AER, *MGN 2023–28 – Draft decision – Attachment 6 Operating expenditure, December 2022,* p.7.

| Revision | Amendment |
|---|---|
| | for calculating the carryover amounts, are equal to the approved forecast operating expenditure for that year as found in the most recent post-tax revenue model, published by the AER (plus any other operating expenditure approved by the AER), subject to any required adjustment listed in clause 12.1 above |
| Revision 8.6 | Include a new clause 12.1(h)(ii), which reads:<br><br>support for customers experiencing vulnerability costs, including approved forecast and actual incurred costs for each respective year of the Access Arrangement Period. |
| Revision 8.7 | Include a new clause 12.1(j), which reads:<br><br>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 still 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). |
| Revision 8.8 | Include a new clause, clause 12.1(k), which reads:<br><br>The approved forecast operating expenditure amount for each year of the applicable access arrangement period will be adjusted to include any Determined Pass Through Amounts or other AER approved expenditure arising from Cost Pass Through Events which apply in respect of that year. |
| Revision 8.9 | Include a new clause 12.1(l), which reads:<br><br>The incremental efficiency gains (or losses) are carried over from year to year in real dollars to ensure that these gains (or losses) are not eroded by inflation. The price indices used in this calculation are to be consistent with those used to forecast operating expenditure for the Access Arrangement Period. |
| Revision 8.10 | Make revisions necessary to update the carryovers from the application of the efficiency carryover mechanism in the 2020–25 Access Arrangement period, in line with our draft decision. |

# Glossary

| Term | Definition |
|---|---|
| AER | Australian Energy Regulator |
| ECM | efficiency carryover mechanism |
| JGN | Jemena Gas Networks |
| NGL | National Gas Law |
| NSW | New South Wales |
| opex | operating expenditure |
| PTRM | post tax revenue model |