29 July 2016

Mr Jai McDermott
General Manager Corporate Affairs
United Energy and Multinet Gas
6 Nexus Court
Mulgrave Victoria 3170
Via Email: jai.mcdermott@ue.com.au

Response to Issues Paper - Incentive Mechanisms for the Victorian Gas Distribution Businesses

Dear Mr McDermott,

The Energy Networks Association (ENA) welcomes the opportunity to provide its comments in relation to the Issues Paper *Incentive Mechanisms for the Victorian Gas Distribution Businesses* (the Issues Paper).

The Issues Paper was released for consultation by Victorian gas distribution businesses Multinet Gas, Australian Gas Networks and AusNet Services (the businesses). The goal of the Issues Paper is to examine potential changes to incentive arrangements that the businesses could propose to the Australian Energy Regulator (the AER) for the forthcoming (2018 to 2022) access arrangement period.

This consultation process demonstrates that network businesses are making genuine efforts to effectively engage with their customers and to increase stakeholder transparency in the development of their access arrangements proposals.

Given that the existing incentive arrangements for gas businesses lack both a service incentive mechanism and a Capital Expenditure Sharing Scheme (CESS) that currently apply in electricity; the ENA considers that there is a clear opportunity to promote the long-term interests of gas customers by improving the existing incentive arrangements in gas.

As such, members of the ENA support the use of incentive-based mechanisms to promote continuous, effective and stable financial incentives for efficient expenditure.

Section 98 of the *National Gas Rules* (NGR) provides the AER with broad power with respect to the implementation of incentive schemes for individual gas distribution businesses. The inclusion of new incentive schemes in the businesses access arrangement proposals is consistent with the requirements of the rules and this matter deserves a detailed assessment by the AER.

The AER indicated in the recent decision for AGN's South Australian network that the lack of an industry wide consideration was a factor that meant it was not sufficiently confident to approve a strengthening of the incentive arrangements. The AER's Statement of Intent 2016-17 states that the AER will consider extending the CESS to gas throughout 2016-17.[1] This represents a positive step by the AER towards enhancing the incentive arrangements in gas. However, the timing of this upcoming review does not align with the businesses' access arrangement process. The ENA is concerned that the potential five-year delay in the introduction of the strengthened incentive arrangements for Multinet Gas, Australian Gas Networks and AusNet Services may result in significant potential customer benefits being delayed in their realisation.

The ENA supports the specific proposals explored by the businesses on the basis that:

» The NGR clearly contemplate that the businesses may propose incentive mechanisms to the AER and the rules were specifically intended as a flexible and adaptive framework allowing innovation in the development and proposal of incentive mechanisms.

[1] AER, Statement of Intent 2016-17, p.8.

- The proposed incentive arrangements are informed by the incentive arrangements that currently apply to electricity distribution businesses in the National Electricity Market. The AER undertook significant industry consultation through its Better Regulation program in 2013 and it would seem appropriate to adopt common approaches for gas and electricity.
- Taking an industry wide approach reduces the administrative costs of regulation lower and provides for consistent cost-efficiency signal across infrastructure types.

In this submission, the ENA does not address the individual questions posed in the Issues Paper.

Comments on Issues Paper

Incentives for efficient expenditure

The ENA supports the use of incentive-based mechanisms to promote continuous, effective and stable financial incentives for efficient expenditure.

During the 2012 rule change process, the Australian Energy Market Commission (AEMC) identified the following potential benefits of a CESS:

> *"The Commission identified the following benefits with capex sharing schemes in the draft rule determination:*
>
> - *they encourage appropriate network investment;*
> - *they encourage NSPs [Network Service Providers] to look for efficiencies, such as by innovation;*
> - *they provide an incentive for NSPs to reveal their efficient costs; and*
> - *they can be designed to provide for a continuous incentive, that is, the incentives could be set so that the incentive power is the same no matter in which year of a regulatory control period an investment is made."*[2]

Subsequently, changes to the *National Electricity Rules* (NER) were introduced to provide the AER with the discretion to develop a capital expenditure sharing scheme, so that the regulator can incentivise network service providers to invest capital efficiently.

The AER currently applies the following incentive mechanisms to electricity distribution and transmission businesses:

- Efficiency Benefit Sharing Scheme;
- Service Target Performance Incentive Scheme; and
- Capital Expenditure Efficiency Sharing Scheme.

The mechanisms listed above complement and reinforce each other to ensure that that incentives for capital and operating expenditure efficiencies are:

- Constant through the duration of a regulatory period;
- Balanced so that cost reduction does not compromise appropriate service quality; and
- Neutral in terms of which expenditure to incur (capex or opex).

The same incentive arrangements currently do not apply to gas distribution businesses. The AER's approach to gas is consistent with its approach to electricity prior to the rule changes, i.e. the AER applies an operating

[2] AEMC 2012, "Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper", November 2012, p.121.

expenditure benefits sharing scheme only. This results in an unbalanced incentive framework in operation for regulated gas distribution businesses across Australia.

To this end, the ENA considers that the development and implementation of a capital expenditure sharing scheme in gas would be desirable.

Balancing incentives for cost reduction and service quality

The ENA recognises that the CESS that applies under the NER is balanced by a Service Target Performance Incentive Scheme (STPIS), which provides a balancing incentive to maintain or improve service quality against incentives for cost reduction. There is no comparable balancing STPIS for gas distribution businesses, although jurisdiction Guaranteed Service Level (GSL) exists in Victoria.

It may be argued that incentive measures relating to reliability are required in order to balance strengthened expenditure incentives (i.e. the CESS) and reduce the scope for inefficient deferrals. However, the incentive problem only applies where businesses have substantial discretion over the timing of investment. Given that the businesses are subject to the GSL obligations under the Victorian Gas Distribution System Code and the licensing and reporting frameworks, the discretion for investment projects to be deferred is limited.

To the extent that the incentive problem exists, the ENA considers that there are practical solutions available to fix this issue. For example, the AER has developed a deferred capex adjustment mechanism for electricity businesses, which is designed to deter network firms from inefficient deferral between regulatory periods.

Customer Service Incentive Scheme

The businesses have proposed a new Customer Service Incentive Scheme (CSIS). The scheme draws on some of the features of the current electricity distribution Service Target Performance Incentive Scheme, including setting revenue at risk, parameters, performance targets, incentive rates and exclusions.[3]

The ENA understands the detailed design of the potential scheme will require considered development, with a key focus being ongoing engagement with stakeholders and the AER on performance measures possible for inclusion, particularly measures around safety, reliability and service.

The ENA considers that the CSIS can provide benefits to consumers by encouraging a strong focus on improving performance and better aligning the incentives for the businesses with outcomes that are desirable for customers.

Network Innovation Scheme

It is widely accepted that the incentive for a regulated monopoly to invest in innovative projects is materially different to an unregulated business. Therefore, the ENA considers that specific measures, such as the proposed Network Innovation Scheme (NIS), are desirable to ensure that optimal levels of investment in network innovation can be delivered.

Gas is often referred to as ‘a fuel of choice’ because practical substitutes such as LPG and electricity are available. Gas networks’ pricing decisions are, therefore, constrained by the risk of declining demand as customers may choose to substitute gas for alternative fuels. It can be argued that this provides gas businesses with greater incentives to innovate. However, gas distributors are still regulated monopolies under the existing regime to which the CPI-X form of regulation is applied. There are a number of aspects unique to the existing regulatory regime that hinder investment in innovation by gas networks:

- » an allowance for innovation is not included in the regulated forecasts;
- » revenues are reset shortly after the innovation (such that the benefits of that innovation are also passed through to consumers after a short period); and[4]

[3] Farrier Swier, Issues Paper, Incentive Mechanisms for the Victorian Gas Distribution Businesses, p.37.
[4] AGN, Access Arrangement Information for Australian Gas Networks’ South Australian Natural Gas Distribution Network. July 2015, p.201.

» due to the uncertainty of outcomes with innovation initiatives, it is often hard to demonstrate that the spend will satisfy the expenditure tests, and is therefore unlikely to be allowed by the regulator.

The ENA notes that the proposed NIS also reflects reforms occurring overseas. In the UK, Ofgem's framework for price controls, known as RIIO (Revenue = Incentives + Innovation + Outputs), includes an Innovation Stimulus Package that applies to gas distributors. It seeks to encourage innovation that contributes to low carbon economy objectives through innovation funding mechanisms, which provide an upfront partial funding of innovation projects.

If further information is sought on this matter, please contact Garth Crawford, Executive Director, Economic Regulation, on 02 6272 1555.

Yours sincerely,

John Bradley

Chief Executive Officer