Draft Decision

AusNet Gas Services
Access Arrangement 2023 to 2028

(1 July 2023 to 30 June 2028)

Overview

December 2022

AUSTRALIAN
ENERGY
REGULATOR

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Amendment record

Version	Date	Pages
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Invitation for submissions

This attachment forms part of the AER's draft decision on the access arrangement that will apply to for the 2023–28 access arrangement period. It should be read with all other parts of the draft decision.

In response to our draft decision, AusNet has the opportunity to submit a revised proposal for its upcoming 2023–28 access arrangement period by **24 January 2023**.

Interested stakeholders are also invited to make submissions on both our draft decision and AusNet's revised proposal (once submitted) by **23 February 2023**.

Subject to stakeholder interest we will also consider holding a public forum following submission of the revised proposal.

Submissions should be sent to: VicGAAR2023@aer.gov.au

Alternatively, submissions can be sent to:

Arek Gulbenkoglu
General Manager
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Submissions should be in Microsoft Word or another text readable document format.

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested.

Parties wishing to submit confidential information should:

1. clearly identify the information that is the subject of the confidentiality claim
2. provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on our website.[1]

[1] For further information regarding our use and disclosure of information provided to us, see the *ACCC/AER Information Policy* (June 2014), which is available on our website: www.aer.gov.au/publications/corporate-documents/accc-and-aer-information-policy-collection-and-disclosure-of-information.

Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to AusNet Gas Services (AusNet) for the 2023–28 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

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

Executive summary

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable, and affordable energy future for Australia. The regulatory framework governing gas transmission and distribution networks is the National Gas Law and Rules (NGL and NGR). Our work is guided by the National Gas Objective (NGO).

A regulated gas network business must periodically apply to us for a ruling on network charges, in the form of an access arrangement specifying the services it will provide, the tariffs for those services, and the other terms and conditions on which they will be provided. AusNet Gas Services[2] (AusNet) has submitted a proposal for its Victorian gas distribution network for the 1 July 2023 to 30 June 2028 access arrangement period (2023–28 period). The day after AusNet's initial proposal was submitted on 1 July 2022, the Victorian government released its Gas Substitution Roadmap (Roadmap). We therefore allowed AusNet to submit an addendum to its proposal outlining in which it specified proposed changes in response to the Roadmap. This draft decision is on AusNet's amended proposal.

AusNet's proposal would allow it to set gas network charges resulting in the recovery of an expected $1260.7 million ($ nominal, smoothed) in revenues from consumers over the 2023–28 period. Our draft decision is not to accept that proposal. This draft decision would currently allow AusNet to recover an estimated $1205.2 million from consumers over the 2023–28 period: a reduction of $55.5 million (4.4%).

This draft decision marks the mid-point in our assessment of AusNet's proposal. Final decision outcomes may be significantly different:

- Our draft decision has accepted much of AusNet's proposal, including its forecasts of capital expenditure (capex) and demand. We have included an alternative forecast of operating expenditure (opex) that includes levies AusNet pays to Energy Safe Victoria (which AusNet had proposed instead to recover through its annual tariff variation mechanism). However, we have not accepted the full amount of its proposed accelerated depreciation. It is now open to AusNet to submit additions or other amendments to the access arrangement proposal in a revised proposal, to address matters raised in this draft decision. This may result in changes to the revenue requirement we ultimately approve.
- Movements in market variables such as interest rates, bond rates and expected inflation are currently acting to increase the return on AusNet's capital base. Updates for these movements are a standard part of our decision making process and do not result from differences between us and AusNet. Our final decision will reflect the latest available market information and therefore will likely be different to what is forecast at this draft decision stage.

In simple terms, AusNet's tariffs reflect cost (forecast nominal revenue) and demand. Our draft decision accepts AusNet's forecast of declining demand over the period of this access arrangement. Applied to growing nominal revenue (as interest rates and expected inflation rise), lower demand will lead to an increase in tariffs. For illustrative purposes only, we estimate the potential impact of AusNet's initial proposal at a system wide level would be a

2 AusNet Gas Services Pty Limited (ABN 43 086 015 036),

25.9% nominal increase to average network charges over the next 5 years. Our draft decision would allow for a lower revenue than AusNet's proposal, with reductions to revenue from lower accelerated depreciation and higher expected inflation more than offsetting the increases from the higher rate of return and opex. Our adopted revenue smoothing approach means the modelled impact of our draft decision is a nominal increase of around 18%.

In arriving at this draft decision, our reasons for which are set out in this Overview and its attachments, we make the following observations.

Transformation in the energy system and the explicit policy goal of reaching net zero emissions by 2050 create considerable uncertainties in future gas demand expectations. The Roadmap steps out how Victoria will move towards net zero emissions whilst providing greater choice and cutting energy bills through the use of energy efficiency, electrification, hydrogen and biogas. Change will be driven through several initiatives including stronger incentives to switch from gas to efficient electric appliances, and the removal of planning provisions requiring new housing developments to connect to gas. Whilst these measures are expected to accelerate the decline of gas demand, there is uncertainty as to how quickly that will happen.

As usage falls and fewer customers remain connected, the ongoing costs of maintaining the network are shared by a smaller number of customers over time. This poses a number of challenges, including that the cost burden of past investments may be disproportionately borne by future gas customers and that assets may be economically stranded. These considerations prompted us to explore—in our information paper, '*Regulating gas pipelines under uncertainty*'—what we can do to manage these risks in our regulation of gas distribution and transmission networks.

The decision we make on this access arrangement cannot resolve the current uncertainty. It can, however, begin to manage some of the risks that it presents and mitigate their potential impact. We have been mindful of these challenges in arriving at an outcome with sufficient flexibility to balance affordability with the safe, reliable, and secure delivery of essential energy services, so that consumers are better off both now and in the future.

This draft decision approaches this in two ways:

- by ensuring consumers pay no more than necessary and closely scrutinising forecasts of the capex and opex required to provide safe, secure, and reliable gas supply.
- by taking small steps now to manage the equitable recovery of those costs from a declining, and sometimes vulnerable, customer base over time.

Our review of proposed capex and opex forecasts recognises that as long as there is demand from consumers and businesses for gas distribution services, a level of investment in the networks that provide those services is necessary to ensure safe, reliable and secure gas supply.

Our draft decision has not accepted AusNet's proposed opex forecast. There are few material areas of difference between us and AusNet on the prudent and efficient level of expenditure it is likely to require over the 2023–28 period. Where we have differed is primarily in AusNet's proposed approach to the recovery of levies it pays to Energy Safe Victoria. AusNet proposed removing the cost of the levies from its opex forecast, and instead recovering its actual levy costs annually through the price control mechanism. The alternative estimate of opex we have included in this draft decision returns these levies to its opex forecast (consistent with the current period) and is therefore higher than AusNet proposed because we have included these. We consider it appropriate that the ESV levy costs, as with all other opex costs, are subject to the ex-ante incentive-based regime rather than a cost-of-service approach as would be the case under the price control mechanism.

Our draft decision accepts AusNet's total forecast capex. Following reductions to projected connections and growth driven capex in response to the Roadmap, this forecast is a significant step down from the current period. We have looked closely at remaining growth capex and other key drivers of the proposed expenditure for 2023–28. These include continuation of AusNet's mains replacement program and investment in information and communications technology required to maintain acceptable levels of service on the network. Our assessment is that the total capex forecast proposed will allow AusNet, acting prudently, efficiently and in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services over the 2023–28 period.

Capex mostly relates to assets with long lives, the costs of which are recovered—or depreciated—over several access arrangement periods. In the context of the anticipated reductions in demand driven by the Roadmap, and subsequent reduced forecasts for investment in new connections and network growth, we consider there is sufficient evidence, backed up by a convincing business narrative, to support some acceleration of that depreciation but not by the full amount proposed by AusNet. For the purposes of this draft decision, we have reduced AusNet's accelerated depreciation to target a 0% per annum real price change. We consider that consumers need to be further consulted on AusNet's proposed approach to, and the level of, accelerated depreciation included in its proposal and the impact it will have in this and future access arrangement periods. We acknowledge that the final decision outcome on accelerated depreciation may therefore differ from this draft decision.

By taking measured steps now to bring forward the cost recovery of efficient investments, accelerated depreciation would provide investment certainty for capex still needed to maintain safe, reliable, and secure supply. In doing so, it also mitigates the risk of material price increases in the future as costs are recovered from a declining customer base. However, it is important to consider the impact accelerated depreciation may have on price stability and affordability. If not balanced carefully, the higher prices that flow from accelerated depreciation in the short term can potentially drive accelerated disconnections from the network. A balance needs to be struck between what consumers pay now to mitigate future price increases, and the risk of greater increases in the future if mitigation is delayed. In this draft decision, we have therefore allowed a smaller amount of accelerated depreciation than AusNet proposed.

As more customers choose to move permanently from gas to other sources of energy the costs of removing connection assets for individual premises, and the safety risks associated with leaving dormant connection assets in situ, have also come under close scrutiny. In reviewing this proposal, we have considered the costs of abolishing connections and the broader question of how these costs are recovered from consumers over time.

The cost recovery choices are broadly to recover from individual customers at the time of disconnection or to socialise them across all customers in the network. The high proposed cost of recovery from individual customers may act as a barrier to switching to alternative fuels. The socialising of costs may create a risk of leaving a diminishing pool of those least able to move carrying the burden of this cost, as well as paying a higher maintenance cost to keep the network going. In addition, there may also be a discussion to be had around the merits of permanent versus temporary disconnection, subject to safety considerations. The most equitable solution to this question still warrants further debate.

Our draft decision is to keep open both of the two cost recovery approaches described above, and to invite AusNet's revised proposal and stakeholder submissions to comment on the merits of each.

Regulatory proposals benefit from genuine engagement with consumers. AusNet has engaged early and widely on its proposal and has demonstrated a strong commitment to building dialogue with both consumers and advocates. The lengthy nature of this engagement has meant that a lot of these discussions pre-dated subsequent significant policy and economic changes. While we've seen the benefits of early engagement in considered and impactful submissions to this review, it is not surprising that there is still some lack of consensus whilst the impact of these changes is being considered by stakeholders. Maintaining and increasing this level of engagement will play a critical role in resolving the issues that have been most contentious and have been identified in our draft decision as requiring further consideration. We expect AusNet's commitment to engagement to continue as it works with consumers to arrive at its revised proposal.

Contents

1 Our draft decision

AusNet's proposed access arrangement sets out the services it will provide in the five years from 1 July 2023 to 30 June 2028 (2023–28 period), the tariffs for those services, and the other terms and conditions on which they will be provided.

The day after AusNet's initial proposal was submitted on 1 July 2022, the Victorian government released its Gas Substitution Roadmap. We therefore allowed AusNet to submit an addendum to its proposal in which it specified proposed changes in response to the Roadmap. This draft decision is on AusNet's amended proposal.

The AER's decision on an access arrangement proposal must approve it in its entirety or not at all. An access arrangement draft decision indicates whether the AER is prepared to approve the access arrangement proposal as submitted and, if not, the nature of the amendments that are required in order to make the proposal acceptable to the AER.

At the centre of our decision is the forecast total revenue requirement for the provision of the regulated reference services over the next five years. In the sections below we briefly outline what is driving the expected revenue in this draft decision, and the key differences between our draft decision revenue of $1205.2 million ($ nominal, smoothed) compared to AusNet's proposed $1260.7 million.

Since AusNet lodged its proposal, we have seen increases in interest rates. In this draft decision we have employed current interest rates rather than the placeholder values in AusNet's proposal, as set out in section 3.2. It is important that we update for the latest market data so that our draft decision reflects current financial market conditions. This enables AusNet to attract the capital it needs to provide the services that consumers want.

Moreover, the return investors receive on their assets should reflect the risks of their investment. These risks include the prospect of inflation eroding the investor's purchasing power. An allowance for expected inflation provides compensation for this risk.

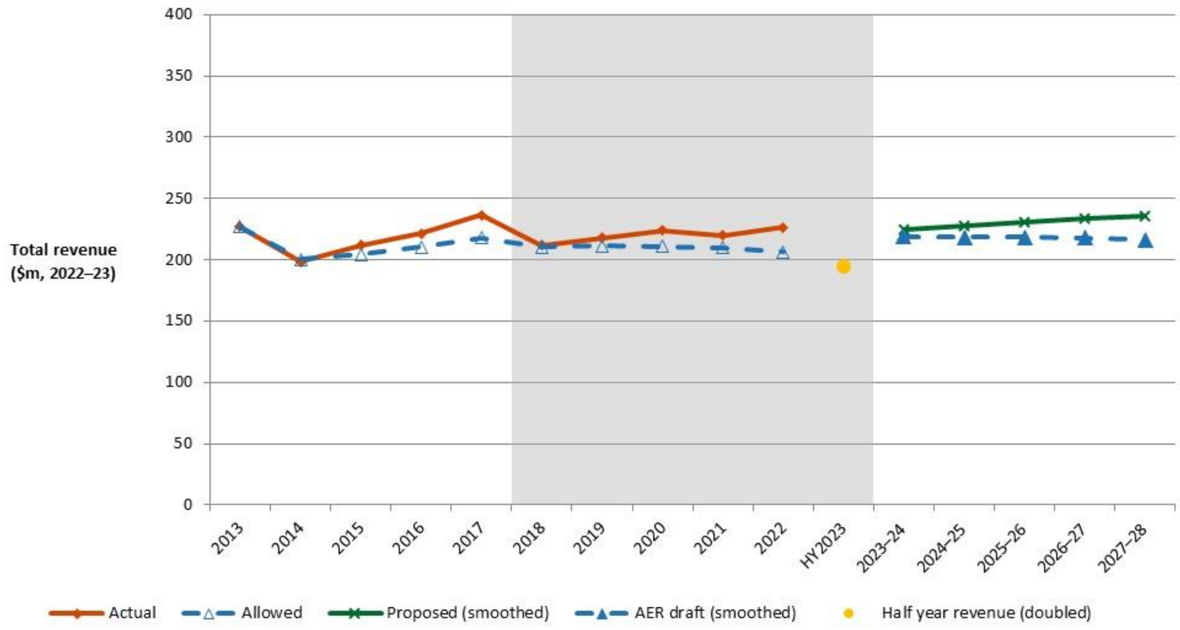
- The return on capital building block applies a nominal rate of return to the capital base. As the nominal rate of return includes expected inflation, part of that building block compensates for expected inflation. Higher expected inflation increases the return on capital mainly due to the capital base and capex.
- The return of capital building block removes expected inflation indexation of the capital base from forecast depreciation. This avoids compensation arising from the effects of inflation being double counted by including it in the return on capital building block and also as a capital gain (through the indexation of the capital base). Higher expected inflation therefore reduces the regulatory depreciation allowance.
- Other building blocks (such as opex, and revenue adjustments) include an inflation component, as the costs forecast in real dollar terms are escalated to nominal dollars using expected inflation in determining the required nominal revenues. Higher expected inflation will increase opex and revenue adjustments.

1.1 What is driving revenue?

Over time, inflation impacts the spending power of money. To compare revenue from one period to the next on a like-for-like basis, in this section we use ‘real’ values based on a common year (2022–23) that have been adjusted for the impact of inflation instead of the nominal values above.

Figure 1 shows how revenue would change over the next 5 years in real terms, under AusNet’s proposal and our draft decision.

Figure 1 Changes in regulated revenue over time ($million, 2022-23)

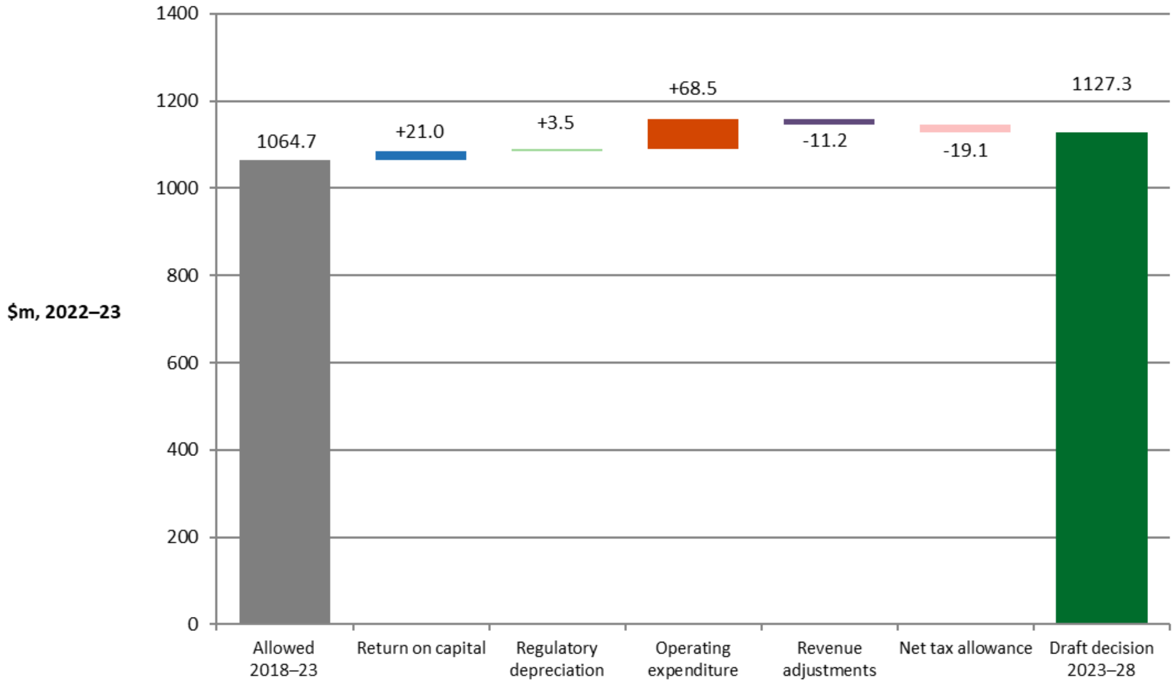


Source: AER, *AusNet Services - PTRM - Final Decision - 2022 RoD update*; AusNet, *ASG - GAAR 2024-28 PTRM*, September 2022; AER, *AER DD - AusNet gas - 2023-28 PTRM*, December 2022

Where the assumptions in AusNet’s proposal would have resulted in total smoothed revenue that was $103.0 million (9.8%) higher than approved for the current period, the modelled impact of our draft decision is currently an increase of $41.0 million (3.9%).

Figure 2 highlights the key drivers of the change between the expected revenue approved for AusNet’s current, 2018–22 period and that approved in this draft decision for 2023–28, again in real terms.

Figure 2 Change in building block revenue 2018–22 to 2023–28 ($million, 2022-23; unsmoothed)



Source: AER, *AusNet Services - PTRM - Final Decision - 2022 RoD update*; AER, *AER DD - AusNet gas - 2023-28 PTRM*, December 2022. The $68.5 million increase in opex building block also includes the $21.4 million ($2022–23) increase in ancillary reference services.

The return on capital in AusNet's draft decision is higher than in the current period. The value of AusNet's capital base is projected to decline in real terms over 2023–28 as a result of accelerated depreciation of assets and lower forecast capex compared to the current period. The total forecast capex for 2023–28 included in our draft decision revenue requirement is lower than AusNet's forecast capex in the 2018–22 period, which would reduce the return on capital in the 2023–28 period compared to the 2018–22 period. However, the placeholder rate of return for the 2023–28 period is also higher on average than applied for the 2018–22 period and will be updated in next year's final decision in accordance with the incoming and binding 2022 Rate of Return Instrument.

The return of capital (regulatory depreciation) is slightly higher. Depreciation is a method used in our decision to allocate the cost of an asset over its useful life, rather than allocating the full cost to the period in which it is incurred. AusNet's 'price cap' form of control means that declining demand will drive the prices it charges to recover its revenue requirement upwards. Our draft decision allows for accelerated depreciation of AusNet's capital base as a way to balance the recovery of investment between current users of the network and a declining number of future users. The higher inflation rates we're currently seeing would (all else held constant) be reducing regulatory depreciation. Here, that effect is largely offsetting the impact of accelerated depreciation.

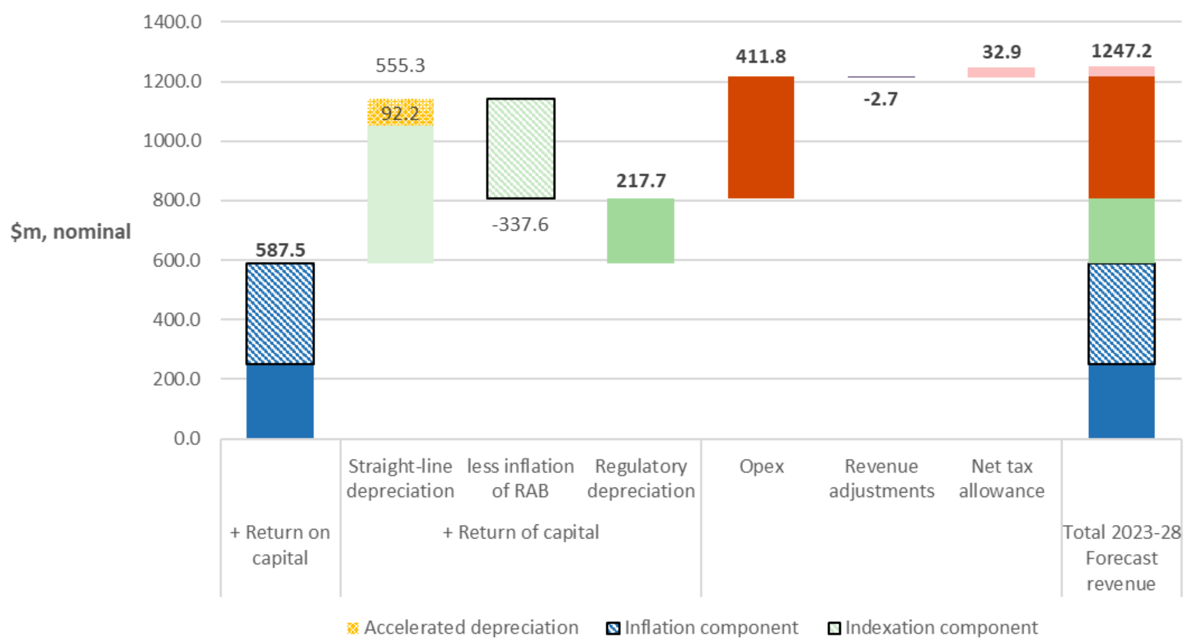
Forecast opex is increasing most significantly as a result of changes to the treatment of costs that enable AusNet to move from current on-premises IT solutions to the cloud, and the transfer of 'Software as a Service' (SaaS) expenditure from the capex forecast to opex. This means that these costs will be recovered through revenues in the period incurred rather than distributed across periods through the regulatory depreciation allowance.

The cost of corporate income tax for the 2023–28 period is lower than for the 2018–22 period, primarily due to applying our regulatory tax approach following our 2018 tax review.

Revenue adjustments for the 2023–28 period are lower than the 2018–22 period. This is primarily driven by the inclusion for a one-off reduction (or 'true up') of $29.8 million to complete the transition of the access arrangement from a calendar year to a financial year cycle. For the 2023-28 period, this 'true up' more than offsets the higher positive revenue adjustment from the opex efficiency carryover mechanism and a positive revenue adjustment resulting from the introduction of the Capital Expenditure Sharing Scheme (CESS) for the first time in this period.

Figure 3 isolates the impact of rising inflation from other parts of our final decision.

Figure 3 Inflation components in draft decision revenue building blocks



Source: AER Analysis.
Note: The opex building block and total 2023-28 forecast building block revenue are inclusive of ARS revenue

1.2 Key differences between this draft decision and AusNet's proposal

Our draft decision accepts much of AusNet's proposal. The main areas of difference between our calculation of expected revenue and AusNet's are:

- Our higher forecast of total opex ($335.7 million ($2022-23) compared to AusNet's proposed $306.4 million), which returns the expected cost of Energy Safe Victoria (ESV) levies to the ex-ante expenditure forecast and does not accept AusNet's proposal to instead recover its actual expenditure ex post via the price control mechanism.
- Our lower regulatory depreciation amount ($217.7 million ($ nominal) compared to AusNet's proposed $385.0 million ($ nominal), which includes a measured start to

accelerated depreciation of AusNet's network but not the full amount included in its proposal.

- Higher expected inflation, based on the Reserve Bank of Australia's November 2022 Statement on Monetary Policy (3.37% per annum, compared to 2.95% in AusNet's proposal), has also decreased the return of capital (regulatory depreciation) relative to AusNet's revised proposal.
- Our corporate income tax amount of $32.9 million ($ nominal) which is a decrease of $18.2 million (35.7%) from AusNet's proposal. The key reason for the decrease is the inclusion of the tax loss over the 2023 half year extension period and our draft decision for a lower regulatory depreciation, which in turn decreased AusNet's taxable revenue and, therefore, the cost of corporate income tax.

Movements in market variables including interest rates and expected inflation have led to revenue outcomes that are materially different in our draft decision compared with AusNet's proposal. These include our updated calculation of AusNet's rate of return, which has increased to 5.68% from the placeholder estimate of 5.10% in AusNet's proposal. These updates are a standard part of our decision making process and do not reflect areas of difference between us and AusNet.

This draft decision marks the mid-point in our consultation on AusNet's proposal, and final decision outcomes are likely to differ. AusNet now has the opportunity to submit additions or other amendments to its access arrangement proposal to address matters raised in this draft decision, in the form of a revised proposal.[3] The amendments must be limited to those necessary to address matters raised in the access arrangement draft decision unless we approve further amendments.[4] They should be limited to externally driven changes that AusNet was not in a reasonable position to respond to at the time of its initial proposal. They should also be subject to further engagement with consumers. Independent of this, components of forecast revenue will also change when we update our final decision for movements in market variables such as interest rates, bond rates and inflation. These movements are currently increasing revenue relative to AusNet's proposal.

1.3 AusNet's consumer engagement

Genuine, high quality consumer engagement by AusNet is essential to ensuring that its proposal is driven by consumer preferences, supports the delivery of services that meet the needs of its consumers, and does so at a price that is affordable and efficient. We've seen through experience that a regulatory proposal developed through genuine engagement with consumers is more likely to be largely, or wholly, accepted in our decisions. Our framework for considering consumer engagement in access arrangement determinations for gas network businesses is set out in the Better Resets Handbook.[5]

In developing their 2023–28 proposals for lodgement with the AER in July 2022, the three Victorian gas distribution network service providers—AusNet, Multinet Gas Networks (MGN) and Australian Gas Networks (AGN)—undertook an extensive and industry award-winning

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3 NGR, r. 60(1).

4 NGR, r. 50(2).

5 AER, *Better Resets Handbook*, December 2021.

joint engagement program over 18 months with consumers and industry. The two key stakeholder groups that the businesses jointly engaged were the:

- Victorian Gas Networks Stakeholder Roundtable (VGNSR): comprising residential customers and communities, business customers and major gas users, as well as building, development and property industries
- Retailer Reference Group (RRG): comprising gas retailers.

The joint engagement program included customer workshops, co-design activities and dedicated engagement with major energy users and the property and development industries. Models were also developed to examine possible future scenarios for the gas networks. Each of the three businesses consulted stakeholders on draft proposals to validate what they had heard up to that point from stakeholders, and to articulate how they had responded to stakeholders' concerns around price and affordability, reliability of service, public safety, customer service, sustainability and innovation.

We have been observers to the three businesses' joint engagement program and we have been impressed by:

- the comprehensive nature of the program, which has facilitated open and transparent discussions,
- the vast amounts of time and effort invested by the businesses and their staff to deliver the program, including additional meetings to round out previous discussions, and
- the extraordinary levels of commitment and endurance from consumer and industry stakeholders who have largely remained engaged in the process despite competing time commitments elsewhere.

We acknowledge that some of the issues considered over the course of the review to date, such as proposals for accelerated levels of depreciation to mitigate against the potential for asset standing risk, have been difficult for stakeholders to fully engage with due to prevailing future uncertainties for gas networks, especially in the absence of the Roadmap during the development stage of the proposals.

Prior to lodgement of the proposals, the three businesses engaged KPMG to independently obtain feedback from the VGNSR and RRG on the businesses' responses to stakeholders' feedback on the draft proposals:

> 'VGNSR feedback on the engagement process was positive overall and stakeholders stated they felt they were heard and engaged with. The integrated engagement approach by AusNet, AGN and MGN was positively received and stakeholders would like to see this repeated in future engagement programs. Overall, while the process was viewed positively, stakeholders noted that the Draft Plans were not yet capable of acceptance. Primarily, this was due to policy uncertainty and the likelihood of Plans needing to change once policy directions are made. The Draft Plans have been developed in an environment of political and economic uncertainty with businesses awaiting the development of the Gas Substitution Roadmap by the Victorian

> Government…[The VGNSR] did note that AusNet appear[ed] to have responded more to their concerns, by way of changes to the Draft Plan.'[6]
>
> 'Retailers [RRG] were in agreement that the current Draft Plans are not capable of acceptance, primarily due to concerns regarding the tension between accelerated depreciation and spend on capex and opex.'[7]

After the release of the Roadmap, the businesses worked diligently under very tight timelines to submit updated proposals (addendums) in response to the just-released Roadmap so that stakeholders could more meaningfully engage with the subject matter. Engagement with stakeholders post release of the Roadmap was limited in time and depth compared to that on the initial proposals and largely at an 'inform' level. Our observation is that little new insight was provided by stakeholders.

In submissions on the lodged proposals, stakeholders generally commended the businesses for their joint engagement process, including their future of gas scenario modelling initiative. We encourage stakeholders to continue their participation in the joint engagement process as there are inherent efficiencies to be derived from a single engagement process. However, the Consumer Challenge Panel (CCP28) expressed reservations about whether this achieved 'partnership' in the development of proposals, and with the lack of engagement with end customers since the draft proposals.[8]

Overall, whilst we have been impressed by AusNet's engagement approach to date, there are a limited number of areas that warrant further engagement with consumer and industry stakeholders. For example, there are unresolved matters relating to the proposed priority services program for consumers, gas meter disconnection and abolishment, and credit support arrangements for retailers. In responding to our draft decision, AusNet's revised proposal needs to explain what further engagement it has undertaken (either independently or jointly with AGN and MGN) with stakeholders to understand and respond to their residual concerns.

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6 AusNet, *Draft five year plans for the Victorian network (July 2023 – June 2028), Stakeholder engagement report*, 27 June 2022, pp. 3.

7 AusNet, *Draft five year plans for the Victorian network (July 2023 – June 2028), Stakeholder engagement report*, 27 June 2022, pp. 8.

8 CCP28, *CCP28 advice to the AER, Victorian gas distribution network access arrangement 2023-28 proposals*, 30 September 2022, p. 1.

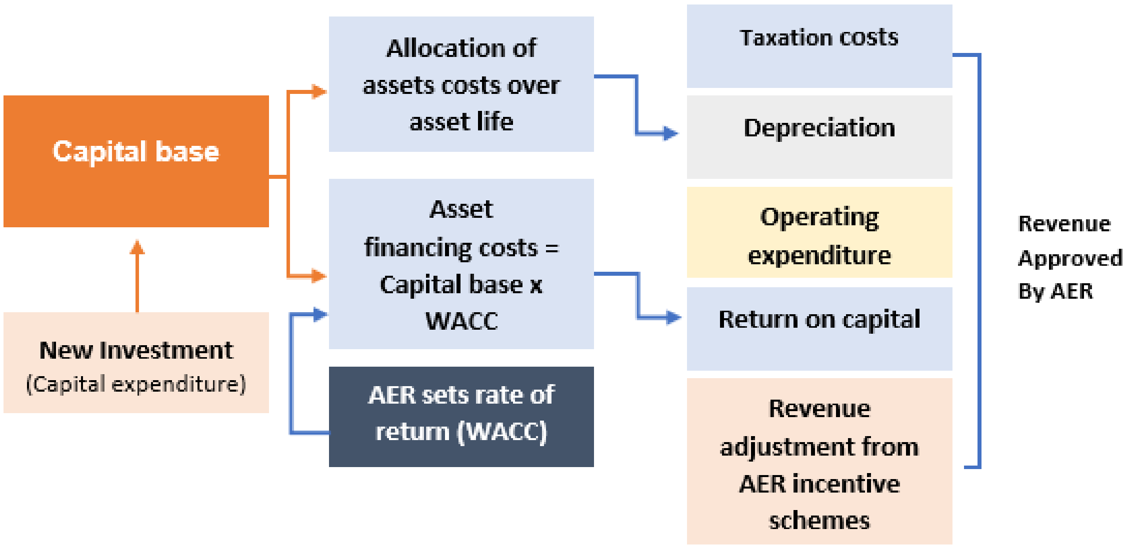
2 Total revenue requirement

The foundation of our regulatory approach is a benchmark incentive framework to setting revenues: once regulated revenues are set for the 5-year period, a network that keeps its actual costs below the regulatory forecast of costs retains part of the benefit. Service providers have an incentive to become more efficient over time, as they retain part of the financial benefit from improved efficiency. Consumers also benefit when efficient costs are revealed, and a lower cost benchmark is set in subsequent regulatory periods.

AusNet's proposed revenue requirement, and our assessment of it under the NGL and NGR, is based on six cost components or 'building blocks', illustrated in Figure 4:

- return on the capital base – to compensate investors for the opportunity cost of funds invested in this business
- depreciation of the capital base – or return of capital, to return the initial investment to investors over time
- capex – the capital costs and expenditure incurred in the provision of network services, which directly affects the size of the capital base and, therefore, the revenue generated from the return on capital and depreciation building blocks
- forecast opex – the operating, maintenance and other non-capital expenses, incurred in the provision of network services
- revenue increments/decrements resulting from the application of incentive schemes, such as the opex efficiency carryover mechanism that applies to AusNet
- estimated cost of corporate income tax.

Figure 4 The building block approach to determining total revenue



Source: AER.

2.1 Draft decision on total revenue

The total revenue requirement is a forecast of the efficient cost of providing gas distribution services over the access arrangement period. We determine annual revenue, and the total revenue requirement, in nominal terms that take expected future inflation into account. We use 5-year inflation expectations to convert revenues to nominal values.

Our draft decision on AusNet’s total revenue requirement is $1205.2 million ($ nominal, smoothed). This is a reduction of $55.5 million (4.4%) from AusNet’s proposal.

Table 1 sets out our draft decision on AusNet’s total revenue requirement (by building block) for each year of the 2023–28 period, the total revenue after equalisation (smoothing), and the X factors that we have determined for use in the tariff variation mechanism.

Table 1 AER’s draft decision on AusNet’s smoothed total revenue and X factors for the 2023–28 period ($ million, nominal)

Building block	2023–24	2024–25	2025–26	2026–27	2027–28	Total
Return on capital	106.0	112.1	118.2	123.6	127.6	587.5
Regulatory depreciation	35.6	35.1	41.9	49.6	55.6	217.7
Operating expenditure	78.1	82.1	81.9	83.6	86.2	411.8
Revenue adjustments	6.4	2.1	–1.6	–3.7	–5.9	–2.7
Net tax allowance	7.0	6.2	5.8	6.6	7.3	32.9
Building block revenue – unsmoothed (including ARS)	233.1	237.4	246.2	259.7	270.7	1247.2
Less ancillary reference services revenue	7.5	7.8	8.2	8.5	8.9	40.9
Total revenue - unsmoothed (excluding ARS)	225.6	229.6	238.0	251.2	261.9	1206.3
Building block revenue – smoothed	**226.1**	**233.4**	**241.2**	**248.8**	**255.7**	**1205.2**
X factors[a]	0.00%	0.00%	0.00%	0.00%	0.00%	n/a

Source: AER analysis.
n/a: not applicable.
(a) Under the CPI–X form of control, a positive X factor is a decrease in price (and therefore, in revenue). The X factor for 2023–23 is indicative only. Our decision establishes 2023–24 tariffs directly, rather than referencing a change from tariffs for 1 January to 30 June 2023.

2.2 Revenue smoothing and tariffs

AusNet operates under a weighted average price cap as its tariff variation mechanism. This means we must determine the weighted average tariff change each year such that the net present value (NPV) of unsmoothed and smoothed revenue is equal across the 2023–28 period. This average tariff change is known as the ‘X factor’.

Our decision on AusNet’s access arrangement proposal includes a determination of AusNet's total building block revenue (unsmoothed revenue), and a smoothed revenue profile across the 2023–28 period.

The X factors represent the weighted average *real* change in tariffs. As part of the annual reference tariff variation process applying from 2024, we combine the X factors we have determined in our decision with actual inflation to create *nominal* reference tariffs for the coming year. This means that the prices paid by consumers, and therefore the revenues received, change with actual inflation, plus the annual X factor rate.

By smoothing revenue we also aim to minimise price volatility between and within access arrangement periods by keeping the difference between smoothed and unsmoothed revenue in the final year of each period as close as possible, and to provide price signals across tariffs that reflect AusNet's underlying, efficient costs of providing services.

The lower revenue we have arrived at in this draft decision means that revenue smoothing has also changed.[9] Further, our smoothing achieves the price stability which was a key consideration of our decision to reduce AusNet's proposed accelerated depreciation. As a result, the average annual tariffs in year 1 (2023–24) are 3.37% higher in nominal terms than those for the six-month extension period. This is not necessarily indicative of final decision tariffs, which will change again with our final decisions on revenue and forecast demand.

While our decision establishes tariffs for year 1 (2023–24) directly, tariffs for years 2 to 5 will be set as part of the annual reference tariff variation mechanism reflecting actual inflation, updated return on debt and any cost pass throughs.[10]

Figure 5 shows indicative tariff paths for AusNet's reference services across the 2023–28 period. It compares AusNet's proposed tariff path with that approved previously for the 2018–23 period, and with this draft decision. For illustrative purposes, the modelled impact of this draft decision is an estimated increase of around 18.0% These are simple estimates only, calculated based on an aggregate level rather than individual zone level tariffs. Final decision outcomes will be different again.

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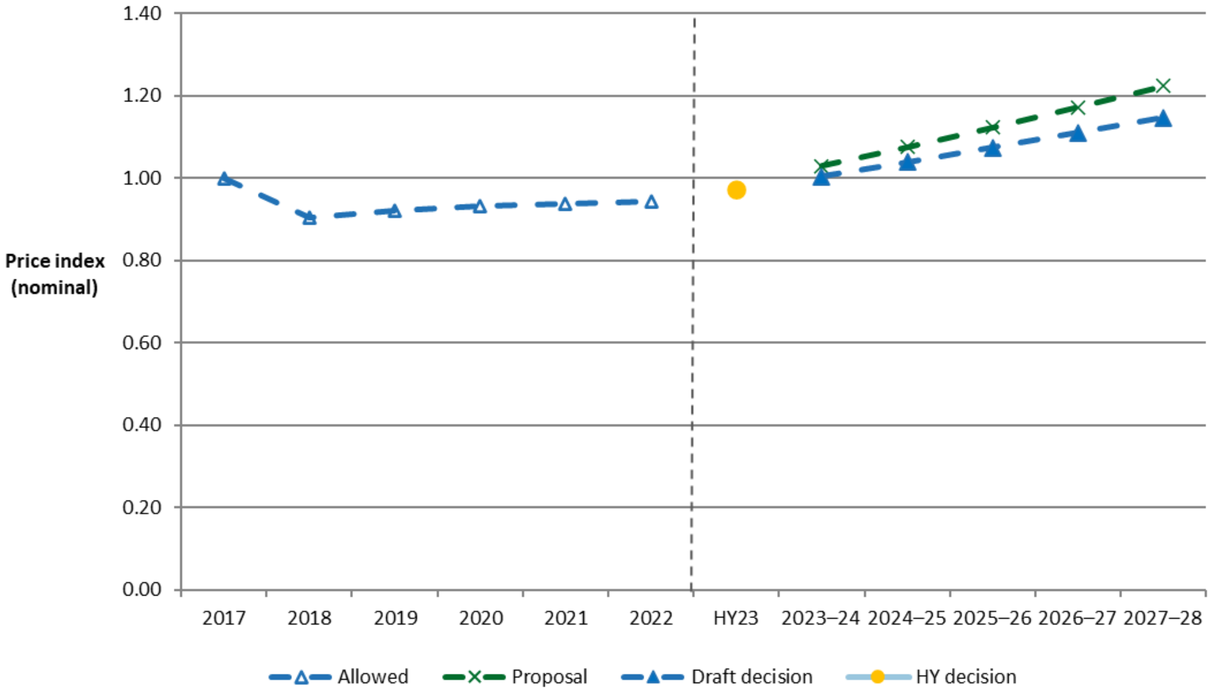
9 Our revenue smoothing for the 2023–28 period will also smooth the return of AusNet's over-recovered revenue of $29.8 million from the 6-month extension period. This return will reflect interest to be calculated at the regulatory WACC to maintain the time value of money. This true up is net present value (NPV) neutral and so should ensure that both AusNet and consumers are not materially better (or worse) off as a result of continuing the 2022 tariffs (extended for actual inflation) throughout the applicable access arrangement extension period.

10 The annual reference tariff variation mechanism is discussed in Attachment 10.

Figure 5 Indicative reference tariffs paths for AusNet's reference services from 2018 to 2028 ($/GJ, nominal)



Source: AER analysis.

AusNet's distribution charges make up around 33.0% of its customers' gas bills.[11] Other components of the supply chain—the cost of purchasing energy from the wholesale market, transmission charges, and the costs and margins applied by electricity retailers in determining the prices they will charge consumers for supply—make up larger portions of the prices ultimately paid by consumers. These sit outside the decision we are making here but will also continue to change throughout the period.

In nominal terms, which include the impact of expected inflation, the impact of this draft decision would be an increase to the current distribution component of energy bills for AusNet customers. For illustrative purposes only, holding other components constant, we estimate the modelled impact of this draft decision on the average annual gas bill for a residential customer,[12] as it is today, would be an increase of $98 (6.0%) by 2027–28 ($ nominal). For small business customers,[13] the impact would be $677 (6.0%) by 2027–28.

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11 This proportion reflects the estimate proposed by AusNet. AusNet, *ASG - GAAR 2024–28 - Reset RIN Workbook 4 - Indicative Bill Impact - July 2022*, July 2022.

12 Based on typical gas consumption of 54,400 MJ. Bill impact is compared to a nominal annual residential gas bill of $1,647 as at 30 June 2023. The base bill is sourced from Essential Services Commission, *Victorian Energy Market Report*, September 2022, Figure 34, p. 53. indexed by expected inflation from the RBA's November 2022 SoMP.

13 Based on typical gas consumption of 500,000 MJ. Bill impact is compared to a nominal annual small business gas bill of $11,369 as at 30 June 2023. The base bill is sourced from Essential Services Commission, *Victorian Energy Market Report*, September 2022, Figure 71, p. 77. indexed by expected inflation from the RBA's November 2022 SoMP.

3 Key elements of our draft decision on revenue

The components of our draft decision include the building blocks we use to determine the total revenue requirement. The following sections summarise our revenue decision by building block. The attachments to this draft decision provide a more detailed explanation of our analysis and findings.

3.1 Capital base

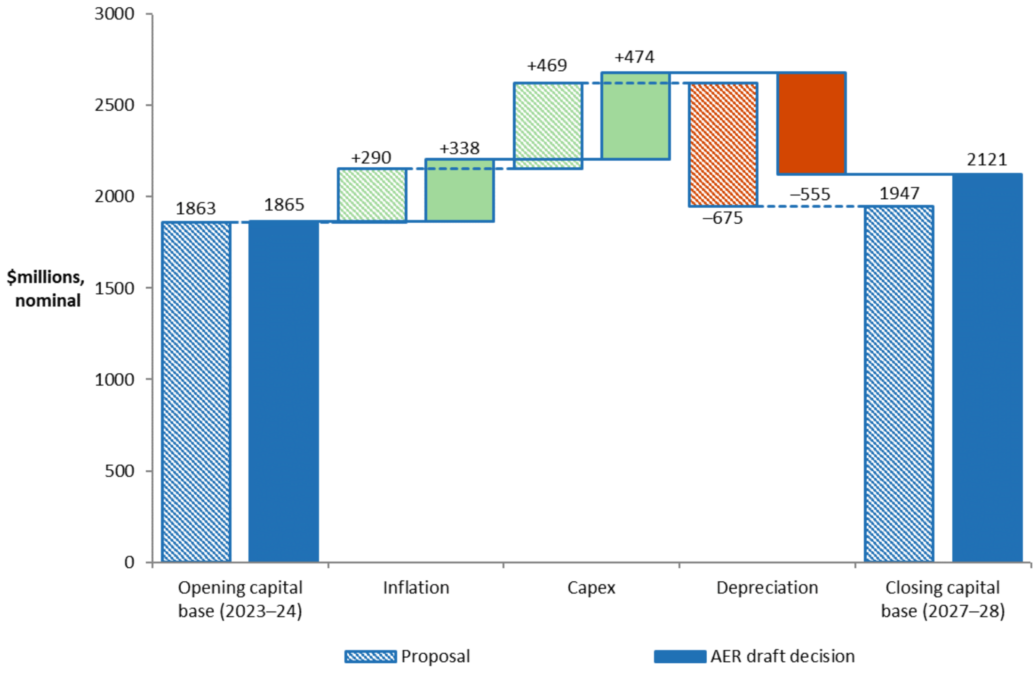
The capital base accounts for the value of regulated assets over time. To set revenue for a new access arrangement period, we take the opening value of the capital base from the end of the last period and roll it forward year by year by indexing it for inflation, adding new capex and subtracting depreciation and other possible factors (such as disposals). This gives us a closing value for the capital base at the end of each year of the access arrangement period. The value of the capital base is used to determine the return on capital and depreciation building blocks.

For this draft decision, we have determined an opening capital base value of $1865.3 million ($ nominal) as at 1 July 2023. This value is $2.8 million (0.2%) higher than AusNet's proposed opening capital base of $1862.5 million as at 1 July 2023. This increase is mainly driven by our amendments to AusNet's proposed approach on capitalisation changes for leases and Software as a Service (SaaS) related expenditures. While we largely accept the proposed method for calculating the opening capital base, we made several input updates to AusNet's proposed roll forward model (RFM) for expected inflation, nominal weighted average cost of capital (WACC) and forecast depreciation for the six-month extension period to be consistent with our final decision post-tax revenue model (PTRM) for that period.

Figure 6 shows the key drivers of the change in capital over the 2023–28 period compared to AusNet's proposal. Our draft decision projects an increase of $255.9 million (13.7%) to the capital base by the end of the 2023–28 period compared to the $84.4 million (4.5%) increase from AusNet's proposal. We have determined a projected closing capital base of $2121.2 million ($ nominal) as at 30 June 2028, which is $174.3 million (9.0%) higher than AusNet's proposed $1947.0 million. This increase is mainly due a combination of a higher expected inflation rate and reduction to AusNet's proposed forecast straight-line depreciation resulting from our draft decision to reduce AusNet's proposed accelerated depreciation amount.[14] It also reflects our draft decisions on the opening capital base as at 1 July 2023 and forecast capex (discussed in the sections below).

14 Regulatory depreciation is the net total of straight-line depreciation and inflation indexation of the capital base.

Figure 6 Key drivers of changes in the capital base over the 2023–28 period – AusNet's proposal compared with AER draft decision ($ million, nominal)



Source: AusNet, *2023–28 Post-tax revenue model*, 2 September 2022; AER, *2023–28 Draft decision – PTRM*, December 2022.

3.2 Rate of return and value of imputation credits

The return each business is to receive on its capital base (the 'return on capital') is a key driver of proposed revenues. We calculate the regulated return on capital by applying a rate of return to the value of the capital base.

We estimate the rate of return by combining the returns of two sources of funds for investment – equity and debt. The allowed rate of return provides the business with a return on capital to service the interest rate on its loans and give a return on equity to investors. We have applied our 2018 Instrument to estimate the rate of return for this draft decision.[15] For our final decision, we will apply the 2022 Rate of Return Instrument, which is scheduled to be published in February 2023. This may affect the estimate of the rate of return as well as the value of imputation credits.

For the purposes of this draft decision, the placeholder rate of return is 5.68% (nominal vanilla). Updates to risk-free rate and the return on debt have resulted in an increase from the placeholder estimate of 5.10% in AusNet's proposal.

Our estimate of expected inflation for the purposes of this draft decision is 3.37% per annum. It is an estimate of the average annual rate of inflation expected over a 5-year period based on the approach adopted in our 2020 Inflation Review[16] and the forecast from the Reserve

15 AER, *Rate of return Instrument*, December 2018. See www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018/final-decision.

16 AER, *Final position – Regulatory treatment of inflation*, December 2020.

Bank of Australia's November 2022 Statement on Monetary Policy. This is a higher estimate of inflation than used in AusNet's proposal (2.95%).

These variables will be updated again in AusNet's revised proposal and in our final decision, which is part of our standard process.

Both AusNet's proposal and our draft decision apply a value of imputation credits (gamma) of 0.585 as set out in the 2018 Instrument.[17]

3.3 Regulatory depreciation (return of capital)

Depreciation is a method used in our decision to allocate the cost of an asset over its useful life. It is the amount provided so capital investors recover their investment over the economic life of the asset (otherwise referred to as 'return of capital'). When determining the total revenue for AusNet, we include an amount for the depreciation of the projected capital base.[18]

Our draft decision includes a regulatory depreciation amount of $217.7 million ($ nominal). This is $167.3 million (43.4%) lower than from AusNet's proposed $385.0 million ($ nominal). One reason for this decrease compared to AusNet's proposal is the higher expected inflation rate for the 2023–28 period, which increases the adjustment for indexation of the capital base that is offset against straight-line depreciation in determining regulatory depreciation. Updates to inflation are a standard part of our process, and this is not an area of disagreement between us and AusNet. Our final decision will update these same inputs again.

Where we have differed from AusNet is in our assessment of its proposed accelerated depreciation. Our draft decision includes $83 million ($2022–23) in accelerated depreciation. This is significantly lower than AusNet's proposed $200 million ($2022–23) to straight-line depreciation over the 2023–28 period, which is about 17.4% of its total proposed revenue for the 2023–28 period.[19] That proposal, made in September with the benefit of the Roadmap, was an increase from the $150 million ($2022–23) it initially included in its July proposal.

In accepting some accelerated depreciation for AusNet, we recognise that the publication of the Roadmap indicates that the Victorian Government is committed to the net zero emissions target by 2050.[20] This will likely mean a limited role for gas beyond this date. The Roadmap included several initiatives that will reduce the role for gas in Victoria, such as incentives for residential customers to switch to electric appliances, and the removal of planning provisions requiring new housing developments to connect to gas. The future role for hydrogen is also uncertain at this time.

We have considered the balance between accepting some accelerated depreciation and also price stability. This is consistent with our information paper on Regulating Gas Pipelines Under Uncertainty which stated that:

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17 AER, Rate of return Instrument, Explanatory Statement, December 2018, pp. 307–382.

18 NGR, r. 76(b).

19 Based on proposed total revenue in real ($2022–23) terms and excluding ancillary reference services.

20 Victorian State Government, *Gas Substitution Roadmap*, July 2022.

> "… regulated depreciation or risk compensation cannot be adjusted without constraint to guarantee cost recovery for the regulated businesses. [The AER] must have regard to consumers' interest in having affordable and stable or reasonably predictable gas access prices to encourage their use of the gas infrastructure. Having said that, it is fair to note that regulated businesses also have an interest to maintain price affordability to avoid further decline in gas customer numbers."

Submissions have also raised concerns about escalating distribution prices in the face of rising cost of living stresses, and the risk that higher prices resulting from accelerated depreciation in the immediate term may lead to customers increasingly disconnecting from the network sooner than necessary.

AusNet has recognised in its engagement on accelerated depreciation that price stability is important to avoid this disconnection 'death spiral'. We agree that long term price stability should be considered. However, price stability for the 2023–28 period should also be a focus noting the current cost of living pressures and the concerns submitted by stakeholders. A balance needs to be struck between what consumers pay now to mitigate future price increases, and the risk of greater increases in the future if mitigation is delayed.

For the purposes of this draft decision, we have reduced AusNet's accelerated depreciation to target a 0% p.a. real price change. We consider that consumers need to be further consulted on this topic. Subject to additional consultation, we acknowledge that the final decision outcome on accelerated depreciation may differ from the draft decision.

In undertaking this consultation and considering its response to this draft decision, we expect AusNet to look at accelerated depreciation in the context of other components of its total revenue requirement. AusNet has noted that rising inflation has the effect of reducing regulatory depreciation. It also needs to consider the potential impact of that rising inflation, and higher WACC values, on other building blocks, and in particular the return on capital, in modelling the impact accelerated depreciation will have on revenue and prices.

3.4 Capital expenditure

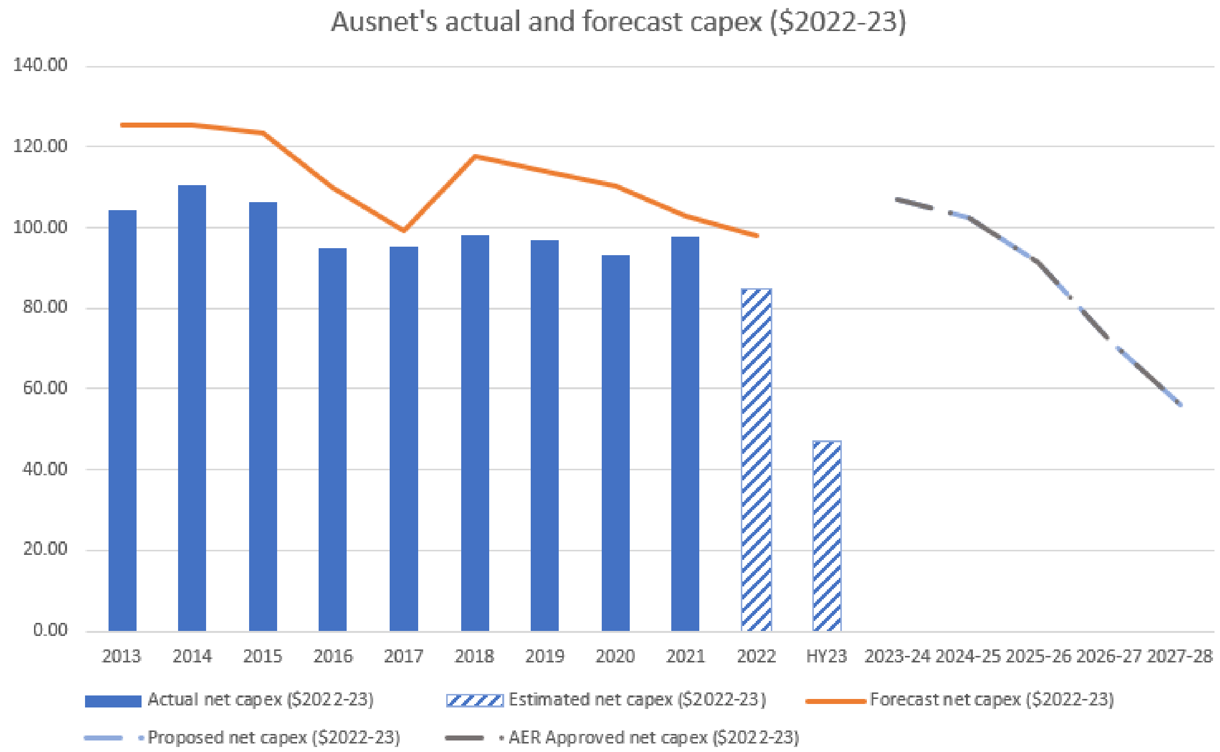
Capital expenditure (capex)—the capital costs and expenditure incurred in the provision of network services—mostly relates to assets with long lives, the costs of which are recovered over several regulatory control periods. Forecast capex directly affects the size of the capital base and the revenue generated from the return on capital and depreciation building blocks.

Our draft decision accepts AusNet's total forecast capex of $427.6 million ($2022-23) for the 2023–28 access arrangement period.[21]

[21] Net of capital contributions. Total gross capex for 2023-28 is forecast to be $504.3 million ($2022-23).

Figure 7 compares the approved forecast in our draft decision to forecast and actual capex in the current and previous periods. The forecast we have approved for 2023-28 is 14% lower than the $502.4 million ($2022-23) actual net capex for the 2018–22 period.[22]

Figure 7 Historical and forecast capex ($ million, 2023)



Source: AER analysis

Our draft decision relates to AusNet's total capex proposal. To make this decision, we construct an alternative estimate of efficient capex, and compare it to AusNet's proposal. If our alternative estimate is not materially different to AusNet's proposal, we will accept the proposal. On the other hand, if there is a material difference at the total capex level, we will not accept AusNet's forecast, and substitute it with our alternative estimate.

To construct our alternative estimate, we focussed on assessing the key drivers of AusNet's capex forecast. This included programs where we observed significant changes in capex compared to the current period, and in areas of strategic importance stakeholders.

Overall, we found that most aspects of AusNet's proposal were likely to be conforming capex. We determined an alternative forecast of $426 million, which is $1.6 million or 0.3% lower than AusNet's forecast, because we did not accept all of AusNet's proposed information technology expenditure to uplift its cyber security capabilities. On balance, our alternative estimate is not materially different from AusNet's forecast capex and we accepted AusNet's total capex proposal as prudent and efficient. This includes:

22 AusNet's capex for both 2019-20 and 2020-21 are estimates only.

- $132.3 million for forecast mains replacement (26.2% of total capex), which is similar to replacement expenditure in the current period, and we consider is reasonably required to maintain network safety.
- $187 million for forecast new customer connections (37.1% of total capex). This amount is a significant reduction from the current period and from the proposal AusNet initially submitted to us on 1 July. In line with the Roadmap, the Victorian Government will clarify that natural gas connections to new estates are not compulsory and implement a 7 star energy efficiency rating for new dwellings. This new standard will make the installation of gas appliances less attractive than electric alternatives, as new dwellings will need to meet a carbon emission “budget”. Forecast capex for new customer connections is consistent with the forecast of demand we have accepted in this draft decision.
- $72.0 million for forecast information and communications technology (17% of total capex). This is an increase of $29.4 million (69%) compared to the current period estimate of $42.6 million. Approximately half of this category of capex relates to programs shared among AusNet’s electricity distribution and transmission businesses, which we have recently considered and accepted in revenue determinations for those networks. However, we consider AusNet's proposed cyber security uplift for its gas distribution business is not prudent and efficient and does not constitute conforming capex, as the expenditure proposal for the gas distribution network is higher than the efficient investment required to meet the likely security capabilities under the *Security Legislation Amendment (Critical Infrastructure Protection) Act 2022*. Our decision on AusNet’s ICT capex is set out in attachment 5.

3.5 Operating expenditure

Opex is the operating, maintenance and other non-capital expenses incurred in the provision of pipeline services.

Our draft decision is not to accept AusNet’s proposed opex forecast of $306.4 million ($2022-23)[23] for the 2023-28 access arrangement period. Our alternative estimate of total opex that is the basis of this draft decision is $335.7 million.

The key area of difference leading to our alternative estimate of total opex being higher than AusNet’s updated proposal is that we have included $28.6 million for recovery of Energy Safe Victoria (ESV) levies, in base opex. AusNet’s proposal removed the levies from base opex, proposing to recover the expenditure via the price control mechanism. We consider it appropriate that ESV levy costs, as with all other opex costs, are subject to the ex-ante incentive based regime rather than a cost of service approach as would be the case under the price control mechanism.

Other differences between our calculation of forecast opex and AusNet’s are largely mechanical and, as discussed in Attachment 6 to this draft decision, offset each other so that our views on total forecast opex outside the ESV levies are not materially different. While we may have arrived at our alternative estimate in a different way to AusNet it is unlikely that

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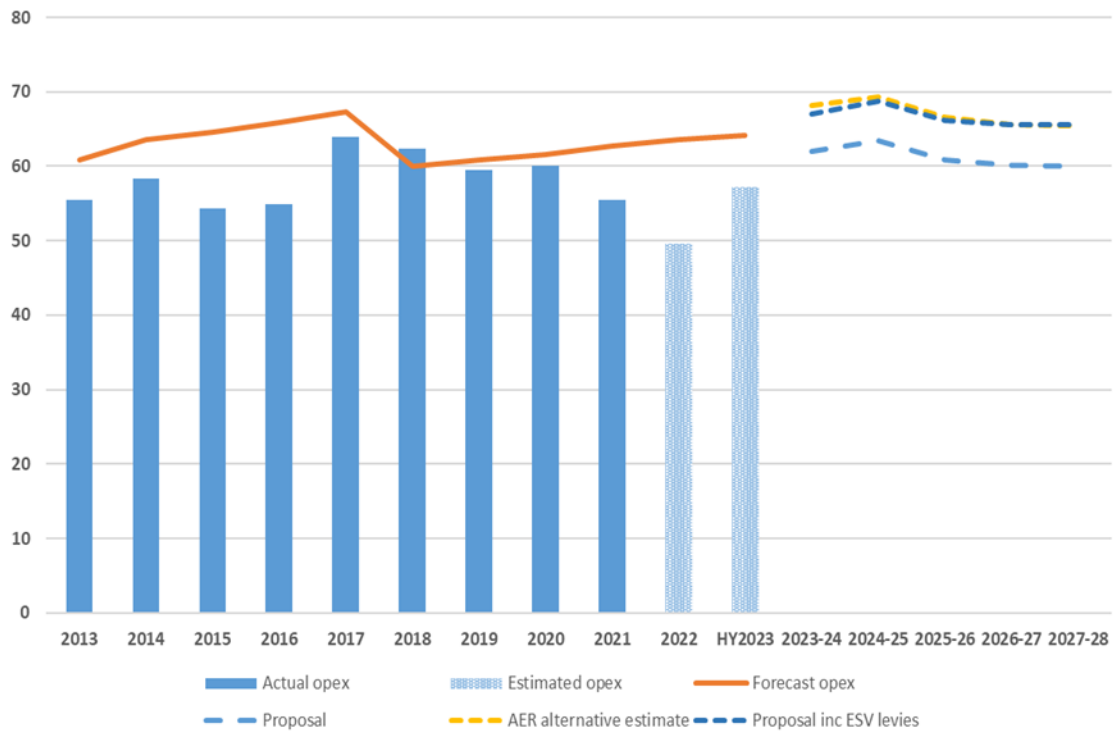
23 Excluding ancillary reference services.

there would have been a material difference between AusNet's proposed opex forecast and our alternative estimate if AusNet had included ESV levy costs in base opex.

Figure 8 compares our draft decision, AusNet's proposal, and AusNet's actual and estimated opex in the current and previous periods. AusNet's proposed opex forecast of $306.4 million was $2.3 million (0.7%) lower than approved for the 2018-22 period, and $19.2 million (6.7%) higher than its expected actual opex over the 2018-22 period. With the ESV levies returned to the opex forecast, the total forecast opex in this draft decision is $48.5 million (16.9%) higher than AusNet's expected, actual opex for 2018–22.

Figure 8 Historical and forecast opex ($ million, 2023)



Note: Includes debt raising costs and movements in provisions. We have removed software as a service opex in 2021 and added capitalised leases to estimated opex for 2019 to 2021, to align with accounting standards applied in the 2018–22 final.

Source: AusNet, Regulatory accounts 2013 to 2021; AusNet Services, *Access arrangement 2024-28 – Opex Model*, September 2022; AER, *AusNet revenue determination*, PTRM (multiple periods 2013-17, 2018-22, 2023-28), AusNet Services, *Response to information request #017 Q.5-7,* 12 August 2022; AER analysis.

After its initial proposal in July 2022, AusNet submitted an addendum in September 2022, to reflect changes to estimates following release of the Roadmap. From an opex perspective, this primarily impacted the trend forecasts with updated output and productivity growth forecasts. We have considered this updated proposal, and the opex forecast it contained, in making our draft decision to not accept the proposed opex forecast.

Price and output growth, which we include in our assessment of forecast opex, are increasing in line with forecast changes to the consumer and wage price indices and forecast growth on the network. A further key driver of the increase is a change to the treatment of costs related to AusNet's move from current on-premises IT solutions to the cloud, and the transfer of 'Software as a Service' (SaaS) expenditure from the capex forecast to opex. This means that these costs will be recovered through revenues in the period incurred rather than distributed across periods through the regulatory depreciation allowance. AusNet has made corresponding changes to its capex forecast.

The total forecast opex in this draft decision includes $4.4 million in new funding for a Priority Service Program to support customers experiencing vulnerability. Our *Towards Energy Equity Strategy*,[24] recognises the need to deliver better outcomes for customers experiencing vulnerability and avoid exacerbating harm, which is a core objective of this program.[25] We recognise the genuine effort and processes undertaken to engage with customers in relation to the program and their support as well as the impact that engagement has had on some of the initiatives before us. However, noting that submissions have raised concerns about the funding of the program, we encourage AusNet to continue to work with customers and relevant stakeholders in preparing its revised proposal. This includes to consider refining and revising the scope of the program, particularly where there are differing views between customers and stakeholders. This continued discussion is important given the economic and policy changes that have occurred since customer workshops on the program ended in March 2022.

3.6 Revenue adjustments

Our calculation of total revenue for AusNet includes adjustments under the opex efficiency carryover mechanism and capital expenditure sharing scheme in its access arrangement. These mechanisms provide a continuous incentive for AusNet to pursue efficiency improvements in opex and capex and provide for a fair sharing of these between AusNet and users.

Our draft decision includes a positive adjustment of $21.8 million from the application of the opex efficiency carryover mechanism (ECM) in the 2018–22 period. This is $9.5 million higher than AusNet's proposal. This difference reflects adjustments we have made to align the treatment of actual and estimated expenditure to be consistent with approved expenditure in the 2023-28 regulatory determination (so that differences between actual and forecast expenditure are measured on a like-for-like basis), and to remove exclusions from the earlier, 2013–17 period that did not apply in 2018–22. We have also updated inputs for actual and forecast inflation. Our carryover amount also excludes ancillary reference services.

We have also included a positive adjustment of $8.23 million under the capital expenditure sharing scheme (CESS), consistent with AusNet's proposal. Minor calculation errors were identified in the CESS model and have been confirmed with AusNet. The draft decision will require AusNet to correct these in its revised proposal.

We have also approved AusNet's proposal that the ECM and CESS continue to apply during the 2023–28 period. For the CESS going forward, we consider AusNet should exclude connections capex from the calculation of rewards or penalties. AusNet has agreed to this, and we have required it to update its access arrangement accordingly.

On 20 October 2020, the *National Energy Legislation Amendment Act 2020* (Vic) was enacted, changing the timing of Victorian gas distribution access arrangements to financial

[24] AER, *Towards energy equity – a strategy for an inclusive energy market*, October 2022 p.2.

[25] AusNet, *Priority Service Program - Business Case*, April 2022, p.6.

years rather than calendar years. To facilitate this, our 2018–22 access arrangement was extended by 6 months from 1 January to 30 June 2023 until our decision for the 2023-28 period takes effect on 1 July 2023. We approached tariffs and revenue for the extension period in three parts:

1. We extended AusNet's current, 2022 tariffs (adjusted for 6 months' inflation to keep them constant in real terms) for an additional 6 months to cover the extension period.
2. To determine a building block revenue allowance for the extension period we used simple, trend-forward approaches to forecast capital expenditure (capex) and operating expenditure (opex) at a level that should be proportionate to the extended tariffs.
3. In this draft decision for the 2023-28 period, we have returned the difference of $29.8 million ($2022–23) between allowed revenue under the extended, 2022 tariffs and the trended forward building block revenue calculation to customers as an adjustment (reduction) to AusNet's total revenue requirement for 2023-28. In applying this revenue adjustment in the 2023-28 PTRM, we have appropriately applied the WACC to reflect the time value of money.

This negative adjustment to close out the extension period effectively offsets those made under the ECM and CESS.

3.7 Corporate income tax

Our determination of the total revenue requirement includes the estimated cost of corporate income tax for 2023–28 period. Under the post-tax framework, this amount is calculated as part of the building blocks assessment using our PTRM. Our adjustments to the return on capital (sections 3.1, 3.2 and 3.4) and the regulatory depreciation (section 3.3) building blocks affect revenues, which in turn impacts the tax calculation.

Our draft decision determines an estimated cost of corporate income tax amount of $32.9 million ($ nominal) for AusNet over the 2023–28 period. This decision represents a decrease of $18.2 million (35.7%) from AusNet's proposal of $51.1 million. The key reason for the decrease is the inclusion of the tax loss over the 2023 half year extension period and our draft decision on regulatory depreciation which, in turn, decreased AusNet's taxable revenue and, therefore, the cost of corporate income tax.

Our draft decision on the forecast tax amount for the 2023–28 period is significantly lower than that forecast for the 2018–22 period. This change is primarily due to the accumulated tax loss of $8.6 million ($2022–23) at the start of the 2023–28 period, and the implementation of our findings from the 2018 tax review, which introduced the immediate expensing of capital expenditure (capex) and diminishing value method of tax depreciation, resulting in a significant increase in forecast tax depreciation.

4 Forecast demand

Forecast demand plays an important role in AusNet's access arrangement:

- Demand is an important input into the derivation of AusNet's reference tariffs under the price cap form of control in its access arrangement. In simple terms, tariffs are determined by dividing cost (forecast revenue) by total demand. This means that a decrease in forecast demand leads to an increase in tariffs, and vice versa.
- Forecast demand is also a driver of opex and capex (new connections), which inform our decision on the total revenue requirement.

The NGR require demand forecasts and estimates that are arrived at on a reasonable basis and represent the best forecast or estimate possible in the circumstances.

Our draft decision accepts the updated demand forecasts AusNet submitted on 2 September 2022, taking into account the implications of the Roadmap. These project a significant reduction in new connections, and an increase in disconnections as customers choose to leave the network. It also anticipates a fall in usage for customers that continue to rely on gas as part of their energy mix. New connections are forecast to use significantly less gas than existing connections, due to incentives to install heat pumps instead of gas central heating. For existing dwellings, an adjustment has been made for progressive replacement of space and water heating demand as customers replace aging appliances and respond to cash incentives. The combined impact is a 3% overall reduction in small customer consumption on the network by the end of the 2023-28 access arrangement period.

Forecast demand for AusNet's industrial customers has been less impacted by the Roadmap. Industrial customers are more difficult to electrify given the need for high heat applications and using gas as a feedstock, and the Roadmap is less clear on options for large industrial users to reduce their natural gas use. New connections for industrial customers are expected to fall slightly, and consumption only marginally, over the 2023-28 period.

When compared to AEMO's 2022 GSOO, AusNet's demand is still relatively close to the progressive change scenario but reduces slightly more than AEMO's projection. It remains well above the step change scenario and short term projections in the Roadmap. For our final decision, we will also have regard to AEMO's 2023 GSOO when released early next year.

Under a price cap form of control, the risk that actual demand in the 2023-28 period is less than forecast rests with AusNet, rather than its customers. If, however, it becomes clear that there is a material difference between actual demand and the forecast we use to set revenue and tariffs in our final decision, it is open to AusNet to seek an earlier review of its access arrangement under rule 65 of the NGR.

5 Reference services and tariffs

AusNet's access arrangement specifies the reference service it will provide, the tariffs for that service, and the other terms and conditions on which it will be provided.[26]

5.1 Services covered by the access arrangement

AusNet is to provide access to its reference services on the terms set out in the access arrangement but may negotiate alternative terms and conditions at alternative prices with users. AusNet may also offer other non-reference services (negotiated services) which are not subject to regulation under the access arrangement. We may be called upon to determine the tariff and other conditions of access to services if an access dispute arises.[27]

AusNet submitted its reference service proposal for 2023-28 in July 2021. We published our decision to approve that proposal in November 2021. This draft decision confirms our approval of AusNet's proposed reference services, with the exception of the customer connection abolishment ancillary reference service. In its revised proposal we would like AusNet to delineate between residential (small) customer connection abolishments, which we agree should be a reference service, and business (large) customer connection abolishments, which we consider should be a non-reference ancillary service. Doing so would align AusNet with the approach taken by AGN and MGN.

As more customers choose to move from gas to other sources of energy, the costs of removing connection assets for individual premises—abolishing the connection permanently— have come under close scrutiny. Connection abolishment involves removal of pipes connecting a customer's premises to the mains pipeline, sealing the mains, and making the site safe.

The alternative cease of service options are to either cap supply at the meter (a temporary disconnection that can be reversed by removing the cap at a later date) or to have the meter itself removed while connecting pipes are retained. In both cases, safety issues arise because gasified connection pipes remain underground. While these alternatives are considerably cheaper than abolishment, they raise issues such as the safety aspect of gas pipelines remaining underground and the costs to maintain this unused service.

The decision on which type of cease of service is safest is not for us to make. It sits with Energy Safe Victoria as the jurisdictional safety regulator. While we may have a view on such safety aspects, our role in assessing AusNet's proposed access arrangement is to determine:

- whether this pipeline service should be price regulated, and if so
- the efficient price for the regulated service, and

whether the costs should be socialised across all (or a class of) customers or recovered from individual customers requesting it. In reviewing this proposal, we have therefore considered

[26] NGR, r. 48(1).

[27] NGL, Chapter 6.

the costs of abolishing connections and the broader question of how they are recovered from consumers over time.

AusNet's proposal classifies this as an ancillary reference service, the cost of which is recovered solely from the requesting customer. Its proposed price for this service in 2023–28 is $825.90.[28] Based on both our benchmarking analysis and cost build up assessment, AusNet's proposed charge for the abolishment service appears reasonable. It is consistent with abolishment charges levied by gas distributors outside Victoria. The abolishment service is almost entirely opex and does not include an additional cost recovery. It reflects the labour cost of staff attending the customer's premises to perform the task. It does not incorporate any contribution to shared network cost recovery – it is not an exit fee.

While we, like the Victorian distributors, expect the Roadmap will see more demand for small customer connection abolishment we are not yet satisfied that we have sufficient information to approve small customer connection abolishment as an ancillary reference service for the 2023-28 period. We are considering 2 pathways for small customer connection abolishment cost recovery, which we set out below for stakeholder comment:

- As an ancillary reference service (as proposed by the Victorian distributors). A number of gas distributors across Australia provide abolishment as a price regulated ancillary network service currently, consistent with the Victorian distributors' proposals. The nature of the abolishment service, provided in respect of an individual customer's connection, has to date led to the service being considered an ancillary network service, because it is not a haulage service provided using shared network assets.
- The alternative cost recovery mechanism would be to bundle abolishment with haulage tariffs. This is sometimes referred to as 'socialising' abolishment costs. As a socialised cost, abolishment would be funded by haulage tariffs paid by customers using gas network services at the time. That is, customers choosing to permanently disconnect from the gas network would not be required to pay an abolishment charge.

The implications of socialising or bundling abolishment costs require consideration of equity issues. By sharing these costs across the customer base a cross subsidy would be created, benefiting customers who switch earliest. As larger numbers of small customers permanently disconnect from Victoria's gas distribution networks over time, the financial burden of abolishment costs would fall on a diminishing customer base, exacerbating the equity issue.

However, in other respects bundling abolishment costs with haulage services may be beneficial. It would reduce the financial barrier to customers switching from natural gas to electricity, consistent with the Roadmap. As such it may facilitate realisation of the environmental benefits described by the Roadmap. Any customer choosing to switch from natural gas to electricity would receive a benefit financed by those customers who continue to receive gas network supply services.

Perhaps most importantly, socialising small customer connection abolishment costs may be the most pragmatic way of giving effect to Energy Safe Victoria's safety determination. This is because socialising those costs would remove the financial barrier to small customer connections being abolished in a timely manner. The alternative, to levy an ancillary service

28 Ausnet, *ASG - Access Arrangement - Part B - July 2022 (With tracked changes)*, July 2022, p. 44

reference tariff on disconnecting customers, may give rise to material risk of small customer connection pipes remaining in situ with gas in them for extended periods.

Our draft decision is to not approve AusNet's proposed ancillary reference service for customer connection abolishments. Instead, we consider AusNet and stakeholders need further time to consider the relative strengths and weaknesses of the two approaches above, and to respond to these in AusNet's revised proposal and in submissions on our draft decision and that revised proposal.

5.2 Reference tariff setting and variation mechanism

Our draft decision is that the same tariff setting and tariff variation mechanisms that have applied in the current period should continue to apply to AusNet in 2023–28, noting the above discussion about customer connection abolishment relates to tariff setting in addition to determining reference services.

We also accept AusNet's proposal that the cost pass through events available to AusNet in the current period will continue to apply in the 2023–28 period, but with some minor revisions to provide greater drafting consistency between AusNet and other network service providers.

5.3 Non-tariff terms and conditions

In addition to its total revenue requirement, demand forecast and resultant tariffs, our decision on AusNet's proposed access arrangement includes an assessment of a range of non-tariff components that go to the commercial relationships between AusNet and its retailer and other network users. Our draft decision approves the majority of the non-tariff components of AusNet's proposed access arrangement for the 2023–28 period.

There are, however, a small number of elements of the terms and conditions set out in Part C of AusNet's proposed access arrangement around customer data and the provision its access arrangement makes for a requirement of up-front credit support from retailers that we have decided require further consideration by AusNet in its revised proposal before we can accept them.

In addition, since AusNet has submitted its proposal, the Australian Energy Market Commission (AEMC) has made the *National Gas Amendment (DWGM Distribution connected facilities) Rule 2022*. That rule amends the NGR to allow the participation of distribution connected facilities in the Victorian gas market. It contemplates a range of matters to be addressed, or managed, in accordance with the terms and conditions of a distributor's access arrangement. The final rule will come into effect on 1 May 2024, within the first year of the 2023-28 period. While the final rule was not made in time for AusNet's proposal, it is therefore one that we expect to see fully addressed in its revised proposal.

We are mindful that there will be limited time for iterative engagement on options and solutions between submission of AusNet's revised proposal in January 2023 and the close of stakeholder submissions in February 2023. We have therefore encouraged AusNet to make full use of the time available between the publication of the final rule and January 2023 to engage on options and solutions with a view to presenting a revised proposal that has stakeholder support.

A. List of submissions

Submission	Received
Brotherhood of St. Laurence	30 September 2022
Consumer Challenge Panel, sub-panel 28	30 September 2022
Darebin Climate Action Now	28 September 2022
EnergyAustralia	30 September 2022
Energy Users Association of Australia	30 September 2022
Evoenergy	30 September 2022
Friends of the Earth Melbourne	30 September 2022
Origin Energy	30 September 2022
Red Energy / Lumo Energy	5 October 2022
Simply Energy	3 October 2022
Sumo / 1st Energy / Energy Locals	30 September 2022
Victorian Community Organisations	30 September 2022

B. Glossary

Term	Definition
AGN	Australian Gas Networks
ARS	Ancillary reference service
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AusNet	AusNet Gas Services
CESS	Capital expenditure sharing scheme
DWGM	Declared Wholesale Gas Market
ECM	Efficiency carryover mechanism
GSOO	Gas Statement of Opportunities
MGN	Multinet Gas Networks
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
Capex	Capital expenditure
CCP/CCP28	Consumer Challenge Panel, sub-panel 28
CPI	Consumer price index
NPV	Net present value
Opex	Operating expenditure
PTRM	Post-tax revenue model
RBA	Reserve Bank of Australia
Roadmap	Victorian Gas Substitution Roadmap
RFM	Roll forward model
RRG	Retailer Reference Group
SoMP	Statement on Monetary Policy
VGNSR	Victorian Gas Networks Stakeholder Roundtable
WACC	Weighted average cost of capital