

Final decision

Australian Gas Networks (Victoria & Albury)
Gas distribution access arrangement
1 July 2023 to 30 June 2028

Attachment 13 – Capital expenditure sharing
scheme

June 2023

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13 Capital expenditure sharing scheme

This attachment outlines our assessment of AGN’s revised proposal for a capital expenditure sharing scheme (CESS) for the 2023–28 access arrangement period. This includes CESS rewards or penalties to be applied next period based on AGN’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 threshold, rewards are multiplied by zero. Conversely, the CESS will lead to a penalty if the NSP spends above its approved capex. The CPF does not apply to penalties, so if a penalty is incurred, it will not be reduced.

AGN’s revised proposal also includes updates to the design of AGN’s CESS for the next period. AGN’s proposed CESS design for the 2023–28 period is based on our approved CESS for the Victorian gas businesses (2018–2022) but with adjustments. The most significant of which is that CESS will not apply to capital expenditure (capex) for connections.

AGN also proposes to exclude augmentation expenditure (augex) from the CESS. We do not accept the proposed exclusion of augex. Our reasons for this position are outlined in section 13.4.2 below.

13.1 Final decision

AGN spent more capex in the 2018–22 access arrangement period than our forecast in the final decision for the 2018-22 access arrangement period. This results in a CESS penalty being deducted from AGN’s revenue in the 2023–28 access arrangement period. AGN’s proposed CESS carryover amount and our final decision carryover amount for the Victorian network is set out in Table 13-1. Our final decision is to broadly accept a AGN’s revised proposal. AGN proposes a CESS penalty of \$12.48 million (\$2022/23). Our final decision figure is a penalty of \$12.70 million (\$2022/23).

Table 13-1 Our final decision on AGN’s CESS amounts (\$ million, \$2022/23)

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
AGN's initial CESS proposal	-4.33	-4.33	-4.33	-4.33	-4.33	-21.65
AGN's revised CESS proposal	-2.50	-2.50	-2.50	-2.50	-2.50	-12.48
AER final decision CESS	-2.54	-2.54	-2.54	-2.54	-2.54	-12.70

Source: AER analysis. AER, *AER - AGN 2023-28 - Draft Decision - CESS model - December 2022*, December 2022; AGN, *AGN - Revised Final Plan 2023-28 - Attachment 12.4 - Updated CESS Model - PUBLIC*, January 2023. Numbers may not add up due to rounding

The difference between AGN's initial proposal carryover amounts and its revised proposal amounts owes to lower-than-estimated actual 2022 capex and to updated weighted average cost of capital (WACC) and consumer price index (CPI) figures.¹ We are satisfied that AGN's application of the CESS is appropriate, and consistent with the CESS mechanism set out in its access arrangement. The difference between our final decision figures and AGN's figures owes entirely to WACC and CPI being updated since the revised proposal submission.

We accept AGN's proposal to retain a CESS for the 2023–28 access arrangement period. We accept AGN's proposed update to the CESS to exclude new connections capex from the CESS. This is in line with our most recent decisions for AGN (SA), Jemena Gas Network (JGN) and Evoenergy.²

We do not accept AGN's proposed update to the CESS to exclude augex from the CESS.

13.2 AGN's revised proposal

13.2.1 CESS amounts from the 2018–22 access arrangement period

AGN proposed a \$12.5 million (\$2022/23) penalty be deducted from its revenue in the 2023–28 access arrangement period.³

AGN has adopted measures to monitor service performance. The five target measures are:

- unplanned System Average Interruption Frequency Index (SAIFI) (weighting 25%)
- unplanned System Average Interruption Duration Index (SAIDI) (weighting 25%)
- mains leaks (weighting 31.2%)
- service leaks (weighting 15.6%)
- meter leaks (weighting 3.2%)

Performance targets for each measure have been set using the previous five years of historical data. The performance targets are weighted to produce a CPF. 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 AGN for an under-spend is an index score of 80 (base is 100).

¹ Attachment 2 on the capital base sets out our CPI final decision, while Attachment 3 on rate of return details our vanilla WACC final decision.

² The operation of the CESS is set out in: AGN, *Australian Gas Networks Access Arrangement, Victorian and Albury Distribution Network, 2023/4-2027/8*, July 2022, pp.23-5.

³ AGN, *AGN - Revised Final Plan 2023-28 - Attachment 12.4 - Updated CESS Model - PUBLIC*, January 2023

13.2.2 Application of CESS in the 2023–28 access arrangement period

AGN proposes to continue using a CESS mechanism into the next access arrangement period. It proposes to update the CESS used in the 2018–22 access arrangement period by excluding new connections capex. AGN states that new connections capex is largely outside a NSP's control, making it unresponsive to incentive mechanisms. This would bring the CESS in line with previous AER decisions for JGN and AGN (SA).⁴

AGN has repropoed updating the CESS by excluding augex.⁵ AGN argues that augex should be excluded for the same reason as new connections capex. It argues augex, like new connections capex, is driven by customers entering and exiting the market, variables outside its control.⁶

In response to an information request, the Australian Gas Infrastructure Group (AGIG) gave further reasoning, which applies to both AGN and MGN. Augex, it argues, is driven mainly by demand. In the next period, if gas demand is lower than expected, because of electrification incentives, then augex would be deferred. This would lead to a windfall reward despite no efficiency increases. A windfall penalty would occur if electrification incentives were to reduce gas demand by a lower-than-expected amount, resulting in an augex increase.⁷ We address this in our response below in section 13.4.2.

13.2.3 Submissions on AGN's revised proposal

No submissions to the revised proposal related to the CESS.

13.3 Assessment approach

Our assessment approach is the same as in our draft decision on AGN's CESS proposal.⁸

13.4 Reasons for final decision

13.4.1 CESS amounts from the 2018–22 access arrangement period

We consider AGN's proposed penalty of \$12.54 million (\$2022/23) is broadly consistent with the CESS mechanism in its 2018–22 access arrangement. The difference between the

⁴ AGN, *Attachment 1.2: Draft Plan: Five-year plan for our Victorian network, Final Plan 2023/24-2027/28*, July 2022, p. 113

⁵ AGN, *AGN - Revised final plan - Access Arrangement 2023–28 - Current AA with credit support*, 24 January 2023, p. 25.

⁶ AGN, *AGN - Revised final plan - Access Arrangement 2023–28 - Attachment 12.2 - Response on incentives*, January 2023

⁷ MGN, *Response to information request #023*, received 13 February 2023. MGN responded on behalf of both itself and AGN (VIC), both being AGIG's Victorian gas distribution networks.

⁸ AER, *AER - AGN 2023-28 - Draft Decision - Attachment 13 - Capital expenditure sharing scheme - December 2022*, December 2022, pp. 2-3

CESS penalty in AGN's draft proposal and the reward in its revised proposal owes to lower-than-estimated actual 2022 capex. Our slightly higher in magnitude final decision penalty of \$12.70 million (\$2022/23) owes to updated WACC and CPI figures. We note that, as AGN is incurring a penalty, the CPF does not apply, so they will incur the penalty in full.

13.4.2 Updates to CESS in the 2023–28 access arrangement period

In agreeing to implement an updated CESS for AGN, we have had regard to:

- the potential benefits and risks of the updated CESS, and
- how AGN's proposed CESS mitigates these risks.

AGN has proposed to remove connections capex from the CESS as the volume of new connections is largely outside a NSP's control. We view the benefit of this updated CESS is that it avoids windfall gains or losses for the NSP that are unrelated to the incentive mechanism. Potential risks associated with this update had been raised in submissions to the initial proposal and addressed in our draft decision.⁹ We accept the exclusion of new connections capex from the CESS.

AGN has proposed to remove augex from the CESS. AGN argues augex should be excluded for the same reason that connections capex is excluded. That is, augex volume is primarily driven by demand, a variable outside of its control.

We do not accept the proposed exclusion of augex from the CESS. We view connections capex and augex as meaningfully different. New connections capex is customer-initiated and funded. Augex is organisation-initiated and funded, although driven by customer demand. As augex is funded primarily by revenue and not customer contributions, we believe that it is business-as-usual expenditure. This is different from new connections capex, where an organisation acts as intermediary between a customer and the contractor who installs the connection. Further, as augex is initiated by the organisation in response to localised growth, which can be planned for, the organisation has discretion to defer or stagger augmentation projects (as AGN has done in response to the Gas Substitution Roadmap¹⁰) and perform work efficiently. Given these factors, we consider the NSP should be subject to incentive mechanisms.

13.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable as set out in Table 13.2.

⁹ AER, *AER – MGN 2023-28 – Draft Decision – Attachment 13 – Capital expenditure sharing scheme – December 2022*, December 2022

¹⁰ AGN, *AGN Victoria – Revisions to Final Plan 2023-28 – Attachment 9.11A – GSR Response – Addendum to Network Capacity Strategy*, September 2022

Table 13.2 AGN's CESS revisions

Revision	Amendment
Revision 13.1	Make revisions necessary to update CPI and real vanilla WACC in the calculation of the CESS, in line with our final decision.
Revision 13.2	Remove exclusion of augex from the operation of the CESS.

Glossary

Term	Definition
AER	Australian Energy Regulator
AGIG	Australian Gas Infrastructure Group
AGN (SA)	Australian Gas Networks (South Australia)
AGN (VIC)	Australian Gas Networks (Victoria and Albury)
Augex	Augmentation capex
Capex	Capital expenditure
CESS	Capital expenditure sharing scheme
CPF	Contingent Payment Factor
CPI	Consumer price index
JGN	Jemena Gas Networks (NSW) Ltd
MGN	Multinet Gas Networks
NGL	National Gas Law
NGR	National Gas Rules
NSP	Network Service Provider
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
WACC	Weighted average cost of capital
