AUSTRALIAN ENERGY REGULATOR

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17 August 2020

Mr Tony Narvaez
Managing Director
AusNet Services
Locked Bag 14051
MELBOURNE VIC 8001

By email: [redacted]

Dear Mr Narvaez

Re: Victorian distribution reset – 6-month extension period – Final approach

This letter sets out the AER's position on the distribution determination for AusNet Services for the 6-month extension period.

These positions are based on initial guidance provided to AusNet Services on 6 November and 2 December 2019 and the material submitted in the regulatory proposal on 31 January 2020. We have also been in regular communication with AusNet Services, through meetings and Information Requests, regarding positions on the extension period.

Please note that the AER's position is subject to the Victorian amending legislation and the AER's final decision.

The position is as follows:

Standard control services revenue

Operating expenditure (opex): the previous year's allowance trended forwarded by 9 months rate of change, then halved[1]

AusNet Services has accepted the methodology for calculating the 6-month allowance for opex.

AusNet Services proposed the use of trimmed mean inflation forecasts instead of CPI forecasts.[2] The calculation of the 6-month allowance requires the use of one forecast of inflation, being the inflation in the year to December 2020.

The AER's position is that we will use CPI forecasts from the August 2020 Reserve Bank of Australia (RBA) Statement on Monetary Policy (SMP). We consider the CPI forecasts should be used as opposed to Trimmed Mean Inflation (TMI) forecasts because CPI forecasts better reflect:

- Expected inflation over the full calendar year ending 31 December 2020
- Expected inflation over future periods after 31 December 2020

We used TMI forecasts in making our June 2020 decisions, due to exceptional COVID-19 related volatility reflected in the inflation forecasts over the course of the 2020 calendar year.[3] This included a price reduction that materially impacted the last quarter of the regulatory control periods ending in June 2020, and the expected price rebound in the first six months of the next regulatory control period. A major driver of this volatility was temporary government policy responses to COVID-19 circumstances. As a result, we did not consider the use of CPI forecasts appropriate for forecasting inflation changes either side of 1 July 2020 forwards. The TMI forecasts trimmed out large COVID-19 related temporary volatility.

We note that the use of CPI forecast for the entire 2020 calendar year is not subject to the same issue. The CPI forecast for the year ending 31 December 2020 captures both the decrease and increase in inflation due to the temporary government policy initiative. By contrast, TMI forecasts may exclude variations arising from key drivers of inflation, such as fuel costs, that are ordinarily captured in CPI. As such, CPI forecasts are a better estimate of broad-based inflation changes over this period than TMI forecasts.

Using the RBA May SMP December 2020 CPI forecast, we calculate AusNet Services' 6-month allowance to be $132.5 million ($Dec 2020). We intend to update the 6-month allowance calculations to use the latest inflation forecasts in the RBA's August SMP, which is expected to be published on 7 August 2020.

Capital expenditure (capex): the previous year's allowance halved

We accept AusNet Services' proposed half-year capex allowance. AusNet Services has applied the methodology of halving the 2020 allowance and escalated it via CPI.

Opening RAB (regulatory asset base) as at 1 January 2021, based on actual capex/latest estimates for 2016–20, using the standard 5 year RFM for that period

We have reviewed our position on AusNet Services' proposed treatment of metering IT assets. AusNet Services' proposed roll forward model (RFM) contained a new 'Non-network – metering related IT' asset class with $27 million capex in 2019 and 2020. AusNet Services clarified that this capital expenditure related to the 5 minute settlement rule change and should instead be allocated to the existing 'Non-network general assets – IT' asset class. We accept this revised approach.

[3] The RBA noted in its May SMP government policy decisions in response to the COVID-19 pandemic were expected to reduce CPI inflation by around 1.5 per cent in the June 2020 quarter, followed by a large rebound when the government policies reversed. Reserve Bank of Australia, Statement on Monetary Policy, May 2020, p 79.

We have reviewed AusNet Services' proposed treatment of capitalised property leases. AusNet Services' proposed RFM contained 2 new asset classes for which $32 million capitalised lease expenditure was recorded as actual capex in 2019 and 2020, and no depreciation was applied. After considering the associated effects on opex, EBSS and CESS, we broadly agree that the undepreciated value of these capitalised leases should enter the RAB. Our approach is to roll the amounts into the RAB as an end of period adjustment at 30 June 2021. Our approach reduces the 1 January 2021 opening RAB but the effect on the 1 July 2021 opening RAB will be the same as proposed by AusNet Services.

In AusNet Services' roll forward model (RFM) we:

- updated AusNet Services' estimated capex inputs for 2019 with actual capex amounts
- amended 2018 gross capex to be consistent with the annual reporting RIN.

AusNet Services agreed with these amendments.

Depreciation of capex is based on existing asset classes/lives/methods, adjusted to reflect the half-year

The AER notified AusNet Services that its half-year revenue proposal did not use the depreciation model for the 6-month period. We advised AusNet Services that the half- year depreciation amount must come from the model reflecting the latest opening RAB for 1 January 2021. This approach is consistent with our guidance on the package of models to be used emailed on 11 September 2019 (and finalised in an email dated 16 October 2019). AusNet Services has agreed with this approach.

We have also amended the standard life for the 'Equity raising costs' asset class to reflect the standard life approved for the 2016–20 regulatory control period. This is consistent with the initial guidance provided to AusNet Services on 6 November and 2 December 2019.

No revenue adjustments for 2016–20 EBSS/ CESS calculations—these are deferred to begin from 1 July 2021

The AER's position is to apply no adjustments in the 6-month period pricing.

Rate of return based on the 2018 Rate of Return Instrument (RoRI), reflecting the agreed implementation method

The key details of the AER's proposed approach to the application of the 2018 RoRI to the six month period were communicated to AusNet Services in October 2019. These include the available averaging period windows and the method for adjusting the trailing average return on debt. AusNet Services nominated averaging periods (risk free rate and debt). Subject to the Victorian amending legislation, we intend to use placeholder periods (based on June data) for any averaging period not available at this time, and then true up revenue in the following regulatory year for any difference between the placeholder rate of return and the final rate of return calculated using any averaging periods accepted by the AER.

Inflation forecasts

AusNet Services proposed the AER's current approach for estimating inflation as set out in the AER's Post Tax Revenue Model.[4] This is calculated as a 10 year geometric average

[4] AusNet Services, *EDPR 2022-26 Regulatory Proposal Part 3*, 31 January 2020, pp.217

based on short term inflation forecasts from the RBA for the first two years combined with inflation estimates equal to the mid-point of the RBA inflation target band (of 2.5 per cent) for the next 8 years.

We accept AusNet Services' proposal. In implementing our current approach and calculating a 10 year geometric average inflation estimate the AER's position is:

- We will use inflation forecasts from the August RBA SMP for years ending on 31 Dec 2021 (year 1) and 31 Dec 2022 (year 2) and will use 2.5 per cent for years 3 through 10
- We will use the August RBA SMP CPI forecasts (and not TMI forecasts) for the reason set out earlier in this letter.

Corporate income tax is based on the approach used for the current regulatory control period, except for gamma, which is to be based on the 2018 RoRI

This position is consistent with the proposed approach to the application of the 2018 rate of return instrument communicated to AusNet Services in October 2019.

For the capitalised property leases, we intend to make an end of period tax asset base adjustment similar to the RAB adjustment (see opening RAB section above).

Efficiency benefit sharing scheme (EBSS) would apply

As previously discussed, the EBSS will apply for the 6-month period but revenue adjustments for 2016-20 EBSS calculations are to be deferred to 1 July 2021. Consistent with this approach, the positive EBSS carryovers which AusNet Services has accrued for the 6-month period, will not be factored into its revenue for the half year and will be deferred to the start of the next regulatory control period.

Capital expenditure sharing scheme (CESS) would not apply

Our position is that no CESS is allowed for the 6-month period and subject to the Victorian amending legislation.

STPIS

Subject to the Victorian amending legislation, our position on the application of the STPIS to the transitional period of 1 January to 30 June 2021 is as follows:

- the 2019 s-factor outcome will be applied to the 2021-22 regulatory year, rather than the transitional period
- continuation of current performance targets for the 2016–2020 regulatory control period, with an adjustment to reflect average performance in the first six months of the year. Specifically, actual performance of first six months of the year for 2010–2014 should be used to derive the targets for the transitional period
- adoption of the incentive rates for current 2016–2020 regulatory control period to the transitional period
- application of actual performance in this period should be applied with a 2.5 year lag into the 2022–23 financial year.
- the s-factor outcome of the transitional period will be applied to the allowable annual revenue (AAR) of the 2022/23 regulatory year.

Demand management innovation allowance (DMIA)

DMIA allowances were not outlined in the AER's Letters of Guidance.

For the 6-month period, the AER's position is to allow AusNet Services one-half of its annual DMIA allowance, or $0.30 million.

F-factor

The F-factor is prescribed by the "F-factor Scheme Order 2016". The performance measures under the F-factor are already, and will continue to be, on a financial year basis.

The treatment of F-factor incentive payment for the 2018–19 reporting period was not outlined in the AER's Letters of Guidance. Subject to anticipated amendments to the F-factor order by the Victorian Government, the AER's position is that the F-factor incentive payments arising from 2018–19 performance would not be applied in the 6-month extension, but rather take the form of adjustments to the distributors' regulated revenues for regulatory year 2021–22.

Metering revenue

For revenue-capped metering services (type 5 and 6 metering services including smart metering), the AER's position is to generally accept AusNet Services' approach to calculating opex and capex. However, the AER has previously communicated to AusNet Services our concerns with calculation of the opening asset base. The AER's position is to substitute Ausnet Services' proposed opening asset base with an opening asset base consistent with our most recent decision on metering (the AER's Final Decision on AMI transition charges 2018 – December 2016). We consider the application of this asset base correctly reflects the compensation already built in to our decision on AMI transition charges. In addition, AusNet Services has proposed to introduce a new asset class relating to capitalised leases – our position is that it is not appropriate to accept this new asset class in within the currently regulatory control period. The AER has also identified some other minor modelling issues, including in relation to the calculation of debt raising costs. In finalising the allowed revenue for revenue-capped metering services our position is to apply these adjustments and update for any new inputs available.

Control Mechanisms

The control mechanisms for standard and alternative control services (e.g. revenue cap or price cap control) remain as defined in the 2016–20 determination, however the price control formulae have been simplified for the 6-month extension period.[5] These simplified price control formulae were discussed with the networks in the second half of 2019, with an indicative position provided by email in December 2019.

Revenue-capped services

As per the indicative advice, the AER's position is to set revenue requirements for the 6-month extension for both standard control services and revenue-capped type 5 and 6 metering services with no further adjustments to be made in the annual pricing process. That is, no adjustments for incentive schemes (e.g. STPIS), prior year under or over-recoveries or cost pass-throughs. The AER is currently considering a cost-pass through application from AusNet Services in relation to the 6-month period. If required, the AER would amend the

[5] See AusNet Services' Network Determination 2021–26 page on the AER website for a listing of the proposed price control formulae.

relevant formulae accordingly to cover this cost pass-through.

The side constraints mechanism (which operates to limit movements in tariffs) will be adjusted to reflect these changes, and the application of the unders/overs mechanism will be delayed until the 2021/22 period, with a three-period account being held until the 6-month period is trued-up in 2022/23 pricing.

Price-capped services

For price-capped alternative control services (ancillary network services, public lighting, type 7 metering and metering exit fees), the AER's position is to approve prices in the annual pricing process that align with simplified price control formulae.
For example, we will derive the ancillary network services prices for the 6-month extension period by escalating the 2020 prices by:

- CPI (on the latest June to June basis); and
- An X-factor that reflects an updated labour escalation forecast for the extended period and will be calculated in line with the calculation of the 2021–26 draft decision. This should reflect half of the forecast yearly change in the State utilities sector real wages for Victoria for 2021–22.

In developing the indicative price control formulae the AER took into account the price control formulae as defined in the 2016-20 determination, the objective of simplifying the pricing process for the 6-month period, and expectations of the effects of likely CPI growth and the amended RORI where relevant.

Actual CPI outcomes over the relevant period have differed from these expectations, with CPI growth over the year to June 2020 slightly negative. While this outcome differs from our expectations in preparing the indicative price control formulae in 2019, we consider it is appropriate to maintain the approach indicated in December 2019. This reflects several factors, including that: we have not received stakeholder feedback recommending a change of approach in light of CPI outcomes; we consider the costs or benefits of any change in approach are likely to be relatively immaterial given the proportion of revenues accounted for by these price-capped services and noting that adjustments to the formulae would likely create some offsetting instances of both lower and higher price caps; and, given the indicative approach set out in December 2019, we do not have the information available that would support a more detailed bottom-up assessment.

Consistent with the indicative advice provided in December 2019, the AER's position is that the X factor for ancillary network services (which represents a real wage growth escalator in this instance) will be calculated in line with the calculation of the 2021–26 draft decision. While the AER has not yet made its draft decision for this regulatory period, it is important that the X factor for ancillary network services appropriately reflects the impact of COVID-19 on expected wage growth.

Pricing – Tariff structure statements (TSS)

The National Electricity (Victoria) Amendment Bill 2020 will require distributors to submit pricing proposals for the 6-month determination extension period that are consistent with the TSS approved by the AER in 2017. Noting the Bill deems the 6-month period to be a regulatory year. The levels of these tariffs should be set to recover the AER approved revenue for the 6-month extension. As a new TSS will apply from 1 July 2021, indicative prices are not required.

As noted above, the AER's position is subject to the Victorian amending legislation and the AER's final decision. We expect to release the AER's final decision on the 6-month period on 30 September.

With the decision expected to be released on 30 September, we consider it is reasonable to allow for a slight delay in the submission of pricing proposals. We expect distributors to submit these proposals by 5 October.

To facilitate submission of pricing proposals for the 6-month period on or before this date, we will provide the distributors with indicative information to use in preparing these proposals by 16 September.

Please contact Kami Kaur, General Manager (A/g) of Networks Distribution Branch on [redacted] if you have any questions.

Yours sincerely

[redacted]

Eric Groom
AER Board Member

Sent by email on: 17.08.2020

Cc: Thomas Hallam, General Manager Regulation, AusNet Services
Ian McNicol, AusNet Services
Charlotte Eddy, Manager Economic Regulation, AusNet Services