

# **AusNet Electricity Services Pty Ltd**

## **Electricity Distribution Price Review 2022-26**

### **Appendix 1C**

#### **Extension Period Revenues (1 January – 30 June 2021)**

**Submitted: 31 January 2020**

## 1 Background

This document sets out AusNet Services' forecast revenues for the extension period 1 January to 30 June 2021.

In April 2019 the Victorian Government formally communicated its intent to extend the current regulatory period by 6 months, which was due to end on 31 December 2020. This change will amend the timing of the Victorian distribution regulatory years to an Australian financial year (ending 30 June), rather than calendar years.

In November 2019 the AER issued written guidance to the Victorian distributors setting out interim measures that should be adopted by the Victorian distributors to forecast revenues for the extension period in their revenue proposals.<sup>1</sup> This guidance reflects the policy intent that the extension period is an extension of the current regulatory period, and therefore sets allowances based on the approaches applied in the current period where possible. The exception to this is the application of the 2018 Rate of Return Instrument. AusNet Services has adopted the AER's guidance.

AusNet Services considers that AER's interim measures to setting revenues and prices for the 6 month extension period is reasonable and pragmatic given the unusual circumstances. A final decision will be made by the AER on extension period revenues in August or September.

AusNet Services has formulated its business plans for the extension period based on the guidance provided by the AER and the revenues set out in this document. Deviations to the guidance provided by the AER will provide very little time for AusNet Services to amend its plans. The consequences of a material late change, and the corresponding erosion in regulatory certainty, should be considered by the AER when making its decision about extension period revenues.

While this document contains forecast revenues for the extension period, it does not present trend analysis, showing how extension period revenues and expenditure allowances compare to the current (2016-20) and forthcoming (2022-26) regulatory periods. This is provided in AusNet Services' Revenue Proposal for 2022-26, to which this document is attached.

## 2 Revenue Requirement

The table below sets out forecast building block revenues for standard control and metering services and a brief explanation of how they were calculated.

A more detailed explanation of components of the revenue setting approach is set out below.

**Table 2-1: Extension Period Building Block Revenues – Standard Control Services (\$m real \$2020)**

Building Block	Revenue	Approach
Return on Assets	109.33	Based on the AER's interim period capex allowance and the rate of return based on the 2018 Instrument
Depreciation	51.78	Based on existing asset classes, lives and methods, adjusted to reflect the half year

<sup>1</sup> <https://www.aer.gov.au/system/files/AER%20-%20Letter%20to%20AusNet%20Services%20-%20Reset%20timing%20interim%20measure%20-%206%20November%202019.pdf>

## Extension Period Revenues (1 January – 30 June 2021)

Operating Expenditure	137.18	Allowance for 2020 trended forward by the relevant rate of change, halved
Tax	0.97	Based on the tax approach applied in the 2016-20 regulatory period  Adopts the value of imputation credits (0.585) included in the 2018 Rate of Return Instrument
Revenue Adjustments	5.34	Includes adjustments for EBSS, shared assets and the demand management incentive allowance.
<b>Total</b>	<b>304.60</b>	n/a

Source: AND Distribution PTRM – Version 3 – Extension Period

**Table 2-2: Metering Services – Extension Period Building Block Revenues (\$m real \$2020)**

Building Block	Revenue	Approach
Return on Assets	5.8	Based on the AER's interim period capex allowance and the rate of return based on the 2018 Instrument
Depreciation	13.7	Based on existing asset classes, lives and methods, adjusted to reflect the half year
Operating Expenditure	7.9	Allowance for 2020 trended forward by the relevant rate of change, halved
Tax	1.4	Based on the tax approach applied in the 2016-20 regulatory period  Adopts the value of imputation credits (0.585) included in the 2018 Rate of Return Instrument
<b>Total</b>	<b>28.8</b>	n/a

Source: AusNet Services Extension Period PTRM – Metering Services

## 2.1 Rate of Return

A placeholder rate of return of 4.90% has been adopted to set extension period revenues. This is based on the parameters in the table below.

**Table 2-2: Nominal Rate of Return Build-Up**

Parameter	Value
<i>Risk free rate</i>	1.26%
<i>Market risk premium</i>	6.10%
<i>Equity beta</i>	0.6

Return on Equity	4.90%
Return on Debt	4.90%
<b>Nominal Rate of Return</b>	<b>4.90%</b>
<b>Value of Imputation Credits</b>	<b>0.585</b>

Source: AusNet Services Extension Period PTRM (note the PTRM input is adjusted to reflect a 6 monthly, rather than annual, rate of return reflecting the length of the extension period)

Both the cost of debt and the cost of equity will be updated to reflect the extension period actual averaging periods in the AER's final decision.

### 2.1.1 Return on Debt

The 6 month extension period requires a change in the way that the trailing average return on debt is implemented. Typically, the regulated cost of debt is calculated as an equally weighted average of the previous 10 years of prevailing debt costs<sup>2</sup>, which mirrors the way in which the benchmark entity issues long term, staggered debt to finance its asset base. As such, the AER has provided guidance on how the trailing average should be modified to reflect the revised timing of the regulatory period. AusNet Services has agreed to this approach and therefore adopts it in full in this proposal.

The revised approach is as follows:

- Revenues in the extension period include 10% of the prevailing cost of debt estimated for the 1 January – 30 June 2021 extension period
- Thereafter, revenues incorporate a trailing average cost of debt over an 11 year period, with a 5% weighting applied to both the debt estimate for the extension period and the first (i.e. least recent) observation.
- This continues until the 2030-31 regulatory period, at which point the trailing average reverts to an equally weighted, 10 year average.

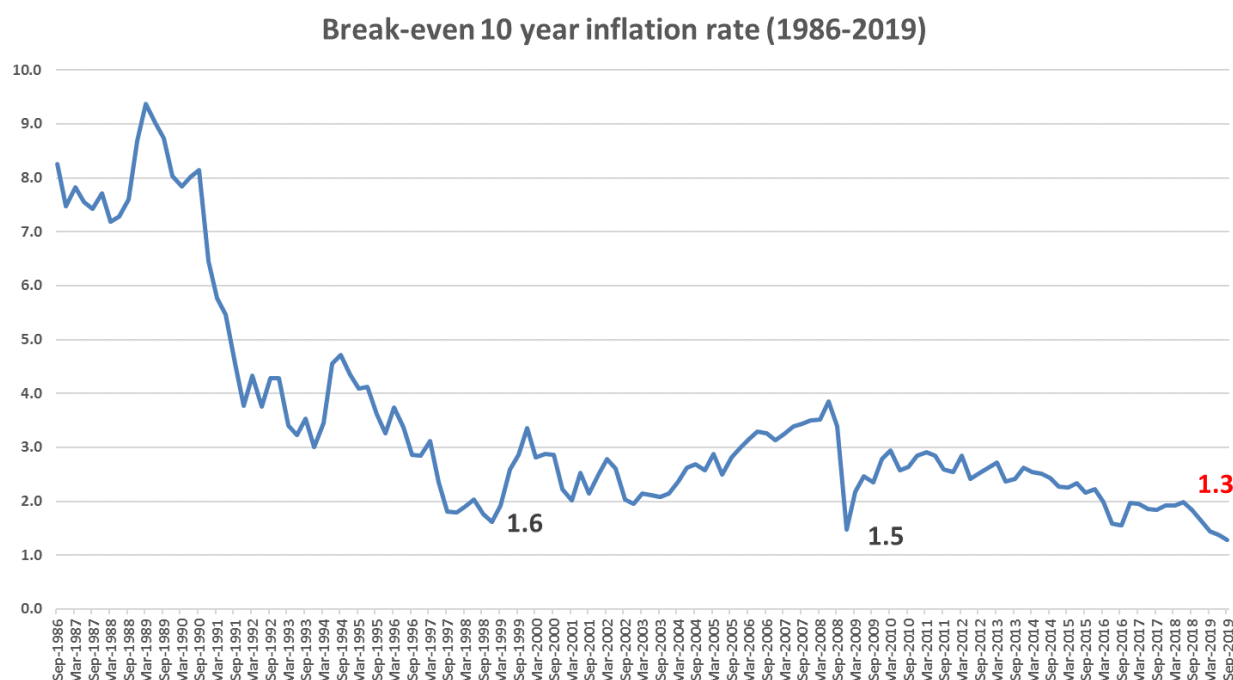
## 2.2 Expected Inflation

As set out in its 2022-26 Revenue Proposal, in common with other network businesses and Energy Networks Australia, AusNet Services considers that the AER should review its inflation forecasting approach as soon as possible, as the current approach continues to deliver outcomes that are significantly higher than those of the expectations of market participants. This has been the case for some time and there is no reason to believe that this will change in the near future. The result of this is to deliver a real rate of return that is materially below that required by investors. In addition, the impacts of RAB indexation at the rate of inflation forecast by the AER result in negative profits over the next regulatory period.

While this proposal adopts forecast inflation as per the 2016-20 determination, it is worth noting that throughout the first four years of this period the break-even inflation rate (the difference between 10 year nominal and inflation indexed bond yields) and market expectations have consistently been at or below 2.0%. Over 2019 there has been a rapid decline in market inflation

<sup>2</sup> This assumes the transition period has been completed. For AusNet Services, the transition path set out in the AER's 2013 Rate of Return Guideline will continue until 2026. However, this does not impact the modifications to the trailing average cost of debt required due to the change in the timing of the regulatory control period.

expectations and this is now very materially below the 2.32% adopted by the AER in Ausnet Services' final determination for 2016-20.



Source: ENA; RBA, Average annual inflation rate implied by the difference between 10-year nominal bond yield and 10-year inflation indexed bond yield; End-quarter observation

While the AER reviewed its approach in 2017, since the review inflation expectations continue to be consistently below the results of the AER's forecasting approach. As such, we strongly support another review of the AER's inflation approach, which aims to amend the AER's methodology to adopt one which leads to a forecast of inflation that is commensurate with the expectations of market participants, and therefore appropriately adjusts the nominal rate of return set by the 2018 Rate of Return Instrument.

Actual inflation to be applied in the regulatory roll forward modelling for the extension period will become known in July 2020, prior to the AER finalising its decision on extension period revenues. It is therefore logical that the AER should also adopt this estimate in its PTRM modelling. This ensures that the framework overall will deliver the nominal rate of return over the 6 month period, as set by the 2018 Rate of Return Instrument.

If the AER's forecast of inflation is applied, rather than the actual inflation input that will be adopted in the modelling, windfall losses for consumers or distributors will be knowingly embedded in revenues. In addition, locking in a known windfall gain or loss for distributors will distort investment incentives, which would be contrary to the National Electricity Objective.

## 2.3 Capital Expenditure

The capital expenditure allowance adopted for the extension period is the 2020 allowance, halved. This is calculated in the table below.

**Table 2-2: Gross Capital Expenditure Allowance (\$m real \$2020)**

	Amount
Gross Capex allowance \$2015	417.71
Adding Escalation to \$2020	452.80

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**Extension Period Revenues (1 January – 30 June 2021)**


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Half gross capex allowance	226.40
Plus equity raising costs	227.71

**Table 2-2: Metering Services – Capital Expenditure Allowance (\$m real \$2020)**

Amount	
Capex allowance \$2015	6.37
Adding Escalation to \$2020	6.90
Half capex allowance	3.45

**2.4 Operating Expenditure**

The operating expenditure allowance adopted for the extension period is the 2020 allowance, escalated by the rate of change applied in 2020 in the 2016-20 decision and escalated into real \$2020, halved. This is calculated in the table below.

**Table 2-2: Operating Expenditure Allowance (\$m real \$2020)**

Amount	
Opex allowance \$2015 (excluding Debt Raising Costs (DRC) and Demand Management Incentive Allowance (DMIA))	242.78
Plus Rate of Change	247.97
Plus Escalation to \$2020	269.70
Half opex allowance (Excluding DRC and DMIA)	134.85
Debt raising costs	2.33
Half Opex Allowance	137.18

The Rate of Change applied was 2.14%, which was the rate of change in AusNet Services approved opex model for the year 2020. As the rate of change applied in the last year of the current regulatory period, this is the best forecast available for the 2021 half year.

Debt raising costs have been calculated in the PTRM in accordance with the AER's benchmark methodology.

**Table 2-2: Metering Services – Operating Expenditure Allowance (\$m real \$2020)**

Amount	
Opex allowance \$2015	15.27

Plus Rate of Change	14.20
Plus Escalation to \$2020	15.39
Half opex allowance	7.70

## 2.5 Depreciation

The depreciation approach for both standard control and metering services is based on the existing asset classes, lives and methods adopted in the 2016-20 decision.

This has been calculated through the AER's adjusted PTRM for the 6 month period. For metering services, actual depreciation has been used.

## 2.6 Tax

The 2016-20 tax forecasting approach for both standard control and metering services has been adopted, as per the AER's interim measures and the 6 month PTRM issued by the AER.

The value of imputation credits adopted is 0.585 in accordance with the 2018 Rate of Return Instrument.

## 2.7 Revenue Adjustments

The revenue adjustments for standard control services are set out below.

The payment of incentive scheme revenue due to expenditure efficiencies achieved over the 2016-20 period has been deferred until 1 July 2021.

**Table 2-3: Breakdown of Revenue Adjustments (\$m real \$2020)**

Building Block	Revenue	Approach
Efficiency Benefit Sharing Scheme (EBSS) increments	0.9	The AER's revised EBSS approach has been adopted.  This subtracts half of the actual incremental gain made in 2015. Otherwise the actual incremental gain made in 2015 would be retained for 5.5 years through the opex forecast, rather than 5
Demand Management Incentive Allowance	0.3	Half of the annual allowance for 2016-20, of \$600k based on the AER's 2009 Victorian Demand Management Incentive Scheme
Shared Assets	-0.3	Half of the annual shared asset revenue reduction applied to 2016-20 revenues, escalated to \$2020.  This is calculated based on the AER's 2013 Shared Asset Guideline
<b>Total</b>	<b>1.0</b>	<b>N/A</b>

Source: AND Distribution PTRM – Version 3 – Extension Period

There are no revenue adjustments for metering services.

### 3 Price Control Formula

AusNet Services received guidance from the AER on 2 December 2020 relating to the price control formula for the extension period. This is copied below.

The SCS revenue cap will be as set in the amended PTRM, with no other factors applied:

$$TAR_t \geq \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij} \quad TAR_t = AR_t$$

The metering revenue cap will be as set in the amended PTRM, with no other factors applied:

$$TARM_t \geq \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij} \quad TARM_t = AR_t$$

The SCS and metering side constraint will be just CPI and the 2% allowance:

$$\frac{\left( \sum_{i=1}^n \sum_{j=1}^m d_t^{ij} q_t^{ij} \right)}{\left( \sum_{i=1}^n \sum_{j=1}^m d_{t-1}^{ij} q_t^{ij} \right)} \leq (1 + \Delta CPI_t) \times (1 + 2\%)$$

Type 7 metering will be escalated for CPI:

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i (1 + \Delta CPI_t)$$

ANS will be escalated for CPI and x-factor.

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i (1 + \Delta CPI_t)(1 - X_t)$$

Metering exit fees and public lighting prices will not be escalated:

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i$$

Notes:

$$\Delta CPI_t = \frac{CPI_{Jun\ t-1}}{CPI_{Jun\ t-2}} - 1$$

- CPI for the extended period will be measured as
- No amounts for incentive schemes, cost pass-throughs, or licence fees will be incorporated into revenue for the extended period
- Unders/overs accounts will not be included for the extended period.
- The x-factor for ANS is intended to reflect an updated labour escalation forecast for the extended period and will be calculated in line with the calculation of the 21-25 draft decision. This should reflect half of the forecast yearly change in the State utilities sector real wages for Victoria for 21-22.



AusNet Services accepts with this guidance with one exception. The eastern Victorian bushfires that occurred in late 2019 and early 2020 resulted in extensive damage to its network. These bushfires were ongoing at the time of submission. AusNet Services expects to submit a cost pass through application<sup>3</sup> in relation to costs resulting from these fires. Should this be submitted by AusNet Services and a decision made by the AER in advance of AusNet Services' pricing proposal for the extension period being submitted at the end of September 2020, it would be desirable to include cost pass through revenue in the price control formula for the extension period. This is because it would smooth price outcomes for customers and enable AusNet Services to recover costs closer to when they were incurred.

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<sup>3</sup> Under the nominated 'Natural Disaster' pass through event included in its 2016-20 determination

## 4 Operation of Incentive Schemes

### 4.1 Expenditure Efficiency Incentive Schemes

#### 4.1.1 EBSS

The Efficiency Benefit Sharing Scheme, which provides businesses with a continuous, strong incentive to make opex efficiency savings, sharing the benefits with customers, will apply during the extension period. During this period, AusNet Services' benchmark opex which is the baseline for the scheme, is \$130.4m. This is calculated in accordance with the tables below)

**Table 4-2: Operating Expenditure for EBSS (\$m real \$2020)**

	Amount
Opex allowance	137.18
Less GSLs (half allowance)	2.33
Opex allowance for EBSS	134.85

#### 4.1.2 CESS

The Capital Expenditure Sharing Scheme will not apply in the extension period.

### 4.2 Reliability Incentive Schemes

#### 4.2.1 Service Target Performance Incentive Scheme

AusNet Services proposes that version 1.0 of the STPIS operates in the extension period with minimal adjustments.

We have re-calculated targets for SAIDI, SAIFI and MAIFI based on the first six months of 2010, 2011, 2012, 2013 and 2014.<sup>4</sup> We have applied the STPIS adjustments for animal proofing capex that the AER approved in its final decision for 2020 to these targets. We have halved the forecast improvement in 2020 to make it match a six month target for the period. We consider the telephone answering parameter is not materially impacted by seasonality and so have not proposed to alter the target for this parameter in the six month period. We propose that the incentive rates from 2016-20 regulatory period apply unaltered in this six month period.

<sup>4</sup> ASD - STPIS Extension period calculation.xls

Table 4-4: Proposed STPIS Targets and Incentive Rates for 1 January to 30 June 2021

Measure	Average Historic Performance (6 months)	Modification	Proposed Targets	Proposed Incentive Rates
<b>USAIDI</b>				<b>(%/minute)</b>
Urban	39.46	0.70	38.76	0.0207
Rural short	91.28	1.00	90.28	0.0161
Rural long	113.52	1.40	112.12	0.0074
<b>USAIFI</b>				<b>(%/0.01 Interruptions)</b>
Urban	0.55	0.01	0.54	1.5872
Rural short	1.16	0.02	1.14	1.4396
Rural long	1.43	0.02	1.41	0.6618
<b>MAIFI</b>				<b>(%/0.01 Interruptions)</b>
<b>Urban</b>				
Rural short	1.48	0.00	1.48	0.1270
Rural long	3.09	0.01	3.08	0.1152
Telephone answering	6.04	0.01	6.02	0.0529
Percentage of calls will be answered within 30 seconds	80.330		80.330	-0.040

Source: AusNet Services

#### 4.2.2 Guaranteed Service Levels

The Guaranteed Service Level Scheme set by the Victorian Essential Services Commission will continue to apply. The scheme is currently under review as part of the review of the Electricity Distribution Code. If the new scheme is developed in time, it is expected that this will apply during the extension period.

#### 4.3 F Factor

The F-Factor scheme set by the Victorian Essential Services Commission will continue to apply. In accordance with the AER's proposed price control formula, any revenue increments or decrements will not be applied in the six month period.