DRAFT DECISION

AusNet Services
Distribution Determination
2021 to 2026

Overview

September 2020

Director, Corporate Communications
Australian Competition and Consumer Commission
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Executive summary

The Australian Energy Regulator (AER) works to make all Australian energy consumers better off, now and in the future. We regulate energy networks in all jurisdictions except Western Australia. We set a maximum revenue that network businesses are allowed to recover from consumers in providing network services.

AusNet Services owns and operates one of the five electricity distribution network service providers in Victoria and services around 737,000 customers across the east of Victoria, from the edge of Melbourne to the border with New South Wales. On 31 January 2020, AusNet Services submitted its regulatory proposal for the five year regulatory period commencing 1 July 2021.[1]

This draft decision sets out the amount of money AusNet Services can collect from electricity consumers for using its network in the 2021–26 regulatory control period.

We note that the unprecedented changes to the economic environment as a result of COVID-19 will have wide ranging impacts which may cause aspects of AusNet Services' proposal to differ at the revised proposal stage. We base this draft determination on current information and best forecasts that can reasonably be made, but acknowledge that some proposals may need to change.

AusNet Services can recover $3259.3 million ($ nominal) from its consumers in the 2021–26 regulatory control period. This is 5.6 per cent lower than the revenue allowed for in our 2016–20 final decision and leads to lower network charges for AusNet Services' consumers from the next regulatory control period. The total revenue allowed in our draft decision is $171.5 million (or 5.0 per cent) less than the $3430.8 million ($ nominal) proposed by AusNet Services.

The revenue we allow forms the distribution network component of retail electricity bills, making up about 34 per cent of a standard residential bill (39 per cent for small businesses).

We estimate that if this draft decision is implemented, compared to current charges, AusNet Services' distribution network charges in the first year of the 2021–26 regulatory control period will drop by $6 (0.3 per cent) for residential consumers and $85 (1.1 per cent) for small business consumers. Thereafter, charges will increase by an average of $3 (0.1 per cent) and $13 (0.2 per cent) each year over the remaining four years of the regulatory control period for residential and small businesses consumers, respectively.

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[1] We note that AusNet submitted its regulatory proposal in January 2020, shortly after the 2020 'black summer' bushfires caused significant damage to parts of AusNet Services' distribution network. In total 1,000km of power lines were affected, with 7,000 customers off supply as a result of the damage. AusNet Services has submitted a pass-through application to recover costs associated with the restoration of its network. Further details on this pass through are available here: https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/cost-pass-throughs/ausnet-services-cost-pass-through-2019–20-bushfire-natural-disaster.

We estimate these bill impacts by calculating the average revenue per unit of energy charged to customers under our determination. We have adopted standard assumptions about the amount of energy used by customers and hold all other bill components constant.

These estimates may vary between our draft and final determinations following additional information provided in response to our draft decision. Further changes may occur during the subsequent annual pricing process. These changes may increase or decrease customer bills.

Customers' final bills may differ from the draft determination estimates because, for example:

- revised capital expenditure (capex) and operating expenditure (opex) estimates may be made in the final determination
- energy consumption forecasts may change
- the structure of tariffs may vary from the simple assumption of a constant amount for each unit of energy used
- a different rate of return may be made in the final determination reflecting updated market data
- the return on debt will be updated in each of years 2 to 5 of the 2021−26 regulatory control period
- revenue adjustments may be required to ensure compliance with the revenue cap
- penalties and rewards from the incentive schemes may be subtracted from or added to revenue
- adjustments to revenue may be required as a result of the transition in 2021 from a calendar to a financial year basis for this determination. We expect that a true-up will be needed during the 2021−26 regulatory control period
- our forthcoming decision on the approach to estimating expected inflation will apply to the final determination
- approved network charges will include transmission charges and possible jurisdictional scheme charges.

Notably, for AusNet Services we are currently considering a separate pass through application related to the 2020 ' black summer' bushfires and the cost has not been included in our estimates; if approved and applied to the 2021−26 regulatory control period, this cost pass through would increase revenues and hence the network charges that customers face.

AusNet Services' consumer engagement has led to a regulatory proposal that has been influenced by AusNet Services' consumers. AusNet Services is the first energy network to trial the New Reg process. Developed in conjunction with Energy Networks Australia as well as Energy Consumers Australia, the New Reg process empowers a Customer Forum to negotiate on behalf of AusNet Services' consumers to implement a proposal that reflects its priorities and preferences. AusNet Services regulatory proposal reflects the outcome of its negotiations with its Customer Forum which has stated that it considers that the proposal represents good value for money for consumers.

In making this draft decision we have had regard to a range of sources including AusNet Services' proposal and its Customer Forum's final engagement report, submissions received, as well as analysis undertaken and published by us. We have also given effect to the outcomes of this engagement outside of the building blocks of a regulatory reset, such as the proposed customer service incentive scheme.

Our draft decision largely accepts AusNet Services' proposed opex and capex which allows for sufficient revenue to replace ageing infrastructure and operate its network in a safe and reliable manner in the long-term interest of consumers. However, AusNet Services' proposal does need to be updated to reflect changed economic conditions due to the impact of COVID-19.

Based on the information currently before us, we are satisfied that our draft decision on AusNet Services' 2021–26 regulatory proposal is in the long-term interests of consumers. AusNet Services now has the opportunity to consider our draft decision, the latest economic data, engage with its consumers and put forward a revised proposal with updated information.

In making this draft decision, we note the following key themes:

- AusNet Services' engagement with consumers
- ensuring consumers pay no more than necessary for safe and reliable services
- facilitating the emergence of distributed energy resources
- network tariff reform proceeding in Victoria.

AusNet Services' engagement with consumers

All five Victorian distributors made a concentrated effort to improve engagement with their customers and strive to better capture the diversity of their preferences. While each distributor approached this differently, all published an early draft of their regulatory proposal to gauge consumer views. We were encouraged to see these efforts to understand consumer preferences before the proposal has been finalised.

AusNet Services trialled a new form of consumer engagement in the development of its regulatory proposal.[2] The goal of the New Reg process is to ensure consumers' preferences drive energy network regulatory proposals and outcomes.[3] Under the New Reg process an independent Customer Forum was engaged to negotiate aspects of AusNet Services' regulatory proposal. The Customer Forum comprised members

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2 Further details on AusNet Services' consumer engagement is available in its regulatory proposal. Link: https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausnet-services-determination-2021–26/proposal

3 AER, ECA, ENA, *New Reg: Towards Consumer-Centric Energy Network Regulation Approach Paper*, March 2018.

chosen for their skills and experience to ensure they functioned as an effective and robust counterparty to AusNet Services. It was given autonomy and funding to undertake consumer research and was required to evidence positions in its engagement report.[4]

Through its broad engagement process, consumers told AusNet Services that affordability and reliability were key concerns. Consumers also wanted the regulatory proposal to reflect their expectations of better customer experience, support for solar exports, modest innovation to transform the network, and network expansion plans.[5] We find these themes reflected in the regulatory proposal.

AusNet Services and the Customer Forum negotiated components of AusNet Services' regulatory proposal, including opex, elements of capex (including augmentation expenditure, replacement expenditure, innovation expenditure and distributed energy resources), customer experience and hardship arrangements, metering, price path, and the overall reasonableness of the proposal.

While not required by the National Electricity Rules (the Rules), AusNet Services and the Customer Forum chose to include customer experience and hardship arrangements within their negotiations because of a concern that without a specific consumer focus, the services consumers expect and value may not receive the attention they deserve.[6] The Customer Forum and AusNet agreed to:

- design and implement the first Customer Service Incentive Scheme (CSIS), which rewards AusNet Services for improving customer service outcomes - this was submitted to the AER; and
- a range of customer experience improvements.

The Customer Forum undertook extensive engagement and research in order to represent AusNet Services' consumers. This engagement is documented in its Final Engagement report.[7] The Customer Forum considered that its negotiations with AusNet Services contributed to cost savings for consumers of at least $490 million ($2020–21) over the 2021–26 regulatory control period. Ultimately, AusNet Services and the Customer Forum reached agreement in their negotiations, concluding that AusNet Services' proposal represented overall value for money for consumers.

We find AusNet Services' engagement with its consumers resulted in a regulatory proposal that was strongly and directly influenced by its consumers. The nature of the engagement was well defined and the Customer Forum members brought relevant skills and expertise including specialist consumer engagement expertise. We also found the scope of the engagement sufficiently broad and that the Customer Forum independently expanded the scope with AusNet Services to negotiate a wider range of

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4 AusNet Services' Customer Forum, *Customer forum final engagement report*, January 2020.

5 AusNet Services, *EDPR 2021–26 Regulatory Proposal Part I & II*, 31 January 2020, p. 42.

6 AusNet Services' Customer Forum, *Customer forum final engagement report*, January 2020, p. 22.

7 AusNet Services' Customer Forum, *Customer forum final engagement* report, January 2020.

topics. The Customer Forum was provided with resources and time to undertake independent research. The involvement of AER staff provided an opportunity to observe the depth of this engagement. The Customer Forum's draft and final reports gave us good visibility on the engagement, including how negotiations were undertaken and positions reached. Our assessment found that AusNet Services' proposed capex and opex proposals were clearly influenced by its commitment to consumer affordability.

We were also encouraged to see all five Victorian distributors coordinate their engagement on tariff structure statements in acknowledgement of the Victorian context and challenges advocates and representatives can face in finding resources to engage. The distributors collaborated on a series of forums to develop principles for their tariff strategies for small users as a basis to develop structures. Participating stakeholders included consumer representatives and advocates, community groups, the Victorian Government, and retailers. The consistent use of language and structured, focused points of engagement were noted in the generally supportive submissions we received from stakeholders.

Ensuring consumers pay no more than necessary for safe and reliable services

Ensuring consumers pay no more than necessary for safe and reliable electricity is a cornerstone of the regulatory determination process. We must assess whether a business' proposal is a reasonable and realistic forecast of how much money it needs for the safe and reliable operation of the network. It also involves encouraging distributors to explore how they can provide better services at lower cost through a range of incentive schemes.

We found AusNet Services' capex proposal, which is 19 per cent below its current regulatory period capex, to be acceptable, apart from our adjustments to address changes in economic conditions, and reclassify some proposed expenditures and corrections. The forecast capex allowance of $1369.1 million ($2020–21) determined in this draft decision is 22 per cent lower than the $1758.2[8] million AusNet Services' spent on capex in the 2016–20 regulatory period. Having regard to AusNet Services' network health indicators, we are satisfied that the total forecast capex amount in this draft decision is sufficient for it to continue to provide safe and reliable services.

We assessed AusNet Services' capex proposal applying a top-down and bottom-up analysis. Our top-down assessment indicated that AusNet Services' proposal, after making the adjustments mentioned above, was in aggregate prudent and efficient. AusNet Services' has taken on board consumer expectations for a reliable service at an affordable price and adjusted its proposed capex forecast. We placed appropriate

[8] We compare forecast capex with actual capex in the current period; i.e. calendar year 2016 to 2019 pro-rated to five years. The impact of the COVID-19 pandemic and the derivation of calendar year 2020 estimate as the average of two financial year estimates creates uncertainty regarding the validity of the estimate.

weight on AusNet Services' consumer engagement and its consumers' support for the capex proposal in assessing whether the proposed forecast is prudent and efficient.[9]

Our bottom-up category level capex assessment identified some issues where individual category estimates were not fully justified, but these did not warrant adjustments to the total capex forecast because AusNet Services' made a top-down adjustment to its overall capex proposal which at least covers the sum of adjustments we would otherwise make on an individual category basis.

AusNet Services' proposed accelerated depreciation for some asset classes to reflect their economic life. We assessed the proposal and accept it in principle, but made changes to AusNet Services' approach to calculating the depreciation amount. The changes mean AusNet Services will recover $43.4 million less than its proposed depreciation amount of $209.1 million for the 2021–26 regulatory period. Of this reduction, $30.9 million ($2020–21) will be recovered in the 2026–31 regulatory period rather than in the next five years.

We reviewed AusNet Services' total opex proposal and find it mostly reasonable, with the main difference to our alternative estimate being the impact of unforeseen changes in economic conditions (as a result of COVID–19) on the rate at which we trend opex forward over the next five years. Without those changes in economic conditions we would likely have accepted AusNet Services' proposal.

Our draft decision is to include our alternative total opex forecast of $1187.4 million ($2020–21) in AusNet Services allowed revenue for the 2021–26 period. This is $46.1 million ($2020–21), or 3.7 per cent, lower than AusNet Services' total opex forecast of $1233.4 million ($2020–21).[10] Of this, $37.9 million ($2020–21) is driven by the impact of forecast lower output and real price growth on the rate of change in opex. While our alternative estimate includes different forecasts for some components of opex compared to AusNet Services' proposal, these did not drive significant differences.

Facilitating the emergence of distributed energy resources

As noted in the Issues Paper, facilitating the transition of the energy system is a key theme for this Victorian regulatory determination process. Various mechanisms can play a part, such as expenditure to physically accommodate greater exports, demand management initiatives and more cost reflective network tariffs to incentivise the efficient location of distributed energy resources (DER) to optimise use of the networks. We consider this work so important that we have made incentivising networks to become platforms for energy services a strategic objective in our regulation of networks. But it is imperative that these mechanisms are coordinated to ensure a coherent approach.

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[9] NER, cl.6.5.7(e)(5A

[10] Including debt raising costs.

DER is no longer a marginal technology. This pattern will strengthen over the regulatory period with the Victorian Government's Solar Homes Program supporting the installation of 700,000 solar PV systems (for around one in four households) between 2018–19 and 2027–28. Networks are also preparing for the electric vehicle (EV) market and supporting charging infrastructure. While less developed than solar PV or battery storage systems, the EV market has the potential to provide significant network support.

We support AusNet Services facilitating solar PV growth on its network, particularly in the context of the Victorian Government's Solar Homes Program, and have provided for this in our draft decision. Our decision provides for the Solar Homes Program while ensuring allowances are prudent. We have some concerns about the underlying assumptions and forecasts of AusNet Services' DER integration capex. In particular, the approach to valuing the benefits of DER and the appropriate period over which to apply those benefits. Given that we find AusNet Services' capex forecast is prudent and efficient at the total capex level, we have not made an adjustment to any one capex category driver including DER capex.

We also note that AusNet Services' tariff strategy was not well linked to its DER strategy. We encourage a more unified approach in its revised proposal.

Network tariff reform proceeding in Victoria

We are encouraged by the Victorian distributors' efforts to progress network tariff reform in the 2021–26 regulatory control period. The distributors took on guidance from our 2017 decision and worked with customers to develop a unified approach for residential and small business customers in Victoria. This enabled distributors to move from opt-in to opt-out assignment to cost reflective network tariffs and allowed them to target the charging structures at periods of network constraints. They are also exploring pricing arrangements for DER such as electric vehicles and battery storage. Their efforts to explore appropriate price signals, including by considering stakeholder perspectives, indicate they are on the right track.

But we recommend the distributors build on this progress in their revised proposals. For small users, we advise the distributors to explore reassigning customers on legacy cost reflective tariffs to the new time of use and demand tariffs. Doing so would simplify the suite of network tariffs, improve the targeting of price signals for customers, and increase the magnitude of the customer base retailers are managing these signals for. For large users, distributors should offer choice of tariff structure, given those customers are more likely and able to face and respond to network tariff structures than smaller users. While the standard large user tariffs proposed are consistent with industry practice, offering optional tariffs would improve the matching of network tariffs to forward-looking costs at a more disaggregated level. Greater choice would also help emerging technologies to efficiently integrate into, and support the operation of the network.

Finally, distributors could do more to help customers understand the linkages between tariff strategies, tariff trials, DER and broader expenditure proposals. Linking tariff strategies for each tariff class with information and initiatives relating to demand management is also encouraged.

Change to the regulatory control period

In April 2019, the Victorian Minister for Energy, Environment and Climate Change indicated her intention to change the timing of the regulatory control period for electricity distribution networks from a calendar year basis to a financial year basis. We prepared this decision on the basis that the Victorian Government will enact legislation to change the commencement date of the next regulatory control period from 1 January 2021 to 1 July 2021.

The National Energy Legislation Amendment Bill 2020 (the Bill) currently before the Victorian parliament, provides for an extension of the current regulatory control period (1 January 2016 to 31 December 2020) by 6 months. Unfortunately the impact of external factors such as COVID-19 lockdown prevented the passage of the legislation and related Orders in Council prior to release of this decision. In a letter to the AER on 2 September 2020, the Minister reaffirmed the Victorian Government's commitment to change electricity and gas network regulatory periods from a calendar to financial year basis. The AER will publish the draft decisions for the five businesses for the next regulatory control period on this basis. It should be noted the draft decision was prepared under the expectation the legislation would be in place.

We separately assessed the total allowed revenue for AusNet Services for the six month period from 1 January 2021 to 30 June 2021, based on the trend-forward approach outlined in our letter to the Victorian distributors in November 2019, our April 2020 Issues Paper, and the application of the 2018 Rate of Return instrument to the six month period. We set out our final approach to this assessment in a letter to AusNet Services in August 2020.[11] Due to the delay in the passage of the legislation, we will not formally make a revenue decision for the relevant six-month period at this time.

We expect that the legislation and related Orders in Council, once in effect, will provide for a pricing proposal for the six month period. We will continue to work with distributors and the Victorian government to ensure any effects of this delay are minimised. We will provide further communication on the timing of the publication of our final decision for the six month period and the expected timing of our assessment of network tariffs shortly.

What are the next steps?

AusNet Services now has the opportunity to consider our draft decision and submit its revised proposal and supporting material in December 2020.[12]

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11 AER letter to distributors August 2020, https://www.aer.gov.au/system/files/AER - Correspondence to AusNet Services - Victorian EDPR and the six-month extension - 17 August 2020.pdf

12 The numbers in this draft determination may change in the final determination.

We will make our final determination by 30 April 2021.

Detailed explanations of factors informing our draft decision can be found in the overview section and attachments to this draft determination.

Invitation for submissions

In response to our draft decision, AusNet Services now has the opportunity to submit a revised proposal for its next regulatory control period (2021–26) by 3 December 2020. Submissions on our draft decision and AusNet Services' revised proposal are invited from interested stakeholders by 8 January 2021. We will consider and respond to all submissions received by that date in our final determination.

Submissions should be sent to: VIC2021-26@aer.gov.au

Alternatively, submissions can be sent to:

Kami Kaur
General Manager, A/g
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

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

(3) all non-confidential submissions will be placed on our website.[13]

[13] 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: https://www.aer.gov.au/publications/corporate-documents/accc-and-aer-information-policy-collection-and-disclosure-of-information

Review timeline

The key milestones for our review of AusNet Services' regulatory proposal are set out below:

Milestone	Date
AusNet Services submitted its proposal	31 January 2020
AER issues paper published	30 March 2020
Virtual public forum on AusNet Services' proposal held	22 April 2020
Submissions on AER's issues paper and AusNet Services' proposal closed	3 June 2020
AER draft decision published	30 September 2020
Public forum on draft decision	15 October 2020
AusNet Services submits revised proposal	3 December 2020
Submissions on draft decision and revised proposal due	8 January 2021
AER final decision to be published	30 April 2021

Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to AusNet Services for the 2021–26 regulatory control period. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset 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 benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Demand management incentive scheme and demand management innovation allowance mechanism

Attachment 12 – Customer service incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

Attachment 19 – Tariff structure statement

Attachment A – Victorian f-factor incentive scheme

Contents

1 Our draft decision

Our draft decision would, if implemented, allow AusNet Services to recover a total revenue of $3259.3 million ($ nominal) from its consumers from 1 July 2021 to 30 June 2026.

AusNet Services is regulated using a revenue cap. Incentives are provided to it to reduce costs, improve service quality and undertake efficient investments.

Our draft decision for AusNet Services determines the total revenue it can recover from consumers for the provision of common distribution services (standard control services (SCS)). This forms the basis of AusNet Services' distribution tariffs for the 2021–26 regulatory control period. AusNet Services' Tariff Structure Statement (TSS) sets out the tariff structure through which it will recover its regulated revenue for SCS from consumers.

AusNet Services also provides alternative control services (ACS), the costs of which are recovered only from users of those services, through a capped price on the individual service. These costs are considered separately to our building block determination.[14] Our draft decision sets out the prices AusNet Services is allowed to charge consumers for the provision of ACS: ancillary network services, public lighting and metering. AusNet Services has not proposed to provide any services on a negotiated basis in the 2021–26 regulatory control period.[15]

We have taken AusNet Services' consumer engagement into account in developing our draft decision. More information is provided in section 3.

1.1 What's driving revenue?

Revenue is driven by changes in real costs and inflation. We assess costs (such as capital and operating expenditure) in real terms (using 2020–21 as a common year) to reveal the underlying cost trends over a number of years or regulatory control periods. The numbers presented in this overview are in real 2020–21 dollars unless otherwise noted. Some aspects of our decision are presented in nominal terms to be consistent with the NER and to enable consumers to see the full impact of our determination inclusive of expected inflation.

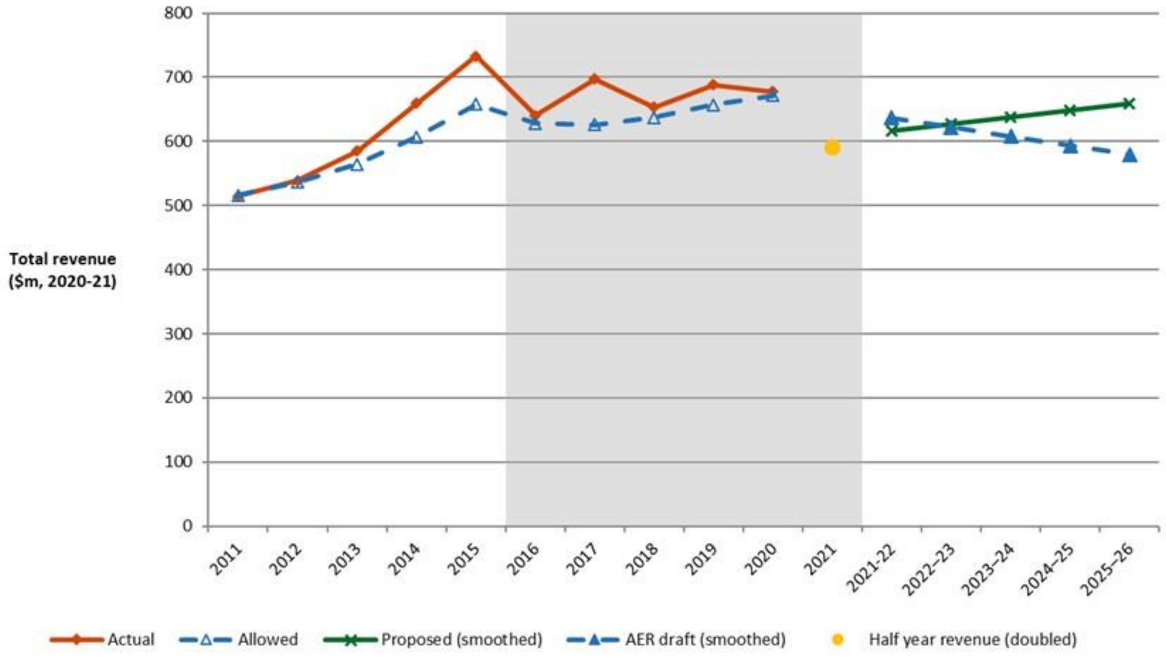
The total revenue allowance in this 2021–26 draft decision is 5.6 per cent lower than the allowed revenue provided for in our 2016–20 final decision. Figure 1 shows real revenue decreases from 2020 levels by 6.0 per cent in the first year of the next

[14] We discuss alternative control services in Attachment 16 to this draft decision.

[15] Our distribution determination for AusNet Services includes an approved negotiating framework and negotiated distribution service criteria, as required by the NER. Because AusNet Services has not included any negotiated services in its proposal, these elements of our determination will be inactive for the 2021–26 regulatory control period.

regulatory control period. After that, AusNet Services' revenue decreases by 2.3 per cent per year.

Figure 1 Revenue over time ($ million, 2020–21)



Source: AER analysis, smoothed revenue.

Figure 2 highlights the key drivers of AusNet Services' allowed revenue for the 2021–26 regulatory control period. It illustrates that the largest driver of change is the return on capital building block. The nominal weighted average cost of capital (WACC) has decreased from around 6.31 per cent in the 2016–20 regulatory control period to 4.63 per cent for the 2021–26 regulatory control period.[16] Other reductions include:

- Forecast opex compared to the 2016–20 regulatory control period.[17]
- Corporate tax amount, due to changes in our regulatory tax approach (following our 2018 tax review) and the 2018 rate of return instrument.[18]

The increase in regulatory depreciation is due to the increase in straight-line depreciation which is driven by regulatory asset base (RAB) growth in the 2016–20 period and also the increase in the amount of accelerated depreciation.[19]

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16 The WACC is a nominal WACC unless stated otherwise. The real WACC is impacted to a similar degree. See section 2.2 for further details.

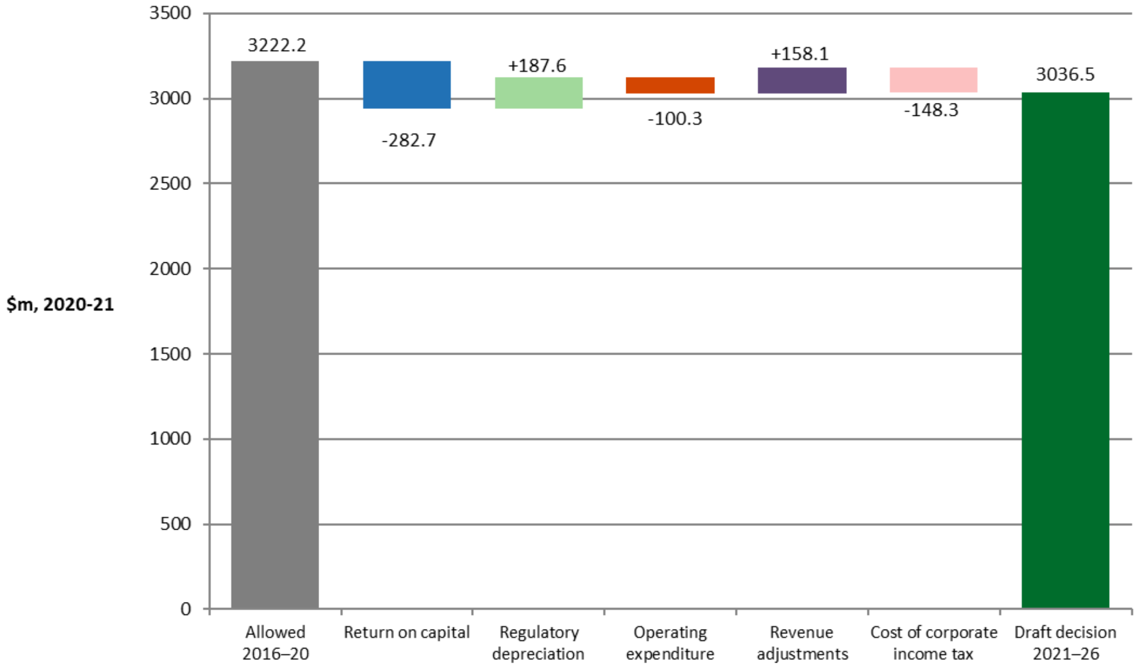
17 See section 2.5 for further details.

18 See section 2.6 for further details.

19 The increase due to accelerated depreciation is approximately $62 million ($2020–21), based on $96.8 million for 2016–20 and $159.2 million for 2021–26.

The increase in the revenue adjustments is largely driven by positive incentive scheme payments over the 2021–26 regulatory control period, compared to negative Efficiency Benefit Sharing Scheme (EBSS) payments and no Capital Expenditure Sharing Scheme (CESS) payments over the 2016–20 regulatory control period.[20]

Figure 2 Change in revenue from 2016–20 to 2021–26 ($ million, 2020–21)



Source: AER analysis.

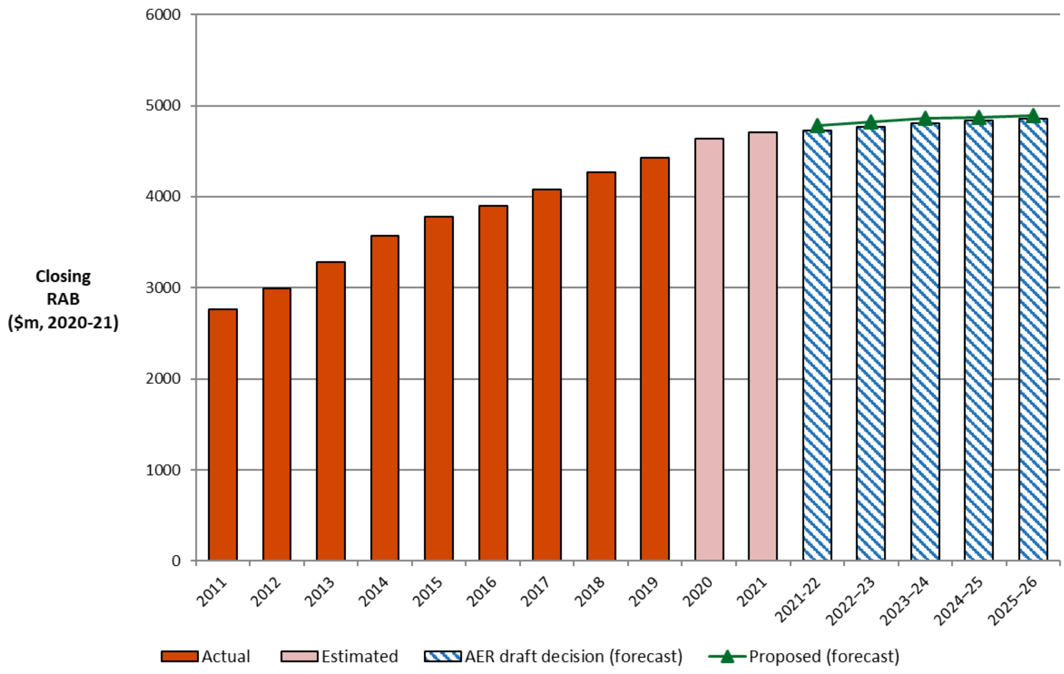
Note: Revenue adjustments include increments or decrements accrued under incentives schemes such as the CESS, EBSS, and Demand Management Innovation Allowance Mechanism (DMIAM).

Figure 3 compares our draft decision forecast RAB to AusNet Services' proposed and actual RAB. This shows that AusNet Services' RAB is forecast to increase by around 3.1 per cent in value over the 2021–26 regulatory control period, compared to a 22.7 per cent increase in the current 2016–20 regulatory control period.[21] This difference is mainly driven by lower forecast capex for the 2021–26 regulatory control period compared to capex incurred (and estimated) in the 2016–20 regulatory control period.

[20] See section 2.7 for further details

[21] See section 2.1 for further details.

Figure 3 Value of AusNet Services' RAB over time ($ million, 2020–21)



Source: AER analysis.

1.2 Key differences between our draft decision and AusNet Services' proposal

Our draft decision has determined total revenues of $3259.3 million ($ nominal) for the 2021–26 regulatory period. This is $171.5 million or 5.0 per cent lower than AusNet Services' proposed $3430.8 million.

While AusNet Services applied the 2018 rate of return instrument, the risk free rate and cost of debt are now both lower than at the time of submitting its proposal. As a result of this and the lower forecast RAB discussed below, the revenue for the cost of capital component is lower by $93.6 million ($ nominal) compared to AusNet Services' proposal.

We have largely accepted AusNet Services' opex and capex proposals but for the adjustments that were mainly driven by changed economic conditions due to COVID-19. Our alternative opex forecast of $1187.4 million ($2020–21) is $46.0 million or 3.7 per cent lower than AusNet Services' proposal. Our alternative net capex forecast of $1369.1 million ($2020–21) is $63.0 million or 4.4 per cent lower than the updated $1432.1 million it proposed.[22]

[22] This takes into account the updates to its initial net capex proposal of $1459.6 million ($2020–21).

This lower capex leads to a lower forecast RAB than AusNet Services' proposal. The lower forecast RAB also contributes to our lower draft decision revenues through a lower return on capital and regulatory depreciation allowance. We also reduced AusNet Services' proposed accelerated depreciation by $43.3 million ($2020–21) for the 2021–26 regulatory control period.

1.3 Expected impact of our draft decision on electricity bills

AusNet Services' distribution network SCS charges make up about 34 per cent of the total residential and 39 per cent of the small business retail electricity bills paid by consumers in AusNet Services' area.[23] Our decision also covers charges for revenue-capped metering services (that form a part of ACS) and these costs are included in this estimated bill impact analysis.[24] Other components of the electricity bill include wholesale electricity costs, retail costs and environmental policy costs. Figure 4 illustrates the different components of the electricity supply chain. Each of these costs contributes to the retail prices charged to consumers by their chosen electricity retailer.

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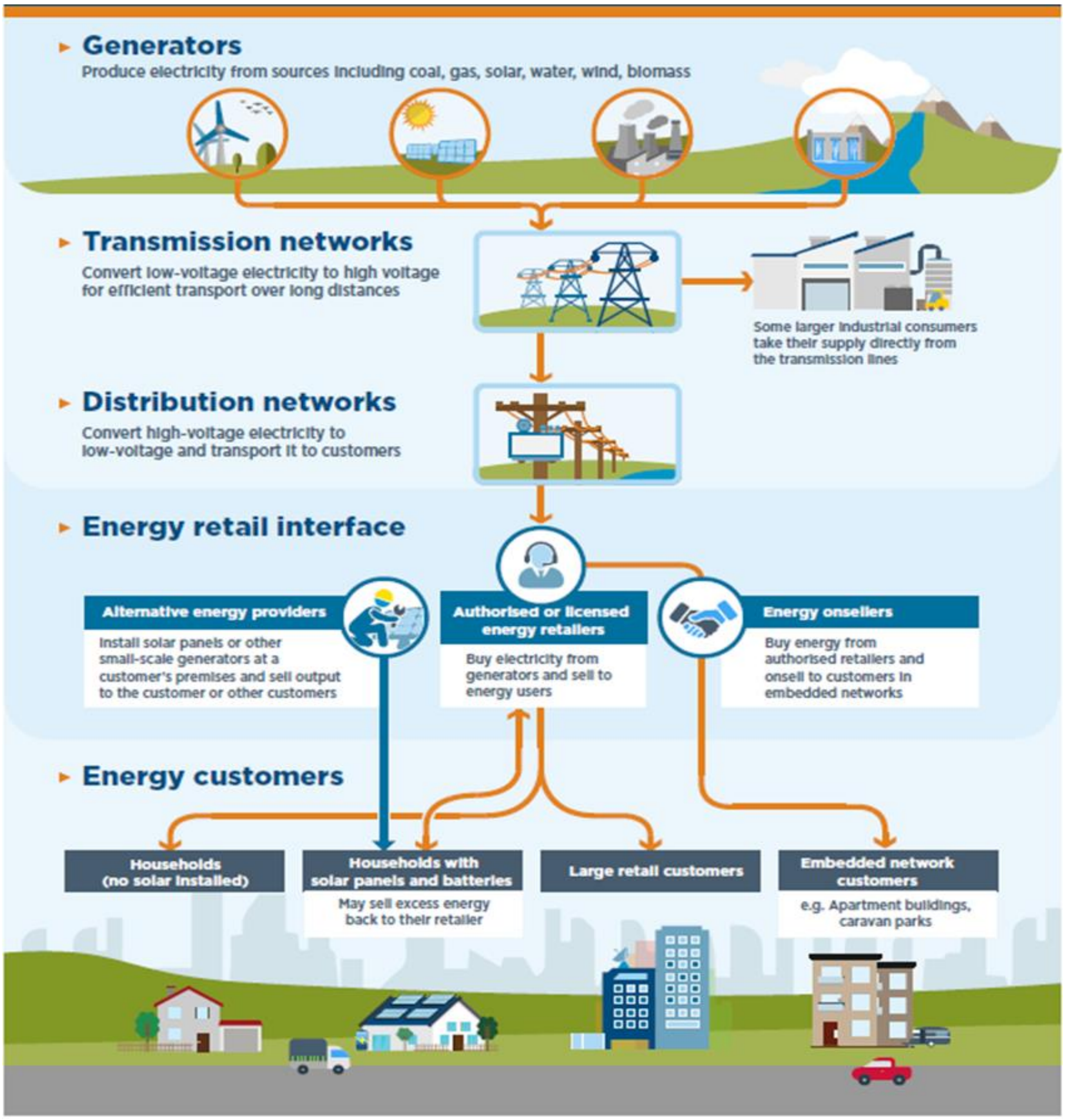
[23] AusNet Services, *ASD - Workbook 7 - Bill Impacts 2022–26*, January 2020

[24] The metering costs referenced in the estimated bill impact analysis refer only to the revenue-capped type 5 and 6 (including. smart metering) services, and do not include any other price-capped metering services. For more information on metering services, see Attachment 16 – Alternative control services.

Figure 4 Electricity supply chain



Source: AER, *State of the Energy Market*, December 2018, p. 28.

For this draft decision, we have estimated average distribution price impacts flowing from our revenue determination. These prices are indicative and will vary for a number of reasons. For example, a change in forecast demand will affect annual price updates. We have also not factored in any changes arising from incentive scheme amounts, cost pass throughs or unders/overs reconciliation that usually occur in the annual pricing process to come up with the total allowed revenue.

Table 1 shows the estimated average annual impacts of our draft decision on electricity bills for residential and small business consumers for the 2021–26 regulatory control period. We estimate these impacts while holding all other components constant. This approach isolates the effect of our draft decision on distribution network tariffs from other bill components. However, this does not imply that other components will remain unchanged across the regulatory control period.[25]

The final bill impact is likely to be affected by our final decision on any revisions made by AusNet Services, changes in consumption, the return on debt, cost pass throughs, adjustments for under or over recovery and incentive schemes. The final outcome of our inflation review later this years and the Victorian Government's legislation on the 6 month extension period will also change the final bill impact. We note that due to the economic uncertainties and concurrent review of our methodology for estimating expected inflation there is potential for a larger-than-normal change between the draft and final decisions.

Under the draft decision we estimate that compared to current charges, the distribution network charges ($ nominal) in AusNet Services' area:

- for an average residential consumer would:
  - reduce by $6 (0.3 per cent) in the first year of the 2021–26 regulatory control period
  - increase on average by $3 (0.1 per cent) for each of the remaining four years of the 2021–26 regulatory control period.
- for an average small business consumer would:
  - reduce by $85 (1.1 per cent) in the first year of the 2021–26 regulatory control period
  - increase on average by $13 (0.2 per cent) for each of the remaining four years of the 2021–26 regulatory control period.

Table 1 Estimated contribution to annual electricity bills for the 2021–26 regulatory control period ($ nominal)

	2020	2021–22	2022–23	2023–24	2024–25	2025–26
AER draft decision						
Residential annual bill	1725[a]	1720	1723	1726	1728	1730
Annual change[c]		–6 (–0.3%)	3 (0.2%)	3 (0.1%)	2 (0.1%)	2 (0.1%)
Standard control services		–18	3	2	2	2
Metering		12	0	0	0	0
Small business annual bill	8004[b]	7919	7937	7950	7961	7971

25 It also assumes that actual energy consumption will equal the forecast adopted in our final decision. Since AusNet Services operates under a revenue cap, changes in energy consumption will also affect annual electricity bills across the 2021–26 regulatory control period.

	2020	2021–22	2022–23	2023–24	2024–25	2025–26
Annual change[c]		–85 (–1.1%)	18 (0.2%)	13 (0.2%)	11 (0.1%)	10 (0.1%)
Standard control services		–97	18	13	11	10
Metering		12	0	0	0	0
AusNet Services proposal						
Residential annual bill	1725[a]	1700	1726	1752	1780	1808
Annual change[c]		–26 (–1.5%)	26 (1.5%)	26 (1.5%)	27 (1.6%)	28 (1.6%)
Standard control services		–35	25	26	26	27
Metering		9	1	1	1	1
Small business annual bill	8004[b]	7822	7961	8102	8248	8398
Annual change[c]		–182 (–2.3%)	139 (1.8%)	141 (1.8%)	145 (1.8%)	150 (1.8%)
Standard control services		–191	139	140	145	149
Metering		9	1	1	1	1

Source: AER analysis; Essential Services Commission, *Victorian Default Offer to apply from 1 January 2020 - Final decision*, 18 November 2019, p. 76.

(a) Annual bill for 2020 is sourced from Essential Services Commission, *Victorian Default Offer to apply from 1 January 2020 - Final decision* and reflects the average consumption of 4000 kWh for residential customers in Victoria. This is then indexed by CPI for the half year period from 1 January 2021 to 30 June 2021 to allow comparison of the bill impact from 1 July 2021 onwards.

(b) Annual bill for 2020 is sourced from Essential Services Commission, *Victorian Default Offer to apply from 1 January 2020 - Final decision* and reflects the average consumption of 20000 kWh for small business customers in Victoria. This is then indexed by CPI for the half year period from 1 January 2021 to 30 June 2021 to allow comparison of the bill impact from 1 July 2021 onwards.

(c) Annual change amounts and percentages are indicative. They are derived by varying the distribution component of the 2020 bill amounts in proportion to yearly expected revenue divided by forecast energy as provided by AusNet Services. Actual bill impacts will vary depending on electricity consumption and tariff class.

AusNet Services used a revenue per customer approach to measure bill impacts, whereas our approach is different leading to some differences in the forecast impacts.[26] The revenue per customer approach uses the change of revenue divided by customer numbers. Our approach uses the change of revenue divided by energy consumption. The concepts are closely related as forecast increases in customer numbers will also be reflected in greater forecast energy consumption. Forecast energy consumption, however, can also change due to any changes in the average level of energy each customers is forecast to consume. In this regard, using energy

26 AusNet Services, *Response to AER information request #045*, 06 July 2020.

consumption is a way to capture more potential sources of bill changes from one year to the next. This matter is discussed further in attachment 1.

Our calculated bill impact assessment for AusNet Services shows a $4 increase from 2020 to 2025–26. However, our similar bill impact assessments for each of the other Victorian DNSPs show reductions. There are several factors for this difference including:

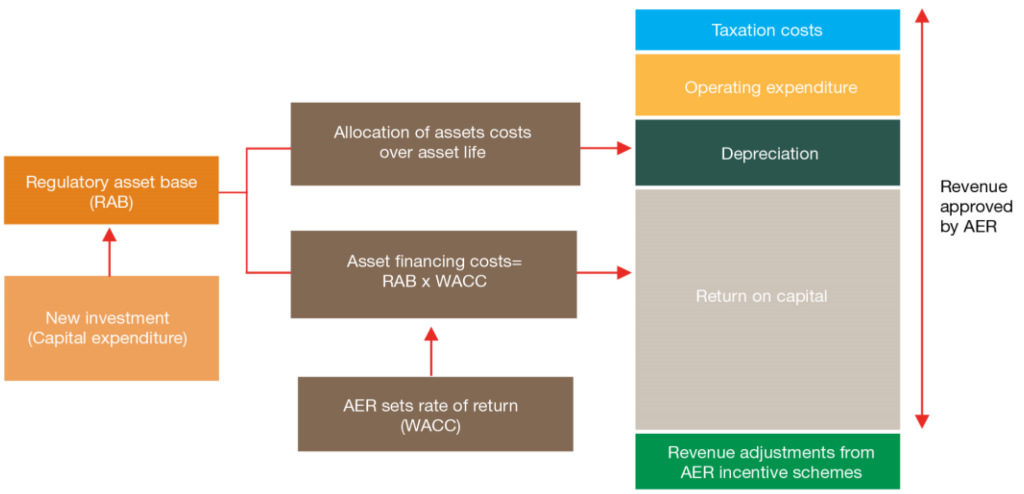
- AusNet Services' aggregate energy throughput profile is forecast to decrease over the 2021–26 regulatory period whereas for each of the other Victorian DNSPs it is forecast to increase. In our approach, a lower energy throughput results in a higher price path.
- AusNet Services' Annual Revenue Requirement (ARR) for the 2021–26 regulatory control period reflects a 6 per cent real reduction relative to the ARR for the 2016–20 regulatory period. This is the smallest reduction (in percentage terms) among the Victorian DNSPs. Figure 2 shows the relative change to each revenue building block between the 2016–20 and 2021–26 regulatory periods. On the other hand, AusNet Services' RAB growth over the 2016–21 period of 25 per cent (Figure 3) is the highest among the Victorian DNSPs and this is a factor in AusNet Services having a period-to-period reduction to return on capital which is (in percentage terms) the second-lowest among the Victorian DNSPs. This relatively high 2016–21 RAB growth along with a large amount of accelerated depreciation in the 2021–26 regulatory control period also contributes to AusNet Services having the highest period-to-period increase (in percentage terms) to regulatory depreciation among the Victorian DNSPs. While a higher depreciation increases revenue in the period in which it occurs, all things being equal it reduces the forecast RAB which leads to a lower return on capital (and therefore revenue) in future periods.
- AusNet Services' forecast (revenue-capped) metering services per customer in 2025–26 are higher than those in 2020 whereas for each of the other Victorian DNSPs they are lower.
- In our price path calculation, for the 2020 base year revenue, we used the total allowed revenue (TAR) and adjust for CPI. AusNet Services' 2020 TAR includes a B factor reduction to true-up recent over-recovery of revenue. This B factor reduction for AusNet Services is the largest among the Victorian DNSPs. Similarly, Jemena and Powercor also each include a (smaller) B factor reduction to 2020 revenue while conversely CitiPower and United Energy each include a B factor addition. AusNet Services' relatively lower base (2020) revenue therefore slightly decreases the magnitude of its SCS bill reduction arising from our decision for the 2021–26 regulatory control period.

2 Key components of our draft decision on revenue

The total revenue AusNet Services proposed reflects its forecast of the efficient cost of providing network services over the 2021–26 regulatory control period. AusNet Services' proposal, and our assessment of it under the National Electricity Law (NEL) and Rules, are based on a 'building block' approach to determining a total revenue allowance (see Figure 5) which looks at six cost components:

- a return on the RAB (or return on capital, to compensate investors for the opportunity cost of funds invested in this business) (section 2.2)
- depreciation of the RAB (or return of capital, to return the initial investment to investors over time) (section 2.3)
- capex — the capital expenditure incurred in the provision of network services — mostly relates to assets with long lives, the cost of which are recovered over several regulatory control periods. The forecast capex approved in our decisions directly affects the projected size of the RAB and therefore the revenue generated from the return on capital and depreciation building blocks (section 2.4)
- opex—the operating, maintenance and other non-capital expenses incurred in the provision of network services (section 2.5)
- the estimated cost of corporate income tax (section 2.6)
- revenue adjustments, including revenue increments or decrements resulting from the application of incentive schemes, such as EBSS, CESS that applied to AusNet Services for the 2016–20 regulatory control period and the Demand Management Innovation Allowance Mechanism (DMIAM) allowance for 2021–26 (section 2.7).

Figure 5 The building block model to forecast network revenue



Source: AER, *State of the Energy Market, December* 2018, p. 28.

We use an incentive approach where, once regulated revenues are set for a five year period, networks that keep actual costs below the regulatory forecast of costs retain part of the benefit. This incentive framework is a foundation of the regulatory framework, which aims to promote the NEO. Distributors 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 control periods.

Our draft decision on AusNet Services' distribution revenues for the 2021–26 regulatory control period is set out in Table 2.

Table 2 AER's draft decision on AusNet Services' revenues for the 2021–26 regulatory control period ($ million, nominal)

	2021–22	2022–23	2023–24	2024–25	2025–26	Total
Return on capital	218.1	215.5	213.5	211.3	207.9	1066.4
Regulatory depreciation	162.5	140.0	138.9	144.5	147.6	733.5
Operating expenditure	240.4	247.6	253.9	262.0	271.1	1275.0
Revenue adjustments	82.1	50.7	29.4	8.7	6.5	177.4
Net tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Annual revenue requirement (unsmoothed)	703.0	653.8	635.7	626.6	633.2	3252.2
Annual expected revenue (smoothed)	**651.6**	**651.7**	**651.9**	**652.0**	**652.1**	**3259.3**
X factor[d]	n/a[e]	2.30%	2.30%	2.30%	2.30%	n/a

Source: AER analysis.

(a) Regulatory depreciation is straight-line depreciation net of the inflation indexation on the opening RAB.

(b) Includes debt raising costs.

(c) Includes revenue adjustments from EBSS, CESS and DMIAM.

(d) The X factors will be revised to reflect the annual return on debt update. Under the CPI–X framework, the X factor measures the real rate of change in annual expected revenue from one year to the next. A negative X factor represents a real increase in revenue. Conversely, a positive X factor represents a real decrease in revenue.

(e) AusNet Services is not required to apply an X factor for 2020–21 because we set the 2020–21 expected revenue in this decision. The expected revenue for 2021–22 is around 6.0 per cent lower than the approved total annual revenue for 2020 in real terms, or 3.8 per cent lower in nominal terms after taking into account the escalation by half year CPI to allow comparison of the revenue from 1 July 2021 onwards.

Under the rules we are required to maintain the net present value between smoothed and unsmoothed revenues over the regulatory control period, and minimise the difference between expected smoothed and unsmoothed revenues at the end of a regulatory control period. To do so, it is not always possible to achieve a revenue profile that has been negotiated before our determination outcomes are known. We noted these requirements in our guidance note on the revenue path smoothing for facilitating the New Reg process.[27]

In the present circumstances, we have been able to achieve a significant reduction to the revenue for 2021–22 as sought by the Customer Forum. This first year reduction would have been significantly larger had we also smoothed revenues over the remaining four years with the aim of flat real prices on a per customer basis. However, we do not consider such an approach is appropriate now that the draft decision outcomes are known. We will consider submissions on this before we make our final decision.

For the reasons discussed attachment 1, we have concerns with the use of customer numbers as the measure of demand for bill impact estimation purposes. In addition, applying flat real prices on a per customer basis, would have resulted in a significant divergence of over 11 per cent between smoothed and unsmoothed revenues for the final year of the regulatory control period. Such a difference sets up a prospect for significant price adjustments at the start of the subsequent regulatory control period. Our approach for this draft decision is to keep the final year divergence to 3 per cent. It also results in real decreases in price per customer over the subsequent four years, rather than the flat prices as proposed.

In the sections below we discuss each component of our draft decision on AusNet Services' revenue building blocks for the 2021–26 regulatory control period.

2.1 Regulatory asset base

The RAB is the value of assets used by AusNet Services to provide regulated distribution services. The value of the RAB substantially impacts AusNet Services' revenue requirement, and the price consumers ultimately pay. This makes it a key issue for many stakeholders. Other things being equal, a higher RAB would increase both the return on capital and depreciation (return of capital) components of the revenue determination.

As part of our decision on AusNet Services' revenue for the 2021–26 regulatory control period, we make a decision on AusNet Services' opening RAB as at 1 July 2021. We use the RAB at the start of each regulatory control period year to determine the return of capital (regulatory depreciation) and return on capital building block allowances.

We determine an opening RAB value of $4709.8 million ($ nominal) as at 1 July 2021 for AusNet Services. This value is $5.3 million (or 0.1 per cent) lower than AusNet Services' proposed opening RAB of $4715.1 million ($ nominal) as at 1 July 2021.[28] While we largely accept the proposed methodology for calculating the opening RAB, we made the following revisions to AusNet Services' proposed inputs to the roll forward model (RFM):

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27 AER, *AusNet Trial – AER staff guidance note 6: Revenue path profile*, 29 August 2018

28 AusNet Services, *ASD - Distribution Proposal RFM (2016–21) - 310120 - PUBLIC,* January 2020.

- consolidated the three new asset classes AusNet Services proposed for capitalised leases into a single new 'Non-network leasehold land & buildings – 1 July 2021'.[29] Removed the proposed annual capex entries for the three asset classes over the 2019–21 period and recorded them as a single capitalised value of these leases at 30 June 2021 (end of current period);
- removed the proposed 'Non-network - Metering related IT' asset class based on further information provided by AusNet Services.[30] We re-allocated the capex for this proposed asset class to the existing 'Non-network general asset - IT' asset class;
- amended the capex inputs for 2018 to be consistent with the values reported in the annual regulatory information notice (RIN) for that year;
- consolidated the two asset classes for equity raising costs into a single asset class and amended the value for the equity raising costs in 2021;
- amended the 2016–20 forecast depreciation amounts, an input for the RAB roll forward calculation, to be consistent with the values in the 2020 return on debt update in the 2016–20 post-tax revenue model (PTRM), as required under the 2016–20 distribution determination;[31]
- amended the proposed end of period re-allocation for the 'Secondary systems (pre 2016)' asset class. This relates to the accelerated depreciation of SCADA/Network control assets and our detailed reasons for this amendment are set out in section 4.4.2 of Attachment 4 of this draft decision; and
- updated the following inputs as newer information has become available since AusNet Services submitted its proposal:
    - the actual capex for 2019 reported in the annual RIN for that year;
    - actual inflation for the six month period of 1 January to 30 June 2021, reflecting the lagged CPI series; and
    - forecast inputs for inflation, nominal WACC, equity raising costs and depreciation for the 6 month period of 1 January to 30 June 2021.

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29 These three new proposed asset classes includes the capitalised value of both the existing 2019, the estimated 2020, and the first half of 2021 expenditure associated with property-related leasing arrangements. In the current regulatory control period, the cost associated with these leases are categorised as opex. In April 2019, there was a change in accounting reporting standards which allows the business to capitalise the cost of these leases. We accept that the cost of the leases can be capitalised but consider this re-categorisation of expenditure should be implemented at the end of the current regulatory control period for inclusion in the RAB roll forward. This approach is consistent with the requirements of the RFM and Capital expenditure incentive guideline. Please see section 2.4.1 for further details.

30 AusNet Services, *Response to AER IR#028*, 24 June 2020.

31 AER, *Final decision AusNet Services distribution determination 2016 to 2020, Attachment 2*, p. 20, May 2016. The 2016–20 final decision is to roll forward the RAB for the commencement of AusNet Services' next regulatory control period using depreciation based on forecast capex (updated for actual inflation).

To determine the opening RAB as at 1 July 2021, we have rolled forward the RAB over the 2016–20 regulatory control period and a further roll forward for six months (the 1 January to 30 June period)[32] to arrive at a closing RAB value at 30 June 2021 in accordance with our RFM. This roll forward process includes an adjustment at the end of the 2016–20 regulatory control period to account for the difference between actual 2015 capex and the estimate approved in the 2016–20 determination.[33] All other adjustments are applied as part of the final year adjustments at 30 June 2021 to establish the opening RAB value at 1 July 2021.[34]

Table 3 sets out the roll forward of AusNet Services' RAB over the 2016–21 period.

Table 3 AER's draft decision on AusNet Services' RAB for the 2016–21 period ($ million, nominal)

	2016	2017	2018	2019	2020[a]	2021[b]
Opening RAB	3442.1	3610.5	3809.4	4067.6	4308.1	4530.4
Capital expenditure	298.7	332.6	367.3	349.0	411.6	188.7
Inflation indexation on opening RAB	52.0	36.9	73.7	84.5	68.6	55.2
Less: straight-line depreciation	182.3	170.6	182.8	193.0	208.2	99.3
Interim closing RAB	3610.5	3809.4	4067.6	4308.1	4580.1	4675.0
Difference between estimated and actual capex in 2015					–38.1	
Return on difference for 2015 capex					–11.6	
Closing RAB as at 31 December 2020					4530.4	
Final year asset adjustments						34.8
Closing RAB as at 30 June 2021						**4709.8**

Source: AER analysis.

(a) Based on estimated capex provided by AusNet Services. We expect to update the RAB roll forward for actual capex in the final decision.

(b) The half year period of 1 January to 30 June 2021. Based on estimated capex provided by AusNet Services. We expect to update the RAB roll forward with a revised capex estimate in the final decision, and true-up the RAB for actual capex at the next reset.

(c) Net of disposals and capital contributions, and adjusted for actual CPI and half-year WACC.

(d) Adjusted for actual CPI. Based on forecast capex.

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32 The additional roll forward for six months is due to the decision by the Victorian government to change the timing of the annual Victorian electricity network price changes to financial year basis from calendar year basis. This change means the current regulatory control period of 2016–20 is extended by six months and the next regulatory control period will commence on 1 July 2021.

33 The end of period adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved at the 2016–20 determination.

34 This includes adjustment for capitalised leases, and re-allocation for accelerated depreciation purposes associated with SCADA/Network and rapid earth fault current limiter (REFCL) assets.

We determine a forecast closing RAB value as at 30 June 2026 of $5458.2 million ($ nominal) for AusNet Services. This is $57.7 million or 1.0 per cent lower than AusNet Services' proposed closing RAB value of $5516.0 million ($ nominal).[35] Our draft decision on the forecast closing RAB value reflects the amended opening RAB as at 1 July 2021, and our draft decisions on the expected inflation rate (Attachment 3), forecast depreciation (Attachment 4) and forecast capex (Attachment 5).[36]

Table 4 sets out our draft decision on the forecast RAB values for AusNet Services over the 2021–26 regulatory control period.

Table 4 AER's draft decision on AusNet Services' RAB for the 2021–26 regulatory control period ($ million, nominal)

	2021–22	2022–23	2023–24	2024–25	2025–26
Opening RAB	4709.8	4840.6	4997.0	5160.5	5308.3
Capital expenditure	293.3	296.4	302.3	292.4	297.5
Inflation indexation on opening RAB	111.8	114.9	118.6	122.5	126.0
Less: straight-line depreciation	274.3	254.9	257.5	267.1	273.6
Closing RAB	**4840.6**	**4997.0**	**5160.5**	**5308.3**	**5458.2**

Source: AER analysis.

(a) Net of forecast disposals and capital contributions. In accordance with the timing assumptions of the PTRM, the capex includes a half-year WACC allowance to compensate for the six month period before capex is added to the RAB for revenue modelling.

We accept AusNet Services' proposal that the forecast depreciation approach is to be used to establish the opening RAB at the commencement of the 2026–31 regulatory control period.[37] We consider this approach is consistent with our *Framework and approach* paper.[38] It is also consistent with the capex incentive objective, in that it will provide sufficient incentives for AusNet Services to achieve capex efficiency gains over the 2021–26 regulatory control period.

Figure 6 sets out AusNet Services' proposal and AER's draft decision RAB over the 2021–26 regulatory control period.

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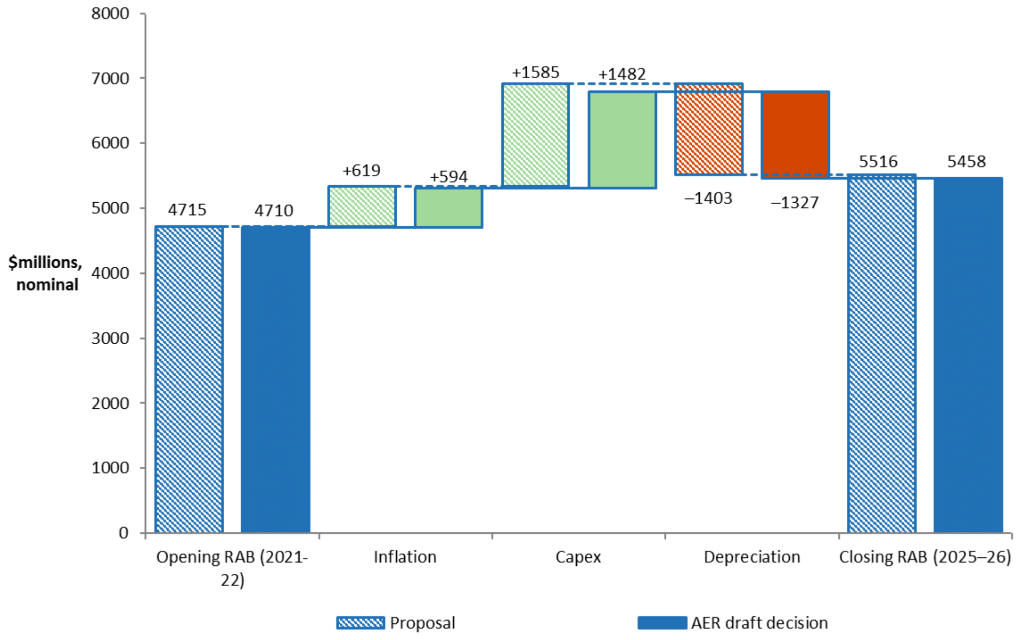
35 AusNet Services, *ASD, Distribution Proposal RFM (2016–21), 310120, PUBLIC*, January 2020.

36 Capex enters the RAB net of forecast disposals. It includes equity raising costs (where relevant) and the half-year WACC to account for the timing assumptions in the PTRM. Therefore, our draft decision on the forecast RAB also reflects our amendments to the rate of return for the 2021–26 regulatory control period (Attachment 3).

37 NER, cl. 6.12.1(18).
AusNet Services, *Response to AER IR#057,* 3 August 2020.

38 AER, *Final framework and approach for AusNet Services, AusNet Services, Jemena, Powercor and United Energy*, January 2019, p. 12.

Figure 6 AusNet Services' proposal and AER's draft decision RAB ($ million, nominal)



Source: AER analysis.

Further detail on our draft decision regarding the RAB is set out in Attachment 2.

2.2 Rate of return and value of imputation credits

The return each business is to receive on its RAB (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 RAB.

We estimate the rate of return by combining the returns of the 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 on its loans and give a return on equity to investors.

An accurate estimate of the rate of return is necessary to promote efficient prices in the long-term interests of consumers. If the rate of return is set too low, the network business may not be able to attract sufficient funds to be able to make the required investments in the network and reliability may decline. Conversely, if the rate of return is set too high, the network business may seek to spend too much and consumers will pay inefficiently high tariffs.

The Victorian Government is intending to move the Victorian electricity distribution network service providers from a calendar year regulatory period to a financial year regulatory period.[39] This entails a 6 month extension to the current regulatory period (2016–20) through to June 2021 then a 5 year regulatory control period starting on 1 July 2021.[40]

We are required by the National Electricity Law (NEL) to apply a rate of return instrument—the current 2018 Rate of Return Instrument (2018 Instrument)—to estimate an allowed rate of return.[41] However, the 2018 Instrument was developed on the basis of consecutive 12-month regulatory years, and does not contemplate an intervening 6 month extension period when moving from calendar years to financial years. This is important for the calculation of the trailing average portfolio return on debt under the Instrument. The 2018 Instrument also did not contemplate the nomination of averaging periods for a 6 month extension period.

The Victorian Government intends to enact the change to a financial year regulatory period through the National Energy Legislation Amendment (NELA) Bill. By the time of this draft decision, the Bill has not been passed. In a letter to the AER on 2 September 2020, the Minister reaffirmed the Victorian Government's commitment to change electricity and gas network regulatory periods from a calendar to financial year basis. We anticipate that we will be able to apply a modified 2018 instrument in the final decision on this basis.[42]

Subject to the passing of the NELA Bill and relevant Orders in Council, application of a modified 2018 Instrument in this draft decision would estimate a placeholder allowed rate of return of 4.63 per cent (nominal vanilla) which will be updated for our final decision on the averaging periods.[43] AusNet Services' regulatory proposal has also accepted the application of these modifications to the 2018 Instrument.[44]

Our calculated rate of return, in Table 5, will apply to the first year of the 2021–26 regulatory control period. A different rate of return will apply for the remaining regulatory years of the period. This is because we will update the return on debt component of the rate of return each year in accordance with a modified 2018 instrument to use a 10-year trailing average portfolio return on debt that is rolled-forward each year.

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39 Victorian Government, *Letter re: Intention to change the timing of annual Victorian network price changes*, April 2019, available at https://www.aer.gov.au/system/files/VIC%20DELWP%20letter%20to%20AER%20re%20intention%20to%20change%20the%20timing%20of%20annual%20Victorian%20network%20price%20changes%20-%20April%202019_0.pdf

40 The 6 month extension period was labelled as the 'mini-year' when we consulted on modifications to the 2018 Rate of Return Instrument.

41 NEL, Part 3, division 1B. AER, *Rate of return instrument*, December 2018, available at https://www.aer.gov.au/networks-pipelines/guidelinesschemes-models-reviews/rate-of-return-guideline-2018/final-decision

42 Hon Lily D'Ambrosio MP, *Letter re: Reaffirming commitment to change the timing of Victorian network pricing*, 2 September 2020.

43 See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-guideline-2018/final-decision. NGL, Chapter 2, Part 1, division 1A; NEL, Part 3, division 1B.

44 AusNet, *Electricity Distribution Price Review 2022–26 Part III*, January 2020, p. 212–214

Subject to the passing of the NELA Bill and relevant Orders in Council, our draft decision is to accept AusNet Services' proposed risk free rate averaging period[45] and debt averaging periods because they would comply with conditions proposed for a modified 2018 Instrument.[46]

Table 5 Draft decision on AusNet Services' rate of return (% nominal)

	AER final decision (2016–20)	AusNet Services' proposal (2021–26)	AER draft decision (2021–26)	Allowed return over regulatory control period
Nominal risk free rate	2.93%	1.26%	0.93%[a]	
Market risk premium	6.5%	6.1%	6.1%	
Equity beta	0.7	0.6	0.6	
Return on equity (nominal post–tax)	7.5%	4.92%	4.59%	Constant (%)
Return on debt (nominal pre–tax)	5.52%	4.79%	4.66%[b]	Updated annually
Gearing	60%	60%	60%	Constant (60%)
Nominal vanilla WACC	6.31%	4.84%	4.63%	Updated annually for return on debt
Expected inflation	2.32%	2.45%	2.37%	Constant (%)

Source: AER analysis; AusNet, *Electricity Distribution Price Review 2022–26 Part III*, January 2020.

[a,b] Calculated using a placeholder averaging period.

Debt and equity raising costs

In addition to providing for the required rate of return on debt and equity, we provide an allowance for the transaction costs associated with raising debt and equity. We include debt raising costs in the opex forecast because these are regular and ongoing costs. We include equity raising costs in the capex forecast because these costs are only incurred once and would be associated with funding the particular capital investments.

For debt raising costs, our draft decision is to accept the method used in AusNet Services' proposal which uses an annual rate of 8.16 basis points per annum.[47] We have considered this annual rate and found that our alternative benchmark estimate (7.9 basis points) is not materially different from AusNet Services' proposal.

45 This is also known as the return on equity averaging period.

46 See AER, *Rate of return instrument*, December 2018, cl. 7–8, 23–25, 36; Parliament of Victoria, *National energy legislation amendment bill 2020*, June 2020; and AER, *Draft decision, AusNet Services draft determination 2021 to 2026, Attachment 3—Rate of return confidential appendix A: Equity and debt averaging periods*, September 2020.

47 AusNet Services, *Electricity Distribution Price Review 2022–26 Part III*, January 2020, p. 216

We accept AusNet Services' proposal to use our approach to estimate equity raising costs.[48] Using this approach, AusNet Services forecast zero equity raising costs.[49] We have updated our estimate for this regulatory control period based on the benchmark approach using updated inputs. This results in zero equity raising costs.

Imputation credits

Subject to the passing of the NELA Bill and relevant Orders in Council, our draft decision is to apply a gamma of 0.585 as provided in the 2018 Instrument.[50] AusNet Services' proposal has adopted a value of 0.585 which is consistent with this.[51]

Inflation

AusNet Services proposed to apply our current approach to estimate expected inflation.[52] Our draft decision estimate of expected inflation is 2.37 per cent for the regulatory control period. Each Victorian distributor's proposal noted concerns with our current approach to estimating expected inflation. We are currently undertaking a review into the treatment of inflation in our regulatory framework, including the method likely to result in the best estimate of expected inflation. The final outcomes of this review are expected in December 2020, with a draft position to be published in early October. The draft position will provide guidance on the potential impact of alternative methods of estimating expected inflation. If we consider a different method for estimating expected inflation should be adopted, we intend to commence the consultation process under the NER for amending the PTRM. We expect to apply amendments to the PTRM (if any) in our final determination for each of the Victorian distributors in April 2021, unless a rule change proposal is required.

2.3 Regulatory depreciation (return of capital)

Regulatory depreciation is the allowance provided so capital investors recover their investment over the economic life of the asset (return of capital). AusNet Services invests capital in large assets to provide electricity network services to its consumers. The costs of these assets are recovered over the asset's useful life, which in many cases can be 50 or more years. This means only a small part of the cost of such assets are recovered from consumers upfront or in any year. The greater proportion is recovered over time through the depreciation allowance. The regulatory depreciation allowance is the net total of the straight-line depreciation less the inflation indexation adjustment of the RAB.

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48 AusNet Services, *Electricity Distribution Price Review 2022–26 Part III*, January 2020, p. 215

49 AusNet Services, *ASD - Distribution Proposal PTRM model (2022–26) - 310120 - PUBLIC.*

50 See Parliament of Victoria, *National energy legislation amendment bill 2020*, June 2020; AER, *Rate of return instrument*, December 2018.

51 AusNet Services, *Electricity Distribution Price Review 2022–26 Part III*, January 2020, pp. 216–217.

52 AusNet Services, EDPR 2022–26 Regulatory Proposal Part 3, 31 January 2020, p.217.

Our draft decision on AusNet Services' revenue for 2021–26 includes a regulatory depreciation amount of $733.5 million ($ nominal). This is $50.5 million (6.4 per cent) lower than AusNet Services' proposal.

We adopt the same approach to regulatory depreciation as AusNet Services, including its proposed standard asset lives which determine how quickly an asset class is removed from the RAB. We also accept AusNet Services' proposal to apply the year-by-year tracking approach, subject to minor changes to its depreciation tracking model.

However, we made substantive changes to its proposed accelerated depreciation amount. AusNet Services proposed accelerated depreciation of $209.1 million of relays and remote terminal units. Based on our assessment (See Attachment 4), we have reduced the amount of depreciation in relation to these assets by $43.4 million for the 2021–26 regulatory control period. Compared to AusNet Services proposal, we have reduced the unit rates used to determine the proportion of assets subject to accelerated depreciation. This reduces the total amount subject to accelerated depreciation by $12.5 million. We also consider that a tracking approach should be used for these asset, which means about $30.9 million will instead be recovered in the 2026–31 regulatory control period.

We have also made determinations on other components of AusNet Services proposal, which in turn impacts the forecast regulatory depreciation. Reductions in the opening RAB (Attachment 2) and forecast capex (Attachment 5) lead to a $75.7 million reduction in straight-line depreciation. Offsetting this, our draft decision on the indexation of the RAB is $25.2 million lower than the proposal. This is due to a lower forecast RAB and applying a lower expected inflation rate in this draft decision (Attachment 3).

Further detail on our draft decision regarding depreciation is set out in Attachment 4.

2.4 Capital expenditure

Capex—the capital costs and expenditure incurred to provide network services—mostly relates to assets with long lives, the costs of which are recovered over several regulatory control periods. Capex is added to AusNet Services' RAB, which is used to determine the return on capital and return of capital (regulatory depreciation) building block allowances. All else being equal, higher forecast capex will lead to a higher projected RAB value and higher return on capital and regulatory depreciation allowances.

Our draft decision on AusNet Services’ revenue includes a total net capex forecast of $1369.1 million ($2020–21) for the 2021–26 regulatory control period. This is 4.4 per cent lower than AusNet Services’ updated forecast (‘forecast assessed’) of $1432.1 million.[53] We consider that this capex forecast is prudent and efficient, and sufficient for

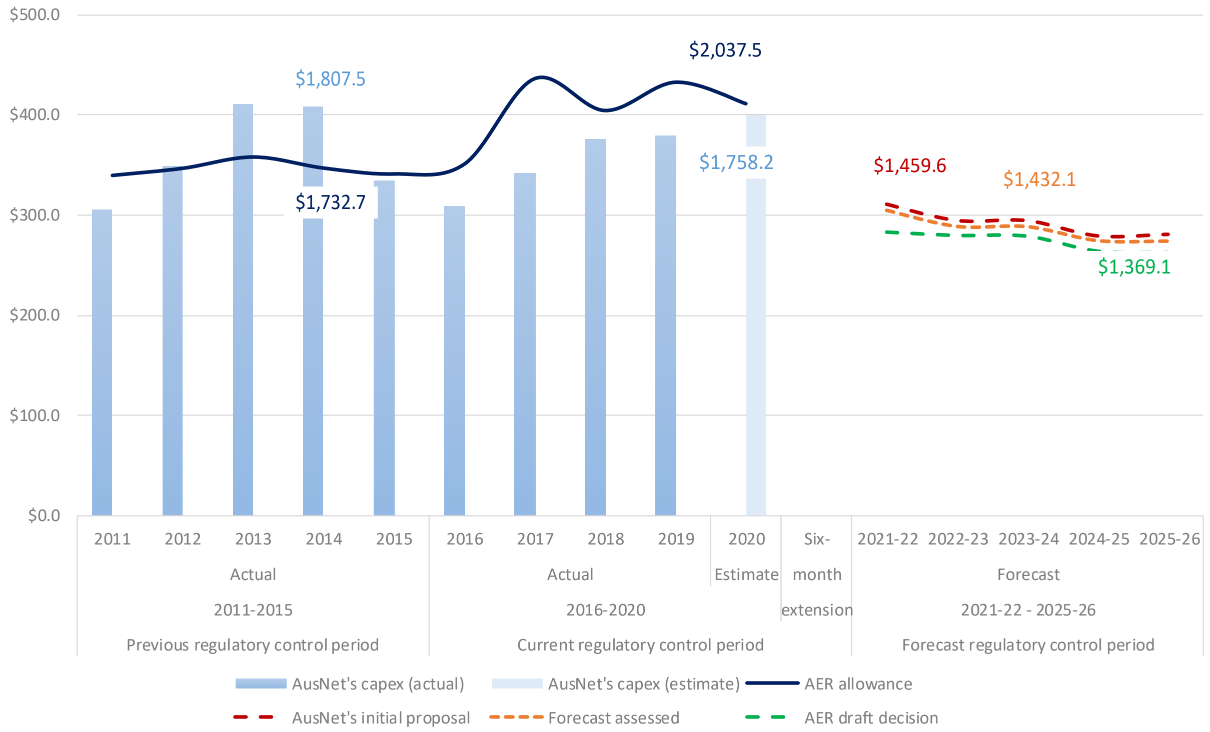
53 This takes into account the updates to its initial net capex proposal of $1459.6 million ($2020–21).

AusNet Services to maintain its service levels given that it has performed well on a number of network health indicators over the current period.

We note that with the exception of modelling errors, reclassification of some expenditures and changes to economic conditions, AusNet Services' forecast of total capex was reasonable and represented value for money for its customers. We have used the most up-to-date information to take into account changes in economic conditions. For example, we have used updated housing data from the Housing Industry Association (HIA) to develop our forecast connections and labour price growth was calculated consistent with the approach used in our opex decision (see section 2.5).

Figure 7 illustrates the change in AusNet Services' capex over time. AusNet Services' forecast is a 19 per cent decrease from its actual capex over the 2016–20 regulatory control period. It also underspent its current period allowance by 12 per cent.

Figure 7 AER's draft decision on total forecast capex ($ million, 2020–21)



Source: AusNet Services' initial proposal and AER analysis.

Note: The capex figures reported refer to five-year totals over a regulatory control period. The 2020 estimate has been included in this chart for indicative purposes. We have not use this estimate in our trend comparison.

We typically analyse a distributor's total capex forecast from a top-down perspective.[54] This top-down review forms the starting point of our capex assessment to determine whether further detailed analysis is required, but is also used throughout our review process to test the results of our bottom-up assessment. We apply both top-down and bottom-up reviews so that our decision is fully informed. In this case, we are satisfied that AusNet Services' forecast capex is prudent and efficient having regard to both top-down and bottom-up reviews.

We acknowledge that AusNet Services' capex forecast, submitted prior to the increase in severity of COVID-19, could not have adequately taken into account changes in economic conditions. Subject to the adjustments mentioned above, we concluded that a top-down assessment indicated that the total capex reasonably reflects the capex criteria. An important factor in this position was the top-down adjustment to total individual program requirements implemented by AusNet Services in developing its aggregate capex proposal.

Given our top-down assessment, an examination of the proposed expenditures at the program level was given relatively less weight than if AusNet Services' forecast was materially higher than its historical capex. We also undertook a bottom-up review at the category level, consistent with our standard approach. While we identified some areas where individual capex categories were not fully justified we are satisfied that, having regard to AusNet Services' top-down challenge, these concerns are not material. That is, the top-down adjustment made by AusNet Services was as large, or larger, than the total sum of the adjustments that we would otherwise make at the individual category level.

AusNet Services' constructive top-down challenge and its consumer engagement has genuinely tested the forecast capex submitted by AusNet Services. This top down review reduced its forecast capex by $151.8 million, and AusNet Services then applied a further $9.0 million top down adjustment for efficiency savings. We especially note AusNet Services' genuine willingness to understand the consumer perspective by testing different feasible options to address consumers' needs and view its efforts to sincerely listen to its consumers as setting a high standard. We placed appropriate weight on AusNet Services' consumer engagement and its consumers' support for the capex proposal in deciding whether the proposed forecast is prudent and efficient.[55]

In determining whether AusNet Services' total capex forecast is prudent and efficient, we also note the following:

- Given the application of the CESS in the current period, we place weight on AusNet Services forecast capex being 19 per cent lower than its actual capex over the first four years of the current period. In addition, its forecast is 18 per cent lower than its longer term actual capex trend, going back to the start of the 2011–2015 regulatory

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[54] A top down analysis focusses on overall trends and adjustments rather than a bottom-up analysis which focusses on aggregating category specific drivers.

[55] NER, cl.6.5.7(e)(5A).

control period. We also note that for almost all capex categories, AusNet Services' forecast was lower than its current regulatory period spend.

- AusNet Services' system average interruption frequency index (SAIFI) results are improving, indicating that it has successfully managed its network reliability over the current period with its current spend levels. It is also expected to improve its reliability even further in the forecast period, despite forecasting total capex materially below its current period levels.
- We also note that some categories such as Rapid Earth Fault Current Limiter (REFCL) capex is subject to updated information which is not yet available. We also expect AusNet Services to reflect updated economic conditions in its revised proposal for real cost escalations, connections and demand forecasts.
- In response to the initial proposal, most stakeholders were supportive of investment by networks to integrate a greater level of PV export. [56] However, several stakeholders raised concerns with using the feed-in tariff as the basis for the value of DER, and the likelihood of negative pool prices in Victoria based on the Queensland and South Australian experience.[57] More specifically, the VCO called for a standard approach for valuing exported generation that reflects the expected changes in the value of DER exports over time.[58]
- Similar concerns about a lack of consistency across distributors in valuing the benefits associated with investing in DER integration were raised in response to the AER's consultation paper on Assessing DER Integration Expenditure.[59] In response, the AER and ARENA commissioned the value of DER (VaDER) study with ARENA earlier this year.[60] CSIRO and Cutler-Merz were engaged to conduct a study into potential methodologies for valuing DER and have extensively engaged with stakeholders, including AusNet Services, as part of the study.
- The final report of the VaDER study is due to us in early October 2020, which will help to address some of the stakeholder concerns outlined above. We will publish the final report as soon as practicable. We will then consider the report's recommendations and formally implement them as we consider appropriate as part of our DER integration expenditure guideline, now due for completion in 2021. Given the extensive stakeholder engagement in forming the VaDER study's

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56 Victorian Community Organisations, *2021–26 Victorian EDPR,* May 2020, p.4, Local Government Response, *2021–26 Victorian EDPR, May 2020,* p.30, Origin Energy, *Submission to Victorian electricity distributors' regulatory proposals,* June 2020, p.3, Vector Limited, *2021–26 Victorian EDPR,* June 2020, p.4, DELWP, *Victorian Government submission on the electricity distribution price review 2021–26,* May 2020, p. 2.

57 Energy Australia, *Victorian electricity distribution determinations 2021–26 regulatory proposal*, June 2020, p. 14; CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals,* June 2020, p. 106; Energy Users' Association of Australia, *Submission: AusNet Services EDPR 2021–26*, June 2020, pp. 11–12.

58 Victorian Community Organisations, *2021–26 Victorian EDPR,* May 2020, p. 10.

59 See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/assessing-distributed-energy-resources-integration-expenditure/initiation.

60 See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/assessing-distributed-energy-resources-integration-expenditure/consultation

recommendations, we anticipate that consumers will expect Victorian distributors to prepare their revised proposals in the spirit of these recommendations.

We have set out the reasons for our draft decision on capex in more detail in Attachment 5.

2.5 Operating expenditure

Opex is the forecast of operating, maintenance and other non-capital costs incurred in the provision of standard control services. Forecast opex is one of the building blocks we use to determine AusNet Service total regulated revenue requirement.

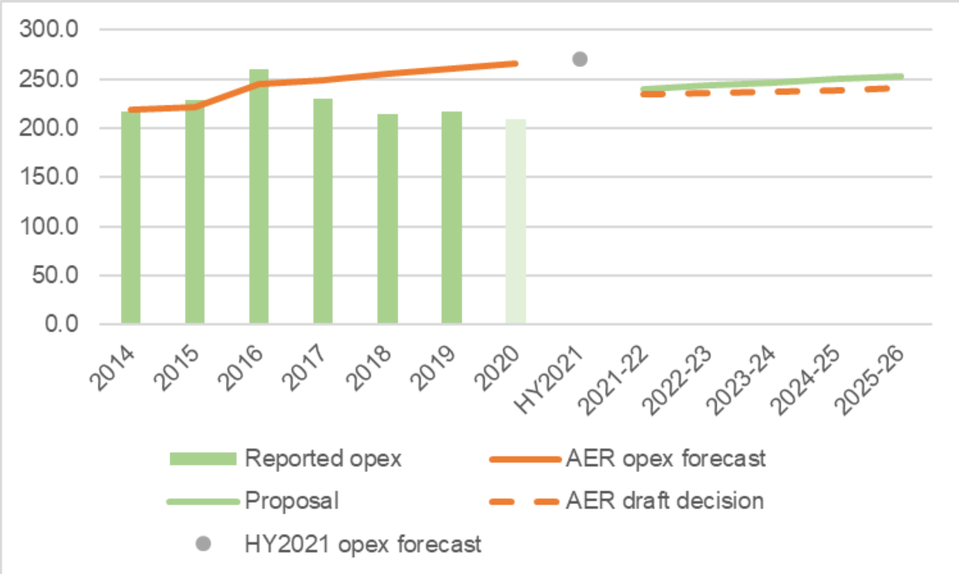
We have reviewed AusNet Services' total opex proposal and find it is largely reasonable, with the main difference to our alternative estimate being the impact of unforeseen changes in economic conditions on the rate of change as a result of COVID–19. Without these changes in economic conditions impacting the rate of change we would have been likely to accept AusNet Services' proposal.

Our draft decision is to include our alternative total opex forecast of $1187.4 million ($2020–21) in AusNet Services allowed revenue for the 2021–26 regulatory control period. This is $46.1 million ($2020–21), or 3.7 per cent, lower than AusNet Services' total opex forecast of $1233.4 million ($2020–21).[61] Of this, $37.9 million ($2020–21) is driven by the impact of the lower output and real price growth.

Figure 8 shows AusNet Services' actual opex, our previous approved forecast, proposed opex for the next five years and our draft decision. AusNet Services' opex forecast was 9.2 per cent higher than its actual and estimated opex in the 2016–20 regulatory control period. Our draft decision forecast opex is 5.1 per cent higher than AusNet Services' actual and estimated opex in the current regulatory control period.

61 Including debt raising costs.

Figure 8 AusNet Services' opex over time ($ million, 2020–21)



Source: AusNet Services, *2021–26 Regulatory proposal –Supporting document –Workbook 1 –Regulatory determination,* January 2020; AusNet Services, *2021–26 Regulatory proposal –Supporting document –Opex model,* January 2020; AER, *Draft Decision –AusNet Services distribution determination 2021–26 –Opex model,* September 2020; AER, *Draft Decision –AusNet Services distribution determination 2021–26 –Efficiency Benefit Sharing Scheme model,* September 2020; AER analysis.

Table 6 sets out AusNet Services' proposal, our alternative estimate for the draft decision and the key differences.

Table 6 Comparison of AusNet Services' proposal and our draft decision on opex ($ million, 2020–21)

	AusNet Services' Proposal	AER draft decision	Difference
Base (reported opex in 2018)	1080.1	1080.1	0.0
Efficiency adjustment	0	0	0
Base year adjustments	-5.0	-14.0	-9.0
Final year increment	65.9	75.1	9.2
Trend: Output growth	47.6	26.5	-21.2
Trend: Real price growth	18.9	2.2	-16.8
Trend: Productivity growth	-16.0	-15.1	0.9
Step changes	16.9	9.3	-7.6
Category specific forecasts	13.2	11.9	-1.3
Total opex (excluding debt raising costs)	1221.6	1176.0	-45.6
Debt raising costs	11.8	11.3	-0.5

	AusNet Services' Proposal	AER draft decision	Difference
Total opex (including debt raising costs)	1233.4	1187.4	-46.1
Percentage difference to proposal			-3.7%

Source: AusNet Services, *2021–26 Regulatory proposal –Supporting document –Proposal Opex model*, January 2020; AER analysis.

Note: Numbers may not add up to totals due to rounding. The difference is between AusNet Services' proposal and our draft decision. Category specific forecasts for Guaranteed Service Level (GSL) payments reflect the net change.

We have found AusNet Services base year opex to be not materially inefficient and have not included an efficiency adjustment in our alternative estimate. However, the following factors have contributed to our lower alternative total opex forecast:

- Our forecast rate of change by which we trend opex forward over the next five years is on average 0.6 per cent each year, which is lower than AusNet Services' proposed 1.5 per cent per year. This is primarily driven by our lower output and price growth forecasts, reflecting the impact of COVID-19 and our lower forecasts of wage price growth, and updating maximum demand to reflect the Australian Energy Market Operator's most recent forecasts. This lowers our alterative estimate compared to AusNet Services' proposal by $37.9 million ($2020–21).
- With the exception of forecasting labour price growth, we have used our standard approach to trend opex forward over the next five years. For labour price growth, we have used a forecast prepared by Deloitte Access Economics rather than the standard approach of averaging two forecasts as this is the only forecast available which factors in the impacts of COVID-19. For the final decision we will reconsider updating the rate of change forecast using our standard approach provided the necessary forecasts are available.
- We generally only include step changes where we are satisfied there are efficient costs associated with new regulatory obligations or capex/opex trade-offs and these costs are not already captured in base opex or through our trend forecast. We have not included two step changes proposed by AusNet Services related to transitioning to the IT cloud and anticipated cyber security obligations. We do not consider sufficient evidence has been provided to justify the capex/opex substitution for the IT cloud costs. Further, while we consider it is prudent for businesses to meet anticipated cyber security obligations, we do not consider that AusNet Services' proposed approach and cost to meet these obligations is efficient. For the step changes we included in our alternative estimate, the amount included is slightly lower than AusNet Services' proposal (this is detailed in Attachment 6). This lowers our alternative estimate compared to AusNet Services' proposal by $7.6 million ($2020–21).
- We have reallocated a lower amount to SCS metering than AusNet Services' proposed, which is partly offset by our decision to not accept AusNet Services' proposal to remove the Energy Safe Victoria levy from base opex (for recovery

through the annual L-factor). The net impact is that our alternative estimate is $9.0 million ($2020–21) lower than what AusNet Services' proposed.[62]

- Our final year increment is $9.2 million ($2020–21) higher than AusNet Services' proposal.

In making our draft decision we have taken into account AusNet Service's engagement activities including via its Customer Forum and the feedback we have received from stakeholders.

Under the New Reg trial, opex was an in-scope item for negotiation with the Customer Forum, and AusNet Services negotiated each element of the opex forecast with the Customer Forum. The final positions for each element were detailed in AusNet Services' opex proposal (e.g. where an element was agreed to or considered appropriate for further investigation by us). AusNet Services' proposal also documented the input from the EUAA and CCP17 to the opex proposal. This allowed us to clearly see how AusNet Services had engaged with its customers on each element of the opex forecast and how that engagement had impacted its proposal. Further, we could see those areas where a more detailed review by us was appropriate. We also received feedback from a number of stakeholders in relation to AusNet Services' proposal. These expressed a number of concerns, including the efficiency of AusNet Services' base year opex, the trend forecasts in light of COVID-19 impacts and the quantum of proposed step changes. We have used these views to inform our assessment.

We have set out the reasons for our draft decision on opex in more detail in Attachment 6. Our opex model, which calculates our alternative estimate of opex, is available on our website.

2.6 Corporate income tax

We determine an estimated cost of corporate income tax of zero for AusNet Services in the 2021–26 regulatory control period. This is consistent with AusNet Services' proposal.

We expect AusNet Services to incur a forecast tax loss over the 2021–26 regulatory control period.[63] For this reason, our draft decision is to set the cost of corporate income tax at zero for the 2021–26 regulatory control period.

We have determined that $266.2 million in tax losses as at 30 June 2026 will be carried forward to the 2026–31 regulatory control period where it can be used to offset future tax liabilities. The forecast tax loss arises because AusNet Services' forecast tax

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62 The net impact also takes into account AusNet Services' revised amount for capitalisation of leases, which we have included in our alternative estimate. This is detailed in Attachment 6.

63 A forecast tax loss occurs when the forecast taxable income is lower than the forecast tax expense. In this event no tax is payable. Any residual amount of tax loss will be carried forward over to future regulatory control periods to offset future taxable income until the tax loss is fully exhausted.

expenses will exceed its revenue for tax assessment purposes over the 2021–26 regulatory control period. This is mostly due to the implementation of our findings from the 2018 *Review of the regulatory tax approach*, where the introduction of immediate expensing of capex and diminishing value method of tax depreciation have resulted in a significant increase of forecast tax depreciation.

For this draft decision, we have:

- Increased the proposed forecast immediately expensed capex
- Adjusted the proposed opening tax asset base as at 1 July 2021, including amendments and updates for actual and estimated capex, and a reallocation for accelerated tax depreciation consistent with the accelerated depreciation approach for the RAB.

We accept AusNet Services' proposed standard tax asset lives for all of its existing asset classes, and we have amended the standard tax asset lives for AusNet Services' new 'In-house software' and 'Secondary systems (pre 2016) asset classes. The proposed standard tax asset lives are broadly consistent with the tax asset lives prescribed by the Commissioner for taxation in the Australian Taxation Office taxation ruling 2019/5 and are the same as the approved standard tax asset lives for the 2016–20 regulatory control period.

We also accept AusNet Services' proposed weighted average method to calculate the remaining tax asset lives as at 1 July 2021. This method is a continuation of the approved approach used in the 2016–20 regulatory control period and applies the approach as set out in our RFM. Further, we accept AusNet Services' proposed remaining tax asset life for its new 'Secondary systems (pre 2016)' asset class. However, we determine alternative remaining tax asset lives for the 'Accelerated depr - distr assets (contingent project 3)' and 'Accelerated depr - distr assets (other)' asset classes.

Our adjustments to the return on capital (Attachments 2, 3 and 5) and the regulatory depreciation (Attachment 4) building blocks affect revenues, which in turn impacts the tax calculation. The changes affecting revenues are discussed in Attachment 1.

Further detail on our draft decision regarding the corporate income tax is set out in Attachment 7.

2.7 Revenue adjustments

Our draft decision on AusNet Services' total revenue also included a number of adjustments:

- EBSS – AusNet Services accrued EBSS carryovers totalling $109.3 million ($2020–21).[64] This is $17.7 million higher than $91.6 million proposed, reflecting a

[64] Includes accrued EBSS carryovers for the HY2021 period

number of adjustments we made to correctly apply the scheme. In particular, we corrected some cost categories that AusNet Services had mistakenly excluded and we also accounted for capitalisation policy changes differently.[65] The EBSS is intended to provide a continuous incentive for distributors to pursue efficiency improvements in opex, and provide for a fair sharing of these between distributors and network users.

- CESS – AusNet Services has accrued rewards under the CESS we applied in the current 2016–20 regulatory control period to incentivise AusNet Services to undertake efficient capex throughout the period. The CESS rewards efficiency gains and penalises efficiency losses, each measured by reference to the difference between forecast and actual capex. In the 2016–20 period, AusNet Services out-performed our capex forecast, and our draft decision is to approve a CESS revenue increment amount of $56.5 million ($2020–21). This is more than AusNet Services' proposed $47.5 million mainly due to us updating its estimated 2019 capex spend with the actual amount.
- DMIAM – an allowance of $3.3 million ($2020–21) has been has been applied to AusNet Services over the 2021–26 regulatory control period. The DMIAM aims to encourage distribution businesses to find investments that are lower cost alternatives to investing in network solutions.

Section 4 sets out our draft decision on the incentive schemes that might apply to AusNet Services over the next regulatory control period.

[65] Includes accrued EBSS carryovers for the HY2021 period

3 AusNet Services' consumer engagement

The National Electricity Objective focuses our work on the long-term interests of consumers[66] and we think including consumers in the development of proposals is the best way to deliver this. Genuine, high quality engagement with consumers helps distributors better understand consumers' preferences and experiences and tailor their proposals to align with consumers' long-term interests. The Rules also require us to consider the extent to which elements of the proposals address relevant concerns identified during the distributor's engagement with consumers.[67]

We value the work of the distributors to constructively engage with consumers when preparing their draft proposals. They all acknowledged the diversity within their consumer base in terms of the manner in which they engage with the network, as well as the linguistic, cultural and demographic characteristics that influence this engagement. The interactions between the distributors' senior management (including board members) and the engagement initiatives also suggested the distributors were keen to hear what their consumers had to say.

We used the results of each distributor's consumer engagement to inform our draft decisions. High quality consumer engagement can take a range of forms and we encourage distributors to consider which approach best suits them and consumers in their network. The best approach to take may depend on the nature of a distributor's consumer base and the issues of importance to those consumers.

Regardless of the approach taken, we believe that proposals which have been developed with the influence of consumers, and their preferences, are more likely to be in the long-term interests of consumers than those which have not. Taking this into account, the elements outlined in Table 7 represent a range of considerations that we think can clearly demonstrate whether consumers have been genuinely engaged in the development of the proposals.

The elements of consumer engagement which informed how we viewed this engagement and the weight we were able to place on the outcomes in our consideration of the regulatory proposal are summarised in Table 7. The rest of this section discusses our assessment of each distributor's engagement against this framework. These elements are intended to show how our thinking has evolved since our 2013 Consumer Engagement Guideline but are not intended to provide a fixed view. Our framework will continue to evolve as distributors' models of consumer engagement mature over time.

66 NEL, s. 16(1)(a).

67 NER, cl. 6.5.6(e)(5A) and 6.5.7(e)(5A).

Table 7 Framework for considering consumer engagement

Element	Examples of how this could be assessed
Nature of engagement	• Consumers partner in forming the proposal rather than asked for feedback on distributor's proposal • Relevant skills and experience of the consumers, representatives, and advocates • Consumers provided with impartial support to engage with energy sector issues • Sincerity of engagement with consumers • Independence of consumers and their funding • Multiple channels used to engage with a range of consumers across a distributor's consumer base
Breadth and depth	• Clear identification of topics for engagement and how these will feed into the regulatory proposal • Consumers consulted on broad range of topics • Consumers able to influence topics for engagement • Consumers encouraged to test the assumptions and strategies underpinning the proposal • Consumers were able to access and resource independent research and engagement
Clearly evidenced impact	• Proposal clearly tied to expressed views of consumers • High level of business engagement, e.g. consumers given access to the distributor's CEO and/or board • Distributors responding to consumer views rather than just recording them • Impact of engagement can be clearly identified • Submissions on proposal show consumers feel the impact is consistent with their expectations

Proof point	• Reasonable opex and capex allowances proposed
	    ○ In line with, or lower than, historical expenditure
	    ○ In line with, or lower than, our top down analysis of appropriate expenditure
	    ○ If not in line with top down, can be explained through bottom up category analysis

Nature of engagement

Overall we consider that AusNet Services' consumer engagement was genuine, independent and consumer focused. We have not undertaken a formal audit against the IAP2 spectrum. However, from the information provided it would appear that AusNet's proposal is broadly consistent with the collaborate or empower end of the spectrum.

The New Reg trial and AusNet Services' negotiations with its Customer Forum was the corner stone of AusNet Services' consumer engagement. The nature of AusNet Services negotiations made consumers a partner in the process of developing AusNet Services' proposal.

The Customer Forum was selected to have the skills and expertise to serve the role of being a credible counterparty to AusNet Services in order to represent its customer base and negotiate on their behalf.[68] AusNet Services sought input on the selection criteria for the Customer Forum and tested a shortlist of candidates with AER and ECA, as well as included a member of their consumer consultative committee reference group on the selection committee.[69]

To maintain its independence from AusNet Services, the Customer Forum was remunerated by ECA using funding provided by AusNet Services. The Customer Forum was also able to commission its own customer research and consultant reports to ensure it could effectively represent the perspectives of AusNet Services' customers.

The full extent of the Customer Forum's consultation is set out in its final engagement report.[70] Importantly this consultation and research involved multiple channels and covered many different customer cohorts. This included face-to-face meetings with residential, rural and business customers, telephone surveys, observing customer focus groups, and meetings with customer representative groups, Members of Parliament, local Government, and peak body organisations.

AusNet services also undertook engagement with its broader consumer base which the Customer Forum reflected on its final negotiations. Early initiatives included qualitative research involving interviews and surveys aimed at gaining an understanding of key customer and stakeholder needs as well as focus groups.[71] Later engagement included small workshops for each of four key stakeholder groups –

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68 AusNet Services*, Electricity Distribution Price Review 2022–26, Part I & II*, January 2020, p. 9.

69 AusNet Services, EDPR Customer Forum - Recruitment process, 2018. The panel was comprised of: Tony Robinson: consumer advocate and previous Victorian Minister for Consumer Affairs; Helen Bartley: market and social researcher; John Mumford: consumer advocate, financial counsellor and rural AusNet Services customer; Greg Camm: financial sector executive and former Director of Yarra Valley Water which pioneered the Citizens Jury process in the water sector; and Dianne Rule: a former Chief of Staff and senior advisor to both State and Federal MPs

70 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020, pp. 63–79.

71 AusNet Services*, Electricity Distribution Price Review 2022–26, Part I & II*, January 2020, p. 36.

advocates for vulnerable consumers, residential consumer advocates, large energy users, and environmental interest groups, to test the negotiating positions to be included in the draft proposal. AusNet Services also facilitated feedback from key stakeholders, through a series of deep dives on the draft proposal.[72]

The Department of Environment, Land, Water and Planning (DELWP) submitted that AusNet Service's Customer Forum as a best practice process had facilitated effective negotiation. We support best practice engagement to understand consumer perspectives and to consider their views in the development of proposals.[73] Local Government organisations submitted that the AER should replicate the Customer Forum process in future EDPRs, with careful consideration of the skills and experience of nominated representatives and the scope of the negotiation.[74]

The AER's Consumer Challenge Panel (CCP17) was complimentary of AusNet Services' multiple and diverse engagement approaches, their comprehensive draft proposal and the customer forums' focus on customer service.[75] However, CCP17[76] expressed concern regarding the lack of an 'overarching consumer engagement strategy'[77] and considered its absence made consumer engagement activities – outside of the customer forum "somewhat ad-hoc and reactive and not as effective as it could have been".[78] However, CCP17 also noted that the outcomes achieved through the negotiation process with the Customer Forum were in line with the 'Collaborate' level of the IAP2 Public Participation Spectrum.[79]

A joint submission by Victorian Community Organisations (VCO), noted the significant gains for consumers between the draft and initial proposal, but questioned whether a distributor-run engagement program can be interpreted as a full representation of consumer priorities, due to the knowledge imbalance between distributors and their customers. VCO submitted that the results of New Reg should not be adopted as deterministic but be used to gain an understanding of what aspects can be usefully negotiated and what can't.[80]

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72 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 13.

73 Department of Environment, Land, Water and Planning, *Victorian Government submission on the electricity distribution price review 2021–26*, May 2020, p. 2.

74 Local government response to the Victorian electricity distribution price review (EDPR) 2021–26, May 2020 p. 9.

75 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, pp. 15, 19.

76 We tasked CCP17 specifically with advising us on the effectiveness of AusNet Services' engagement activities with consumers and how this was reflected in the development of its proposal.

77 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 16.

78 CCP17, *Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 16.

79 CCP17, Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26, June 2020, p.158.

80 Victorian Community Organisations, *Submission on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26,* May 2020, p.15.

The AER, ENA and ECA's involvement in AusNet Services' trial of New Reg is documented on our website.[81] The operations of the trial were governed by:

- an Early Engagement Plan, reviewed and accepted by the AER on 11 March 2018;
- a Memorandum of Understanding between AusNet Services, the AER and the Customer Forum, covering responsibilities and deliverables, funding arrangements and conflict resolution mechanisms.[82]

We supported the Customer Forum to allow it to effectively engage with AusNet Services. This included providing the Customer Forum with the technical and economic support during the negotiation process, such as education on our expenditure assessment approaches. We also developed a series of guidance notes on AusNet Services' negotiating positions and draft regulatory proposal.[83]

We consider that AusNet Services' engagement with the Customer Forum was genuine. In the words of the Customer Forum:

> AusNet Services is to be commended for being the first Australian utility to engage a Customer Forum as part of a revenue application. It is evident to the Customer Forum that AusNet Services genuinely wants to better understand the way it impacts the lives and livelihoods of its customers.[84]

Breadth and Depth

Overall we consider that AusNet Services' consumer engagement was appropriately broad, and went into detail where necessary.

The early engagement agreement provided for us, AusNet Services and the Customer Forum to limit the scope of negotiations.[85] Ultimately AusNet Services and the Customer Forum, through bi-lateral discussions, agreed on a broader scope of negotiations than that agreed with us. Figure 9 sets out the issues which we agreed to include in the scope of negotiations, those issues AusNet Services and the Customer Forum considered outside this agreed scope as well as those issues outside scope.

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81 https://www.aer.gov.au/networks-pipelines/new-reg/ausnet-services-trial

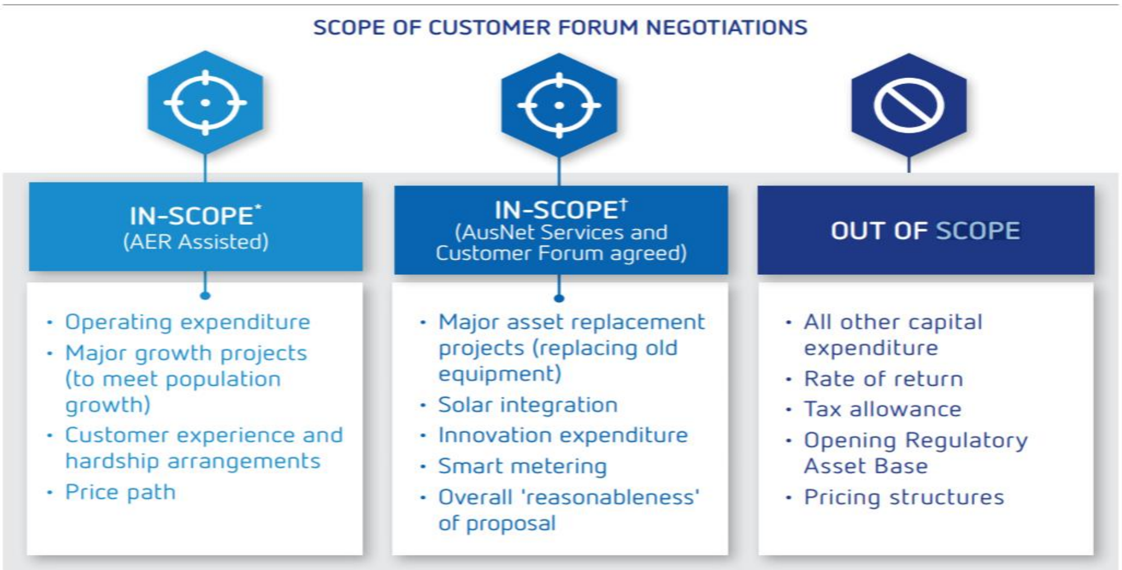
82 Both of these documents have been published on the AER's website, here: https://www.aer.gov.au/networks-pipelines/new-reg/ausnet-services-trial

83 These documents have been published on our website here: https://www.aer.gov.au/networks-pipelines/new-reg/ausnet-services-trial

84 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020, p. ii.

85 The scope agreed with the AER, and reasons for the scope, is set out in Guidance Note 2 available here: https://www.aer.gov.au/system/files/AER%20-%20AusNet%20Trial%20Staff%20Guidance%20Note%202%20-%20Scope%20of%20negotiation%20-%20July%202018.pdf

Figure 9 Scope of Negotiations under New Reg trial



Source: AusNet Services, Electricity Distribution Price Review 2022–26, Part I & II, January 2020, p. 28.

The Energy Users Association of Australia (EUAA) criticised the limited scope of negotiations noting that accelerated depreciation and much of capex and opex was outside of scope.[86] The ECA's consultant also noted that only 7 per cent of capex was within scope. Given the detail to which the Customer Forum delved, the ECA’s consultant was disappointed that more of the program was not subject to its scrutiny.[87] We acknowledge the ECA and EUAA’s comments and consider broadening the scope of negotiations in future may have merit. However, we also note that 40 per cent of AusNet Services’ revenues (not including metering services) was subject to negotiations.[88]

Customers were provided with a number of opportunities to engage with AusNet Services and comment on its draft proposal.[89] AusNet Services also hosted five deep dives, with the customer forum in attendance, covering: customer experience; innovation; public lighting; DER; and information and communications technology (ICT). AusNet Services also met with its customer consultative committee on a number of occasions.[90]

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86 EUAA, *Submission on the Victorian Electricity Distributors’ Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 2.

87 ECA, *Submission on the Victorian Electricity Distributors’ Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 14.

88 CCP17, Advice to the AER on the Victorian Electricity Distributors’ Regulatory Proposals for the Regulatory Determination 2021–26, June 2020, p.158.

89 CCP17, Advice to the AER on the Victorian Electricity Distributors’ Regulatory Proposals for the Regulatory Determination 2021–26, June 2020, p. 17.

90 The customer consultative committee includes: the Australian Energy Council, Clean Energy Council, Dairy Australia, Energy Users Association of Australia, Eastern Alliance for Greenhouse Action, Renew (formerly Alternative Technology Association), St Vincent de Paul Society, The Australian Industry Group, Victorian Farmers Federation, Energy and Water Ombudsman Victoria (as an independent observer)

Under the Early Engagement Plan and Memorandum of Understanding, we had a formal role in providing support to the Customer Forum. For example, we made presentations to the Customer Forum on our assessment approaches for expenditure, as well as publishing guidance notes for each of the issues in the agreed negotiating scope.[91] When requested, we and members of our Technical Advisory Group met with the Customer Forum. We published detailed submissions on the draft negotiating positions and interim engagement report in advance of the Customer Forum's formal negotiations with AusNet Services.[92] This provided the Customer Forum the opportunity to drill down in to the detail to better understand the technical aspects of the proposed positions.

Clearly evidenced impact

As agreed under the Memorandum of Understanding[93], the Customer Forum delivered a detailed report, supported by its independent research, on its negotiations with AusNet Services.[94]

The Customer Forum evidenced a wide range of initiatives in line with its in-scope agreement, which through its negotiations with AusNet Services were included as part of the regulatory proposal. As part of its own assessment framework of negotiated outcomes, the Customer Forum considered whether the negotiated positions delivered on customer preferences and benefits were tangible. Finally, the Customer Forum tested whether the negotiated outcomes represent overall value for money. The Customer Forum stated that the evidence it gathered suggested that all its negotiated positions demonstrated benefits for customers and were value for money. The Customer Forum's final engagement report sets out each of their negotiated positions with evidence of customer support for those positions.[95]

The Customer Forum considered that its negotiations with AusNet Services contributed to cost savings for customers of at least $490 million ($2020–21) over the 2021–26 regulatory period.[96] The Customer Forum also reported on the overall reasonableness of the AusNet Services draft proposal. In particular it took into account concerns about the cost of energy and customer preferences for reliability of supply and safety of the network. Taking these factors into account, and recognising the promised cost reductions to customer bills as negotiated, the Customer Forum concluded that AusNet Services' "revenue proposal represents overall value for money for customers".[97]

Stakeholders expressed some concerns with this conclusion. For example, the EUAA and CCP17 cited that the narrow scope of issues subject to negotiation —particularly

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91 The guidance notes are available here: https://www.aer.gov.au/networks-pipelines/new-reg/ausnet-services-trial

92 https://www.aer.gov.au/networks-pipelines/new-reg/ausnet-services-trial

93 AER, AusNet Services, Customer Forum, *Revised early engagement MOU*, August 2019.

94 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020.

95 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020.

96 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020, p. 5.

97 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020, p. 51.

the large impact of proposed accelerated depreciation on revenue— which was deemed out of scope, limited the Customer Forum's ability to make such a judgement.[98] However, we note that the Customer Forum was provided AusNet Services' final regulatory proposal, including the impact of depreciation, prior to making its judgement whether the proposal represented value for money.

While we note these observations, we believe that overall the Customer Forum has assisted in focussing AusNet Services' attention on the priorities of consumers, which has had a positive impact on the development of its regulatory proposal. This has resulted in a demonstrated cultural shift in AusNet Services' approach to developing its regulatory proposals and putting customers at the heart of its decision making.[99]

Further, AusNet Services' trial of New Reg has led to the development of CSIS.[100] Under the new CSIS, AusNet Services will be incentivised to improve customer satisfaction measured in terms of: Communication on unplanned outages; Communication on planned outages; Customer service for new connections (basic and standard); and Customer service in managing complaints.[101]

As part of their negotiations on customer experience and hardship, AusNet Services and the Customer Forum agreed to implement a broad range of customer service improvements as set out in its regulatory proposal.[102] AusNet Services has committed to implementing these measures at no additional cost to customers (aside from a modest increase in costs for improved communication systems) and has already implemented a number of them. This includes publishing its first Customer Interactions and Monitoring Report.[103]

The VCO compared the result of engagement across all five Victorian distributors and noted varying results in key areas – such as the value of reliability, safety and affordability. They also noted that all distributor's programs demonstrated benefits to customers, especially in terms of new or changed programs or processes developed in direct response to customer feedback. In relation to the benefits to AusNet Services' customers the VCO highlighted AusNet Services' initiatives on 'cost-neutral improvements to customer service communications protocols'.[104]

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98 EUAA, *Submission on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 5.; CCP17, Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26, June 2020, p. 19.

99 AusNet Services, *EDPR 2021–26 Regulatory Proposal Part I & II*, 31 January 2020, p. 50.

100 Our CSIS is available at: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/customer-service-incentive-scheme. We understand that other Victorian DNSPs, including CitiPower, Powercor and United Energy intend to seek to implement a CSIS in time for our final decision.

101 AusNet Services, *EDPR 2021–26 Regulatory Proposal Part I & II*, 31 January 2020, p. 54.

102 AusNet Services: Delivering better outcomes for customers, Overview of our electricity distribution regulatory proposal 2021–26, January 2020, p. 28.

103 This report is available on AusNet Services' website, here: https://www.ausnetservices.com.au/en/Community/Customer-Interactions-and-Monitoring-Report

104 Victorian Community Organisations, *Submission on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26,* May 2020, p.14.

Proof point

We accept that the revenue proposal submitted by AusNet Services was developed with the influence of its consumers, who through the Customer Forum found that the "revenue proposal represents overall value for money for customers".[105] We agree with CCP17[106], EUAA[107] and VCO[108] that the outcomes from the Customer Forum's negotiation process should inform rather than determine our decision. As a result, we have applied appropriate weight to whether the proposal addresses the concerns of consumers, as required by the Rules[109], and ensured that the revenue proposal meets the capex and opex criteria.[110] Accordingly, we have assessed all the material and evidence before us to be satisfied that our determination is likely to contribute to the NEO to the greatest extent.[111]

Our assessment found that AusNet Services' proposed capex and opex proposals were clearly influenced by its commitment to consumer affordability, which was demonstrated by AusNet Services' top down adjustment of its capex forecast. AusNet Services' proposed capex forecast is 19 per cent below its actual and estimated expenditure in the current regulatory control period. As outlined in section 2.4, once we made the adjustments to address changes in economic conditions, reclassification of some expenditures and corrections proposed by AusNet Services, the proposed capex forecast was in line with our top down analysis. While AusNet Services' proposed opex forecast is 9.2 per cent higher than the current regulatory control period, as outlined in section 2.5, our assessment found that but for the unforeseen changes in economic conditions as a result of COVID-19 we would have been likely to accept the opex proposal.

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105 AusNet Services Customer Forum, *Customer forum final engagement report*, January 2020, p. 51.

106 CCP17*, Advice to the AER on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, pp. 153-159.

107 EUAA, *Submission on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26*, June 2020, p. 6.

108 Victorian Community Organisations, *Submission on the Victorian Electricity Distributors' Regulatory Proposals for the Regulatory Determination 2021–26,* May 2020, p.15.

109 NER, cl. 6.5.6 (e)(5A) and 6.5.7(e)(5A).

110 NER, cl. 6.5.7(c) & 6.5.6(c).

111 NEL, s 16(1)(a) and (d).

4 Incentive schemes

Incentive schemes are a component of incentive based regulation and complement our approach to assessing efficient costs. These schemes provide important balancing incentives under the revenue determination we've discussed in section 2, to encourage AusNet Services to pursue expenditure efficiencies and demand side alternatives while maintaining the reliability and overall performance of its network.

The incentive schemes that might apply to an electricity distribution network as part of our decision are:

- the opex EBSS
- the CESS
- the service target performance incentive scheme (STPIS)
- the CSIS
- the demand management incentive scheme (DMIS) and allowance (DMIAM)
- the f-factor scheme.

Once we make our decision on AusNet Services' revenue cap, it has an incentive to provide services at the lowest possible cost, because its returns are determined by its actual costs of providing services. Our incentive schemes encourage network businesses to make efficient decisions. They give network businesses an incentive to pursue efficiency improvements in opex and capex, and to share them with consumers. If networks reduce costs to below our forecast of efficient costs, the savings are shared with its consumers in future regulatory control periods through a lower opex allowance and a lower RAB.

We understand the strong concerns of stakeholders, that the CESS not only rewards efficiency gains but also over forecasting and deferral of capex. The current CESS guideline includes protections against material deferrals that have been triggered for some elements of Powercor's proposal[112] but not for AusNet Services. Protection against over forecasting of capex lies in the rigorous assessment of proposed capex.

The DMIS and the DMIAM provide businesses an incentive to undertake efficient expenditure on non-network options relating to demand management research and development in demand management projects that have the potential to reduce long-term network costs.

The STPIS balances a distributor's incentive to reduce expenditure with the need to maintain or improve service quality. It achieves this by providing financial incentives to

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[112] AER, *Draft Decision, Powercor Distribution Determination 2021–26, Attachment 9 Capital Expenditure Sharing Scheme*, September 2020.

businesses to maintain and improve service performance and not by simply cutting costs at the expense of service quality. Once improvements are made, the benchmark performance targets will be tightened in future years.

To accompany the STPIS we have established the CSIS to try and capture how well the distributor is meeting customer preferences. The intention is for this to replace the 0.5 per cent of revenue tied to the telephone answering parameter under the STPIS. The CSIS was one of the outcomes of the engagement between AusNet Services and its Customer Forum. It was developed in the context of initiatives to encourage AusNet Services to continue to monitor and improve customer experience over the regulatory control period. AusNet Services has proposed to apply the CSIS in the next regulatory control period.

Our draft decision is that each of the EBSS, CESS, STPIS, CSIS, DMIS and DMIAM should apply to AusNet Services for the 2021–26 regulatory control period.

Our draft decision also includes how the f-factor scheme is applied to AusNet Services in the next regulatory control period. The f-factor scheme is prescribed by the Victorian Government's 'f-factor scheme order 2016' to reduce the risk of fire starts by network assets.[113] We will continue to adopt our current approach to give effect of the outcomes of the scheme as an 'I-factor' component within the price control formula.

We discuss our draft decisions on each incentive scheme in Attachments 8 to 12. Our draft decision on the f-factor scheme is discussed in Attachment A.

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113 *Victoria Government Gazette, G 51*, 22 December 2016, p. 3239.

5 Tariff structure statement

The requirement on distributors to prepare a tariff structure statement (TSS) arises following significant reforms to the rule governing distribution network pricing. The purpose of the reforms is to empower customers to make informed choices by:

- providing better price signals to retailers to reflect what it costs to use the networks to supply electricity at different times;
- transitioning to greater cost reflectivity while engaging with customers, customer representatives, and retailers to consider the impacts of tariff changes on customers; and
- managing future expectations for retailers, energy service providers and customers by providing guidance on distributors' tariff strategy.

It is important to note that distributors charge retailers for the network services provided to end-customers. There is no obligation on retailers or energy service providers to pass the network tariff structure through to their end-customers. The structure of retail offers should be determined by retailers responding to consumer preferences and competitive pressures.

Network tariff reform aims to help distributors charge retailers in a manner which more closely reflects the cost of providing electricity network capacity to their end customers. Retailers can then decide how best to manage these price signals which may include "insurance-style" flat rate offers and non-price measures such as well targeted demand management initiatives. If customers are well placed to respond to these price signals, retailers may pass through the structures and reward customers for helping to manage the commercial risk.[114] But at present, it is more common for retailers to pass through the cost reflective network tariff structures to large business customers, than for residential or small business customers.

The TSS must set out a number of matters. These include tariff classes, proposed tariffs and the structures and charging parameters, and the approach to setting tariff levels in each year of the regulatory control period.[115] The policies and procedures it will use to assign customers to tariffs, or reassign customers from one tariff to another must also be outlined.

In this determination we decide the structure of tariffs that will form the basis of annual pricing proposals throughout the regulatory control period.[116] We are also required to decide the policies and procedures for assigning or re-assigning customers to tariff classes.[117] While an indicative pricing schedule must accompany the TSS, the tariff

114 See our recently published Retailer Engagement Report on the Network Tariff Reform webpage

115 NER, cl. 6.18.1A.

116 NER, cl. 6.12.1(14A).

117 NER, cl. 6.12.1(17).

levels for each tariff for each year of the 2021–26 regulatory control period are not set as part of this determination.[118]

Tariffs for the regulatory year commencing 1 July 2021 will be subject to a separate approval process in May 2021, after we have made our final revenue determination in April 2021. Tariffs for the next four years will also be approved on an annual basis.[119]

We commend the Victorian distributors for their work to engage with stakeholders in a series of forums to help develop a state-wide proposal for the small user components of their TSSs. Similar to our recent decisions, we have given weight to both the involvement of consumers in developing these proposals, as well as the supportive submissions we have received.[120] In forming our views for this draft decision we have also taken into account the DELWP submission which strongly encourages us to broadly accept these elements.[121]

Our draft decision broadly supports the direction of these proposals. Particularly as the distributors have generally met the expectations we set out in our final decision for the first round of TSS (2017–20). At that time we encouraged the Victorian distributors to move from opt-in to opt-out tariff assignment to cost reflective tariffs to increase the pace at which network tariff reform progresses. We also urged the Victorian distributors to refine their tariff structures to include more targeted peak period charging windows. The Victorian distributors have also generally adopted strategies we have encouraged within our determinations for other networks, such as discounting their cost reflective tariffs relative to the flat rate option.[122]

However, we have concerns that some aspects of the proposed TSS do not comply with the pricing principles set out in the NER.[123] We require:

- greater clarity around the interlinkages between DER initiatives, including tariff trials, and the tariff strategies for the 2021–26 regulatory period
- consideration of interactions between emerging DER technologies, such as batteries and EV, and proposed tariff structures
- refining the charging windows for large user tariffs to more closely reflect periods of network constraint for each distributor
- responses to large businesses' requests for greater choice in network tariff structures as large users generally have network structures passed through.

In Attachment 19 we have therefore set out a series of changes that we consider necessary for us to approve the Victorian distributors' TSS proposals.

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118 NER, cl. 6.8.2(d)(1).

119 NER, cl. 6.18.2 and 6.18.8.

120 For example, see our final decision for SA Power Network's TSS for the 2020–25 regulatory control period.

121 DELWP, *Submission on Tariff Structure for the Victorian Electricity Distribution Proposal 2021–26*, June 2020.

122 For example see our final decision for Essential Energy's TSS for the 2019–24 regulatory control period.

123 NER, cl. 6.18.5.

6 The National Electricity Law and Rules

The NEL and NER provide the regulatory framework governing electricity distribution networks. Our work under this framework is guided by the NEO:[124]

> "…to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system."

The NEL requires us to make our decision in a manner that contributes, or is likely to contribute, to achieving the NEO.[125] The focus of the NEO is on promoting efficient investment in, and operation and use of, electricity services (rather than assets) in the long-term interests of consumers.[126] This is not delivered by any one of the NEO's factors in isolation, but rather by balancing them in reaching a regulatory decision.[127]

Electricity determinations are complex decisions. In most cases, the provisions of the NER do not point to a single answer, either for our decision as a whole or in respect of particular components. They require us to exercise our regulatory judgement. Where there are choices to be made among several plausible alternatives, we have selected what we are satisfied would result in an overall decision that is likely to contribute to the achievement of the NEO to the greatest degree.[128]

Our distribution determinations are predicated on a number of constituent decisions that we are required to make.[129] These are set out in Appendix A and the relevant attachments. In coming to a decision that contribute to the achievement of the NEO, we have considered interrelationships of the constituent components of our draft decision in the relevant attachments. Examples include:

- underlying drivers and context which are likely to affect many constituent components of our decision. For example, forecast demand affects the efficient levels of capex and opex in the regulatory control period (see Attachment 5 and 6).
- direct mathematical links between different components of a decision. For example, the level of gamma has an impact on the appropriate tax allowance; the benchmark

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124 NEL, s. 7.

125 NEL, section 16(1)(a)

126 This is also the view of the Australian Energy Markets Commission (the AEMC). See, for example, the AEMC, *'Applying the Energy Objectives: A guide for stakeholders'*, 1 December 2016, p. 5.

127 Hansard, *SA House of Assembly,* 26 September 2013, p. 7173. See also the AEMC, *'Applying the Energy Objectives: A guide for stakeholders'*, 1 December 2016, pp. 7–8.

128 NEL, s. 16(1)(d).

129 NER, 6.12.1

efficient entity's debt to equity ratio has a direct effect on the cost of equity, the cost of debt, and the overall vanilla rate of return (see attachments 3 and 7).

- trade-offs between different components of revenue. For example, undertaking a particular capex project may affect the need for opex or vice versa (see Attachments 5 and 6).

In general, we consider that the long-term interests of consumers are best served where consumers receive a reasonable level of safe and reliable service that they value at least cost in the long run.[130] A decision that places too much emphasis on short term considerations may not lead to the best overall outcomes for consumers once the longer term implications of that decision are taken into account.[131]

There may be a range of economically efficient decisions that we could make in a revenue determination, each with different implications for the long-term interests of consumers.[132] A particular economically efficient outcome may nevertheless not be in the long-term interests of consumers, depending on how prices are structured and risks allocated within the market.[133] There are also a range of outcomes that are unlikely to advance the NEO, or advance the NEO to the degree than others would. For example, we consider that:

- the long-term interests of consumers would not be advanced if we encourage overinvestment which results in prices so high that consumers are unwilling or unable to efficiently use the network.[134]
- equally, the long-term interests of consumers would not be advanced if allowed revenues result in prices so low that investors do not invest to sufficiently maintain the appropriate quality and level of service, and where consumers are making more use of the network than is sustainable leading to safety, security and reliability concerns.[135]

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130 Hansard, *SA House of Assembly,* 9 February 2005, p. 1452.

131 See, for example, the AEMC, *'Applying the Energy Objectives: A guide for stakeholders'*, 1 December 2016, pp. 6–7.

132 *Re Michael: Ex parte Epic Energy* [2002] WASCA 231 at [143].

133 See, for example, the AEMC, *'Applying the Energy Objectives: A guide for stakeholders'*, 1 December 2016, p. 5.

134 NEL, s. 7A(7).

135 NEL, s. 7A(6).

A Constituent decisions

Our draft decision on AusNet Services' distribution determination for the 2021–26 regulatory control period includes the following constituent components:

Constituent decision
In accordance with clause 6.12.1(1) of the NER, the AER's draft decision is that the classification of services set out in Attachment 13 will apply to AusNet Services for the 2021–26 regulatory control period.
In accordance with clause 6.12.1(2)(i) of the NER, the AER's draft decision is not to approve the annual revenue requirement set out in AusNet Services building block proposal. Our draft decision on AusNet Services' annual revenue requirement for each year of the 2021–26 regulatory control period is set out in Attachment 1 of the draft decision.
In accordance with clause 6.12.1(2)(ii) of the NER, the AER's draft decision is to approve AusNet Services' proposal that the regulatory control period will commence on 1 July 2021. Also in accordance with clause 6.12.1(2)(ii) of the NER, the AER's draft decision is to approve AusNet Services' proposal that the length of the regulatory control period will be five years from 1 July 2021 to 30 June 2026.
The AER did not receive a request for an asset exemption under clause 6.4.B.1 (a) (1) and therefore has not made a decision in accordance with clause 6.12.1(2A) of the NER.
In accordance with clause 6.12.1(3)(ii) and acting in accordance with clause 6.5.7(d) of the NER, the AER's draft decision is not to accept AusNet Services' proposed total forecast capital expenditure of $1459.6 million ($2020–21). Our draft decision therefore includes an alternative estimate of AusNet Services' total forecast capex for the 2021–26 regulatory control period of $1369.1 million ($2020–21). The reasons for our draft decision are set out in Attachment 5.
In accordance with clause 6.12.1(4)(ii) and acting in accordance with clause 6.5.6(d) of the NER, the AER's draft decision is to not accept AusNet Services' proposed total forecast operating expenditure, inclusive of debt raising costs and exclusive of DMIAM of $1233.4 million ($2020–21). Our draft decision therefore includes an alternative estimate of AusNet Services' total forecast opex for the 2021–26 regulatory control period of $1187.4 million ($2020–21) including debt raising costs and exclusive of DMIAM. This is discussed in Attachment 6 of the draft decision.
AusNet Services did not propose any contingent projects and therefore the AER has not made a decision under clause 6.12.1(4A) of the NER.
In accordance with clause 6.12.1(5) of the NER and the 2018 Rate of Return Instrument (to be modified subject to the passing of relevant Victorian legislation), the AER's draft decision is that the allowed rate of return for the 2021–22 regulatory year is 4.63 per cent (nominal vanilla) as set out in Attachment 3 of the draft decision. The rate of return for the remaining regulatory years 2022–26 will be updated annually because our decision is to apply a trailing average portfolio approach to estimating debt which incorporates annual updating of the allowed return on debt.
In accordance with clause 6.12.1(5A) of the NER and the 2018 Rate of Return Instrument (to be

Constituent decision
modified subject to the passing of relevant Victorian legislation), the AER's draft decision on the value of imputation credits as referred to in clause 6.5.3 is to adopt a value of 0.585. This is discussed in section 2.2 of this draft decision overview.
In accordance with clause 6.12.1(6) of the NER, the AER's draft decision on AusNet Services' regulatory asset base as at 1 July 2021 in accordance with clause 6.5.1 and schedule 6.2 is $4709.8 million ($ nominal). This is discussed in Attachment 2 of the draft decision.
In accordance with clause 6.12.1(7) of the NER, the AER's draft decision is to accept AusNet Services' proposed corporate income tax of $zero. This is discussed in Attachment 7 of the draft decision.
In accordance with clause 6.12.1(8) of the NER, the AER's draft decision is to not approve the depreciation schedules submitted by AusNet Services. Our draft decision substitutes alternative depreciation schedules that accord with clause 6.5.5(b) and this is discussed in Attachment 4 of the draft decision.
In accordance with clause 6.12.1(9) of the NER the AER makes the following draft decisions on how any applicable efficiency benefit sharing scheme (EBSS), capital expenditure sharing scheme (CESS), service target performance incentive scheme (STPIS), demand management incentive scheme (DMIS), demand management innovation allowance mechanism (DMIAM) or small scale incentive scheme (customer service incentive scheme) is to apply: • We will apply version 2 of the EBSS to AusNet Services in the 2021–26 regulatory control period. This is discussed in Attachment 8 of the draft decision. • We will apply the CESS as set out in version 1 of the Capital Expenditure Incentives Guideline to AusNet Services in the 2021–26 regulatory control period. This is discussed in Attachment 9 of the draft decision. • We will apply our Service Target Performance Incentive Scheme (STPIS) to AusNet Services for the 2021–26 regulatory control period. This is discussed in Attachment 10 of the draft decision. • We will apply the DMIS and DMIAM to AusNet Services for the 2021–26 regulatory control period. This is discussed in Attachment 11 of the draft decision. • We will apply the customer service incentive scheme (CSIS) to AusNet Services for the 2021–26 regulatory control period. This is discussed in Attachment 12 of the draft decision.
In accordance with clause 6.12.1(10) of the NER, the AER's draft decision is that all other appropriate amounts, values and inputs are as set out in this draft determination including attachments.
In accordance with clause 6.12.1(11) of the NER and our framework and approach paper, the AER's draft decision on the form of control mechanisms (including the X factor) for standard control services is a revenue cap. The revenue cap for AusNet Services for any given regulatory year is the total annual revenue calculated using the formula in Attachment 14, which includes any adjustment required to move the Distribution Use of Service (DUoS) unders and overs account to zero. This is discussed in Attachment 14 of the draft decision.
In accordance with clause 6.12.1(12) of the NER and our framework and approach paper, the

Constituent decision
AER's draft decision on the form of the control mechanism for alternative control services is to apply a revenue caps for type 5 and 6 metering (including smart metering) services and price caps for all other services. The revenue cap for AusNet Services’ type 5 and 6 metering (including smart metering) services for any given regulatory year is the total annual revenue for type 5 and 6 (inc. smart metering) services calculated using the formula in Attachment 14, which includes any adjustment required to move the metering unders and overs account to zero. This is discussed in Attachment 14 of the draft decision.
In accordance with clause 6.12.1(13) of the NER, to demonstrate compliance with its distribution determination, the AER's draft decision is that AusNet Services must maintain a DUoS unders and overs account and a metering unders and overs account. It must provide information on these accounts to us in its annual pricing proposal. This is discussed in Attachment 14 of the draft decision.
In accordance with clause 6.12.1(14) of the NER the AER's draft decision is to apply the following nominated pass through events to AusNet Services for the 2021–26 regulatory control period in accordance with clause 6.5.10: • Terrorism event • Insurance coverage event • Natural disaster event • Insurer credit risk event • Retailer insolvency event These events have the definitions set out in Attachment 15 of the draft decision.
In accordance with clause 6.12.1(14A) of the NER, the AER's draft decision is to not approve the tariff structure statement proposed by AusNet Services. This is discussed in Attachment 19 of the draft decision.
In accordance with clause 6.12.1(15) of the NER, the AER's draft decision is that the negotiating framework as proposed by AusNet Services will apply for the 2021–26 regulatory control period. This is discussed in Attachment 17 of the draft decision.
In accordance with clause 6.12.1(16) of the NER, the AER's draft decision is to apply the negotiated distribution services criteria published in February 2020 to AusNet Services. This is discussed in Attachment 17 of the draft decision.
In accordance with clause 6.12.1(17) of the NER, the AER's draft decision on the procedures for assigning retail customers to tariff classes for AusNet Services is set out in Attachment 19 of the draft decision.
In accordance with clause 6.12.1(18) of the NER, the AER's draft decision is that the depreciation approach based on forecast capex (forecast depreciation) is to be used to establish the RAB at the commencement of AusNet Services' regulatory control period as at 1 July 2026. This is discussed in Attachment 2 of the draft decision.
In accordance with clause 6.12.1(19) of the NER, the AER's draft decision on how AusNet Services is to report to the AER on its recovery of designated pricing proposal charges is to set

Constituent decision
this out in its annual pricing proposal. The method to account for the under and over recovery of designated pricing proposal charges is discussed in Attachment 14 of the draft decision.
In accordance with clause 6.12.1(20) of the NER, the AER's draft decision is to require AusNet Services to maintain a jurisdictional scheme unders and overs account. It must provide information on this account to us in its annual pricing proposal as set out in Attachment 14 of the draft decision.
In accordance with clause 6.12.1(21) of the NER, the AER's draft decision is to not approve the connection policy proposed by AusNet Services. Our draft decision is to amend AusNet Services' proposed connection policy as set out in Attachment 18 of the draft decision.
In accordance with section 16C of the *National Electricity (Victoria) Act 2005*, the NEL, the NER and the 'f-factor scheme order 2016',[136] the AER's draft decision is to apply the f-factor incentive payments/penalties as a part of the 'I-factor' adjustment to the annual revenue requirement calculation formula.

[136] http://www.gazette.vic.gov.au/gazette/Gazettes2016/GG2016G051.pdf, Victoria Government Gazette, G 51 22 December 2016, p. 3239.

B List of submissions

We received 21 submissions in response to AusNet Services' revenue proposal. These are listed below.

Submission from	Date received
AGL Energy Limited	3 June 2020
CCP17	10 June 2020
Department of Environment, Land, Water & Planning	2 June 2020
Department of Environment, Land, Water & Planning – specific submission on TSS	2 June 2020
Electric Vehicle Council	3 June 2020
EnergyAustralia	3 June 2020
Energy Consumers Australia	16 June 2020
Energy Safe Victoria	3 June 2020
Energy Users' Association of Australia	10 June 2020
Evie Networks	3 June 2020 and 17 August 2020
Local Government Response (prepared by Eastern Alliance for Greenhouse Action)	27 May 2020
Origin Energy	2 June 2020
Red Energy / Lumo Energy	19 June 2020
Vector Limited	3 June 2020
Victorian Community Organisations (prepared by Brotherhood of St Laurence, Renew, Victorian Council of Social Service)	3 June 2020
Allan Campbell	1 June 2020
Bernie Free	2 June 2020
Oonagh Kilpatrick	3 June 2020
Sarah Campbell	3 June 2020
Wannon Branch United Dairy Farmers	3 June 2020

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ATO	Australian Tax Office
ARR	Annual Revenue Requirement
augex	augmentation expenditure
CAM	cost allocation method
capex	capital expenditure
CCP	Consumer Challenge Panel
CCP 17	Consumer Challenge Panel, sub-panel 17
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance mechanism
DMIS	demand management incentive scheme
Distributor/DNSP	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ECA	Energy Consumers Australia
ERP	equity risk premium
F&A	framework and approach
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER or the rules	National Electricity Rules

Shortened form	Extended form
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIFI	system average interruption frequency index
STPIS	service target performance incentive scheme
TSS	tariff structure statements
VCO	Victorian Community Organisations
WACC	weighted average cost of capital