Draft decision

AusNet Services gas distribution access arrangement

1 January – 30 June 2023 extension period

July 2022

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601
Tel: 1300 585 165

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Executive summary

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. Consumers are at the heart of our work, and we focus on ensuring a secure, reliable, and affordable energy future for Australia. The regulatory framework governing gas transmission and distribution networks is the National Gas Law and Rules (NGL and NGR). Our work is guided by the National Gas Objective (NGO).[1]

A regulated gas network business must periodically apply to us for a ruling on network charges, in the form of an access arrangement. Our decision on the access arrangement currently in place for Victorian gas distributor AusNet Gas Services (AusNet) was made in November 2017, for the period 1 January 2018 to 31 December 2022 (2018–22 period).

On 20 October 2020, the *National Energy Legislation Amendment Act 2020* (Vic) was enacted to change the timing of Victorian gas distribution access arrangement periods. Future access arrangements for AusNet will now be made for financial years rather than calendar years. To facilitate this, the 2018–22 period for AusNet will be extended by 6 months from 1 January to 30 June 2023 (extension period). AusNet's next access arrangement period will then cover the period 1 July 2023 to 30 June 2028 (2023–28 period).

We will determine revenue and prices for the extension period in accordance with Orders in Council made on 30 September 2021 (the Orders).[2] Our proposed approach to that determination was set out in a position paper in November 2021:[3]

- To minimise price volatility resulting from price changes on both 1 January and 1 July 2023, we would extend AusNet's current, 2022 prices (adjusted for 6 months' inflation to keep them constant in real terms) for an additional 6 months to cover the extension period.
- To determine a building block revenue allowance for the extension period we would use simple, trend-forward approaches to forecast capital expenditure (capex) and operating expenditure (opex) at a level that should be proportionate to the extended tariffs.
- We would then return any difference between allowed revenue under the extended, 2022 tariffs and the trended forward building block revenue calculation to customers in the new, 2023–28 period.

Submissions received from AusNet, the AER's Consumer Challenge Panel (CCP28) and Victoria's other gas distributors (Australian Gas Network (AGN) and Multinet Gas Networks

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1 NGL, s. 23: "...to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

2 Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 64 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2076 [Section 64 Order]; Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 65 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2081 [Section 65 Order].

3 AER - Position paper: Approach to six-month extension of access arrangements for Victorian gas distributors - November 2021

(MGN)) were broadly supportive of that approach.[4] Each suggested some refinements and clarifications that have been taken into account in this draft decision.

The key variable remaining at the time of this draft decision is the demand forecast that should be used for the purposes of calculating extension period allowed revenue. In our position paper we suggested that, for consistency with the simple 'trend forward' approach applied to other elements of this draft decision, we could assume forecast demand for 1 January to 30 June 2023 would be the same or similar to that in recent years. Instead, AusNet has provided forecasts are informed by an October 2021 report commissioned from The Centre for International Economics (CIE) which it submits are more robust estimates for demand in the 6-month extension period and better reflects AusNet's circumstances. AusNet's.

The Australian Energy Market Operator's (AEMO) 2022 Gas Statement of Opportunities (GSOO) consider a number of potential demand scenarios, with greatest emphasis on:

- The step change scenario: an accelerated transition towards a net zero economy with significant electrification occurring in the short to medium term.
- The progressive change scenario, which considers slower action towards the transition to a net zero economy.

While AEMO has observed that stakeholders consider the step change scenario the most likely pathway for Australia's energy sector, it has also noted that 'urgent action would be needed to put south-eastern regions on the step change path by next winter'.

The CIE report provided by AusNet pre-dates the 2022 GSOO but sits closer to the progressive change scenario than step change. We can see the benefits of a more detailed approach to forecasting, in principle, but have not had time to fully assess the supporting information provided. We have used AusNet's forecast as a placeholder for this draft decision, subject to stakeholder views on the forecast and our completion of that assessment prior to our final decision later this year.

For illustrative purposes, based on the latest available inflation forecasts, this draft decision assumes that AusNet's distribution tariffs from 1 January to 30 June 2023 will be 2.71% higher in nominal terms, reflecting a half-year inflation applied to its current, 2022 tariffs. In our upcoming final decision, we will update this indexation with actual inflation. If we were to accept AusNet's forecast of demand, the expected, allowed revenue recovered at those prices over the 6-month extension period would be $98.7 million.[5] This would be $14.7 million (17.5%) higher than our draft decision on AusNet's building block revenue of $83.9 million for the extension period.[6] This over-recovery of $14.7 million would therefore be returned to customers over the course of the next, 2023–28 period as an offset to approved prices for that period.

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4 https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausnet-services-access-arrangement-2023%E2%80%9328/transitional-decision

5 The allowed revenue total of $98.7 million comprises $97.0 million for reference services and $1.6 million for ancillary reference services.

6 The building block total of $83.9 million comprises $82.2 million for reference services and $1.7 million for ancillary reference services.

These draft decision outcomes will change as we update our calculations for changes to market variables, such as inflation. They may also change if our final decision applies a different demand forecast compared with AusNet's. Our final decision must be made in time for us to determine what prices will apply from 1 January to 30 June 2023. Our intention is to release our final decision for the 6-month extension period in conjunction with our draft decision for the 2023–28 period later this year.

How you can get involved

Interested parties are invited to make submissions on this draft decision by **24 August 2022**.

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

Alternatively, submissions can be sent to:

Sebastian Roberts
Specialist Advisor
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. We will treat submissions as public documents unless otherwise requested. All non-confidential submissions will be placed on the AER's website.

We request parties wishing to submit confidential information:

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

For further information regarding the AER's use and disclosure of information provided to it, see the ACCC/AER Information Policy, which is available on our website.

1 Introduction

On 20 October 2020, the *National Energy Legislation Amendment Act 2020* (Vic) was enacted to change the timing of Victorian gas distribution access arrangement periods. Where previous access arrangement decisions for AusNet have been made by reference to calendar years, future access arrangements will be made for financial years. To facilitate this, AusNet's approved access arrangement for the period 1 January 2018 to 31 December 2022 (2018-22 period) will be extended by 6 months from 1 January to 30 June 2023 (extension period). AusNet's next access arrangement will then cover the period 1 July 2023 to 30 June 2028 (2023–28 period).

We will determine revenue and prices for the extension period in accordance with Orders in Council made on 30 September 2021 (the Orders).[7] Our approach to this determination has been informed by the equivalent process we completed for Victorian electricity distributors, including AusNet, in 2020. That approach drew on the discretion afforded us under Orders in Council to adopt a pragmatic approach to extending the life of the existing decisions to cover an additional 6 months, keeping the transition process simple by trending forward most elements of our previous decision as a basis for the additional revenue requirement. The Orders in place for Victorian gas distributors give us a similar level of discretion.[8] In addition, they allow us to smooth revenue between the extension period of 1 January to 30 June 2023, and the new 2023–28 period commencing on 1 July 2023.[9]

Our draft decision is to extend AusNet's current, 2022 prices to 30 June 2023, adjusted for a half-year of expected inflation to keep them constant in real terms. To the extent the expected revenue that would be recovered at those prices is lower or higher than the building block revenue we approve for that period, any under- or over-recovery will then be corrected in—and its impact on prices smoothed over—the 2023–28 period. This means our decision on revenue and prices for the extension period is in three parts:

1. *Extension period allowed revenue* (the revenue to be derived from the provision of the relevant pipeline services for the 1 January to 30 June 2023 extension period) is determined by reference to the extended, 2022 tariffs and to forecast demand for the extension period. We discuss this in section 2.
2. *Extension period building block revenue* is determined within the parameters set out in the NGR and the Orders, applying a similar, trend forward approach for capex and opex to that used for the electricity distribution extension period. We discuss this in section 3.
3. When smoothing revenue and price paths for the new, 2023–28 period we will complete a *'true up'* of any difference between extension period allowed revenue and extension period building block revenue. We will distribute that difference over one or more of the next 5 years to achieve the best outcome for consumers. We discuss this in section 4.

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7 Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 64 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2076 [Section 64 Order]; Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 65 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2081 [Section 65 Order]

8 Section 64 Order.

9 Section 64 Order.

2 Extension period allowed revenue

Extension period allowed revenue is AusNet's revenue from the provision of services over the 6-month extension period. Under the Orders, our determination of extension period allowed revenue must be an amount between: [10]

- extension period building block revenue (discussed in section 3), and
- the total revenue for the applicable access arrangement extension period determined by the AER based on the tariffs and tariff classes approved by the AER for the regulatory year commencing on 1 January 2022, adjusted for inflation.

The approach taken in this draft decision is to apply AusNet's tariffs and tariff classes from the current (2022) regulatory year, adjusted for a half-year of forecast inflation (1-year lagged), for an additional 6 months over the extension period (i.e. from 1 January to 30 June 2023).

Extension period allowed revenue, in simple terms, will be the approved extended tariffs multiplied by forecast demand.

2.1 Extending 2022 prices over the extension period

Our draft decision is to extend the 2022 tariffs by indexing for a half year of inflation, consistent with the approach set out in our position paper. Therefore, we have indexed the tariffs by 2.71% which is a half year adjustment to the Reserve Bank of Australia's (RBA) full year inflation forecast of 5.50% for the June 2022 quarter.[11] We note the actual inflation for the June 2022 quarter is not yet available and will be published in late-July 2022. In our final decision, we will update the extension period tariffs using the actual inflation adjusted for a half year.

We consider applying a half year of inflation appropriately converts the tariffs from 'end-of-year' (31 December) 2022 terms to 'end-of-half-year' (30 June) 2023 terms. Further, the June 2022 quarter is appropriate as the June series (1-year lagged) is consistent with the annual tariff mechanism for haulage reference services in our 2018–22 decision, subject to an adjustment for the half year.

In their respective submissions on our position paper, AusNet and Australian Gas Infrastructure Group (on behalf of AGN and MGN) both supported the approach to apply a half year inflation.[12]

AusNet has subsequently reconsidered its position. It submitted that a full year inflation is appropriate because the 2022 tariffs represent average tariffs that are applied across the 2022 calendar year, and should therefore be seen as reflecting mid-year (30 June 2022) dollar terms. On that basis it considers applying a full year inflation adjustment will bring the

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10 Section 64 Order, p. 2079.

11 The 5.50% inflation is taken from the Reserve Bank of Australia's May 2022 Statement on Monetary Policy. The 2.71% is derived from the equation: (1+5.5%)^0.5 –1.

12 AusNet Services, *Submission to AER on the 6 month approach*, December 2021, p.1; Australian Gas Infrastructure Group, *Response on six month extension position paper*, December 2021, p.1.

tariffs to 30 June 2023 terms. AusNet's proposal therefore extends 2022 calendar year prices to 30 June 2023 by indexing them by the RBA's full year inflation forecast of 5.50% for the June 2022 quarter.

We do not agree that the 2022 tariffs should be seen as being in mid-year terms. They are correctly regarded as being in end-of-year terms because our post tax revenue model (PTRM) applies cash flows for forecast revenues in end-of-year terms.[13] AusNet operates under a price-cap control mechanism, which means that in its 2018–22 PTRM, the tariffs for year 1 and the X factors for years 2 to 5 were set based on end-of-year nominal revenues using forecast inflation. In years 2 to 5, the annual tariff variation mechanism formula ensures the year on year movement (in percentage terms) in expected revenue is less than or equal to the CPI-X formula, updated for actual inflation and return on debt. Because year 1 tariffs (2018) were set in the PTRM in end of year terms, we consider that the tariffs set in each subsequent year of the 2018–22 period through the annual tariff mechanism are also in end-of-year terms. Therefore, the 2022 approved tariffs are in end of year terms and applying a half year inflation correctly brings them to 30 June 2023 dollar terms.[14]

AusNet has also suggested that a full year escalation is consistent with the inflation approach in the control mechanism for some price-capped services in our earlier decisions on extension period revenue and prices for Victorian electricity distributors. However, in those decisions the actual CPI (full year) adjustment only applied to price-cap formulas for alternative control services. It did not apply to standard control services, which are more analogous to the reference services provided under AusNet's gas access arrangement. Our determination of half year revenue (and prices) for standard control electricity distribution services was not based on indexing for CPI.

In its response to our position paper, CCP28 submitted that while it supported the extension of 2022 tariffs into the 6-month extension period it did not support indexation of the tariffs for inflation.[15] It suggested adjusting 2022 tariffs for inflation is inconsistent with our position paper and the Orders. We consider that adjusting the 2022 tariffs by a half year inflation is consistent with the approach in our position paper and the intent of the Orders.[16] We are satisfied with this approach as it extends the tariffs in real terms.

AusNet also raised an unrelated concern that the proposed approach to trending forward tariffs conflicts with the way its tariffs are currently set. Under its current Access Arrangement, AusNet bills customers based on forecast demand and then, if actual demand differs from forecast, a true-up is undertaken.[17] This approach is not viable under the proposed approach for the 6-month extension period. AusNet will instead bill customers

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13 AER, *Gas distribution services providers post-tax revenue model handbook, Final Decision*. April 2021, p.28.

14 Even if we treated the 2022 approved tariffs as mid-year (30 June 2022) terms then it would be appropriate to convert them to 'mid-year' terms for the half year which would be 31 March 2023 terms (i.e. middle of the Jan-June 2023 extension period), and this would therefore be 9 months' indexation.

15 CCP28, *Advice to Australian Energy Regulator on approach to six-month extension of access arrangements for Victorian gas distributors*, December 2021, p. 3.

16 Section 64 Order, p. 2079. Under heading *Revenue and tariffs for the applicable access arrangement extension period* the Order refers to 2022 tariffs being "adjusted for inflation".

17 AusNet, *Submission to AER on the 6 month approach*, December 2021, p. 1.

using actual demand. We support this approach as being the most straightforward option in the circumstances.

2.2 Expected demand over the extension period

We need a demand forecast for each reference service that AusNet will provide during the extension period in order to calculate its extension period allowed revenue.

The Orders do not prescribe an approach to our assessment of demand forecasts for the extension period. Our approach to forecast demand for the purposes of the extension period is guided by principles for forecasts and estimates set out in the NGR:[18]

- Information in the nature of a forecast or estimate must be supported by a statement of the basis of the forecast or estimate, and
- A forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.

Given the short length of the extension period, our position paper suggested a simple approach using the most recent actual demand for an equivalent, January to June period would be reasonable. In the context of this extension decision, the continued application of 2022 tariffs, and the simple, trend-forward approach we have used for our building block determination, we considered this an acceptable approach given the limited time available for submission of proposals.

In its extension period proposal, AusNet has instead put forward demand forecasts based on an October 2021 report commissioned from The Centre for International Economics (CIE) that it submits results in more robust estimates for demand in the 6-month extension period and better reflects AusNet's circumstances. CIE's report was provided to us separately in May 2022.

Ongoing transformation in Australia's energy system and the explicit policy goals of reaching net zero emissions by 2050 create considerable uncertainties in future gas demand. The Australian Energy Market Operator's (AEMO) 2022 Gas Statement of Opportunities (GSOO). considers five potential demand scenarios (step change, progressive change, hydrogen superpower, strong electrification, and low gas price) with greatest emphasis on:

- The step change scenario, which considers an accelerated transition towards a net zero economy with significant electrification occurring in the short to medium term, increasing renewable energy penetration and retiring coal generation.
- The progressive change scenario, which considers slower action towards the transition to a net zero economy, allowing time for technologies to develop with strong transformation efforts occurring in the long term to achieve net zero 2050.

AEMO has observed that stakeholders consider the step change scenario the most likely pathway for Australia's energy sector. However, it has also noted that 'urgent action would be needed to put south-eastern regions on the step change path by next winter'.

[18] NGR, r. 74.

The CIE report provided by AusNet pre-dates the 2022 GSOO but sits closer to the progressive change scenario than step change.

We can see the benefits of a more detailed approach to forecasting, in principle, but have not had time to fully assess the supporting information provided. We have used AusNet's forecast as a placeholder for this draft decision, subject to stakeholder views on the forecast and our completion of that assessment prior to our final decision later this year.

The same CIE report has been provided in support of AusNet's demand forecasts for its full, 2023-28 access arrangement period. A submission from stakeholders in support of using AusNet's proposed forecasts for the extension period does not mean stakeholders also have to agree to its forecasts for the whole 5-year access arrangement. Nor would a decision by us to adopt AusNet's forecasts for the immediate purposes of the extension period require us to accept its forecasts for next five years. Demand forecasts for the 2023–28 period will require greater consideration of how outcomes between progressive and step change may converge over time.

2.3 Calculating extension period allowed revenue

AusNet operates under a weighted average price cap. This means the prices we determine and the means of varying the prices from year to year are the binding constraint across an access arrangement period rather than the revenue requirement that informs them.

In a typical access arrangement determination, forecast demand is applied to the forecast revenue requirement to derive reference tariffs. In this decision, we already have the 2022 reference tariffs and, as discussed above, have indexed these for a half year of inflation to apply them to the extension period. So we are instead multiplying those tariffs by forecast demand to produce extension period allowed revenue.

For illustrative purposes, we estimate that adopting AusNet's proposed demand forecasts for 1 January to 30 June 2023 and applying those forecasts to the extended, 2022 tariffs, would result in extension period allowed revenue of $98.7 million.[19]

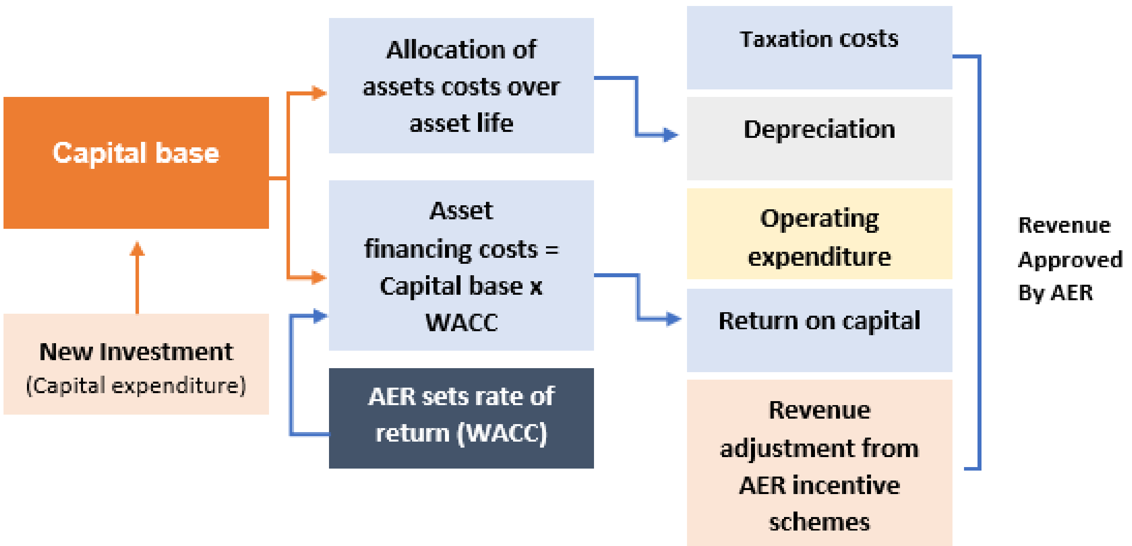
[19] The allowed revenue total of $98.7 million comprises $97.0 million for reference services and $1.6 million for ancillary reference services.

3 Extension period building block revenue

Our determination of extension period building block revenue is based on a similar 'building block' approach to our usual regulatory decisions. It looks at five cost components:

- return on the capital base – or return on capital, to compensate investors for the opportunity cost of funds invested in this business
- depreciation of the capital base – or return of capital, to return the initial investment to investors over time
- forecast opex – the operating, maintenance and other non-capital expenses, incurred in the provision of network services
- revenue increments/decrements resulting from the opex efficiency carryover mechanism that applied to AusNet in the 2018–22 access arrangement period.
- estimated cost of corporate income tax.

Figure 1 The building block approach to determining total revenue



Source: AER.

For the purposes of determining building block revenue for the 1 January to 30 June 2023 extension period, the Orders allows us to apply variations to our standard, 5-year revenue models.[20] The models used in AusNet's proposal and this draft decision for the extension period are based on the PTRM and Roll Forward Model (RFM)[21] that AusNet must use for its 2023-28 access arrangement proposal, adjusted to accommodate the additional 6-month period.

20 Section 64 Order, p. 2078

21 AER, *Gas transmission and distribution network service providers, Roll forward models (version 1.1)*, April 2020; AER, *Gas transmission and distribution network service providers, Post-tax revenue models (version 2)*, April 2021.

Our draft decision is that AusNet's building block revenue for the 1 January to 30 June 2023 extension period is $83.9 million.[22] Table 1 shows our draft decision on the building block revenue for the 6-month extension period.

Table 1 Extension period building block revenue 1 January to 30 June 2023 ($nominal)

	HY2023[d]
Return on capital	46.4
Regulatory depreciation[a]	0.5
Operating expenditure[b]	33.1
Revenue adjustments[c]	3.0
Cost of corporate income tax	1.0
Building block revenue (including ARS)	**83.9**
Less: Ancillary reference services	1.7
Building block revenue (excluding ARS)	**82.2**

Source: AER analysis.

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

(b) Includes debt raising costs.

(c) Revenue adjustments from the efficiency carryover mechanism.

(d) This is for the 6-month extension period of 1 January to 30 June 2023.

We discuss the building block components of this calculation in the sections below.

3.1 Capital base

The capital base roll forward accounts for the value of AusNet's regulated assets over the extension period. The opening value of the capital base on 1 January 2023 is used to determine the return on capital and return of capital (depreciation) building blocks.

This draft decision includes opening capital base value of $1802.3 million as at 1 January 2023. To determine the opening capital base, AusNet has rolled forward the capital base over the 2018–22 access arrangement period. We have reviewed the key inputs of AusNet's proposed RFM, such as forecast inflation, rate of return, gross capex values, capital contribution values, forecast depreciation amounts and asset lives. We found these inputs were correct and reconciled with relevant data sources.[23]

We have established the opening capital base on 1 January 2023 using the standard published RFM that roll forwards the capital base for 2018–22, based on actual capex up to 2021 and latest estimates for 2022 capex. We note that AusNet might provide an updated estimated capex for 2022 before our final decision for the half year extension period, in which case the opening capital base may increase or decrease. The RFM also reflects 2018–22 forecast depreciation and actual CPI.

22 Includes Ancillary Reference Services. Nominal revenue includes the expected impact of inflation.

23 Data sources included Australian Bureau of Statistics (ABS) data, annual regulatory information notices (RINs) and the 2018–22 decision models.

This roll forward process includes an adjustment at the end of the 2018–22 access arrangement period to account for the difference between actual 2017 capex and the estimate approved in the 2018–22 decision.[24] Additionally, final year adjustments may be applied at 30 June 2023 to establish the opening capital base value at 1 July 2023 for the purposes of the 2023–28 access arrangement.[25] Table 2 sets out the roll forward of AusNet's capital base over the 2018–22 access arrangement period.

Table 2 Capital base roll forward for the 2018–22 period ($nominal)

	2018	2019	2020	2021	2022[a]
Opening capital base	1562.7	1611.6	1671.8	1717.4	1732.0
Net capex[b]	98.1	97.0	93.2	97.9	89.5
Indexation of capital base	30.2	33.5	26.6	–6.0	66.6
Less: straight-line depreciation[c]	79.4	70.3	74.3	77.2	84.1
Interim closing capital base	1611.6	1671.8	1717.4	1732.0	1804.1
Difference between estimated and actual capex in 2017					–1.4
Return on difference for 2017 capex					–0.4
Closing capital base as at 31 December 2022					**1802.3**

Source: AER analysis.

(a) Based on estimated capex provided by AusNet. We will true-up the capital base for actual capex at the next access arrangement review.

(b) As-incurred, net of disposals, and adjusted for actual CPI and half-year WACC.

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

Reference tariffs for the 2023–28 period (from 1 July 2023) will be established using a modified, 5.5 year RFM to establish an opening capital base at 1 July 2023. That opening capital base will include capex undertaken during the extension period.

3.2 Regulatory depreciation

Our calculation of the extension period building block revenue includes $0.5 million for the depreciation of AusNet's capital base. AusNet's proposal reflects:

- the straight-line depreciation method for calculating the regulatory depreciation amount as set out in the PTRM, and the year-by-year tracking approach to implement this method.[26] An adjustment is required to reflect that the 2023 period is a half year rather than full year and AusNet has therefore used our modified depreciation tracking module of the RFM, which allows for the tracking calculations to reflect the extension period
- the same asset classes and standard asset lives approved for the 2018–22 period
- the opening capital asset base at 1 January 2023 (section 3.1)

[24] The end of period adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved at the 2018–22 decision.

[25] This includes reallocation for accelerated depreciation purposes.

[26] For this 6-month extension period, the straight-line depreciation is not impacted by the 6-month forecast net capex. This is consistent with our standard approach of capex entering the capital base at the end of the year in which it is incurred and depreciating from the following year.

- expected inflation (section 3.3.1) for the 6-month extension period.

In our final decision, we will update the regulatory depreciation amount to reflect any updates to the opening capital base and expected inflation.

Table 3 sets out our draft decision on the regulatory depreciation amount for AusNet's 6-month extension period.

Table 3 Regulatory depreciation amount for 1 January to 30 June 2023 ($nominal)

	HY2023[a]
Straight-line depreciation	38.4
Less: inflation indexation on opening capital base	37.9
Regulatory depreciation	**0.5**

Source: AER analysis.

(a) HY2023 is the 6-month extension period of 1 January to 30 June 2023.

Reference tariffs for the 2023–28 period will also be established using the modified depreciation tracking module to calculate the depreciation of assets in the 1 July 2023 capital base.

3.3 Rate of return and value of imputation credits

For the purposes of determining extension period building block revenue, the Orders require us to apply our 2018 Rate of Return Instrument (2018 Instrument), with modifications to give effect to the change of the access arrangement period from a calendar year to a financial year basis:[27]

We published the modified 2018 Instrument that applies to this decision on 29 October 2021.[28] The key reasons the application of the 2018 Instrument and modifications are required are:

- The 2018 Instrument reduces the allowed return on both debt and equity compared to those applied in the current period, all else remaining equal. Not applying these changes from 1 January 2023 would delay the impact of these lower returns for consumers.
- Debt yields have changed materially since the commencement of the trailing average. Consequently, not modifying the weights feeding into the trailing average return on debt in an appropriate way could make consumers materially better or worse off. For this reason, we have modified the trailing average weights in a manner that can prevent consumers and businesses from being materially impacted, including to have a new on the day return on debt for the applicable access arrangement extension period feed into the trailing average.[29]

27 Section 64 Order, pp. 2077-2078.

28 Available here and on project page for the AusNet access arrangement review: https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausnet-services-access-arrangement-2023%E2%80%9328/transitional-decision.

29 The decision on how the trailing average will apply post 1 July 2023 will be determined by future rate of return instruments.

The rate of return applied in this draft decision on extension period building block revenue is 2.57% (5.21% annualised). This is a higher placeholder rate of return than applied in AusNet's proposal because we have updated our estimates of the risk-free rate using more recent placeholder dates and the return on debt using AusNet's nominated averaging period. The risk-free rate estimate will be updated again in our final decision. We accept AusNet's proposed risk-free rate averaging period[30] and debt averaging periods because they comply with the conditions set out in the modified Instrument.[31]

CCP28 questioned why we use the weighted average cost of capital (WACC) to adjust under- or over-recovery of revenues in the extension period and instead proposed that we use the trailing average cost of debt.[32] We do not agree with this view, because the networks' capital investment, including any capital required for a period of under- or over-recovery of revenues, is funded by all of the capital holders of the firm, including both shareholders and debt holders. Therefore, the risk associated with any under- or over-recovery of revenues would be best approximated by the WACC. It is also our standard practice to adjust under- or over-recovery of revenues in a net present neutral way using the WACC.

3.3.1 Expected inflation

In implementing our current approach to estimating the expected inflation rate for the 6-month access arrangement extension period, this draft decision:

- uses inflation forecasts (CPI) from the May 2022 RBA Statement of Monetary Policy for the year ending 30 June 2023.
- halves this one-year forecast from the RBA to derive an estimate of expected inflation for the 6-month period, 1 January to 30 June 2023.

This results in an inflation forecast of 2.10%. Our estimate of expected inflation will be updated again in our final decision.

3.4 Capital expenditure

For the purposes of determining the projected capital base for the applicable access arrangement extension period, the Orders require forecast capital expenditure (capex) consists of parts that:[33]

- the AER is satisfied meet the new capital expenditure criteria set out in rule 79 of the NGR; or
- are expenditure not exceeding half of the average of the corresponding forecast capital expenditure as approved by the AER over the previous regulatory years as selected by the AER, adjusted for inflation.

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

31 AER, *Modified Rate of Return Instrument for the Victorian gas distribution networks during the extension period of 1 January 2023 to 30 June 2023*, October 2021, cll. 7–8, 23–25 and 36.

32 CCP28, Advice to Australian Energy Regulator on: Approach to six-month extension of access arrangements for Victorian gas distributors, 7 December 2021, p.4.

33 Section 64 Orders, p. 2078.

As set out in our position paper, we and AusNet have taken the second of these options. To forecast capex for the 6 months from 1 January to 30 June 2023, we have:

- Halved the forecast conforming capex that we determined for 2022, and
- Escalated the resultant allowance by CPI only.

This produces forecast capex of $47.3 million for the extension period.

Table 4 Forecast capex allowance 1 January to 30 June 2023 ($2022-23)

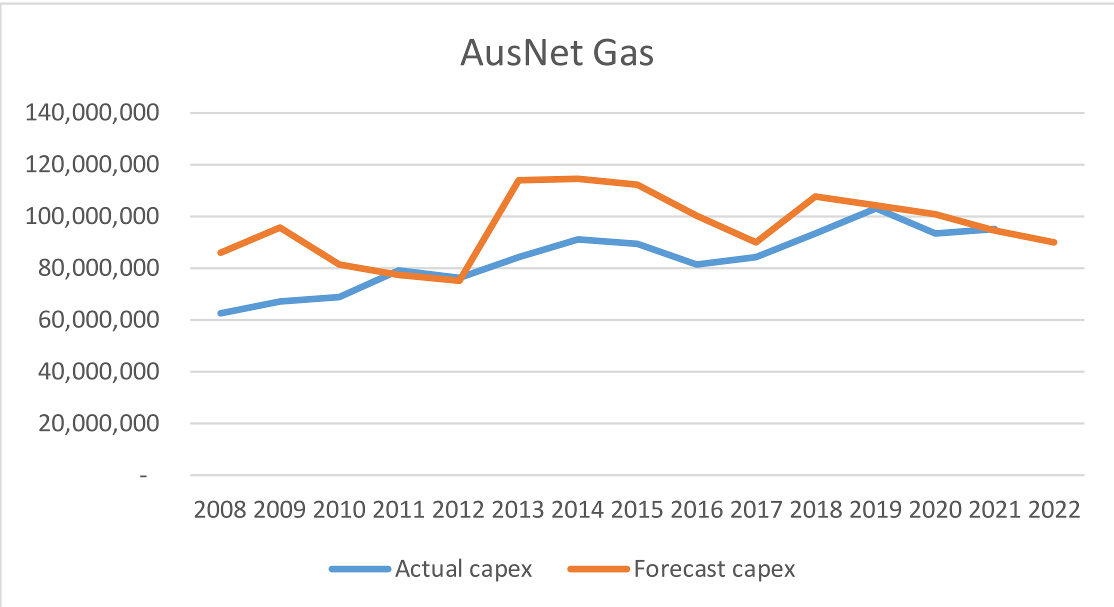
	Forecast capex ($ million)
Total capex (including customer contributions)	$49.6
Customer contributions	$2.3
Net capex (excluding contributions)	**$47.3**

Source: AusNet Services, AST - GAAR Half Year PTRM Capex inputs

This approach, which was supported in submissions to our position paper, recognises the limited time available between the making of the Orders and the due date for AusNet's extension period proposal, which was insufficient for us to prepare and serve specifications for a full capex proposal in a Regulatory Information Notice, and for AusNet to then comply with that notice. It is also consistent with the approach we took in the equivalent determination for Victorian electricity distributors.

Noting that our decision on AusNet's forecast capex for the 2022 regulatory year was made more than 5 years ago, actual capex reported by AusNet in the first 3 years of the 2018–22 period was lower than our approved forecast. Figure 2 compares AusNet's actual capex to the forecasts in our last decision.

Figure 2 Comparison of actual and forecast capex



Source: AER analysis

In the latest reporting year (2021), actual capex was $0.5 million (0.6%) more than forecast. While forecast and actual capex amounts have differed, AusNet's actual capex profile over the current period has thus far remained similar to those forecast in our final decision. This gives us confidence that reliance on the lower, final year forecast in our previous decision in preference to an average including years with higher forecasts is likely to remain reasonably reflective of AusNet's expenditure needs. Irrespective of any over or under spend during the extension period, it is AusNet's actual capex, which must be assessed by us as conforming capex under the NGR as part of our next review, that will ultimately be rolled into the capital base at the conclusion of the 2023–28 access arrangement period.

3.5 Operating expenditure

For the purposes of determining the extension period building block revenue, the Orders require that the forecast of operating expenditure (opex) consist of parts that:[34]

- the AER is satisfied meet the criteria governing opex set out in rule 91 of the NGR; or
- are expenditure not exceeding half of the corresponding forecast opex as approved by the AER for the regulatory year commencing on 1 January 2022, adjusted for inflation and any rate of change that the AER considers appropriate having regard to changes in output, prices, productivity, and any other relevant factors that the AER may consider relevant.

As set out in our position paper, we and AusNet have taken the second of these options. To forecast opex for the 6 months from 1 January to 30 June 2023, we have:

- Applied a rate of change to half the forecast opex that we determined for 2022[35], in addition to adjusting for inflation. The applicable rate of change is equal to three quarters of the rate of change we used for 2022. We apply three-quarters of the rate of change for 2022 to forecast opex for the extension period, rather than half, to represent the change in the *average* level of output, opex input prices (e.g. wages), and productivity between the *average* levels over the 2022 calendar year and the first six months of 2023. This can be thought of as the change in prices, output and productivity at the end of June 2022 compared to the end of March 2023 (that is, at the mid points of the 2 periods). This is 9 months. Further, the change in prices output and productivity between the 6-month extension period and the first year of the new access arrangement period will also be 9 months. This gives a total of 18 months rate of change between calendar year 2022 and 2023–24.
- Forecast debt raising costs consistently with our use of category specific forecasts for debt raising costs in our opex forecasts for 2022. Debt raising costs are transaction costs incurred each time debt is raised or refinanced. Unlike other elements of our opex forecasts for 2022, for which we used a base–step–trend forecasting approach, we forecast debt raising costs based on a benchmarking approach rather than a service provider's actual costs. This ensures consistency with the forecast of the cost of debt in the rate of return building block.

This produces forecast opex for the 1 January to 30 June 2023 extension period of $32.4 million. This is consistent with AusNet's proposed forecast, but applies a more recent

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[34] Section 64 Orders, p. 2078.

[35] Excluding debt raising costs.

forecast of inflation for the year to December 2022.[36] We will update forecast opex again in our final decision, with the RBA's latest available forecast of inflation.

Table 5 Forecast opex allowance 1 January to 30 June 2023 ($2022-23)

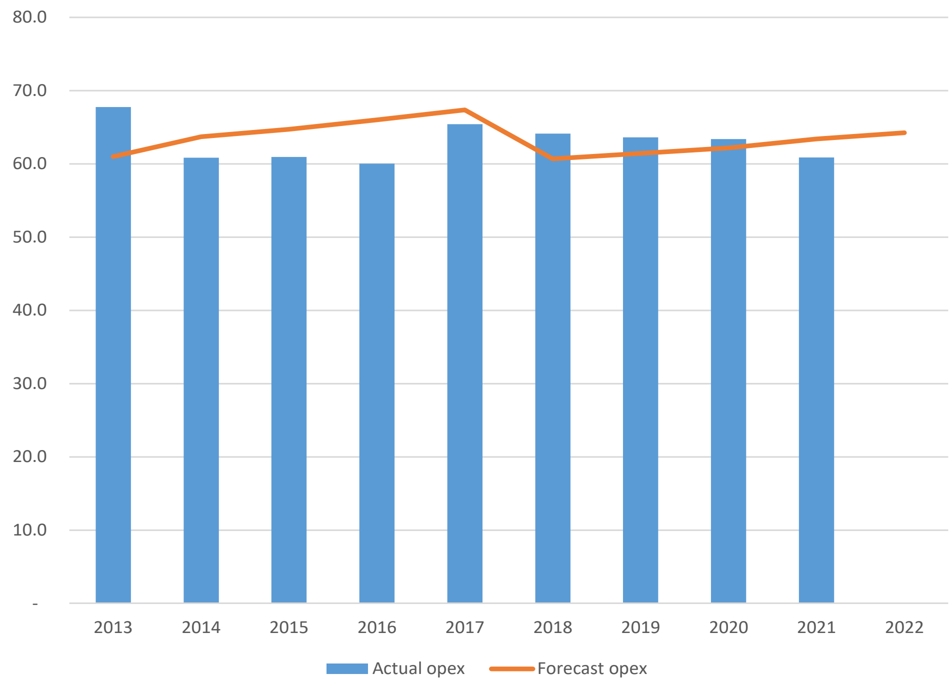
	AusNet proposal	AER draft decision
Forecast opex, excluding ARS & DRC	29.6	30.3
Ancillary reference services	1.6	1.6
Debt raising costs	0.4	0.4
Total forecast opex	**31.6**	**32.4**

Source: AusNet, *Proposed half year 2023 PTRM*, April 2022; AER analysis.

As with capex, this approach recognises the limited time available between the making of the Orders and the due date for AusNet's extension period proposal and is consistent with the approach we took in the equivalent determination for Victorian electricity distributors.

Noting that our decision on AusNet's forecast opex for the 2022 regulatory year was made more than 5 years ago, annual reporting from AusNet during the 2018–22 period shows that its total actual opex over the first 4 years has been $4.3 million (1.7%) above our approved forecast. Figure 3 compares AusNet's actual opex during the current period to the forecast approved in that decision.

Figure 3 Comparison of actual and forecast opex ($million 2022)



Source: AER analysis.
Note: Includes debt raising costs.

36 RBA, *Statement on Monetary Policy, Forecast Table*, 5 May 2022.

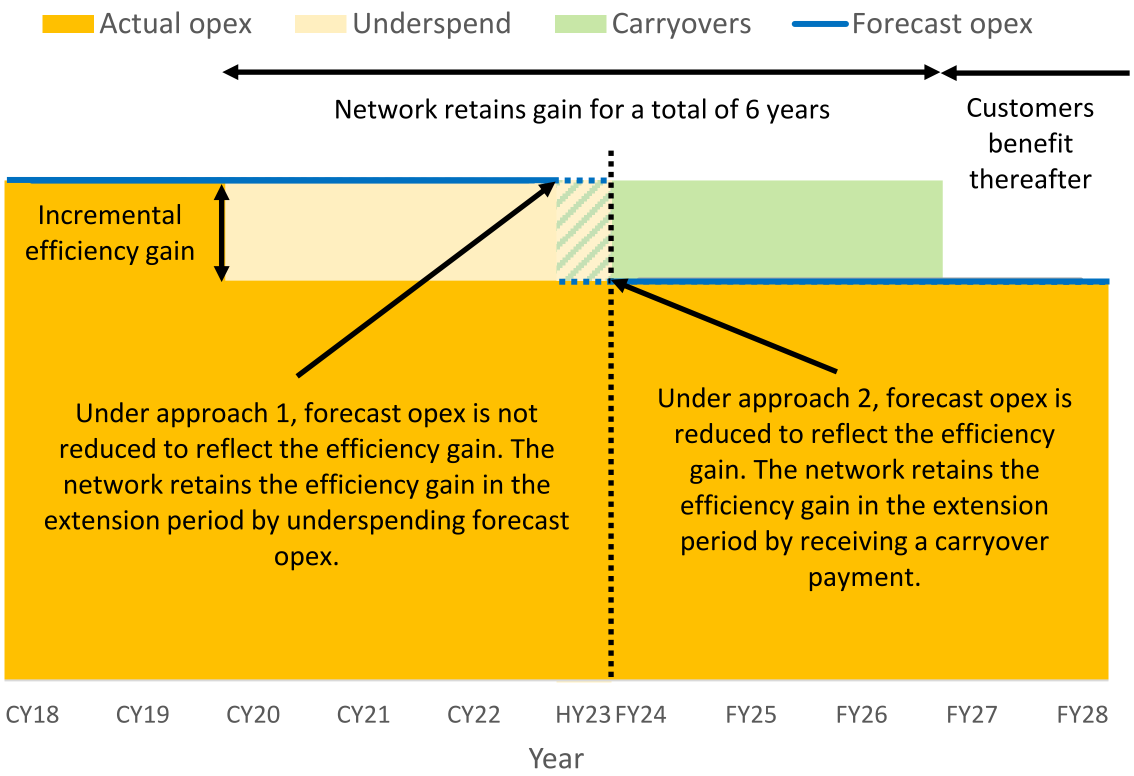
The approach we have taken to forecasting extension period opex does not account for the efficiency gains and losses AusNet has achieved in the current period. That is, forecast opex for the extension period allows AusNet to retain the recurrent efficiency gains and losses it has achieved in the 2018–22 access arrangement period. We will account for this when we calculate the efficiency carryover amounts to be included in AusNet's revenue for the extension period so that these efficiency gains are not double counted. While we could have adjusted the opex in the 6-month extension period to account for efficiency gains and losses, as illustrated below, we would also need to take into account the efficiency carryover amounts, which results in the same revenue outcome.

In its submission on our position paper, CCP28 suggested a fuller explanation of this would be helpful to assure customers that our approach will deliver a fair outcome.[37]

Under the approach taken in this draft decision for the 6-month period, we set (annualised) forecast opex equal to the level previously determined for the period. This can be thought of as the level of opex we would have forecast for the 6-month extension period had we known the full period would be 5.5 years in total. To illustrate, in Figure 4 we assume the distributor reduces its ongoing level of opex in 2020 as can be seen by the step down in the yellow actual opex box in 2020. So the network underspends its opex forecast for an extra 6 months. This is not reflected in our (lower) opex forecast until the start of the next access arrangement period (the blue line from 2023-24). Under the incentive mechanism in place, the business retains the lower spend for 3.5 years in the current period (the light brown underspend box) and it will receive carryovers for 2.5 years in the next period (the green carryover box). Therefore, the business retains the benefits from the lower ongoing opex for six years, after which customers benefit.

[37] CCP28, *Gas distribution businesses extension advice*, 7 December 2021, p. 3.

Figure 4 Draft decision approach to forecasting opex



Source: AER

If we had instead reflected the lower opex revealed in 2020 in the forecast opex for the extension period, we would then need to include these gains in the carryover amounts for the extension period. This would reduce forecast opex, but increase carryover amounts. It would not change the overall opex and efficiency carryover revenues since the two impacts would offset each other.

Using the same example as above, in Figure 4 we could have set (annualised) forecast opex for the 6-month extension period to reflect the now lower ongoing level of opex in 2020 (as reflected by the lower blue dashed line). The distributor would now no longer underspend its opex forecast in the 6-month period because we set opex to reflect the lower level of opex. In addition to the underspend for three years (the light brown underspend box), the incentive mechanism that is operating allows the network to retain the opex reduction it has made as a carryover in the extension period (shown by the green hatched box) and for 2.5 years in the in the next period (the green carryover box). Therefore, under both approaches the distributor retains its gains for the same amount of time, the difference being whether this is through underspending opex in the 6-month period or through a carryover (the green hatched box).

3.6 Revenue adjustments and the application of incentive mechanisms

Our draft decision includes revenue adjustments of $2.9 million ($2022) from the application of the opex incentive mechanism in the 2018–22 access arrangement period in AusNet's building block revenue for the extension period.

As we noted in our position paper, this is a change from how we applied the efficiency benefit sharing scheme (EBSS) to the Victorian electricity distributors. In that case we considered there was insufficient time to determine the carryover amounts and include them in revenues for the extension period. In this case, we consider there is sufficient time and carryovers could be included in the revenues for the extension period.

Our calculation of the carryover amount is based on the calculation of carryovers for the current access arrangement period. The purpose of the carryover amount for the half year is to subtract half of the efficiency gain made in 2017. Because 2015 was used as the base year to forecast opex for the 2018–22 access arrangement period, forecast opex did not reflect any efficiency gains (or losses) made after 2015. Similarly, the calculation of carryovers for the 2018–22 access arrangement period assumed AusNet underspent its opex in 2017 by the same amount it underspent opex in 2015. Because the access arrangement period was expected to be 5 years this would allow AusNet to retain the actual efficiency gain it made in 2017 for an additional five years, consistent with gains made in other years. However, because the access arrangement period has been extended by 6 months we need to subtract half of the difference between the actual efficiency gain it made in 2017 and the efficiency gain we assumed for 2017 when we calculated carryovers for the 2018–22 period. This ensures the efficiency gain made in 2017 is only retained for five years, consistent with the access arrangement for the 2013–17 access arrangement period.

This is more than the $2.2 million ($2022) that AusNet included in its proposal,[38] because:

- we have included ancillary reference services in both forecast and actual opex in our calculation. This is consistent with how we treated ancillary reference services when we calculated carryover amounts from the application of the opex incentive mechanism in the 2013–17 access arrangement period.[39]
- we have made a scale adjustment for forecast opex. This is consistent with both the access arrangement in place in the 2013–17 period and how we calculated carryover amounts from the application if the opex incentive mechanism in that period.[40]
- we used the actual opex amount for 2015 reported by AusNet in its 2015 regulatory accounts. This is the same amount that we used to calculate carry carryover amounts from the application if the opex incentive mechanism in the 2013–17 access arrangement period. It is also the same amount that we, and AusNet, used to forecast opex for the 2018–22 access arrangement period. In contrast, AusNet used the total opex amount that it reported for 2015 in its 2011 to 2019 annual RIN.[41]

Our draft decision does not include any revenue adjustments associated with capital expenditure sharing scheme (CESS) calculations for the 2018-22 period. Consistent with our position paper, these revenue adjustments will be deferred to begin from 1 July 2023.

38 AusNet, Proposal PTRM for six month period, April 2022.

39 AER, Draft decision, *Efficiency carry-over mechanism (ECM) Model*, July 2017.

40 AER, Draft decision, *AusNet Services Gas access arrangement 2018 to 2022, Attachment 9, Efficiency carryover mechanism*, July 2017, p. 12.

41 AusNet, Response to information request, GAAR HY2023 ECM model, 27 May 2022.

3.7 Corporate income tax

AusNet's proposal, and our draft decision, have based the calculation of the cost of corporate income tax on the approach used for the current 2018–22 period, except for the value of imputation credits (gamma), which is based on the modified 2018 Instrument discussed in section 3.3.

For our draft decision, we determine a cost of corporate income tax of $1.0 million for AusNet for the 6-month extension period. This is higher than AusNet's proposed amount of $0.2 million, reflecting our draft decision on AusNet's proposed return on capital (section 3.3), which affects total revenues and therefore impacts the forecast corporate income tax amount.

Our draft decision:

- applies an opening TAB of $1005.1 million as at 1 January 2023, consistent with AusNet's proposal. The opening TAB may be updated as part of the final decision for the extension period to reflect any revised 2022 capex estimates
- reflects AusNet's proposed standard tax asset lives that are the same as the approved standard tax asset lives for the 2018–22 period
- reflects AusNet's proposed approach to calculating the remaining tax asset lives as at 1 January 2023 for all asset classes, because they are calculated based on the weighted average method as set out in our RFM.

Table 6 sets out our draft decision on the estimated cost of corporate income tax for AusNet over the 6-month extension period.

Table 6 Corporate income tax allowance for 1 January to 30 June 2023 ($nominal)

	HY2023[a]
Tax payable	2.3
Less: value of imputation credits	1.4
Net corporate income tax	**1.0**

Source: AER analysis.

(a) HY2023 is the 6-month extension period of 1 January to 30 June 2023.

4 True up for revenue for the applicable access arrangement extension period

Because there is a difference between the extension period allowed revenue and the extension period building block revenue set out in sections 2 and 3 above, the Orders allow us to make adjustments for that difference through the 2023–28 access arrangement.[42]

Our draft decision suggests that AusNet will over recover by $14.7 million[43] during the extension period if we accept its proposed demand forecast for the extension period.[44] As a result, its tariffs in the 2023–28 access arrangement period will be adjusted (reduced) so that AusNet will return $14.7 million dollars to consumers, with interest at the regulatory WACC to maintain the time value of money.

Table 7 True up between extension period allowed revenue and extension period building block revenue ($nominal)

	HY2023[a]
Building block revenue (excluding ARS)	82.2
Less: Total revenue - AER determined (excluding ARS)	97.0
True-up amount (excluding ARS)	**–14.8**
ARS building block revenue	1.7
Less: ARS revenue - AER determined	1.6
True-up amount for ARS revenue	0.1
Total true-up amount (including ARS)	**–14.7**

Source: AER analysis.
Note: Totals shown in table may not add up due to rounding.
(a) HY2023 is the 6-month extension period of 1 January to 30 June 2023.

This true up is net present value (NPV) neutral and so should ensure that both AusNet and consumers are not materially better (or worse) off as a result of continuing the 2022 tariffs throughout the applicable access arrangement extension period.

The Orders allow us to spread this adjustment over the whole of the 2023–28 access arrangement period, or to apply it only to some years within that period. This decision does not need to be made now, and can instead be deferred until our final decision on revenue and price paths for the 2023–28 access arrangement period. In considering this, we will have

42 Section 64 Orders, p. 2080

43 Including Ancillary Reference Services.

44 This true up is based on AusNet's expected revenue during the extension period and not its actual revenue. If actual revenue and allowed revenue in the extension period differ—e.g. because customer numbers or actual demand differ from the forecast customer numbers and demand over the 6-month period applied in our decision on extension period allowed revenue—this will not be adjusted for. This outcome is consistent with the existing weighted average price cap form of control.

regard to any submissions from stakeholders on the 2023–28 price paths in AusNet's proposal for 2023–28.

Glossary

Term	Definition
AER	Australian Energy Regulator
AEMO	Australian Energy Market Operator
AusNet	AusNet Gas Services
EBSS	Efficiency benefit sharing scheme
CESS	Capital expenditure sharing scheme
Capex	Capital expenditure
Opex	Operating expenditure
CPI	Consumer Price Index
Instrument (2018)	2018 Rate of Return Instrument
NGL	National Gas Law
NGR	National Gas Rules
NPV	Net present value
PTRM	Post tax revenue model
Orders	Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 64 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2076 [Section 64 Orders] Minister for Energy, Environment and Climate Change, *'Order Setting Requirements for Modifications and Variations to Instruments – Section 65 National Gas (Victoria) Act 2008'*, Victoria Government Gazette, No. G39, 30 September 2021, p. 2081 [Section 65 Orders]
RBA	Reserve Bank of Australia
RFM	Roll forward model