



AusNet Services gas mains replacement cost pass through

AER decision

September 2016

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au
AER Reference: D16/115589

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1 Summary

On 11 August 2016 we, the Australian Energy Regulator (AER), received an application for a mains replacement cost pass through event from AusNet Services (AusNet) for its Victorian gas distribution network.¹

AusNet's application is for costs to complete 85 km of mains replacement in addition to that approved in its 2013–17 access arrangement. AusNet is replacing low pressure distribution mains with high pressure polyethylene mains. The replacement is expected to mitigate safety risk, reduce operating costs and improve supply reliability. The responsible replacement of aging mains, on a safety risk prioritisation basis, is a key mitigation control set out in AusNet's Gas Safety Case.

We must approve a proposed cost pass through if it satisfies the access arrangement's requirements. We have assessed AusNet's pass through application in accordance with the procedures set out in its access arrangement.

We consider AusNet's proposed pass through event variation satisfies the requirements of its access arrangement. We approve:

- an additional 85 km of mains replacement, which takes the total volume to 500 km over the 2013–17 access arrangement period
- an additional \$14.8 million (\$2012) in capital expenditure to complete the additional 85 km of mains replacement
- recovering the additional capital expenditure by increasing reference tariffs by an additional 0.68 per cent (around 68 basis points) per annum for 2017.²

¹ AusNet Services changed its trading name from SP AusNet in August 2014.

² To bring the total expected annual tariff increase to an average of 3.68 per cent across 2017, excluding inflation.

2 Background

We regulate gas distribution businesses in Victoria. We do so under the National Gas Law (NGL) and the National Gas Rules (NGR). We made our final decision on the 2013–17 access arrangement for AusNet's Victorian Gas Distribution System on 15 March 2013.³ As part of that decision we approved a mains pipeline replacement cost pass through provision. If we approve the cost pass through proposed by AusNet under that provision, AusNet may raise reference tariffs to pass through the event's costs to customers.

This pass through provision was implemented in the context of the Victorian gas distribution businesses receiving funding for mains replacement during the previous access arrangement period but not completing the work. For the current access arrangement period we approved mains replacement based on the amount of mains replacement undertaken in the previous period. We approved expenditure for AusNet to undertake 415 km of mains replacement—the 'historical volumes'. This is less than AusNet had proposed. AusNet was given funding for this amount of mains replacement through the 2013–17 reference tariffs we approved.

In setting the allowance for a lower volume, we acknowledged that the objective of the mains replacement program is to remove all cast iron mains over the longer term, consistent with the Victorian gas distribution businesses' Asset Management Plans approved by Energy Safe Victoria (ESV). We therefore provided for a pass through to enable the gas distribution businesses to receive further funding, once they had delivered a specified volume of mains replacement.

³ AER, *Access Arrangement Final Decision – SP AusNet – 2013–17– Parts 1, 2 and 3*, 15 March 2013.

3 Regulatory requirements

The NGR allows a reference tariff variation mechanism to vary reference tariffs due to a cost pass through for a defined event.⁴ Detailed provisions for cost pass through events and how we must assess them are provided in each service provider's access arrangement. In this case, Part B of AusNet's access arrangement.⁵

Subject to our approval, reference tariffs may be varied after one or more cost pass through event/s occurs. One of those events is a mains replacement event.⁶

A mains replacement event is defined as an event in which AusNet:

- completes 348 km of mains replacement during the course of the 2013–17 access arrangement period, and
- costs are incurred, or are to be incurred, by AusNet in the remainder of the 2013–17 access arrangement period to complete a mains replacement in excess of the historical volumes.

Historical volumes means 415 km, being the volume of mains replacement completed by AusNet for the 2008–2012 access arrangement period.

Mains replacement means replacement of low pressure distribution pipeline with high pressure polyethylene pipeline. This is done by dividing a low pressure region into smaller areas (blocks) which are then systematically replaced.

Approved unit rates (cost per metre of mains replaced) are set out in our decision to approve AusNet's 2013–17 access arrangement. Where unit rates have not been pre-approved for an area in which AusNet now proposes to undertake mains replacement, unit rates must be determined as set out in our final decision.

In determining whether to approve the proposed cost pass through event variation, we must take into account the following:

- (a) whether the costs to be passed through are for the delivery of Pipeline Services;
- (b) whether the costs are incremental to costs already allowed for in Reference Tariffs;
- (c) whether the costs to be passed through meet the relevant National Gas Rules criteria for determining the building block for total revenue in determining Reference Tariffs;
- (d) the efficiency of the Service Provider's decisions and actions in relation to the risk of the Relevant Pass Through Event occurring, including whether the Service Provider has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the Relevant Pass Through Event and whether the Service Provider has taken or omitted to take any action where such action or omission has increased the magnitude of the costs; and

⁴ Rule 97(1)(c) of the NGR.

⁵ *SP AusNet Access Arrangement Information: Part B – Reference Tariffs and Reference Tariff Policy*, April 2013.

(e) any other factors the AER considers relevant and consistent with the NGR and NGL.

The other factors we consider relevant to our assessment of AusNet's proposed reference tariff variation are those set out in the mains replacement section (section 4.4.1) of part 2 of our final decision for AusNet's 2013–17 access arrangement.⁷

Under AusNet's access arrangement, we must notify AusNet of our decision to approve or reject the proposed variation within 90 business days of receiving its application and all necessary supporting information.⁸

Where we approve the variation, it is to take effect from 1 January of the next regulatory year unless we agree otherwise.

⁷ AER, *Access Arrangement for SP AusNet's Victorian Gas Distribution System 2013 – 2017, Final Decision, Part 2*, March 2013, pp. 29-55.

⁸ AER, *Access Arrangement for SP AusNet's Victorian Gas Distribution System 2013 – 2017, Final Decision, Part 2*, March 2013, p. 46. 90 business days from AusNet's application date of 11 August 2016 is 19 December 2016.

4 AusNet's application

AusNet submitted its application for a mains replacement pass through tariff variation on 11 August 2016. The key features of its pass through application are listed below:

- AusNet submitted that the mains replacement event was triggered on or around 30 May 2016 when it completed 348 km of its mains replacement program.
- AusNet intends to replace 500 km of mains during the 2013–17 arrangement period, which it stated is consistent with eliminating all low pressure mains in its network by 2025 (consistent with its *Asset Management Plan for 2016/17-2020/21*)
- The pass through application is to fund 85 km of mains replacement in excess of the 415 km we approved in the 2013–17 access arrangement.
- The additional capital expenditure to replace the additional 85 km of mains is \$14.8 million (\$2012).
- AusNet proposed to recover the additional costs by increasing reference tariffs by an average of 3.68 per cent (excluding inflation) on 1 January 2017. This is an increase of 0.68 per cent per annum compared to our final decision.

Table 1 summarises AusNet's proposed expenditure in each regulatory year during 2013–17.

Table 1 AusNet proposed revised total capital expenditure (\$2012)

| 2013 | 2014 | 2015 | 2016 | 2017 | Total |
|-------|-------|-------|------|------|-------|
| 106.6 | 110.4 | 103.1 | 92.4 | 91.1 | 503.6 |

Source: AusNet Services, Cost pass through application, p. 16.

With its cost pass through application, AusNet submitted:

- evidence it has completed 348 km of mains replacement in the current access arrangement period, which is the trigger point for AusNet to apply for funding to complete additional mains replacement km.
- evidence for the intended completion of volumes in excess of the mains replacement allowance we have already approved (415 km).
- details of the calculation of the additional capital expenditure and reference tariff adjustments.

5 Occurrence of the pass through event

We are satisfied that AusNet's pass through application meets the definition of a mains replacement event as specified in Schedule 2 (Part A) of its access arrangement. This is because AusNet provided evidence:

- it has completed 348 km of mains replacement during the current access arrangement period, which constitutes the trigger event
- it has, or will, incur costs in the remainder of the access arrangement period to complete a volume of mains replacement in excess of the historical volumes (415 km).

5.1 Completion of 348 km of mains replacement

We are required to verify AusNet has triggered the mains replacement event. The trigger event is defined as AusNet completing 348 km of mains replacement during the 2013–17 access arrangement period. As evidence of triggering the mains replacement event, AusNet submitted:

- our mains replacement pass through model
- a report by Advisian verifying the volume of mains replacement undertaken by AusNet.

Advisian's report provides third party verification that the pass through event occurred. To form its view, Advisian corroborated a range of reports prepared for external and internal use, reporting progress at the program level, with raw geographical information system (GIS) data.⁹

5.2 Intent to complete mains replacement in excess of historical volumes

We are required to verify AusNet intends to incur costs to:

- complete the outstanding mains replacement for which we approved an allowance in its 2013–17 access arrangement (415 km)
- complete the total of 500 km reflected in its cost pass through application during the 2013–17 access arrangement period.

AusNet submitted that it expects to complete the 415 km for which we have already provided funding by 31 December 2016. Advisian reviewed internal project cost data and compared it with data provided in Regulatory Information Notices (RINs) and confirmed that AusNet will incur expenditure to complete historical volumes.

AusNet expects to undertake around 83 km of mains replacement in 2017. AusNet submitted signed Business Cases, providing evidence that the required expenditure for the continuation of the low pressure mains replacement program has been approved. Advisian

⁹ Advisian, *AusNet Services LPMR Program Pass Through – Independent Verification Report*, p. 13.

confirmed that the replacement volumes in these cases are consistent with AusNet's Gas Distribution Asset Management Plan 2016/17 to 2020/21.

Based on this information we are satisfied AusNet intends to complete its proposed volumes of mains replacement in excess of the historical volumes during the remainder of the access arrangement period.

6 Approved costs to be passed through

Once we determine a mains replacement pass through event has occurred we must approve:

- the additional mains replacement volume
- the additional capital expenditure to complete the additional mains replacement
- the tariff variation to recover the additional capital expenditure.

We approve the proposed additional mains replacement of 85 km and an increase in capital expenditure of \$14.8 million (\$2012) to complete that mains replacement. We consider this expenditure meets the capital expenditure criteria under the NGR.

The costs will be passed through by increasing reference tariffs by an additional 0.68 per cent per annum for 2017.

6.1 The costs to be passed through are for the delivery of pipeline services

We are satisfied the costs to be passed through are for delivery of pipeline services. The costs relate to capital expenditure on gas pipeline mains infrastructure.

6.2 The costs are incremental to costs already allowed for in reference tariffs

We are satisfied the costs are incremental to costs already allowed for in reference tariffs. The costs relate to mains replacement in addition to volumes approved in AusNet's access arrangement.

6.3 The total costs to be passed through are building block components of total revenue

We are satisfied the total costs to be passed through are building block components of total revenue related to:

- return on the capital base
- depreciation of the capital base
- cost of corporate income tax.

6.4 The costs to be passed through meet the relevant NGR criteria for determining the building blocks

We are satisfied AusNet's proposed cost of \$14.8 million (\$2012) to undertake additional mains replacement meets the capital expenditure criteria under cl. 79(1) of the NGR. The key elements of the total costs to be passed through are:

- the mains kms to be replaced, or volumes

- the per kilometre costs, or unit rates, for each area in which mains will be replaced.

Total costs are derived by multiplying the volume (km) by the unit rates. In the sections below we set out our considerations for AusNet's proposed volumes and unit rates.

Volumes (km)

We are satisfied AusNet's proposed additional 85 km of mains replacement is consistent with the capex criteria under cl. 79(1) of the NGR. In reaching this view we have had regard to:

- AusNet's Asset Management Plan and AusNet's submission that its proposed mains replacement align with the Asset Management Plan
- the views of Energy Safe Victoria on AusNet's proposed volumes, given the underlying safety driver for the mains replacement program
- AusNet's current level of completed mains replacement in the 2013–17 access arrangement period and its evidence of future works to be undertaken.

We note that AusNet has a general statutory obligation under s.32 of the Gas Safety Act to "manage and operate each of its facilities to minimise as far as practicable" the hazards and risks to the safety of the public and customers arising from gas, interruptions to the conveyance or supply of gas and the reinstatement of an interrupted gas supply. The obligation also includes minimising hazards and risks of damage to public property and the property of customers.

AusNet's Asset Management Plan forms part of its Gas Safety Case.¹⁰ As the main driver of AusNet's low pressure mains replacement program is safety, we consider mains replacement volumes consistent with the Asset Management Plan are also consistent with safe operation of its network. AusNet's proposed mains replacement volumes are consistent with the Gas Safety Case previously accepted by Energy Safe Victoria.

Under AusNet's Asset Management Plan it is scheduled to complete its low pressure mains replacement work program in 2025. This end date is a critical factor in considering what is an efficient and prudent volume of mains replacement under r.79(1) given the long term safety objective of removing all cast iron and unprotected steel mains from AusNet's network. We noted in our final decision that the mains replacement pass through provides a means by which AusNet can complete the mains replacement program by 2025. Therefore we have had regard to AusNet's ability to meet this timeframe for completing its mains replacement in considering the efficiency and prudence of the proposed volumes.

AusNet has acknowledged its mains replacement volumes undertaken in the previous access arrangement period fell short of the Asset Management Plan work program. AusNet's reasons for the shortfall included the impact of the global financial crisis which impacted its ability to secure financing. AusNet further submitted that it had higher than

¹⁰ AusNet is required to submit a Gas Safety Case to Energy Safe Victoria every five years, setting out the system and processes to identify and mitigate network risks. Energy Safe Victoria must accept a Gas Safety Case if satisfied it is appropriate and complies with the Victorian Gas Safety Act and regulations. Energy Safe Victoria has advised us AusNet's Gas Safety Case (due for renewal in May 2015) is under assessment.

forecast connections expenditure, and so was unable to undertake the desired levels of mains replacement. The shortfall led us to approve the cost pass through mechanism for AusNet's mains replacement work in the current access arrangement period. AusNet has submitted that the volumes proposed in its current cost pass through application will bring it back into line with the mains replacement schedule set out in its Asset Management Plan, which ensures the entire replacement of the low pressure network by 2025. In considering AusNet's application, we have consulted with Energy Safe Victoria.

In considering the proposed volumes we have also had regard to the information AusNet provided on its rate of mains replacement to date. Also, to evidence it intends to complete the outstanding mains replacement it proposed over the remainder of the access arrangement period. Based on this information, we consider AusNet has the intention and processes in place to undertake the proposed volumes of mains replacement in the remainder of the access arrangement period.

Unit rates

Unit rates are the per km costs of undertaking mains replacement work. In our final decision on AusNet's current access arrangement we determined unit rates for the areas in which AusNet proposed, at that time, to undertake mains replacement work during the current access arrangement period. For those areas, AusNet is required to use the already approved unit rates for any additional kilometres proposed in the current pass through application. However, AusNet's pass through application is not limited to the areas for which we have already approved unit rates. AusNet may propose mains replacement work in other areas, for which we have not yet approved unit rates.

For areas we have not approved unit rates, AusNet must propose new unit rates for our assessment. We must be satisfied AusNet's proposed new rates are prudent and efficient.¹¹

AusNet's cost pass through application sets out proposed unit rates for five new areas of mains replacement. AusNet submitted that the requirement to undertake these projects is driven by an increase in gas leaks, and subsequently an increase in the risk profile of these network areas. AusNet submitted details of its methodology used to derive the unit rates.

For three of the five new areas, the mains replacement works were completed in 2013. In these areas AusNet used actual market-based unit rates to complete the work, based on a competitively tendered process.¹² The fourth proposed unit rate was based on market testing undertaken in 2016.¹³ The fifth proposed unit rate was calculated based on an average of market testing and actual historical unit rates in surrounding suburbs.¹⁴

We consider the methodology used by AusNet to derive unit rates for the new areas of mains replacement work is reasonable. On the basis of the information provided to us by

¹¹ AER, Access Arrangement final decision for *SPI Networks (Gas) Pty Ltd 2013-17, Final Decision, Part 2*, March 2013, p. 45.

¹² Project name: Williamstown, Fawkner and Castlemaine.

¹³ Project name: Ballarat.

¹⁴ Project name: Geelong.

AusNet we are satisfied its proposed unit rates for new areas of mains replacement are prudent and efficient.

Building block costs

AusNet used our capital expenditure model to determine the capex required to complete the additional mains replacement.

Table 2 sets out AusNet's revised total capex resulting from its mains replacement cost pass through application.

Table 2 AusNet's proposed total mains replacement capex (\$m 2012)

| | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
|---------------------------------------|-------|-------|-------|------|------|-------|
| Capex included in access arrangement | 104.1 | 106.1 | 102.9 | 92.3 | 83.5 | 488.8 |
| AusNet's revised total proposed capex | 106.6 | 110.4 | 103.1 | 92.4 | 91.1 | 503.6 |
| Variance | 2.5 | 4.3 | 0.3 | 0.2 | 7.6 | 14.8 |

Note: May not add due to rounding.

Source: AusNet, Cost pass through application, table 4.

We assessed and verified the inputs and adjustment AusNet made to the capex model.

The increase in capex will impact several building blocks:

- return on capital (rate of return or weighted average cost of capital (WACC))
- depreciation (return of capital)
- corporate income tax.

The scale of the building block impacts is determined by incorporating AusNet's revised total proposed capex within our post tax revenue model (PTRM).

Tariff variation calculation

Our PTRM from our final decision on AusNet's current access arrangement also determines the annual change in AusNet's network tariffs during the access arrangement period. With its cost pass through proposal AusNet submitted a revised PTRM. This shows:

- X factors for 2013, 2014, 2015 and 2016 are unchanged¹⁵
- revised X factor for 2017 is -3.68 per cent.

¹⁵ X factors are the PTRM output. These are in turn used to convert tariffs from the year ending to tariffs for the year beginning. A negative X factor translates into a year on year tariff increase. A positive X factor translates into a year on year tariff decrease.

The revised X factor for 2017 is around 68 basis points higher (more strongly negative) than the X factor from our access arrangement final decision.

We have assessed the inputs and operation of AusNet's revised PTRM.