



DRAFT DECISION
Jemena Gas Networks (NSW)
Ltd
Access Arrangement

2020 to 2025

Attachment 8
Efficiency carryover
mechanism

November 2019

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Jemena Gas Networks (NSW) Ltd ('JGN') for the 2020–2025 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

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

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Attachment 13 – Capital expenditure sharing scheme

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Shortened forms

Shortened form	Extended form
ABS	Australian Bureau of Statistics
AER	Australian Energy Regulator
CESS	Capital expenditure sharing scheme
EBSS	Efficiency benefit sharing scheme
ECM	Efficiency carryover mechanism
EWON	Energy & Water Ombudsman NSW
IPART	Independent Pricing and Regulatory Tribunal
JGN	Jemena Gas Networks (NSW) Ltd
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
Opex	Operating expenditure
RBA	Reserve Bank of Australia
RIN	Regulatory Information Notice
UAG	Unaccounted for gas

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 JGN accrued over the 2015–20 access arrangement period, and the ECM we will apply in the 2020–25 period.

8.1 Draft decision

Our draft decision is to approve a carryover amount totalling –\$9.9 million (\$2019–20) from the application of the ECM in the 2015–20 access arrangement period. This is more than the amended proposal JGN submitted to us on 8 October 2019, which was –\$10.6 million (\$2019–20).¹ It is \$71.7 million (\$2019–20) less than JGN’s initial proposal of \$61.8 million (\$2019–20).²

Our calculated carryover amounts differ from JGN’s amended carryover amounts because we:

- used different inflation figures to convert amounts into 2019–20 dollars
- excluded the costs which JGN recovered through its licence fee factor in its reference tariff variation mechanism during the 2015–20 period, but was not reported as part of the excluded cost category ‘licence fee costs’ in its ECM calculation
- have relied on the amounts of movements in provisions reported in JGN’s access arrangement Regulatory Information Notice.

We have set out our draft decision on the carryover amounts JGN accrued from the operation of the ECM during the 2015–20 access arrangement period in Table 8.1.

¹ JGN, *Response to AER information request 44 – ECM Model*, 8 October 2019.

² JGN, *2020–25 Access Arrangement Proposal – Attachment 7.6 ECM Model*, June 2019.

**Table 8.1 AER’s draft decision on JGN's carryover amounts
(\$ million, 2019–20)**

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
JGN's proposed carryover (as at 8 October 2019)	–5.4	–8.9	4.9	–	–1.3	–10.6
AER's draft decision	–5.0	–8.7	4.9	–	–1.1	–9.9
Difference	0.4	0.1	0.0	–	0.2	0.7

Source: JGN, *Response to AER information request 44 – ECM Model*, 8 October 2019; AER analysis.

Note: Numbers may not add up due to rounding.

Our draft decision takes into account JGN’s estimated opex for 2018–19. In our final decision, we will update our calculation of the carryover amounts using actual opex in that year. We will also update our inflation forecast for 2019–20.

Our draft decision is to approve the application of an ECM to JGN in the 2020–25 access arrangement period, subject to minor amendments that we discuss in section 8.4.2 below. Our revisions to JGN’s proposed ECM are set out in section 8.5.

In applying the ECM to JGN in the 2020–25 period, consistent with JGN’s proposal, we will exclude:

- unaccounted for gas (UAG) costs, licence fee costs (corresponding to those costs that are accounted for in the licence fee factor as an automatic tariff adjustment), carbon costs, the cost of any Relevant Tax change and debt raising costs
- cost categories that are not forecast using a single year revealed cost approach in the access arrangement period commencing on 1 July 2025
- any cost that we agree with JGN to exclude from the operation of the ECM.

We have set out in Table 8.2 the forecast opex we will use to calculate efficiency gains and losses for the 2020–25 period, including forecast debt raising costs.

Table 8.2 AER’s draft decision on JGN’s forecast opex for the ECM for the 2020–25 access arrangement period (\$ million, 2019–20)

	2017–18	2018–19	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25
Total forecast opex	174.2	179.2	178.4	207.4	218.0	222.9	222.4	225.9
Less UAG costs	-17.4	-17.4	-17.4	-31.2	-31.6	-31.7	-31.6	-31.4
Less licence fee costs	-4.3	-4.3	-4.3	-4.7	-4.7	-4.7	-4.7	-4.7
Less debt raising costs	-1.7	-1.7	-1.7	-1.1	-1.1	-1.1	-1.1	-1.1
Less carbon costs	-	-	-	-	-	-	-	-
Forecast opex for the ECM	150.8	155.8	155.0	170.4	180.5	185.4	185.0	188.7

Source: AER, *JGN draft decision - Post tax revenue model*, November 2019; AER analysis.

Note: Numbers may not add up due to rounding.

8.2 JGN’s proposal

8.2.1 Carryover amounts from the 2015–20 period

In its initial proposal, JGN calculated carryover amounts totalling \$61.8 million (\$2019–20) from the application of the ECM in the 2015–20 access arrangement period.³ In its calculation, JGN assumed that it would make an efficiency gain in 2019–20. This assumed efficiency gain corresponds to its removal of one-off costs from its base year (2018–19) expenditure in its initial opex forecast.⁴

Calculating the ECM carryover amount in this manner has the effect of shifting the forecast revenue from JGN’s opex forecast to its calculated ECM carryover amounts. As we stated in the Explanatory Statement of our electricity networks efficiency benefit sharing scheme (EBSS), where base opex is not reflective of the ongoing efficient level of opex, our preferred approach is to select a different base year. The opex forecast and the calculation of ECM carryover amounts should only be adjusted to account for significant one-off factors in the chosen base year if there is no base year reflective of efficient opex available.⁵ Therefore, we advised JGN that our preferred approach would be to adopt 2017–18 as its base year to forecast its opex, thereby removing the need to make any adjustment to its base year opex and its ECM calculation. JGN’s opex for 2017–18 did not include any significant one-off costs.

³ JGN, *2020–25 Access Arrangement Proposal – Attachment 7.11 Incentive schemes*, June 2019, p. 1; JGN, *2020–25 Access Arrangement Proposal – Attachment 7.6 ECM Model*, June 2019.

⁴ JGN, *2020–25 Access Arrangement Proposal – Attachment 7.6 ECM Model*, June 2019.

⁵ AER, *Better Regulation – Explanatory Statement Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 16.

On 2 September 2019, JGN submitted an amended opex forecast with 2017–18 as its base year. The forecast did not adjust base year opex adjustment to remove any one-off costs. It also removed the associated adjustment in its ECM calculation.⁶

On 8 October 2019, JGN submitted a further amended ECM calculation, updating its reported movements in provisions.⁷ JGN's most recent ECM calculation produced carryover amounts totalling –\$10.6 million (\$2019–20).

JGN excluded the following cost categories in calculating its ECM carryover amounts:⁸

- UAG costs
- licence fee costs
- debt raising costs
- carbon costs
- the cost of any Relevant Tax.

It also reversed its movements in provisions related to opex.

8.2.2 Application in the 2020–25 period

JGN proposed that we apply an ECM consistent with version 2 of the electricity network EBSS in the 2020–25 access arrangement period.⁹

JGN updated the proposed ECM so that any cost category not forecast using a single year revealed cost approach in the access arrangement period commencing 1 July 2025 will be automatically excluded from the operation of the ECM — consistent with other gas business' access arrangements, such as AusNet Services and Multinet. It also included an adjustment for costs that we agree should be excluded.¹⁰

JGN removed from its proposed ECM the requirement to make adjustments for capitalisation policy changes. JGN stated that this is to ensure consistent treatment of expenditure across the capital expenditure sharing scheme (CESS) it is proposing (see Attachment 13) and the ECM. JGN states that its proposed CESS is modelled on the CESS we recently approved for other gas businesses and it does not have an equivalent requirement to make adjustments for capitalisation policy changes.¹¹

⁶ JGN, *Response to information request 21*, 2 September 2019.

⁷ JGN, *Response to information request 44 – ECM Model*, 8 October 2019.

⁸ Ibid.

⁹ JGN, *2020–25 Access Arrangement Proposal – Attachment 7.11 Incentive schemes*, June 2019, pp. 1–2.

¹⁰ Ibid, p. 2.

¹¹ Ibid.

8.2.3 Stakeholder submissions

AGL submitted that JGN's efficiency carryover of \$61.8 million (\$2019–20) appears to be incongruous because JGN's proposed opex is 13 per cent higher than its actual and estimated opex in the current (2015–20) access arrangement period.¹²

As explained in section 8.2.1, and in Attachment 6, JGN's initial ECM calculation assumed that it would make an efficiency gain in 2019–20. This corresponds to its removal of one-off costs from its base year (2018–19) expenditure in its initial opex forecast. This does not reflect the actual efficiency gains JGN has made within the 2015–20 period to date. JGN has since submitted an amended opex forecast and ECM calculation. The amended ECM carryover amounts total –\$10.6 million (\$2019–20).¹³

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.¹⁴ An incentive mechanism must be consistent with the revenue and pricing principles.¹⁵

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
- (b) the efficient provision of pipeline services
- (c) the efficient use of the pipeline.”¹⁶

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,

¹² AGL Energy Limited, *Jemena Gas Networks (NSW) Access Arrangement 2020–25*, August 2019, p. 4.

¹³ JGN, *Response to information request 21 – ECM Model*, 2 September 2019.

¹⁴ NGR, r. 98(1).

¹⁵ NGR, r. 98(3).

¹⁶ NGL, s. 24(3).

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 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 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 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 to JGN has a strong interrelationship with our decision on its 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 JGN's opex.

8.4 Reasons for draft decision

8.4.1 Carryover amounts from the 2015–20 period

Our draft decision is to approve carryover amounts totalling –\$9.9 million (\$2019–20) from the application of the ECM in the 2015–20 access arrangement period.

Our calculated carryover amounts differ from the carryover amounts in the amended proposal JGN submitted to us 8 October 2019 because we:

- used different inflation figures to convert amounts into 2019–20 dollars
- amended the reported amounts of JGN's 'licence fee costs' in our ECM calculation
- have relied on the amounts of movements in provisions reported in JGN's access arrangement RIN.

Our draft decision is based on JGN's estimated opex for 2018–19. In our final decision, we will update our calculation of the carryover amounts using actual opex in that year. We will also update our inflation forecast for 2019–20.

Inflation

We have used different inflation figures for 2018–19 and 2019–20 than JGN did. For 2018–19 we used the actual CPI figures published by the Australian Bureau of Statistics (ABS), which were released after JGN submitted its proposal.¹⁷ For 2019–20 we used the inflation forecast in the Reserve Bank of Australia's (RBA) August 2019 *Statement on monetary policy*.¹⁸ This was also published after JGN submitted its proposal.

Licence fee costs

The excluded cost category 'licence fee costs' is intended to capture government levies and licence fees that are 'trued up' under the automatic adjustment licence fee factor within the reference tariff variation mechanism. The automatic adjustment allows JGN to recover the exact amount it incurs for these costs from its network users. Consequently we exclude these costs from the ECM.

JGN stated that the amount it reports for 'government levies', which is the basis for the 'government levies' forecast in its opex forecast, only includes charges levied by local government areas in NSW (mains tax) and licence fees charged by the Independent Pricing and Regulatory Tribunal (IPART).¹⁹ JGN's reported 'government levies' amounts are the same as the reported 'licence fee costs' amounts in its ECM calculation and do not include the:²⁰

- annual licence fees for individual pipelines that JGN paid to the Department of Planning and Environment (Pipeline fees)
- annual fees, customer number fees and projected case work fees that it paid to the Energy & Water Ombudsman NSW (EWON fees).

Both of these costs were recovered from JGN's network users via the reference tariff adjustment licence fee factor in the 2015–20 access arrangement period the same way as JGN's IPART licence fees.

To calculate the opex efficiency gains and losses JGN has made in the current (2015–20) access arrangement period and the appropriate ECM carryover amounts, we must exclude costs that JGN has recovered through automatic adjustments. Accordingly, we have amended the reported 'licence fee costs' amounts to also include the Pipeline fees and EWON fees in our ECM calculation.

¹⁷ ABS, *Catalogue number 6401.0, Consumer price index*, June 2019.

¹⁸ RBA, *Statement on monetary policy, Appendix: Forecasts*, August 2019.

¹⁹ JGN, *Response to information request 18(Q4) – Opex Multiple Matters (Confidential)*, 29 August 2019, pp. 3–4.

²⁰ JGN, *2020–25 Access Arrangement Proposal – Attachment 6 Workbook 2 – Historical data Consolidated (Confidential)*, June 2019.

Movements in provisions

We have relied on the movements in provisions amounts JGN reported in its access arrangement RIN to calculate its ECM carryover amounts because these were audited.²¹ When JGN resubmitted its ECM calculation on 8 October 2019, it included movements for an additional provision that it had not reported in its access arrangement RIN. The additional provision was for ‘compensation’.²²

JGN explained that it identified the omission of the ‘provision for compensation’ in its 2017–18 RIN response when it was preparing its 2018–19 RIN response. It stated that it intends to rectify this error in its 2017–18 RIN response when it submits its 2018–19 RIN response.²³

We will update our ECM carryover calculation with the corrected provision amounts when JGN resubmits its 2017–18 RIN, when those corrections will have been audited. This is to ensure that we take into account any change to JGN’s reported total opex arising from the reporting of the new provision.

8.4.2 Application in the 2020–25 period

Our draft decision is to approve the application of an ECM to JGN in the 2020–25 access arrangement period.

We have made minor amendments to JGN’s proposed ECM in this draft decision to be consistent with version 2 of the EBSS for electricity service providers and other gas distribution business equivalent incentive mechanisms.²⁴ In particular, we have changed the ECM formula to reflect that the chosen base year for our opex forecast is 2017–18, rather than 2018–19. We have also changed the forecast opex specified in clause 12.1(i) to reflect our opex draft decision. We have set out our revisions to JGN’s proposed ECM in section 8.5.

Length of carryover period

To ensure continuous incentives, the length of the carryover period for the 2020–25 access arrangement period will be the same as the length of JGN’s following access arrangement period. We expect JGN’s next access arrangement period will be five years, starting from 1 July 2025.

Adjustments to forecast or actual opex when calculating carryover amounts

In applying the ECM to JGN in the 2020–25 access arrangement period, consistent with JGN’s proposal, we will exclude:

²¹ Ibid, ‘F.7 Provisions’.

²² JGN, *Response to information request 44 – ECM model*, 8 October 2019.

²³ JGN, *Email to the AER – Provisions*, 15 October 2019.

²⁴ AER, *Efficiency benefit sharing scheme for electricity network service providers*, November 2013.

- UAG costs, licence fee costs (corresponding to those costs that are accounted for in the licence fee factor as an automatic tariff adjustment), carbon costs, the cost of any Relevant Tax change and debt raising costs
- cost categories that are not forecast using a single year revealed cost approach in the access arrangement period commencing on 1 July 2025
- any cost that we agree with JGN to exclude from the operation of the ECM.

For avoidance of doubt, consistent with our standard approach, we will also adjust:

- forecast opex to add (subtract) any approved revenue increments (decrements) made after our 2020–25 final decision, such as approved pass through amounts
- actual opex to reverse any movements in provisions
- forecast and actual opex for inflation.

In our draft decision on opex, we have not forecast JGN’s EWON costs as part of our ‘licence fee costs’ opex category specific forecast. This is because we have not allowed JGN’s EWON fees to be automatically adjusted in JGN’s reference tariff variation mechanism. Allowing JGN’s EWON costs to be included in the automatic adjustment ‘licence fee factor’ would reduce the incentive for JGN to improve its complaint-handling process and reduce the fees it pays to EWON. It would not be in the long term interests of JGN’s network users, and the National Gas Objective (NGO), for the cost of EWON handling complaints to be passed through to network users. Accordingly, while we continue to exclude JGN’s ‘licence fee costs’ from the ECM in the 2020–25 period, this exclusion does not include EWON fees.

8.5 Revisions

To be consistent with our opex draft decision and reflect our selection of 2017–18 as the base year for our opex forecast, we require the following revisions to JGN’s proposed ECM:

Table 8.3 JGN’s ECM revisions

Revision	Amendment
Revision 8.1	<p>Amend clause 12.1(c) so that it reads:</p> <p>(c) The incremental efficiency gain (or loss) for the Financial Year 2020–21 will be calculated as:</p> $(F_{2020-21} - A_{2020-21}) - [(F_{2019-20} - A_{2019-20}) - (F_{2017-18} - A_{2017-18})] - \text{non-recurrent efficiency gain}_{2017-18}$ <p>where:</p> <p>$F_{2020-21}$ is the forecast operating expenditure for Financial Year 2020–21;</p> <p>$A_{2020-21}$ is the actual operating expenditure for Financial Year 2020–21;</p> <p>$F_{2019-20}$ is the forecast operating expenditure for Financial Year 2019–20;</p> <p>$A_{2019-20}$ is the actual operating expenditure for Financial Year 2019–20;</p> <p>$F_{2017-18}$ is the forecast operating expenditure for Financial Year 2017–18; and</p> <p>$A_{2017-18}$ is the actual operating expenditure for Financial Year 2017–18.</p>

*non – recurrent efficiency gain*_{2017–18} is the adjustment made to $A_{2017–18}$ used to forecast operating expenditure in the access arrangement period commencing 1 July 2020 to account for operating expenditure associated with one-off factors.

Revision 8.2 Amend clause 12.1(e) so that it reads:

The incremental efficiency gain (or loss) for Financial Year 2024–25 will be calculated as:

$$(F_{2024–25} - A_{2024–25}^*) - (F_{2023–24} - A_{2023–24})$$

where actual operating expenditure in the Financial Year 2024–25 is to be estimated using the following equation:

$$A_{2024–25}^* = F_{2024–25} - (F_b - A_b) + \textit{non – recurrent efficiency gain}_b$$

and where:

$A_{2024–25}^*$ is the estimate of operating expenditure for Financial Year 2024–25;

$F_{2024–25}$ is the forecast operating expenditure for Financial Year 2024–25;

F_b is the forecast operating expenditure for the base year used to forecast operating expenditure in the access arrangement period commencing 1 July 2025;

A_b is the actual operating expenditure for the base year used to forecast operating expenditure in the access arrangement period commencing 1 July 2025; and

*non – recurrent efficiency gain*_b is the adjustment made to A_b used to forecast operating expenditure in the access arrangement period commencing 1 July 2025 to account for operating expenditure associated with one-off factors.

Revision 8.3 Amend clause 12.1(f)(ii) so that it reads:

(ii) the incremental efficiency gains (or losses) are carried over from Financial Year to Financial 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 commencing 1 July 2025.

Revision 8.4 Amend clause 12.1(h)(ii) so that it reads:

(ii) licence fee costs that are accounted for in the calculation of the licence fee factor amount in clause 2.1 of Schedule 3 of this Access Arrangement;

Revision 8.5 Delete the table in clause 12.1(i) and replace it with Table 8.2 from this document.