Gas Access Arrangement Review 2018-2022:

Revised Access Arrangement Information

Submitted: 11 August 2017

About AusNet Services

AusNet Services is a major energy network business that owns and operates key regulated electricity transmission and electricity and gas distribution assets located in Victoria, Australia. These assets include:

- A 6,574 kilometre electricity transmission network that services all electricity consumers across Victoria;
- An electricity distribution network delivering electricity to approximately 680,000 customer connection points in an area of more than 80,000 square kilometres of eastern Victoria; and
- A gas distribution network delivering gas to approximately 665,000 customer supply points in an area of more than 60,000 square kilometres in central and western Victoria.

AusNet Services' purpose is 'to empower communities and their energy future.'

For more information visit: www.ausnetservices.com.au

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Revised Access Arrangement Information

Executive summary

On 16 December 2016, AusNet Services submitted to the Australian Energy Regulator (AER) its initial Access Arrangement (AA) Proposal for the 1 January 2018 to 31 December 2022 AA period. The AER published its Draft Decision on that proposal on 6 July 2017. This document sets out AusNet Services' response to the Draft Decision.

We are not challenging the AER's Draft Decision

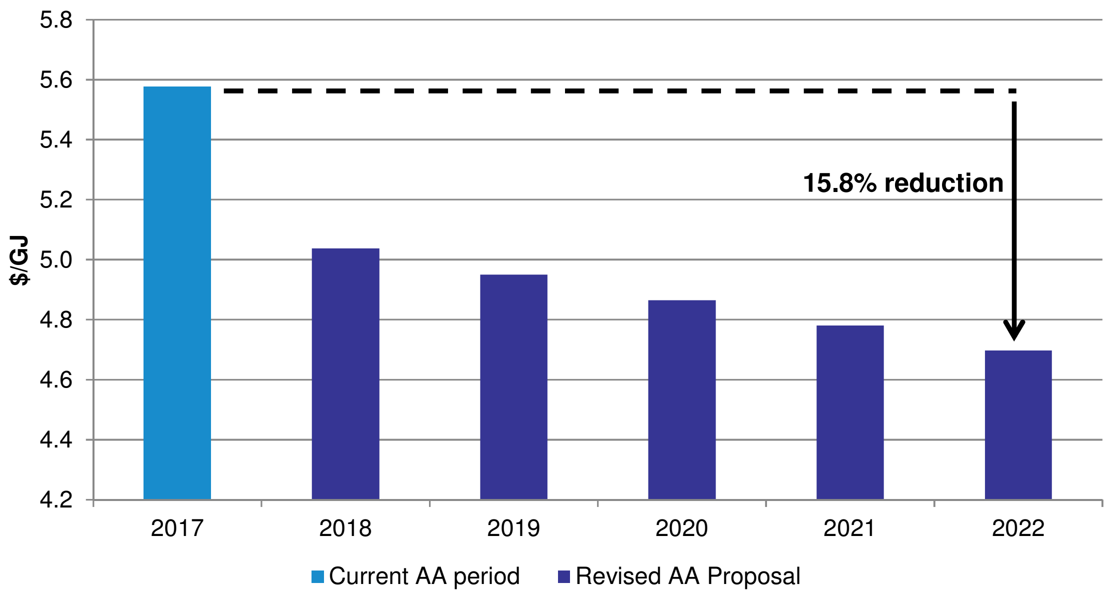
The AER's Draft Decision determined a total revenue requirement 9.4% lower than the revenues initially proposed by AusNet Services.

We believe customers would have benefited from our proposed gas marketing program and mains replacement volumes. However, AusNet Services considers the Draft Decision enables it to continue to provide safe, affordable and efficient gas distribution services. Therefore, it has decided to accept the Draft Decision for the 2018-22 AA period. This will provide increased certainty to customers on gas distribution charges over the next five years, and simplify and shorten the regulatory review process.

Our revised proposal provides price cuts to customers

Our revised proposal provides for a 9.7% real decrease in the distribution component of customer bills on 1 January 2018, followed by annual price cuts of 1.7% (see figure below). This translates to a total real reduction of **15.8%** across the five-year AA period. This reduction may help to moderate the impacts of current wholesale market conditions, which are placing upward pressure on our customers' overall gas costs.

Figure 1: AusNet Services' Revised AA Proposal price path (real $2017)



Source: AusNet Services

The price reductions shown above are subject to the following updates we expect the AER to make in its final decision:

- Updated financing costs to reflect interest rate movements; and
- The outcomes of the AER's current review of forecast inflation.

By incorporating updated demand forecasts, and lower than expected actual expenditure outcomes, this revised proposal offers greater price reductions than those set out in the Draft Decision. In particular, by updating our demand forecasts, we are able to spread the largely fixed costs of operating our network more widely across our customer base.

We will continue to manage our assets safely

Our initial proposal planned to remove over 410 kms of aged low pressure mains over the next five years in order to maintain the safety of the network. Even though the AER reduced our capital expenditure forecast to reflect a lower volume of mains replacement, AusNet Services remains confident that sufficient funding will be provided to allow completion of the LP mains replacement by the end of the subsequent access arrangement period in 2027.

Our commitment to safety is consistent with our customers' views that safety is of paramount importance to them, and reflects good industry practice. Our focus on completing the mains replacement program by 2025 is driven by the serious consequences that major gas leaks can have for public safety.

We have continued to listen to our customers

Our initial proposal was underpinned by a comprehensive research program that sought to understand the needs, wants and preferences of our customers. This included a range of engagement activities aimed at understanding our customers' attitudes to network investment and trade-offs between reliability and safety outcomes and operating costs. Over 700 customers and stakeholders participated in the program across a range of customer categories.

We are confident this revised proposal is consistent with the preferences expressed by our customers during these customer engagement activities, including that the operation of our network safely is the top priority for our customers, and that they expect us to be transparent around the drivers of future price changes.

As part of developing our revised proposal, we have provided regular website and email updates to our large customers and Customer Consultative Committee (CCC). In particular, we informed them of the details of the Draft Decision and notified them of our decision to accept it. We also consulted with our CCC on the customer-friendly summary document submitted with this RAAP. Finally, we met with a number of our largest customers to explain what accepting the Draft Decision will mean for future gas network charges. Customers were pleased to learn that, all else equal, our revised proposal would provide greater price reductions than those set out in the Draft Decision and, therefore, place downward pressure on their overall gas costs.

Conclusion

Our initial proposal sought to promote the long-term interests of its customers by meeting the immediate needs of the network and continuing to provide efficient gas services in a prudent, safe and reliable manner.

This revised proposal remains consistent with those priorities and the objectives set out in our initial proposal, and will enable us to provide our consumers with efficient and low cost gas pipeline services.

Introduction

On 16 December 2016, AusNet Services submitted to the Australian Energy Regulator (AER) its Access Arrangement (AA) Proposal for the 1 January 2018 to 31 December 2022 AA period. The AER published its Draft Decision on that proposal on 6 July 2017.

This document, together with the accompanying Revised AA and supporting attachments, constitutes AusNet Services' Revised AA Proposal (RAAP). It has been prepared in accordance with the National Gas Rules (NGR). The RAAP responds to the Draft Decision and updates our AA Proposal for new information.

The AER's Draft Decision

The AER's Draft Decision accepted many aspects of our AA Proposal, including most elements of our capital expenditure forecast, our proposed contingent capital expenditure sharing scheme (CESS), our demand forecasting approach, our proposed changes to calculating regulatory and tax depreciation, and our pricing methodology.

However, the Draft Decision also set out a number of revisions to our AA Proposal, which the AER required we make to our AA Proposal in order to receive its approval. The key revisions sought by the AER are to (all amounts are expressed in real 2017 dollars):

- Reduce the volume of low pressure mains replacement from the 410 kilometres proposed by AusNet Services to 350 kilometres, decreasing the capital expenditure forecast by $16M;
- Remove the proposed gas marketing operating expenditure step change, decreasing the operating expenditure forecast by $22M;
- Calculate output growth operating expenditure based on different data, decreasing the operating expenditure forecast by $8M;
- Apply the AER's preferred gamma value of 0.40;
- Apply the AER's preferred approach to estimating expected inflation; and
- Apply the AER's Guideline approach to setting the Rate of Return;

Overall, the Draft Decision determined a nominal smoothed revenue requirement that was 9.4% lower than the revenues proposed by AusNet Services.

We have reviewed the Draft Decision thoroughly to determine its impacts on our customers, and its implications for our ability to recover our efficient costs during the forthcoming AA period.

While we have some concerns regarding some aspects of the Draft Decision, we recognise the merits of aligning our RAAP and the Draft Decision in relation to issues that are being reviewed in separate processes, have been addressed by the AER in recent regulatory determinations, or are not material. In particular, we consider the upcoming review of the Rate of Return Guideline is the most appropriate process for this topic to be re-examined.

For these reasons, AusNet Services accepts the Draft Decision. This will allow us to focus on delivering safe and efficient gas pipeline services and provide certainty to our customers and investors.

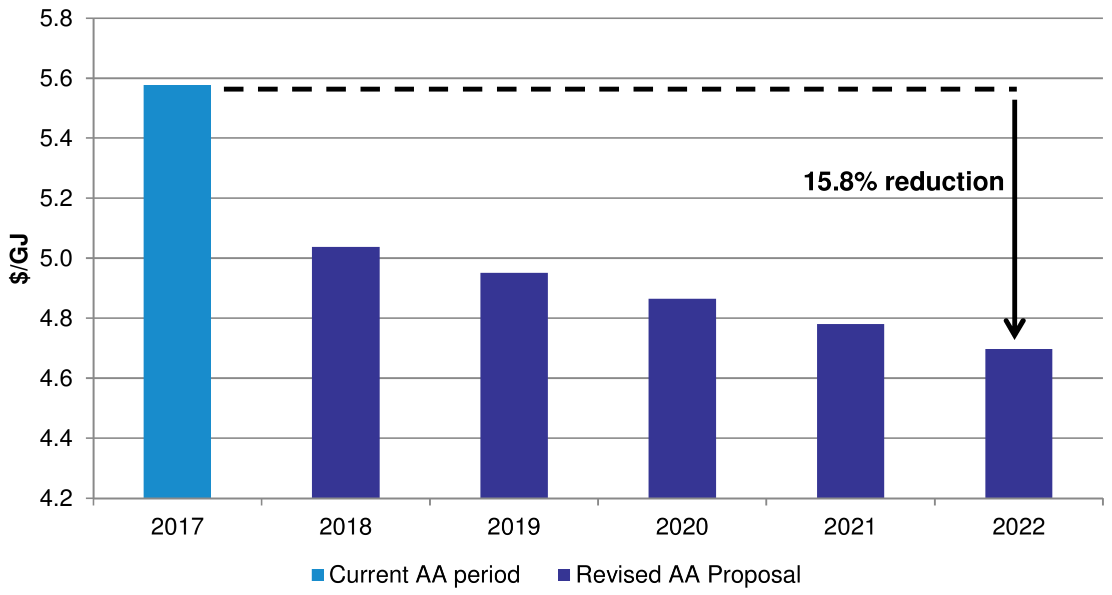
This Revised Access Arrangement Proposal

As we have accepted the Draft Decision, the Revised AA submitted in conjunction with this proposal reflects the required revisions. Appendix 1A details where each of the AER's revisions is reflected in this RAAP.

Importantly, AusNet Services' RAAP is consistent with the priorities and the objectives set out in the AA Proposal, and will continue to provide our consumers with efficient and low cost gas pipeline services.

Total forecast revenues in this RAAP are $1,036M (nominal), a reduction of 0.8% on the Draft Decision and a reduction of 9.4% on our initial AA Proposal. Importantly, this RAAP provides a 9.7% real decrease in the distribution component of customer bills for customers on 1 January 2018, followed by annual price cuts of 1.7% (see figure below). This translates to a total real reduction of **15.8%** across the five-year AA period.

Figure 2: AusNet Services' Revised AA Proposal price path (real $2017)



Source: AusNet Services

The greater price reductions offered by this RAAP compared to the Draft Decision largely reflects lower than forecast expenditure in the current AA period. The price reductions also reflect our updated forecast of demand, which will allow for the largely fixed costs of operating our network to be spread more widely across a larger customer base.

We expect that the AER's final decision, and hence the above price path, will incorporate the following further updates:

- A revised rate of return based on our actual equity averaging period; and
- The outcomes of the AER's current inflation review.

The following sections provide further detail on the contents of this RAAP.

Updates to reflect new information

We have updated a number of aspects of our AA Proposal to reflect new information, as requested by the AER. Specifically, we have updated:

- The demand forecasts to account for the most recent data;
- The operating and capital expenditure forecasts to reflect the updated demand forecast;
- The opening capital base to reflect actual 2016 capital expenditure and a revised estimate of 2017 expenditure.
- The estimate of expected inflation forecast to take account of the Reserve Bank of Australia's most recent short-term inflation forecasts; and
- Our proposed tariffs to reflect:
    - The revisions set out in the Draft Decision; and
    - The updates listed above.

These updates are discussed further below.

Further information for the AER's consideration

For some matters, while we accept the Draft Decision we have provided further information that we invite the AER to consider as part of its final decision. These are:

- The methodology for forecasting output growth expenditure, particularly whether a consistent approach should be applied for gas distribution networks, given each network's opex growth is driven by the same factors;
- Alternative drafting for the Retailer Insolvency Event cost pass through event definition; and
- Multinet Gas' proposed fixed principle to address the 'dead zone' cost pass through issue, which we request the AER apply in our final decision.

While we have reflected the two cost pass through related suggestions in our Revised AA, we have maintained the Draft Decision's approach to output growth in this RAAP's opex forecast.

Each of these issues is discussed further in the sections below.

Issues for future consideration

As noted above, we have reservations in relation to some aspects of the Draft Decision. These are the AER's:

- Reasons for rejecting our proposed gas marketing step change; and
- Approach to calculating some elements of the rate of return, and the value of imputation credits (gamma).

Nevertheless, we consider these concerns can be raised in other forums and should not diminish the benefits of accepting the Draft Decision, namely providing increased certainty to customers and simplifying the regulatory process.

For completeness, these issues are discussed briefly in the sections below.

Customer engagement

As part of developing this RAAP, we have provided regular website and email updates to our large customers and Customer Consultative Committee (CCC). In particular, we informed them of the details of the Draft Decision and notified them of our decision to accept it. We also consulted with our CCC on the customer-friendly summary document submitted with this RAAP. Finally, we met with a number of our largest customers to explain what accepting the Draft Decision will mean for future gas network charges. Customers were pleased to learn that, all else equal, our revised proposal would provide greater price reductions than those set out in the Draft Decision and, therefore, place downward pressure on their overall gas costs.

We also note that our initial Proposal was underpinned by a comprehensive research program that sought to understand the needs, wants and preferences of our gas customers. For instance, customers revealed that safety is of paramount importance to them, and they expect AusNet Services to manage its network in a way that ensures high levels of safety in the future. We are confident this RAAP is consistent with the preferences expressed by our customers during our prior customer engagement activities.

Updates to reflect new information

The following aspects of the initial Proposal have been updated to reflect the most recent data:

- The demand forecasts to account for the most recent data, together with the operating and capital expenditure forecasts to ensure consistency with the updated demand forecasts;
- The opening capital base to reflect actual 2016 capital expenditure and a revised estimate of 2017 expenditure.
- The estimate of expected inflation forecast to take account of the Reserve Bank of Australia's most recent short-term inflation forecasts; and

- Our proposed tariffs to reflect
  - The revisions set out in the Draft Decision; and
  - The updates listed above.

Each of these updates is discussed below.

Demand forecasts

The Draft Decision accepted AusNet Services' demand forecasts, with the exception of the customer growth and demand driven by the proposed gas marketing program, which was not approved by the AER as part of its operating expenditure decision.

AusNet Services accepts the Draft Decision on demand forecasts. As requested by the AER, we have obtained updated forecasts of demand from The Centre for International Economics (CIE), which take account of information not available at the time the initial AA Proposal was submitted. Specifically, CIE's demand forecasts have been updated as follows:[1]

- The starting point for customer number projections has been updated and is now based on actual customer numbers and disconnections for 2016;
- Projections of actual customer numbers for 2017 and onwards have been updated using the dwelling approvals, commencements and completions data available from the ABS for the 2016/17 financial year to-date and Census 2016;
- The starting point for usage per customer forecasts has been updated from 2016 to 2017;
- Forecasts of usage per customer have been updated to account for the 2017 observations of gas prices and weather (using the Effective Degree Days metric); and
- Projections of Tariff D usage have been updated using AEMO's projections of Industrial gas demand in Victoria from the 2016 NGFR.

The AER encouraged us to incorporate the latest Victoria in Future (ViF) population growth forecasts in this RAAP. However, as a more recent ViF forecast is not presently available, we have been unable to update population growth forecasts.

A revised post-modelling adjustment for appliance switching has also been applied in the updated CIE forecasts, which we have adopted in this RAAP. We did not apply a post-modelling adjustment for appliance switching in our AA Proposal due to its impact on prices and the difficulty of precisely estimating appliance switching trends.[2]

As foreshadowed in our initial AA Proposal, as part of updating our demand forecasts we have revisited the drivers of future demand, including the need for an appliance switching post-modelling adjustment.[3] We now consider the best possible forecasts of demand should incorporate a post-modelling adjustment for appliance switching.

[1] CIE, *Update of 2018-22 GAAR consumption and customer forecasts*, August 2017

[2] AusNet Services, *Gas Access Arrangement Review 2018-2022: Access Arrangement Information*, December 2016, p.67

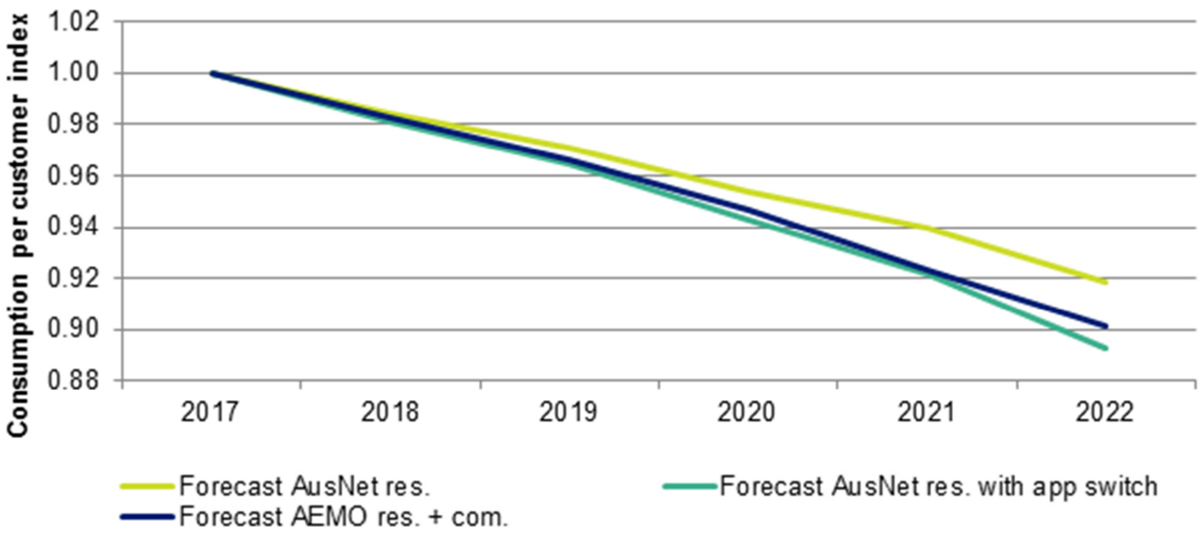
[3] AusNet Services, *Gas Access Arrangement Review 2018-2022: Access Arrangement Information*, December 2016, p.69

In particular, the revised forecasts are more robust **with** the post-modelling adjustment because they:

- Take into account the latest AEMO projections of the impact of appliance switching from the 2016 National Gas Forecasting Report (NGFR);
- Align more closely with AEMO's latest forecast of consumption per customer compared to:
  - The demand forecasts included in our AA Proposal; and
  - The revised forecasts *without* the post-modelling adjustment.

To demonstrate this, the figure below shows our revised forecasts of consumption per customer, with and without the post-modelling adjustment, as well as AEMO's latest projections. The forecasts have been converted to index form for ease of comparison.

Figure 3: CIE and AEMO forecasts, consumption per customer index, 2017-22



Source: CIE; AusNet Services analysis

The figure above shows that the revised forecasts *with* the appliance switching adjustment are more closely aligned to AEMO's forecast than the forecasts *without* the adjustment. Furthermore, CIE note that "during the GAAR forecasting period (2017–2022) the trend in the unadjusted forecasts is significantly weaker than the trend in NGFR 2016 forecasts."[4] CIE's report, which provides further detail on the updated demand forecasts, is provided as Appendix 2A.

Finally, we note that the impact of the post-modelling adjustment – a 1.6% reduction in total forecast consumption – is significantly less than in the original CIE forecasts, where the adjustment reduced total consumption by 4%. This reflects a refinement of CIE's expert view of the impact of appliance switching having regard to the most recent information on appliance switching trends, consistent with demand forecasting best practice.

For the reasons above, we consider the updated CIE forecasts that incorporate an appliance switching post-modelling adjustment are the best possible demand forecasts for the forthcoming AA period.

Accordingly, we have incorporated these forecasts into our RAAP. This has resulted in a decrease in total forecast usage of 0.9%, and an increase in forecast total gross connections of 10.7%. The large increase in gross connections reflects the use of recent, actual information on dwelling growth rates from the 2016 Census. In contrast, the original forecasts were based on

[4] CIE, *Update of 2018-22 GAAR consumption and customer forecasts*, August 2017, p.8

2016 ViF forecasts which due to timing, were based on projections of growth from 2011-16. Accordingly, the revised forecasts are considered more robust.

The table below compares the original and revised demand forecasts.

Table 1: Comparison of original and revised demand forecasts

	2015	2016	2017	2018	2019	2020	2021	2022
Residential consumption								
Original (GJ)	32.4	31.5	31.5	31.6	31.8	32.0	32.2	32.1
Revised (GJ)	32.4	31.7	31.6	31.7	31.9	31.9	32.0	31.6
Difference (%)	*0.0%*	*0.7%*	*0.2%*	*0.4%*	*0.3%*	*-0.3%*	*-0.6%*	*-1.4%*
Commercial consumption								
Original (GJ)	6.2	6.3	6.2	6.2	6.3	6.4	6.4	6.5
Revised (GJ)	6.2	6.1	6.1	6.1	6.1	6.1	6.1	6.1
Difference (%)	*0.0%*	*-2.5%*	*-3.0%*	*-2.3%*	*-2.4%*	*-4.2%*	*-4.2%*	*-5.1%*
Total new connections								
Original	14,666	13,613	15,254	15,927	16,167	16,457	16,787	16,296
Revised	14,666	17,472	16,859	17,647	17,946	18,302	18,705	17,791
Difference (%)	*0.0%*	*28.3%*	*10.5%*	*10.8%*	*11.0%*	*11.2%*	*11.4%*	*9.2%*

Source: AusNet Services; CIE

Note: the large variation in 2016 total connections reflects an update for actuals

Updating the demand forecasts has resulted in changes to other aspects of the RAAP. These changes relate to:

- The capital expenditure forecast, which has increased by $18M compared to the Draft Decision to reflect an increase in the volume of forecast new connections;
- The operating expenditure forecast, which has increased by $4M compared to the Draft Decision to reflect revised forecasts of energy throughput and the volume of forecast new connections; and
- Proposed tariffs, which have been revised to reflect the updated demand forecasts.

Opening capital base

AusNet Services has updated its opening capital base to reflect actual 2016 capital expenditure and a revised estimate of 2017 capital expenditure, as requested by the AER.

These updates have led to a reduction in the opening capital base of 0.7%, or $12M. The opening tax asset base has also been updated to reflect this change.

Inflation

The Draft Decision rejected AusNet Services' proposed estimate of expected inflation and instead applied an estimate based on the geometric average of 10 annual expected inflation rates, with the first two years reflecting the RBA's forecasts of inflation and the remaining eight years reflecting the mid-point of the RBA's inflation target band.

AusNet Services accepts the Draft Decision on inflation. However, we have updated the estimate of expected inflation to account for new information, as foreshadowed in the Draft Decision:[5]

[5] AER, *Draft Decision – AusNet Services gas access arrangement 2018 to 2022: Attachment 3*, July 2017, p.156

For this draft decision, only the first annual rate is based on an RBA inflation forecast. By the time we make our final decision, an RBA forecast for the second annual rate will be available and will be used.

As an RBA forecast is now available for the second year of the 10-year geometric average, this RAAP incorporates an estimate of expected inflation that reflects this information. This has led to an increase in the inflation forecast from 2.45% in the Draft Decision to 2.47%.

As noted by the AER, the regulatory treatment of inflation and the best estimate of expected inflation are currently being reviewed in a separate process.[6] We consider that the inflation review is the most appropriate process to determine which methodology produces the best estimate of expected inflation. We understand that the AER intends to reflect the outcomes of that review in the final decision, in line with good regulatory practice.

Tariffs

We have revised the tariffs set out in our AA Proposal to be consistent with this RAAP. Specifically, we have revised our proposed tariffs to reflect the revisions set out in the Draft Decision, as well as the following updates the AER requested we make:

- Demand forecasts;
- Forecasts of capital and operating expenditure, to reflect the updated demand forecasts;
- The opening capital base and tax asset base; and
- The estimate of expected inflation.

Our revised tariffs are set out in the Revised AA submitted with this proposal. The table below compares the RAAP's X factors and price changes with those set out in the Draft Decision. The RAAP provides for a total real price reduction of 15.8% across the next AA period, compared with the Draft Decision's 12.9% reduction.

Table 2: RAAP and Draft Decision X factors and nominal price changes

	2018	2019	2020	2021	2022	Cumulative change
Revised Access Arrangement Proposal						
X factor	9.68%	1.73%	1.73%	1.73%	1.73%	**15.8%**
Nominal price change	-7.45%	0.69%	0.69%	0.69%	0.69%	**-4.9%**
Draft Decision						
X factor	9.68%	0.90%	0.90%	0.90%	0.90%	**12.9%**
Nominal price change	-7.47%	1.53%	1.53%	1.53%	1.53%	**-1.7%**

Source: AusNet Services; AER Draft Decision. Note: Positive X factors represent real price reductions

Further information for the AER's consideration

For some matters, while we accept the Draft Decision we have provided further information that we invite the AER to consider as part of its final decision. These are:

- Output growth;

[6] AER, *Draft Decision – AusNet Services gas access arrangement 2018 to 2022: Attachment 3*, July 2017, p.157

- The Retailer Insolvency Event cost pass through event; and
- A fixed principle addressing the ‘dead zone’ cost pass through issue.

While we have reflected the two cost pass through related suggestions in our Revised AA, we have maintained the Draft Decision’s approach to output growth in this RAAP’s opex forecast.

Output growth

We consider that a consistent output growth methodology should be applied to gas distributors, in line with the AER’s practice in its recent determinations for electricity distribution and transmission networks. This is because gas distributors are likely to face the same opex cost drivers. While the AER has not developed a standard output cost function for gas distributors, as it has for electricity networks, recent Economic Insights econometric analysis shows that network length and customer numbers are the most robust measures of output growth. Accordingly, we have reassessed our initial approach (described below) and support an alternative output growth methodology that relies on network length and customer numbers.

AusNet Services’ approach to forecasting output growth in the initial AA proposal was consistent with the methodology used for the current AA period, which used a composite growth rate of gas throughput and customer numbers.

To assess each distributor’s output growth proposal, the AER determined a ‘reasonable range’ for each distributor using cost functions estimated by Economic Insights and ACIL Allen. By also taking account of the forecast productivity growth from these cost functions, the reasonable ranges reflected output growth net of productivity growth. The AER considered that the output growth rate produced by our proposed methodology fell outside the reasonable range it had determined for AusNet Services. On that basis, the AER did not accept our forecast output growth opex.

The AER also identified that forecast gas throughput for industrial customers had been excluded from our proposed output growth calculation and corrected this oversight in its Draft Decision. This correction reduced output growth opex from the $11.7M we proposed to $2.3M. The AER’s approach to applying the rate of change to final year opex, rather than base year opex, also contributed to this reduction.

We recognise the Draft Decision accepted the output growth methodology featured in our AA proposal, subject to data corrections and its different way of applying the rate of change. We also recognise that total gas throughput should be used when applying this approach.

Accordingly, we accept the Draft Decision on output growth. However, we have updated the energy throughput and customer number forecasts to reflect our updated demand forecasts (discussed in the section below). Importantly, the revised output growth rate also falls within the AER’s reasonable range.

We note that Multinet Gas and AGN proposed different output growth methodologies and, given that common factors are likely to drive the costs of the Victorian gas distributors, we consider there is merit in applying a consistent approach. This has been the AER’s practice in its recent determinations for electricity distribution and transmission networks, recognising that more work has taken place to develop robust cost functions for electricity networks

We also note that AusNet Services was the only network to propose energy throughput as an opex driver. However, Economic Insights, in a report prepared for Multinet Gas, stated:[7]

> *The conclusions of this study in regard to the significance of outputs are as follows:*
>
> - *gas throughput is not a statistically significant determinant of real opex;*
> - *network length is a statistically significant determinant of real opex; and*

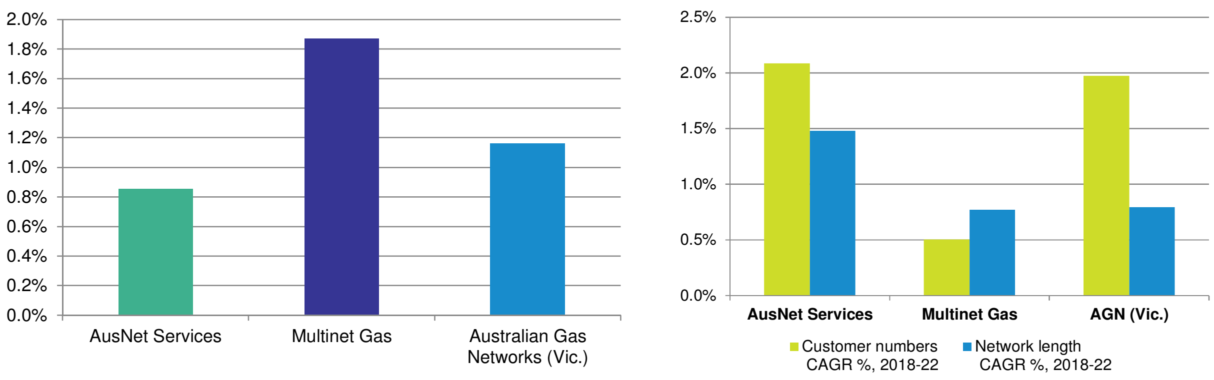
[7] Economic Insights, *Gas Distribution Businesses opex cost function*, August 2016, p. ii

- *customer numbers are a statistically significant determinant of real opex.*

Having considered this analysis, we agree that network length and customer numbers are the most robust proxies for gas distribution output, and that energy throughput is a less relevant measure. This is supported by the recent econometric analysis performed by Economic Insights. Therefore, we consider that Multinet Gas' approach, which formed a composite index of customer numbers and network length, is a more robust methodology than the methodology we originally proposed.

In light of this, the output growth expenditure approved for the three Victorian distributors appears out of step with the cost driver growth each distributor has projected. This is demonstrated by the figures below, which compare output growth expenditure approved in the AER's draft decisions (measured as a proportion of total opex), with each distributor's projected growth in customer numbers and network length.

Figure 4: Approved output growth expenditure (%) vs. projected growth in output cost drivers (%)



Source: AER draft decisions and opex models; distributor opex models and reset RINs; AusNet Services analysis

Note: Projected growth in output cost drivers is measured as the compound annual average growth rate from 2018-22.

All else equal, one would expect distributors with a higher forecast growth rate in the common cost drivers (customer numbers and network length) to incur higher efficient expenditure due to output growth during the next AA period. However, the output growth expenditure approved for AusNet Services in the Draft Decision is relatively low, despite the high growth rates expected for our customer numbers and network length.

Accordingly, we would welcome the AER's reconsideration of the use of a consistent output growth methodology, and its consideration of applying an approach based solely on customer numbers and network length, such as the approach approved for Multinet Gas, in its final decision for AusNet Services.

Appendix 3A provides a forecast of output growth calculated in accordance with this approach. This forecast is net of productivity growth, where productivity growth has been forecast using a weighted average of the four productivity forecasts implicit in the AER's reasonable range analysis.

Retailer Insolvency Event

The Draft Decision required AusNet Services to replace the Declared Retailer of Last Resort (RoLR) Event with the Retailer Insolvency Event. The proposed cost pass through event was intended to allow AusNet Services to recover the costs arising from a retailer becoming insolvent, including billed but unpaid charges, unbilled charges and other costs incurred or likely to be incurred as a result of the insolvency, therefore placing AusNet Services in an equivalent position to gas distributors in NECF jurisdictions.

We invite the AER to consider alternative drafting that would ensure the pass through event gives full effect to the AER's stated intention of placing AusNet Services in an equivalent position to gas distributors in NECF jurisdictions. For completeness, we have reflected the alternative drafting in the Revised AA submitted with this RAAP.

Table 3: Retailer Insolvency Event, alternative drafting for AER consideration

Draft Decision definition	Alternative definition
Retailer Insolvency Event means the occurrence of an event where: (a) a Retailer of Last Resort (RoLR) Event as defined in section122 of the National Energy Retail Law has occurred; and (b) Service Provider incurs costs in responding to the RoLR event in accordance with its obligations under the NERL, NERR, NGL or NGR (including Guidelines and procedures that are binding under those instruments), and (c) the costs are not recoverable by Service Provider under other provisions of the NERL, NERR, NGL or NGR as in force at the time of the event, including but not limited to rule 531 of the NGR and other pass through events in this Access Arrangement. Note for the avoidance of doubt, in making a determination on a Retailer Insolvency Event, the AER will have regard to, amongst other things, the extent to which Service Provider has taken steps to minimise the costs associated with its responsibilities in a RoLR Event, both prior to, and after, the RoLR Event was triggered.	Until such time as the National Energy Retail Law set out in the Schedule to the National Energy Retail Law (South Australia) Act 2011 of South Australia is applied as a law of Victoria, retailer insolvency event has the meaning set out in the National Gas Rules as in force from time to time, except that: (a) where used in the definition of 'retailer insolvency event' in the National Gas Rules, the term 'retailer' means the holder of a licence to sell gas under the Gas Industry Act 2001 (Vic); and (b) other terms used in the definition of retailer insolvency event in the Rules as a consequence of amendments made to that definition from time to time, which would otherwise take their meaning by reference to provisions of the National Gas Law, the National Gas Rules or National Energy Retail Law not in force in Victoria, take their ordinary meaning and natural meaning, or their technical meaning (as the case may be). Note: This retailer insolvency event will cease to apply as a Relevant Pass Through Event on commencement of the National Energy Retail Law in Victoria.

Source: AER Draft Decision; AusNet Services

Fixed principles

AusNet Services accepts the Draft Decision on fixed principles.

We note that the AER's Draft Decision for Multinet Gas approved Multinet's proposed fixed principle to address the 'dead zone' issue, which is not present in Multinet's AA for the current AA period.[8] This issue arises where the timing of a cost pass through event impacts a network's ability to recover the related costs. For consistency, we request that the AER apply this same fixed principle in its final decision for AusNet Services.

For completeness, we have included this fixed principle in the Revised AA submitted with this RAAP.

Issues for future consideration

Notwithstanding our decision to accept the Draft Decision, we have reservations in relation to some aspects of it. These are the AER's:

- Reasons for rejecting our proposed gas marketing step change; and
- Approach to calculating some elements of the rate of return, and the corporate tax allowance.

[8] AER, *Draft Decision – MultiNet gas gas access arrangement 2018 to 2022: Attachment 10*, July 2017, p.13

Despite our concerns in respect of these issues, we have adopted the Draft Decision to provide certainty to customers and simplify the regulatory process. For completeness, each of these issues is briefly discussed below.

Gas marketing program

The gas marketing program step change was proposed to facilitate a joint gas marketing program with the other two Victorian gas distributors. Based on modelling conducted by AusNet Services and Axiom Economics, the program was projected to result in price reductions in future access arrangement periods, by increasing the customer base over which fixed costs would be spread.

The Draft Decision rejected the proposed operating expenditure step change of $22M for a number of reasons, including that:[9]

- AusNet Services would be financially better off not investing in gas marketing, with or without a step change;
- The AER was not satisfied that the marketing campaign is likely to benefit consumers; and
- The NPV modelling supporting the program included some unrealistic assumptions that overstated the benefits of the program.

We recognise that further work may be required to better understand the benefits, for both AusNet Services and its customers, of a joint gas marketing campaign. On this basis, we are not challenging the Draft Decision on gas marketing.

However, we note that a number of other gas distributors have established gas marketing programs, indicating that these programs may be more commercially viable than the Draft Decision concludes. In addition, for businesses which currently do not have established gas marketing programs, initiating one in the absence of a step change is likely to result in a substantial unfunded expense until the next access arrangement commences, and potentially a penalty under the EBSS.

AusNet Services considers the potential benefits of gas marketing and the appropriate treatment of this expense under the regulatory framework warrant further investigation. There would be value in further engagement with the AER and other stakeholders on this topic. This could include exploration of alternative regulatory mechanisms to facilitate gas marketing expenditure, such as capitalising this expenditure to moderate its short-term price impacts.

Rate of Return and Corporate Tax Allowance

The Draft Decision rejected a number of aspects of our rate of return proposal, instead applying the approach set out in the AER's Rate of Return Guideline. Specifically, the AER rejected our proposal to:

- Apply a Market Risk Premium (MRP) of 7.5%;
- Use the RBA curve exclusively to measure the return on debt; and
- Estimate expected inflation using the breakeven approach.

The AER also rejected our proposed value of imputation credits (gamma) of 0.25, an input into calculating the corporate tax allowance.

While we remain of the view that the approaches set out in our initial AA proposal yield more accurate estimates, we accept the revisions required by the Draft Decision on the rate of return and gamma. We consider the upcoming review of the Rate of Return Guideline is the most appropriate process in which to continue the debate about these issues, as well as the AER's broader approach to setting the rate of return.

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[9] AER, *Draft Decision – AusNet Services gas access arrangement 2018 to 2022: Attachment 7*, July 2017, pp.26-32

Finally, as noted by the AER, the regulatory treatment of inflation and the best estimate of expected inflation are currently being reviewed in a separate process.[10] We consider that the inflation review is the most appropriate process to determine which methodology produces the best estimate of expected inflation. We expect the conclusion of the review will be applied in the AER's final decision.

Structure of this Revised AA Proposal

This Revised AA Proposal comprises:

- A Revised Access Arrangement Information (this document);
- A customer-friendly summary of this RAAP;
- A Revised Access Arrangement, including Terms and Conditions;
- A Summary Table of AA revisions (Appendix 1A);
- The following new appendices:
  - A CIE report on its updated demand forecasts (Appendix 2A);
  - Alternative output growth calculations (Appendix 3A);
- Updated regulatory models;
- A revised RIN template reflecting the updated demand forecasts;
- An updated Rules Compliance Checklist; and
- Our Initial AA Proposal (not submitted with this RAAP for the purposes of brevity), including its attachments and supporting documents.

All information contained in this RAAP supersedes information previously provided in the Initial AA Proposal, to the extent that there is any conflict.

[10] AER, *Draft Decision – AusNet Services gas access arrangement 2018 to 2022: Attachment 3*, July 2017, p.157