Explanatory Statement

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

AUSTRALIAN ENERGY REGULATOR

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Amendment Record

Version	Date	Pages
1.0	October 2021	12

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Shortened Forms

Shortened form	Extended form
2018 Instrument	2018 Rate of return instrument
AER	Australian Energy Regulator
CY	Calendar year (i.e. from 1 January to 31 December)
Applicable access arrangement extension period	The extension period from 1 January 2023 to 30 June 2023 of the 2018-2022 access arrangements for the Victorian gas distribution network service providers
DNSPs	Distribution network service provider
FY	Financial year (i.e. from 1 July to 30 June)
NGL	National Gas Law
NELA	National Energy Legislation Amendment Act 2020 (Vic)
NGVA	National Gas (Victoria) Act 2008 (Vic)
RBA	Reserve Bank of Australia
Vic	Victoria

1 Overview

This is the explanatory statement to the modified 2018 Rate of Return Instrument (2018 Instrument) as it applies to the 6 month extension period of the 2018–2022 access arrangements for the Victorian gas distribution networks (the Modified Instrument).[1] It should be read in conjunction with that document.

We explain the following:[2]

- the move from a calendar year access arrangement period to a financial year access arrangement period for the Victorian gas distribution businesses
- the policy intent for application of the 2018 Instrument to these businesses and required modifications
- how the Modified Instrument was developed
- how the modifications are likely to contribute to the achievement of the National Gas Objective and are consistent with the revenue and pricing principles.

1 AER, *Modified rate of return instrument for the Victorian gas distribution networks during the extension period of 1 January 2023 to 30 June 2023*, .

2 This document does not explain the content of the original 2018 Instrument. See AER, *Explanatory statement, Rate of return Instrument*, December 2018. Available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-instrument-2018.

2 Move to financial year regulatory period

The Victorian Government has determined to move the access arrangement periods of the state's gas distribution businesses from a calendar year (CY) access arrangement period to a financial year (FY) basis. This is consistent with the change implemented for Victorian electricity distribution businesses.[3] This change means all full access arrangements for gas distribution businesses the AER regulates will have financial year based regulatory years.

This means the next access arrangement period for the Victorian gas distribution businesses will commence on 1 July 2023. The Order in Council made by the Victorian Minister under section 64 of the National Gas (Victoria) Act 2008 (Vic) that was published in the Victorian Government Gazette G39 30 September 2021 (Order), amends the revision commencement date for the 2018-2022 access arrangements to 1 July 2023.[4] The Order also provides that the six month period of 1 January 2023 to 30 June 2023 is taken to be an extra regulatory year of the 2018-2022 access arrangements (applicable access arrangement extension period).[5]

The Order declares that the 2018 Instrument applies to the applicable access arrangement extension period for each of the 2018–2022 access arrangements. The Order also provides that, for the purposes of giving effect to the change of the access arrangement period from the CY to FY basis, the AER may modify the application of the 2018 Instrument to the applicable access arrangement extension period. The Order requires the AER to publish any such modification.

The 2018 Instrument was developed on the basis of consecutive 12-month regulatory years, and does not contemplate an intervening six month extension period when moving from calendar years to financial years. The use of consecutive 12 month regulatory years is important for the calculation of the trailing average portfolio return on debt under the Instrument. The 2018 Instrument also did not contemplate the nomination of averaging periods for a six month extension period.

Therefore, we have modified the application of the 2018 Instrument to the six month applicable access arrangement extension period to allow correct application of the methods set out in the instrument to the period. This is explained in more detail in the next section. We made similar modifications when the Victorian electricity distribution businesses were moved to financial year regulatory years.

The reasoning behind the 2018 Instrument is set out in the explanatory information for that Instrument.[6] We have not repeated this reasoning in this document. The effect of the modifications is that the substance of the 2018 Instrument continues to apply to the six month applicable access arrangement extension period.

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3 For an explanation of the move of Vic electricity distributors to financial regulatory years see the explanation for Jemena here (same explanations are available on the other distributor web pages): https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/jemena-determination-2021-26/aer-position#step-72921

4 Order in Council made under section 64 of the National Gas (Victoria) Act 2008 (Vic), clause 5.

5 This period was referred to as a 'mini year' in consultation on the modifications to the 2018 Instrument.

6 See AER, *Explanatory statement, Rate of return Instrument*, December 2018. Available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-instrument-2018.

3 Legal Framework

The transition to a FY access arrangement period is provided under the National Energy Legislation Amendment Act 2020 (Vic) (NELA Act), which amends the National Gas (Victoria) Act 2008 (Vic) (NGVA).

The amended NGVA and the Order include the following key changes relating to the application of the rate of return instrument:

1. amend the access arrangement period to commence on 1 July on a financial year basis[7]
2. extend the current access arrangement period (2018–2022) to allow the 6 month extension period (1 Jan 2023–30 Jun 2023) to be treated as a regulatory year of the current access arrangement period[8]
3. provide that the AER may make a variation to the 2018–2022 access arrangements that it considers necessary to be made as a consequence of the change of the access arrangement period from the CY to FY basis[9]
4. provide that the 2018 Instrument applies to the applicable access arrangement extension period, subject to the AER's modifications of the Instrument to give effect to the change of the access arrangement period from a CY to a FY basis.[10]

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7 National Gas (Victoria) Act 2008, section 62.

8 Order in Council made under section 64 of the National Gas (Victoria) Act 2008 (Vic) on 30 September 2021, clause 5.

9 National Gas (Victoria) Act 2008, section 69.

10 Order in Council made under section 64 of the National Gas (Victoria) Act 2008 (Vic) on 30 September 2021, clause 6.

4 Developing the modifications

We commenced discussion with the businesses on the rate of return instrument for the applicable access arrangement extension period for gas businesses in July 2021 after discussing the matter with the Victorian Department of Environment, Land, Water and Planning (DELWP). The businesses were already aware of the expected change to financial years following the enactment of the NELA in 2020. Previously, we had undertaken consultation with respect to moving the Victorian electricity distribution businesses to financial year regulatory years. For context, that earlier consultation is included in Table 1 below.

Table 1 Timeline of stakeholder consultation related to Vic electricity distribution

Date	Key actions
July 2019	• Discussed our proposal to apply the 2018 Instrument from 1 January 2021 in accordance with the Victorian government direction. • Circulated our proposed approach and undertook further explanation and discussions. • Circulated modelling of several alternative debt trailing average options.
August 2019	• The Brotherhood of St Laurence indicated support for our proposed approach • The five Victorian DNSPs proposed an alternative response and we discussed their response with them • We proposed options for determining the return on debt and return on equity: ○ A 6 month period to be used in the trailing average debt portfolio for the period from 1 Jan 2021 to 30 June 2021 ○ The return on equity to be set separately for the 6 month transition period and the 5 regulatory years (FY basis) • We circulated a spreadsheet to the five Victorian DNSPs that set out the trailing average debt option using a 6 month period and a 12 month period
September 2019	• Notified the Brotherhood of St Laurence of the proposed modifications in setting the allowed rate of return ○ They indicated general support with some reservations about hedging costs and the potential for gaming averaging periods • We proposed to substantively apply the 2018 Instrument to the five Victorian electricity distribution businesses from 1 January 2021
October 2019	• Notified businesses about the agreed implementation of the 2018 Instrument.

Subsequently, this year we discussed moving the Victorian gas distribution businesses to financial years. We proposed substantively the same approach we used for moving the electricity businesses to financial years.

Table 2 Timeline of stakeholder consultation related to Vic gas distribution

Date	Key actions
March 2021	• AER discussions with DELWP on how we might deal with the 6 month extension period in accordance with the NELA.
July 2021	• AER circulated a draft of the Modified Rate of Return Instrument to the Victorian gas distribution businesses and Energy Consumers Australia (ECA) for consideration. • The Victorian gas distribution businesses indicated they considered the Modified Rate of Return Instrument appropriate subject to considering the Orders in Council when it was made. Energy Consumers Australia did not express a view on the proposed modified instrument.
September 2021	• Orders in Council were made by the Victorian Government under sections 64 and 65 of the *National Gas (Victoria) Act* 2008 and published in the Victorian government gazette on 30 September 2021.
October 2021	• The AER notified the Victorian gas businesses the Orders in Council had been made and requested any further submissions on the draft modified instrument in consideration of these Orders. • The business indicated they had no further comments on the proposed final Modified Rate of Return Instrument circulated to them in October 2021.

5 The modified Instrument for the six month period

The Rate of return instrument sets out the methodology to calculate the rate of return on capital and states the value of imputation credits.[11]

In accordance with clause 5 of the Order, we modify the 2018 Instrument for Victorian gas distribution businesses, as it applies to the 6 month extension period (i.e. the applicable access arrangement extension period) added to the 2018–22 regulatory period.

We note that the six month extension period has implications for the calculation of a trailing average return on debt in ten subsequent regulatory years (i.e. as long as the six month period stays in the trailing average).

Table 2 sets out the modifications and we explain them in more detail in the sections below.

Table 2 Summary of modifications in the modified Instrument

Clauses in the 2018 Instrument	Summary of the modifications
3	• Conversion of an effective annual (12 month) rate of return into a six month rate of return.
7, 8, 23 and 24	• The six month applicable access arrangement extension period is treated as a regulatory year, labelled the applicable access arrangement extension period. • Criteria for the debt and equity averaging periods have been adjusted for the six month extension period. • Averaging periods may be periods nominated by the service providers that meet the criteria, or may be default averaging periods. • The averaging periods are subject to the Order.
9	• The six month applicable access arrangement extension period feeds into the trailing average.
10	• The Calculation of the on-the-day rate of return on debt for the applicable access arrangement extension period is calculated in accordance with the 2018 Instrument methodology.

11 AER, *Rate of return instrument*, December 2018, p. 3.

5.1 Six month rate of return

We have modified clause 3 in the 2018 Instrument to be explicit on the conversion of the effective annual (12 month) rate of return into the 6 month rate of return that will apply to the applicable access arrangement extension period. This is because the applicable access arrangement extension period is for a period of 6 months so we need to estimate and apply a rate of return for six months that accounts for the semi-annual compounding that occurs where returns are paid twice per year.

5.2 Risk free rate averaging period

We have modified clauses 7 and 8 in the 2018 Instrument to allow for the return on equity for the six month applicable access arrangement extension period (from 1 January 2023 to 30 June 2023) to be set separately from the earlier five year access arrangement period based on calendar years (even though the applicable access arrangement extension period is a part of an extended access arrangement period under the changes).

We have also modified clauses 7 and 8 in the 2018 Instrument to specify the criteria for the risk free rate averaging period. The key rationale for this approach is to determine a risk free rate close to the commencement of the applicable access arrangement extension period, and that the averaging period is nominated in advance of the period commencing. All else equal, this approach is consistent with correct net present value (NPV) compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NEL and likely to contribute to the achievement of the National Gas Objective (NGO) to the greatest degree.

5.3 Return on debt averaging period

We have modified clauses 23 and 24 in the 2018 Instrument to allow for the return on debt to be set separately for the six month applicable access arrangement extension period (from 1 January 2023 to 30 June 2023).

We have modified clauses 23 and 24 in the 2018 Instrument to specify the criteria for the debt averaging period. The key rationale for this approach is that the averaging period is nominated in advance of the period commencing. All else equal, this approach to setting debt averaging periods is consistent with correct net present value (NPV) compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NGL and likely to contribute to the achievement of the National Gas Objective (NGO) to the greatest degree.

5.4 Return on debt trailing average

We have modified the method for estimating the return on debt trailing average portfolio (clause 9 in the 2018 Instrument) so that the applicable access arrangement extension period feeds into the trailing average.

In particular:

- The weighting adjustment to the 10 year trailing average portfolio is to accommodate the return on debt for the six month extension period.

- The debt averaging periods must comply with the clauses 23 and 24 in the 2018 Instrument which have also been modified

The key rationale for the changes to clause 9 is that the approach, with appropriate weights used in the future, is approximately NPV neutral (relative to maintaining the status quo of calendar year regulatory periods). As a result, all else equal, this approach is consistent with correct NPV compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NGL and likely to contribute to the achievement of the NGO to the greatest degree. While the operation of any trailing average approach in the 2022 Rate of return instrument will be considered as a part of the process for that instrument, it is our intention that the weights used in any trailing average approach adopted in the future should give an approximately NPV neutral outcome.

In addition, secondary considerations in support of this approach are, with appropriate weights used in the future:

- It is relatively simple to implement, effectively transitioning the trailing average to FY through the use of an appropriately weighted 6 month applicable access arrangement extension period, and
- It is relatively close to the prior trailing average approach.

In the modified clause 9, ‘transition period’ retains essentially the same meaning as in the 2018 Instrument, which is to refer to the transition from an on-the-day debt approach to a trailing average debt portfolio approach.

Clause 10 is modified so the on-the-day rate of return on debt for the applicable access arrangement extension period is calculated in accordance with the 2018 Instrument methodology.

Finally, we note that this modified rate of return instrument only applies to the applicable access arrangement extension period from 1 Jan 2023 to 30 June 2023. Therefore, while we have set out how the trailing average may work in future periods to achieve NPV neutrality in a spreadsheet published with this decision, the spreadsheet is for illustration only. The calculation of the rate of return for the Victorian gas distribution businesses from 1 July 2023 will be based on the 2022 rate of return instrument.