Multinet Gas (DB No. 1) Pty Ltd

Multinet Gas (DB No. 2) Pty Ltd

2013–17 Access arrangement

Opening capital base

Decision

Pursuant to Orders of the Australian Competition Tribunal in *Application by Multinet Gas (DB No. 1) Pty Ltd (No 2) [2013] ACompT 6*

October 2013

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Contents

Background

In March 2013, the AER released its final decision on Multinet DB No. 1 Pty Ltd and Multinet DB No.2 Pty Ltd's (Multinet) access arrangement for the 2013–17 period. The AER did not accept Multinet's proposed access arrangement. The AER issued a revised access arrangement in April 2013. This access arrangement decision gave effect to the revisions required by the AER in its March 2013 final decision.

In May 2013, Multinet sought review by the Australian Competition Tribunal of the AER's access arrangement decision. Specifically, Multinet sought review of the AER's decision on the opening capital base for the 2013–17 access arrangement period. The Tribunal subsequently made orders remitting the matter to the AER to remake its decision on the opening capital base, having regard to the most accurate information available.

This document contains the AER's decision on Multinet's opening capital base for the 2013-17 access arrangement period, made in accordance with the Tribunal's orders. The AER has amended Multinet's access arrangement and access arrangement information to reflect this decision.

1 Australian Competition Tribunal orders

In March 2013, the AER released its final decision on Multinet DB No. 1 Pty Ltd and Multinet DB No.2 Pty Ltd's (Multinet) access arrangement for the 2013–17 period. In its final decision, the AER did not accept Multinet's proposed access arrangement. The AER then issued a revised access arrangement in April 2013. This access arrangement gave effect to the revisions required by the AER in its March 2013 final decision.

In making its decision, the AER did not accept Multinet's proposed opening capital base for the 2013–17 access arrangement period. The AER determined the opening capital base using benchmark 2012 capex forecast by the Essential Services Commission (ESC), adjusted for actual growth ($47.6 million).[1] This approach was consistent with clause 6.4(b)(2) of the efficiency incentive mechanism contained in Multinet's 2008–12 access arrangement. Multinet had not applied this clause. It proposed to use its estimate of conforming capital expenditure (capex) for 2012 when determining the opening capital base.

On 5 July 2013, the Australian Competition Tribunal (Tribunal) granted leave to Multinet to apply for review of the AER's access arrangement decision. Specifically, Multinet sought review of the AER's decision to use the ESC's benchmark of 2012 capex in the capital base.

Following Multinet's application for review, the AER reconsidered its decision on the application of the efficiency incentive mechanism and came to the view that it had made an error of fact in its finding on Multinet's 2012 capex. This was based on the AER's acceptance that clause 6.4(b)(2) of Multinet's 2008–12 access arrangement did not permit a negative carry-over of a decrement or financial penalty. As such, if Multinet's conforming capex in 2012 was higher than the ESC forecast, the inclusion of the forecast in the opening capital base for the 2013–17 period would result in a decrement or financial penalty to Multinet and clause 6.4(b) would be inapplicable.

The parties agreed that there was evidence before the AER that Multinet's conforming capex in 2012 would be higher than the ESC forecast. Consequently, clause 6.4(b) of Multinet's 2008–12 access arrangement was not applicable, and it was necessary for the AER to determine the opening capital base in accordance with r. 77(2)(b) of the National Gas Rules (NGR). The parties asked the Tribunal to make a determination by consent to this effect.

On 31 July 2013, the Tribunal did so after it had satisfied itself that the material submitted by the parties supported such a determination. The Tribunal made its orders that the matter be remitted to the AER to remake its decision under r 64(4) of the NGR in accordance with the following directions:

- The opening capital base for the 2013–17 period be determined by reference to conforming capex made by Multinet in 2012, and not by reference to the forecast of 2012 capex made by the ESC in relation to the preceding access arrangement period;
- In assessing the conforming capex made by Multinet in 2012, the AER shall have regard to the most accurate information available regarding Multinet's actual capex, including Multinet's audited statutory and regulatory accounts submitted to the AER;
- Despite r. 64(2) of the NGR, the AER shall consult Multinet and take into account any written submissions made by Multinet.

[1] AER, *final decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2 Attachments,* March 2013. p.23.

1.1 The AER's approach to remaking its decision

The Tribunal's orders require the AER to re-make its decision on the opening capital base for 2013. This decision is to be arrived at using Multinet's actual conforming capex for 2012.

In assessing Multinet's conforming capex for 2012, the AER first considered Multinet's actual 2012 capex against the ESC's forecast for each capex category. The AER identified those categories where Multinet exceeded the forecast, and sought further information from Multinet on the reasons for its expenditure. The AER then made an assessment on whether Multinet's capex conformed with the criteria set on in the NGR. For the remaining categories where Multinet underspent the benchmark allowance, the AER accepted that the lower expenditure was prudent and efficient. The AER's assessment process reflects the approach the AER undertook to assessing conforming capex for the years 2007–11 in its final decision.

Any change to the opening capital base will change Multinet's revenue requirement for the access arrangement period and its tariffs for reference services. The AER has adjusted these aspects of the access arrangement to account for the remaking of its decision on the opening capital base. This decision does not affect any other aspect of the access arrangement issued by the AER in April 2013.

This decision document is set out in the following way:

- Chapter 2 – an assessment of actual conforming capex for 2012
- Chapter 3 – the opening capital base
- Chapter 4 – cost of income tax
- Chapter 5 – total revenue requirement for 2013–17
- Chapter 6 – reference tariffs

The AER has released an updated version of Multinet's access arrangement and access arrangement information to reflect this decision.

This decision is made on the basis of Multinet's actual audited accounts for 2012, rather than an estimate. Consequently, the opening capital base for 2013 will not need to be adjusted for the next access arrangement period.

2 Capital expenditure

The AER approves $75.7 million ($2012) total net capex for 2012 as conforming capex under r. 79(1) of the NGR. Table 2.1 sets out the AER's decision on capex by category in 2012. The AER's assessment of conforming capex is outlined below.

Table 2.1 AER approved capital expenditure by category in 2012 ($million, 2012)

Category	AER approved capex
Mains replacement	9.5
Residential connections	14.5
Commercial/industrial connections	2.4
Meters	1.9
Augmentation	17.3
Gas extensions – NGEP	1.4
IT	30
Other	1.1
Internal direct overheads	0.0
Indirect overheads	0.0
GROSS TOTAL	78.1
Customer contributions	2.4
Government contributions	0.0
Net total	75.7

Source: AER analysis
Note: Totals may not add due to rounding.

2.1 Assessment approach

The AER must accept, as part of the opening capital base for the access arrangement period, any conforming capex made (or to be made) during the earlier access arrangement period.[2]

Capex will be conforming if it:

- meets the definition of capex in r. 69 of the NGR. Capex is defined as costs and expenditure of a capital nature incurred to provide, or in providing, pipeline services.
- Conforms with the capex criteria in r. 79 of the NGR. There are two criteria that must be met under this rule:
  - The expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with good industry practice, to achieve the lowest sustainable cost of providing services; and
  - The expenditure must be justifiable on one of four grounds set out in r. 79(2) of the NGR.

The grounds set out in r. 79(2) of the NGR are that the capex must either:

- Have an overall economic value that is positive
- Demonstrate an expected present value of the incremental revenue that exceeds the expenditure
- Be necessary to maintain and improve the safety of services, or maintain the integrity of services, or comply with a regulatory obligation or requirement, or maintain capacity to meet levels of demand existing at the time the capex is incurred, or
- Be justifiable as a combination of the preceding two dot points.

The AER has limited discretion when making decisions under r. 79 of the NGR.[3] This means the AER must approve a particular element of the access arrangement proposal if that element complies with the applicable requirements of the NGR and NGL and is consistent with any criteria set out in the NGR or NGL.

In assessing Multinet's proposed capex for 2012, the AER reviewed Multinet's supporting material. This included information on Multinet's reasoning and, where relevant, business cases, audited regulatory accounts, and other relevant information. This information helped the AER identify the need for the capex in 2012 and, in turn, whether that capex should be included in the opening capital base in accordance with r. 77(2)(b) of the NGR.

The AER engaged Nous Group Pty Ltd to provide technical advice on the prudency and efficiency of Multinet's IT capex in 2012.

2.1.1 Multinet's audited regulatory accounts

In accordance with the Tribunal's directions, in assessing Multinet's conforming capex for 2012 the AER had regard to Multinet's audited regulatory accounts.

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2 NGR. r. 77(2)(b).
3 NGR, r. 40(2), r. 79(6).

In response to AER information requests, Multinet identified errors in the classification of its capex items for 2012.[4] In order to ensure the accuracy of the information forming the basis of the AER's assessment, the AER requested Multinet correct the errors and provide reaudited accounts.[5]

Multinet provided the AER with reaudited accounts on 12 September 2013. The following assessment is based on those accounts.

2.2 Reasons for decision

Multinet incurred total net capex of $75.7 million ($2012) in 2012. This is approximately $30.1 million ($2012) above the 2012 forecast approved by the Essential Services Commission of Victoria (ESC).[6]

The AER considers that this capex complies with r. 79(1) of the NGR.

In assessing whether Multinet's capex for 2012 complies with the criteria in the NGR, the AER first considered Multinet's actual 2012 capex against the ESC's benchmark allowance for each capex category. The AER identified that Multinet exceeded the benchmark allowance in four out of ten categories, being IT, residential connections, augmentation and Gas Extensions - NGEP.

For these categories, the AER inquired further into the justification for, and the prudency and efficiency of, Multinet's expenditure for 2012. For the remaining categories where Multinet underspent the benchmark allowance, the AER accepts that lower expenditure as prudent and efficient.

2.2.1 Information technology

Multinet’s IT capex for 2012 was approximately $30 million ($2012). This exceeded the ESC benchmark for IT capex by approximately $29.6 million. The expenditure is significantly above the ESC benchmark and has not previously been the subject of regulatory scrutiny. Consequently, the AER closely reviewed Multinet’s 2012 IT capex to determine whether it met the criteria for conforming capex in the NGR.

Multinet provided an expert opinion from Deloitte in support of its 2012 IT capex.[7] Multinet’s expenditure was driven by two major projects, its *Customer, Outage and Market System replacement project* (COMS) and its *SAP ERP replacement project*.[8] Together these accounted for around $23 million of expenditure. The COMS and SAP ERP replacement projects were not envisaged at the time of the ESC’s access arrangement review in 2007, and account for a significant amount of the difference between forecast and actual capex.

The AER engaged Nous Group Pty Ltd to give an expert opinion on Multinet’s 2012 IT capex. Nous considered the majority of Multinet’s IT capex was prudent and efficient. In particular, Nous considered that the COMS and SAP ERP replacement programs were necessary to replace aging or unsupported IT systems.

Nous initially identified $2.7 million of capex that it considered may not have been carried out by a prudent or efficient service provider. This expenditure related to project management, administration,

4 Multinet, Email entitled ‘Residential connections’ received 15 August 2013.

5 AER, Email to Multinet entitled ‘Multinet conforming capex - information request 2’ sent 23 August 2013

6 Essential Services Commission of Victoria, *Final decision: Gas Access Arrangement Review 2008–12*, 7 March 2008, p. 421.

7 Deloitte Touche Tohmatsu, 2012 Actual IT capital Expenditure review, report prepared for Multinet, 8 August 2013

8 The AER included forecast capital expenditure for these two projects as part of the 2013–17 access arrangement review. During that review, the AER considered that the projects would be carried out by a prudent service provider.

and licence costs.[9] In Nous' opinion, these projects and related expenses were considered to be inefficiently delivered, because:

- they arose from foreseeable delays in project delivery that could have been more efficiently managed;
- the expenditure was higher than would be expected from an efficient provider; or
- they involved the inefficient procurement of licences.

Multinet provided a submission and supporting material in response to Nous' report.[10] Multinet disputed Nous' findings and pointed to further information supporting its position. Nous provided updated information in response to Multinet's submission.[11] In light of the further information, Nous' revised its original pfindings, and identified $386,000 of Multinet's IT capex as being non-conforming. Nous accepted that a larger portion of Multinet's IT project management expenditure and software licence fees were likely to be prudent and efficient.

The AER considered the expert reports put forward by Nous and Deloitte, along with the further information submitted by Multinet.

The AER accepts that Multinet needed to commit to significantly higher IT capex in 2012 than was envisaged at the time of the last access arrangement review. Multinet was in a position in 2012 where it needed to replace major parts of its IT systems in order to maintain its services. The expert opinion from Nous acknowledged this need, but indicated that Multinet could have potentially delivered aspects of its IT capex program in a more efficient manner.

While it may be the case that Multinet could have potentially made cost savings on aspects of its 2012 IT program, the AER is of the view that these are relatively minor in scope, particularly when set against Multinet's need to make significant investments in IT. The AER considers that, overall, Multinet's expenditure was necessary to maintain the integrity of services.

2.2.2 Non-IT capex

Multinet's non-IT capex for 2012 was $45.7 million ($2012). Multinet's capex was above the ESC's forecast benchmark amounts in three categories, augmentation, residential connections and extensions. Table 2.2 shows a comparison of Multinet's actual expenditure on these categories with the ESC forecast amounts.

Table 2.2 Comparison of Multinet's actual 2012 capex with the ESC's forecast amounts (Smillion, 2012)

Category	ESC approved forecast	Multinet's actual capex	Difference (%)
Augmentation	5.2	17.3	232
Residential connections	12.7	14.5	14

9 Nous Group, updated review of Multinet Gas 2012 IT capital expenditure, report prepared for the AER, 6 September 2013.

10 Multinet, Multinet's comments on the Nous Group report to the AER, 12 September 2013.

11 Nous Group, response to Multinet's further information of 12 September 2013, 27 September 2013.

Gas extensions – NGEP	0.2	1.4	600
Total non-IT capex	45.3	45.7	1

The AER sought further information from Multinet on the justification for its expenditure in these categories. The AER took into account this information. The AER found that:

- Multinet's augmentation costs were largely influenced by spending on the Lilydale pipeline project. Multinet's other augmentation projects were small by comparison. The AER approved a component of costs for the Lilydale pipeline project in its review of conforming capex for 2007–11. The AER reviewed the costs associated with this project in 2012 and considered them to be reasonable.
- Multinet's unit rate for residential connections was marginally higher than it had been in 2011, but was not unreasonably high when compared to the average for the 2008–11 period or against the ESC approved forecast benchmark.
- a small amount of extensions work was carried out in South Gippsland. The unit cost for this work was higher per connection than Multinet's residential connections unit rate. However, the unit rate for rural connections is expected to be higher, and the AER considers this expenditure to be reasonable.

The AER considers that expenditure on each of these categories meets the capex criteria set out above. In addition to this, Multinet's aggregate expenditure on non-IT capex for 2012 was in line with the ESC forecast for the year.

3 Opening capital base

The AER has calculated the opening capital base for 2013 in accordance with the Tribunal's orders.

3.1 Decision

The AER approves an opening capital base of $1055.0 million ($nominal) as at 1 January 2013. The capital base roll forward for the 2008–12 access arrangement period is set out in table 3.1.

Table 3.1 AER's decision on Multinet's capital base roll forward for 2008–12 ($million, real 2012)

	2008	2009	2010	2011	2012
Opening capital base	1090.5	1080.2	1041.6	1026.4	1034.2
Net capex	38.8	13.2	38.3	62.3	75.7
Less: regulatory depreciation	49.1	51.8	53.6	54.3	54.9
Closing capital base	1080.2	1041.6	1026.4	1034.2	1055.0

Source: AER analysis.
Note: Totals may not add due to rounding.

The AER's adjustment to increase the opening capital base also results in an increase to the projected capital base for the 2013–17 access arrangement period. The AER has determined a projected closing capital base of $1169.6 million ($nominal) as at 31 December 2017 and this is set out in table 3.2.

Table 3.2 AER's decision on Multinet's projected capital base roll forward for 2013–17 access arrangement period ($million, nominal)

	2013	2014	2015	2016	2017
Opening capital base	1055.0	1109.7	1121.9	1139.6	1171.5
Net capex	74.5	40.2	48.9	66.1	35.6
Less: regulatory depreciation	19.9	28.0	31.2	34.2	37.5
Closing capital base	1109.7	1121.9	1139.6	1171.5	1169.6

Source: AER analysis.
Note: Totals may not add due to rounding.

4 Cost of income tax

The AER has calculated the opening tax asset base in accordance with the Tribunal's orders. The adjustment to the opening tax asset base affects the revenues and costs used to estimate Multinet's cost corporate income of tax.

4.1 Decision

The AER's decision on Multinet's cost of corporate income tax is $30.6 million ($nominal) for the 2013–17 access arrangement period as set out in table 4.1.

Table 4.1 AER's decision on Multinet's corporate income tax allowance ($million, nominal)

	2013	2014	2015	2016	2017	Total
Tax payable	6.7	6.8	7.6	8.9	10.8	40.8
Less: value of imputation credits	1.7	1.7	1.9	2.2	2.7	10.2
Net corporate income tax allowance	5.0	5.1	5.7	6.7	8.1	30.6

Source: AER analysis.
Note: Totals may not add due to rounding

4.2 Tax asset base

The AER approves an opening tax asset base of $371.5 million ($nominal) as at 1 January 2013. The tax asset base roll forward for the 2008–12 access arrangement period is set out in table 4.2.

Table 4.2 AER's decision on Multinet's tax asset base roll forward for 2008–12 ($million, nominal)

	2008	2009	2010	2011	2012
Opening tax asset base	299.0	301.7	304.8	309.6	335.4
Tax additions	36.5	36.3	38.3	62.3	78.1
Less: tax depreciation	33.8	33.2	33.5	36.5	42.1
Closing tax asset base	301.7	304.8	309.6	335.4	371.5

Source: AER analysis.
Note: Totals may not add due to rounding.

The AER's adjustment to increase to the opening tax asset base also results in an increase to the projected capital base for the 2013–17 access arrangement period. The AER has determined a projected closing tax asset base of $411.9 million ($nominal) as at 31 December 2017 and this is set out in table 4.3.

Table 4.3 AER's decision on Multinet's projected tax asset base roll forward for 2013–17 access arrangement period ($million, nominal)

	2013	2014	2015	2016	2017
Opening tax asset base	371.5	411.8	405.5	406.3	423.7
Tax additions	88.3	43.8	49.6	66.5	36.7
Less: tax depreciation	48.0	50.1	48.9	49.0	48.5
Closing tax asset base	411.8	405.5	406.3	423.7	411.9

Source: AER analysis.
Note: Totals may not add due to rounding.

5 Total revenue requirement

The total revenue requirement is a forecast of the efficient cost of providing gas distribution services over the access arrangement period.

The AER determined Multinet's total revenue requirement in its final decision by assessing each of Multinet's building block costs.[12] However, this decision on the increase to the opening capital base and tax asset base, holding all other building block costs constant, results in an increase to Multinet's total revenue requirement for the 2013–17 access arrangement period. Consequently, the AER has made a new decision on the total revenue requirement for Multinet.

5.1 Decision

The AER's decision on the total (smoothed) expected revenue derived from MultiNet's reference services is $905.3 million ($nominal). The smoothed revenue is calculated by smoothing the total building block revenue requirement of $908.7 million ($nominal).

Table 5.6 shows the AER's decision on the revenue requirement for each of the building blocks, which have been adjusted from the final decision to account for this decision on the increased opening capital base.

Table 5.6 AER's final decision on Multinet's revenue requirements for its reference services ($million, nominal)

	2013	2014	2015	2016	2017	Total
Return on capital	74.2	78.0	78.9	80.1	82.4	393.6
Regulatory depreciation	19.9	28.0	31.2	34.2	37.5	150.8
Operating expenditure	59.0	66.2	70.3	71.7	74.4	341.6
Efficiency carry-over	–	–	–	–	–	–
Net corporate income tax allowance	5.0	5.1	5.7	6.7	8.1	30.6
Less: ancillary reference service revenues	1.5	1.5	1.6	1.6	1.7	7.9
Annual building block requirement (unsmoothed)	156.6	175.8	184.6	191.1	200.7	908.7
Annual expected revenue (smoothed)	174.6	171.5	178.1	186.4	194.7	905.3
X factor	13.28%	-1.53%	–1.50%	–2.00%	–2.00%	n/a

Source: AER analysis.

12 The AER uses the building block approach to determine the total revenue requirement. This approach is set out in Part 1 of the AER's final decision on Multinet's access arrangement for 2013–17.

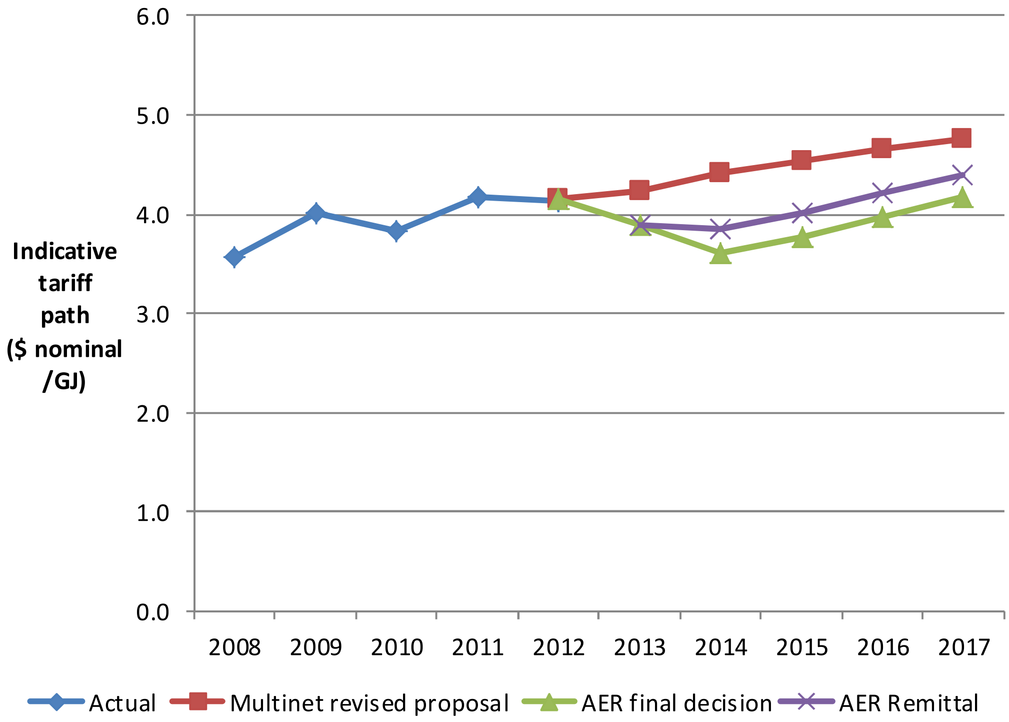
6 Reference tariffs

The tariffs charged for Multinet's reference services give it the opportunity to recover at least its total revenue requirement in the access arrangement period (reflecting its efficient cost). Multinet's total revenue requirement has increased due to its higher opening capital base allowed in this decision. Consequently, reference tariffs need to be adjusted to reflect the new total revenue requirement.

6.1 Decision

The AER proposes revisions to the X factors to adjust the tariffs from 2014 reflecting its decision on the opening capital base, as shown in Figure 6.1. The AER's decision on the revised X factors will result in average reference service distribution charges that are 3.2 per cent higher than average reference service charges per GJ for the 2008–12 access arrangement period.

Figure 6.1 Indicative reference paths for Multinet's reference services from 2013 to 2017 ($/GJ)



Source: AER Analysis.
Note: This chart shows an indicative tariff path, based on forecast revenues and forecast demand for Multinet's network.