

Draft Decision

APA Victorian Transmission System

Access Arrangement 2023 to 2027

(1 January 2023 to 31 December 2027)

**Attachment 8 Operating
expenditure incentive
mechanism**

December 2022

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Amendment record

Version	Date	Pages
1	9 December 2022	13

Note

This attachment forms part of the AER’s draft decision on the access arrangement that will apply to APA’s Victorian Transmission System (VTS) for the 2023–27 access arrangement period. It should be read with all other parts of the draft decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The final decision attachments have been numbered consistently with the equivalent attachments to our draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The draft decision includes the following documents:

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 – Operating expenditure incentive mechanism

Attachment 10 – Reference tariff variation mechanism

Attachment 12 – Demand

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8 Operating expenditure incentive mechanism

An operating expenditure incentive mechanism (OEIM) 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 customers and the network business.

This attachment sets out our final decision on the OEIM carryover amounts accrued over the 2018–22 access arrangement period (2018–22 period) for the Victorian Transmission System (VTS). It also sets out the OEIM that we will apply in the 2023–27 access arrangement period (2023–27 period).

8.1 Final decision

Our final decision is to approve carryover amounts totalling -\$4.1 million (\$2022) from the application of the OEIM in the 2018–22 period. This is \$0.8 million (\$2022) lower than APA's revised proposal of -\$3.2 million (\$2022).¹ This difference reflects adjustments we have made to:

- Include a non-recurrent efficiency gain of \$0.2 million (\$2022) for water bath heater integrity costs
- update forecast inflation.

We set out our final decision on the carryover amounts APA accrued from the operation of the OEIM during the 2018–22 period in Table 8.1.

Table 8.1: AER's final decision on OEIM carryover amounts (\$million, 2022)

	2023	2024	2025	2026	2027	Total
APA's revised proposal	-2.3	-1.8	-2.0	–	2.9	-3.2
AER's final decision	-2.5	-2.0	-2.2	-0.2	2.8	-4.1
Difference	-0.2	-0.2	-0.2	-0.2	-0.1	-0.8

Source: APA VTS, *APA VTS – APA VTS 2023–27 AA Revised Proposal – PTRM*, August 2022; AER analysis.

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

Our final decision is to approve, and continue to apply, subject to the amendments detailed below, the OEIM proposed by APA for the 2023–27 period. This reflects the same OEIM that applied in the current access arrangement period, which is based on version 2 of the Efficiency Benefit Sharing Scheme (EBSS), which we use for electricity service providers.²

Consistent with past applications of the OEIM, we will exclude debt raising costs from the scheme, because we have forecast them on a category specific basis and expect to continue doing so in the 2028–32 access arrangement period. We will also make other adjustments as permitted by the Access Arrangement in the 2023–27 period, such as removing movements in provisions.

¹ APA VTS, *APA VTS – APA VTS 2023–27 AA Revised Proposal – PTRM*, August 2022.

² AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

8.2 APA’s proposal

8.2.1 Carryover amounts from the 2018–22 period

APA’s revised proposal for the VTS included OEIM carryover amounts totalling -\$3.2 million (\$2022) in its revenues for the 2023–27 period from the application of the OEIM in the 2018–22 period.³ APA did not provide an OEIM model in its revised proposal, but instead populated its carryover amounts in its revised proposal post-tax revenue model (PTRM). We note these values are consistent with those we published in our draft decision.⁴ In our draft decision, we excluded the following cost categories in calculating the OEIM carryover amounts:⁵

- debt raising costs
- linepack allowance
- spares allowance.

8.2.2 Application in the 2023–27 period

APA’s revised proposal for the VTS re-proposed the same OEIM apply in the 2023–27 period as applied in the current access arrangement period, taking into account the revisions proposed in the draft decision.⁶

8.2.3 Stakeholder submissions

We received one submission from stakeholders on APA’s revised proposal in relation to the OEIM. TRAC Partners for the Brotherhood of St Laurence noted that it supported the retention of the OEIM, but that the calculation of this will need to be reviewed as a result of further proposed opex changes. TRAC Partners further supported APA’s proposal not to include property taxes in the OEIM formula, as this is consistent with regulatory precedent with distribution businesses.⁷

8.3 Assessment approach

An OEIM is a form of incentive mechanism. A full access arrangement may include one or more incentive mechanisms to encourage efficiency in the provision of services by the service provider.⁸ An incentive mechanism must be consistent with the revenue and pricing principles.⁹

We consider the following revenue and pricing principle is most relevant for assessing APA’s proposed efficiency carryover:

³ APA VTS, *APA VTS – APA VTS 2023–27 AA Revised Proposal – PTRM*, August 2022.

⁴ AER, *Draft decision, APA Victorian Transmission System Access Arrangement 2023 to 2027 (1 January 2023 to 31 December 2027) – Attachment 8 Operating expenditure incentive mechanism*, June 2022, p. 5.

⁵ AER, *AER – Draft Decision – APA VTS 2023–27 Access Arrangement – OEIM model*, June 2022.

⁶ APA VTS, *Victorian Transmission System 2023–27 access arrangement*, 10 August 2022, pp. 7–11.

⁷ TRAC Partners – prepared for the Brotherhood of St. Laurence, *Response to AER draft decision & APA Victorian Transmission System (VTS) Revised 2023–27 Access Arrangement Proposal*, September 2022, p. 34.

⁸ National Gas Rules (NGR), r. 98(1).

⁹ NGR, r. 98(3).

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.¹⁰

8.3.1 Interrelationships

The OEIM 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 OEIM therefore serves two important functions:

- 1) It removes the incentive for a service provider to inflate opex in the expected base year in order 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 OEIM 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 OEIM.

When a business makes an incremental efficiency gain, it receives a reward through the OEIM, and consumers benefit through a lower revealed cost forecast for the subsequent access arrangement period. This is how efficiency improvements are shared between consumers and the business. If we subject costs to the OEIM that are not forecast using a revealed cost approach, a business would in theory receive a reward for efficiency gains through the OEIM (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 OEIM has a strong interrelationship with our decision on a business's opex (see Attachment 6). We have careful regard to the effect of our OEIM decision when making our opex decision, and our OEIM decision is made

¹⁰ National Gas Law (NGL), s. 24(3).

largely in consequence of (and takes careful account of) our past and current decisions on opex.

8.4 Reasons for the final decision

8.4.1 Carryover amounts from the 2018–22 period

Our final decision is to approve carryover amounts totalling -\$4.1 million (\$2022) from the application of the OEIM in the 2018–22 period. This is \$0.8 million (\$2022) lower than the carryover amounts in APA’s revised proposal of -\$3.2 million (\$2022).¹¹ This difference is due to us:

- including a non-recurrent efficiency gain related to water bath heaters, which resulted in a decrease of \$0.8 million (\$2022)
- updating forecast inflation for 2022, which resulted in a decrease of \$0.1 million (\$2022)

We discuss each of these reasons in more detail below.

8.4.1.1 Non-recurrent efficiency gain related to water bath costs

Our final capital expenditure (capex) decision accepted APA’s change in treatment of water bath costs from opex to capex.¹² Accordingly, we consider that the \$0.4 million (\$2022) annual forecast capex should be removed from base year opex (equal to \$2.0 million (\$2022) over the 2023–27 period).¹³ As there is an annual reduction to opex, a base adjustment was made – see Attachment 6, section 6.4.1.2. This reflects that these costs will no longer be incurred as opex. However, actual water bath opex in the 2020 base year is equal to \$0.2 million (\$2022) (being the costs incurred for the Wollert water bath).¹⁴ To account for the difference between the actual opex costs in the base year (\$0.2 million (\$2022)) and the forecast annual capex amount (\$0.4 million (\$2022)) removed from opex, we have also assumed a \$0.2 million (\$2022) non-recurrent base year efficiency gain to both forecast our alternative estimate of opex and to calculate OEIM carryovers.¹⁵

One of the opex factors we must have regard to when assessing a service provider’s opex forecast, is whether the opex forecast is consistent with the EBSS,¹⁶ which is consistent with the OEIM for APA for the VTS. The level of opex used as the starting point to forecast opex should be consistent with the opex used to calculate the OEIM rewards and penalties. This consistency is essential to ensure that the business is only rewarded (or penalised) for any efficiency gains (or losses) that are passed on to network users through lower (or higher) forecast opex.

¹¹ APA VTS, *APA VTS – APA VTS 2023–27 AA Revised Proposal – PTRM*, August 2022.

¹² AER, *Final decision, APA Victorian Transmission System (VTS) Access Arrangement 2023 to 2027 (1 January 2023 to 31 December 2027) – Attachment 5 – Capital expenditure*, December 2022.

¹³ These adjustments were based on forecast water expenditure of \$0.2 million per annum per water bath, with an expected maintenance of two water baths per year. Refer to APA VTS, *VTS - BC328 AA23-27 Waterbath Heater Integrity Option 3 - December 2021 – Public.pdf*. p.4.

¹⁴ APA VTS, *Information request 20 – Q8*, 26 August 2022, p. 6.

¹⁵ AER, *Final Decision, APA Victorian Transmission System (VTS) Access Arrangement 2023 to 2027 (1 January 2023 to 31 December 2027) – Attachment 6 Operating Expenditure*, December 2022, pp. 17–18.

¹⁶ NER, cl. 6A.6.6(e)(8).

Accordingly, and consistent with the net adjustment we have made in our opex forecast, we have included a non-recurrent efficiency gain in our OEIM model of \$0.2 million (\$2022) related to the change in treatment of water bath costs from opex to capex. This has reduced the OEIM carryover amount by \$0.8 million (\$2022).

8.4.1.2 Inflation

Consistent with our standard approach and opex forecast, we used unlagged inflation to convert opex amounts to 2022 real terms.

To do this, we have used updated consumer price index values compared to those APA used for its revised VTS proposal, and specifically we used the inflation forecast for the year to December 2022 in the Reserve Bank of Australia's (RBA) November 2022 Statement on monetary policy.¹⁷ This has reduced the OEIM carryover amount by \$0.1 million (\$2022).

Full details of our OEIM calculations are set out in our final decision OEIM model, which is available on our website.¹⁸

8.4.2 Application in the 2023–27 period

Our final decision is to approve the continuation of the application of the OEIM for the 2023–27 period, subject to the one amendment detailed below. This reflects the same OEIM that applies in the current access arrangement period, which is based on version 2 of the EBSS which we use for electricity service providers,¹⁹ with a small number of changes.

We consider applying the scheme will benefit the long-term interests of gas consumers as it will provide continuous incentives to reduce opex. Provided we forecast APA's future opex using its revealed costs in the 2023–27 period, any efficiency gains that APA achieves will lead to lower opex forecasts, and thus lower network tariffs.

Version 2 of the EBSS, on which the OEIM is based, specifies our approach to adjusting forecast or actual opex when calculating carryover amounts.²⁰

APA proposed to exclude, from the calculation of the OEIM carryover amounts, \$1.1 million (\$2022) in costs related to property taxes for each year of the 2023–27 period.²¹ This was because APA considered that these are truly uncontrollable opex.²² Our final decision for opex did not include property tax increases as we did not consider that the proposed increases were prudent and efficient, including that we considered these are already included in forecast trend. Further, we note that as we discussed in the Explanatory Statement for the EBSS, we do not consider uncontrollability a reason for exclusion in the EBSS.²³ We stated that by including such costs in the EBSS, uncontrollable cost decreases or increases are shared between Network Service Providers and consumers in the same

¹⁷ RBA, *Statement on Monetary Policy, Forecast Table - November 2022*, 4 November 2022.

¹⁸ AER, *AER – Final Decision – APA VTS 2023–27 Access Arrangement – OEIM model*, December 2022.

¹⁹ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

²⁰ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013, p. 6–7.

²¹ APA VTS, *Victorian Transmission System 2023–27 access arrangement*, 10 August 2022, p. 10.

²² APA VTS, *APA Victorian Transmission System 2023–27 access arrangement. Revised proposal – Overview of Revised Proposal*, 10 August 2022, p. 98.

²³ AER, *Explanatory Statement, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, pp. 19–21.

way as any efficiency gain or loss.²⁴ Additionally, Network Service Providers nominating costs to be excluded from the scheme on an ex-post basis would risk biased outcomes, as Network Service Providers would have no incentive to nominate the costs from uncontrollable events to be excluded where doing so would reduce their carryover.²⁵ And that allowing exclusions would reduce the incentive to respond to such events efficiently.²⁶ On the whole, the risk of uncontrollable events presents both upside and downside risk to Network Service Providers, including that any material risks can be managed through pass-through events.²⁷ We therefore will not exclude property tax costs from the OEIM for the 2023–27 period.

We have made minor amendments to APA's proposed OEIM in this final decision to be consistent with version 2 of the EBSS. In particular, we have revised the formula in 3.6(c) in the Access Arrangement for calculating the incremental gain for 2023 to reflect that a non-recurrent efficiency gain adjustment has been made to the 2020 base year and needs to be included when calculating the carryover amounts. This is Revision 8.1 below. We have also removed the reference in the Access Arrangement to the approved forecast operating expenditure for the OEIM in the 2023–27 period, as this information is in the PTRM and is updated annually. This is Revision 8.2 below.

8.4.2.1 Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2023–27 period will be the same as the length of the following access arrangement period. We expect the next APA access arrangement period will be five years, starting from 1 January 2028.

8.4.2.2 Adjustments to forecast or actual opex when calculating carryover amounts

The OEIM 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 the OEIM and consumers receive 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. As noted in 3.6(g)(iv) in APA's 2023–27 Access Arrangement, 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.²⁸ It follows that consumers should not pay for OEIM rewards where they do not receive the benefits of a lower opex forecast.

We do not forecast debt-raising costs using a single year revealed cost forecasting approach. Instead, we provide a benchmark allowance. Accordingly, we have excluded these

²⁴ AER, *Explanatory Statement, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 19.

²⁵ AER, *Explanatory Statement, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 20.

²⁶ AER, *Explanatory Statement, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 19.

²⁷ AER, *Explanatory Statement, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 19.

²⁸ APA VTS, *Victorian Transmission System 2023–27 access arrangement*, 10 August 2022, p. 10.

costs from the OEIM for the 2023–27 period since any achieved efficiency gains (or losses) would not be passed on to network users.

In addition to excluding debt raising costs, APA has accepted our draft decision’s Revisions and included the following in section 3.6 of its Access Arrangement in relation to the calculation of the OEIM carryover amounts accrued during the 2023–27 period:

- reported actual opex for the 2023–27 period will be adjusted to exclude any movements in provisions (3.6(g)(iii)).
- the AER will exclude any cost that the AER determines appropriate to be excluded from the operation of the OEIM because it is satisfied it would not promote the NGO (3.6(k)).

Further, in addition to the excluded cost categories discussed above, we will also make the following adjustments when we calculate the OEIM carryover amounts accrued during the 2023–28 period:

- exclude cost categories that are not forecast using a single year revealed cost approach in the access arrangement period commencing on 1 January 2028
- adjust forecast opex to add (or subtract) any approved revenue increments (decrements) made after our 2023–27 final decision, such as approved cost pass through amounts
- adjust forecast and actual opex for inflation.

8.5 Revisions

Our final decision makes the following revisions to APA’s access arrangement proposal, consistent with the National Gas Rules and the National Gas Law.

Revision number	Detail
Revision 8.1	<p>Amend clause 3.6 (c) so that it reads:</p> <p>The efficiency gain for 2023 is to be calculated in accordance with the following formula:</p> $E_{2023} = (F_{2023} - A_{2023}) - (F_{2022} - A_{2022}) + (F_{2020} - A_{2020}) - \text{non-recurrent efficiency gain}_{2020}$ <p>where:</p> <p>E_{2023} is the Service Provider’s efficiency gain in 2023</p> <p>F_{2023} is the Service Provider’s forecast operating costs for 2023 as specified in section 3.6(h)</p> <p>A_{2023} is the Service Provider’s actual operating costs for 2023 as specified in section 3.6(g)</p> <p>F_{2022} is the Service Provider’s forecast operating costs for 2022 as specified in section 3.6(h)</p> <p>A_{2022} is the Service Provider’s actual operating costs for 2022 as specified in section 3.6(g)</p> <p>F_{2020} is the Service Provider’s forecast operating costs for 2020 as specified in section 3.6(h)</p> <p>A_{2020} is the Service Provider’s actual operating costs for 2020 as specified in section 3.6(g).</p>

Attachment 8 – Operating expenditure incentive mechanism | Final Decision – APA VTS gas access arrangement 2023–27

Revision number	Detail																																								
	<i>non-recurrent efficiency gain</i> ₂₀₂₀ is the non-recurrent efficiency gain in the base year of 2020.																																								
Revision 8.2	<p>Delete the following table on page 10 of Access Arrangement 2023–27 (no replacement)</p> <p>Approved forecast operating expenditure for the incentive mechanism (\$ million, 2022)</p> <table border="1"> <thead> <tr> <th></th> <th>2020</th> <th>2022</th> <th>2023</th> <th>2024</th> <th>2025</th> <th>2026</th> <th>2027</th> </tr> </thead> <tbody> <tr> <td>Forecast total opex</td> <td>29.9</td> <td>31.2</td> <td>39.1</td> <td>37.7</td> <td>36.5</td> <td>36.5</td> <td>36.5</td> </tr> <tr> <td>Less debt raising costs</td> <td>0.1</td> <td>0.1</td> <td>0.6</td> <td>0.7</td> <td>0.7</td> <td>0.7</td> <td>0.6</td> </tr> <tr> <td>Less category specific forecast</td> <td>0.3</td> <td>0.3</td> <td>1.1</td> <td>1.1</td> <td>1.1</td> <td>1.1</td> <td>1.1</td> </tr> <tr> <td>Forecast opex for the OEIM</td> <td>29.5</td> <td>30.9</td> <td>37.4</td> <td>35.9</td> <td>34.7</td> <td>34.7</td> <td>34.8</td> </tr> </tbody> </table> <p>Note: may not add due to rounding</p>		2020	2022	2023	2024	2025	2026	2027	Forecast total opex	29.9	31.2	39.1	37.7	36.5	36.5	36.5	Less debt raising costs	0.1	0.1	0.6	0.7	0.7	0.7	0.6	Less category specific forecast	0.3	0.3	1.1	1.1	1.1	1.1	1.1	Forecast opex for the OEIM	29.5	30.9	37.4	35.9	34.7	34.7	34.8
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A Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
APA / APA VTS	APA VTS Australia (Operations) Pty Ltd and APA VTS Australia (NSW) Pty Ltd
Capex	Capital expenditure
EBSS	Efficiency benefit sharing scheme
NGR	National Gas Rules
OEIM	Operating expenditure incentive mechanism
Opex	Operating Expenditure
PTRM	Post-tax revenue model
2018–22 period	2018–22 access arrangement
2023–27 period	2023–27 access arrangement
RBA	Reserve Bank of Australia