Access arrangement final decision

Multinet Gas (DB No. 1) Pty Ltd

Multinet Gas (DB No. 2) Pty Ltd

2013–17

Part 2: Attachments

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AUSTRALIAN ENERGY REGULATOR

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Shortened forms

Shortened form	Full title
2008-12 access arrangement	Access arrangement for Multinet effective from 1 January 2008 to 31 December 2012
2013-17 access arrangement	Access arrangement for Multinet effective from 1 January 2013 to 31 December 2017
2018-22 access arrangement	Access arrangement for Multinet effective from 1 January 2018 to 31 December 2022
ACCC	Australian Competition and Consumer Commission
AER	Australian Energy Regulator
access arrangement information	Multinet, Access arrangement information, 30 March 2012
revised access arrangement information	Multinet, Revised access arrangement information, 9 November 2012
access arrangement proposal	Multinet, Access arrangement proposal, 30 March 2012
revised access arrangement proposal	Multinet, Revised access arrangement proposal, 9 November 2012
capex	capital expenditure
CAPM	capital asset pricing model
CPI	consumer price index
Code	National Third Party Access Code for Natural Gas Pipeline Systems
DRP	debt risk premium
ESC	Essential Services Commission (Victoria)
MRP	market risk premium
Multinet	Multinet Gas (DB No.1) Pty Ltd (ACN 086 026 986), Multinet Gas (DB No.2) Pty Ltd (ACN 086 230 122)
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
opex	operating expenditure
PTRM	post tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RPP	revenue and pricing principles
WACC	weighted average cost of capital

1 Review framework

The AER is responsible for the economic regulation of covered natural gas distribution and transmission pipelines in all states and territories except Western Australia. The AER is currently conducting a review of the revised access arrangements of the three Victorian gas distribution networks, including Multinet, and the Victorian gas transmission network. The National Gas Law (NGL) and National Gas Rules (NGR) provide the overarching regulatory framework for the gas distribution and transmission sectors.

The Victorian gas distribution networks are subject to full regulation, which requires a service provider[1] to submit an initial access arrangement to the AER for approval, and to revise it periodically (typically every five years). The access arrangement sets out the terms and conditions on which third parties can access the distribution pipeline.[2]

1.1 Overview of the service provider

Multinet distributes gas to more than 665 000 customers throughout the South and East areas of metropolitan Melbourne, Yarra Ranges and South Gippsland Towns. Multinet's network covers an area of 1790 square kilometres (see figure 1.1 below).

Multinet was established when the State Government-owned Gas and Fuel Corporation was corporatised in the 1990s. Multinet was subsequently privatised in 1999. In July 2011, Diversified Utility and Energy Trust (DUET) increased its shareholding in Multinet to 100 per cent. DUET is an ASX-listed owner of energy utility assets in Australia.

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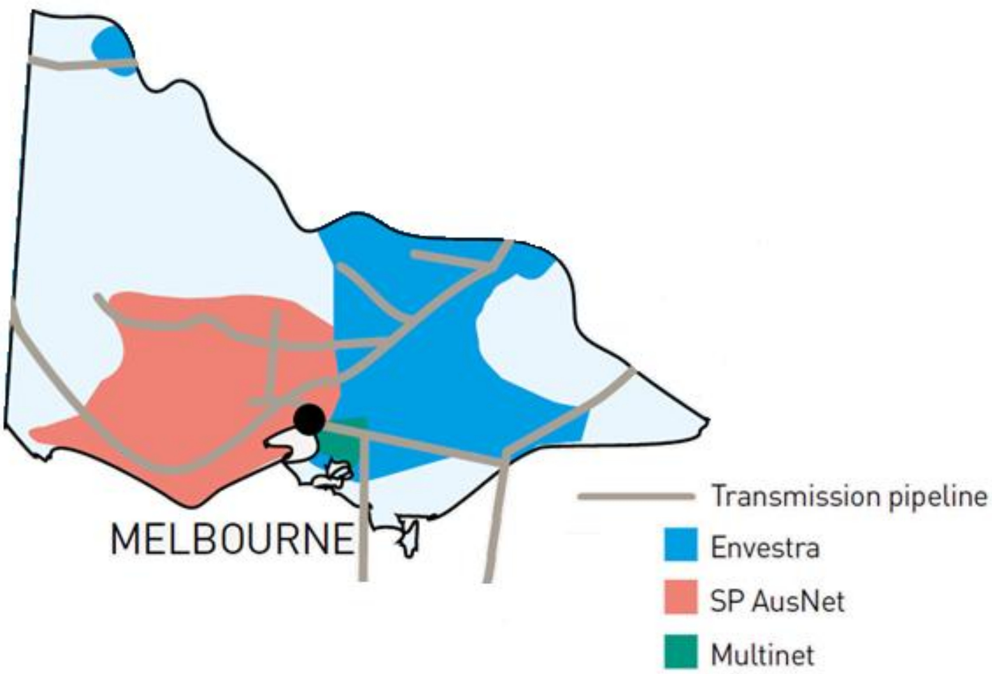
1 Under s.8 of the NGL a service provider is a person who owns, controls or operates a gas pipeline.

2 Providers of gas distribution services typically negotiate contracts to sell pipeline services to customers such as energy retailers. Section 322 of the NGL provides that contracts between service providers and users may differ from those approved by the AER as part of an access arrangement review. In the event of a dispute, however, a user or prospective user may request dispute resolution by the AER under Chapter 6, Part 3 of the NGL. In the event that the AER makes an access determination in order to resolve the dispute, it must give effect to the access arrangement: s. 189.

Figure 1.1 Map of the Victorian gas distribution and transmission networks



1.1.1 Regulation prior to 1 July 2008

The Essential Services Commission of Victoria (ESC) made the previous determination on Multinet's access arrangement for the period 1 January 2008 to 31 December 2012. The ESC made its determination in accordance with the provisions of the National Third Party Access Code for Natural Gas Pipeline Systems (the Code).

Responsibility for the regulation of Victorian gas networks transferred from the ESC to the AER on 1 July 2008 as part of the move towards the national regulation of the energy market.[3] This current determination process is the first full assessment by the AER of the access arrangements of the Victorian gas distribution businesses under the NGL and the NGR.

1.2 The relevant requirements of the NGL and the NGR

The AER's final decision is not to approve Multinet's revised access arrangement proposal. This access arrangement final decision specifies the amendments that the AER considers are required in order for Multinet's access arrangement proposal to be acceptable. These amendments have been identified by assessing each element of Multinet's revised access arrangement proposal in accordance with the relevant requirements set out in the NGL and the NGR. It is important to recognise that the requirements in the NGL and the NGR relevant to (and accordingly, the assessment required of) a particular element of Multinet's access arrangement proposal may differ. For example, the NGR ascribes different levels of discretion—namely full, limited or no discretion—when making certain decisions on an access arrangement proposal. Specifically:

No discretion

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3 National Gas (Victoria) Act 2008 (Vic), Part 5.

> (1) If the Law states that the AER has no discretion under a particular provision of the Law, then the discretion is entirely excluded in regard to an element of an access arrangement proposal governed by the relevant provision.
>
> Limited discretion
>
> (2) If the Law states that the AER's discretion under a particular provision of the Law is limited, then the AER may not withhold its approval to an element of an access arrangement proposal that is governed by the relevant provision if the AER is satisfied that it:
>
> (a) complies with applicable requirements of the Law; and
>
> (b) is consistent with applicable criteria (if any) prescribed by the Law.
>
> Full discretion
>
> (3) In all other cases, the AER has a discretion to withhold its approval to an element of an access arrangement proposal if, in the AER's opinion, a preferable alternative exists that:
>
> (a) complies with applicable requirements of the Law; and
>
> (b) is consistent with applicable criteria (if any) prescribed by the Law.[4]

For these reasons, each element of Multinet's revised access arrangement proposal has been assessed individually in separate attachments in this draft decision. The requirements relevant to each element are also set out in each of these attachments.

However, there are two overarching requirements that apply to the assessment of Multinet's access arrangement proposal as a whole. First, the AER must make an access arrangement decision that is in the long term interests of consumers. Specifically, the AER must do so in a manner that will or is likely to contribute to the NGO.[5] Section 23 of the NGL relevantly provides:

> The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

Consistent with this, r. 100 of the NGR, provides:

> The provisions of an access arrangement must be consistent with:
>
> (a) the national gas objective; and
>
> (b) these rules and the Procedures as in force when the terms and conditions of the access arrangement are determined or revised.

Second, the AER must take into account the revenue and pricing principles (RPP) when exercising a discretion in approving or making those parts of an access arrangement relating to a reference tariff, or where it considers appropriate to do so.[6] Section 24 of the NGL relevantly provides:

> (1) The revenue and pricing principles are the principles set out in subsections (2) to (7).
>
> (2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in-
>
> (a) providing reference services; and
>
> (b) complying with a regulatory obligation or requirement or making a regulatory payment.

4 NGR, r. 40.
5 NGL, s. 28(1).
6 NGL, s. 28(2).

(3) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes-

(a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and

(b) the efficient provision of pipeline services; and

(c) the efficient use of the pipeline.

(4) Regard should be had to the capital base with respect to a pipeline adopted-

(a) in any previous-

(i) full access arrangement decision; or

(ii) decision of a relevant Regulator under section 2 of the Gas Code;

(b) in the Rules.

(5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.

(6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services.

(7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services.

Ultimately, in order to properly take into account the RPP and to determine whether it will or is likely to contribute to the achievement of the NGO, a holistic assessment of an access arrangement proposal must be undertaken. This is because an access arrangement is a complex instrument that is more than just the sum of its elements or component parts. An access arrangement also represents a balance between the possible outcomes, reflecting the AER's judgment on the level of scrutiny and the form of examination afforded to all relevant material before it.

That balance also recognises that there are interlinkages between different elements of an access arrangement. These interlinkages must be taken into account in order to ensure that all of the elements of an access arrangement work together as a whole. That is, so that the terms and conditions, including prices, will, among other things, contribute to achieving efficient investment in and operation of Multinet's gas distribution network in the long term interests of consumers whilst providing Multinet with a reasonable opportunity to recover at least its efficient costs and effective incentives to promote economic efficiency.

1.3 Access arrangement review process

Under the NGL a service provider must submit an access arrangement proposal to the AER for approval under the NGR.[7] An access arrangement proposal contains the terms, including prices, under which the service provider proposes to provide access to the services provided by their networks to users and prospective users.

When submitting an access arrangement proposal, the service provider must submit 'access arrangement information' for the proposal. The term 'access arrangement information' is defined by r. 42(1), which provides:

7 NGL, s. 132.

Access arrangement information for an access arrangement or an *access arrangement proposal* is information that is reasonably necessary for users and prospective users:

(a) to understand the background to the access arrangement or the *access arrangement proposal*; and

(b) to understand the basis and derivation or the various elements of the access arrangement or the *access arrangement proposal*.

Rule 42(2) provides that access arrangement information must include the information reasonably required by the NGL and the NGR. Rule 48 sets out general requirements including that the service provider must describe the pipeline services it proposes to offer by means of the pipeline and must specify the reference services and reference tariffs. Rule 72 lists specific information relevant to price and revenue regulation that also must be included in an access arrangement. This includes detailed forecasting information and the service provider's proposed approach to the setting of tariffs.

Following the service provider's submission of an access arrangement proposal, the AER conducts a preliminary assessment of the proposal and access arrangement information against the requirements of the NGR (see section 1.3.1 below). The AER must publish a notice (initiating notice) on its website and in a newspaper notifying receipt of, and describing the access arrangement proposal, giving a website where it can be inspected, and inviting written submissions on the proposal by a specified date.[8] The AER may defer the initiating notice if, on a preliminary inspection, the AER considers the proposal or related information are deficient in some respect.[9]

After considering the access arrangement proposal, any submissions in response to the service provider's access arrangement proposal, and any other matters the AER considers relevant, the AER must make an access arrangement draft decision.[10] The AER must include a statement of the reasons for the draft decision.[11] An access arrangement draft decision indicates whether the AER is prepared to approve the service provider's access arrangement proposal as submitted and, if not, the nature of the amendments that are required in order to make the proposal acceptable to the AER.[12]

1.3.1 Access arrangement proposal to be approved in its entirety or not at all

The AER's approval of an access arrangement proposal implies approval of every element of the proposal.[13] It follows that, if the AER withholds its approval to any element of an access arrangement proposal, the proposal cannot be approved.[14]

If, in an access arrangement final decision, the AER does not approve an access arrangement proposal, the AER must itself propose an access arrangement or revisions to the access arrangement for the relevant pipeline.[15] The AER's proposal for an access arrangement or revisions is to be formulated with regard to:

- the matters that the NGL requires an access arrangement to include
- the service provider's access arrangement proposal

8 NGR, r. 58(1).
9 NGR, r. 58(2).
10 NGR, r. 59(1); r. 71(2).
11 NGR. r. 59(4).
12 NGR, r. 59(2).
13 NGR, r. 41(1).
14 NGR, r. 41(2).
15 NGR, r. 64(1).

- the AER's reasons for refusing to approve that proposal.[16]

1.3.2 Revision of access arrangement proposal and commencement of public consultation

If an access arrangement draft decision indicates that revision of the access arrangement proposal is necessary to make the proposal acceptable to the AER, the decision must fix a period for revision of the proposal.[17] This is known as the revision period. In the revision period, the service provider may submit additions or other amendments to the access arrangement proposal to address matters raised in the access arrangement draft decision.[18] The amendments must be limited to those necessary to address matters raised in the access arrangement draft decision unless the AER approves further amendments.[19]

After the AER makes an access arrangement draft decision, it must notify stakeholders, establish a procedure for stakeholders to make written submissions on the draft decision, and make the draft decision available. It must do this by publishing the decision on its website, and publishing a notice on its website and in a national newspaper.[20] Pursuant to r. 59(5)(c), the notice must invite written submissions. The due date for written submissions must be at least 20 business days after the end of the revision period.

After considering the submissions made in response to the access arrangement draft decision within the time allowed, and any other matters the AER considers relevant, the AER must make an access arrangement final decision.[21]

An access arrangement final decision is a decision to approve, or to refuse to approve, an access arrangement proposal.[22] An access arrangement final decision, like an access arrangement draft decision, must include a statement of the reasons for the decision.[23] The final decision must also be published on the AER's website.

1.3.3 Time limits on AER decision making

The AER is required to make an access arrangement final decision to approve or not approve the access arrangement proposal within six months of receipt of the access arrangement proposal.[24] For the calculation of elapsed time for making a decision under the NGL and NGR, certain periods may be disregarded, such as a period allowed for public consultation and a period taken by the service provider to respond to a request for information from the AER.[25]

For instance, when calculating the six month period, the AER may disregard any period allowed for public submissions on the proposal or on a draft decision.[26] The time taken for a service provider to remedy a deficiency in their access arrangement information under r. 43(3) of the NGR can also be disregarded for the purposes of calculating the six month period. However, the access arrangement

16 NGR, r. 65(2).
17 NGR, r. 59(2).
18 NGR, r. 60(1).
19 NGR, r. 60(2). For example, the AER might approve amendments to the access arrangement proposal to deal with a change in circumstances of the service provider's business since submission of the access arrangement proposal.
20 NGR, r. 59(5)(b) & (c).
21 NGR, r. 62(1).
22 NGR, r. 62(2).
23 NGR, r. 62(4).
24 NGR, r. 62(7).
25 NGR, r. 11.
26 NGR, r. 11(1)(c).

review must be completed within an absolute overall time limit of 13 months between the date on which the service provider submits its access arrangement proposal and the AER's final decision.[27]

1.4 Public consultation

The NGR require the AER to consult with interested parties at various stages during an access arrangement review. Effective consultation and engagement with stakeholders is essential to the AER's performance of its regulatory functions.

The AER invited interested parties to make submissions on the AER’s draft decision and Multinet's revised access arrangement proposal. The AER considered all submissions in making this final decision.

The AER also hosted a consumer group roundtable. The purpose of the roundtable discussion was to explain the access arrangement review process and the AER’s assessment approach, to inform participants and to seek their comments on consumer specific issues, and to encourage submissions on the AER’s draft decision.

Table 1.1 below outlines the various stages of public consultation that the AER undertook as part of the review process.

Table 1.1 Key stages in the decision making process

Key stages in the decision making process	Scheduled date
AER received Multinet proposal	30 March 2012
Multinet proposal published	2 May 2012
Industry workshop on terms and conditions	18 May 2012
AER draft decision released	24 September 2012
Multinet revised proposal to be submitted	9 November 2012
Consumer group roundtable	27 November 2012
Closing date for submissions on revised proposal	7 January 2013
AER final decision released	15 March 2013

1.4.1 Protected information submitted to the AER

As part of the review process the AER receives protected information from the businesses and other stakeholders. The AER is committed to treating protected information responsibly and in accordance with the law.

Division 1 of Part 2 of Chapter 10 of the NGL deals with disclosure of confidential information held by the AER. The NGL authorises the AER to disclose confidential information in specified

27 NGR, r. 13.

circumstances.[28] In summary, the AER is authorised to disclose confidential information where it is of the opinion that:

- disclosure would not cause detriment to the person who gave the information or
- although disclosure would cause detriment, the public benefit in disclosing the information outweighs the detriment to the disclosing person.[29]

Before disclosing information, the AER must undertake the process set out in s. 329(2) of the NGL. It provides that the AER must: give a notice to the person who gave the information of the intended disclosure; give the person an opportunity to address the AER's case for disclosure; and properly consider that person's case for nondisclosure in making its decision.

The AER undertook the NGL process described above to disclose information where it was of the opinion that the information would be relevant to stakeholder submissions or would need to be referred to in its decision, and after it had conducted the tasks and satisfied itself of the matters required under the NGL.

[28] NGL, ss. 324 to 329 (Division 1 of Part 2 of Chapter 10 of the NGR).
[29] NGL, s. 329(1).

2 Pipeline services

Multinet's revised access arrangement proposal describes the type and nature of pipeline services to be provided.

Rule 48(1) of the NGR provides that a full access arrangement must specify certain information for pipeline services, including reference services. Pipeline services include haulage services, interconnection services and ancillary services.[30] Reference services are defined as pipeline services that are likely to be sought by a significant part of the market.[31] An access arrangement must:

- identify the pipeline to which the access arrangement relates and a website at which a description of the pipeline can be inspected[32]
- describe the pipeline services the service provider proposes to offer to provide by means of the pipeline[33]
- specify the reference services, and the reference tariff for each reference service.[34]

Rule 109(1) of the NGR provides that a pipeline service provider must not make it a condition of the provision of a service that the prospective user also accept another non-gratuitous service, unless the bundling of services is reasonably necessary.

2.1 Final decision

The AER considers that Multinet has met its obligations to describe the pipeline services and specify the reference services that it proposes to offer.

The AER approves Multinet's:

- Residential Haulage Reference Service
- Non-residential Haulage Reference Service
- Ancillary Reference Service

However, the AER does not approve Multinet's Services Policy with respect to clause 5.1.4 of Multinet's Access Arrangement. The AER proposes revisions to clause 5.1.4 to make Multinet's access arrangement proposal acceptable.

2.2 Revised proposal

Multinet's revised access arrangement proposal in relation to pipeline services has adopted each of the amendments required by the AER in its draft decision.[35]

However, Multinet set out further amendments to its Services Policy.[36] Multinet submits that if end-users are to be entitled to directly contract for reference services, various changes are required to Parts A and C to accommodate this.[37]

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30 NGL. s. 2.
31 NGR, r. 101(2).
32 NGR, r. 48(1)(a).
33 NGR, r. 48(1)(b).
34 NGR, r. 48(1)(c) and r. 48(1)(d).
35 AER, *Multinet access arrangement proposal, Draft Decision*, September 2012, p. 5.

2.3 Assessment approach

The AER's assessment approach for pipeline services is set out in its draft decision. See section 1.3 in Attachment A of the AER's draft decision for a detailed explanation of the AER's assessment approach.

The AER received a submission from AGL relating to clause 5.1.4 of Multinet's Access Arrangement.[38]

For the remaining services, the AER received no further information and for the reasons in its draft decision approves those pipeline services.[39]

2.4 Reasons for decision

2.4.1 Multinet change to Services Policy

The AER considers that Multinet's amendment clarifies which reference service will apply in situations where the party seeking the service is not a retailer and will not be on-supplying the service. The AER considers that this is consistent with r. 48(1). Further, the AER considers that Multinet's amendment does add clarity and avoids the potential for disputes to arise. This is in the long term interests of consumers with respect to price. Accordingly, the AER considers that the amendment is consistent with the NGO.

Multinet's detailed amendment to its Services Policy sets out the relevant Haulage Reference Service where the User acquires Pipeline Services as an End-User. Multinet sets out the details of when a User will be considered to acquire Pipeline Services as an End-User.[40] The amendment provides that in these circumstances, the relevant Haulage Reference Service is the Non-Residential Haulage Reference Service.

The effect of this amendment is to deem a User who acquires pipeline services as an End User to be a non-residential customer, except where the User is a natural person acquiring the service for its own use or domestic purposes. This amendment acts to clarify the application of the relevant Haulage Reference Service in circumstances where the service is being sought by someone other than a retailer.

2.4.2 Clause 5.1.4 of the Services Policy

The AER does not accept the changes proposed in AGL's submission. However, after considering AGL's submission, the AER proposes a further revision to clause 5.2.4 to make Multinet's access arrangement acceptable.

Clause 5.1.4 provides that:

> Upon Part 12A of the NGR coming into operation in Victoria, the procedures for the provision of Connection Services will be set out in that Part.
>
> An application for a Connection Service may be made by a Customer but except where rule 119O(2) of the NGR ("Payment of connection charges") applies otherwise the Charges for that Pipeline Service are payable by the User.

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36 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 8.
37 Multinet, *Revised access arrangement proposal*, 9 November 2012, Appendix 13.1, p.1.
38 AGL, *Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals*, 7 January 2013.
39 AER, *Multinet access arrangement proposal Draft decision*, September 2012, pp. 2-5.
40 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 8.

> The Charges for Connection Services will be determined in accordance with any applicable requirements of relevant Regulatory Instruments (including where provided for by those Regulatory Instruments by negotiation between the Customer and the Service Provider or between the User and the Service Provider in accordance with those Regulatory Instruments).

AGL questions the clarity of clause 5.1.4 and the reference to r. 119O of the NGR. AGL submits that the second paragraph in clause 5.1.4 is poorly drafted. AGL states that it seeks clarification around the intent of this clause. AGL also seeks to understand why this clause only refers to sub-rule 119O(2) and not sub-rule 119O(1) as well. AGL states that sub-rule 119O(2) directly references sub-rule 119O(1). AGL submits that the current wording should be replaced with the entirety of r. 119O.[41]

Clarity

AGL submitted that the wording of clause 5.1.4 was unclear and questioned the purpose of the clause.[42]

Multinet informed the AER that the purpose of the clause is to cater for the commencement of NECF in Victoria at some stage during the access period. The purpose is to clarify the default position that connection charges are payable by the retailer. Unless r. 119O applies, the User will be liable for payment.[43]

Multinet agreed to amend the clause to remove the word 'otherwise' and to insert a comma between the words 'but' and 'except'.[44]

Sub-rule 119O(1)

The AER proposes that clause 5.1.4 be amended to refer to r. 119O(1) as well as r. 119O(2).

AGL made a submission in relation to Multinet's access arrangement proposal that clause 5.1.4 (which only referred to r 119O(2)) should be replaced with the entirety of r. 119O (r. 119O(1), (2) and (3)).[45] This clause relates to the allocation and provision of reference services.

The AER considers r. 119O(3) is not relevant as it does not concern who pays for a connection charge. Further, the AER considers that it is not necessary to copy the entirety of r. 119O(1) and (2) into Multinet's Access Arrangement.

The AER considers that the amendment acts to make it absolutely clear that r. 119O(1) also applies. This is consistent with r. 48(1). Further, the AER considers that this creates greater clarity and avoids the potential for confusion or disputes. This is consistent with the NGO because it promotes the efficient operation and use of gas services.

The AER raised this amendment with Multinet. Multinet stated that it considers that the existing drafting is satisfactory. Nonetheless, it proposed to insert the phrase 'and the Customer is paying the charges directly under one of the circumstances set out in rule 119O(1)'.[46] This is consistent with r. 48(1). Further, the AER considers that this creates greater clarity and avoids the potential for

41 AGL, *Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals*, 7 January 2013, Attachment A.

42 AGL, *Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals*, 7 January 2013, p. 130.

43 Multinet, response to information request Fd22a, 7 February 2013.

44 Multinet, response to information request Fd22a, 7 February 2013.

45 AGL, *Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals*, 7 January 2013, Attachment A.

46 Multinet, response to information request Fd22a, 7 February 2013.

confusion or disputes. This is consistent with the NGO because it promotes the efficient operation and use of gas services. The AER considers that this approach resolves the concerns raised by AGL.

2.4.3 Revisions

The AER proposes the following revision to make Multinet's access arrangement acceptable.

Revision 2.1: Amend the second paragraph in clause 5.2.4 of the access arrangement by;

removing the word 'otherwise'

insert a comma between 'but' and 'except'

insert 'and the Customer is paying the charges directly under one of the circumstances set out in Rule 119O(1),' between 'applies' and 'the charges'

3 Capital base

The capital base roll forward accounts for the value of Multinet's regulated assets over the access arrangement period. The opening capital base value for a regulatory year is rolled forward by indexing it for inflation, adding any conforming capex, and subtracting depreciation and other possible factors (for example, disposals or customer contributions). Following this process, the AER arrives at a closing value of the capital base at the end of the relevant year. The opening value of the capital base is used to determine the return of capital (regulatory depreciation) and return on capital building block allowances.

The AER is required to make a decision on Multinet's opening capital base as at 1 January 2013 for the 2013–17 access arrangement period. The AER is also required to make a decision on Multinet's projected capital base for the 2013–17 access arrangement period. This attachment presents the AER's final decision on these matters.

3.1 Final decision

The AER does not approve Multinet's proposed capital base as at 1 January 2013.

The AER accepts Multinet's revised proposal to roll forward the capital base using its revised estimate of 2012 capex. However, the AER does not approve Multinet's proposed opening capital base of $1046.2 million ($nominal) as at 1 January 2013 because it does not include an additional six months indexation adjustment. The AER considers the adjustment is necessary to transition from the ESC's assumed timing of the capital base to the AER's timing assumption.

After making this adjustment, the AER has determined an opening capital base of $1024.9 million ($ nominal) as at 1 January 2013, which is approximately $21.3 million less than that proposed by Multinet. Table 3.1 summarises the AER's final decision on the roll forward of Multinet's capital base during the 2008–12 access arrangement period.

Table 3.1 AER's final decision on capital base roll forward for the 2008–12 access arrangement period ($million, 2012)

	2008	2009	2010	2011	2012
Opening capital base	1090.5	1080.2	1041.6	1026.2	1034.2
Net capex	38.8	13.2	38.3	62.3	45.6
Less: regulatory depreciation	49.1	51.8	53.6	54.3	54.9
Closing capital base	1080.2	1041.6	1026.2	1034.2	1024.9

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

Based on the approved opening capital base and the AER's final decisions on forecast capex, forecast depreciation and the inflation forecast, the AER has determined a projected closing capital base of $1169.1 million ($nominal) as at 31 December 2017. Table 3.2 sets out the projected roll forward of the capital base during the 2013–17 access arrangement period.

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

	2013	2014	2015	2016	2017
Opening capital base	1024.9	1084.8	1102.6	1126.3	1164.4
Net capex	74.5	40.2	48.9	66.1	35.6
Less: straight-line depreciation	40.3	49.5	52.9	56.1	60.0
Indexation	25.6	27.1	27.6	28.2	29.1
Closing capital base	1084.8	1102.6	1126.3	1164.4	1169.1

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

3.2 Revised proposal

In its revised proposal, Multinet did not accept the AER's draft decision adjustments to 2012 capex when rolling forward the capital base during the 2008–12 access arrangement period.[47] In particular, Multinet submitted that the AER misinterpreted the clause describing how the ESC's capex incentive scheme operates. As capex is an input to the capital base roll forward, Multinet did not accept the AER's draft decision on its opening capital base as at 1 January 2013. In its revised proposal, Multinet proposed an opening capital base as at 1 January 2013 of $1046.2 million, which includes a revised estimate for 2012 capex, as set out in table 3.3.[48]

Table 3.3 Multinet's revised proposed capital base roll forward for the 2008–12 access arrangement period ($million, 2012)

	2008	2009	2010	2011	2012
Opening capital base	1082.1	1071.8	1033.1	1017.8	1025.8
Net capex	38.8	13.2	38.3	62.3	75.3
Less: straight-line depreciation[a]	49.1	51.8	53.6	54.3	54.9
Closing capital base	1071.8	1033.1	1017.8	1025.8	1046.2

Source: Multinet, *Revised proposal roll forward model*, November 2012.
Note: Totals may not add due to rounding.
(a): The ESC's forecasts did not make an indexation adjustment to the straight-line depreciation amounts.

In its revised proposal, Multinet projected a closing capital base at 31 December 2017 of $1226.4 million ($nominal). Multinet's revised proposed roll forward of the capital base for the 2013–17 access arrangement period is set out in table 3.4.

47 Multinet, *Revised access arrangement information*, November 2012, p. 130.
48 Multinet, *Revised access arrangement information*, November 2012, p. 131.

Table 3.4 Multinet's revised proposed capital base roll forward for the 2013–17 access arrangement period ($million, nominal)

	2013	2014	2015	2016	2017
Opening capital base	1046.2	1113.6	1136.2	1163.3	1208.4
Net capex	88.5	50.1	57.8	78.9	55.3
Less: straight-line depreciation	46.2	52.7	54.9	57.0	59.7
Indexation	26.2	27.8	28.4	29.1	30.2
Closing capital base	1113.6	1136.2	1163.3	1208.4	1226.4

Source: Multinet, *Revised proposal post tax revenue model,* November 2012.
Note: Totals may not add due to rounding.

3.3 Assessment approach

The AER's approach to assessing Multinet's revised proposed capital base is set out in its draft decision. See section 2.3, attachment 2 of the draft decision for a detailed explanation of the assessment approach.

The AER also took into account submissions received on its draft decision in forming its final decision on Multinet's capital base. However, these submissions related mainly to capex and depreciation, which are inputs to the projected capital base at 31 December 2017. Accordingly, these submissions are addressed in the capex attachment (attachment 4) and the depreciation attachment (attachment 6).

3.4 Reasons for decision

The AER is required to make a decision on Multinet's proposed capital base roll forward. As part of this, the AER must make decisions on specific inputs to the roll forward process. Specifically, the AER must determine:

- the opening capital base at 1 January 2008—this is the base from which the AER rolls forward the capital base to reflect actual capex and forecast depreciation for the 2008–12 access arrangement period. The AER has increased Multinet's proposed capital base at 1 January 2008 by $8.4 million ($2012) or 0.8 per cent due to a transitional indexation adjustment.
- the opening capital base at 1 January 2013—this is the capital base at the end of the 2008–12 access arrangement period. This in turn will be used as a base for the return on capital and depreciation building blocks over the 2013–17 access arrangement period. The AER has reduced Multinet's proposed opening capital base as at 1 January 2013 by $21.3 million ($nominal) or 2.0 per cent due to the treatment of 2012 capex.[49]
- the projected capital base at 31 December 2017—this is the forecast of the closing capital base for the 2008–12 access arrangement period. It includes forecast capex and depreciation. The AER has reduced Multinet's proposed projected capital base at 31 December 2017 by $57.2

[49] The effect of the AER's final decision on 2012 capex is offset to some extent by the transitional indexation adjustment. That is, the reduction to 2012 capex by itself is greater than $21.3 million.

million ($nominal) or 4.7 per cent due to the AER's final decisions on forecast capex and forecast depreciation.

- the depreciation approach used to roll forward the capital base from 2013–17 at the next access arrangement review.

3.4.1 Opening capital base at 1 January 2008

The AER does not approve Multinet's revised proposal on the opening capital base at 1 January 2008. In its revised proposal, Multinet proposed to adopt the requirements in the AER's draft decision. However, the AER has considered further information that supports the need to apply an additional 6 months of indexation to Multinet's opening capital base at 1 January 2008 as part of transitioning to the AER's modelling framework. The result is that the AER has approved a higher opening capital base than that proposed by Multinet. The AER's reasons for this decision are set out below.

Having made this adjustment, the AER has determined Multinet's opening capital base at 1 January 2008 to be $1090.5 million ($2012).

Transitional indexation adjustment

The AER has adjusted Multinet's revised proposal on the opening capital base at 1 January 2008 to account for an additional 6 months indexation to determine the opening capital base as at 1 January 2013. The adjustment is necessary because Multinet's capital base was valued in 1 July dollars under the ESC's regulatory modelling. The AER's regulatory modelling requires the capital base to be valued in 31 December dollars when rolling forward the capital base from year to year. Accordingly, for this access arrangement review, the AER has made an additional 6 months indexation adjustment to Multinet's capital base to transition from the ESC's regulatory modelling to the AER's regulatory modelling. This adjustment increases Multinet's opening capital base at 1 January 2008 by $8.4 million ($2012) or 0.8 per cent.

In the draft decision, the AER did not accept proposals from SP AusNet and Envestra to index their closing capital bases by an additional six months as part of the roll forward for the 2008–12 access arrangement period.[50] Multinet did not propose this adjustment in either its initial or revised proposals. However, SP AusNet provided further information in support of this adjustment in its revised proposal. Having considered this additional information, the AER accepts that the transitional indexation adjustment is necessary. The need for this additional indexation also applies to Multinet's capital base. To ensure consistency between the service providers, the AER has therefore indexed the closing capital base using the same CPI applying to SP AusNet. This means that the capital base is indexed forward using six months of inflation from the CPI at 30 June 2006 to the CPI at 31 December 2006. The AER consulted with Multinet on the proposed method to determine the additional 6 months indexation. Multinet confirmed the appropriateness of the proposed method.[51]

3.4.2 Opening capital base at 1 January 2013

The AER does not approve Multinet's revised proposal on the opening capital base as at 1 January 2013. In particular, the AER does not accept:

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50 For example, see: AER, *Draft decision: Envestra access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 21–22.

51 Multinet, *Response to AER information request FD23*, 12 February 2013.

- The opening capital base at 1 January 2008—the transitional indexation adjustment increases the opening capital base at 1 January 2008. This is an input to the capital base roll forward for the 2008–12 access arrangement period. As a result, the transitional indexation adjustment results in a higher capital base at 1 January 2013.
- Multinet's proposed estimate of 2012 capex—Multinet's access arrangement includes a specific process to roll forward the capital base for the 2008–12 access arrangement. This requires the AER to include in the capital base the ESC's forecast of 2012 capex benchmark, adjusted for actual growth on Multinet's network. Using this 2012 capex benchmark reduces Multinet's opening capital base as at 1 January 2013 by $21.3 million compared to Multinet's revised proposal.

Use of benchmark 2012 capex

The AER's final decision is to roll forward the capital base for 2012 capex using the ESC's approach specified in clause 6.4(b)(2) of Multinet's access arrangement. This approach is set out at section 2.4 of the draft decision.[52] It requires the AER to use the ESC's forecast of 2012 capex, adjusted for actual growth on Multinet's network. The AER does not approve Multinet's revised proposal to roll forward the capital base during the 2008–12 access arrangement period using its revised estimate of 2012 capex.

The need for this approach arises because actual capex for 2012 is not yet known. It typically takes several months after a reporting period to prepare audited regulatory accounts including actual capex values. Therefore, in order to determine an opening capital base as at 1 January 2013, the AER must use an interim value for 2012 capex. Under the NGR, the AER must ensure that revenue calculations for the 2013–17 access arrangement period properly reflect increments or decrements resulting from the operation of the ESC's incentive mechanism.[53] As the actual value of 2012 capex is currently unknown, application of the ESC's approach does not result in reduced revenues, as submitted by Multinet.[54] The use of ESC's 2012 capex benchmark is only a revenue decrement compared to Multinet's estimate, not compared to Multinet's actual capex. If Multinet's actual capex is less than its estimate, application of the ESC's approach could increase revenues. The effect of the ESC's approach cannot be determined until actual capex is available. As such, the AER is required to apply the ESC's approach as specified in Multinet's access arrangement. The AER will consider whether a penalty has arisen at the time of the next access arrangement review, when actual capex for 2012 is available.

3.4.3 Projected capital base at 31 December 2017

The AER does not approve Multinet's projected capital base as at 31 December 2017. The AER’s forecast of Multinet's projected capital base as at 31 December 2017 is $1169.1 million ($nominal). This is a reduction of $57.2 million or 4.7 per cent from Multinet's revised proposal.

This is because of the AER's final decisions on the inputs to the determination of the projected capital base. The AER has amended the following inputs:

- Reduced Multinet's proposed opening capital base as at 1 January 2013 to reflect the changes required in this attachment.

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52 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 14–17.

53 NGR Schedule 1, clause 5(1)(a).

54 Multinet, *Revised access arrangement information*, November 2012, p. 130.

- Reduced Multinet's proposed forecast capex allowances by $65.3 million ($nominal) or 19.7 per cent.
- Reduced Multinet's proposed forecast depreciation allowance by $29.4 million ($nominal) or 19.5 per cent.

The AER approves Multinet's revised proposal to use forecast depreciation to establish its opening capital base as at 1 January 2018 at the next access arrangement review.[55] This is consistent with the AER's draft decision.[56] The AER considers the forecast depreciation approach will promote effective incentives in order to promote economic efficiency.[57]

3.5 Revisions

The AER proposes the following revisions to make the revised access arrangement proposal acceptable:

Revision 3.1: Make all necessary amendments to reflect the AER's final decision on the roll forward of the opening capital base for the 2008–12 access arrangement period, as set out in table 3.1.

Revision 3.2: Make all necessary amendments to reflect the AER's final decision on the projected opening capital base for the 2013–17 access arrangement period, as set out in table 3.2.

[55] Multinet, *Revised access arrangement information*, November 2012, p. 123.
[56] AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 18.
[57] NGL s. 24.

4 Capital expenditure

This attachment outlines the AER's assessment of Multinet's proposed capital expenditure (capex) for 2007–11 and forecast capex for the 2013–17 access arrangement period.

4.1 Final decision

The AER approves Multinet's proposed capex of $231.7 million ($2012) for 2007–11 as conforming capex.[58]

The AER does not approve Multinet's revised capex forecast of $300.3 million ($2012) for the 2013–17 access arrangement period as it is not satisfied that it is conforming capex[59] or that the forecast was arrived at on a reasonable basis and is the best forecast possible in the circumstances.[60] The AER considers that a capex allowance of $242.5 million ($2012) complies with the NGR requirements and proposes Multinet's access arrangement is revised accordingly.

4.1.1 Conforming capital expenditure for 2007–11

The AER's draft decision was to approve $231.7 million ($2012) as conforming capex for the 2007–11 period. Multinet's revised proposal included the same net capex forecast for this period and the AER received no further submissions on this issue. As such, for the reasons set out in its draft decision the AER approves Multinet's proposed net capex of $231.7 million ($2012) for the 2007–11 period as conforming capex under r. 77(2) of the NGR.[61]

4.1.2 Conforming capital expenditure for the 2013–17 access arrangement period

For the reasons set out below, the AER does not approve Multinet's proposed capex allowance of $300.3 million ($2012) as conforming capex for the 2013–17 access arrangement period. The AER considers $242.5 million ($2012) net capex is conforming capex and proposes Multinet's access arrangement is revised accordingly.

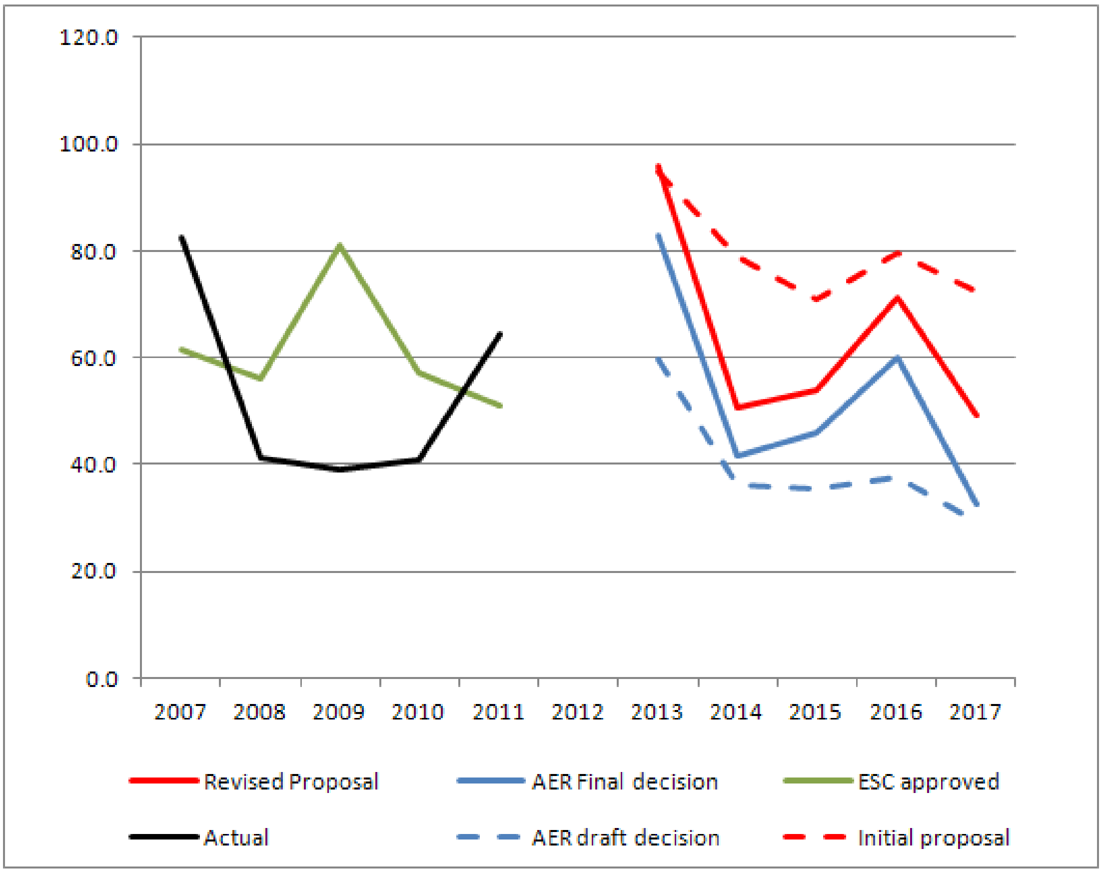
The reasons for the AER's reductions are:

- Mains—The AER considers that the volumes of low pressure to high pressure pipeworks replacement proposed by Multinet are greater than that which a prudent service operator would require to meet its safety and regulatory obligations. The AER does not approve one of the proposed large diameter cast iron projects as there was insufficient evidence to demonstrate that it was necessary to meet safety and reliability obligations. The AER does not approve the large diameter low pressure designated zones progam and does not approve the small diameter low pressure designated zones program (but for one project) as there is insufficient evidence to demonstrate that it is necessary to meet safety or regulatory obligations.
- Residential connections—Multinet identified an error in its revised volume forecast. The AER has corrected for this error in its final decision.

58 NGR, r. 77(2).
59 NGR, r. 79(1).
60 NGR, r. 74(2).
61 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2 Attachments,* September 2012. p.31.

- Commercial connections—Multinet was unable to substantiate the unit rates in its revised proposal. Multinet subsequently stated that it would adopt the AER's draft decision on the industrial and commercial unit rates.
- Residential meters—Multinet's proposed unit rates across its meter categories did not reconcile with its tendered meter purchase contracts.
- Industrial and Commercial Meters—Multinet's proposed unit rates across its meter categories did not reconcile with its tendered meter purchase contracts.
- Augmentation—Multinet did not provide evidence which demonstrated that the proposed augmentation was necessary to meet modelled minimum pressure requirements for 8 projects and so the AER does not approve the associated expenditure. The AER has reduced the overhead rate applied in Multinet's cost build ups to an industry standard level.
- IT—The AER has reduced Multinet's cost build up for its data warehouse project to industry standard levels.
- Other—The AER does not approve a number of other non-demand projects as the AER considers they do not comply with the NGR requirements.

Figure 4.1 Comparison of Multinet's historical, proposed and approved capex ($million, 2012)



Source: AER analysis

Table 4.1 compares the AER's final decision against Multinet's proposals and the AER's draft decision.

Table 4.1 AER approved capital expenditure for the 2013–17 access arrangement period ($million, 2012)

Category	Multinet initial proposal	AER draft decision	Multinet revised proposal	AER final decision
Mains replacement	121.3	44.8	83.8	56.7
Residential connections	96.0	61.5	73.9	69.8
Commercial/industrial connections	12.7	4.2	6.6	6.6
Meters	14.0	11.2	15.0	12.2
Augmentation	35.1	7.4	35.4	23.7
IT	46.9	35.6	48.4	45.7
SCADA	7.4	1.0	2.2	1.1
Other	46.1	32.4	38.8	34.7
Internal direct overheads	16.4	0.0	16.7	12.7
Indirect overheads	-	0.0	0.0	0.0
GROSS TOTAL	396.0	198.4	321.0	263.2
Customer contributions	20.7	20.7	20.7	20.7
Government contributions	-	0.0	0.0	0.0
NET TOTAL	375.3	177.7	300.3	242.5

Source: AER analysis.

Table 4.2 AER final approved capital expenditure by category over the 2013–17 access arrangement period ($million, 2012)

Category	2013	2014	2015	2016	2017	Total 2013–17
Mains replacement	12.6	3.6	12.3	22.6	5.7	56.7
Residential connections	12.8	14.5	14.4	14.0	14.1	69.8
Commercial/industrial connections	1.3	1.3	1.3	1.3	1.3	6.6
Meters	3.4	2.5	2.4	1.8	2.1	12.2
Augmentation	7.0	5.6	5.2	5.5	0.4	23.7
IT	28.1	6.4	4.2	5.3	1.6	45.7
SCADA	0.8	0.1	0.0	0.0	0.0	1.1
Other	15.3	4.9	3.4	6.8	4.3	34.7
Internal direct overheads	1.4	2.8	2.8	2.8	2.9	12.7

Indirect overheads	0.0	0.0	0.0	0.0	0.0	0.0
GROSS TOTAL	82.8	41.7	46.1	60.2	32.4	263.2
Customer contributions	11.6	4.3	1.6	1.6	1.6	20.7
Government contributions	0.0	0.0	0.0	0.0	0.0	0.0
NET TOTAL	71.2	37.4	44.5	58.6	30.8	242.5

Source: AER analysis.

4.2 Revised proposal

2013–17 access arrangement period

In Multinet's revised proposal it forecast total net capex of $300.3 million ($2012) for the 2013–17 access arrangement period. This is a reduction of $75.0 million ($2012) from Multinet's initial proposal of $375.3 million ($2012). The major differences between Multinet's initial and revised proposal are:

- Mains replacement - Multinet reduced its proposed volumes from 420 kilometres to 274 kilometres for the low pressure mains replacement program. Multinet omitted one project from its revised large diameter cast iron mains replacement program.
- Connections—Multinet amended its forecast mix of connections, resulting in a reduction of Multinet's unit rate because of the greater proportion of relatively simple connections. Multinet adopted the historical unit rate for commercial connections.
- Meters—Multinet's volume forecast was revised to incorporate aspects of the AER's draft decision.
- IT—Multinet shifted $10.3 million from 2012 expenditure into 2013 for the ERP SAP implementation project.

Table 4.3 Multinet revised proposal of conforming capital expenditure 2013–17 ($million, $2012)

Category	2013	2014	2015	2016	2017	Total 2013–17
Mains replacement	20.3	8.5	16.0	27.7	11.3	83.8
Residential connections	13.0	15.3	15.3	15.1	15.2	73.9
Commercial/industrial connections	1.2	1.3	1.3	1.4	1.4	6.6
Meters	4.1	3.1	2.9	2.3	2.6	15.0
Augmentation	8.8	6.9	6.1	6.4	7.2	35.4
IT	28.8	6.4	4.5	6.2	2.5	48.4
SCADA	0.9	0.3	0.2	0.8	0.2	2.2
Other	16.1	5.5	4.1	7.8	5.3	38.8

Internal direct overheads	2.5	3.4	3.5	3.6	3.6	16.7
Indirect overheads	0.0	0.0	0.0	0.0	0.0	0.0
GROSS TOTAL	95.8	50.7	53.9	71.3	49.2	321.0
Customer contributions	11.6	4.3	1.6	1.6	1.6	20.7
Government contributions	0.0	0.0	0.0	0.0	0.0	0.0
NET TOTAL	84.2	46.5	52.3	69.7	47.6	300.3

Source: Multinet revised proposal.

4.3 Assessment approach

The AER's approach to assessing Multinet's proposed capex is set out in its draft decision. See Attachment 2 of the AER's draft decision for a detailed explanation of the assessment approach.[62]

The AER also took into account Multinet's responses to information requests, advice from the AER's engineering consultant Zincara and submissions received in relation to its draft decision, in forming its final decision on Multinet's proposed capex. The AER received submissions relevant to its capex assessment from:

- The Hon. Michael O'Brien MP, Victorian Minister for Energy and Resources
- Energy Users Coalition of Victoria
- Origin Energy (Vic) Pty Limited

4.4 Reasons for decision

The AER applied its assessment approach and concluded that Multinet's forecast capex for 2013–17 is not conforming capex[63] and the forecast was not arrived at on a reasonable basis or the best forecast possible in the circumstances.[64] Accordingly, the AER proposes to replace Multinet's capex allowance with $242.5 million ($2012) net capex for the 2013–17 access arrangement period (see Table 4.2).

The AER's reasons for reaching this conclusion are set out in detail in the sub sections below.

4.4.1 Mains replacement

Summary

Multinet proposed four programs under mains replacement. The AER's final decision for each is summarised below with the AER's reasons set out in detail in the following sections.

For the **LP to HP pipeworks program**, the AER does not approve Multinet's proposed expenditure on the basis that:

62 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.26.
63 NGR, r. 79(1).
64 NGR, r. 74(2).

- The proposed volumes are not prudent and efficient[65]. The volumes proposed by Multinet exceed those which Multinet has demonstrated are necessary to meet its safety and regulatory obligations[66] over the current period. The AER considers that these obligations will not materially change in the 2013-17 access arrangement period. In addition, mains risk is unlikely to change in the 2013-17 access arrangement period.

- The proposed unit rates are not the best estimate possible in the circumstances[67] as Multinet's proposed overhead rate is significantly higher than industry standard levels.

For the **large diameter cast iron mains replacement program**, the AER does not approve Multinet's proposed expenditure on the basis that:

- The Aughtie Drive project is not necessary[68] and the proactive replacement is neither prudent nor efficient.[69] The cast iron allocation for ad hoc replacement is not the best estimate in the circumstances,[70] not justified[71] and not prudent and efficient,[72] and

- The proposed unit rates are not the best estimate possible in the circumstances[73] and neither prudent nor efficient[74] as Multinet's proposed overhead rate is significantly higher than industry standard levels.

For the **large diameter and small diameter low pressure designated zone (LPDZ) mains replacement** program, the AER does not approve Multinet's proposed expenditure (except for the Tashinny Rd, Toorak small diameter LPDZ mains replacement project) on the basis that the volumes of mains replacement are not efficient.[75] The AER considers there is insufficient evidence that the mains cannot continue to be managed through reactive replacement and repair.

For the **unplanned services renewal program**, the AER considers that a historical average volume does not provide a reasonable basis for forecasting the volume for the 2013-17 access arrangement period[76] and the proposed capex is not prudent and efficient.[77]

The AER considers the following amounts to be conforming capex:[78]

- $47.1 million ($2012, direct costs, excluding internal direct overheads) for the LP to HP pipeworks program,

- $3.0 million ($2012, direct costs, excluding internal direct overheads) for the large diameter cast iron mains replacement program,

- $0.4 million ($2012, direct costs, excluding internal direct overheads) for the large diameter and small diameter LPDZ mains replacement program,

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65 NGR, r.79(1)(a)
66 NGR, r.79(2)(c)(i)-(iii)
67 NGR, r. 74(2)(b).
68 NGR, r. 79(2)(c)(i).
69 NGR, r. 79(1)(a).
70 NGR, r.74(2)(b).
71 NGR, r.79(2)(c)(i).
72 NGR, r. 79(1)(a).
73 NGR, r.74(2)(b).
74 NGR, r.79(1)(a).
75 NGR, r.79(1)(a).
76 NGR, r.74(2)(b).
77 NGR, r.79(1)(a).
78 NGR, r.79(1)(a).

- $6.2 million ($2012, direct costs, excluding internal direct overheads) for the unplanned services renewal program,

Table 4.4 Final decision – Mains replacement[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	24.8	26.2	22.5	22.1	25.7	121.3
AER draft decision	10.5	7.8	9.9	7.7	9.0	44.8
Multinet revised proposal	20.3	8.5	16.0	27.7	11.3	83.8
AER final decision	12.6	3.6	12.3	22.6	5.7	56.7

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

Table 4.5 Final decision – Mains replacement programs[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
LP to HP pipeworks	11.0	2.3	10.4	20.7	2.7	47.1
Large diameter cast iron mains replacement	–	–	0.6	0.6	1.8	3.0
Large and small diameter LPDZ mains replacement	0.4	–	–	–	–	0.4
Unplanned services renewals	1.2	1.2	1.2	1.2	1.2	6.2
Total	12.6	3.6	12.3	22.6	5.7	56.7

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

Low pressure to high pressure pipeworks

The AER's final decision is to not accept Multinet's revised proposal for 274 kilometres of low pressure (LP) to high pressure (HP) pipeworks replacement at a cost of $58.8 million ($2012, direct costs, excluding internal direct overheads) on the basis that:

- the AER considers that Multinet's estimate of the volumes is neither prudent nor efficient.[79] The volumes proposed by Multinet exceed those which Multinet has demonstrated are necessary to meet its safety and regulatory obligations over the current period. The AER considers that these obligations will not materially change in the 2013-17 access arrangement period. In addition, mains risk is unlikely to change in the 2013-17 access arrangement period.

- The AER considers that estimate of the unit rates is not the best possible in the circumstances[80] and neither prudent nor efficient[81] as the proposed overhead rate is significantly higher than industry standard levels.

79 NGR, r.79(1).
80 NGR, r.74(2)(b).
81 NGR, r.79(1)(a).

The AER considers that $47.1 million ($2012, direct costs, excluding internal direct overheads) of LP to HP pipeworks replacement expenditure is conforming capex.[82] This consists of 255 kilometres of mains replacement, carried out at the unit rates set by suburb. These are commercial in confidence, set out in Confidential Appendix C.

Multinet initially proposed capex of $90.5 million ($2012, escalated direct costs, excluding overheads) consisting of a total of 401 km, at an average unit rate of $226/metre ($2012, direct costs, excluding internal direct overheads), for its LP mains replacement program for the 2013–17 access arrangement period.[83]

In the draft decision, the AER considered that Multinet could continue to manage its safety and regulatory obligations for the 2013–17 access arrangement period by delivering 240 kilometres (which is the 2008–11 annual average volume actually completed by Multinet, applied to the five years of the access arrangement period) in combination with other proactive and reactive mains programs. These volumes were below the volumes that the ESC had approved for that access arrangement period and which had been factored into the tariffs paid by the consumers for that period[84]. While the ESC approved volume was not completed, Multinet met its safety and regulatory obligations for the 2008-12 access arrangement period.[85]

The AER also made provision for a pass through, recognising that circumstances may change. For example, new information or conditions may arise which could lead to a change in the optimal mix of programs employed to address the safety risks associated with mains. The pass through allowed for Multinet, after it has delivered the total historical volume, to apply for additional expenditure for mains replacement.[86]

On the basis of advice from Zincara, the AER considered that Multinet's internal estimate of the material and labour costs for mains replacement are within industry expectations. However, the AER considered the direct overhead rate applied to the internal estimates of the mains replacement unit rates was above industry standard levels. Therefore, the AER reduced the direct overhead rate to industry standard levels[87].

The AER assessed that Multinet has prioritised low cost mains replacement areas in the past and so set an average unit rate of $175/metre ($2012, direct costs, excluding internal direct overheads), prioritising low to high cost mains up to the historical volume. The AER approved a total expenditure of $42.0 million ($2012, direct costs, excluding internal direct overheads).[88]

Following the AER's draft decision, the Energy Users Coalition of Victoria (EUCV) submitted that all the distribution businesses proposed significant mains replacement programs in the 2008–12 access arrangement period yet underspent their allowances. The EUCV stated that it considered the AER's

82 NGR, r.79(1)(a).

83 Multinet, *Response to information request 18 of 20 June 2012*, received 18 July 2012, Capex Breakdown Projects.xlsx

84 The ESC approved 360 km for 2008-11 (450 km for 2008-12).

85 Multinet, *Response to information request 13*, received 18 June 2012, p. 4.

86 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 4 Confidential appendices*, September 2012, pp. 12-14; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, pp. 39-40.

87 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 4*, September 2012, pp. 5-6; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, pp. 35-36.

88 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 4*, September 2012, pp. 14; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, p. 41.

approach of using historical data for setting mains replacement in the 2013–17 access arrangement period was sensible and supported the approach[89].

The EUCV further submitted that it considers the main driver of gas main replacement is the leakage of gas from distribution gas mains and that the cost of unaccounted for gas (UAFG) is primarily borne by consumers. The AER considers that UAFG is a driver of mains replacement but it is not a primary driver. The primary drivers are mitigating the safety risk associated with gas leaks and securing reliability of supply.

The Hon. Michael O'Brien MP, Victorian Minister for Energy and Resources, "support[ed] the approach taken by the AER in its draft decision to consider the level of historical expenditure and to include a pass through event for low pressure to high pressure mains replacement"[90]. The Minister further noted that "the distributors have undertaken less pipeline replacement than was forecast by the Essential Services Commission. This has manifested itself in cost savings for distributors and improved profitability...".[91]

Origin submitted that it "supports the AER's decision to base capital expenditure allowances for low pressure mains replacement on volumes achieved in the current period" and that it "support[s] the cost pass through arrangement". Origin further submitted that it considers that the "pass through arrangement promotes the interests of the consumer, with an appropriate balance between the need to maintain the network and to limit customers' exposure to inaccurate forecasts"[92].

As noted by Origin, consumers bear the cost of Multinet's proposed and approved mains replacement program which is funded but not carried out.

The approved capex for mains replacement is rolled into the business' capital base for the purpose of calculating its required revenue. There are two elements to the required revenue calculation for capex:

- a depreciation allowance, enabling the business to recover the initial cost of the asset, and
- a cost of capital allowance, enabling the business to provide a return to investors for funding the asset.

Regardless of whether the distribution business spends its forecast capex, it retains the full cost of capital allowance. This includes the cost of capital for the mains replacement that the service provider has not spent. Further, the service provider has the use of the depreciation allowance relating to its forecast mains expenditure during the access arrangement period.[93] Overall, the expenditure on the mains replacement program accounts for a considerable proportion of the total capex allowance. This means that when the service provider does not spend its approved maintenance expenditure, customers pay above the efficient costs for the service they receive.

89 Energy Users Coalition of Victoria, Submission to the AER: SP AusNet, Envestra and Multinet access arrangment proposals, 29 June 2012, p.17.
90 Minister for Energy and Resources, Submission to the AER: Victorian Gas Access Arrangement Review January 2013 - December 2017, Revised Proposal and Draft Determination- Victorian Government Submission, 14 January 2013, p.2.
91 Minister for Energy and Resources, Submission to the AER: Victorian Gas Access Arrangement Review January 2013 - December 2017, Revised Proposal and Draft Determination- Victorian Government Submission, 14 January 2013, p.2.
92 Origin, Submission to the AER: Submission to Multinet revised access arrangement proposal, 7 January 2013.
93 However, at the end of the access arrangement period, as part of the capital base roll forward, the capital base decreases to remove the total forecast depreciation. This removes the excess depreciation allowance that the service provider recovered over the access arrangement period.

In its revised proposal Multinet submitted that its reasons for not completing its benchmark volumes in the 2008–12 access arrangement period were the reduction in the ESC's approved WACC, the GFC-induced credit constraints and increased capex required for IT.[94] Multinet confirmed that there has been no impact on service performance and stated that customers would benefit from lower prices as a result of the deferral of the capex.[95] However, Multintet stated that a consequence of deferring the capex was to increase the risk associated with the LP network and that this risk level will be maintained under the AER's approved volume in the draft decision.[96] For this reason Multinet stated that the 240 km volume approved by the AER in its draft decision is not prudent and efficient. Multinet proposed a volume of 274 km.[97]

In relation to the cost pass through Multinet submitted that it is unsatisfactory as:

- Multinet arranges funding of its 5-year capex allowance upfront and the pass through would require Multinet to seek further funding within that 5 year period. It stated that this exposes Multinet to additional financing risk,
- The uncertainty surrounding whether the AER will approve a pass through application provides a "strong incentive" not to exceed the upfront allowance, and
- The pass through is subject to a materiality threshold. (The AER has since clarified with Multinet that this is incorrect[98]).

Low pressure volumes

The AER's final decision is not to approve Multinet's proposed mains replacement volume of 274 kilometres. The volumes proposed by Multinet exceed those which Multinet has demonstrated are necessary to meet its safety and regulatory obligations over the current period.[99] The AER understands that these obligations will not materially change in the 2013–17 access arrangement period. In addition, mains risk is unlikely to change in the 2013–17 access arrangement period.

The AER considers that 255 kilometres of low pressure to high pressure block rollout mains replacement is prudent and efficient.[100] This volume is higher than the approved volume in the draft decision because the AER has taken account of the volume of mains replacement undertaken in 2012.

In arriving at this decision, the AER has taken into account the following matters:

- The safety risk of the low pressure network in the 2013–17 access arrangement period relative to the 2008–12 access arrangement period,
- The impact of the GFC and Multinet's chosen level of risk on the use of historical volumes for forecasting efficient and prudent volumes in the 2013–17 access arrangement period, and
- 2012 volumes and reprioritisation.

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[94] Multinet, *Revised access arrangement proposal*, 9 November 2012, p.80.
[95] Multinet, *Revised access arrangement proposal*, 9 November 2012, pp.80-81.
[96] Multinet, *Revised access arrangement proposal*, 9 November 2012, p.81.
[97] Multinet, *Revised access arrangement proposal*, 9 November 2012, p.81.
[98] AER, *VIC gas access arrangement review 2012 - capital expenditure - note for file - - 1211213 Multinet Mains replacement pass through*, 17 December 2013, p.1.
[99] NGR, r.79(2)(c)(i)-(iii).
[100] NGR, r.79(1)(a).

The safety risk of the low pressure network in the 2013–17 period relative to 2008–12 period.

As stated in the draft decision, the AER considers that Multinet is currently meeting its safety and reliability obligations while delivering a lower volume of mains replacement than that which was approved by the ESC. The AER has no evidence to indicate otherwise. As noted above, the ESC approved 557 kilometres of mains replacement which was factored into tariffs for the 2008-12 access arrangement period. For that period Multinet instead completed 255 km. There is no record of non-compliance with the Gas Safety Act during this period.

Based on the information provided by Multinet, Zincara advises that the low pressure mains risk is unlikely to materially change in the 2013–17 access arrangement period relative to the 2008–12 access arrangement period.[101]

In assessing safety risk, Zincara, considered the indicators generally accepted by industry as the best measures of mains deterioration. The indicators are mains leaks, breaks and water-in-mains.[102]

Zincara assessed the risk level of the low pressure network is likely to remain around the levels experienced in 2008–12. Zincara's advice is that Multinet should be able to manage the risk associated with the low pressure network through the continuation of the same mains replacement rate as in 2008–12 together with other risk mitigation programs including reactive replacement and repair, leakage survey and syphoning.[103]

The AER accepts Zincara's analysis and considers that Multinet should be able to remain compliant with its safety and regulatory obligations in the 2013–17 access arrangement period by undertaking the 2008–12 volume of mains replacement together with other mains risk mitigation programs. The AER has also taken Multinet's record of compliance under the Gas Safety Act into account in reaching this conclusion.

The impact of the GFC, the ESC decision on WACC and the diversion of capex towards IT on the use of historical volumes for forecasting efficient and prudent volumes in the 2013–17 access arrangement period

Multinet stated that the ESC decision to reduce the equity beta from 1 to 0.8 and its flagging of the possibility of a further reduction led to a downgrading of investor's assessment of investment returns and a subsequent tightening of the funding environment.[104]

Multinet and the other gas distribution businesses submitted that the GFC was an exceptional event and, as such, the volume of mains replacement undertaken in GFC-affected years does not reflect their normal or desired level of mains replacement[105].

Multinet submitted that additionally, it experienced "pressure for increased capital expenditure in other aspects of Multinet's business - most notably IT capital expenditure...".[106] The AER notes that SP AusNet similarly diverted capex to meet greater than expected connections expenditure.

[101] Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, p.21.
[102] Zincara, *Review of Multinet's Capital Expenditure*, March 2013, p.16.
[103] Zincara, *Review of Multinet's Capital Expenditure*, March 2013, p.8.
[104] Multinet, *Revised access arrangement proposal,* 9 November 2012, p.80.
[105] Envestra, *Revised access arrangement proposal: Attachment 7.7 Response to Draft Decision – Capital Expenditure*, 9 November 2012, p.7; Multinet, *Revised Access Arrangement Information*, November 2012, p.80; SP AusNet, *Revised access arrangement proposal: Chapter 2 Capex (Confidential)*, November 2012, pp.27-28.
[106] Multinet, *Revised access arrangement proposal,* 9 November 2012, p.80.

The AER has assessed the information provided by each of the gas distribution businesses in relation to the impact of the GFC on their respective mains replacement programs. The AER notes that there is considerable variation as to the timing of the claimed impact on the businesses. Declines in volumes of mains replacement were experienced by SP AusNet in 2009, Multinet in 2011, while Envestra was impacted in 2009–10.

The businesses put forward a number of reasons which they submit led to significant under delivery of the mains replacement program besides the GFC, including:

- diversion of capex, towards connections, in the case of SP AusNet [107], and towards IT, in the case of Multinet[108], and
- the ESC reduction in the equity beta leading to investors being unwilling to fund capex, to the level expected by the business, in the case of Multinet.[109]

While the AER accepts that credit conditions may have impacted on the volume of mains replacement undertaken by the business during the 2008-12 access arrangement period, it also notes that there are other factors, nominated by the businesses, which would equally account for not spending their benchmark capex such as diversion of capex to other projects. This suggests that the type of factors highlighted by the businesses may occur during any economic and regulatory cycle and therefore, the AER considers that there is an insufficient basis on which to normalise for any such conditions.

In undertaking the volume of mains replacement in the current access arrangement period, Multinet has met its safety and regulatory obligations. This is not withstanding Multinet's stated investor downgrade causing capital availability to be reduced, the occurrence of the GFC or the requirement to divert capex towards other areas or any other circumstances that may have been present during the access arrangement period.

In assessing the prudent and efficient volume of mains replacement that a distribution business requires, the AER is assessing the level of expenditure that would be incurred by a prudent service provider, acting efficiently, to achieve the lowest sustainable cost that allows the distribution business to meet its safety and regulatory obligations[110]. The AER considers that the revealed actual volumes over a five year period is the best proxy for estimating the prudent and efficient volumes in these circumstances. An average taken over the five year period smooths the impact of both windfall gains and losses resulting from unforecast impacts on expenditure. Hence, the AER considers that it is not appropriate to give particular weight to the tight credit conditions of the GFC in calculating historical volumes.

On the basis of the above, the AER considers that it is neither prudent nor efficient nor would it be in the long term interests of consumers for a service provider to incur expenditure in excess of that which is required to satisfy its safety and regulatory requirements.[111]

2012 volumes and reprioritisation

SP AusNet submitted that 2012 data should be included in the calculation of historical volumes.[112] The AER accepts that the inclusion of 2012 data results in the best possible forecast in the

107 SP AusNet, *Access Arrangement Information*, March 2012, p.49.
108 Multinet, *Access Arrangement Information*, March 2012,p.112.
109 Multinet, *Access Arrangement Information*, March 2012,p.112
110 NGR, r.79(1)(a).
111 NGR, rr. 79(1) and 100(a)

circumstances as it represents the full five years of data. The AER has included 2012 data in the calculation of the average historical volume.

Multinet and the other distribution businesses submitted that the AER's reprioritisation did not reflect their mains replacement methodology of prioritising areas based on safety and reliability considerations.[113]

At the time of making its draft decision the AER was awaiting the outcome of the ESV's review of the distribution businesses processes regarding prioritisation of areas of mains replacement. The ESV has advised the AER that it considers the distribution businesses' methodology and approach for identifying areas for replacement to be satisfactory to it[114]. On this basis, the AER has applied the prioritisation presented by the businesses for the historical volumes which the AER considers are prudent and efficient.

In relation to the volumes of mains replacement contained in Multinet's Asset Management Plan, the AER notes that Multinet submitted that:

- It is not bound by the volumes included in the five year plans in its Asset Management Plan, mains replacement plan. Multinet stated that the Asset Management Plan, which references the mains replacement volumes, is not "an approved program for specific work ... [and that] inevitably, actual projects and programs will differ from this plan"[115]. Further, Multinet stated that:

  > "Although the planning process normally covers five years (six years in this plan), experience has shown that the most efficient outcome for capital projects is obtained by an annual planning process at which the five year plan is reviewed in the light of the latest performance information, load forecasts and failure history"[116].

  Multinet indicated that "annual safety risk modelling is necessary due to the unpredictability of problem areas arising [and that] [a] rigid long-term plan will result in sub-optimal replacement". Multinet stated that "the safety risk projects within the five year plan are reviewed each year based on the previous year['s] failure history and [the] ranking may change within the plan period".[117] All of these matters indicate that Multinet adjusts its annual volume of mains replacement on an annual basis in response to the prevailing conditions at the time.

- Multinet indicated that its mains replacement program is discretionary.[118] Further, Multinet has indicated that if particular conditions prevail, such as capital constraints, that capex may be deferred:

  > "While financial markets remain unsettled, there remains a possibility of capital constraints and undesirable deferrals of capital expenditure."[119]

- Multinet stated that at the time of introducing the LP to HP mains replacement program in 2003, a 30-year program was planned. However, Multinet stated that with regard to the reduced volumes

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112 SP AusNet, *Response to AER draft decision*, 9 November 2012, p. 26; SP AusNet, *Response to AER draft decision*, 9 November 2012, Appendix 2.C, SP AusNet - ESV Additional Information 31072012, pp.26-27.

113 Envestra, *Revised access arrangement proposal: Attachment 7.7 Response to Draft Decision – Capital Expenditure*, 9 November 2012, pp.13-14; SP AusNet, *Response to AER draft decision*, 9 November 2012, Appendix 2.C, SP AusNet - ESV Additional Information 31072012, pp.31-32, Multinet, *Revised Access Arrangement Proposal*, November 2012, pp.82-83.

114 AER, *VIC gas access arrangement review 2012 - capital expenditure - note for file - - Discussions with ESV re mains replacement, AER13/1094*, 7 March 2013.

115 Multinet, *Access Arrangement Information*, March 2012, Appendix D-1: Network Asset Management Plan, p.14

116 Multinet, *Access Arrangement Information*, March 2012, Appendix D-1: Network Asset Management Plan, p.14

117 Multinet, *Access Arrangement Information*, March 2012, Appendix D-1: Network Asset Management Plan, p.124

118 Multinet, *Access Arrangement Information*, March 2012, Appendix D-1: Network Asset Management Plan, p.138

119 Multinet, *Access Arrangement Information*, March 2012, Appendix D-1: Network Asset Management Plan, p.112

undertaken in the current period, it "is not proposing to “catch up” the shortfall in the current period [and that] [a]ny decision to “catch up” the program or simply extend it will be made at a later time”.[120] Furthermore, Multinet stated that "[t]his strategy ... is unlikely to be achieved on schedule".[121]

All of these points indicate that Multinet appears to consider that the volumes of mains replacement in its Gas Safety Case are subject to change and are not a fixed component of Multinet's Gas Safety Case. To the extent that the AER's conclusions about the requirement to meet the annual volumes set out in a gas safety case are relevant to Multinet, these are set out in attachment 4 of the AER's final decision for Envestra.

Pass through mechanism

The AER's final decision is to include a pass through. As in its draft decision, and as set out above, the AER recognises that the timing of low pressure mains replacement is somewhat discretionary and potentially subject to the changing risk profile of the network and resource availability. The AER considers that a pass through mechanism will provide Multinet with sufficient flexibility to respond to changing conditions, which may require Multinet to alter the volume of mains replacement delivered during the 2013–17 access arrangement period.[122] This pass through will apply to all Victorian gas distribution businesses. Should they decide to undertake mains replacement in excess of historical volumes in order to accommodate any change in circumstances, they may submit an application to the AER for that expenditure.

The AER has revised the operation of the pass through. The pass through differs to that proposed by the AER in its draft decision. It takes into account information provided by Multinet and the other distribution businesses following the draft decision.

The pass through will only allow for low pressure to high pressure block rollout mains replacement and medium pressure supply mains replacement, which is necessary for carrying out of the proposed low pressure to high pressure block rollout proposed in the pass through for the 2013-17 access arrangement period.

Only one pass through application will be allowed for the 2013–17 access arrangement period. Multinet commented that there should be more than one opportunity for the business to make a pass through application[123]. The AER notes that this is in contrast with Multinet's comment in its revised proposal that it incurs additional financing risk in having to go out to the market more than once. The AER also notes that applying Multinet’s proposed schedule of mains replacement, it will make the pass through application in October 2016. The AER considers that Multinet would have a reasonable idea of its replacement requirements within this timeframe.

No materiality threshold for the mains pass through will apply. As explained in the AER's draft decision, this takes into account the nature of the costs to be passed through as the replacement of low pressure mains is undertaken for safety and reliability reasons. Further, alterations in the volume of mains replacement delivered may be driven by factors such as new information on safety risks and changes in the relative costs for different methods for mitigating or removing those safety risks. The

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120 Envestra, *Access Arrangement Information*, March 2012, p.104

121 Multinet, *Access Arrangement Information*, March 2012, D-6 Distribution Mains Strategy, p.12.

122 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 4 Confidential appendices*, September 2012, pp.8-9; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, pp.39-40.

123 Multinet, *Response to information request FD29a,* received 27 February 2013.

AER therefore considers it is not appropriate to apply a materiality threshold where it may operate as a disincentive to Multinet to undertake mains replacement work where it may be efficient and prudent having regard to the change in circumstances.[124] As noted above, Multinet submitted in its revised proposal that it considered that the pass through should not be subject to a materiality threshold. The AER has since clarified with Multinet that its understanding on this matter is not correct.

In its revised proposal SP AusNet submitted that there was little scope to respond to new knowledge about risks or costs due to the capping of the pass through.[125] The AER agrees with SP AusNet's reasoning that if circumstances change it is not clear in advance what magnitude of mains volume may be necessary. Hence, in its final decision the AER has not capped the pass through.

The businesses' responses to the AER's original trigger event, which was completion of historical volumes, was set out in their revised proposals and in subsequent information requests. The businesses submitted that the pass through would create uncertainty as to whether a pass through application would be approved by the AER. According to the businesses, this may affect or may prevent the awarding of contracts due to the lack of certainty. In their view, this would reduce the cost efficiency of the mains replacement work[126] .

In order to clarify the effect on contracting, the AER sought further information from the distribution businesses regarding their particular contracting practices. The AER received information from all the distributors which indicated that the lead time for the awarding of contracts to work execution ranged from two months to two years. Following its assessment of this information and in order to take account of variable contracting practices, the AER has built in a nine month lead time into the pass through event. This factors in average lead time for contracting, based on the information received, as well as time for the application approval process which provides for ninety business days (subject to any extension).

For Multinet the trigger event for the pass through is completion of 207 kilometres of mains replacement. This takes into account information received by the AER in response to an information request on the contracting practices of the respective businesses.[127] The 207 kilometres is calculated by deducting nine months worth of mains replacement from the historical volume over the 2008-12 access arrangement period. This is calculated using the mains replacement schedule provided by Multinet in its revised proposal.[128]

The unit rates approved in the AER's final decision are to be applied in calculating the expenditure amount for the pass through.

Where volumes are undertaken in suburbs where unit rates have not been approved in the AER's final decision, the distribution business will be required to submit a proposal to the AER for those unit rates as part of the pass through application. The evidence that the AER will consider in assessing the efficiency of the proposed unit rates may include but shall not be limited to:

- whether the unit rate is an awarded tender rate and whether the rates were determined through a competitive tender process.

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[124] AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 4 Condential appendices*, September 2012, pp.8-9; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, pp.39-40.

[125] SP AusNet, *Revised Access Arrangement Proposal*, November 2012, p. 40.

[126] SP AusNet, *Revised Access Arrangement Proposal*, November 2012, p.40; Multinet, *Revised Access Arrangement Proposal*, November 2012, p.81; Envestra, *Revised Access Arrangement Proposal*, November 2012, pp.9-10..

[127] SP AusNet, *Response to information request FD7a*, received 11 January 2013, p.2.

[128] Multinet, *Revised Access Arrangement Proposal*, November 2012, Appendix 3-1 MG Capex Model.xls.

In the instance where the approved volumes of mains replacement for a particular suburb or suburbs have not been carried out, and are resubmitted as part of the pass through application, the expenditure differential only will be approved. This will be calculated by:

- calculating the difference between the total capex for mains replacement approved by the AER in its final decision, and the total area adjusted approved expenditure[129] undertaken by Multinet to complete the approved volumes
- subtracting this difference from the total approved pass through expenditure.

The AER considers that this:

- is consistent with the cost pass through event mechanism included in Multinet's revised access arrangement proposal which requires the costs of the pass through event to be incremental to costs already allowed for in reference tariffs.
- allows for the distribution business to reprioritise its mains replacement in order to undertake work in suburbs for which there is not a pre-approved unit rate. Where the unit rate is higher, the distribution business will be able to recover the higher unit rates actually incurred, subject to the AER's assessment that the unit rate is prudent and efficient. This therefore means there is no disincentive to undertake works in higher cost areas. Similarly, where work is undertaken in a suburb where there is no pre-approved unit rate and the unit rate is lower, the distribution business will be able to recover the lower unit rates actually incurred, subject to the AER's assessment that the unit rate is prudent and efficient. This therefore means that customers are protected from the costs associated with any incentive to nominate works in higher cost areas but to undertake works in lower cost areas.
- maintains the incentive for the business to attain lower unit rates than those approved in the final decision.

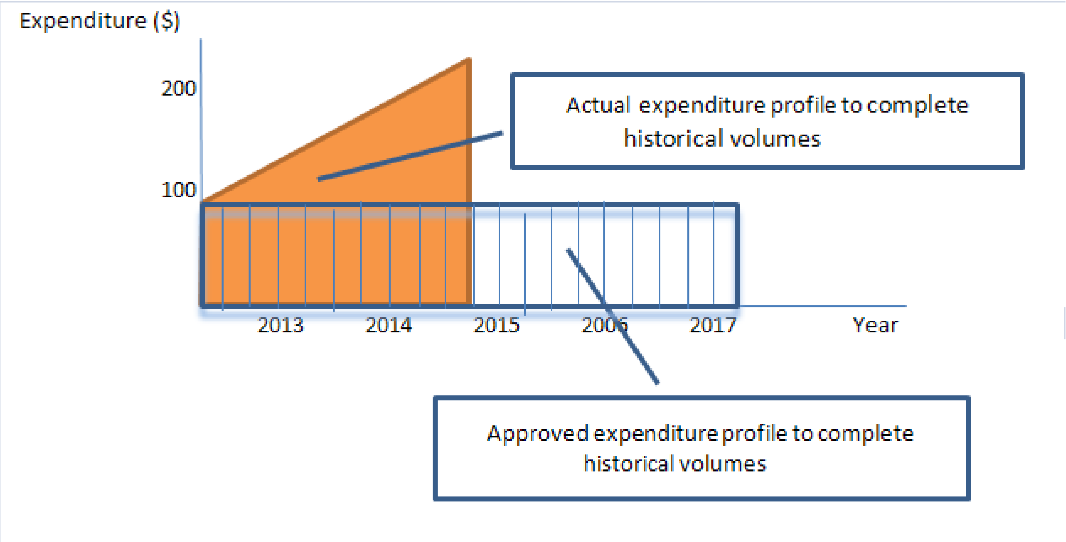
If approved, the pass through expenditure will consist of:

- The expenditure incurred or to be incurred in order to undertake the approved volumes, less any adjustment amount.
- An adjustment for the difference between:
    - the time value of money allowed for the expenditure approved in the AER's final decision for completion of historical volumes (as per the blue hatched area in Figure 4.2), and
    - the time value of money for the expenditure approved in the AER's final decision but undertaken in the timeframe that the volume was actually completed (as per the orange shaded area)[130]. This ensures that from a time value of money perspective the business is neutral as to whether the volume of mains replacement was approved entirely upfront (as per the orange shaded area in Figure 4.2) or via a combination of upfront funding plus the pass through.

[129] This is the sum of the volume multiplied by pre-approved unit rate for suburbs/postcodes where the AER has approved a unit rate plus the volume multiplied by the actual unit rate for suburbs/postcodes where the AER has not approved a unit rate (subject to the AER assessing that the unit rate actually incurred was prudent and efficient).

[130] Where volumes have been undertaken in suburbs/postcodes where the AER has not pre-approved a unit rate, the AER will apply a residual unit rate to these volumes. The residual unit rate will be calculated as the total approved expenditure for historical volumes less the expenditure incurred for mains replacement actually undertaken in the suburbs/postcodes included in the AER's approved historical expenditure, divided by, the total approved historical volume less the volume undertaken in the suburbs/postcodes included in the AER's approved historical expenditure.

Figure 4.2 AER approved expenditure profile versus actual completion profile



Source: AER analysis

The pass through expenditure does not include a separate allowance for the equity and debt raising costs associated with financing the pass through volume of mains expenditure as adjustments for these are automatically made on re-running the AER model once the approved pass through amount is rolled into the regulatory asset base (see attachment 3).

In assessing the proposed pass through volume and unit rates the AER must consider whether the costs to be passed through meet the relevant NGR criteria for determining the building block for total revenue for reference services (for example, the prudency and efficiency of the capex).

The tariff variation mechanism is specified in attachment 12.

In submitting a pass through application the AER will require that the distribution business provides:

- evidence of completion of the 207 kilometres of LP to HP block rollout and the medium pressure supply mains replacement necessary for carrying out the LP to HP block rollout which constitutes the trigger event. The AER will require that the distribution business submit independently verifiable information which details the low pressure to high pressure block replacement mains and the integral medium pressure supply mains volume by suburb and the unit rate which applied for that volume.
- evidence that the proposed pass through capex meets the NGR criteria.
- evidence that the business has and will incur expenditure to complete historical volumes.
- evidence of planned expenditure to complete the pass through volumes.

As per other tariff variations, the AER will make its decision on the pass through application within 90 business days (subject to any extension) of receiving a pass through application which contains the information required for the AER to make its assessment. The AER encourages the distribution businesses to consult with the AER before submitting their applications in order to ensure that the requisite information is included at the time of lodgement.

Unit rates

For the final decision, the AER does not approve Multinet's proposed unit rates. The AER considers the unit rates are not the best possible in the circumstances[131] as the overhead rate applied in Multinet's cost build ups was significantly higher than industry standard levels.

The AER considers that the unit rates approved in the AER's final decision, which reduce the overhead rate to 10 per cent, are prudent and efficient.[132] These are commercial in confidence (see Confidential Appendix C).

In its revised proposal, Multinet re-submitted its initial cost build ups for each main replacement project.

Zincara assessed the cost estimate build ups, consisting of detailed base unit rates and an overhead rate of 29 per cent. Zincara considered that the base unit rates were within industry standard ranges. However, Zincara considered the overhead was higher than industry standard levels.

Contractor overheads applied to the internal cost build ups

Multinet provided internal cost build ups as the basis for forecasting main replacement, augmentation and other programs. All cost build ups for the revised proposal included an overhead rate which the AER considered to be higher than industry standard averages.

In its draft decision, the AER did not approve this rate on the basis that it was not the best estimate in the circumstances and not efficient.[133] The AER formed this view on the basis of Zincara's advice that Multinet's overhead rate was significantly higher than industry standard levels of 10 per cent. The AER's draft decision reduced the percentage proposed by Multinet to 10 per cent[134].

In its revised proposal Multinet stated that "the AER has misunderstood the build-up of the proposed direct cost overhead" and referred to further explanation being provided in Appendix 3.11[135].

Multinet based its overhead rate in the cost build ups for mains replacement, augmentation and other projects on the contracting regime which was in operation for the 2008-12 access arrangement period. Consistent with the draft decision, Zincara assessed the cost build up and considered that:

- the base unit rates were efficient against industry standards,
- the overhead rate was significantly higher than industry standards, and
- by virtue of the overhead cost being high, that the total costs were significantly higher than industry standard levels[136].

The AER accepts Zincara's assessment. For these reasons, the AER considers that Multient's overhead rate is not the best estimate possible in the circumstances[137]. The AER proposes an

131 NGR, r.74(2)(b).
132 NGR, r.79(1)(a).
133 NGR, rr. 79(2)(b) and 79(1)(a); AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017: Part 2*, September 2012, pp.35-36.
134 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.37.
135 Multinet, *Revised access arrangement proposal*, 9 November 2012, p.84.
136 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.37.
137 NGR, r.74(2)(b)

overhead rate of 10 per cent. The AER has applied this overhead rate to all the cost build ups for mains replacement, augmentation and other projects.

The AER notes Multinet's submission in its revised proposal that the AER has misunderstood the build-up of the proposed direct cost overhead. The AER disagrees with Multinet's assertion.

There are a number of methods that Multinet could have used to forecast its pipeworks capex. These include projecting forward historical (2008-12) actual expenditure, using tendered rates for the next period, or constructing an internal cost build-up. Multinet has chosen to provide a detailed cost build-up, consisting of base unit rates and a particular percentage overhead. The AER considers that a cost build-up should reflect the costs expected to be incurred over the 2013-17 access arrangement period. While historical actual costs may have included the particular overhead rate proposed by Multinet, the AER does not have before it the actual base unit costs incurred. Similarly, while the AER understands that Multinet has tender responses which specify that it will incur a different, significantly lower overhead rate, the AER does not have the tendered base unit rates before it. Without the respective base unit rates the AER is unable to make an assessment of the efficiency of the total forecast cost.

Large diameter cast iron mains replacement

The AER's final decision is to not approve Multinet's proposed large diameter cast iron mains replacement capex of $6.8 million ($2012, direct costs, excluding internal direct overheads) for the following reasons:

- The AER considers that the Aughtie Drive project is not justified[138] as there is insufficient evidence that the mains cannot continue to be managed through reactive replacement or repair.
- The AER considers that it is not necessary to make an additional allowance for ad hoc replacement. As leakage survey is undertaken annually and any necessary replacement should be planned for the future period. To the extent that there is as any unforeseen replacement it is likely to be small. The AER considers that any amounts should be covered from within the approved mains replacement budget.
- For the three projects which the AER considers to be justified and prudent, the costs are not efficient. The AER considers that the base unit rates are reasonable when compared with industry standard levels, however the overhead rate applied is above industry standard levels. The AER considers that the costs for these three projects are not efficient.[139]

The AER considers that $3.0 million ($2012, direct costs, excluding internal direct overheads) for three of the large diameter cast iron mains replacement projects over the 2013–17 access arrangement period is conforming capex.[140]

Multinet originally proposed five replacement projects and an ad hoc allowance for the 2013–17 access arrangement period worth $10.4 million ($2012, direct costs, excluding internal direct overheads).[141]

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138 NGR, r.79(2)(c)(i).
139 NGR, r.79(1)(a).
140 NGR, r. 79(1)(a).
141 Multinet, *Response to information request 18 of 20 June 2012*, received 18 July 2012, Capex Breakdown Projects.xlsx

In the draft decision, the AER, on the basis of advice received from Zincara, assessed that the large diameter cast iron mains replacement program was not justified to meet safety obligations.[142] The AER considered that there was no information which indicated that these mains could not continue to be adequately managed on a reactive basis, as per the current access arrangement period. Furthermore three of the replacement projects were rated as a low priority or a combination of low and high or medium priority. Based on the information provided, the AER did not consider that low priority mains should be replaced. The AER therefore did not approve any capex for the large diameter cast iron mains replacement program.[143]

In its revised proposal Multinet reproposed four of the five replacement programs (Aughtie Drive St Kilda, Summerhill Rd Glen Iris, Riversdale Rd Hawthorn and Auburn Rd, Hawthorn) from its initial proposal and the ad hoc allowance. All project expenditure was the same except for the Auburn Rd project which was revised down reflecting a reduction in mains length from 3.8 to 2 kilometres at the same unit rate in the initial proposal.[144] Wellington Rd Kew was not reproposed as Multinet assessed that it was not required since its proposed 4B Kew low pressure to high pressure replacement project would cause the project to be redundant.[145]

In assessing the prudency of each of the four programs, the AER considered advice from Zincara. In providing its advice Zincara had regard to the information Multinet provided in its initial and revised proposals.

Zincara considered that the Auburn Rd, Hawthorn, Riversdale Rd, Hawthorn, and Summerhill Rd, Glen Iris large diameter cast iron mains replacement projects pose a safety risk which is most efficiently managed through proactive replacement[146].

On the basis of this advice, the AER considers these three projects to be necessary to maintain the safety and integrity of services and to comply with regulatory obligations[147] and prudent.[148]

In relation to the Aughtie Drive project, the AER considers that this expenditure is not justified[149] and not prudent and efficient.[150] On this basis Zincara considered that there was insufficient evidence that the mains could not continue to be managed through reactive replacement or repair. Zincara considered that reactive replacement or repair is the most efficient way to manage these mains[151]. The AER accepts Zincara's advice and therefore considers that the expenditure for the Aughtie Drive project is not justified and not prudent and efficient.[152]

The AER considers that the additional allowance proposed expenditure for ad hoc replacement is not the best forecast in the circumstances[153] and not prudent and efficient.[154] As leakage surveys are undertaken annually, the majority of any necessary replacement for the 2013-17 access arrangement period should already be planned. To the extent that there is as any unforeseen replacement, it is

142 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2*, September 2012. pp. 41-43; Zincara, *Review of Multinet's Capital Expenditure, Addendum, March 2013, p.8.*
143 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. pp. 10-15.
144 Multinet, *Revised access arrangement proposal*, 9 November 2012, p.88.
145 Multinet, *Revised access arrangement proposal*, 9 November 2012, p.88.
146 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.8.
147 NGR, r.79(2)(c)(i)-(iii).
148 NGR, r.79(1)(a)
149 NGR, r.79(2)(c)(i)-(iii).
150 NGR, r.79(1)(a).
151 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.8.
152 NGR, rr.79(2)(c)(i) and 79(1)(a).
153 NGR, r.74(2)(b).
154 NGR, r.79(1)(a).

likely to be small.[155] The AER considers that any amounts should be covered from within the approved mains replacement budget. The AER considers that no allowance is required for the ad hoc allowance.

For the three projects which the AER considers are justified and prudent, the AER considers that the costs are not efficient.[156]

Multinet provided internal cost build ups for each project.[157] There are two components in Multinet's build up: base unit rates and a particular overhead rate. Zincara assessed the efficiency of these cost build ups.

With respect to the base unit rates, Zincara considered that the cost build ups for the base unit rates for Auburn Rd and Riversdale Rd were reasonable relative to industry standards.[158]

The Summerhill Rd project had an error in its base unit rate cost build up. Once this was corrected Zincara considered that it was reasonable relative to industry standards.

All cost build ups for the revised proposal included a percentage overhead rate which the AER considers is significantly higher than industry standard averages.

Consistent with its draft position[159], the AER, for its final decision, considers that this rate is not the best estimate in the circumstances[160] and not efficient.[161] The AER considers that a 10 per cent overhead rate is the best estimate in the circumstances and efficient[162] (see page 42 for the discussion of this under LP to HP pipeworks unit rates).

The AER noted that there are differences between the cost build ups and the amounts in Multinet's capex forecast model. The AER sought advice from Multinet regarding these differences. Multinet advised the AER to use the expenditure presented in the capex model[163]. The AER considers that the cost build-up amount is the best estimate in the circumstances[164] and reveals the efficient and prudent amount[165]. The AER has therefore used the cost build-up amounts to make its adjustment of the overhead to 10 per cent.

Low pressure designated zone (LPDZ) mains replacement

The AER's final decision is to not approve Multinet's proposed low pressure designated zone (LPDZ) mains replacement expenditure of $10.5 million ($2012, direct costs, excluding internal direct overheads). The AER considers that the LPDZ mains replacement expenditure may be justified on safety or reliability grounds due to the existence of breaks and leaks.[166] However, the proposed mains

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155 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.8.
156 NGR, r.79(1)(a).
157 Multinet, Email entitled 'FW: Emailing: Demand Cost Estimates.zip', received 17 July 2012.
158 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.7-8.
159 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.4; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2*, September 2012. pp.42-43.
160 NGR, r.79(2)(b).
161 NGR, r.79(1)(a)
162 NGR, rr. 79(2)(b), 79(1)(a)
163 Multinet, *Response to information request FD21a*, received 5 February 2013.
164 NGR, r.79(2)(b).
165 NGR, r.79(1)(a).
166 NGR, r.79(2)(c)(i)-(iii).

replacement is not prudent and efficient[167] as the AER considers that the current level of risk associated with the mains can be adequately mitigated through reactive repair and replacement.

For the final decision, the AER considers that $0.4 million ($2012, direct costs, excluding internal direct overheads) for the Tashinny Rd, Toorak small diameter LPDZ replacement project is conforming capex[168].

Multinet initially proposed a new program of like-for-like replacement of mains in areas which would not be reached by the LP to HP rollout for more than 20 years[169].

Multinet proposed a total expenditure of $6.0 million ($2012, direct costs, excluding internal direct overheads) for the LPDZ large diameter mains replacement program and a total expenditure of $4.5 million ($2012, direct costs, excluding internal direct overheads) for the LPDZ small diameter mains replacement program for the 2013–17 access arrangement period[170].

In the draft decision, the AER assessed that, on the basis of advice received from Zincara, the low pressure designated zones was not justified[171]. Multinet did not provide any risk or demand information which supported a like-for-like proactive replacement program. The AER therefore did not approve any capex for the LPDZ mains replacement program.

In its revised proposal Multinet proposed the same small and large diameter LPDZ programs as it had included in its initial proposal[172].

Zincara considered that the frequency of breaks and water in mains incidents and the relative recency of the incidents and assessed that they were not of a level that would lead a prudent service provider acting efficiently to undertake proactive replacement, except for the Tashinny Rd, Toorak replacement project. Zincara considered that that the current level of risk associated with the remaining mains can be adequately mitigated through reactive repair and replacement.[173]

With regard to the Tashinny Rd, Toorak replacement project, Zincara assessed that due to the frequency of the supply reliability issues the mains replacement is justified.

Zincara assessed the cost build up for the Tashinny Rd, Toorak project and considered that the direct costs were within industry standard ranges. The AER do not consider the overhead rate to be the best estimate possible in the circumstances[174]. The AER has reduced the overhead rate applied to 10 per cent (as discussed in the section on LP to HP pipeworks unit rates on page 42).

On the basis of Zincara's advice, the AER considers that only the Tashinny Rd, Toorak project is prudent and effficient. The AER considers that a prudent service provider acting efficiently would continue to manage the risk associated with the other mains through reactive replacement or repair and not through proactive replacement[175].

167 NGR, r.79(1)(a).
168 NGR, r.79(1)(a).
169 Multinet, *Access arrangement information*, 30 March 2012, Appendix D-7 Distribution mains strategy, pp.12-14, 27, 35-37.
170 Multinet, Email titled ' Information request 18', received 18 July 2012, Capex Breakdown Projects.xlsx.
171 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. pp.15-18; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2*, September 2012. pp.43-45.
172 Multinet, *Revised access arrangement proposal*, 9 November 2012, p.89-92.
173 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.13.
174 NGR, r.74(2)(b); Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.13.
175 Zincara, *Review of Multinet's Capital Expenditure, Addendum,* March 2013, p.13.

Unplanned service renewal

The AER's final decision is to not approve Multinet's proposed unplanned service renewal expenditure of $7.8 million ($2012, direct costs, excluding internal direct overheads) as conforming capex.[176] There is a clear downwards trend in services. For this reason, the AER considers that Multinet's expenditure forecast for unplanned service renewals has not been formed on a reasonable basis and is not prudent and effiicent.[177]

The AER considers that $6.2 million ($2012, direct costs, excluding internal direct overheads) for unplanned service renewal expenditure for the 2013-17 access arrangement period is conforming capex.

In its initial proposal Multinet submitted an allowance for unplanned service replacement of $9.8 million[178] ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period.

In its draft decision, the AER considered that given the decline in service numbers which were replaced over the 2008–11 period that the estimate of the service numbers over the 2013–17 access arrangement period are too high. The AER projected forward the 2011 number of service renewals, on the basis that service renewals should continue to decline as the LP to HP mains replacement program continues to roll out at the same rate as over 2008–11. It was unclear whether the unit rates provided by Multinet which were described as tendered rates, were final. In the absence of a contract to confirm the final unit rates the AER applied the 2008-11 average unit rate. The AER approved $2.8 million in total unplanned services renewal for the 2013-17 access arrangement period[179].

In its revised proposal Multinet reduced the volume of unplanned service renewals compared with its initial proposal. This reflected the updated actual annual average volume of unplanned service renewals for 2008-12. Multinet resubmitted the unit rates provided in its initial proposal[180].

The AER notes that there is a clear downwards trend in services. The AER considers that given this, an historical average volume does not provide a reasonable basis for forecasting the volume for the 2013–17 access arrangement period. The AER therefore considers that Multinet's expenditure forecast for unplanned service renewals has not been formed on a reasonable basis and is not prudent and efficient.[181] Consistent with the draft decision, the AER has projected forward the 2012 number of service renewals on the basis that service renewals should continue to decline as the LP to HP mains replacement program continues to roll out at the same rate during 2013-17 as over 2008–12.

For the unit rates, the AER considers that Multinet's tendered unit rates provide the best estimate possible in the circumstances[182]. The AER considers that the tendered rates are the result of a competitive process. The AER considers that the use of tendered rates is preferable to the use of historical data as it provides the most reliable basis in the circumstances for estimating the unit rates

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176 NGR, r.79(1)(a).

177 NGR, r r.79(2)(b) and 79(1)(a).

178 Multinet, *Response to Information Request 5 (incorrectly labelled 'Information request No.3 Q34') of 18 May 2012*, received 7 June 2012, resp 5 capital forecasts.xlsx.

179 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.18-20; *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2*, September 2012. pp.45-46.

180 Multinet, *Response to information request FD18a*, received 17 January 2013, Copy of Service Replacements Unplanned.xlsx.

181 NGR, rr. 79(2)(b) and 79(1)(a).

182 NGR, r. 74(2)(b).

for the 2013–17 access arrangement period. On the basis that the tendered rates are a competitive market outcome, the AER considers that the unit rates are efficient.[183]

4.4.2 Connections

The AER's final decision to not approve Multinet's revised capex proposal of $80.6 million ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period. The AER does not approve Multinet's revised proposal because:

- The AER does not accept Multinet's residential volumes. Multinet identified an error in its revised proposal.[184] The AER has corrected for this error in its final decision.
- The AER does not accept Multinet's industrial and commercial unit rates. Multinet was unable to substantiate the unit rates in its revised proposal. Multinet subsequently stated that it would adopt the AER's draft decision on the industrial and commercial unit rates.[185]
- The AER does not accept Multinet's revised proposal for Tariff D connections as Multinet's forecast does not reconcile with Multinet's historical data. The AER proposes to adopt the average of Multinet's historical Tariff D expenditure, as provided by Multinet.[186]

The AER proposes to replace Multinet's proposed capex allowance with $76.4 million ($2012, direct costs, excluding internal direct overheads) capex for the 2013–17 access arrangement period. The AER considers this amount is consistent with the NGR requirements.[187]

Table 4.6 Final decision – Tariff V residential[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	15.0	19.9	20.4	20.4	20.4	96.0
AER draft decision	12.6	12.6	12.5	12.0	11.9	61.5
Multinet revised proposal	13.0	15.3	15.3	15.1	15.2	73.9
AER final decision	12.8	14.5	14.4	14.0	14.1	69.8

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

Table 4.7 Final decision – Tariff V commercial/industrial[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	1.7	2.1	2.0	2.2	2.1	10.0
AER draft decision	0.9	0.8	0.8	0.8	0.8	4.2

183 NGR, r.79(1)(a).
184 Multinet, *response to AER information request FD6a, Vic GAAR - AER information request - Multinet - FD6a final.doc*, 12 December 2012. p. 2.
185 Multinet, *response to AER information request FD6a, Vic GAAR - AER information request - Multinet - FD6a final.doc*, 12 December 2012. p. 3.
186 Multinet, *Tariff D Augmentation AER Response v2.docx*, 29 January 2013. p. 1.
187 NGR, rr. 74(2) and 79.

Multinet revised proposal	0.7	0.9	0.9	0.9	0.9	4.3
AER final decision	0.9	0.9	0.9	0.9	0.9	4.3

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

Table 4.8 Final decision – Tariff D commercial/industrial[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	0.6	0.5	0.5	0.5	0.5	2.7
AER draft decision	0.0	0.0	0.0	0.0	0.0	0.0
Multinet revised proposal	0.6	0.5	0.5	0.5	0.5	2.7
AER final decision	0.5	0.5	0.5	0.5	0.5	2.3

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

Tariff V class customer connections

The AER's final decision is to not approve the forecasts in Multinet's revised proposal because information provided subsequent to the revised proposal has revealed that those forecasts are not arrived at on a reasonable basis and are not the best estimates possible in the circumstances.

Distribution businesses have a regulatory obligation to connect residential, industrial and commercial customers to the distribution network upon request. The capex associated with connecting customers to the distribution network generally includes the cost of new mains, gas service pipe from the main to the meter, and the meter itself.

Multinet stated in its revised proposal that:[188]

> Residential connections forecasts are based on the tendered prices received during the tender process from its contractors. These prices are multiplied by the forecast of the number of new connections derived from the NIEIR report. The forecast of commercial connections in Multinet's original proposal was prepared in the same manner as the residential connection forecast. In this revised proposal however Multinet has adopted historical average unit rates rather than tendered rates.

The forecast model provided with Multinet's revised proposal was hardcoded and did not allow the AER to verify the methodologies used, or the volume and unit rate assumptions which were used. In response to an AER information request Multinet indicated that:[189]

- It had made an error with its residential forecast. The error was assuming that the number of connections equals the number of services laid. Multinet considered this assumption is incorrect because multiple customers connect to the same service at multi user sites.
- It could not provide sufficient disaggregated data to support its revised proposal forecast for industrial and commercial customers. As such, Multinet proposed to adopt the AER's draft decision on industrial and commercial unit rates.

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188 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 93.
189 Multinet, *response to AER information request FD6a*, Vic GAAR - AER information request - Multinet - FD6a final.doc, 12 December 2012. p. 2.

Multinet provided a corrected and updated forecast model.[190] The AER accepts this model as the basis for Multinet's proposed forecast. The AER's detailed reasons on Multinet's forecasts for residential connections and industrial and commercial connections are set out below.

Residential connections

Multinet's updated residential connections capex is forecast by multiplying contracted unit rates by the relevant forecast volumes.[191] These volumes have been derived by splitting the high level gross connections forecast into forecasts of the volume of sub-components of a connection, e.g. mains, services and inlets.

Unit rates

The AER accepts Multinet's residential unit rates are prudent, efficient and have been arrived at on a reasonable basis.[192] The AER initially was unable to reconcile Multinet's revised cost build-up against the unit rates in the contracts Multinet entered into with its contractors.[193] However, Multinet has now demonstrated that its revised forecast unit rates are consistent with its contracts. Multinet also has adjusted these contracted unit rates for the Limb 2 payments and inflation.[194] Multinet had not previously shown these adjustments to the contracted rates to the AER. As such, the AER is satisfied that the unit rates forecasts in the corrected and updated forecast model have been arrived at on a reasonable basis and are the best possible in the circumstances.[195]

Volumes

The AER accepts NIEIR's demand forecast[196] as an appropriate basis for Multinet's gross connections forecast.

The AER's draft decision did not accept Multinet's gross connections forecast because the AER was unable to verify the veracity of the abolishment ratio used by NIEIR for deriving the residential and commercial/industrial gross connections.[197] As such, the AER considered that Multinet's forecast of gross connections had not been arrived at on a reasonable basis as required.[198] The AER instead used the 2012 gross connections number derived from sheet 3a of the RIN and adjusted these by NIEIR's growth rates for 2013–17 to derive estimates of the gross connections numbers for 2013–17.[199]

Multinet did not adopt the AER's draft decision and considered the AER's draft decision to reduce Multinet's forecast number of new residential connections was in error.[200] Multinet's revised proposal

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190 Multinet, *response to AER information request FD6a*, FD 6.a Multinet connections - AER questions to submit.xlsx, 12 December 2012. p. 2.

191 Multinet, *response to AER information request FD6a*, FD 6.a Multinet connections - AER questions to submit.xlsx, 12 December 2012. p. 2.

192 NGR, rr. 74(2) and 79.

193 AER, *Information request FD10a,* 10 December 2012.

194 Multinet has adopted a three limb structure in its contracting arrangements. The forecast unit cost is equal to — tendered cost (limb 1) plus contractor profit margin (limb 2) plus incentive payments (limb 3).

195 NGR. r. 74(2).

196 Multinet, *Access Arrangement Information: Attachment C-1 NIEIR Energy report, December 2011, Table 6.1*, December 2011, p. 72.

197 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.22.

198 NGR, r. 74(2)(a); AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.23.

199 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.23.

200 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 94.

was to maintain its forecast of residential connections as set out in its original proposal.[201] In its revised proposal Multinet stated that:[202]

> Multinet notes that the information contained in RIN template 3a contains "mixed" data. The number of physical connections shown in that template is metropolitan connections only. RIN template 3a does not include data relating to connections in the Yarra Valley and South Gippsland. Therefore the method applied by the AER to calculate the number of connections effectively assumes that no connections are made in the Yarra Valley or South Gippsland. The correct connections data to be used are contained in RIN template 20, 26 and 26a. The data in these templates is consistent with the energy volume forecast.

On the basis of the additional statements provided by Multinet, the AER has now been able to verify the gross connections forecast proposed by Multinet. Accordingly, the AER now accepts the NIEIR gross connections forecast as the basis for Multinet's revised gross connections forecast.

Multinet's corrected and updated forecast model disaggregated the gross connections forecast into the different subcomponents of a connection.[203] The AER examined this disaggregation and is satisfied that the manner in which the gross connections forecast is disaggregated is supported by historical data. Accordingly, the AER considers the volume forecasts in the corrected and updated forecast model are prudent, efficient and the best forecast possible in the circumstances.[204]

Industrial and commercial connections

Multinet's updated industrial and commercial connections capex is forecast by multiplying the gross connections forecast by an average unit rate. This is consistent with the AER's methodology in its draft decision.

Unit rates

The AER does not accept Multinet's revised unit rate forecast, because Multinet has not substantiated the manner in which it was derived.[205] The AER notes that Multinet's revised forecast resulted in the same average unit rate as the AER's draft decision, however the unit rate varied across years. As Multinet has not substantiated the reasons for these variations, the AER has applied the same average unit rate across all years of the 2013–7 access arrangement period.

The forecast model provided with Multinet's revised proposal was hardcoded and did not allow the AER examine how Multinet's forecast had been derived.[206] The AER requested further justification of Multinet's revised forecast, which Multinet did not provide.[207] Multinet stated:[208]

> There is no reason why the forecast rate would be different to the historical rate which is why Multinet has adopted the AER draft decision.

Multinet stated that it adopted historical average unit rates rather than tendered rates for the following reasons:[209]

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[201] Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 94.
[202] Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 94.
[203] Multinet, *response to AER information request FD6a*, FD 6.a Multinet connections - AER questions to submit.xlsx, 12 December 2012. p. 2.
[204] NGR, rr. 74(2) and 79.
[205] Multinet, *response to AER information request FD6a, FD 6.a Multinet connections - AER questions to submit.xlsx*, 12 December 2012. p. 2.
[206] Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012.
[207] Multinet, *response to AER information request FD6a, Vic GAAR - AER information request - Multinet - FD6a final.doc*, 12 December 2012. p. 3.
[208] Multinet, *response to AER information request FD6a*, Vic *GAAR - AER information request - Multinet - FD6a final.doc*, 12 December 2012. p. 2.

> This is because the average tendered rates include a proportionally excessive number of difficult sites in the mix of works, and this has the effect of increasing the average unit rate to a level significantly higher than the historical average. Unlike residential connections where Multinet has been able to simply adjust the mix of connections, this task is too difficult in the commercial/industrial category, because of the variation in the cost and frequency of the connections. In these circumstances, Multinet has adopted historical average unit rates.

For the reasons set out in its draft decision, the AER considers that a weighted average of the 2008–12 unit rates is the best estimate possible in the circumstances for the 2013–17 unit rates for industrial and commercial connections.[210] The AER considers that Multinet's forecast, where the unit rate varies each year, is not the best forecast possible in the circumstances, because Multinet has not substantiated the manner in which it was derived.[211]

Volumes

The AER accepts NIEIR's demand forecast as an appropriate basis for Multinet's gross connections forecast.

The AER in its draft decision did not accept Multinet's gross connections forecast because the AER was unable to verify the veracity of the abolishment ratio used by NIEIR for deriving the residential and commercial/industrial gross connections.[212] As stated in regards to residential connections, the AER has now been able to verify the gross connections forecast proposed by Multinet. Accordingly, the AER considers the volume forecasts in the corrected and updated forecast model is prudent, efficient and the best possible in the circumstances.[213]

Tariff D

The AER does not accept Multinet's revised forecast because it does not reconcile with Multinet's historical data. As such, the AER considers it is not prudent or efficient and the forecast has not been reached on a reasonable basis.[214]

Multinet initially forecast of between $0.6 million and $0.5 million ($2012, direct costs, excluding internal direct overheads) per year in capex for Tariff D ‘customer initiated capital’ over the 2013–17 access arrangement period.[215] Multinet based its forecast on "recent actual average levels" of Tariff D related customer initiated capital expenditure given the lumpy growth in Tariff D customers.[216]

The AER did not accept this forecast in its draft decision as Multinet did not provide total cost and volume data for Tariff D over 2008–12.[217] As such, the AER was unable to verify the average and was not satisfied that the forecast had been arrived at on a reasonable basis.[218]

Multinet's revised proposal maintained its initial forecast of between $0.6 million and $0.5 million per year ($2012, direct costs, excluding internal direct overheads).[219] The AER requested further

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209 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 96.

210 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.25.

211 NGR. r. 74(2).

212 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.23.

213 NGR, rr. 74(2) and 79.

214 NGR, rr. 74(2) and 79.

215 Multinet, *Access arrangement information*, 30 March 2012, p. 107.

216 Multinet, *Access arrangement information*, 30 March 2012, p. 107.

217 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.26.

218 NGR. r.74(2)

substantiation from Multinet on the derivation of this forecast. Multinet indicated it wanted to change its forecast to $0.45 million per year ($2012, direct costs, excluding internal direct overheads).[220] Multinet provided details of Tariff D connections from 2008-12 to support its revised forecast.[221]

The AER has examined the details of Multinet's Tarff D connections in 2008-12 and considers using an average of the annual costs detailed in this information is a reasonable basis for forecasting Tariff D connections. Accordingly the AER proposes to revise Multinet's Tariff D connections forecast to $0.45 million ($2012, direct costs, excluding internal direct overheads), which is consistent with the historical data provided by Multinet. The AER considers this amount is prudent, efficient and the best forecast possible in the circumstances.[222]

4.4.3 Meter replacement

The AER's final decision is not to approve Multinet's revised proposal for $15.0 million ($2012, direct costs, excluding internal direct overheads) in meter replacement capex over the 2013–17 access arrangement period. The AER considers $12.2 million ($2012, direct costs, excluding internal direct overheads) is conforming capex for Multinet's metering replacement program over the 2013–17 access arrangement period. The AER does not accept Multinet's revised proposal because:

- Multinet's proposed unit rates across its meter categories did not reconcile with its tendered meter purchase contracts.
- Multinet's proposed meter replacement volumes are too high because they reflect the incorrect assumption that all meters located on abolished premises will be replaced. Multinet's meter replacement forecast does not account for the proportion of those meters that are refurbished instead of being replaced.

Table 4.9 Final decision - meter capex ($million, 2012)[(a)]

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	3.6	3.3	2.4	2.3	2.4	14.0
AER draft decision	2.2	2.2	2.2	2.2	2.2	11.2
Multinet revised proposal	4.1	3.1	2.9	2.3	2.6	15.0
AER final decision	3.4	2.5	2.4	1.8	2.1	12.2

Source: AER analysis.
Notes: (a) Direct costs, excluding internal direct overheads

Meter replacement is an ongoing activity which is necessary to ensure that gas meters in the field are replaced when they fail to accurately read data. Gas meters are continually sampled and tested for accuracy, and based on sample test results, the wider meter population (meter family) is allocated a life and a forecast replacement date. New meters are required to be installed for new premises being constructed - either as a result of new estates being developed or abolishment of existing premises with a meter that is unrepairable.

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219 Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012.
220 Multinet, *email—Multinet Tariff D Augmentation,Tariff D Augmentation AER Response v2.docx*, 29 January 2013
221 Multinet, *email—Multinet Tariff D Augmentation,Tariff D Augmentation AER Response v2.docx*, 29 January 2013
222 NGR, rr. 74(2), 79.

Multinet initially proposed metering capex of $14.0 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period.[223] The AER's draft decision was not to accept Multinet's proposed metering capex.[224] The AER determined that Multinet's capex forecast for meters had not been arrived at on a reasonable basis and did not represent the best forecast possible in the circumstances.[225] Specifically, Multinet had not provided sufficient information for the AER to reconcile Multinet's meter purchase contract unit rates with its detailed cost build-up.[226] Further, due to lack of substantiation of its calculated meter unit rates, the AER considered Multinet's proposed unit rates were not prudent or efficient as required by the NGR.[227] Accordingly, the AER's draft decision calculated Multinet's allowance from a historical average of unit rates.[228] The AER accepted Multinet's proposed forecast volume of meters to be replaced.[229]

Multinet's revised proposal was for a capex allowance for meter replacement capex of $15.0 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period.[230] Multinet's revised proposal included a detailed cost build-up using meter purchase unit rates and meter purchase volumes.[231] The AER was unable to reconcile the unit rates in the capex model with Multinet's contracts for new meter purchases. Multinet acknowledged that its revised proposal did not match the unit rates in its contracts.[232] As such, the AER does not accept Multinet's revised proposal forecasts because Multinet has demonstrated its revised proposal is incorrect (and so would not be incurred by a prudent service provider), has not been reached on a reasonable basis and is not the best forecast possible in the circumstances.[233]

As Multinet has acknowledged errors in its revised proposal, the AER has used information provided in response to its information requests to determine the best forecast possible in the circumstances.

Cost of new meters (unit rate)

The AER generally considers that unit rates which have been reached as a result of a competitive tender are generally those which would be incurred by a prudent and efficient service provider, have been reached on a reasonable basis and are the best forecasts possible in the circumstances.[234]

The AER notes that Multinet provided several versions of its capex model which contained unit rates that did not reconcile with Multinet's contracted unit rates.[235] As such, the AER provided Multinet with unit rates, which it considers reconcile with Multinet's contracts.[236] Multinet accepted the AER's calculation for the 8m3, 10m3, AL425 and AL800 meters.[237] Multinet considered the AER had made

223 Multinet, Access arrangement information, 30 March 2012, p. 119.
224 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.29.
225 NGR. rr. 74(2(a) and 74(2(b).
226 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.29.
227 NGR. r. 79(1).
228 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.29.
229 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.31.
230 Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012.
231 Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012.
232 Multinet, *email—Meter capital response*, 11 January 2013
233 NGR. 74(2) and 79(1)
234 NGR. 74(2) and 79(1)
235 Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012. And Multinet, *email—Meter capital response*, *Meter Replacement New meter purchase Final AER assumption update.xlsx*, 11 January 2013
236 AER, *Information request FD10e*, 12 February 2013.
237 Multinet, *Response to AER information request FD10d,* 15 February 2013.

an error in its calculation of the meter costs for the AL1000 meters.[238] The AER corrected the error it made in calculating the unit rates for the AL1000 meters. For these meters the AER has applied unit rates, which reconcile with Multinet's contracts. The AER considers these unit rates are prudent, efficient and represent the best forecast possible in the circumstances.[239]

In respect to Multinet's AL1400, AL2300 and Var I&C meters, Multinet submitted that there is an error in the unit rates in Multinet's contracts.[240] Multinet provided a quote from its meter provider demonstrating the costs it is incurring in relation to these meters.[241] Multinet stated that:[242]

> We assume that the tenderers have incorrectly estimated some mix of repaired meters and new meters in providing these costs. The costs provided for the TCE codes titled "Procure New/Repaired meters" bear no resemblance to the costs charged by the meter manufacturer for new meters and cannot be used for compiling metering capital forecasts.

The AER accepts that the unit rates for the AL1400, AL2300 and Var I&C meters are incorrect and considers that the quote provided by Multinet's meter provider[243] is a reasonable basis for the forecast and is the best forecast possible in the circumstances.[244]

Volume of meter purchases

In its draft decision, the AER considered that Multinet's volume forecast appeared appropriate.[245] However, Multinet submitted that the AER had made several errors in manipulating the information provided by Multinet:[246]

> As well as not properly accounting for unrepairable meter families, refurbishment of test meters and faults, Table A.15 AER draft decision on Multinet's meter replacement volumes assumes 80 per cent of meter families can be refurbished. Multinet's experience is that 90 per cent of repairable families can be refurbished.

As such, the AER re-examined Multinet's volume forecasts. Additionally, Multinet's revised proposal applied NIEIRs growth forecast to determine the total number of meter required for new connections.[247] As discussed in relation to Multinet's connections forecast (section 4.4.2) the AER now accepts NIEIR's forecast of gross new connections.

However, the AER does not accept Multinet's proposed volume of meter purchases for the following reasons:

- Multinet does not need to replace every meter removed from an abolished premises. Rather, the AER considers that Multinet can refurbish many of these meters. As such, these repaired meters are assessed as part of the opex allowance instead of new meter purchases in the capex allowance.

- Multinet's allocation of meters required for new connections between the residential and commercial categories meter categories does not match the connections forecast in the NIEIR report.

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238 Multinet, *Response to AER information request FD10d,* 15 February 2013.
239 NGR. 74(2) and 79(1)
240 Multinet, *Response to AER information request FD10d,* 15 February 2013.
241 Multinet, *Response to AER information request FD10d, FW: Price for AL1400 & AL2300's* 15 February 2013.
242 Multinet, *Response to AER information request FD10d,* 15 February 2013.
243 Multinet, *Response to AER information request FD10d, FW: Price for AL1400 & AL2300's* 15 February 2013.
244 NGR. 74(2)
245 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.30.
246 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 98.
247 Multinet, *Revised access arrangement proposal*, *Appendix 3-1 MG Capex Model.xlsx,* 9 November 2012.

The AER's examination of these two issues is set out below.

Treatment of abolished meters

The AER considers that Multinet's revised proposal incorrectly accounted for the replacement of meters on demolished premises. Multinet's revised proposal assumed that Multinet needs to replace all meters which it removes from abolished premises. The AER understands that Multinet refurbishes some of these meters, avoiding the need to replace abolished meters with a brand new meter. As such, the AER considers it necessary to adjust Multinet's forecast to reflect the number of abolished meters Multinet will actually refurbish.[248] In making this adjustment, the AER has assumed that the same proportion of abolished meters can be refurbished as the proportion of refurbishments from those meters removed because they have reached the end of their life. Multinet indicated that it agreed with the AER's adjustment to account for these abolished meters.[249]

This adjustment reduces the forecast number of meters Multinet needs to purchase——which reduces Multinet's capex allowance for meter replacements. Conversely, the forecast number of meters that Multinet needs to refurbish increases—which increases Multinet's opex allowance. The AER considers this better reflects the manner in which Multinet actually operates its network.

Allocation between residential and commercial meters

The AER notes that Multinet's forecast meters for new connections matches NIEIR's total (residential and industrial and commercial combined) forecast. However, the allocation between the residential and industrial and commercial meter categories differed from NIEIR's forecasts.

Multinet explained that it treated all $10m^3$ meters as industrial and commercial for the purpose of its meter capex forecast. However, many of these meters are actually installed in larger residential establishments.[250] Conversely, small industrial and commercial installation may only need meters which are smaller than $10m^3$. The AER is satisfied that the total number of $10m^3$ required for new connections is correct. However, it considers that they should be allocated to the residential and industrial and commercial categories consistent with the NIEIR forecasts. The AER has adjusted this allocation in its final decision.

This reallocation does not reduce the total capex allowance for Multinet's residential and commercial meter installations. Instead, it results in a shift in the expenditure between the two categories. This ensures that the allowance for each category reflects the actual usage of these meters.

4.4.4 Augmentation

The AER's final decision is to not approve the $32.1 million ($2012, direct costs, excluding internal direct overheads) proposed by Multinet for augmentation capex[251]. The AER considers Multinet's proposal is not the best forecast possible[252], is not justifiable[253] or prudent and efficient expenditure[254] for the following reasons:

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[248] Multinet, *Response to AER information request 10a: Meter replacement New meter purchase Final AER assumption update.xlsx,* received 14 January 2013.:.

[249] Multinet, *Response to AER information request FD10e*, 25 February 2013

[250] Multinet, *Response to AER information request FD10b*, 4 January 2013. p.1.

[251] This reflects all the revisions accepted by the AER in repsonse to requests from Multinet to change its revised proposal.

[252] NGR, r. 74(2)(b).

[253] NGR, r. 79(2)(c)(i)-(iii).

[254] NGR, r. 79(1)(a).

- Multinet has not demonstrated that a number of proposed projects are necessary or justified as it has not shown the modelled pressures in the specific network areas are forecast to fall below the minimum system pressure during the 2013–17 access arrangement period.

- Multinet's applied overhead rate is not the best estimate in the circumstances. Based on the advice of Zincara, the AER consider that Multinet's overhead rate is significantly higher than industry standards.

- Multinet did not provide a cost build-up for one of its proposed projects, therefore the AER assessed that the proposed forecast were not arrived at on a reasonable basis and does not reflect the costs of a prudent and efficient service provider.

The AER considers that $23.7 million ($2012, direct costs, excluding internal direct overheads) of augmentation expenditure (see Table 4.10) is conforming capex.

Multinet initially proposed 31 augmentation projects at a cost of $35.4 million over the 2013–17 access arrangement period[255].

The AER's draft decision was to:

- not approve 22 of the augmentation projects on the basis that they were not justified.[256] The AER did not approve proposed projects where the modelled pressure was not forecast to fall below the regulated minimum as it considered the augmentation is not necessary and therefore the expenditure is not justified.[257] The AER also did not approve projects where the proposed project does not address the identified capacity issue as it considered the expenditure was not prudent and efficient.[258]

- not approve the proposed cost of the nine augmentation projects which were otherwise justified under the relevant capex criteria[259], as the input costs were not within industry standards. Therefore the AER considered that forecast costs were not arrived at on a reasonable basis[260] and did not reflect the costs of a prudent and efficient service provider.[261] Multinet also applied direct overheads which the AER considered were not within industry standards. The AER adjusted Multinet's unit rates downwards to reflect an efficient level of overheads.

- approve $23.7 million ($2012, direct costs, excluding internal direct overheads) out of Multinet's total $35.4 million ($2012, direct costs, excluding internal direct overheads) proposed augmentation expenditure.[262]

Multinet's revised proposal did not adopt the AER's draft decision. Multinet considered the AER's draft decision would result in significant capacity-related supply interruptions over a wide range of Multinet's territory in the 2013–17 access arrangement period.[263] Multinet reviewed the augmentation expenditure in its initial proposal in light of the report provided to the AER by Zincara. Multinet considered its initial forecast augmentation expenditure is consistent with the capex criteria and

255 Multinet, *Email titled ' Information request 18'*, received 18 July 2012, Capex Breakdown Projects.xlsx.
256 NGR, rr. 79(1)(a) and 79(2)(c).
257 NGR, r. 79(2)(c).
258 NGR, r. 79(1)(a).
259 NGR, r.79(2).
260 NGR, r. 74(2)(a).
261 NGR, r. 79(1)(a).
262 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 4 Confidential appendices*, September 2012. p.32-37; *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2*, September 2012. pp.56-57.
263 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 101.

provided further information to substantiate its initial proposal.[264] Post meeting with the AER, Multinet submitted a revised proposal for its 2013 Knox HP augmentation which shifted the expenditure from across the 2012-13 financial year to totally within 2013[265]. In response to a request for further information from the AER, Multinet withdrew four of its proposed augmentation projects and submitted two additional augmentation projects.[266] Multinet's updated revised proposal included $32.1 million ($2012, direct costs, excluding internal direct overheads) for augmentation capex for the 2013–17 access arrangement period. The AER approved these ammendments to Multinet's revised proposal[267] as it reflects that Multinet's circumstances have changed such that certain expenditure is nolonger required. The AER considered the additional augmentation projects and the proposed increase in expenditure for the Knox HP project against the capex criteria together with the other proposed projects.

In its submission to the AER, the EUCV stated that AEMO's 2012 Gas Statement of Opportunities indicated that the amount of gas likely to be used in the 2013–17 access arrangement period is considerably less than was used in the 2008–12 access arrangement period. The EUCV considered this top-down analysis indicated that there is no need to augment the distribution networks to accommodate gas usage growth. Further, the EUCV considered augmentation needs in the 2013–17 access arrangement period would be quite modest and only needed in areas of expansion of the distribution networks to accommodate new gas users.[268]

The AER accepts the EUCV's observation that system-wide demand is not forecast to increase in the 2013–17 access arrangement period. However, this does not necessarily mean there is no need to augment the distribution networks because augmentation capex may be required to:

- reinforce sections of distribution networks that are supply constrained
- ensure the distribution networks are capable of continuing to satisfy demand for services, particularly in areas of high growth.

In the draft decision and this final decision the AER examined the drivers of Multinet's proposed augmentation projects and whether they aligned with the above reasons. The AER also considered the timing of the proposed works, the capacity benefit which results from the augmentation solution and the input cost of each project. In undertaking this assessment the AER sought input from its engineering consultant, examined the business cases and requested further information from Multinet.[269]

Multinet's revised proposal did not include sufficient information to justify the proposed augmentation projects. The AER requested the following further information from Multinet for each proposed project:

- the main driver
- the scope of the proposed project, including any alternatives considered
- modelled pressures pre- and post-augmentation in areas forecast to fall below the minimum system pressure pre-augmentation

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264 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 102.
265 Multinet, *Email titled ' FW: Knox HP'*, received 12 December 2012.
266 Multinet, *Email titled ' FW: 2017 Projects'*, received 27 December 2012, p. 2.
267 NGR, r.60(2)
268 Energy Users Coalition of Victoria, *Submission to the AER: AER draft decision and revised applications from Envestra, Multinet and SP AusNet*, January 2013, pp 18–19.
269 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012; Zincara revised report

- cost build-ups.[270]

Multinet provided further information for 14 of its 29 proposed projects[271].

Taking this information into account and the advice provided by Zincara, the AER considers 21 of the 29 proposed projects are justified[272] (see Table 4.10). These proposed augmentation solutions are considered necessary in light of a decline in forecast gas pressure below the minimum regulated pressures in specific network areas.[273]

Table 4.10 Comparison of Multinet's initial and revised proposals and AER draft and final decisions for Augmentation ($'000, 2012)[(a)]

	Multinet initial proposal	AER draft decision	Multinet revised proposal	AER final decision
2013 Knox HP (MP to HP)	1,850	–	2,806	2,387
2013 Mulgrave HP[(b)]	–	–	–	-
2013 Tooronga HP Darling Rd Outlet Grid (#1)	1,251	–	1,251	1,065
2013 Queens Wharf Rd 1050kPa CTS & PRS	1,200	–	1,180	1,180
2013 Aughtie Dr CTS & PRS Augmentation	650	–	645	645
2013 Moorabbin HP	421	–	421	-
2013 South Melbourne HP (Port Melb MP to HP)	1,564	–	1,564	1,331
2013 Nunawading MP (Various MP to HP)	1,113	–	1,121	-
2013/14 Ringwood HP	1,090	–	1,090	927
2014 Tooronga HP Darling Rd Outlet Grid (#2)	1,544	–	1,544	1,326
2014 Nunawading MP - HP	666	–	666	-
2014 Regent St CTS Augmentation M017	500	–	500	-

270 AER, *Information request FD8a*, sent 4 December 2012; AER, *Information request FD8b*, sent 7 January 2013; AER, *Information request FD8c*, sent 22 January 2013.

271 Multinet, *email—FW: Knox HP (response to AER information request 8a)*, 12 December 2012; Multinet, *email—FW: TOORONGA HP DARLING RD OUTLET (response to AER information request 8a)*, 14 December 2012; Multinet, *email—FW: MOORABBIN 2014 (response to AER information request 8a)*, 17 December 2012; Multinet, *email—FW: AUGMENTATION – STH MELBOURNE (response to AER information request 8a)*, 18 December 2012; Multinet, *email—FW: OAKLEIGH HP GRID (response to AER information request 8a)*, 18 December 2012; Multinet, *email—Aughtie Drive (response to AER information request 8a)*, 18 December 2012; Multinet, *email—FW: Sherbrooke and Olinda Sth (response to AER information request 8a)*, 24 December 2012; Multinet, *email—FW: 2017 Projects (response to AER information request 8a)*, 27 December 2012; Multinet, *email—FW: RINGWOOD (response to AER information request 8b)*, 11 January 2013; Multinet, *email—RE: Vic GAAR – AER information request – Multinet FD8c – Augmentation follow up (response to AER information request 8c)*, 29 January 2013.

272 NGR, r. 79(2)(c)(i)-(iii).

273 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012; Zincara revised report

2014 Sherbrooke HP	1,439	1,224	1,439	1,224
2014 Olinda North HP	115	99	115	99
2014 Olinda South HP	430	366	430	366
2014 Ringwood HP (Croydon Rd)	183	–	183	-
2014 Moorabbin HP (Bentleigh)	1,346	–	1,346	2,048
2015 Tooronga HP Darling Rd Outlet Grid (#3)	1,010	–	1,019	867
2015 Sherbrooke HP	1,741	1,482	1,732	1,482
2015 Oakleigh HP Grid	1,407	–	1,407	1,197
2015 Olinda North HP	128	110	128	110
2015/16 Olinda South HP	1,606	1,367	1,606	1,367
2016 Tooronga HP Darling Rd Outlet Grid (#4)	1,061	903	1,061	913
2015/16 Moorabbin HP Grid ("300mm MP uprating")	2,054	1,421	2,043	1,740
2016 Sherbrooke HP	1,363	–	1,363	1,160
2016 Olinda North HP	558	475	558	475
2016/17 Olinda South HP	2,055	–	2,066	1,783
2017 Tooronga HP[(b)]	1,800	–	-	-
2017 Knox HP[(b)]	1,521	–	-	-
2017 Mulgrave HP[(b)]	1,500	–	-	-
2017 Moorabbin HP	1,900	–	1,900	-
2017 Grid Main South, Balcome Rd to Glenelg Dr[(c)]	–	–	1,137	-
2017 Grid Main South, Warren Road[(c)]	–	–	942	-
Total	**35,066**	**7,446**	**32,126**	**23,691**

Source: AER analysis
Note: [(a)] Direct costs, excluding internal direct overheads

[(b)] Multinet withdrew these augmentation projects from its revised proposal in response to an information request from the AER.[274]
[(c)] Multinet proposed these additional projects to its revised proposal in response to an information request from the AER.[275]

The AER considers the remaining eight projects, totalling $6.9 million ($2012, direct costs, excluding internal direct overheads), are not justified. For these projects, Multinet has not demonstrated that the modelled pressure is forecast to fall below the regulated minimum or has not provided the cost build-up.

Multinet submitted that it was unable to provide forecast demand growth, modelled fringe pressures or cost build-ups for the 2017 projects. Multinet submitted that the annual average expenditure from the previous period should be allowed for 2017[276].

On the basis of Zincara's advice, the AER considers that augmentation capex is generally forecast on a project specific basis and not on an historical average expenditure as:

- augmentation will vary with changes in development and population growth areas which tends to depend upon economic cycles and government policies in relation to regional planning and immigration. Growth is not constant, as reflected by the strong growth experienced over the 2008-12 period, but projected growth slowing over the 2013-17 period.
- augmentation will depend on the existing network configuration, spare capacity, and other programs which will impact network capacity. For example, the rolling out of the LP to HP mains replacement program will increase network capacity in these areas. As the areas vary over time, a constant amount of augmentation cannot be assumed[277].

For these reasons, the AER considers the augmentation is not necessary and so the expenditure is not justified.[278] The AER's reasons are set out in Table 4.11 and take into account advice provided by Zincara.[279]

Table 4.11 AER reasons for not approving augmentation capex ($'000, 2012)[(a)]

Project	Total 2013–17	Reason for not approving
2013 Moorabbin HP	421	Multinet's revised proposal and responses to the AER's information requests did not provide further information that demonstrates the project is necessary. On the basis of the information provided, the AER considers Multinet has not demonstrated this project is justified for the same reasons stated in the draft decision.[280]
2013 Nunawading MP (Various MP to HP)	1,121	Multinet's revised proposal and responses to the AER's information requests did not provide further information that

274 Multinet, *Response to AER information request FD8a: 2017 projects.doc*, 27 December 2012, p. 2.
275 Multinet, *Response to AER information request FD8a: 2017 projects.doc*, 27 December 2012, p. 2.
276 Multinet, Email titled ' FW: 2017 Projects', received 27 December 2012, p. 2.
277 Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, p.31.
278 NGR, r. 79(2)(c)(i)-(iii).
279 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012, pp.14-25; Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, pp.22-31.
280 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 36; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 56-57.

		demonstrates the project is necessary. On the basis of the information provided, the AER considers Multinet has not demonstrated this project is justified for the same reasons stated in the draft decision.[281]
2014 Nunawading MP - HP	666	Multinet's revised proposal and responses to the AER's information requests did not provide further information that demonstrates the project is necessary. On the basis of the information provided, the AER considers Multinet has not demonstrated this project is justified for the same reasons stated in the draft decision.[282]
2014 Regent St CTS Augmentation M017	500	Multinet's revised proposal and responses to the AER's information requests did not provide further information that demonstrates the project is necessary. On the basis of the information provided, the AER considers Multinet has not demonstrated this project is justified for the same reasons stated in the draft decision.[283]
2014 Ringwood HP (Croydon Rd)	183	Multinet's revised proposal and responses to the AER's information requests did not provide further information that demonstrates the project is necessary. On the basis of the information provided, the AER considers Multinet has not demonstrated this project is justified for the same reasons stated in the draft decision.[284]
2017 Moorabbin HP	1,900	Whilst Multinet provided further information in response to the AER's information requests, it did not demonstrate pressures in the Moorabbin HP network will fall below the minimum system pressure in the 2013–17 access arrangement period. Therefore, the AER considers Multinet has not demonstrated that this project is justifiable under r. 79(2)(c). Multinet stated it was unable to provide a cost build-up for this project.[285] Therefore the AER was unable to assess whether the proposed costs of the project are a reasonable forecast or reflect the costs of a prudent and efficient service provider, consistent with rr. 74(2)(a) or 79(1)(a) of the NGR.
2017 Grid Main South, Balcome Rd to Glenelg Dr[(b)]	1,137	Multinet was unable to provide information relating to capacity deficiency for this network area.[286] On the basis of the information provided, the AER considers Multinet has not demonstrated that this project is necessary and therefore is not justifiable under r. 79(2)(c).
2017 Grid Main South, Warren Road[(b)]	942	Multinet was unable to provide information relating to capacity deficiency for this network area.[287] On the basis of the information provided, the AER considers Multinet has not demonstrated that this project is necessary and therefore is not

281 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 36; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 56-57.

282 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 37; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 56-57.

283 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 37; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 56-57.

284 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 37; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 56-57.

285 Multinet, *Response to Information request FD8c*, 29 January 2013, p. 2.

286 Multinet, *Response to Information request FD8c*, 29 January 2013, p. 2.

287 Multinet, *Response to Information request FD8c*, 29 January 2013, p. 2.

		justifiable under r. 79(2)(c).
Total	6,862	

Source: Multinet.[288] AER analysis.
Notes: (a) Direct costs, excluding internal direct overheads
(b) Multinet proposed these additional projects in response to an information request from the AER.[289]

For the 21 projects which are justified, Zincara assessed the cost build ups for each project provided by Multinet[290]. Taking this advice into consideration, the AER considers the input costs of the augmentation projects are within industry standards[291]. Therefore, the AER considers the input costs are the best estimate in the circumstances[292] and reflect the costs of a prudent and efficient service provider.[293] However, the AER considers the overhead rate Multinet proposed is not the best estimate in the circumstances and not efficient.[294] On the basis of advice from Zincara, the AER's best estimate in the circumstances of the overhead rate, based on industry standards, is 10 per cent[295]. The overhead rate is discussed in the section on LP to HP pipeworks unit rates on p.42.

The AER therefore considers that $23.7 million ($2012, direct costs, excluding internal direct overheads) out of the proposed capex of $35.4 million ($2012, direct costs, direct costs, excluding internal direct overheads) is conforming capex.

Table 4.12 Final decision – Augmentation ($million, 2012)[a]

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	8.5	6.9	6.1	6.4	7.2	35.1
AER draft decision	–	1.7	2.3	3.5	–	7.4
Multinet revised proposal[(b)]	8.8	6.9	6.1	6.4	7.2	35.4
AER final decision	7.0	5.6	5.2	5.5	0.4	23.7

Source: AER analysis
a Direct costs, excluding internal direct overheads
(b) Multinet amended its revised proposal in response to an information request from the AER and withdrew four of its proposed augmentation projects and submitted two further projects.

4.4.5 Information Technology

There are two components to Multinet's information technology (IT) proposal:

- general IT expenditure for business processes, considered in this section, and
- SCADA-related IT, considered in section 4.4.6.

The AER's final decision is to not approve Multinet's proposed expenditure of $48.4 million ($2012, direct costs, excluding internal overheads) for general IT expenditure for business processes on the basis that:

288 Multinet, *Revised access arrangement proposal*, Appendix 3-1 MG Capex model.xls, 9 November 2012.
289 Multinet, *Response to AER information request FD8a: 2017 projects.doc*, 27 December 2012, p. 2.
290 Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, pp.22-31.
291 Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, pp.22-31.
292 NGR, r. 79(2)(b).
293 NGR, r. 79(1)(a).
294 NGR, rr. 79(2)(b), 79(1)(a).
295 Zincara, *Review of Multinet's Capital Expenditure: Addendum*, March 2013, p.37.

- For the SAP Enterprise Resource Planning system implementation (SAP ERP implementation) there was an unexplained small difference between Multinet's initial proposal and its revised proposal. Given that the overall project cost should not have changed, the AER consider that the 2013 is not the best estimate possible in the circumstances[296] and have removed the difference.

- For the data warehouse enhancement project, the expenditure forecast is not the best estimate possible in the circumstances[297]. The AER considers that external and internal labour costs are higher than industry standard levels and a contingent hardware project is included in the forecast which the AER considers should be covered by the risk/contingency allowance.

- For the 'change request' allowance, the expenditure forecast is not the best estimate possible in the circumstances.[298] The AER considers that the risk/contingency allowance is sufficient to cover any items that would be included under the change request allowance.

- For the 'capitalisable operating expenditure and internal Multinet labour' allowance, the expenditure forecast is not the best estimate possible in the circumstances.[299] The AER considers that the project management office (PMO) allowance is sufficient to cover all internal labour required to undertake Multinet's IT program.

The AER considers that $45.7 million ($2012, direct costs, excluding internal direct overheads) of IT expenditure is conforming capex.

Multinet initially proposed IT-related capex of $46.9 million ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period.[300] The AER's draft decision was to approve 35.6 million ($2012, direct costs, excluding internal direct overheads) as conforming capex.[301]

In its revised proposal, except in relation to three projects, Multinet adopted the AER's draft decision.[302]

The AER received no further information regarding the projects which Multinet adopted in the draft decision. For the reasons in its draft decision[303], the AER considers that these projects worth $25.2 million ($2012, direct costs, excluding internal direct overheads) are conforming capex.[304]

The three projects, for which Multinet did not adopt the AER's draft decision, are discussed below.

SAP Enterprise Resource Planning system implementation (SAP ERP implementation)

The AER's final decision is to not approve Multinet's proposed expenditure for 2013 for SAP ERP implementation. The AER accepts the shift of expenditure from 2012 to 2013 for the SAP ERP

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296 NGR, r.74(2)(b).
297 NGR, r. 74(2)(b).
298 NGR, r. 74(2)(b).
299 NGR, r. 74(2)(b).
300 Multinet, *Access arrangement information*, 30 March 2012, p.134.
301 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, pp. 37–39; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, pp. 58–59.
302 Multinet, *Revised access arrangement proposa*l, 9 November 2012, pp. 102-104; Multinet, *Revised access arrangement proposal*, Appendix 3-1 MG Capex model.xls, 9 November 2012.
303 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, pp. 37–39; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, pp. 58–59.
304 NGR, r. 79(1)(a).

implementation. However, there is a small discrepancy in the amount proposed to be transferred which the AER proposes to correct.

In its revised proposal, Multinet revised its SAP ERP expenditure up for 2013. The AER sought clarification from Multinet of the 2012 and 2013 expenditure amounts.[305] Multinet revised down its initial forecast for 2012, shifting expenditure into 2013[306], which Multinet explained was due to delays in finalising the scope of the project.[307]

The AER notes there is a minor discrepancy between Multinet's total 2012 and 2013 amounts and that initially proposed by Multinet. As Multinet has stated that the adjustment is only a shifting of expenditure between years, the AER has adjusted the 2013 forecast so that the 2012 actual and the 2013 estimate sum to the initially proposed total expenditure amount.

Data warehouse enhancement program and define future data architecture and information model

The AER's final decision is to not approve Multinet's revised proposal for the data warehouse enhancement program (data warehouse program). The AER considers that the expenditure forecast is not the best estimate possible in the circumstances.[308] The AER considers that external and internal labour costs are higher than industry standard levels. Further, there is a contingent hardware project which is included in the forecast which the AER considers should be covered by the risk/contingency allowance.

The AER considers that only $1.2 million ($2012, direct costs, excluding internal direct overheads) for the data warehouse program is conforming capex.

In its revised proposal, Multinet did not propose any expenditure for its define future data architecture and information model (data architecture model).

Multinet initially proposed $2.4 million ($2012, direct costs, excluding internal direct overheads) for its data warehouse program and $0.3 million ($2012, direct costs, excluding internal direct overheads) for its data architecture model.

In its draft decision, the AER considered the initial data warehouse program and data architecture and model projects were necessary but the proposed $2.6 million ($2012, direct costs, excluding internal direct overheads) capex was not efficient. In its draft decision, the AER considered that $1.2 million ($2012, direct costs, excluding internal direct overheads) and $0.2 million ($2012, direct costs, excluding internal direct overheads) were efficient amounts of capex to support the data warehouse and data architecture model projects, respectively.

In its revised proposal, Multinet altered the two projects. For the data warehouse project, it proposed using existing IT hardware and software, rather than undertaking a total replacement of the current IT system and associated investments.[309] Multinet stated that the data architecture model project was to

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305 AER, *Information request FD3a, sent 20 November 2012*, question 1. AER, *Information Request FD3b*, sent 5 December 2012. AER, *Information request FD3c*, sent 19 December 2012, question 2, AER, *Information Request FD3d*, sent 15 January 2013.

306 Multinet, *Response to AER information request FD3d*, received 16 January 2013.

307 Multinet, *Revised access arrangement information*, 9 November 2012, p. 103.

308 NGR, r. 74(2)(b).

309 Multinet, *Revised access arrangement information*, 9 November 2012, p. 103.

be undertaken at a minimal level and so was to be removed from the expenditure forecast.[310] After corresponding with the AER, Multinet's final revised forecast expenditure for the data warehouse project was $3.0 million ($2012, direct costs, excluding internal direct overheads) and for the data architecture model project was nil.

For its final decision, the AER assessed the elements of the detailed cost build-up of the data warehouse enhancement project.

In relation to the external labour component, Multinet advised the AER that there was no change in project scope or the labour skill requirements[311] and that the cost revision upwards merely reflected a firming up of the cost estimate from the SAP provider. Multinet advised the AER that the project would be undertaken over three months. On the basis of advice from Nous Group, the AER considers that the amount approved in the draft decision is sufficient to undertake the project given that there is no change in the scope of work to be carried out[312]. The AER considers that any expenditure for external labour beyond this amount is inefficient.[313]

Multinet proposed an amount for trainingThe AER considers that some training is justified for training the business' users as it is not contained in the base labour/project costs. The AER considers that the training costs are within industry standard ranges. For these reasons the AER considers the training cost is conforming capex.

Multinet proposed an amount for shared hardware costs. Multinet stated that it considered that the base unit included in the SAP costs are sufficient for Multinet's requirements but that it is making allowance for additional capacity in case it is required.[314] The AER considers that the expenditure is not required as there is not a demonstrated need for this shared hardware element. The AER considers that the risk/contingency allowance is sufficient to cover the need for additional capacity, should it eventuate, and no allowance is required for this.

Multinet submitted a revised PMO cost that reflected a change from the modelling approach in Multinet's initial proposal, which costed the PMO at percentage of the external labour cost, to a firm labour estimate based on Hudson's 2011 cost advice in its revised proposal.[315] The AER considers that the amount approved in the draft decision is sufficient to undertake the project. The AER considers that the total PMO allowance provides adequate internal labour capacity for delivering Multinet's entire IT program. This is based on Nous Group's finding that Multinet's approach to estimating the PMO allowance provides a reasonable forecast for internal labour[316]. The AER considers that any amount in excess of this is not what a prudent service provider operating efficiently would incur. Multinet applied a risk/contingency allowance of a certain percentage of the total project cost. As stated in the draft decision, the AER considers that it is reasonable to provide a contingency allowance for IT where project costs may vary.[317] The AER considers that a prudent service provider

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310 Multinet initially proposed $0.2 million in its capex model. However, Multinet requested that this was removed from its revised proposal; Multinet, *Response to information request FD3a*, received 28 November 2012, p.3; Multinet, *Response to information request FD3c*, received 2 January 2013.

311 Multinet, *Response to AER information request Email: Vic GAAR Multinet IT*, received 30 January 2013.

312 AER, *VIC gas access arrangement review 2012 - capital expenditure - note for file - - Nous Group - Discussions regarding Multinet revised proposal*, AER13/1093, 7 March 2013.

313 NGR, r. 79(1)(a).

314 Multinet, *Response to AER information request Email: Vic GAAR Multinet IT* received 30 January 2013.

315 Multinet, *Response to AER information request Email: Vic GAAR Multinet IT* received 30 January 2013.

316 Nous Group, Victorian gas distribution access arrangement 2013-17: Review of IT expenditure Final report (Confidential to Multinet), 25 August 2012, p.11.

317 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 40; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, pp. 58–59.

acting efficiently in accordance with good industry practice would provide for a risk/contingency allowance within this percentage of total project costs.

Change requests

The AER's final decision is to not approve Multinet's proposed change request program. The AER does not approve this allowance as it is not prudent and efficient.[318] On the basis of advice from Nous Group the AER considers that a risk/contingency allowance equal to 15 per cent of the total project cost is sufficient to meet unforeseen cost estimates. The AER considers that any expenditure beyond this 15 per cent, which is already included in the project build ups, is not what a prudent service provider acting efficiently would allow.

The AER considers that no allowance is required for change requests.

In its draft decision, the AER did not accept that Multinet's capex proposal for the change request program was necessary.[319] The AER determined that a sufficient allowance for change requests would be provided for in the overall allowance approved for risk and contingency. The allowance for risk and contingency was calculated as a percentage of overall project costs.

In its revised proposal, Multinet submitted that change requests would address any performance shortcomings or additional infrastructure capacity to support and execute minor works and projects. Multinet resubmitted its initial forecast of capex for its proposed change request program.[320]

Multinet has not provided any further information in its revised proposal which demonstrates that it requires an allowance for change requests above that already provided for in the risk/contingency approved in the AER's draft decision. For the reasons in its draft decision, the AER does not approve the allowance for change requests.

Capitalisable operating expenditure and internal Multinet labour

The AER's final decision is to not approve Multinet's proposed capex for capitalisable opex and internal labour. The AER considers that Multinet has not demonstrated that it requires an allowance for internal labour greater than that provided for by the PMO allowance. The AER therefore considers that the forecast of capitalisable opex and internal labour allowance is not the best estimate possible in the circumstances and not prudent and efficient.[321]

The AER considers that no allowance is required for capitalisable opex and internal labour.

In its draft decision the AER did not accept Multinet's proposed for capitalised opex and internal labour. Multinet sought to recover the costs of its internal labour through:

- capitalisable opex, which Multinet submitted was for consultants and contractors (directly contracted to Multinet) and internal staff,
- internal – MGH Direct Cost, which Multinet submitted was for the provision of direct contractors. Multinet stated that this expenditure was an adjustment to "bring the total capitalisable opex

318 NGR, r. 79(1)(a).
319 NGR, r. 79(2)(c)(i) and (ii); AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 40.
320 Multinet, *Revised access arrangement information*, 9 November 2012, p. 103.
321 NGR, rr. 74(2)(b) and 79(1)(a).

closer to our own internal estimates" and that this adjustment was necessary because they "believed that Deloitte cost model estimate was slightly low", and

- a project management office, which Multinet costed at a certain percentage of external labour costs.

Nous Group advised the AER that the allocation for capitalisable operating expenses and 'direct costs' did not reflect a level of capital expenditure that would be incurred by a prudent service provider acting efficiently. Nous Group advised the AER that the oversight of the Multinet IT capital program was efficiently costed as the project management office allocated to each capital project, representing 10 per cent of the labour cost for each project[322]. On the basis of this advice, the AER considered that the approved project management office (PMO) allowance would be sufficient to provide for the expenditure of IT consultants, contractors and internal staff for delivering Multinet's IT program.[323]

Multinet's revised proposal submitted a capex allowance for capitalisable opex and internal labour. Multinet submitted that the capitalised internal labour cost is for the labour cost of contractors, consultants and staff tasked with delivering Multinet's IT capital projects. Multinet stated that the activities undertaken under this cost centre includes architecture, solution outline and governance, which it submits are not provided for by the projects team and PMO.[324]

The AER agrees that these functions need to be provided by Multinet in order to deliver its IT program. However, on the basis of advice from Nous Group, the AER considers that the PMO allowanceprovides sufficient internal labour capacity for delivering Multinet's entire IT program[325]. The capitalisable opex and internal labour allowance represents expenditure beyond the PMO allowance. The AER considers that a prudent service provider, operating efficiently would not incur this additional expenditure[326].

Table 4.13 AER final decision – Information Technology capex[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	19.9	8.8	6.9	7.8	3.5	46.9
AER draft decision	17.8	6.4	4.5	5.3	1.6	35.6
Multinet revised proposal	28.8	6.4	4.5	6.2	2.5	48.4
AER final decision	28.1	6.4	4.2	5.3	1.6	45.7

Source: AER analysis.
Notes: (a) Direct costs, excluding internal direct overheads

4.4.6 SCADA

There are two components relating to SCADA in Multinet's proposal:

- IT-related capex, and

322 Nous Group, Victorian gas distribution access arrangement 2013-17: Review of IT expenditure Final report (Confidential to Multinet), 25 August 2012, p.11.
323 Nous Group, *Victorian gas distribution access arrangement 2013-17: Review of IT expenditure*, Final Report, 13 August 2012 (confidential), p. 78.
324 Multinet, *Revised access arrangement information*, 9 November 2012, p. 104.
325 Nous Group, Victorian gas distribution access arrangement 2013-17: Review of IT expenditure Final report (Confidential to Multinet), 25 August 2012, p.11.
326 NGR, r. 79(1)(a).

- Hardware capex.

IT-related SCADA capex

The AER's final decision is to not approve Multinet's proposed expenditure for IT-related SCADA capex of $1.2 million ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period. Multinet did not provide further information in its revised proposal to justify two of its reproposed projects. For the reasons in its draft decision, the AER considers these two projects are not prudent and efficient.

The AER considers that an allowance of $0.6 million for one IT-related SCADA project in 2013 is conforming capex.

Multinet initially proposed IT-related SCADA capex of $5.3 million ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period[327].

The AER's draft decision was to approve $0.6 million ($2012, direct costs, excluding internal direct overheads) of capex for the SCADA replacement project in 2013. In the draft decision, the AER did not accept three IT-related SCADA projects, which are interdependent.[328]

The AER, on the basis of advice provided by Nous Group, considered that one of these three projects was not necessary or efficient.[329]

As a consequence of this project not being considered necessary, the other two projects, which are to subsequently support the project, were considered by the AER to be no longer required.[330]

In its revised proposal, Multinet adopted the AER's draft decision to approve $0.6 million ($2012, direct costs, excluding internal direct overheads) for one project in 2013. Multinet did not adopt the AER's draft decision and resubmitted its initial proposal for a further two projects worth $0.6 million ($2012, direct costs, excluding internal direct overheads) and scheduled for 2016. Multinet also proposed internal labour of $0.3 million ($2012, direct costs, excluding internal direct overheads).

Besides being included again in the capex model, no further information was provided by Multinet in relation to these three projects and the internal labour expenditure.

No other information was received in relation to these projects. For the reasons provided in its draft decision, as presented above, the AER does not accept Multinet's proposed expenditure for two projects worth $0.6 million ($2012, direct costs, excluding internal direct overheads).

On the basis of advice received from the Nous Group, the AER considers that the PMO amount of a percentage of external labour is efficient[331]. The IT-related SCADA internal labour allowance

[327] Multinet, *IT Capital Plan 2012-2017* (E-1 IT AMP); Multinet, *Response to information request 43*, received 7 August 2012.

[328] AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 40; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 58-59.

[329] Nous Group, Victorian gas distribution access arrangement 2013-17: Review of IT expenditure Final report (Confidential to Multinet), 25 August 2012, p.11.

[330] AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 42; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 58-59.

[331] Nous Group, Victorian gas distribution access arrangement 2013-17: Review of IT expenditure Final report (Confidential to Multinet), 25 August 2012, p.11.

represents expenditure beyond the PMO allowance. The AER considers that a prudent service provider, operating efficiently would not incur this additional expenditure[332].

SCADA hardware capex

The AER's final decision is to not approve Multinet's proposed expenditure for SCADA hardware of $1.0 million ($2012, direct costs, excluding internal direct overheads) for the 2013–17 access arrangement period. The AER considers that the expenditure does not meet the NGR requirements because Multinet did not provide:

- Evidence that the Kingfisher remote terminal unit (RTU) replacement was necessary.[333] Multinet was unable to provide evidence of when the RTUs are likely to fail and submitted that the likelihood of the units failing and not being detected as failing was low. The RTU manufacturer advised Multinet that replacement parts were available, which would extend the life of the RTU beyond its design life. The AER assessed that a prudent service provider, acting efficiently, would not undertake the proposed proactive replacement.
- Evidence of changes in demand or forecast growth which would indicate that two of the 14 proposed additional RTUs are necessary.[334]
- An estimate of the likely net benefits of collecting additional data which would result from the upgrade of daily metered flow computers.
- Evidence that the current pressure monitoring capabilities are inadequate or that a safety and reliability concern exists which would underpin the requirement for the proposed electronic gas detectors.
- Any cost benefit analysis or provide confirmation of the sites it proposed to upgrade for its upgrade of monitor only sites to control sites program.

The AER considers that $0.3 million ($2012, direct costs, excluding internal direct overheads) for the installation of 12 additional RTUs and $0.2 million ($2012, direct costs, excluding internal direct overheads) for Radio upgrade D to E series (approved in the AER's draft decision) is conforming capex. The AER considers that no allowance is required for:

- Kingfisher RTU replacement,
- upgrade of daily metered flow computers,
- electronic gas detectors, and
- upgrade of monitor only sites to control sites.

In the draft decision, the AER did not accept the following SCADA-hardware projects as they were not justified by evidence of failure, change in load conditions or of a demonstrable benefit to the network by Multinet:

- proactive replacement of Kingfisher RTUs[335]

332 NGR, r. 79(1)(a).
333 NGR, r. 79(2)(c)(i)-(iii).
334 NGR, r. 79(2)(c)(i)-(iii).

- additional fringe RTUs[336]
- uprade of daily metered flow computers[337]
- electronic gas detectors[338]
- upgrade of monitor only sites to control[339]

In its revised proposal, Multinet submitted revised expenditure requirements for all the SCADA hardware projects that were not approved by the AER. It adopted the AER's draft decision to approve $0.2 million ($2012, direct costs, excluding internal direct overheads) for radio upgrade of D to E series.

Kingfisher RTU replacement

The AER's final decision is to not approve Multinet's revised proposal to replace two Kingfisher RTUs per annum. Multinet did not justify the proactive replacement of two RTUs per annum[340]. Multinet was unable to provide evidence of when the RTUs are likely to fail and submitted that the likelihood of the units failing and not being detected as failing was low.[341] The RTU manufacturer advised Multinet that replacement parts were available, which would extend the life of the RTU beyond its design life.[342] For these reasons, the AER assessed that a prudent service provider, acting efficiently would not undertake the proposed proactive replacement.[343]

The AER considers that no allowance is required for Kingfisher RTU replacement.

In its revised proposal, Multinet scaled down its replacement from 50 Kingfisher RTU sites per annum in its initial proposal, to two per annum, at a cost of $25,000 per site over the 2013–17 access arrangement period. Multinet did not justify its proposed replacement of two RTUs per annum.

In assessing Multinet's revised proposal to replace the Kingfisher RTUs, the AER had regard to the need to proactively replace the RTUs or whether it is possible to reactively replace the RTUs.

Multinet proposed proactive replacement on the basis that :

- in its initial proposal Multinet submitted that the manufacturer was phasing out the Kingfisher RTU II

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335 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, pp. 43–44; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 59-62.

336 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 44; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 59-62.

337 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 45; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 59-62.

338 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 45; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 59-62.

339 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 45; AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 2, September 2012, p. 59-62.

340 NGR, r. 79(2)(c).

341 Multinet, *Revised access arrangement information*, 9 November 2012, p. 105.

342 Multinet, *Response to AER information request FD7b*, received 7 January 2013.

343 NGR, r. 79(1)(a).

- it was concerned about a bow wave effect created by the Kingfisher RTUs failing at similar times leading to unmanageable replacement schedules[344]
- proactive replacement would avoid the consequences of undetected failure of Kingfisher RTUs.

The AER accepts that there is a requirement for Kingfisher RTUs to provide data for network management. This means that where these RTUs fail they should be replaced. However, on the basis of the information provided by Multinet and the manufacturer of Kingfisher RTUs, the AER considers that the proactive replacement of RTUs is not prudent and efficient.[345]

In particular, Multinet was not able to provide the age profile of its Kingfisher RTU assets.[346] Mulltinet was not able to provide any failure history for the Kingfisher RTUs and did not attempt to quantify the likelihood that these assets will fail in the 2013–17 access arrangement period.[347] It is therefore unclear how many Kingfisher RTUs are expected to fail over the 2013–17 access arrangement period. On the basis of this information the AER considers there is no evidence to support Multinet's assertion of a bow wave which would warrant proactive replacement.

The AER contacted CSE Semaphore, the manufacturer of the Kingfisher RTU II. It stated that whilst it phased from the Kingfisher Series II to the Kingfisher Series PLUS in 2007, backwards compatibility has been retained. It advised that the design life is 15 years, however, that most users simply replace the CPU. Further, it stated that there is no need to change the RTU hardware unless the site application was being changed[348].

The AER considers the manufacturer's statements provide evidence that the Kingfisher RTU can be maintained beyond its design life, as its parts can be replaced iteratively as they fail, avoiding the need to replace the entire RTU at the end of its design life.

Based on the advice of Zincara, the AER considers that the consequences of a Kingfisher RTU failing are short-term loss of data input or incorrect data being relayed back to control room. Zincara advises that RTU failure would be detected reasonably quickly and data from surrounding RTUs would be used to monitor the network if one of the RTUs failed[349]. In its revised proposal, Multinet stated that it:

> "accepts that undetected failure of these assets or their sub components is a rare occurrence, and hence the associated risk of such events is low."[350]

On the basis that the likelihood of undetected failure is low and that the consequences are also low, the AER considers that proactive replacement on these grounds has not been justified.

The AER therefore determines that Multinet's proposed strategy to proactively replace two entire RTUs per annum is not necessary.[351] Therefore the AER considers that it is not necessary to make any allowance for reactive replacement.

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344 Multinet, *Response to AER information request 22*, received on the 2 July 2012, question 3e.
345 NGR, r. 79(1)(a).
346 Multinet, *Revised Access Arrangement Information*, November 2012, p.105.
347 Multinet, *Revised Access Arrangement Information*, November 2012, p.105.
348 CSE Semaphore, *Email 'Kingfisher RTU information'*, received 26 February 2013.
349 Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, p.32.
350 Multinet, *Revised Access Arrangement Information*, November 2012, p.105.
351 NGR, r. 79(2)(c)(i)-(iii).

Additional RTUs

The AER's final decision is to not approve Multinet's proposed expenditure of $0.3 million ($2012, direct costs, excluding internal direct overheads) for 14 additional RTUs. The AER considers that two of the additional RTUs are not justified as Multinet has not provided evidence of changes in demand or forecast growth which indicate that they are necessary.[352]

The AER considers that $0.26 million ($2012, direct costs, excluding internal direct overheads) for the installation of 12 RTUs is conforming capex.

In its draft decision, the AER approved the installation of additional RTUs at seven of Multinet's proposed 14 sites across its network, at a cost of $0.16 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period.[353]

Multinet's revised proposal included the seven additional RTUs that the AER approved in the draft decision and the seven additional RTUs that the AER did not approve in its draft decision. The additional RTUs which the AER did not approve and which Multinet reproposed are for the following locations:

- Dandenong - 2 RTUs proposed across HP1 and HP2 networks
- South Gippsland - 3 RTUs proposed across Wonthaggi, Leongatha and Inverlock networks
- South Melbourne/Southbank - 2 RTUs proposed across Southbank and South Melbourne networks

In its revised proposal, Multinet justified the installation of the additional RTUs on the basis of network analysis, assessment of connection forecasts for proposed developments and that the additional RTUs would enable it to use the best available information.[354]

The AER's final decision is to:

- Accept the installation of the two additional RTUs at Multinet's proposed unit cost for the Dandenong HP1 and HP2 networks. Zincara considered that continued industrial growth will shift significant loads around, justifying the need for additional monitoring points across the network. The AER therefore considers that the two additional RTUs are justified and prudent and efficient.[355]
- Accept the installation of the three additional RTUs at Multinet's proposed unit cost in the South Gippland network areas of Wonthaggi, Inverloch and Leongatha as prudent and efficient.[356] Multinet has demonstrated that it currently has insufficient pressure monitoring capability in these network areas[357]. Additionally, the AER considers that increased connection growth in the South Gippsland networks will alter the position of fringe pressure points and therefore necessitate additional monitoring capabilities at the new network fringe points. The AER considers that the

352 NGR, r. 79(2)(c)(i)-(iii).
353 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017,* Part 4 –Confidential appendices, September 2012, p. 44.
354 Multinet, *Revised access arrangement information*, November 2012, p. 106.
355 NGR, rr. 79(2)(c)(ii)-(iii) and 79(1); Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, pp.33-35.
356 NGR, rr. 79(1) and 79(2)(c)(i)-(ii).
357 Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, pp.33-35.

additional RTUs in the South Gippsland network are justified to maintain the safety and integrity of Multinet's network services, and prudent and efficient.[358]

- Not accept Multinet's proposed South Melbourne RTU expenditure for two RTUs. Multinet has not provided evidence that the Fisherman's Bend development in Port Melbourne together with increased load from the Port Melbourne and South Melbourne areas will create changes in load characteristics or cause changes in the position of network fringe points before 2018[359]. Zincara advised the AER that given the uncertainty of the forecast out to 2018 and that an RTU can be constructed within a short time period, that the RTU is not required in the 2012–17 access arrangement period and could be delayed until 2018[360]. On this basis, the AER considers that additional RTUs are not required to accommodate changes in fringe points in the 2013–17 access arrangement period. As such, Multinet has not demonstrated that the installation of additional RTUs in South Melbourne is justified by safety or integrity of its network services, regulatory obligations or capacity requirements within the 2012-17 access arrangement period.[361] The AER therefore does not approve the proposed $0.04 million ($2012, direct costs, excluding internal direct overheads) of expenditure for RTUs in the Southbank and South Melbourne areas.
- Accept the $0.16 million ($2012, direct costs, excluding internal direct overheads) expenditure for 7 additional RTUs which was approved in the AER's draft decision. No further information was received in relation to these RTUs.

The AER considers that a total of $0.26 million ($2012, direct costs, excluding internal direct overheads) is conforming capex for Multinet's proposed installation of 12 additional RTUs for:

- Moorabbin HP1 (2013)
- Ringwood HP (2013)
- South Gippsland - Wonthaggi (2013)
- South Gippsland Korumburra (2014)
- Oakleigh HP (2014)
- Doncaster HP (2014)
- South Gippsland - Leongatha (2014)
- South Gippsland - Inverloch (2015)
- Moorabbin HP2 (2016)
- South Melbourne HP/Southbank (2016)
- Dandenong HP 1 (2015)
- Dandenong HP 2 (2017).

358 NGR, rr. 79(2)(c)(i)-(ii) and 79(1).
359 Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, p.33-35.
360 Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, p.33-35.
361 NGR, r. 79(2)(c)(i)-(iv); Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, p.33-35.

Upgrade daily metered flow computers

The AER's final decision is to not approve Multinet's proposed expenditure of $0.03 million ($2012, direct costs, excluding internal direct overheads) for the upgrade of the daily metered flow computers over the 2013–17 access arrangement period. The AER considers that Multinet's proposed trial program to upgrade daily metered sites with metered flow computers is not prudent.[362] The AER considers that no allowance for the upgrade of daily metered flow computers is necessary.

In its draft decision, the AER did not approve Multinet's initial proposal to upgrade 40 daily metered sites with metered flow computers at a cost of $0.02 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period. The AER considered that Multinet was unable to provide an estimate of the likely net benefits of collecting the additional data and did not demonstrate that this program is required to meet a change in network safety or reliability or regulatory obligations.[363]

Multinet's revised proposal outlined a trial program to upgrade one daily metered site with metered flow computers per annum for a total of $0.03 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period. Multinet justified this project on the basis that additional data captured by flow computers may give it a better understanding of its network operating conditions. However, Multinet was unable to provide an estimate of the likely net benefits of collecting the additional data. Multinet considered that this trial program could be used to assess the benefits of flow meter upgrades in order to justify this trial strategy as a wider program.[364]

The AER considers that Multinet did not provide any new information in its revised proposal which addresses the AER's reasons for not approving this project. As such, Multinet has not provided sufficient justification that this project should be undertaken.[365] For the reasons in its draft decision the AER does not approve this expenditure.[366]

Electronic gas detectors

The AER's final decision is to not approve Multinet's proposed expenditure of $0.1 million ($2012, direct costs, excluding internal direct overheads) for the installation of electronic gas meters. The AER considers that the expenditure is not prudent and efficient.[367]

The AER considers that no allowance is necessary for electronic gas detectors.

In its draft decision, the AER did not approve Multinet's initial proposal to install 3 electronic gas detectors per annum at various sites across its network for a total cost of $0.1 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period. The AER considered that Multinet had not provided evidence that the current pressure monitoring capabilities

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362 NGR, r. 79(1); Zincara, *Review of Multinet's Capital Expenditure: Addendum,* March 2013, p.33-35.

363 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices,* p.45; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 2,* pp.59-62.

364 Multinet, *Revised access arrangement information*, November 2012, p. 108.

365 NGR, r. 79(2)(c)(i)-(iv).

366 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices,* p.45; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 2,* pp.59-62.

367 NGR, r. 79(1).

are inadequate or that a safety and reliability concern exists which would underpin the requirement for the proposed electronic gas detectors.[368]

Multinet's revised proposal re-stated Multinet's initial proposal to install 3 SCADA-monitored electronic gas detectors at large pressure reduction stations at a cost of $0.1 million ($2012, direct costs, excluding internal direct overheads) over the 2013–17 access arrangement period.[369] Multinet considered that the sites targeted for installation exhibit a higher probability of leak occurrence at higher pressures than upstream and downstream pipework. Furthermore, Multinet submitted that the use of gas detectors would enable advanced notification of leak sites in close proximity to residential or commercial premises. However, Multinet stated that at present, it is unable to quantify the net benefits associated with the installation of electronic gas detectors.[370]

Multinet did not provide any new information which addresses the AER's reasons for rejecting this project in its draft decision. The AER considers that Multinet has not demonstrated that the installation of gas detectors is required to meet safety or integrity of its network services, regulatory obligations or capacity requirements.[371] For the reasons in its draft decision the AER does not approve this expenditure.[372]

Upgrade of monitor only sites to control

The AER's final decision is to not approve Multinet's proposed expenditure of $0.1 million ($2012, direct costs, excluding internal direct overheads) for the upgrade of regulator sites with remote solenoid control. Multinet has not detailed any cost benefit analysis, nor provided confirmation of the sites which it proposes to upgrade. The AER considers that Multinet has not demonstrated that the upgrade of monitor only sites to control sites is required to meet safety or integrity of its network services, regulatory obligations or capacity requirements.[373] As such, Multinet has not provided sufficient justification that this project should be undertaken.

The AER considers that no allowance is necessary for the upgrade of monitor only sites to control.

In its draft decision, the AER did not accept Multinet's proposed upgrade of 24 monitor sites to control sites on the basis that Multinet had not detailed any cost benefit analysis, nor provided confirmation of the sites which it proposed to upgrade.[374] The AER did not approve an allowance for the upgrade of monitor only sites to control sites.

In its revised proposal, Multinet submitted plans to upgrade 24 regulator sites with SCADA solenoid control functionality, allowing remote control of regulator operating pressure. Multinet justified this project on the basis that it potentially allows for the mitigation of network losses in unaccounted for gas. Finally, Multinet stated that:[375]

> "The ability to quantify UAFG savings as a result of an individual upgrade is difficult to assess due to the substantial number of variables that are attributable to UAFG."

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368 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012, p. 41.
369 Multinet, *Revised access arrangement information*, November 2012, p. 108.
370 Multinet, *Revised access arrangement information*, November 2012, p. 109.
371 NGR, rr. 79(2)(c)(i)-(iv) and 79(1)(a).
372 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices,* p.45; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 2,* pp.59-62.
373 NGR, r. 79(2)(i)-(iv).
374 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012, pp. 40–41.
375 Multinet, *Revised access arrangement information*, November 2012, p. 109.

The AER considers that Multinet has not provided any additional information to address the AER's reasons for rejecting this project in its draft decision and no other information has been received. The AER considers that the capex is not prudent and efficient[376] for the same reasons given in its draft decision.[377]

Table 4.14 AER Final decision - SCADA hardware capex by program ($000, 2012)[(a)]

	Total
Kingfisher RTU replacement	-
Additional RTU	257
Upgrade daily metered flow computers	-
Electronic gas detectors	-
Monitor site conversion	-
Radio upgrade	233
Total	490

Source: AER analysis.
Notes: (a) Direct costs, excluding internal direct overheads

The total SCADA amount of capex which the AER considers is conforming capex is $1.1 million (2012, direct costs, excluding internal direct overheads) (see Table 4.15).

Table 4.15 AER final decision – Total SCADA (IT-related and hardware)[(a)] ($million, 2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	1.1	0.5	0.5	5.0	0.4	7.4
AER draft decision	0.8	0.1	0.0	0.0	0.0	1.0
Multinet revised proposal	0.9	0.3	0.2	0.2	0.2	1.6
AER final decision	0.8	0.1	0.0	0.0	0.0	1.1

Source: AER analysis.
Notes: (a) Direct costs, excluding internal direct overheads

376 NGR, r. 79(1).
377 Zincara, *Review of Multinet's Capital Expenditure*, 21 September 2012, pp. 41–42.

4.4.7 Other non-demand

The AER's final decision is to not approve Multinet's other non-demand capex totalling $38.8 million ($2012 direct costs, excluding internal direct overheads). The AER considers $34.7 million ($2012 direct costs, excluding internal direct overheads) is conforming capex for the 2013-17 access arrangement period. In particular, the AER considers that the following projects do not comply with the criteria for conforming capex.[378]

- Syphon replacement—Multinet's proposed capex allowance does not reconcile with the bottom up forecast provided by Multinet prior to the AER's draft decision. Further Multinet applied an overhead rate, exceeding the 10 per cent which the AER considers standard industry practice.[379]
- John valve replacement—Multinet failed to demonstrate there is a need to replace equipment which is currently functioning to an adequate level.
- Equipment Enclosures—Multinet has based its forecast on historical budgeted costs and not the costs that it actually incurred in performing these works. As such, the AER considers this forecast has not been reached on a reasonable basis.
- Overheads—Multinet applied an overhead rate to four of the other non-demand projects, exceeding the 10 per cent which the AER considers standard industry practice.[380]
- Modelling errors—Multinet states that it adopted the AER's draft decision on four other non–demand capex projects. However, Multinet's capex model did not reflect the AER's draft decision regarding these projects. Multinet has since acknowledged this was a mistake.[381]
- Recoverable works—The AER considers that as recoverable works are usually fully cost recovered that it is not necessary to have a contingency amount for this category.

Table 4.16 Final decision - Other non-demand capex ($ million 2012)[(a)]

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	17.7	7.1	6.1	9.0	6.2	46.1
AER draft decision	14.9	4.7	3.1	6.1	3.6	32.4
Multinet revised proposal	16.1	5.5	4.1	7.8	5.3	38.8
AER final decision	15.3	4.9	3.4	6.8	4.3	34.7

Source: AER analysis
Note: (a) Direct costs, excluding internal direct overheads

The AER considered Multinet's initial proposal contained 27 projects which fall into the other non-demand category of capex, with a total proposed expenditure of $46.1 million ($2012, direct costs, excluding internal direct overheads). The AER's draft decision approved $32.4 million ($2012, direct costs excluding internal direct overheads) in other non-demand capex over the 2013–17 access arrangement period.

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378 NGR, rr. 74(2) and 79(1)
379 NGR rr. 74(2) and 79(1)(a)
380 NGRr.79(1)(a)
381 Multinet, *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,*7 January 2013

The AER, in its draft decision, considered Multinet's proposed capital expenditure for 13 projects did not comply with the relevant rule requirements. The AER's reasons varied across the different projects and are discussed in detail in the draft decision.[382]

Multinet adopted the AER's draft decision on 15 of its proposed other non-demand capex projects.[383] The AER did not receive any further submissions on these projects. As such, for the reasons set out in the AER's draft decision, the AER accepts Multinet's revised proposal on these projects.[384]

Multinet did not adopt the AER's draft decision on other non-demand capex in regards to the following 12 projects:[385]

- Syphon replacement
- District regulator replacement
- Hydraulic regulator replacement
- Equipment enclosures
- Rectification for pigging
- Distribution Valve - John Valve Rectification
- Above Ground Supply Regulators: Toorak Road Tooronga
- Large Consumer Regulators
- Environmental noise improvement
- Obsolete regulator replacement
- Cathodic Protection Systems (Dist & Trans - New = Pba)
- Cathodic Protection Systems (Distribution - Existing = Pbc)

The AER's final decision on other non-demand capex is set out in Table 4.17.

Table 4.17 AER final decision – Other non-demand capex ($ million, 2012)[(a)]

Project Title	2013	2014	2015	2016	2017	Total
Hydraulic regulator Replacement	0.19	0.37	0.37	0.37	0.19	1.50
Environmental noise improvement	0.01	0.01	0.01	0.01	0.01	0.05
Equipment Enclosures	0.10	0.10	0.10	0.10	0.10	0.48

382 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017, Part 2 – Attachments*, September 2012, p. 62-66.

383 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012, p.115

384 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013–31 December 2017, Part 2 – Attachments*, September 2012, p. 62-66.

385 After correcting for Multinet's modelling errors as discussed in Multinet's *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc, 7 January 2013*

Obsolete regulator replacement	0.23	0.23	0.23	0.23	0.23	1.15
District regulator replacement	0.26	0.26	0.26	0.26	0.26	1.28
Non-compliant fittings	0.05	0.05	0.05	0.05	0.05	0.23
John Valve replacement	-	-	-	-	-	-
Albion Street, Glen Iris	-	-	-	-	-	-
Paschal St, Bentleigh	0.50	-	-	-	-	0.50
Graham St, Sth Melbourne	-	0.40	-	-	-	0.40
Vickery Rd, Bentleigh East	-	-	0.40	-	-	0.40
Wheatley Rd, Bentleigh	-	-	-	0.40	-	0.40
Toorak Rd, Tooronga	-	-	-	0.60	0.40	1.00
Large consumer regulators	0.10	-	0.10	0.10	0.10	0.40
Gas heaters (excl. Lang Lang)	-	-	0.02	-	-	0.02
Lang Lang heater	-	-	-	-	-	-
Telemetered CPUs	-	-	-	-	-	-
Cathodic Protection Systems (DIST & TRANS)	0.14	0.14	0.14	0.14	0.14	0.70
Cathodic Protection Systems (DISTRIBUTION)	0.04	0.04	0.04	0.04	0.04	0.22
Rectification for PIG; FTG	-	0.10	-	-	-	0.10
Rectification for PIG; Edithvale	-	-	-	0.89	1.91	2.81
Rectification for PIG; Murrumbeena	-	-	1.01	3.03	0.29	4.33
Syphon removal	0.61	0.61	0.61	0.61	0.61	3.04
Property projects	3.30	-	-	-	-	3.30

Non network	0.10	0.01	0.02	-	0.01	0.14
Recoverable works Highett	9.71	2.57	-	-	-	12.28
Other recoverable Works	-	-	-	-	-	-
Total	15.32	4.88	3.35	6.82	4.33	34.71

Source: AER analysis
Note: Direct costs, excluding internal direct overhead

The AER's assessment of each of these projects is set out below.

Overheads on other non-demand projects

The AER's final decision is not to approve the contractor overhead rate applied to Multinet's cost build-ups. This impacts the following four other non-demand projects:

- Syphon replacement
- District regulator replacement
- Hydraulic regulator replacement
- Rectification for pigging

In its draft decision the AER rejected this rate on the basis that it was not justified and would not be incurred by a prudent service provider operating efficiently.[386] Multinet's revised proposal included its initial overhead rate for the abovementioned other non-demand projects.[387]

For the reasons set out in section 4.4.1 the AER considers that the overhead rate is not the best estimate in the circumstances and would not be incurred by a prudent service provider acting efficiently.[388] The AER considers an overhead rate of 10 per cent is the best forecast possible in the circumstances.

Syphon removal

The AER's final decision is not to approve Multinet's revised proposal capex for syphon removal. The AER considers Multinet's proposed capex allowance is not consistent with the cost build-up it provided.[389] As such, Multinet's forecast capex allowance has not been arrived at on a reasonable basis and is not the best possible in the circumstances.[390] Further, for the reasons set out in section 4.4.1, the AER considers that the overhead rate is not the best estimate in the circumstances and would not be incurred by a prudent service provider acting efficiently.[391] The AER considers an overhead rate of 10 per cent is the best forecast possible in the circumstances.

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386 AER Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012,Part 4: Confidential Appendices p. 58
387 Multinet, *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012, p.110
388 NGR rr.74(2) and 79(1)(a)
389 Multinet, *Response to AER information request 17, Syphon Removal.xls*, 5 July 2012.
390 NGR, rr. 74(2) and 79(1)
391 NGR rr.74(2) and 79(1)(a)

Multinet initially proposed $7.6 million ($2012 direct costs, excluding internal direct overheads) to remove all 108 syphons on several of Multinet's pipeline.[392] Multinet proposed this expenditure in anticipation of upgrading the operating pressure of these pipelines from 840 kPa to 1050 kPa.

In its draft decision the AER considered expenditure for replacing all 108 syphons is not justified as necessary to maintain and improve the safety of the services, maintain the integrity of the services or comply with a regulatory obligation.[393] The AER considered that a prudent and efficient distribution business acting to achieve the lowest sustainable cost of providing services would: [394]

- implement an inspection program to ascertain the condition of the syphons on these pipelines.
- replace syphons which are identified as having corrosion problems.

Multinet's revised proposal reflected an allowance for the replacement of up to 10 syphons per year at a cost of $80,000 per site, and resulting in a total cost of $4 million for the forthcoming access arrangement period.[395] Multinet stated that previous assessments of syphons along the pipeline route have shown the condition of the syphons to be poor.[396] Accordingly Multinet was of the view that to prove the integrity of these pipelines and to obtain the regulatory endorsement required to up-rate them, there will be a need to expose and likely remove a majority if not all of the noted syphons.[397]

The AER requested additional information demonstrating the poor condition of these syphons.[398] Multinet submitted:[399]

> Within the past few years syphon inspections have been carried out at:
>
> - Dandenong Road, Malvern (site of a third party damage to the syphon tube by the Tramways Board)
> - On Pipeline T02 at Moorabbin for a shallow installation
> - Dandenong (in relation to Eastlink works) 2 sites
>
> Field Supervisory Staff also advise that a number of syphons have been excavated, had tubes removed and have been recoated although this process has been discontinued due to risk to field staff in the process and doubt over the effectiveness of the work in mitigating further corrosion. Of the above sites noted, two syphons were removed and one modified.

On the basis that Multinet has previously been required to remove a number of syphons, due to poor condition, the AER now accepts that Multinet will need to remove some syphons in the 2013—2017 access arrangement period to maintain and improve the safety of the services.[400]

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392 Multinet, Access Arrangement Information: Appendix 10_Transmission Pipelines_Strategy_2012-2018 21-03-2012.pdf, 9 March 2012. p. 24.

393 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices p. 54

394 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices p. 54

395 Multinet *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012 p.111

396 Multinet *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012 p.111

397 Multinet *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012 p.111

398 AER, *AER Information Request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 12 December 2012

399 Multinet *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 7 January 2013

400 NGR, r.79(2)c)(i)

The AER requested additional information to assess the reasonableness of Multinet's forecast that it will need to remove 10 syphons per year over the access arrangement period.[401] Multinet submitted:[402]

> Having excavated and inspected syphons which proved to be in poor condition Multinet has a responsibility to address the risk associated with the remaining syphons which, being of a similar age, are likely to also be in poor condition. The AER has rejected Multinet's proposal to remove all syphons so a lesser program has been submitted. The basis of Multinet's program is that at the rate of 10 sites per annum, all syphons will be removed within a 10 year period. Multinet's view is that, given the inevitable further deterioration of syphons which will occur, 10 years is the longest reasonable period that these syphons can be expected to last before unacceptable failure rates occur

The AER accepts on the basis of the above that Multinet's forecast volume of syphon removal has been arrived at on a reasonable basis and is the best possible estimate in the circumstances.[403]

The AER notes that in its revised proposal, Multinet applied an average cost of $80,000 for the removal of each syphon.[404] This does not reconcile with the bottom-up forecast provided by Multinet prior to the AER's draft decision.[405] Multinet's cost build-up indicates the cost to remove each syphon is $54,704.[406] Further, Multinet's cost build-up applies a contractor overhead rate which the AER considers is not representative of expenditure that prudent service provider acting efficiently would incur, as discussed on p42. Finally, this cost build up also contained a fixed cost of $27,545 for provings.[407] The AER considers this fixed cost component is appropriate to include in Multinet's capex allowance.

On the basis of Multinet's cost build-up, including the fixed costs and allowing for a 10 per cent overhead, the AER considers an average cost to replace each syphon of $71,450 is the best forecast possible in the circumstances. As such, the AER considers expenditure of $3.04 million ($2012 direct costs, excluding internal direct overheads) to be conforming capex in the 2013—17 access arrangement period. This capex allowance is calculated on the basis of removing 10 syphons per year.[408]

Distribution valve - John Valve rectification

The AER's final decision to not approve Multinet's proposed expenditure for John Valve rectification. The AER considers Multinet has not provided evidence that the condition of the John Valves is sufficiently poor that Multinet needs to replace these valves. As such, the AER considers this expenditure would not be incurred by a prudent service provider acting efficiently in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services.[409]

In its initial proposal Multinet included capital expenditure of $1.5 million ($2012 direct costs, excluding internal direct overheads) for the replacement of 35 John Valves at a cost of $50 000 per

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401 AER, *AER Information Request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 12 December 2012

402 Multinet *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 7 January 2013 p.6

403 NGR, r74(2)

404 Multinet *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012 p.111

405 Multinet, *Response to AER information request 17, Syphon Removal.xls*, 5 July 2012.

406 Multinet, *Response to AER information request 17, Syphon Removal.xls,* 5 July 2012

407 Multinet, *Response to AER information request 17, Syphon Removal.xls*, 5 July 2012.

408 NGR, rr. 79(1), 79(2)(c)(i) and 74(2)

409 NGR, r.79(1)(a)

valve. Multinet considered the expenditure necessary because the John Valves were ageing and could be in poor condition.[410]

In its draft decision the AER accepted that the John valves may be ageing and some may be in poor condition. However, the AER considered it has not been provided with any information to enable it to determine what proportion, if any, of the John valves may need to be removed.[411] The AER considered that a prudent and efficient service provider would instigate an inspection program to ascertain the condition of the valves and replace only those which were identified as corroded.[412]

In its revised proposal Multinet considered that it is prudent and efficient to replace these valves noting:[413]

- the condition of these valves;
- the fact that Multinet is unable to ascertain MAOP for these assets (which means that the valves may not comply with current standards);
- the possibility that all valves may not operate reliably; and
- the cost associated with excavation and inspection of the values,

The AER requested additional information from Multinet regarding its inspections of John Valves, which Multinet would have used to determine that the John valves are in poor condition.[414] In response Multinet submitted:[415]

> As per syphon inspections, Johns Valves inspections are not routine scheduled maintenance tasks and hence the inspections that have been carried out are not recorded in the Multinet SAP maintenance history in a manner that can be interrogated to determine the where or the overall number of inspections carried out. However it is known that these valves are all of a similar age and notwithstanding some variation due to variation in local conditions are likely to be in similar condition to the ones that have been inspected and photographed.
>
> However, as previously communicated to the AER, although the condition of these valves as inspected is poor, also of concern is that fact that they are installed in the high-pressure system and we have been unable to obtain evidence to show that they are rated for high-pressure applications. This raises liability issues for Multinet.

Multinet stated that the John Valves are in poor condition. However, the evidence provided to the AER is limited to a number of photographs and Multinet has been unable to provide detailed information to support its assessment.[416] Further, Multinet has not demonstrated that it has removed any John Valves to date. The AER considers that if the condition of these valves was sufficiently poor, Multinet would have replaced some of the valves it has inspected. This would particularly appear to be the case given Multinet's stated concerns about not knowing the Maximum Allowed Operating Pressure of these valves. The AER contrasts this with Multinet's syphon replacement program where Multinet has shown that the condition of the syphons is such that it has commenced removing the syphons from the pipeline.

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410 Multinet, *Access arrangement proposal: Appendix D-9 Distribution Valves*, 30 March 2012

411 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices p. 55

412 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices p. 55

413 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.114

414 AER, *AER Information Request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 12 December 2012

415 Multinet *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 7 January 2013 p.9

416 Multinet *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 7 January 2013 p.9

Taking this into account, the AER considers that Multinet has not demonstrated that the condition of the valves is such that they need to be replaced. As set out in its draft decision, the AER considers a prudent and efficient distribution business would implement an inspection program to ascertain the condition of these valves.[417] The AER also considers a prudent and efficient service provider may replace valves which are identified as having corrosion or other safety and reliability issues. However, the AER considers a prudent and efficient distributor would not replace all 35 John valves over the next access arrangement period when Multinet has not demonstrated that they are in sufficiently poor condition to warrant removal. As such, the AER considers this program is not one that would be undertaken by a prudent service provider acting efficiently. Therefore, the AER considers it is not conforming capex in the 2013—17 access arrangement period.[418]

Equipment enclosures

The AER's final decision is to not approve Multinet's proposed capex on equipment enclosures. Multinet based its revised forecast on historical budgeted costs and not costs actually incurred. As such, the AER considers this forecast has not been arrived at on a reasonable basis nor is it the best possible in the circumstances.[419]

In the AER's draft decision the AER did not accept Multinet's proposed capex allowance on the basis that it was not supported by the details of historical expenditure that Multinet had provided.[420] In Multinet's revised proposal Multinet revised its forecast and stated that:[421]

> Multinet has now undertaken further validation of the information it provided in response to the AER"s information request 17. After completing that validation exercise, Multinet has determined that it expended a total of $579,000 over the current regulatory period in relation to equipment enclosure works. This equates to an average annual expenditure of $116,000. Multinet has therefore adopted a revised forecast of $116,000 per annum for equipment enclosures.

Multinet provided additional information to support its historical costs.[422] This additional information showed that while Multinet had budgeted for $578,951 over the current access arrangement period, total expenditure actually incurred during the current access arrangement period totalled $477,846. The AER considers that Multinet's forecast has not been reached on a reasonable basis and is not the best forecast possible in the circumstances.[423] This is because the AER does not consider budgeted expenditure is necessarily reflective of the expected expenditure going forward. The AER considers that actually incurred expenditure is a better basis for forecasting Multinet's expected expenditure. As such, the AER considers $0.5 million ($2012, direct costs, excluding internal direct overheads) is conforming capex for the 2013–17 access arrangement period.

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417 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part : Confidential Appendices p. 55-56

418 NGR, r.79(1)

419 NGR. 74(2)

420 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part : Confidential Appendices p. 48.

421 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.110

422 Multinet, Response to AER information request 13a, 7 January 2013.

423 NGR. 74(2)

Above ground supply regulators: Toorak Road Tooronga

The AER final decision is to approve Multinet's revised proposal capex for the Toorak road regulator. The AER considers this expenditure is conforming capex as it is justified and would be incurred by a prudent service provider acting efficiently.[424]

Multinet initially proposed expenditure of $1.0 million ($2012, direct costs, excluding internal direct overheads) for the undergrounding of the Toorak road supply regulator. Multinet's justification for placing the Toorak road supply regulator underground initially appeared to be based on its proximity to a recent development.[425]

The AER, in its draft decision, did not accept Multinet's proposed expenditure on this site because the developer had confined development to accommodate the site of the current regulator.[426]

In its revised proposal Multinet cited a number of additional reasons for proposing to underground the regulator. In particular, Multinet indicated that this site had also been proposed for relocation due to the condition of the outlet pipework.[427] Multinet submitted:[428]

> this site has also been proposed for relocation due to the condition of the outlet pipework on this site. The 450 mm outlet supply main from this site was laid in the 1890s and is in extremely poor condition. The Toorak Road regulator is located on a former gasworks site which is contaminated. This contamination continues to be an aggressive soil environment for pipework located on this site. Assessment of the pipe condition in 2010 found that the thinnest part of the pipe was measured at 8mm thick compared to 20 mm in some areas, with the standards in that period of manufacturing being between 25 mm to 28 mm wall thickness.
>
> Large chunks of graphitised pipe fell off the surface or peeled off with little force during the inspection. The assessment was terminated as further work could have resulted in a failure. The soil was assessed as highly corrosive. The main was deemed to be in poor condition overall as a result of this assessment.

Given the condition of the outlet mains, Multinet considered it prudent and efficient to relocate this regulator for the following reasons:[429]

> Multinet considers that it is prudent to remove these mains through the relocation of the Toorak Road, Tooronga site. The relocation of this site enables the removal of these high risk assets. In addition, the below-ground installation of the regulator station will provide additional security as well as mitigating the risk of vandalism. It will also facilitate the relocation of high pressure facilities from within a property that Multinet no longer has control over in terms of future development.

On the basis of the evidence provided by Multinet, the AER accepts that the conditions of the pipes at this site are in poor condition and that a prudent and efficient service provider would undertake replacement works to maintain and improve the safety of services.[430] The AER examined the proposed length of mains replacement required and the unit rate proposed by Multinet.[431] The AER

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424 NGR, rr.79(1)(a) and 79(2)

425 Multinet, *Access arrangement proposal: Appendix D-4 Above Ground Supply Regulators*, 30 March 2012, p.13-14

426 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part : Confidential Appendices p. 52-53

427 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.113

428 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.113

429 Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.113

430 NGR. r. 79(2)(c)(i)

431 AER, *Information request FD13c*, 13 February 2013: and AER, *Information request FD13d*, 20 February 2013

considers that both forecasts have been reached on a reasonable basis and represent the best forecast possible in the circumstances.[432]

Additionally, the AER examined whether Multinet needed to underground the regulator (in addition to the minimum pipework necessary to maintain and improve the safety of services). The AER requested Multinet provide additional justification for the undergrounding of the regulator.[433] Multinet stated that:[434]

> Through replacement of the outlet supply pipes Multinet is in a position to capitalise on the efficiencies associated with reconfiguring and relocating the pipes in order to also relocate and underground the regulator. Multinet is proposing to remove the existing pipes from the private land thus mitigating future encroachment risk as well as soil contamination damage to pipe coatings. As such to mitigate these concerns full relocation and undergrounding of the station is required.

The AER examined the scope and location of the pipework which needs to be replaced. The AER notes that Multinet will need to do 'like for like' replacement of the 600mm and 450mm cast iron pipes from the Toorak Road Regulator.[435] The AER understands that the complexity of replacing this 600mm and 450mm cast iron pipes would likely require some alteration of the existing Toorak Road regulator and in this circumstance undergrounding the regulator at the same time appears to be prudent and efficient.[436]

On this basis, the AER considers that $1.0 million ($2012, direct costs, excluding internal direct overheads) is conforming capex in the 2013—17 access arrangement period.

Large consumer regulators

The AER final decision is to approve Multinet's revised proposal capex for the Large Consumer Regulators. The AER considers this expenditure is conforming capex as it is justified and would be incurred by prudent service provider acting efficiently.[437]

Multinet initially proposed expenditure of $0.4 million ($2012, direct costs, excluding internal direct overheads) to replace particular families of large consumer regulators. Multinet stated that replacement occurs when associated spare parts are not commercially available.[438]

In its draft decision the AER considered that Multinet's proposed expenditure on large consumer regulators was not justified or necessary.[439] The AER considered that a prudent and efficient service provider would not remove working equipment from its network unless there was a demonstrated economic, safety or regulatory need to do so.[440] The AER considered that Multinet had not demonstrated that this is the case.[441]

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432 NGR. r. 74(2)
433 AER, *AER Information Request FD13b, Multinet AER Information Request FD13b.doc, 6 February* 2013*,* p. *2*
434 Multinet *Response to AER information request FD13b, Multinet AER Information Request FD13b.doc, 12 February 2013* p.*4*
435 Multinet *Response to AER information request FD13d, Multinet Capex info request FD13d.doc, 22 February 2013 p.4*
436 NGR. 79(1)
437 NGR, rr.79(1)(a) and 79(2)
438 Multinet, *Access arrangement proposal: Appendix D-15 Large Consumer Regulators*, 30 March 2012, p.9
439 NGR, rr. 79(1), 79(2)(c)(i), 79(2)(c)(ii) and 79(2)(c)(iii)
440 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part : Confidential Appendices p. 53-54
441 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part : Confidential Appendices p. 53-54

In its revised proposal, Multinet submitted further explanations of the requirement for the proposed expenditure for the large consumer regulators.[442] Multinet cited the scarcity of certain materials required for maintenance of the regulators as the driver of the replacement program.[443]

The AER considered the information Multinet provided was insufficient and requested additional justification for replacing an entire series of regulators given the scarcity of a single input.[444] Multinet submitted:[445]

> Spare parts kits consisting of seals, gaskets and sleeves are no longer produced for the Rockwell 441 VPC regulator. Multinet has a current policy of full replacement of soft spares every 10.5 years for these installations. This replacement interval has been determined based on historical performance and has been subject to review in recent years to determine validity through reliability centred maintenance analysis. Failure to replace these soft spares may result in catastrophic failure of the regulator resulting in failure of the pressure reduction station. Given this, inability to maintain these sites would place Multinet in breach of our current standards, Australian Standards and our Safety Case.

The AER acknowledges regulators require regular servicing otherwise there is the potential for material safety risks. Further, the AER considers the internal maintenance policy used by Multinet is reasonable and would be representative of standard industry practice.[446] The AER requested that Multinet explain whether it had investigated any alternatives to replacing the regulators, including whether there were any substitutes for the parts which are no longer available.[447] Multinet stated:[448]

> Multinet have investigated after-market options for a number of regulator types and does pursue use of alternative spares where available. In the case of those regulators Multinet is proposing to replace these avenues have been exhausted. The manufacturers of these regulator types have advised that the parts are not available. In a number of cases the customer market is a limited market and hence the manufacturer is not incentivised to continue parts production. Multinet is not in a position to manufacture its own spare parts. Multinet historic experience in the review of manufacture of its own spares has raised questions over Multinet being in breach of manufacturer licensing/IP.

The AER accepts that Multinet has investigated alternative options. Further, the AER accepts that if Multinet can no longer acquire the requisite spare parts, Multinet cannot appropriately maintain these regulators.

As such, the AER now considers this expenditure would be incurred by a prudent service provider operating efficiently. The AER also regards Multinet's estimate of the expenditure to replace these regulators to be arrived at on a reasonable basis and is the best possible in the circumstances.[449] On this basis, the AER considers that $0.4m is conforming capex in the 2013—17 access arrangement period.

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[442] Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.112

[443] This applies to both the *Grove Model 80 Regulators and Rockwell 441 VPC Regulator* see Multinet, *Revised access arrangement proposal: Revised Proposal and Response to Draft Decision,* 9 November 2012 p.112

[444] AER, *AER Information Request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc,* 12 December 2012 p.3-4

[445] Multinet *Response to AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc, 7 January 2013 p.7-8*

[446] Multinet, *Response to information request 13b, Attachment 2 - I&C Maintenance Schedule Review.pdf*, 12 February 2013.

[447] AER, *information request FD13b, Multinet AER Information Request FD13b.doc*, 6 February 2013. p.1.

[448] Multinet, *Response to information request 13b, Multinet AER Information Request FD13b.doc*, 12 February 2013

[449] NGR, rr.79(1) and 74(2)

Errors in Multinet's capex model

Multinet's revised proposal indicated that it adopted the AER's draft decision in respect to the following projects:[450]

- Environmental noise improvement
- Obsolete regulator replacement
- Cathodic Protection Systems (Dist & Trans - New = Pba)
- Cathodic Protection Systems (Distribution - Existing = Pbc)

However, Multinet's capex forecast model did not reflect the AER's draft decision on these matters. Multinet subsequently indicated that its capex model was incorrect in respect to these projects and that it adopts the AER's draft decision.[451] For the reasons set out in its draft decision, the AER approves $2.1 million ($2012, direct costs, excluding internal direct overheads) expenditure on these projects as conforming capex.

Recoverable works

The AER's final decision is to not approve Multinet's proposed expenditure of $14.2 million ($2012, direct costs, excluding internal direct overheads) for recoverable works. The AER considers that as recoverable works is usually fully cost recovered that it is not necessary to have an unspecified allowance for this category. The AER therefore considers that Multinet's proposed expenditure is not the best estimate in the circumstances and would not be undertaken by a prudent service provider operating efficiently.[452]

The AER consider that $12.2 million ($2012, direct costs, excluding internal direct overheads) for recoverable works for the 2013-17 access arrangement period is conforming capex.[453]

In its initial proposal Multinet submitted total recoverable works expenditure of $14.2 million ($2012, direct costs, excluding internal direct overheads) for the 2013-17 access arrangement period.

In the draft decision the AER approved $12.2 million ($2012, direct costs, excluding internal direct overheads) of the recoverable works expenditure which was for the fully cost recovered Highett project.[454] The AER did not approve $1.9 million ($2012, direct costs, excluding internal direct overheads) which was an allowance amount. The AER considered that this category is generally fully cost recovered and so it is not necessary to have a contingency amount.[455]

In its revised proposal Multinet reproposed its initial proposal amount of $14.2 million ($2012, direct costs, excluding internal direct overheads).

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450 Multinet *Revised access arrangement proposal: Revised proposal and response to Draft Decision,* 9 November 2012 p.110-115

451 Multinet , *AER information request FD13a, Vic GAAR - AER information request - Multinet - FD13a.doc, 7 January 2013 p.1-3*

452 NGR, rr. 79(2)(b) and 79(1)(a).

453 NGR, r.79(1)(a)

454 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 4: Confidential Appendices*, September 2012, p. 26-27

455 The AER notes that its draft decision set out the reasons for rejecting the $1.9 million on p.51 (Capital appendix pp.26-27) but the amount was not reduced in the AER's capex model. The AER advised Multinet of this via AER, *AER Information Request FD17a, Vic GAAR - AER information request - Multinet - FD17a.doc, 8 January 2013,* and sought comment in response by 15/1/13. Multinet has not responded with any comments as at 8/3/13.

The AER considers that, as recoverable works is usually fully cost recovered, it is not necessary to have an unspecified allowance for this category. Multinet's revised proposal included $1.9 million ($2012, direct costs, excluding internal direct overheads), which was a contingency amount. The AER therefore considers that Multinet's proposed expenditure has not been arrived at on a reasonable basis and is not the best estimate in the circumstances and that the expenditure would not be incurred by a prudent service provider operating efficiently.[456]

4.4.8 Overheads

The AER's final decision is to not approve $16.7 million ($2012) of capitalised internal labour as it is not arrived at on a reasonable basis and not the best estimate possible in the circumstances[457] and not prudent and efficient[458]. This is on the basis that:

- the capitalised internal labour for IT, as discussed in section 4.4.5, is in addition to the PMO allowance, which is the amount that the AER considers is efficient[459] for the internal labour resources required to carry out Multinet's IT program, and
- the labour build up includes bonus payments, which the AER considers a prudent service provider acting efficiently would not pay unless there were at least commensurate offsetting productivity gains, of which Multinet has not taken account.

The AER considers that $12.7 million ($2012) is conforming capex (see Table 4.18).

Multinet's initial proposal stated that no indirect overheads are capitalised.[460] However, Multinet proposed capitalising $16.4 million ($2012, direct cost) of its labour as direct capital overheads. Multinet did not propose any indirect overhead expenditure for the 2013–17 access arrangement period.[461]

The AER's draft decision did not approve the $16.4 million for internal labour on the basis that it is not justifiable[462] and not prudent and efficient.[463] This was because the AER considered that the proposed direct capital overheads was a result of Multinet's business restructure, with a shift from out-sourcing to in-sourcing. This change in structure should result in commensurate cost savings associated with no longer out-sourcing these functions.

Multinet's revised proposal did not adopt the AER's draft decision for internal direct overheads. Multinet reiterated its position from the initial proposal to capitalise internal labour for activities undertaken directly in relation to the provision of capital services. Multinet included $16.7 million ($2012) of capitalised internal labour in its revised proposal.[464]

Multinet provided further information to demonstrate that there is no double counting of costs from the business restructure. The Grant Thornton and AECOM reports indicate that the services provided

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456 NGR, rr. 74(2) and 79(1).
457 NGR, rr. 74(2)(a) and 74(2)(b).
458 NGR, r. 79(1)(a).
459 NGR, r.79(1)(a).
460 Multinet, *Response to information request 5 of 18 May 2012*, received 4 June 2012, Question 13, p. 4.
461 Multinet, *Email 'Request 5' (Response to information request 5 of 18 May 2012)* received 4 June 2012, Question 13, p. 4.
462 NGR, r. 79(2).
463 NGR, r. 79(1)(a).
464 Multinet, *Revised access arrangement proposal*, 9 November 2012, pp. 116–117.

internally are not duplicated with functions that have been tendered out.[465] The AER is therefore satisfied that these costs are not also being recovered in its outsourcing contracts.

However, the AER considers Multinet's forecast is not arrived at on a reasonable basis, or the best estimate possible. Multinet's forecasts are derived from an assessment of Multinet's staffing requirements and an estimate of the market remuneration for each position. The salaries for the majority of these positions were independently verified by Grant Thornton.[466] As noted in appendix D, the AER has concerns surrounding the forecast staff levels and salaries underpinning Multinet's bottom-up forecasts. However, based on Grant Thornton's verification and in the absence of historical information for Multinet's overhead costs it is the best forecasting method in the circumstances.

Multinet's forecast capitalised internal labour includes bonuses for each employee included in the forecasts. The AER considers a forecast including these bonus payments would not be the best possible estimate in the circumstances,[467] or reflect the costs of a prudent and efficient service provider.[468] This is because a prudent and efficient service provider would not pay individual employees a bonus unless they achieve at least commensurate productivity improvements. Where the productivity of individual employees improves, Multinet's overall costs should decrease. That is, while labour costs may increase, total costs per unit of output will decrease. The AER has previously not accepted the inclusion of bonus payments proposed by United Energy.[469] As in the United Energy final decision, the AER is not satisfied that Multinet has taken into consideration the net cost impact of individual performance and productivity bonuses in light of the expected productivity gains. For this reason the AER considers the inclusion of bonuses without taking into account productivity gains does not represent the best forecast possible in the circumstances[470] or the costs of a prudent and efficient service provider.

Further, the proposed bonuses represent a material proportion of total internal capitalised labour costs but were not independently verified, unlike the majority of the underlying salaries[471]. This lack of verification means that there is no basis for finding that Multinet's total forecast internal capitalised labour costs were forecast on a reasonable basis or represent the best estimate possible in the circumstances.[472]

Multinet's forecast internal direct overheads include IT capitalised labour and network capitalised labour. As noted in the IT capex section, the AER did not approve Multinet's proposed IT capitalised labour as the AER considers that the PMO allowance provides sufficient internal labour resources for carrying out Multinet's IT program. The IT capitalised internal labour is in addition to the PMO allowance. The AER therefore considers that it is not prudent and efficient[473].

For these reasons, the AER considers that the forecast of overheads in Multinet's revised proposal has not been reached on a reasonable basis, does not represent the best forecast possible[474] and is

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465 Multinet, *Revised access arrangement proposal – Appendix 2-1: Grant Thornton Review of Multinet's Operating Expense Forecasts*, 9 November 2012, pp. 46–59; Multinet, *Revised access arrangement proposal – Appendix 2-2: AECOM Review of Network Operating Expenditure*, 9 November 2012.

466 Multinet, *Revised access arrangement proposal – Appendix 2-1: Grant Thornton Review of Multinet's Operating Expense Forecasts*, 9 November 2012, pp. 46–59.

467 NGR, r. 74(2)(b).

468 NGR, r. 79(1)(a).

469 AER, *Final decision – United Energy Distribution determination 2011 – 2015*, October 2010, p. 153.

470 NGR, r. 74(2)(b).

471 Multinet, *Revised access arrangement proposal – Appendix 2-1: Grant Thornton Review of Multinet's Operating Expense Forecasts*, 9 November 2012, pp. 46–59.

472 NGR, r. 74(2).

473 NGR, r. 79(1)(a).

474 NGR, r. 74(2)(b).

not prudent and efficient.[475] The AER therefore does not approve the $16.7 million ($2012, direct cost) proposed for overheads.

The AER calculated an alternative forecast for Multinet's internal capitalised labour using Multinet's internal labour model by removing the bonuses and IT labour. This resulted in a forecast of $12.7 million ($2012), which the AER considers the best possible forecast in the circumstances.[476]

Table 4.18 AER final decision – overheads ($million, 2012)

	2013	2014	2015	2016	2017	Total 2013–17
Multinet initial proposal	1.9	3.5	3.6	3.7	3.8	16.4
AER draft decision	0.0	0.0	0.0	0.0	0.0	0.0
Multinet revised proposal	2.5	3.4	3.5	3.6	3.6	16.7
AER final decision	1.4	2.8	2.8	2.8	2.9	12.7

Source: AER analysis

4.4.9 Government and customer contributions

For its final decision, the AER approves Multinet's proposed forecast of government and customer contributions of $20.7 million ($2012). The AER received no further information and for the reasons in its draft decision approves the contribution amount[477].

4.5 Adjustments to labour and material escalation

Multinet did not propose any material and labour escalation for the capital expenditure for the 2013–17 access arrangement period.

4.6 Equity raising costs

Service providers incur equity raising costs when they need to raise new equity from outside the business. The AER's equity raising cost benchmark allows for costs in the form of dividend reinvestment plan costs and seasoned equity offerings. A prudent service provider acting efficiently would incur equity raising costs. Accordingly, the AER provides an allowance to recover an efficient amount of equity raising costs where a service provider's capex forecast is large enough to require an external equity injection (to maintain the benchmark 60:40 debt to equity ratio).

Broadly, the AER's method applies the cash flow analysis in the post–tax revenue model (PTRM) to determine the required benchmark equity raising cost associated with forecast capex. This approach adopts the "pecking order" theory of capital structure. This theory predicts that an efficient service provider will seek to raise capital starting from the lowest cost forms and moving to higher cost forms as the lower cost forms are exhausted.[478]

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475 NGR, r. 79(1)(a).

476 NGR, r. 74(2)(b).

477 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017*, September 2012 - Part 4: Confidential Appendices p.58; AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 - 31 December 2017, September 2012 - Part 2,* p.66.

478 ACG, Estimation of Powerlink's SEO transaction cost allowance–Memorandum, 5 February 2007

Based on the need for any dividend reinvestment plans and seasoned equity offerings, the AER assigns transaction unit costs for each form of equity funding. They are based on the AER's empirical review in assessing the benchmark costs for raising equity finance: [479]

- Retained earnings – 0 per cent
- Dividend reinvestment plans – 1 per cent of total dividends reinvested
- Seasoned equity offerings – 3 per cent of total external equity required.

The AER considers that these unit costs represent the efficient costs required to raise equity in current market conditions because they have been suitably estimated by the AER[480] and ACG,[481] and subsequently reviewed.[482]

The AER considers that this method represents the approach that a prudent service provider acting efficiently would apply in raising equity, given its particular capital raising requirements. This is because the method:

- assumes that service providers first use the cheapest sources of equity
- takes account of all the likely sources of equity
- takes account of the requirements of a prudent service provider acting efficiently, by using the inputs and outputs of the PTRM as found by the AER to be efficient.
- The AER’s draft decision for Multinet outlines the AER's equity raising cost method more fully.[483]

The AER adopted its preferred equity raising cost method in its draft decision for Multinet. It determined that no equity raising costs were required.[484] Multinet's revised proposal also adopted the AER’s preferred method and MultiNet did not comment on this method.[485] The AER therefore agrees with MultiNet’s revised proposal and the AER will adopt its preferred equity raising cost method for this final decision.

The AER has used the updated PTRM inputs and outputs to estimate the costs and total allowance for MultiNet. Table 4.19 and Table 4.20 show the cash flow analysis calculated in the PTRM for Multinet's benchmark equity raising cost. Table 4.19 sets out (in nominal terms) the derivation of the required new equity for the network service provider. The second part of the cashflow analysis (in real terms) derives the benchmark allowance for raising this equity and is set out in Table 4.20. These tables demonstrate that MultiNet does not require an equity raising cost allowance based on the amount of forecast capex.

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479 Final decision, TransGrid transmission determination 2009–10 to 2013–14, April 2009, pp. 233–244. ACG, Debt and Equity Raising Transaction Costs, Final Report to the Australian Competition and Consumer Commission, December 2004, p xiii, 65. Handley, A note on the cost of raising debt and equity capital, April 2009.

480 Final decision, TransGrid transmission determination 2009–10 to 2013–14, April 2009, pp. 233–244.

481 ACG, Debt and Equity Raising Transaction Costs, Final Report to the Australian Competition and Consumer Commission, December 2004, p xiii, 65.

482 Handley, *A note on the cost of raising debt and equity capital,* April 2009.

483 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017 Part 2 attachments, September 2012, p. 66-8

484 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017 Part 2 attachments, September 2012, p. 69.

485 MultiNet, PTRM, ‘’equity raising costs’ tab

4.6.1 Benchmark equity raising costs

The AER has applied its updated equity raising costs method along with the updated PTRM inputs and outputs to determine that Multinet requires no benchmark equity raising costs.

Table 4.19 AER's final decision cash flow analysis for Multinet benchmark equity raising cost ($million, nominal)

Cash flow analysis	Total ($million, nominal)	Notes
Dividends	57.3	Set to distribute imputation credits assumed in the PTRM (70 per cent).
Dividends reinvested	17.2	Availability of reinvested dividends, capped at 30% dividends paid.
Capex funding requirement	256.5	Forecast capex funding requirement (including half year WACC adjustment).
Debt component	86.5	Set to equal 60% of annual change in RAB.
Equity component	170.0	Residual of capex funding requirement and debt component.
Retained cash flow available for reinvestment	217.0	Exclude dividends reinvested.
Equity required	-46.9	Equals equity component less retained cash flows.

Source: AER analysis.

Table 4.20 AER's final decision cash flow analysis for Multinet benchmark equity raising cost ($million, 2012–13)

Cash flow analysis	Total ($million, 2012–13)	Notes
Equity component	157.9	Residual of capex funding requirement and debt component.
Retained cash flow available for reinvestment	202.3	Exclude dividends reinvested.
Equity required	-44.4	Equals equity component less retained cash flows.
Dividends reinvested	15.9	Availability of reinvested dividends, capped at 30% dividends paid.
Dividend reinvestment plan required	0.00	Required reinvested dividends.
Seasoned equity offerings required	0.00	Required seasoned equity offerings (SEOs).
Cost of dividend reinvestment plan	0.00	Required reinvested dividends

		multiplied by benchmark cost.
Cost of seasoned equity offerings	0.00	Required SEOs multiplied by the benchmark cost.
Total equity raising costs	0.00	Sum of costs of dividend reinvestment plan and SEOs. To be added to the RAB at the start of the access arrangement period.

Source: AER analysis

4.7 Revisions

Revision 4.1: Make all necessary amendments to reflect the AER's draft decision on forecast capex by asset class for the access arrangement period, as set out in Table 4.2 AER final approved capital expenditure by category over the 2013–17 access arrangement period ($million, 2012).

5 Rate of return

The return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.[486]

The AER calculates Multinet's return on capital building block by multiplying the rate of return with the value of Multinet's capital base. Consistent with Multinet's revised proposal and previous AER decisions, the rate of return adopted by the AER is the nominal 'vanilla' weighted average cost of capital (WACC) specification.[487]

5.1 Final decision

The AER does not approve Multinet's proposed rate of return of 7.78 per cent (nominal vanilla).[488] The AER considers 7.03 per cent is a preferable alternative that is commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. The AER's rate of return for Multinet combines a cost of equity of 7.92 per cent and a cost of debt of 6.44 per cent.

Consistent with the draft decision, the AER agrees with a number of aspects of Multinet's proposed rate of return in its revised access arrangement proposal. Specifically, the AER agrees with:

- adopting a weighted average of the cost of equity and the cost of debt (known as the weighted average cost of capital (WACC)) to determine the rate of return
- adopting a 60 per cent gearing ratio
- adopting the capital asset pricing model (CAPM) to determine the cost of equity
- adopting the yield on 10 year Commonwealth Government Securities (CGS) as the proxy for the risk free rate
- adopting a 0.8 equity beta
- adopting a 6 per cent market risk premium (MRP)
- specifying the cost of debt as the debt risk premium (DRP) over the risk free rate
- determining the DRP by defining the benchmark bond as a 10 year corporate bond with a BBB+ credit rating and measuring the benchmark bond rate using the extrapolated Bloomberg BBB rated 7 year fair value curve (FVC)
- extrapolating the Bloomberg BBB rated 7 year FVC to a 10 year maturity (consistent with the definition of the benchmark bond) using 'paired bond' analysis
- adopting a recent and short term averaging period for determining the risk free rate and DRP components of the cost of debt (specifically, the 20 business day period from 24 October 2012 to 20 November 2012)

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486 NGR, r. 87(1).
487 A nominal vanilla WACC is the combination of a nominal post-tax cost of equity and a nominal pre-tax cost of debt.
488 Multinet, *Revised Access Arrangement Proposal,* 9 November 2012, p. 174. Multinet's revised proposal document stated a nominal vanilla WACC of 7.96 per cent. This was based on an indicative estimate for Multinet's proposed cost of debt, because Multinet's proposed averaging period for the cost of debt had not yet expired. The AER has updated this estimate, based on Multinet's proposed averaging period, which produces a nominal vanilla WACC of 7.78 per cent.

- determining forecast inflation based on the Reserve Bank of Australia's (RBA's) short term forecasts and the mid-point of the RBA's inflation targeting band.

The AER does not agree with Multinet's proposed historical averaging period for determining the risk free rate component of the cost of equity. [489] Rather, the AER adopts a recent and short term averaging period. The AER has used the risk free rate averaging period Multinet proposed and that the AER agreed for the cost of debt. The AER's position on the averaging period in this final decision is consistent with its position in the draft decision.

The individual WACC parameters and consequent overall rate of return are set out in Table 5.1.

Table 5.1 AER's final decision on Multinet's rate of return (nominal)

Parameter	AER draft decision[(a)]	Multinet revised proposal[(a)]	AER final decision
Nominal risk free rate (cost of equity)	3.12%	5.00%	3.12%
Nominal risk free rate (cost of debt)	3.12%	3.12%	3.12%
Equity beta	0.80	0.80	0.80
Market risk premium	6.00%	6.00%	6.00%
Debt risk premium	3.32%	3.32%	3.32%
Gearing ratio	60.00%	60.00%	60.00%
Inflation forecast	2.50%	2.50%	2.50%
Nominal post-tax cost of equity	7.92%	9.80%	7.92%
Nominal pre-tax cost of debt	6.44%	6.44%	6.44%
Nominal vanilla WACC	7.03%	7.78%	7.03%

Source: Multinet, *Revised Access Arrangement Proposal,* 9 November 2012, and AER analysis.
(a) The AER draft decision and Multinet revised access arrangement proposal parameters have been updated to reflect the final averaging period, based on the respective methodologies. The parameters published in the draft decision and revised access arrangement proposal were calculated based on indicative averaging periods, and hence differ from those in the above table for some parameters.

Multinet's rate of return in this decision is similar to the rates the AER determined in decisions over the past year.[490] It is lower than rates the AER determined in decisions before then. Nonetheless, the AER considers its decision on the rate of return is commensurate with prevailing conditions in the market for funds and the risk involved with providing reference services.

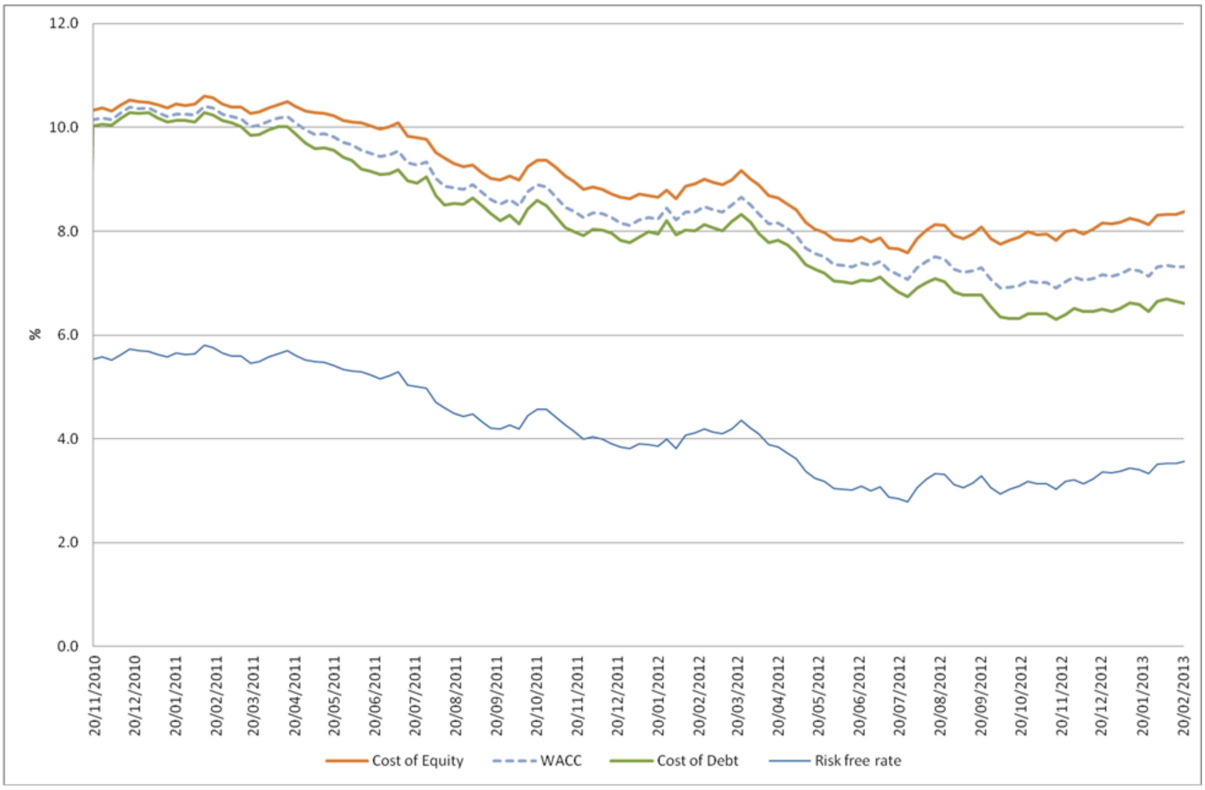
The cost of debt has fallen by approximately 1.5 per cent from its level in late 2011 and early 2012. As a result, the AER and Multinet agree that the lower cost of debt that currently prevails has reduced the overall rate of return from the levels that prevailed around a year ago (all things equal). The cost of debt in this decision accounts for 60 per cent of the overall rate of return. The AER and Multinet agree

489 Specifically, Multinet proposed a 10 year average to October 2012 minus actual inflation over the period, plus forecast inflation of 2.5 per cent. This was one of two alternatives proposed by CEG. CEG, *Response to the AER Vic gas draft decisions*, November 2012, p. 16.

490 AER, *Final decision: APT Petroleum Pipeline Pty Ltd, Access arrangement final decision, Roma to Brisbane Pipeline 2012–13 to 2016–17*, August 2012; AER, *Final distribution determination, Aurora Energy Pty Ltd 2012–13 to 2016–17*, April 2012.

on the approach to determining the cost of debt. Figure 5.1 illustrates the results from applying the AER's rate of return approach in this decision over time.

Figure 5.1 AER's rate of return approach over time (nominal, per cent)[491]



In this access arrangement review, the cost of equity is the key area of disagreement. Multinet's revised access arrangement proposal maintains its initial proposal position. Multinet's main submission was that the AER mixes a "spot" risk free rate with a "long term" average MRP and this currently produces a cost of equity that is too low.[492] As part of this submission, Multinet suggested the cost of equity is relatively stable over time, and related to this point, that the risk free rate and MRP are strongly negatively correlated.[493]

The AER acknowledges that Multinet was concerned with the impact of the lower risk free rate on its cost of equity and this was a driving factor in its proposing a historical average risk free rate for use in calculating the cost of equity.[494]

As illustrated in Figure 5.1, the risk free rate has been continuously less than 4 per cent since early 2012.[495] Combined with a 0.8 equity beta and 6 per cent MRP, this has resulted in a cost of equity in AER decisions since this time that is lower than earlier decisions. The AER has made determinations for Aurora, the Roma-to-Brisbane (RBP) pipeline, and now the Victorian gas businesses, over this

491 This chart illustrates the AER's current approach extrapolated backwards (assuming a 6 per cent MRP over that period). The starting date is chosen as this is when paired bond data was first available (the paired bond approach is applied in this decision when determining the debt risk premium - see attachment 5.3.5 below for further discussion).

492 This is an incorrect characterisation of the AER's approach. The AER estimates a 10 year forward looking risk free rate and a 10 year forward looking MRP. See below and appendix B for more detail.

493 Multinet, *Revised Access Arrangement Proposal,* 9 November 2012, p. 132.

494 Multinet, *Revised Access Arrangement Proposal,* 9 November 2012, p. 136

495 The 10 year CGS yield fell below 3 per cent for a brief period in June and July 2012.

time period[496]. In each decision, the cost of equity arising from the low risk free rate has been a contentious issue, and the AER has considered the matter carefully.

The material in the next few pages provides a high level overview of the process the AER has employed to assess the proposals and subsequent material submitted by the Victorian gas businesses on the cost of equity. A brief summary of the AER's key reasons for its decision then follows. A more detailed explanation of the AER's reasons is then set out later in this attachment. Further detailed consideration of some specific issues is then set out in a separate appendix.

5.1.1 AER process

In view of the substantial material Multinet submitted, the AER has carefully reconsidered the issues raised and has also reassessed its analysis and reasons for the draft and this decision. It has also obtained additional expert advice on the material submitted Multinet. The AER has also extended and expanded its analysis in areas questioned by Multinet. In particular, in the areas of:

- the relationship between the risk free rate and the MRP, and the related issue of the extent of stability in the cost of equity over time
- the relationship between the cost of debt and the cost of equity, and the extent to which changes in the cost of debt over time can be used to inform the estimation of the cost of equity.

The AER has sought a substantial amount of expert advice on the cost of equity over the past 12 months. The advice has come from:

- the Reserve Bank of Australia (RBA)
- the Commonwealth Treasury and Australian Office of Financial Management (AOFM)
- finance academics (Professor McKenzie and Associate Professor Partington from the University of Sydney; Associate Professor Lally from the Victoria University of Wellington), and
- an economic consultancy firm (Cambridge Economic Policy Associates (CEPA))

The AER has sought advice on a wide range of issues associated with the cost of equity. This has included seeking follow up advice from certain experts to consider comments raised by Multinet and its consultants. This process has included:

- In a submission as part of the Aurora determination process, CEG suggested CGS yields might not be an appropriate proxy for the risk free rate in current market circumstances.[497] The AER sought advice from the RBA, Commonwealth Treasury and AOFM. They each advised that the CGS market remains liquid and well functioning. The RBA also advised that CGS bonds remained the best proxy for the risk free rate in Australia.[498]
- In 2011, the AER commissioned a report on the MRP from Professor McKenzie and Associate Professor Partington that comprehensively reviewed each major class of evidence on the MRP. McKenzie and Partington recommended the AER adopt 6 per cent. A regulated business

496 Note over this period, the AER also made determinations for Powerlink and is in the process of making determinations for Murraylink and ElectraNet. However these transmission determinations are not comparable to other AER decisions over this time as the WACC approach and parameters were largely prescribed by the NER and the 2009 WACC review.

497 CEG, *A report on the cost of equity in Aurora's revised proposal: Prepared for Citipower, Jemena, Powercor, SP AusNet, and United Energy*, February 2012, p. 12.

498 See section 5.3.2 below for further discussion.

questioned the relevance of the report because it did not directly consider the MRP in the context of a historically low risk free rate.[499] The AER sought further advice from McKenzie and Partington. The experts concluded there are good reasons for the AER to adopt a 6 per cent MRP and they saw no reason to switch from using the current 10 year CGS yield as the proxy for the risk free rate.[500]

- In the draft decision, the AER set out its reasons for adopting a prevailing risk free rate and 6 per cent MRP and published consultants' reports it had commissioned and accepted in forming this position. This provided an opportunity for the Victorian gas businesses, including Multinet, to respond to this position. The businesses did respond to this position and provided substantial additional material. The AER subsequently sought further advice from experts to critically review their original advice in light of the new material submitted by the businesses.
- For this final decision, the AER sought advice from three separate experts on the reasonableness of adopting prevailing risk free rate and 6 per cent MRP.
  - In a third report, McKenzie and Partington concluded the AER's approach was reasonable. This report contains an extensive review of the theoretical and empirical evidence on the relationship between the risk free rate and MRP. McKenzie and Partington's conclusion is based on a more comprehensive analysis of the academic literature on this issue than that contained in the consultant reports submitted by the Victorian gas businesses.
  - Associate Professor Lally also concluded it is reasonable for the AER to adopt a prevailing risk free rate and 6 per cent MRP.
  - CEPA indentified some concerns with the AER's approach. However, the current market evidence suggests the AER's current estimate is in line with market expectations. It concluded that, based on various criteria it identified, the AER should not change its estimation approach.

5.1.2 Overview of reasons

Compared with the cost of debt, the cost of equity is more challenging to estimate. This is because the cost of debt is observable while the cost of equity is not.[501] Accordingly, a model must be used to estimate the cost of equity. The NGR require that the AER use a well accepted financial model to estimate the cost of equity. The AER and Multinet agree that it is appropriate to use the Sharpe-Lintner capital asset pricing model (Sharpe CAPM) for this purpose.

This model requires the estimation of three parameters:

- The risk free rate—this compensates investors for the time value of money. This is compensation for an investor having committed funds to an investment for a period of time and therefore forgoing the opportunity to spend that money and consume goods now.
- The market risk premium (MRP)—this compensates an investor for the systematic risk of investing in the market portfolio or the "average firm" in the market. Systematic risk is risk that

499 Aurora, *AER's draft distribution determination—Return on capital*, Submission, 20 February 2012, p.2.

500 M. McKenzie, and G. Partington, *Report to Corrs Chambers Westgarth: Equity market risk premium*, December 2011, p. 37. (McKenzie and Partington, *Equity market risk premium*, December 2011)

501 See, for example, RBA, *Latter to the AER*, July 2012, p. 1. The cost of debt can be observed by looking at yields on market traded bonds that match the benchmark characteristics, or fair value curves published by financial data service providers that match the benchmark characteristics.

effects all firms in the market (such as macroeconomic conditions and interest rate risk) and cannot be eliminated or diversified away through investing in a wide pool of firms.

- The equity beta—this reflects the systematic risk exposure of a particular firm, relative to the average firm in the market.

While the equity beta is difficult to estimate with precision, the AER and Multinet agree that 0.8 is a reasonable estimate for this parameter in this determination.

In determining the two remaining parameters within the Sharpe-Linter CAPM, the AER estimates:

- a 10 year forward looking risk free rate based on prevailing conditions in the market for funds, and
- a 10 year forward looking MRP based on prevailing conditions in the market for funds.

Conceptually, the adoption of a 10 year forward looking risk free rate and a 10 year forward looking MRP, based on prevailing conditions in the market for funds at the commencement of the access arrangement period:

- is consistent with the present value principle—this principle states that the present value of a regulated business's revenue stream should match the present value of its expenditure stream (plus or minus any efficiency rewards or penalties). As Lally explains, this is a fundamental principle of economic regulation. Satisfying this principle both promotes efficient investment and avoids the excess profits that regulation seeks to prevent.[502]
- is consistent with the building block model
- is consistent with the Sharpe-Lintner CAPM
- is internally consistent, and
- promotes regulatory certainty and consistency.

Practically, in estimating a 10 year forward looking risk free rate, the AER adopts the prevailing yield on 10 year CGS averaged over a period which is short and as close as practicably possible to the commencement of the access arrangement period.[503] The AER adopts this method because:

- An observable market proxy for the risk free rate is available.
- The yield on CGS is the best proxy for the risk free rate in Australia, as supported by RBA advice.
- The RBA, Commonwealth Treasury and AOFM advised that the CGS market is liquid and functioning well.[504]
- CGS yields are an observable market determined parameter.

502 M. Lally, *The risk free rate and the present value principle*, 22 August 2012, p. 8, (Lally, *Risk free rate and present value*, August 2012)

503 The exact dates of the averaging period are proposed by the regulated business and are accepted by this AER so long as the proposed period: (1) is short (10-40 business days); (2) is as close as practicably possible to the commencement of the access arrangement period; (3) is nominated in advance.

504 Reserve Bank of Australia, *Letter to the ACCC: The Commonwealth Government Securities Market*, 16 July 2012, (RBA, *Letter regarding the CGS market*, July 2012); Australian Treasury and Australian Office of Financial Management, *Letter to the ACCC: The Commonwealth Government Securities Market*, 18 July 2012, p. 2 (Treasury and AOFM, *Letter regarding the CGS Market*, July 2012).

- The prevailing rate at any point in time is the benchmark that returns on risky investments must better
- Prevailing 10 year CGS yields reflect expectations of the risk free rate over the appropriate forward looking investment horizon (which is 10 years).
- Selecting an averaging period in advance ensures the method is unbiased.
- There is no clear evidence that CGS yields are abnormally low. McKenzie and Partington suggest that the current rates may be consistent with a longer term trend.

In estimating a 10 year forward looking MRP, the AER adopts 6 per cent. After carefully assessing the information submitted by the Victorian gas businesses, the AER remains of the view that the available evidence supports a MRP of 6.0 per cent as commensurate with prevailing conditions in the market for funds. This is because:

- historical excess returns—these estimates provide a range of 4.9–6.1 per cent if calculated using an arithmetic mean and a range of 3.0–4.7 per cent if calculated using a geometric mean.
- academic research on excess return predictability—over the past decade, there is an increased scepticism about the ability for particular variables to predict returns. New empirical evidence has cast doubt on previous empirical evidence that suggested particular variables were good predictors of returns. Some studies indicate there is no better forecast of excess returns than the historical average.
- survey evidence—surveys of market practitioners consistently support 6 per cent as the most commonly adopted value for the MRP. These surveys also indicate that the average MRP adopted by market practitioners was approximately 6 per cent.
- forward looking MRP measures—these give mixed results, and are each subject to various limitations. On the one hand, dividend growth model (DGM) estimates suggest the MRP is in the range of 5.9–8.4 per cent. These estimates were provided by Associate Professor Lally who used CEG's DGM method, after adjusting for certain deficiencies in CEG's method. On the other hand, implied volatility based MRP estimates suggest the MRP is currently below its historical average level.
- recent Tribunal decisions—the Tribunal held the view that it was open for regulators to adopt a 6 per cent MRP in all of the recent decisions where regulated businesses sought Tribunal review.
- consultant advice—Associate Professor Lally, Professor McKenzie and Associate Professor Partington all advised the AER that a 6 per cent MRP is reasonable in the prevailing market conditions in their most recent reports and CEPA found the valuation reports do support an MRP that is equal to about 6 per cent..
- recent decisions among Australian regulators—the AER notes both the ERA and the QCA consistently adopted an MRP estimate of 6 per cent under the same CAPM framework. The AER also notes while the IPART consistently adopted an MRP range of 5.5–6.5 per cent, it has made an upward adjustment to the overall WACC in its recent decisions due to the current low risk free rate.

The AER is aware that there are some academic papers that present a plausible argument for an inverse relationship between the risk free rate and MRP. Accordingly, the AER has given careful consideration to this issue in estimating the MRP. The advice from McKenzie and Partington provides a comprehensive review of the academic literature on the theoretical and empirical evidence on the relationship between these two parameters. Among other findings, McKenzie and Partington note:

> Ang and Bekaert (2007) find a negative relationship between short term risk free rates and the equity risk premium. The general message of Ang and Bekaert's work, however, is that "… predictability is mainly a short-horizon, not a long-horizon phenomenon" (p.696). Their implication is that predictive regressions might help forecast market returns at say a one year horizon, but are little use at say a ten year horizon.[505]

This is relevant to the present matter as the AER is estimating a 10 year forward looking MRP, not a short term MRP.

Overall, McKenzie and Partington find that there is evidence to support both a positive and negative relationship between the risk free rate and MRP. They conclude:

> An examination of the relevant evidence leads us to conclude that the relation between the MRP and the level of interest rates is an open question and that the relation, if any, is not sufficiently well established to form the basis for a regulatory adjustment to the MRP.[506]

The AER also considers reasonableness checks on the overall rate of return. These reasonableness checks suggest that the overall rate of return broadly accords with market expectations. For example, recent regulated assets have generally been sold at a premium to the RAB. In addition, recent RAB trading multiples are consistently greater than one (averaging around 1.2). This evidence provides the AER with a degree of confidence that its approach to determining the rate of return is reasonable.

5.2 Assessment approach

The AER's assessment approach for this final decision is consistent with that adopted in the draft decision. This material is not reprinted here; see section 4.2 of attachment 4 – Rate of Return of the draft decision for this detail.[507] The section below sets out the AER's further observations on its assessment approach, including discussion of material arising subsequent to the draft decision.

5.2.1 Requirements of the national gas law and rules on the rate of return

In this section the AER considers the requirements of the NGR and NEL on the rate of return, including in the interpretation of relevant provisions of the NGR in recent Tribunal decisions.

Rule 87 of the NGR states:

> 1) The rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.
>
> 2) In determining a rate of return on capital:
>
> a) it will be assumed that the service provider:
>
> i) meets benchmark levels of efficiency; and
>
> ii) uses a financing structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice; and

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505 M. McKenzie, and G. Partington, *Review of the AER's overall approach to the risk free rate and market risk premium,* February 2013,, p.26 (McKenzie and Partington, *Review of the AER's overall approach*, February 2013).

506 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, p. 6.

507 AER, *Draft decision: Access arrangement draft decision: Multinet Gas (DB No. 1) Pty Ltd, Multinet Gas (DB No. 2) Pty Ltd,* September 2012, pp. 74-82. (AER, *Draft decision: Multinet*, September 2012)

> b) a well accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used.

The AER understands rule 87 operates as follows:

- Rule 87(1) describes the objective in determining the WACC but not how to achieve the objective.
- Rule 87(2) describes how to achieve the objective, including through a well accepted approach (such as the WACC) and through a well accepted financial model (such as the CAPM).
- Rule 87(1) informs the selection of input parameters for the well accepted approach and well accepted financial model. Through the determination of appropriate parameters, it is expected that the overall rate of return will reflect prevailing conditions in the market for funds and the risk involved in providing reference services.[508]

This is consistent with the Tribunal's construction of rule 87 in the ATCO and WAGN matters.

Rule 87 is a full discretion provision. This means the AER may, but is not bound to, approve Multinet's proposed rate of return if that rate complies with, and is consistent with, the NGL's and NGR's requirements and criteria. The AER has the discretion to withhold its approval it considers a preferable alternative exists that complies with, and is consistent with, those requirements and criteria. Further, if an access arrangement contains a fixed principle on the rate of return then that fixed principle is binding on the AER and the service provider for the period for which the principle is fixed.[509]

If the AER does not approve Multinet's access arrangement, then the AER must formulate an access arrangement that accounts for:

- the matters that the NGL and NGR require an access arrangement to include
- the service provider's access arrangement proposal, and
- the AER's reasons for refusing to approve that proposal.[510]

This list is not exhaustive, and the service provider's proposal is not the only source of information that the AER considers when assessing the proposed rate of return. Other regulatory processes provide relevant information sources, because issues with the cost of capital are generally not specific to a service provider. Further, many issues have evolved across a long history of consideration by the AER and other regulators.

The AER considers information that includes:

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508 In its revised proposal, Multinet submitted that it is the result of applying a well accepted financial model (in this case, the Sharpe-Linter CAPM) that is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. The AER agrees with this interpretation. Conceptually, the AER's approach to implementing this is to estimate a risk free rate that is commensurate with prevailing conditions in the market for funds (i.e. a forward looking risk free rate) and a MRP that is commensurate with prevailing conditions in the market for funds (i.e. a forward looking MRP). It follows logically that if each parameter within the Sharpe-Lintner CAPM is commensurate with prevailing conditions, then so too will the total cost of equity be. In contrast, the Victorian gas distribution businesses proposed a historical average risk free rate and a historical average MRP. That is, conceptually, they proposed input parameters that are not commensurate with prevailing conditions, yet considered the combination of these input parameters would result in a cost of equity that is commensurate with prevailing conditions. This approach relies on the assumption that the cost of equity is stable over time.

509 NGR r. 99 (3).

510 NGR r. 64(2).

- previous AER decisions, including the AER's 2009 review of WACC parameters for electricity service providers (the WACC review) and resulting Statement of Regulatory Intent (SRI)
- the service provider's proposal
- expert reports commissioned by the AER, the service provider and other stakeholders
- the decisions of the Tribunal
- the decisions of other economic regulators, particularly in Australia
- submissions

In performing or exercising an economic regulatory function or power, the AER must do so in a manner that will (or is likely to) contribute to the national gas objective.[511] Either the AER's approval or withholding of its approval of Multinet's proposed rate of return—and in the case of the latter the AER's determination of a preferable rate of return—is an AER economic regulatory function or power. The national gas objective is:

> … to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.

In addition, the AER must account for the revenue and pricing principles when approving or making the parts of an access arrangement that relate to a reference tariff.[512] The rate of return is such a part, so the AER must account for the following[513]:

- A service provider should have a reasonable opportunity to recover at least the efficient costs that it incurs in providing reference services[514]
- A service provider should have effective incentives to promote economic efficiency in the reference services that it provides. That economic efficiency should include efficient investment in, or connection with, a pipeline that the service provider uses to provide reference services.
- A reference tariff should allow for a return that matches the regulatory and commercial risks from providing the reference services to which that tariff relates.
- A reference tariff should account for the economic costs and risks of potential under or over investment by a service provider in a pipeline that the service provider uses to provide pipeline services.

In the sections that follow, the AER determines Multinet's rate of return in a manner consistent with the NGO, revenue and pricing principles and rule 87 of the NGR.

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511 NGL s. 28(1).

512 NGL s. 28(2)(a)(i)

513 NGL, s. 24.

514 Multinet submitted a report by PriceWaterhouseCoopers. Among other matters, the report discussed the asymmetric consequences of setting the rate of return too high and too low. The AER considers this matter is embodied in the revenue and pricing principle that service providers should have a reasonable opportunity to recover at least efficient costs. Therefore, by applying the revenue and pricing principles, the AER considers it takes into account the matters raised by PWC. Further, Lally noted the equivalence of the principle of providing a reasonable opportunity to recover at least efficient costs and the present value principle. Lally, *The risk free rate and the present value principle*, 2012. The present value principle is considered extensively in relation to the rate of return in this decision.

5.2.2 Submission from stakeholders

On the rate of return, the AER received submissions on its draft decision and the Victorian gas businesses' revised proposals from:

- the Energy Users Coalition of Victoria (EUCV)[515], and
- the Victorian Minister for Energy and Resources[516]

On the relationship between the risk free rate and MRP, the EUCV considers the adoption of a higher MRP when the risk free rate is low is not supported by the facts. It further states:

> The EUCV makes the rhetorical observation whether the massive debate as to the setting of the risk free rate would have been raised if the bond rates were at the levels seen in the 1980s, with an average value of some 13%, rather than the current value of about 3? Would there be a debate that the return on equity has a constant value of about 12% when the AER approach would deliver a value of 19%?

The EUCV also state that, in the interests of regulatory certainty, the AER has advised it will review the cost of debt approach through industry-wide consultation as part of the next rate of return guideline process, rather than as part of the Victorian gas review. This is despite, in the EUCV's opinion, the current approach to the cost of debt imposing costs on consumers that are higher than warranted. The EUCV consider this context should be taken into account when considering changes to the cost of equity approach in this decision.

The Victorian Minister for Energy and Resources supported the AER's draft decision on the rate of return. The Minister also commented on the construction of rule 87 of the NGR.

5.2.3 Selection of well accepted approach and model

The AER accepts Multinet's proposal to determine the rate of return as the weighted average of the cost of equity and the cost of debt (the WACC approach), weighted 40 per cent to equity and 60 per cent to debt. The AER also accepts Multinet's proposal to determine:

- the cost of equity using the Sharpe Lintner CAPM, and
- the cost of debt as the summation of the risk free rate and DRP.

In the draft decision, the AER agreed with Multinet's approach to determining the rate of return and models to determine the cost of equity and cost of debt. The AER agreed with this approach because the weighted average cost of capital is a well accepted approach to determining the rate of return. The AER agreed with the financial models proposed by Multinet to determine the cost of equity and debt because these are also well accepted.[517]

Multinet also adopted the same WACC approach, use of Sharpe CAPM, and specification of the cost of debt in its revised access arrangement proposal. The AER is not aware of any new information that causes it to depart from its draft decision position. Accordingly, the AER accepts these aspects of Multinet's revised proposal.

515 EUCV, *Victorian gas distribution revenue reset AER draft decision and revised applications*, January 2013
516 Hon. Michael O'Brien MP, Minister for Energy and Resources, *Victorian gas access arrangement review - Victorian government Submission*, 14 January 2013.
517 Australian Competition Tribunal, *Application by WA Gas Network Pty Ltd (No 3) [2012] ACompT*, 8 June 2012, paragraph 64.

5.2.4 Fixed principles on the rate of return

In the draft decision, and in accordance with r. 99(4)(a) of the NGR, the AER sought and received Multinet's consent to revoke the fixed principle in clause 7.2(4) of its 2008–2012 access arrangement.

The fixed principle required that the return on capital building block be calculated using a real (post tax) rate of return. In contrast, the AER's standard PTRM calculates the return on capital building block using a nominal post tax rate of return.

Multinet's initial (and revised) access arrangement proposal used the AER's standard PTRM for modelling its revenue requirements, and accordingly proposed to apply a nominal rate of return for the purposes of calculating the return on capital. However, the NGR requires that fixed principles included in Multinet's access arrangement are binding on both Multinet and the AER for the period over which they are fixed.[518]

Revoking the fixed principle removes the inconsistency between Multinet's fixed principle and its access arrangement proposal. Accordingly, the AER revokes the fixed principle in clause 7.2(4) of Multinet's 2008-12 access arrangement.

5.2.5 Approach to the determination of specific parameters

The AER's assessment approach for each parameter is set out in its draft decision. See section 4.2.4 of the draft decision for a detailed explanation of the assessment approach.

For clarity, and consistent with the draft decision, in this final decision the AER:

- estimates a 10 year forward looking risk free rate
- estimates a 10 year forward looking MRP
- taking into account the economic interdependencies between these two parameters, and
- based on prevailing expectations at the commencement of the access arrangement period.

In doing so, the AER maintains the integrity in estimation of each individual parameter when determining an estimate. The AER does not attempt to address a perceived problem in the estimation of one parameter through the estimation of another parameter. Maintaining the integrity of each parameter promotes rigour and robustness in the estimation of those parameters. Besides, the AER is unaware of any well accepted approach for making adjustments between these parameters without introducing subjectivity and regulatory risk.

The risk free rate and MRP are estimated using differing information. This reflects the differing nature of these two parameters. A proxy for the risk free rate is readily observable.[519] On the other hand, no such proxy is available for the MRP.[520]

Maintaining integrity between these two parameters is important. This including having regard to any economic interdependencies between these parameters.

518 NGR r. 99(3)
519 See section 5.3.2 below for further discussion.
520 See section 5.3.3 below for further discussion.

Further, the AER's approach is internally consistent. This is because for both the risk free rate and MRP the AER is estimating a 10 year forwarding looking rate.

5.2.6 Reasonableness checks on the overall rate of return

In section 4.2.4 of the draft decision, the AER sets out its approach to the determination of each parameter within the overall rate of return. In addition, the AER has given appropriate consideration to reasonableness checks on the overall rate of return. This approach is consistent with the draft decision. See section 4.2.5 of the draft decision for further discussion of the assessment approach.

Overall, the AER:

- determines reasonable estimates for the input parameters into the CAPM (a well accepted financial model), which in turn feeds into the WACC (a well accepted approach)[521]
- gives limited consideration to the overall WACC estimates, in accordance previous Tribunal decisions[522] and the strengths and weaknesses of this approach.

The AER discusses the use of reasonableness checks further in section 5.3.8 and appendix B.

5.2.7 Promotion of regulatory certainty and consistency

As outlined above, the AER has carefully considered the material presented by the Victorian gas businesses on the cost of equity. The end result of this consideration is that the AER has decided to maintain its approach from the draft decision.

The AER has maintained its approach from the draft decision because it considers this approach is reasonable. And applying that approach to the Victorian gas businesses in this final decision, the AER considers this provides a cost of equity commensurate with prevailing conditions in the market for funds and the risks involved with providing reference services.

- Further, the cost of equity approach in this final decision is consistent with the AER's approach in previous decisions. This consistency:
- promotes certainty of process and predictability in regulatory decision making
- promotes symmetry in regulatory outcomes over time. It avoids a bias or arbitrariness in regulatory outcomes that may result from changing to a method that favours a particular outcome or stakeholder at a particular point in time (and then potentially reverting back to the previous method at a later point in time).[523]

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[521] NGR, r. 87.

[522] Australian Competition Tribunal, *Application by Envestra Ltd (No 2) [2012] ACompT 3*, 11 January 2012, paragraphs 166-167. See section 5.3.8 below for further discussion.

[523] A source of potential bias in regulatory outcomes over time is when only the economic interdependencies between some but not all relevant parameters are considered. For example, in this review the Victorian gas businesses have argued in favour of a strongly negative relationship between the risk free rate and MRP. They have highlighted that this relationship is particularly important to take into account in this review because of the low risk free rate. However, the Victorian gas businesses have not considered whether there is a relationship between the risk free rate, MRP and equity beta. For example, it might be that the factors driving the low risk free rate also decrease (or increase) the equity beta of regulated utilities. The AER does not express a view on this relationship. It raises it instead to highlight the importance of considering the independencies between all relevant parameters. For the reasons expressed elsewhere in this decision, the AER does not consider the evidence on the risk free rate and MRP relationship is conclusive enough—in terms of the direction, strength or stability in this relationship—to warrant a higher MRP because of the low risk free rate. However, even if the AER had considered this evidence warranted a higher MRP, it would be necessary to consequentially consider whether any adjustment to the equity beta was warranted.

The AER further notes that is has not changed the cost of debt approach in this final decision from that adopted in the draft decision or other recent AER decisions. While the AER has previously raised concerns that the Bloomberg BBB fair value curve may have overcompensated regulated businesses for the true benchmark cost of debt. This reflects the Tribunal's statement that if the AER were to decide that the extrapolated Bloomberg fair value curve was an unreliable indicator for the purposes of deciding that DRP, it would be desirable in the longer term to develop an alternative coherent and consistent methodology, in consultation with the relevant regulated businesses and other interested parties.[524]

5.3 Reasons for final decision

In the previous section, the AER set out its approach to determining the rate of return. This included the AER's interpretation of the relevant criteria from the NGL and NGR.

In this section the AER applies its approach, and explains why the rate it determines for Multinet's access arrangement period is consistent with the NGL and NGR criteria. In this section, the AER:

- firstly, explains why it adopts the CAPM as the well accepted financial model to determine the cost of equity
- secondly, explains how it determines each of the parameters within the CAPM, with a particular focus on the determination of the risk free rate and MRP.
- then explains how it estimates the DRP and gearing ratio for Multinet
- also outlines its reasons for its position on forecast inflation
- finally, considers the outcome from the above approach against reasonableness checks on the overall rate of return.

5.3.1 The Capital Asset Pricing Model (CAPM)

The cost of equity is not directly observable and therefore a model is required in order to estimate it. Multinet itself acknowledged this and stated:[525]

> Multinet recognises that any estimate of the cost of equity is open to criticism because estimating an unobservable parameter – such as the cost of equity – is bound to be imperfect. The task, therefore, is to make a reasonable judgment based on the available evidence.

This position is similarly noted by Wright[526] and Ernst and Young. Ernst and Young noted:[527]

> The cost of equity is not directly observable, so it must be estimated or inferred from market data. Finance theory usually guides the process of estimation and the CAPM is often applied in this process.

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524 Australian Competition Tribunal, *Application by Envestra Ltd (No 2) [2012] ACompT 3*, 11 January 2012, paragraph 95. In relation to change of the cost of debt approach, the Tribunal noted: "In the longer term, as the Tribunal has said, it is open to the AER to adopt a different methodology. Consideration of the proper composition of the comparison sample of bonds, the methodology for deciding on the appropriate sample of bonds and the relevance of these bonds to its task should be undertaken by the AER in consultation with interested parties across the spectrum of entities in the industries it regulates, consumers of their services and other interested parties." See: Australian Competition Tribunal, *Application by Envestra Limited (No 2) [2012] ACompT 3*, 11 January 2012, paragraph 118

525 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p.153.

526 S. Wright, *Review of risk free rate and cost of equity estimates: A comparison of UK approaches with the AER*, 25 October 2012, p.2.

527 Ernst & Young, *Market evidence on the cost of equity: Victorian gas access arrangement review 2013-2017*, 8 November 2012, p. 7

A financial model must be a well accepted model to be used for determining a return on capital. The Sharpe Lintner CAPM is a well accepted financial model. As noted by the AER during the WACC review, the Sharpe Lintner CAPM has been consistently adopted by regulators and market practitioners. The AER is not aware of any instances where an Australian regulator has adopted an alternative model. Truong, Partington and Peat found that 72 per cent of Australian businesses who responded to their survey adopt the (Sharpe) CAPM in formulating their capital budgeting decisions.[528]

The AER, Multinet and the Tribunal have all agreed that the Sharpe Lintner CAPM is a well accepted financial model and is appropriate to use in order to estimate the cost of equity.[529] The AER therefore estimates the cost of equity by combining the best estimate of each parameter that is required within the CAPM. The AER determines the cost of equity (r_e) using the CAPM formula:

$$r_e = r_f + \beta_e \times MRP$$

where:

the AER and Multinet agree the equity beta estimate (β_e) is 0.8.[530]

5.3.2 Risk free rate

The AER agrees with Multinet's proposed method for estimating the risk free rate component of the cost of debt.[531] The AER does not agree with Multinet's proposed method for estimating the risk free rate component for the cost of equity.[532] On both matters, the AER's position is consistent with its position in the draft decision.

The AER's risk free rate method is also consistent for both the cost of debt and the cost of equity.

Conceptually, this method adopts a 10 year forward looking risk free rate, commensurate with prevailing conditions in the market for funds at the commencement of the access arrangement period. Practically, this method adopts the 10 year CGS yield averaged over a short and recent period (chosen by Multinet), as close as practicably possible to the date of the final decision.

The AER considers this method reflects prevailing conditions in the market for funds and the risks involved in providing reference services.

The AER's reasons for adopting this method are summarised in section 5.1.2. In this section, the AER explains those reasons. Further considerations on the risk free rate are discussed in appendix B.

CGS are the best proxy for the risk free rate in Australia

The risk free rate measures the return an investor would expect from an asset with no default risk. CGS are low default risk securities issued by the Australian Government, and are therefore an

528 AER, *Final decision: Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters*, 1 May 2009, p. 335.
529 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 139.
530 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 137.
531 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 173.
532 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 172.

appropriate proxy for the risk free rate.[533] Each of the three major credit rating agencies issued its highest possible rating to the Australian Government.[534]

Experts generally acknowledge that an observable proxy for the risk free rate is available in Australia.[535] The AER received advice from the RBA, Australian Treasury and AOFM in July 2012 that supported the use of CGS yields as a proxy for the risk free rate in Australia.[536] In the RBA letter, Guy Debelle stated:

> I therefore remain of the view that CGS yields are the most appropriate measure of a risk free rate in Australia.[537]

Similarly, the Treasury and AOFM stated:

> The nominal CGS market is liquid and continues to display the attributes of a well-functioning market.[538]

While there is no explicit statement to this effect, Multinet appears to agree with this conclusion because it proposed prevailing CGS yields for the risk free rate component of its proposed cost of debt.[539] Furthermore, the two approaches Multinet suggests are acceptable for the risk free rate component of the cost of equity both adopt CGS yields for the risk free rate, albeit over different averaging periods.[540]

Furthermore, in advice to Multinet, CEG makes the following statement:

> The AER goes on to address the issues that I raised and, in each case, the AER concludes that CGS is nonetheless the best proxy for the risk free rate. However, I did not argue otherwise...The argument that I did put related to the need for internal consistency between the risk free rate and MRP in the CAPM.[541]

This statement indicates that CEG agrees CGS yields are an appropriate proxy for the risk free in Australia. The AER addresses CEG's argument on internal consistency in appendix B.2.1.

Appropriate averaging period

The AER considers the best method for determining an appropriate risk free rate is to use a short and recent averaging period as close as practicably possible to the commencement of the access arrangement period. The AER explains its reasons for this position in the following sections.

Prevailing CGS yields are consistent with the CAPM

For the following reasons, using a CGS yield estimated as close as practical to the commencement of the access arrangement period is consistent with the CAPM. Inputs to a model must be appropriate

533 Gregory also identifies the absence of re-investment risk and inflation risk and characteristics of a risk free rate. Gregory, *The risk free rate and the present value principle*, November 2012, p.5. Lally discusses these risks in his report. Lally, *The present value principle*, March 2013, p. 10-12.

534 Standard and Poor's, viewed 5 March 2013, http://www.standardandpoors.com/prot/ratings/entity-ratings/en/us/?entityID=268976&sectorCode=SOV; Moody's, viewed 5 March 2013, http://www.moodys.com/credit-ratings/Australia-Government-of-credit-rating-75300; Fitch Ratings, viewed 5 March 2013 http://www.fitchratings.com/gws/en/esp/issr/80442187

535 See, for example, Lally, *The present value principle*, March 2013, p. 13, and Wright, *Review of risk free rate and Cost of equity estimates: A comparison of UK approaches with the AER*, October 2012, p. 3.

536 RBA, *Letter regarding the CGS market*, July 2012; Treasury and AOFM, *Letter regarding the CGS Market*, July 2012.

537 RBA, *Letter regarding the CGS market*, July 2012, p. 1.

538 Treasury and AOFM, *Letter regarding the CGS Market*, July 2012, p. 2.

539 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 173.

540 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 172-173.

541 CEG, *Response to the AER Vic gas draft decisions: Internal consistency of MRP and risk free rate*, November 2012, p. 14. (CEG, *Response to the AER Vic gas draft decisions*, November 2012).

for use in that model, so individual equity parameters in this decision must be consistent with the CAPM framework.

The CAPM uses the most current information to derive the rate of return. In theory, it would use the risk free rate on the day (in this case, the commencement of the access arrangement period), as recognised by the Federal Court in *ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639 (the ActewAGL matter).[542]

During the ActewAGL matter, Associate Professor Lally for the AER and Greg Houston for ActewAGL agreed theory requires the risk free rate be an "on the day" rate.[543] The Federal Court acknowledged this agreement:

> There was no dispute between the experts that the CAPM theory suggests that, ideally, the nominal risk-free rate input will be calculated on the day of the final determination.[544]

Associate Professor Lally advised:

> In relation to the Sharpe-Lintner model, this model always requires a risk free rate prevailing at a point in time for some subsequent period rather than a historical average and application of the model to a regulatory situation would require the risk free rate prevailing at the beginning of a regulatory period.[545]

A prevailing risk free rate is consistent with the building block model and present value principle

For the risk free rate, an averaging period that is as close as practical to the commencement of the access arrangement period promotes consistency with the building block model and the present value principle.

Lally defines the present value principle in this manner:

> The Present Value principle states that the present value of a regulated firm's revenue stream should match the present value of its expenditure stream plus or minus any efficiency incentive rewards or penalties.[546]

The NGR prescribe the use of the building block model when the AER is calculating the total revenue allowance.[547] An important principle of the building block model is the present value principle.[548] Indeed, Lally states:

> In relation to the Building Block model, this is a consequence of the Present Value principle and therefore the same conclusion applies.[549]

Further, as Lally explains:

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542 Federal Court of Australia, *ActewAGL Distribution v The Australian Energy Regulator [2011] FCA 639*, 8 June, 2011, paragraph 119.

543 In advice provided to Multinet by NERA, Greg Houston raised concerns with the AER's presentation of his advice to the Federal Court. NERA, *Estimating the cost of equity under the CAPM: Expert report of Gregory Houston*, November 2012, pp. 36-37. In response, the AER has amended its discussion of Mr Houston's advice to the Federal Court.

544 Federal Court of Australia, *ActewAGL Distribution v The Australian Energy Regulator [2011] FCA 639*, 8 June 2011, paragraph 119.

545 Lally, *Risk free rate and present value*, August 2012, p. 3.

546 M. Lally, *The present value principle: risk, inflation and interpretation*, March 2013, p. 5 (Lally, *The present value principle*, March 2013)

547 NGR r. 76

548 Biggar, D., *Public utility regulation in Australia: Where have we got to? Where should we be going, Working paper no. 4, ACCC/AER working paper series*, July 2011, p. 58. A similar description of the building block model supported by more detailed analysis can be found in Biggar, D., *Incentive regulation and the building block model*, 28 May 2004, pp. 2-21, accessed on 27 August 2012, <http://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=ACE2004&paper_id=133>

549 Lally, *Risk free rate and present value*, August 2012, p. 3.

> The Present Value principle is fundamental to regulation; lower revenues then those that satisfy this principle will fail to entice producers to invest and higher revenues constitute the very excess profit that regulation seeks to prevent (Marshal et al, 1981).[550]

As Lally explains, this principle requires the risk free rate (and MRP) to be estimated at the commencement of the access arrangement period.[551]

The averaging period should be short

A short averaging period provides a reasonable estimate of the prevailing rate while not exposing service providers to unnecessary volatility. It is a pragmatic alternative to using a risk free rate that precisely satisfies the present value principle.

The rate of return must be estimated in a manner consistent with not only that principle, but also the building block model and the CAPM. In advice received prior to the draft decision, Lally stated that all three require a risk free rate estimated at the commencement of the access arrangement period[552]—literally, the first market price on the first day of the access arrangement period.[553] However, Lally explained:

> ... the use of this transaction would expose the regulatory process to reporting errors, an aberration arising from an unusually large or small transaction, and a rate arising from a transaction undertaken by a regulated firm for the purpose of influencing the regulatory decision.[554]

A short averaging period (between 10 and 40 business days) as close as practically possible to the commencement of the access arrangement period provides a pragmatic alternative—violating the present value principle only to the minimum extent necessary. Lally states:

> The use of the CAPM in a regulatory situation requires that the risk free rate and the MRP must be the rates prevailing at the beginning of the regulatory period. However pragmatic considerations suggest that the risk free rate be averaged over a short period close to the beginning of the regulatory period.[555]

On the other hand, Lally noted a long term average would more significantly violate the present value principle without providing any pragmatic gain:

> Rates averaged over a much longer historical period would be inconsistent with the present value principle, i.e., they would violate it without offering any incremental pragmatic justification.[556]

Subsequent advice provided by Lally did not change this conclusion. The presence of risky assets does not justify the use of a long-term averaging period.[557]

The AER does not consider a long-term averaging period is an appropriate and reasonable departure from the present value principle. Therefore, the AER does not accept Multinet's proposed historical averaging period for the cost of equity.

Multinet's nominated averaging period for the cost of debt was 24 October 2012 to 20 November 2012. This AER agrees with this averaging period because it is consistent with the AER's considerations in this section. The AER has applied this averaging period for both the cost of equity and the cost of debt. The averaging period is discussed in more detail in appendix B.4.2.

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550 Lally, *Risk free rate and present value*, August 2012, p. 6.
551 Lally, *The present value principle*, March 2013, p. 6.
552 Lally, *Risk free rate and present value*, August 2012, p. 3
553 Lally, *Risk free rate and present value*, August 2012, p. 7
554 Lally, *Risk free rate and present value*, August 2012, p. 7
555 Lally, *The present value principle*, March 2013, p. 5.
556 Lally, *Risk free rate and present value*, August 2012, p. 7.
557 Lally, *The present value principle*, March 2013, p. 6

CGS are an observable market determined parameter

CGS yields are observable in a market. As that market is liquid and functioning well,[558] the AER has confidence the market rate reflects the prevailing risk free rate.

Changes in yields for securities traded in a liquid market are likely to reflect the actions of many market participants at each point in time. So, market determined CGS yields are likely to reflect prevailing conditions in the market for funds. On its own, a yield that is low relative to historical averages is not a sign that the yield prevailing at any point in time is no longer a good proxy for the risk free rate. The current CGS yields are likely to reflect strong demand from foreign investors and a general re-assessment of the value of a risk free asset. Lower yields (higher prices) are an expected outcome from increased demand for those assets.

The Treasury and the AOFM noted this point:

> The weak and fragile global economy has put downward pressure on benchmark global long-term bond yields, and is driving investors into high quality government debt.[559]

The prevailing yield is the benchmark that risky investments must better

In previous advice, Professor McKenzie and Associate Professor Partington explained the relationship between the prevailing risk free rate and investment decisions:

> There seems to be an implication in some of the submissions that there is something wrong with using the government bond rate as the risk free rate when government bond rates are low. The fundamental point to be made is that the government bond rate sets the current benchmark that a risky project has to beat. Clearly there is little point in taking on a risky project if you can get the same or higher return by investing in a government bond. The government bond thus sets a benchmark; the time value of money.[560][561]

They also advised:

> At the time of writing investors can invest in a 10 year government bond at yield of 3.84%. So a ten year project that offers say 4.5% is worth considering if the risk is low enough. The fact that government bond yields were higher in the past does not make 4.5% a bad deal, or 3.84% too low a benchmark. We see no reason to switch from using the current 10 year government bond yield as the proxy for the risk free rate.[562]

Since the AER received this advice in February 2012, the 10 year CGS yield has further decreased. The risk free rate from Multinet's nominated averaging period is 3.12 per cent. The logic in Professor McKenzie and Associate Professor Partington's advice continues to apply. In prevailing market conditions during Multinet's averaging period, 3.12 per cent is the benchmark that a risky project must exceed. The AER estimates an appropriate risk premium above this rate reflecting prevailing conditions in the market for funds and the risks involved in providing reference services. The risk premium is the product of the equity beta and the MRP. The AER considers the appropriate equity beta and MRP in sections 5.3.4 and 5.3.3.

Prevailing 10 year CGS yield is a forward looking 10 year rate

The prevailing 10 year CGS yield is a forward looking rate. The prevailing 10 year CGS yield varies over time, but this variation does not mean the yield is a 'short term' rate. Rather, according to the

558 Treasury and AOFM, *Letter regarding the CGS Market*, July 2012, p. 2.
559 Treasury and AOFM, *Letter regarding the CGS Market*, July 2012, p. 1.
560 McKenzie and Partington, *Supplementary report on the MRP*, February 2012, pp. 11–12..
561 The advice was provided for the AER's final determination on Aurora. Many of the contentions made in that process are also being made in this process.
562 McKenzie and Partington, *Supplementary report on the MRP*, February 2012, p. 12.

expectations theory on the term structure of interest rates, at any point in time the yield on long dated bonds (such as 10 year CGS) incorporates the market's expectation of the yield on shorter dated bonds over the next 10 years. The expectations theory is generally regarded as a partial but not complete explanation of the term structure of interest rates. Other factors are also likely to be relevant .[563]

The method is unbiased

Determining the averaging period in advance helps achieve an unbiased risk free rate.

Regulated businesses have an incentive to seek a WACC that is as high as possible, because it will increase their revenue allowance. If a regulated business can select an averaging period by looking at historical yields, they may introduce an upward bias.[564] They can select a period with the highest yield available. But, when an averaging period is agreed or specified in advance regulatory "gaming" is less likely because the risk free rate is unknown for that future period.

The possibility of upward bias also applies to a long term average. No particular long term averaging period is clearly superior. Multinet responded to these concerns by proposing the use of a 10 year averaging period.[565] Multinet suggested that there is regulatory precedent from IPART that supports the use of a 10 year averaging period.[566] IPART has indeed taken long term historical averages into account.[567] However, as SFG acknowledges, it has not formally adopted a long term historical estimate in the manner that Multinet has proposed.[568] The precedent value of IPART's approach is not as strong as Multinet suggests. IPART's approach to setting the WACC is discussed in more detail in appendix B.8.2.

The AER thus maintains its position that a short averaging period, determined in advance, minimises the likelihood of bias.

There is no clear evidence that CGS yields are abnormally low

There are references in Multinet's revised proposal, and the consultant reports it submitted, to CGS yields being likely to return to normal. The following statement in Multinet's proposal is an example:

> Under conditions of normally functioning capital markets, the AER's standard approach would generally result in reasonable estimates of the cost of equity. However, we cannot rely on normal conditions persisting and, therefore, the AER's standard regulatory approach will only by chance produce an estimate of the cost of equity that is consistent with clause 87(1) of the NGR. Furthermore, the current market conditions are far from normal.[569]

This position finds support in advice from CEG, who state:

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[563] The 'liquidity premium' theory and the 'preferred habitat' theory identify other important determinants of the term structure of debt. Elton et. al., *Modern Portfolio Theory and Investment Analysis 8th ed.* (2010), pp. 516–-521. These concepts are discussed further in appendix B of the draft decision.

[564] Lally, M., *Expert Report of Martin Thomas Lally*, 13 February 2011, pp. 9-10. Lally's comments in this report were made about a specific approach proposed in the relevant determination but are consistent with the approach taken by the AER in this decision.

[565] Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 172.

[566] Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 172.

[567] IPART, *Review of water prices for Sydney Desalination Plant Pty Limited from 1 July 2012 - Final Report*, December 2011, p. 93.

[568] SFG, *The required return on equity: Response to AER Victorian gas draft decisions*, 7 November 2012, p. 60. (SFG, *The required return on equity*, November 2012)

[569] Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 150.

> The effect of this is that the prevailing cost of equity is at least as high as under normal market conditions - notwithstanding that the CGS yields are at historic lows.[570]

This raises the question of what "normal" conditions are and whether CGS yields are "abnormally" low.

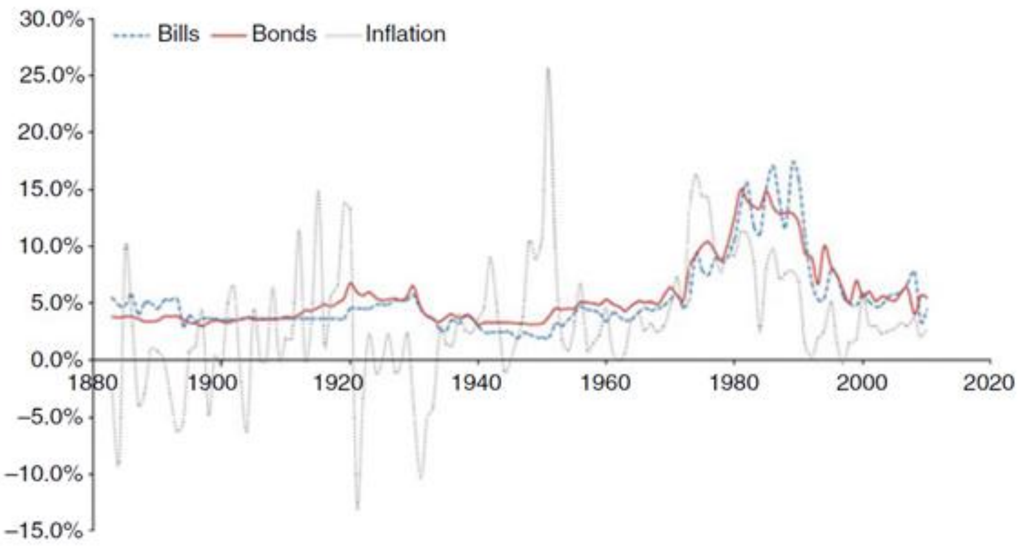
The analysis above demonstrates that the CGS market is liquid and functioning well. There is no evidence before the AER to suggest that conditions in the CGS market are abnormal. Conversely, there is no clear understanding of "normal" market conditions. Prices (and yields) in markets move up and down all the time depending on the circumstances, demand and supply conditions, and investor expectations. There is no evidence before the AER to suggest that there is mispricing in the CGS market.

McKenzie and Partington also considered the question of whether CGS yields are abnormally low. They did not find that there was reason to describe current CGS yields as abnormally low. They state:

> The evidence provided by the data suggests that the history of interest rates over the last few decades is not truly representative of the long run in this market. For both the U.S., UK and Australian markets, evidence exists which suggests that bond yields were stable (and possibly even falling) in the long run. The history of data over the last few decades is anomalous and the high interest rates observed during this period are clearly not representative of the longer time series. As such, one conclusion may be that the current environment is nothing more than a return to the 'normal' long run interest rate regime. On the other hand, it could be argued that there is a new normal and the GFC represents a true regime shirt for global financial markets. It is difficult to determine whether this is the case or not - only in the fullness of time will we be able to comment on this with any certainty.[571]

Their report also presents the following figure from Brailsford et al (2012).[572]

Figure 5.2 Bond yields, bill yields and inflation rates over time



The figure shows:

- Yields in the 1970s and 1980 were high by comparison with historical rates.

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570 CEG, *Update to March 2012 Report: on consistency of the risk free rate and MRP in the CAPM*, November 2012, p. 32. (CEG, *Update to March 2012 Report*, November 2012)

571 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, p. 5.

572 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, p. 13.

- Yields have remained elevated (depressed) for long periods before falling (increasing).

As part of its considerations on the cost of equity, the AER has considered evidence on the stability of the cost of equity and the relationship between the risk free rate and MRP. This issues are furthered considered in appendix sections B.2.1, B.2.2 and B.2.3.

5.3.3 Market risk premium

The AER agrees with Multinet's proposed MRP of 6 per cent.

In the draft decision, the AER also agreed with Multinet's proposal for a 6 per cent MRP. However, the AER noted Multinet's proposed 6 per cent MRP was proposed in connection with a long term historical average risk free rate. Multinet maintained this position in the revised proposal. It submitted its proposed approach, which adopts long term averages for both the risk free rate and MRP, is one of the two legitimate options to estimate the cost of equity by applying the CAPM. While proposing a 'long term average' MRP of 6 per cent, Multinet also suggested it would accept a higher 'spot' MRP if the AER decided to address its arguments through the application of 'spot estimates'.[573]

It is well recognised that the MRP cannot be directly observed. Unlike the risk free rate, the evidence available for estimating the MRP is imprecise and subject to varied interpretation. There is no consensus among experts on which method produces the best MRP estimate. In addition, different methods can produce widely different results at the same point in time.[574] For these reasons, the AER considers that it is reasonable to assess a range of evidence to inform the best estimate of the MRP. In this assessment the AER must apply its judgment to interpret the information before it.

The AER considers a 6 per cent MRP reflects prevailing conditions in the market for funds and the risks involved in providing reference services. The AER's reasons for adopting this value are summarised in section 5.1.2. In this section, the AER explains those reasons. Further considerations on the MRP are discussed in appendix B.

Historical excess returns

Long run historical average excess returns support a 10 year forward looking MRP of 6 per cent as reasonable.

Historical excess returns estimate the realised return that stocks have earned in excess of the 10 year government bond rate. They can be directly measured. Although not strictly forward looking, historical excess returns have been used to estimate a forward looking MRP on the view that investors base their forward looking expectations on past experience. The Tribunal recognised this view in the DBNGP matter.[575] In a regulatory context, the use of historical excess returns has advantages, as supported by McKenzie and Partington:

- The estimation methods and the results are transparent.
- The estimation methods have been extensively studied and the results are well understood.

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[573] Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 138

[574] See: Damodaran, *Equity risk premiums: determinants, estimation and implications - the 2012 edition*, March 2012, p. 93. He also noted: "No matter what the premium used by an analyst, whether it be 3% or 12%, there is back-up evidence offered that the premium is appropriate."

[575] Australian Competition Tribunal, *Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14,* 26 July 2012, paragraph 153.

- Historical estimates are widely used and have support as the benchmark method for estimating the MRP in Australia.[576]

Dimson, Marsh and Staunton (2012) indicate there is no better forecast of expected excess returns than the historical average:[577]

> In summary, there are good reasons to expect the equity premium to vary over time. Market volatility clearly fluctuates, and investors' risk aversion also varies over time. However, these effects are likely to be brief. Sharply lower (or higher) stock prices may have an impact on immediate returns, but the effect on long-term performance will be diluted. Moreover volatility does not usually stay at abnormally high levels for long, and investor sentiment is also mean reverting. For practical purposes, we conclude that for forecasting the long run equity premium, it is hard to improve on extrapolation from the longest history that is available at the time the forecast is being made.

This conclusion is informed by their assessment of the current state of research on the MRP, which they summarize as follows:[578]

> Mean reversion would imply that the equity premium is to some extent predictable…Yet despite extensive research, this debate is far from settled. In a special issue of the Review of Financial Studies, leading scholars expressed opposing views, with Cochrane (2008) and Campbell and Thompson (2008) arguing for predictability, whereas Goyal and Welch (2008) find that 'these models would not have helped an investor with access only to available information to profitably time the market'.

The long term averages of historical excess returns, adjusted to incorporate an imputation credit utilisation rate (theta) of 0.35[579], produce a range of 4.9–6.1 per cent (based on arithmetic averages) and 3.0–4.7 per cent (based on geometric averages) over the periods 1883–2011, 1937–2011, 1958–2011, 1980–2011 and 1988–2011 (Table 5.2). The starting point for each of the five estimation periods was chosen because the quality of the underlying data sources changed (in 1883, 1937, 1958 and 1980) and the imputation tax system was introduced (in 1988).[580]

Table 5.2 Historical excess return estimates—assuming a use rate of distributed imputation credits of 0.35 (per cent)

Sampling period	Arithmetic mean	Geometric mean
1883–2011	6.1[a]	4.7
1937–2011	5.7[a]	3.7
1958–2011	6.1[a]	3.5
1980–2011	5.7	3.1
1988–2011	4.9	3.0

a Indicates estimates are statistically significant at the 5 per cent level using a two tailed test.
Source: Handley.[581]

The AER considers the strengths and weaknesses of each sampling period, which are:

576 M. McKenzie, and G. Partington*, Report to Corrs Chambers Westgarth: Equity market risk premium*, 21 December 2011, pp. 5–6, (McKenzie and Partington, *Equity market risk premium*, December 2011)

577 Dimson, Marsh and Staunton, *Credit Suisse Global Investment Returns Sourcebook 2012*, February 2012, p.37.

578 Dimson, Marsh and Staunton, *Credit Suisse Global Investment Returns Sourcebook 2012*, February 2012, p.36.

579 The 0.35 value for theta is consistent with the Australian Competition Tribunal's position in *Application by Energex Limited (Gamma) (No 5) [2011] ACompT9*, November 2009.

580 Brailsford, Handley and Maheswaran, *Re-examination of the historical equity risk premium in Australia,* Accounting and Finance, vol. 48, 2008, pp. 85-86.

581 Handley, *An estimate of the historical equity risk premium for the period 1883 to 2011*, April 2012, p. 6.

- Longer time series contain a greater number of observations, so produce a more statistically precise estimate.
- Significant increases in the quality of the data becoming available in 1937, 1958 and 1980.
- More recent sampling periods more closely accord with the current financial environment, particularly since financial deregulation (1980) and the introduction of the imputation credit taxation system (1988).[582]
- Shorter time series are more vulnerable to influence by the current stage of the business cycle or other (one-off) events. [583]

The AER considers that there is no one sampling period that is to be preferred, since each period has a number of strengths but at least one weakness. For this reason, the AER considers that all five sampling periods are relevant.

Arithmetic and geometric means

The AER considers the arithmetic average of 10 year historical excess returns would likely be an unbiased estimator of a forward looking 10 year return. However, historical excess returns are estimated as the arithmetic or geometric average of one year returns. If the one year historical excess returns are variable, which they are, then their arithmetic average will overstate the arithmetic average of 10 year historical excess returns. Similarly, the geometric average of one year historical excess returns will understate the arithmetic average of 10 year historical excess returns.[584]

The AER considers both the arithmetic and geometric averages are relevant to consider when estimating a 10 year forward looking MRP using historical annual excess returns.[585] In the Envestra matter, the Tribunal found no error with this approach.[586] The best estimate of historical excess returns over a 10 year period is therefore likely to be somewhere between the geometric average and the arithmetic average of annual excess returns. Also Multinet's consultant, Wright, considers both arithmetic averages and geometric averages of historical data when estimating the MRP.[587]

Bias in historical excess returns

In using historical excess returns as a source of evidence on the forward looking MRP, it is important to consider whether historical estimates are likely to under or overstate a forward looking MRP. As various experts have noted, historical excess returns may be subject to certain biases, including:

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582 In a report submitted on Aurora's revised proposal, NERA raised the issue that the market excess returns were less volatile before the 1950s. See: NERA, *Market risk premium*, 20 February 2012, pp. 13–20. The lack of a well developed theory behind what drives the MRP makes the AER cautious of excluding large periods of data because it does not represent a forward looking MRP. Also, other evidence suggests the historical excess returns were too high before the 1950s. See: AER, *APTPPL access arrangement draft decision*, April 2012, pp. 296297–7.
Further, the arithmetic averages of historical excess returns over 1883–2011 and 1958–2011 both produce a historical MRP of 6.1 per cent. The geometric averages are 4.7 and 3.0 respectively. Accordingly, even if the AER were to rely on only the post 1958 data, it would not change its position on the appropriate value of the MRP.

583 AER, *Final decision—WACC review,* May 2009, pp. 200, 204; Brailsford, Handley and Maheswaran, *Re-examination of the historical equity risk premium in Australia, Accounting and Finance*, 2008, vol. 48, pp. 78–82. (AER, *WACC review final decision*, May 2009)

584 This matter is explained in detail in appendix section B.2.1 of the draft decision.

585 The AER also discusses the comments on the use of geometric averages by SFG, NERA and Lally in appendix section B.5.1.

586 Australian Competition Tribunal, *Application by Envestra Ltd (No 2) [2012] ACompT4*, 11 January 2012, paragraph 157.

587 Wright, *Review of risk free rate and cost of equity estimates*, October 2012, p.20

- suvivorship bias (McKenzie and Partington; Damodoran)[588]
- unanticipated inflation, historically high transaction costs and a historical lack of low cost opportunities for diversification (Siegel)
- bias due to the inclusion of historical data which contains periods of major recessions (Lally)[589]

McKenzie and Partington suggested MRP estimates based on historical data may be overstated relative to true expectations, as a result of survivorship bias.[590] According to Damodoran (2011), survivorship bias is created by estimating historical returns on only stocks that have survived.[591] Historical data excludes negative return stocks that no longer exist, which naturally results in higher return estimates. McKenzie and Partington[592] and Joye[593] supported this view. This upward bias is a relevant consideration because the various Australian stock indexes exclude the failed stocks.[594]

Other arguments also suggest the historical excess returns are upwardly biased. Siegel (1999) considered unanticipated inflation means historical returns underestimate real returns on risk free assets.[595] He also submitted historical returns on equity overstate returns actually realised, given historically high transaction costs and the historical lack of low cost opportunities for diversification.[596]

To address the overestimating problem noted by Siegel, Lally suggested one could estimate the MRP by adding back the historical average real risk free rate to the conventional MRP estimate and then deducting an improved estimate of the long-term expected real risk free rate. The modified MRP estimate is 4.9 per cent. Lally noted results from this methodology have been used by both the QCA and the New Zealand Commerce Commission in reaching their conclusions on the MRP.[597]

McKenzie and Partington noted Multinet's consultant Gregory makes a similar argument to Siegel in support of his view that the regulatory rate of return in the UK has been too high. He submits that a comparison of realised bond returns unprotected from inflation with realised equity returns that have some protection from inflation is likely to overstate the MRP.[598]

Lally also suggested historical excess returns may underestimate the forward looking 10 year MRP when an economy has entered a major recession. But he noted Australia has not recently entered a major recession and, even if it had, the downward bias is unlikely to be very large.[599] He also noted:

> ... the fact that the AER bases its estimate of the MRP at least partly upon historical averaging of excess returns does not invalidate its claim that it is estimating the MRP for the next ten years; this estimation methodology is suitable (in conjunction with other methodologies) for estimating the MRP for the next ten years as well as for estimating the long-term average MRP. The use of historical averaging results may introduce a downward bias at the present time, but the effect is likely to be small relative to the standard

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588 Damodoran, A. *Equity risk premiums: determinants, estimation and implications—the 2012 edition*, Mach 2012, p. 24.

589 M. Lally, *The cost of equity and the market risk premium*, 25 July 2012, p. 24 (Lally, *Cost of equity and the MRP*, July 2012).

590 McKenzie, M. and G. Partington, *Equity market risk premium*, 21 December 2011, pp. 6–7.

591 Damodoran, A. *Equity risk premiums: determinants, estimation and implications—the 2012 edition,* Mach 2012, p. 24.

592 M. McKenzie, and G. Partington, *Report to the AER: Review of regime switching framework and critique of survey evidence,* 27 August 2012, p. 19, (McKenzie and Partington, *MRP: regime switching framework and survey evidence*, August 2012)

593 Joye, C., *Super funds miss mark in bias to equities,* Australian Financial Review, 14 August 2012.

594 For example, the ASX All Ordinaries Index represents the 500 largest companies listed on the ASX. Market capitalisation is the only eligibility requirement. An underperforming stock that is losing its market share would be eventually be removed from the index. See: http://www.asx.com.au/products/capitalisation-indices.htm#all_ordinaries_index.

595 Lally, *Cost of equity and the MRP*, July 2012, p. 8, (Lally, *Cost of equity and the MRP*, July 2012).

596 McKenzie and Partington, *Equity market risk premium*, December 2011, p. 7

597 Lally, *Review of the AER's methodology*, March 2013, p.29.

598 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, pp. 18.

599 Lally, *Cost of equity and the MRP*, July 2012, p. 24.

> deviation in the estimate and to possible upward bias in the methodology arising from significant unanticipated inflation in the 20th century.[600]

The AER considers the bias is a relevant consideration when estimating the MRP using historical excess returns. Since it is not clear what the precise magnitude of the bias is, McKenzie and Partington do not recommend adjusting the historical estimate of the MRP. Given that 6 per cent is towards the top of the range of average historical excess returns, the AER considers 6 per cent is a reasonable estimate, and unlikely to underestimate a forward looking MRP.

Forward looking predictors of excess returns

Multinet has submitted consultant reports in support of using dividend yields, dividend yield based DGM estimates and credit spreads to forecast the MRP. In past regulatory decisions, service providers have also proposed other methods to estimate MRP, such as implied volatility. Over the past decade, there is considerable scepticism about evidence for a relationship between observable variables and the MRP. A few studies indicated there is no better forecast of excess returns than the historical average.[601]

For example, Goyal and Welch examine the performance of variables that academic literature suggested as good predictors of the equity premium. These variables include dividend yield, earnings price ratio, corporate bond returns and volatility. Goyal and Welch find that, of the variables that have been proposed to predict excess returns, many produced poor in-sample forecasts. Moreover, they find most variables that performed well in-sample performed poorly out-of-sample.

Goyal and Welch distinguish between in-sample and out-of-sample performance of forecasting models. To understand this distinction, it may be helpful to consider the following passage in Brooks (2008), which insists on the importance of out-of-sample forecast performance:[602]

> In-sample forecasts are those generated for the same set of data that was used to estimate the model's parameters. One would expect the 'forecasts' of a model to be relatively good in-sample, for this reason. Therefore a sensible approach to model evaluation through an examination of forecast accuracy is not to use all of the observations in estimating the model parameters, but rather to hold some of the observations back. The latter sample, sometimes known as the holdout sample, would be used to construct out-of-sample forecasts.

The conclusion of Goyal and Welch is stated below: [603]

> Most models are no longer significant even in sample (IS), and the few models that still are usually fail simple regression diagnostics…Most models have poor out-of-sample (OOS) performance, but not in a way that merely suggests lower power than IS tests. They predict poorly late in the sample, not early in the sample…Therefore, although it is possible to search for, to occasionally stumble upon, and then to defend some seemingly statistically significant models, we interpret our results to suggest that a healthy scepticism is appropriate when it comes to predicting the equity premium, at least as of early 2006. The models do not seem robust.
>
> ...
>
> OOS, most models not only fail to beat the unconditional benchmark[604] (the prevailing mean) in a statistically or economically significant manner, but underperform it outright.

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600 Lally, *Cost of equity and the MRP*, July 2012, p. 27.

601 Boudoukh, Richardson and Whitelaw, *Myth of long-horizon predictability,* Review of financial studies, July 2008, vol. 21, no. 4, pp. 1577–605; Timmermann, *Elusive return predictability,* International journal of forecasting, January – March 2008, vol. 24, no. 1, pp. 1–18; Goyal and Welch, *A comprehensive look at the empirical performance of equity premium,* Review of financial studies v, 2008, vol. 21 n, no. 4, pp. 1455–508.

602 Brooks, C, *Introductory Econometrics for Finance*, 2nd ed. Cambridge, Cambridge University Press, 2008, p.245

603 Goyal and Welch, *A comprehensive look at the empirical performance of equity premium,* Review of financial studies v, 2008, vol. 21 n, no. 4, p. 1456 & p. 1504.

Forward looking measures

There is growing scepticism in the academic literature of forward looking measures of the MRP. However, in this section the AER considers two forward looking MRP measures that are frequently suggested by service providers. Those are:

- DGM estimates—these estimates are advocated by Multinet and its consultant in the initial proposal and the revised proposal. CEG, Capital Research, NERA and Lally all recommended placing at least some weight on DGM estimates for estimating a forwarding looking MRP. The AER considers that DGM based analysis can provide information on the expected MRP, however, this approach is also subject to a number of limitations.

- Implied volatility glide path—the AER notes this technique was not proposed by Multinet in this review. However, this approach, as suggested by Value Adviser Associates (VAA) in its 2010 report, is the only other forward looking approach that produces an MRP estimate. Therefore the AER gives consideration to this method in both the draft decision and this final decision.

These two forward looking MRP measures give mixed results. DGM estimates can give some insight into the prevailing MRP estimate, although it is subject to a number of limitations. Associate Professor Lally found the current DGM MRP estimates are in the range of 5.9–8.4 per cent after correcting for deficiencies in CEG's method. The other forward looking MRP measure—implied volatility glide path indicates the MRP estimate is currently below its historical average level (and therefore below 6 per cent).

DGM estimates

DGM analysis can provide some information on the expected MRP. The DGM method examines the forecast future dividends of businesses and derives the cost of equity that makes these dividends consistent with the market valuation of the equity of those businesses.

However, DGM based estimates of the return on equity and implied MRP estimates are highly sensitive to the assumptions made. It is necessary that all assumptions made have a sound basis, otherwise estimated results from DGM analysis may be inaccurate and lead analysts into error.[605] This view is also supported by McKenzie and Partington:

> Clearly valuation model estimates are sensitive to the assumed growth rate and a major challenge with valuation models is determining the long run expected growth rate. There is no consensus on this rate and all sorts of assumptions are used: the growth rate in GDP; the inflation rate; the interest rate; and so on. A potential error in forming long run growth estimates is to forget that this growth in part comes about because of injections of new equity capital by shareholders. Without allowing for this injection of capital, growth rates will be overstated and in the Gordon model this leads to an overestimate of the MRP.[606]

Consistent with its position in the WACC review and previous decisions, the AER considers:

- The implied MRP produced by DGM estimates is sensitive to both the model specification and the choice of inputs

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604 Unconditional benchmark refers to average historical excess returns in Goyal and Welch.

605 For example corporate finance texts have noted “The simple constant-growth DCF [discounted cash flows] formula is an extremely useful rule of thumb” but “Naive trust in the formula has led many financial analysts to silly conclusions.” Brealey, Myers and Allen, *Principles of Corporate Finance: International Edition,* 9th Edition, Boston: McGraw-Hill, 2008, p. 95.

606 McKenzie and Partington, *Equity market risk premium*, December 2011, p. 25.

- No input assumptions are reliable. Generally, the expected market growth rate in dividends per share (a key input) is proxied with analysts' short term forecasts of market wide earnings per share growth, or long term expectations of GDP growth (or both). Associate Professor Lally advised such proxies are likely to produce an upward bias in the MRP estimates.[607]

- Regulators had previously been wary to lower the MRP when DGM estimates were below 6 per cent.[608] The AER is similarly wary to increase the MRP (based on DGM estimates) even though the DGM estimates can produce estimates above 6 per cent.

- At the WACC review, academics (Officer and Bishop, and CEG) and industry representatives (including the ENA who represents the Victorian gas businesses) considered DGM estimates should be used only as a 'cross check' on the reasonableness of other methods to estimate the MRP, rather than as the primary method.[609] In contrast, in this review the regulated businesses and CEG consider substantial weight should be placed on DGM estimates. The reasons for this change in position have not been explained.

- Although DGM is extensively used by US economic regulators in estimating the return on equity[610], it is not well accepted for use in the Australian context.[611]

The AER notes different consultants produce widely different DGM based MRP estimates over a short period. Table 5.3 below illustrates the consultants' DGM estimates from the last year, which range from 5.90–9.56 per cent. DGM estimates from the most recent reports (CEG and Lally) produce a lower range of 5.90–8.89 per cent. For the reasons explained in appendix B, the AER gives greater consideration to Lally's estimates than CEG's estimates. This is because Lally's DGM method is based on CEG's method, however adjusts for certain deficiencies in CEG's method identified by Lally. Lally's method produces a range of 5.90–8.39 per cent.

607 Lally, *Cost of equity and the MRP*, July 2012, pp. 11–18.
608 AER, *WACC review final decision*, May 2009, p. 220.
609 AER, *WACC review final decision*, May 2009, pp. 218–219.
610 CEG, Risk free rate and MRP in the CAPM, March 2012, p.38.
611 In most capital markets there are relatively few independent forecasts of future earnings and, consequently, there is a high level of statistical uncertainty surrounding DCF projections of the cost of equity for a particular company. However, in the US there is a very deep market for analysts' projections of company's future earnings. See: NERA, *Review of ESCOSA's decision on ETSA utilities equity beta*, April 2005, p. 23.

Table 5.3 Recent DGM based MRP estimates produced by consultants

		Dividend yield	Dividend per share growth	RFR	MRP estimate
CEG (March 2012)		5.68%	6.60%	3.77%	8.52%
Capital Research (Feb 2012)		4.70%	7.00%	5.08%	6.62%
Capital Research (Feb 2012)		5.23%	7.00%	5.08%	7.15%
Capital Research (Feb 2012)		5.71%	7.00%	5.08%	7.63%
Capital Research (Mar 2012)		6.29%	7.00%	3.73%	9.56%
NERA (Feb 2012)		Bloomberg and IBES forecasts	5.65%	3.96%	7.72–7.75%
NERA (Feb 2012)		Bloomberg and IBES forecasts	5.65%	5.50%	6.18–6.21%
NERA (March 2012)		Bloomberg and IBES forecasts	5.65%	3.99%	7.69–7.72%
CEG (November 2012)		5.34%	6.60%	3.05%	8.89%
Lally (March 2013)		5.34%	a mix of long term and short term dividend growth	3.26%	5.90-8.39%

Sources: CEG, Capital Research, Capital Research, NERA, Lally

DGM analysis is producing relatively high MRP estimates at the moment. However, DGM analysis produced MRP estimates just above 2 per cent in 1994 (CEG's modified approach using indexed CGS rates). It is unlikely this would have been seen then or now as a credible estimate of the MRP in 1994. The AER considers the results from the DGM analysis, while also aware of the limitations to this analysis discussed above. The AER discusses its further considerations on DGM estimates in appendix B.

Implied volatility

VAA estimated the MRP based on an 'implied volatility glide path' approach, the MRP estimate generated from implied volatility will have the same horizon as the underlying options. The implied volatility approach to estimate the MRP is based on an assumption that the MRP is the price of risk times the volume of risk (volatility), which is based on Merton (1980).

The AER has already set out its concerns with using VAA's implied volatility approach and the implied volatility as an indicator for the MRP in the draft decision and its previous decisions[612]. Specifically, the AER considers that the VAA implied volatility approach:

- inappropriately determines the baseline long run average implied volatility by using a different data series—the realised volatility of a 90 day data window for the S&P/ASX 30 from 1980 onwards.[613] Using this (historical) realised volatility series results in a long run average volatility of

612 AER, *Final decision Envestra Ltd access arrangement proposal for the SA gas network*, June 2011, pp. 195-197.

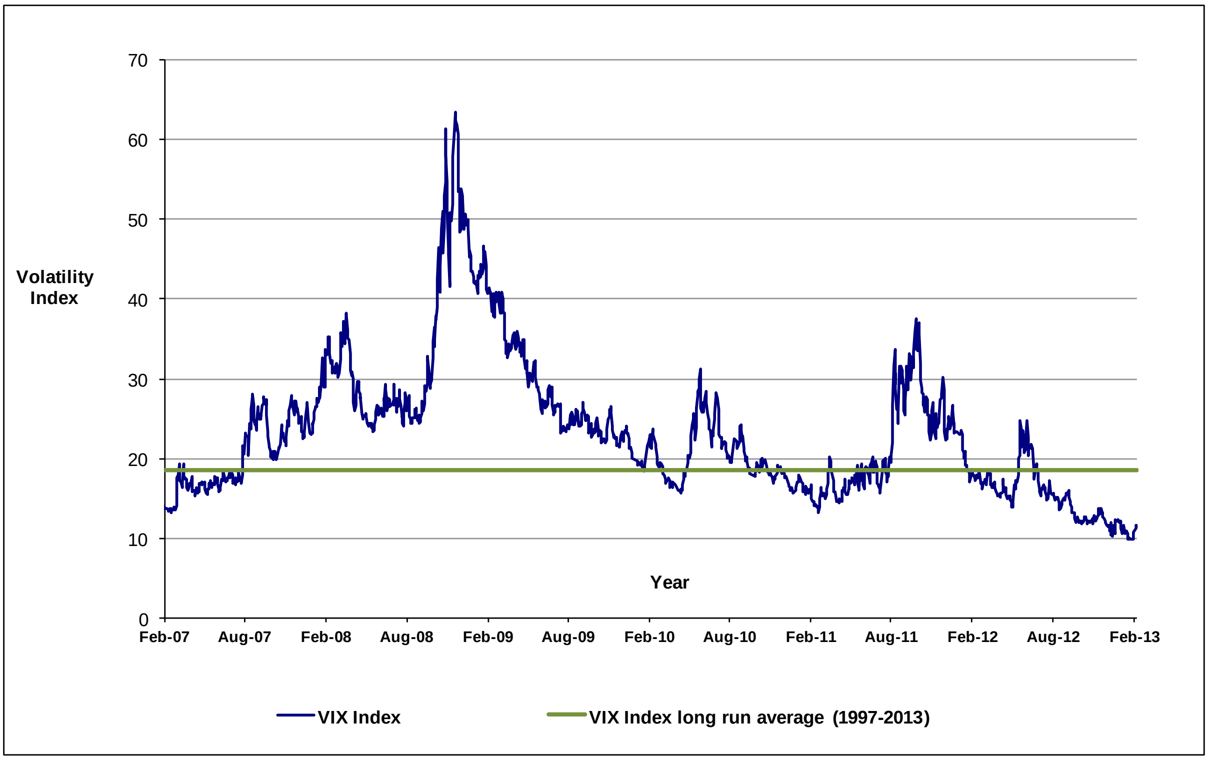
613 VAA, MRP for *Envestra*, March 2011, p. 4 (footnote 7). Further, VAA appears to end its baseline period in 2009 even when using implied volatility data up to the end of 2010. See Bishop, Fitzsimmons, and Officer (2011), pp. 9, 14 (endnote 5).

14 per cent. The actual long run average of one of the (forward looking) implied volatility series used by VAA (3 month VIX) is 18.6 per cent. Adopting the higher baseline would reduce the MRP estimated using the VAA approach in all scenarios.

- incorrectly calculates the price per unit of implied volatility using a 'long run historical average MRP' of 7 per cent, when the evidence indicates that this value is approximately 6 per cent.[614] Adopting the lower historical average MRP would reduce price per unit of volatility, which in turn reduces the MRP estimated using the VAA approach in all scenarios.

Although implied volatility was high during the height of the GFC, the current level is significantly below the long run average. Using data updated to 7 February 2013[615], the VIX implied volatility measures at 11.4 per cent, significantly below the long run average of 18.6 per cent (measured from the start of the data series in 1997). Figure 5.3 shows the value of this measure of implied volatility relative to its long run average level across the period since the global financial crisis.

Figure 5.3 Implied volatility (VIX) over time



Source: Citibank VIX implied volatility index (3 month put/call options on S&P/ASX 200), sourced via Bloomberg code CITJAVIX.

By directly applying VAA's approach, the current one year MRP is 5.7 per cent—this is derived by applying a constant premium per unit risk to implied volatility of 11.4 per cent for 3 month options on th ASX 200 index.[616] Transitioning to a long term average of 6 per cent, this implied volatility approach produces an MRP below 6 per cent.

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614 The AER sets out earlier in this decision its analysis of the historical excess return series.

615 The AER attempts to update rate of return related data in this final decision to 20 February 2013. This is because 20 February 2013 is the end date of the averaging period of the Victorian gas business (Envestra) whose averaging period ended the latest. However, at the time of finalising this decision VIX data from Bloomberg was only available until 7 February 2013. Therefore the data was updated to 7 February 2013 for this implied volatility analysis.

616 Note the constant premium per unit risk is 0.5, which is consistently used by VAA. Also, VAA uses implied volatility for 1 year options on ASX 200 index, while the AER applied implied volatility for 3 month options on ASX 200 index. However, the AER notes VAA found the 3 month and 12 month option volatilities are highly correlated, the correlation coefficient is

Further, if the VAA approach is corrected for the AER's concerns above, it produces a current one year MRP of 3.7 per cent (based on a revised constant premium per unit risk to implied volatility of 11.4 per cent for 3 month options on ASX 200 index). The revised constant premium per unit risk is 0.32, which is derived by dividing a more realistic long term MRP of 6 per cent by the long run average volatility of 18.6 per cent, measured from the start of the data series in 1997. This converts to a 10 year MRP of 5.54 per cent.[617]

The AER does not consider that VAA's implied volatility glide path approach produces a robust basis on which to place substantive weight in estimating a 10 year forward looking MRP. However, even if weight were to be given to this approach, it would currently support an MRP estimate below 6 per cent. The AER notes that this is a forward looking measure that until recently was strongly advocated by regulated businesses. It is appropriate to consider this measure, among other measures of the MRP, having regard to the strengths and weaknesses of this approach.

As noted above, and further in appendix B, both DGM based and implied volatility based estimates of a forward looking MRP are subject to certain limitations. A further limitation is, in prevailing market conditions, these two approaches produce vastly different results. Implied volatility estimates suggest the 10 year forward looking MRP is around 5.54 per cent. This is somewhat below 6 per cent. DGM estimates suggest the MRP is around 5.90–8.39 per cent (based on Lally's estimates). This ranges from slightly below 6 per cent to materially above 6 per cent. However, taking both measures together, and having regard to the strengths and weaknesses of these methods, the AER considers 6 per cent is a reasonable estimate of the 10 year forward looking MRP.

Survey evidence

The AER attempts to estimate investors' expectations of what the MRP will be in the future and not simply rely on the excess stock market returns that have been achieved in the past. The AER considers surveys of market practitioners and academics are relevant as they reflect the forward looking MRP applied in practice. The AER is aware of the Tribunal comments made in relation to the survey evidence. The AER applies the criteria noted by the Tribunal to the survey evidence it considers in this decision and concludes the survey results are still relevant to inform the forward looking 10-year MRP.[618]

In the draft decision, the AER noted that survey based evidence needed to be treated with caution as the results may be subject to limitations. The relevance of some survey results depend on how clearly the survey sets out the framework for MRP estimation. This includes the term over which the MRP is estimated and the treatment of imputation credits. Survey based estimates may be subjective, because market practitioners may look at a range of different time horizons and they are likely to have differing views on the market risk. This concern may be mitigated as the sample size increases.[619]

0.92. See: VAA, *Market risk premium estimate for January 2010-June 2014 prepared for WestNet Energy*, December 2009, p.13.

617 Converting the one-year implied MRP to a 10 year forward looking MRP requires further assumptions, VAA assumed this one-year implied MRP will fade to a long term historical average MRP over three years. It also noted JCP assumed step reversion after two years. The AER is not entirely clear how VAA faded a one-year implied MRP into a long term average MRP, since VAA report provided no further explanation. The AER estimated a 10- year volatility implied MRP of 5.54% based on JCP assumption—that is assuming the MRP will be 3.7% for the first two years and reverts to a long term average MRP for the next eight years. See: Bishop, Fitzsmmons, Officer, 'Adjusting the market risk premium to reflect the global financial crisis', *The Finsia Journal of Applied Finance*, Issue 1, 2011, p.9 and p. 14. For the long term average MRP the AER has adopted 6 per cent, which reflects long term average historical excess returns.

618 Australian Competition Tribunal, *Application by Envestra Limited (No 2) [2012] ACompT 3*, 11 January 2012, paragraphs 159–163.

619 Australian Competition Tribunal, Application by Envestra Limited (No 2) [2012] ACompT 3, 11 January 2012, paragraphs 159–63.

The AER considered survey evidence on the MRP before and after the WACC review. It includes:

- KPMG (2005) surveyed 33 independent expert reports on takeover valuations from January 2000 to June 2005. It found the MRP adopted in valuation reports was in a 6–8 per cent range. KPMG reported 76 per cent of survey respondents adopted an MRP of 6 per cent.[620]
- Capital Research (2006) found the average MRP adopted across a number of brokers was 5.09 per cent.[621]
- Truong, Partington and Peat (2008) surveyed chief financial officers, directors of finance, corporate finance managers or similar finance positions of 365 companies included in the All Ordinaries Index at August 2004. From the 87 responses received, 38 were relevant to the MRP. They found the MRP adopted by Australian firms in capital budgeting was in a 3–8 per cent range, with an average of 5.94 per cent. The most commonly adopted MRP was 6 per cent.[622]
- Bishop (2009) reviewed valuation reports prepared by 24 professional valuers from January 2003 to June 2008. It found the average MRP adopted was 6.3 per cent, and 75 per cent of these experts adopted an MRP of 6 per cent.[623]
- Fernandez (2009) surveyed university finance and economics professors around the world in the first quarter of 2009. The survey received 23 responses from Australia and found the required MRP used by Australian academics in 2008 was in a 2.0–7.5 per cent range, with an average of 5.9 per cent.[624]
- Fernandez and Del Campo (2010) surveyed analysts around the world in April 2010. The survey received seven responses from Australian analysts and found the MRP that they used in 2010 was in a 4.1–6.0 per cent range, with an average of 5.4 per cent.[625]
- A further survey by Fernandez et al. (2011) in April 2011 reported the MRP used by 40 Australian respondents was in a 5–14 per cent range, with an average of 5.8 per cent.[626]
- Asher (2011) surveyed 2000 members of the Institute of Actuaries of Australia. Asher reported 33 of a total of 58 Australian analysts who responded to the survey expected the 10 year MRP to be 3–6 per cent. The most commonly adopted MRP value was 5 per cent. The report also illustrated that expectations of an MRP much in excess of 5 per cent were extreme.[627]
- A further survey by Asher (2012) in March 2012 reported 49 useful responses, with an average 10 year MRP of 4.6 per and two thirds of the responses falling in the range 4-6%.[628]
- Like KPMG (2005), Ernst Young (2012) surveyed 17 independent expert reports on takeover valuations from January 2012 to October 2012. It found the mid-point MRP adopted in valuation

620 KPMG, *Cost of capital—market practice in relation to imputation credits*, August 2005, p. 15.
621 Capital Research, *Telstra's WACC for network ULLS and the ULLS and SSS businesses—review of reports by Prof. Bowman*, March 2006, p. 17.
622 Truong, G. Partington, G. and Peat, M., *Cost of capital estimation and capital budgeting practices in Australia,* Australian Journal of Management, June 2008, vol. 33, no. 1, p. 155.
623 Bishop, S., *A conservative and consistent approach to WACC estimation by valuers*, Value Advisor Associates, 2009.
624 Fernandez and Del Campo, *Market Risk Premium used by Professors in 2008: A Survey with 1400 Answers, IESE Business School Working Paper*, WP-796, May 2009, p. 7.
625 Fernandez and Del Campo, *Market Risk Premium Used in 2010 by Analysts and Companies: A Survey with 2400 Answers, IESE Business School*, May 2010, p. 4.
626 Fernandez, Arguirreamalloa and Corres, *Market Risk Premium used in 56 Countries in 2011: A Survey with 6,014 Answers,* IESE Business School Working Paper, WP-920, May 2011, p. 3.
627 Asher, *Equity Risk Premium Survey—results and comments*, Actuary Australia, July 2011, no. 161, pp. 13–14.
628 Asher, *Equity Risk Premium Survey 2012: results and comments*, Actuary Australia, July 2012, pp. 28-29.

reports was in a 6–7 per cent range and 71 per cent of them adopted a mid-point MRP of 6 per cent.[629]

- The most recent survey by Fernandez et al. (2013) in June 2012 reported the MRP used by 73 Australian respondents. Respondents include both academics and a wide range of practitioners. It found the MRP the respondent used in 2012 was in a 3.0-10.0 per cent range, with an average of 5.9 per cent.[630] The number of Australian respondents to this survey was reasonably large, greater than previous surveys, and resulted in similar MRP responses. This provides the AER with a degree of further confidence in the results of MRP surveys.

Table 5.4 summarises the key findings of the surveys.

Table 5.4 Key findings of MRP surveys

	Numbers of responses	Mean	Median	Mode
KPMG (2005)	33	7.5%	6.0%	6.0%
Capital Research (2006)	12	5.1%	5.0%	5.0%
Truong, Partington and Peat (2008)	38	5.9%	6.0%	6.0%
Bishop (2009)	27	na	6.0%	6.0%
Fernandez (2009)	23	5.9%	6.0%	na
Fernandez and Del Campo (2010)	7	5.4%	5.5%	na
Fernandez et al (2011)	40	5.8%	5.2%	na
Asher (2011)	45	4.7%	5.0%	5.0%
Asher (2012)	49	4.6%	5.0%	4.0-6.0%
Ernst & Young (2012)	17	6.26%[631]	6.0%	6.0%
Fernandez et al (2013)	73	5.9%	6.0%	na

Sources: KPMG (2005), Capital Research (2006), Truong, Partington and Peat (2008), Bishop (2009), Fernandez (2009), Fernandez and Del Campo (2010), Fernandez et al. (2011), Asher (2011), Asher (2012), Fernandez et al. (2013).

Survey measures of the MRP across different years, different survey respondents or sources, and different authors support an MRP of 6.0 per cent. For the surveys under consideration, the most commonly used MRP was 6 per cent.

McKenzie and Partington place significant weight on survey evidence due to the triangulation of that evidence.[632] The idea behind the triangulation is that a specific survey might be subject to a particular type of bias (although there is no compelling demonstration of it). However, that the type of bias would likely be much less consistent across surveys using different methods and different target populations.

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629 Ernst & Young, *Market evidence on the cost of equity: Victorian gas access arrangement review 2013-2017*, 8 November 2012, p.23. The AER further considers the Ernst and Young report in appendix B.

630 Fernandez, Arguirreamalloa and Corres, *Market Risk Premium used in 82 Countries in 2012: A Survey with 7,192 Answers*, IESE Business School Working Paper, CH-14, January 2013, p.3.

631 Ernst & Young only presented mid-point MRP in its report. Therefore the actual mean from those 17 valuation reports might be different to what is presented here.

632 McKenzie and Partington, *Supplementary report on the MRP*, February 2012, p. 19; McKenzie and Partington, *MRP: regime switching framework and survey evidence*, August 2012, p. 28.

Lally also supported the use of survey evidence and suggested the recent Fernandez survey is the most relevant survey evidence. However, its average of 5.9 per cent should be considered as an upper bound as some respondents to this survey will have provided responses for an MRP defined against bank bills.[633]

Appendix B details the AER's further analysis and responds to SFG's view on survey evidence.

Recent Australian Competition Tribunal decisions

In 2011, Envestra challenged the AER’s decisions to adopt an MRP of 6 per cent for Envestra’s South Australia and Queensland gas distribution businesses. Envestra submitted the AER should have accepted Envestra’s proposed 6.5 per cent MRP. The Tribunal concluded the AER's adoption of a 6 per cent MRP was reasonably open to it on the evidence:

> The critical issue in this section of the review is whether the AER’s determination of the MRP at 6% was reasonably open to it on the evidence. As has already been mentioned, there was substantial evidence before the AER, both that submitted to it by service providers and that sourced by the AER itself. This evidence was not conclusive. It was incumbent upon the AER to exercise its judgment in deciding on an appropriate MRP. ...
>
> It is not sufficient for Envestra to persuade the Tribunal that 6.5% should be preferred. It must demonstrate the unreasonableness of the decision made by the AER. Unless this can be done, the Tribunal would be merely reaching a different conclusion as to the preferable result. The mere fact that the Tribunal may prefer a different rate does not entitle it to substitute its preferred MRP for that of the AER unless a ground of review has been made out. In all the circumstances of this matter, it was reasonably open to the AER to choose a MRP of 6%.[634]

The Tribunal handed down a similar decision in its review of ATCO’s (formerly WA Gas Network’s) and DBNGP’s access arrangements.[635] In both decisions, the ERA considered the available information and exercised its judgement to determine the appropriate MRP. The Tribunal subsequently found no error in the ERA’s determination of a 6.0 per cent MRP.

Expert advice commissioned by the AER

CEPA noted when the UK regulators directly estimating the MRP, the starting point is often historical data produced by Dimson, Marsh and Staunton (DMS). Forward looking estimates are often used as cross-checks for the DMS estimates, but are sometimes used more to check the reasonableness of the figure than set such a figure.[636] The premium of Australian equities over bonds for 1900-2011 from DMS is 5.6 per cent based on a geometric mean and 7.5 per cent based on an arithmetic mean. DMS noted this might be an overestimation as Brailsford, Handley and Maheswaran (2008) identified dividend prior to 1958 were overstated. Further, CEPA found the valuation reports presented by Ernst and Young do support an MRP that is equal to about 6 per cent.[637]

McKenzie and Partington agreed with the AER that the 6 per cent MRP as used by the AER is not just a choice based on the historic average of the MRP. Rather, it is based upon a broader set of

633 Lally, *Review of the AER’s methodology*, March 2013, p.32

634 Australian Competition Tribunal, *Application by Envestra Limited (No 2) [2012] ACompT 4*, 11 January 2012, paragraphs 145 and 148.

635 Australian Competition Tribunal, *Application by WA Gas Networks Pty Ltd (No 3) ACompT 12,* 8 June 2012, paragraphs 105–8.
Australian Competition Tribunal, *Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14,* 26 July 2012, paragraphs 161–3.

636 CEPA, *Advice on estimation of the risk free rate and market risk premium, report prepared for the Australian Energy Regulator*, 12 March 2013, p.23.

637 CEPA, *Advice on estimation of the risk free rate and market risk premium, report prepared for the Australian Energy Regulator*, 12 March 2013, p.60.

evidence, which includes historical, utility-based[638], survey based, and implied estimates of the equity market risk premium. Each evidence presents its own unique set of challenges and possesses its own limitations. McKenzie and Partington have comprehensively reviewed the above evidence in their December 2011 paper. In their most recent February 2013 report, they reviewed the AER's method in estimating the cost of equity and concluded again that 6 per cent is a reasonable estimate of the market risk premium.[639]

Lally holds a similar view. He notes the AER did not estimate the long run average value for the MRP. The AER uses results from both forward looking methods and historical averaging of excess returns for estimating the MRP and the results from forward looking methods unambiguously constitute estimates of the prevailing rather than the long-term average value for the MRP.[640]

In estimating the MRP, Lally favours an approach that minimises the mean squared error[641] and this leads to a consideration of the results from a wide range of methods. These methods include the historical averaging of excess returns (6 per cent), the historical average of excess returns modified for the "great inflation shock" in the 20th century (4.9 per cent), the result from the DGM approach (5.9-8.4 per cent), and the result from surveys (up to 5.9 per cent).

The median[642] of these approaches is 6.0 per cent. Lally notes a wide range of other methods are available and the cut-off point is a matter of judgement. If the historical average real market return[643] (favoured by Gregory and Wright) is considered, the estimated nominal MRP is about 8%. Adding this to the other methods, the median of these five approaches is still 6%.

Lally also considers that evidence from foreign markets may also be considered. For the first, second and fourth of the five methods described above, the cross-country averages are 6.0%, 4.0%–5.0%, and up to 5.8%. These additional results are consistent with those for Australia and therefore Lally considers these reinforce the conclusion that the appropriate MRP estimate for Australia at the present time is 6.0 per cent.[644]

Relationship between the risk free rate and market risk premium

CEPA noted the relationship between the risk free rate and the MRP is difficult to test empirically as the MRP is unobservable and any regressions would rely on developing a robust/consistent time series of investors' expectations. As such, the arguments presented by academics, regulators and companies have tended to be more indirect, and conclusions have therefore been presented in more uncertain terms. As a result, CEPA considered there is not enough evidence to justify making a firm conclusion about the relationship between the risk free rate and the MRP.[645]

McKenzie and Partington performed a comprehensive literature review on the relationship between the risk free rate and the MRP. Despite the strong support of a negative relationship by Multinet's consultants, they found both a positive and a negative relationship is possible. Therefore they

638 The AER does not use utility based methods of the MRP as a distinct method on its own. Rather, the AER's application of utility theory has been in relation to assessing the reasonableness of historical excess returns as a forward looking estimate of the MRP. McKenzie and Partington found this utility theory suggests that historical risk premia are too high and therefore historical excess returns may overstate a forward looking MRP. See: M. McKenzie, and G. Partington, *Report to Corrs Chambers Westgarth: Equity market risk premium*, 21 December 2011, pp.4-8 and p.36.

639 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, pp. 30-31.

640 Lally, *Review of the AER's methodology*, March 2013, pp.5-6.

641 The MSE is the average over the squared differences between estimated value and the true value.

642 Lally explained, as some methods provide estimated ranges rather than point estimates, the mean cannot be determined and therefore the median is considered. Lally, *Review of the AER's methodology*, March 2013, p. 32.

643 This approach is discussed in appendix B.

644 Lally, *Review of the AER's methodology*, March 2013, pp.38.

645 CEPA, *Advice on estimation of the risk free rate and market risk premium,* March 2013, p.25.

concluded the relationship between the MRP and the level of interest rates is an open question. They considered submissions received from Multinet in support of such a relationship are not sufficiently well established to form the basis for a regulatory adjustment to the MRP.[646] AER outlines and considers further McKenzie and Partington's report in appendix B.3.3. McKenzie and Partington's review of the academic literature on the theoretical and empirical evidence on the stability of the cost of equity, and on the relationship between the risk free rate and MRP, was more comprehensive than the review of the academic literature in any of the consultant reports submitted by Multinet. For this reason, among others discussed in appendix B, the AER has relied on the conclusion of McKenzie and Partingon's report over the conclusion from the reports submitted by Multinet.

Lally reviewed evidence presented by CEG, Wright, Gregory, SFG and NERA in support of a stable cost of equity or a negative relationship between the risk free rate and MRP. He identified numerous problems in the evidence presented by Multinet's consultants.[647] In addition, Lally applied Australian data using Wright's approach and found the time-series of MRP estimates is much more stable than that for the average real market return, and therefore supports estimating the MRP rather than the real market cost of equity from historical data.[648] While Lally noted there may be a negative relationship between the real risk free rate and the MRP, it isn't sufficiently strong to suggest the real market cost of equity is more stable than the MRP.[649] The AER further considers Lally's report in appendix section B.3.3.

The concerns raised by Lally and McKenzie and Partington on the consultant reports submitted by Multinet are relevant. Based on their advice, the AER concludes the theoretical and empirical evidence is not sufficiently strong in support of a relatively stable cost of equity or a strong negative correlation between the risk free rate and the MRP. Accordingly, the AER concludes its approach in estimating the cost of equity produces a reasonable cost of equity estimate that is commensurate with the prevailing conditions in the market for funds.

Recent practice among Australian regulators

Australian regulators consistently applied an MRP of 6 per cent in recent regulatory decisions. The regulators determined the MRP under a specific CAPM framework:

- The MRP is forward looking (not an historical measure) and cannot be directly observed.
- The MRP is a long term forward looking MRP (for example, 10 years) rather than a short term forward looking MRP (for example, one year). As a result, short term MRP estimates have little relevance.
- The MRP is for a domestic CAPM, which means the relevance of overseas evidence depends on the similarities between overseas and domestic market conditions, and consequently may have limited relevance.[650]

Table 5.5 sets out the MRP adopted recently by Australian state and territory regulators responsible for economic regulation across the electricity, water and rail industries.

646 McKenzie and Partington, *Review of the AER's overall approach*, February 2013, pp. 21-28
647 Lally, *Review of the AER's methodology*, March 2013, pp.8-18.
648 Lally, *Review of the AER's methodology*, March 2013, p.13. .
649 Lally, *Review of the AER's methodology*, March 2013, pp.16..
650 For example, Lally considers and compares evidence on the MRP based on domestic and overseas data.

Table 5.5 Recent regulatory decisions

Regulator	Decision date	Sector	MRP (%)
ESCOSA	February 2012	Water	6.0
QCA	May 2012	Water	6.0
ESCV	June 2012	Rail	6.0
IPART	June 2012	Water	5.5–6.5
IPART	June 2012	Water	5.5–6.5
ERA	September 2012	Electricity	6.0
QCA	December 2012 (draft decision)	Water	6.0

Source: ERA, ESCV, QCA, IPART, ESCOSA. [651]

In the DBNGP matter, the Tribunal commented on the desirability of regulatory consistency:[652]

> The Tribunal regards regulatory consistency as a laudable objective, provided the particular regulator (in this case the ERA) independently fulfils its decision-making functions and responsibilities. Each regulator must do so in the context of the particular applicable legislation, and in the context of the particular issue and relevant material on that issue. The NGL under the NGA WA Act, the National Gas Law and the NGR are in most respects the same. It is not therefore surprising that the ERA should be aware of decisions of the AER, and vice versa, on particular provisions which have to be addressed. It is to be expected, in such circumstances, that experienced and well qualified regulators would also reach similar conclusions on such matters. It is to the benefit of providers of regulated services, the users of those services, and the community that—where appropriate—regulatory consistency should exist.

The AER has independently reached its conclusion by exercising its judgment on the evidence presented above. The AER has reached a similar conclusion on the MRP as that reached by state regulators. Like the AER, the ERA and QCA have consistently applied an MRP of 6.0 per cent over the recent years. While IPART has consistently set the boundaries of its WACC range by applying an MRP in the range of 5.5-6.5 per cent and a prevailing (low) risk free rate, it has chosen an overall WACC point estimate towards the top of its WACC range due to the current low risk free rate. The AER discusses the approaches of ERA, QCA and IPART in detail in appendix B. In appendix B, the AER also considers the approaches of UK and US regulators.

5.3.4 Equity beta

The AER accepts Multinet's proposed equity beta of 0.8 in its revised access arrangement proposal.

The equity beta provides a measure of the 'riskiness' of an asset's return compared with the return on the entire market. The equity beta reflects the exposure of the asset to systematic or 'non-diversifiable' risk, which is the only form of risk that requires compensation under the CAPM.

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651 Essential Service Commission of South Australia (ESCOSA), *Final Advice:* Advice on a Regulatory Rate of Return for SA Water, February 2012, p. 50; Queensland Competition Authority, *Final Report:* SunWater Irrigation Price Review: 2012–17, Volume 1, May 2011, p. 503; Essential Service Commission of Victoria (ESCV)), *V/line access arrangement final decision*, June 2012, p. 208. Independent Pricing and Regulatory Tribunal (IPART), *Water – Final report:* Review of prices for Sydney Water Corporation's water, sewerage, drainage and other services: From 1 July 2012 to 30 June 2016, June 2012, pp. 198, 204; IPART, *Water – Final report: Review of prices for Sydney Catchment Authority: From 1 July 2012 to 30 June 2016,* June 2012, pp. 90, 118, 123; ERA, *Final decision on proposed revisions to the access arrangement for the* Western Power network submitted by Western Power, 5 September 2012, p. 241. QCA, *Draft Report:* Seqwater Irrigation Price Review: 2013–17, Volume 1, December 2011, p. 259.

652 Australian Competition Tribunal, Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14, 26 July 2012, paragraph 333.

In the draft decision, the AER agreed with Multinet's proposed equity beta of 0.8. The AER agreed with this value because the empirical evidence indicated a point estimate of between 0.4 and 0.7 for the equity beta of electricity and gas service providers.[653] Adopting an equity beta just above this range was in recognition of the level of imprecision around these estimates and the desirability of stability in regulatory decision making over time.[654] The AER's full reasons are set out in its draft decision.[655]

Multinet's also adopted an equity beta of 0.8 in its revised access arrangement proposal.[656] The AER is not aware of any new information that causes it to depart from its draft decision position. Accordingly, the AER accepts Multinet's 0.8 equity beta in its revised proposal.

5.3.5 Debt risk premium

The AER accepts Multinet's proposed DRP method in its revised access arrangement proposal.

The DRP is the margin above the nominal risk free rate that a debt holder would require to invest in the debt issued by a benchmark efficient service provider. Combined with the nominal risk free rate, the DRP represents the return on debt and is an input into the rate of return.

In the draft decision, the AER agreed with Multinet's proposed benchmark and method for estimating the DRP.[657] Multinet also adopted the same benchmark and method in its revised access arrangement proposal.[658] For this final decision, the AER has updated Multinet's proposed DRP to reflect the agreed averaging period.[659] This results in a DRP of 3.32 per cent.[660]

In assessing Multinet's proposal, the AER also took into account recent market evidence. This includes two debt issuances by the APA Group.[661] The AER, however, considers that the available market evidence is of limited use. The reasons for this are discussed in greater detail in section B.7.2 of the appendix, and include:

- the financing costs of a single entity should not be considered to be reflective of either the market as a whole, or the benchmark regulatory firm
- the available market evidence does not match the characteristics of the benchmark firm (or debt issuance).

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653 AER, *Final decision: Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters*, 1 May 2009, pp. 239–344

654 Most Australian regulators had previously provided electricity and gas service providers with an equity beta of either 0.9 or 1.0.

655 AER, *Draft decision: Multinet*, September 2012, p. 107-109

656 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 137.

657 The AER made minor amendments to the bond sample selected by Multinet for the extrapolation of the Bloomberg fair value curve. However, these amendments were to achieve consistency with the bond selection criteria proposed by Multinet. See section 4.3.6 of the draft decision for a detailed explanation. AER, *Draft decision: Multinet*, *Part 2 attachments*, September 2012.

658 Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 173

659 The agreed averaging period was from 24 October 2012 to 20 November 2012.

660 For clarity, the paired bonds used to extrapolate the Bloomberg fair value curve in this final decision are the pair of Stockland bonds (maturing in 2016 and 2020), and the pair of Sydney Airport Finance bonds (maturing in 2015 and 2021). Estimated yields from both UBS and Bloomberg are available for the Stockland issuances, while only UBS data is available for the Sydney Airport Finance bonds. Each bond pair has been given equal weight in determining the extrapolation adjustment. That is, the Stockland spreads have been averaged to determine a single estimate, with this estimate subsequently averaged with the single Sydney Airport estimate.

661 In September 2012, the APA Group completed the issuance of $515 million of subordinated notes in Australia. This hybrid capital was issued at 450 basis points above the BBSW. Shortly thereafter, in November 2012, the APA Group raised £350 million of debt financing in the UK. The APA Group swapped this debt into AUD at an average fixed rate of 7.36 per cent.

The AER also considered the submission by the Energy Users Coalition of Victoria—that the Bloomberg BBB fair value curve overcompensated service providers for their actual cost of debt.[662] The AER stated in its draft decision that it intends to undertake a review into alternatives to the Bloomberg fair value curve. The AER considers that the current development of the rate of return guidelines represents the most appropriate forum to consider these alternatives.

5.3.6 Forecast inflation

The AER accepts Multinet's proposed inflation forecasting method in its revised access arrangement proposal.

This methodology is based on the geometric average of:

- the RBA's most recent inflation forecasts for the longest period available (two years), and
- the mid-point of the RBA's inflation targeting band for a further eight years.

Following this method, in this final decision, the AER adopts a 10 year forward looking inflation forecast of 2.50 per cent. This result is shown in Table 5.6.

In the draft decision, the AER agreed with Multinet's proposed inflation forecasting method. Multinet's proposed method was consistent with that adopted by the AER in previous decisions. Multinet also adopted the same method in its revised access arrangement proposal.

Since the draft decision, the RBA released its February 2013 *Statement on Monetary Policy* which includes updated inflation forecasts for 2013 and 2014. As indicated in the draft decision, the AER has updated the RBA's short term inflation forecasts based on the most recent RBA statement available at the time of the final decision.

Table 5.6 AER inflation forecast (per cent)

	2013	2014	2015 to 2022	10 year forecast (Geometric average)
Forecast inflation	2.50 [a]	2.50[a]	2.50	2.50

Source: RBA, Statement on Monetary Policy, February 2013, p. 65.
Notes: (a) The RBA published a range of 2-3 per cent for its 2013 and 2014 forecast inflations. The AER has selected the mid-point of 2.5 for the purposes of this final decision.

5.3.7 Gearing ratio

The AER accepts Multinet's proposed gearing ratio of 60 per cent in its revised access arrangement proposal.

The gearing ratio is the ratio of the value of debt to total capital (that is, both debt and equity) and is used to weight the cost of equity and cost of debt when determining the rate of return. Under NGR, in determining the rate of return, it is assumed the service provider meets benchmark levels of efficiency and uses a financing structure that meets benchmark standards as to gearing for a going concern.[663]

662 Energy Users Coalition of Victoria, *Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals*, June 2012.
663 NGR, r.87(2)(a).

In the draft decision, the AER agreed with Multinet's proposed gearing ratio of 60 per cent. The AER agreed with a 60 per cent gearing ratio because this level is supported by relevant available empirical evidence.[664]

Multinet also adopted a gearing ratio of 60 per cent in its revised access arrangement proposal.[665] The AER is not aware of any new information that causes it to depart from its draft decision position. Accordingly, the AER accepts Multinet's 60 per cent gearing ratio in its revised proposal.

5.3.8 Reasonableness checks on overall rate of return

The AER considers the approach in this decision provides a reasonable estimate of the benchmark rate of return. At the same time, the AER recognises that while the overall rate of return in this decision is similar to that in recent decisions, it is lower than that in previous decisions. There is no single robust method for estimating the overall rate of return. However, the AER's reasonableness checks suggest that the overall rate of return broadly accords with market expectations.

Techniques available to assess the overall rate of return can produce a range of plausible results. Each of these techniques has weaknesses that prevent them from being given significant weight. Nevertheless, they do provide a useful reasonableness check for the AER's primary approach. The AER examined:

- assets sales
- trading multiples
- broker WACC estimates
- recent decisions by other regulators
- the relationship between the cost of equity and the cost of debt.

For this final decision, the AER determines an overall rate of return using a nominal vanilla WACC of 7.03 per cent. This is based on a cost of equity of 7.92 per cent, a cost of debt of 6.44 per cent and a gearing level of 60 per cent. The cross checks listed above suggested the regulated rate of return is not unreasonable:

- Recent regulated assets have generally been sold at a premium to the RAB. In addition, recent RAB trading multiples are consistently greater than one (averaging around 1.2). This evidence provides the AER with a degree of confidence that its current approach in calculating the rate of return is reasonable.
- The overall rate of return does fall below the range of estimates found in broker reports (7.38-10.02 per cent). The lower bound of this range has decreased from the draft decision due to lower WACCs in more recent broker reports. The upper bound was calculated from a less recent report dated October 2012[666], and if this one report was excluded the upper bound would reduce to 9.52%. However, the AER notes the broker WACC technique is subject to known limitations and inherent imprecision. Further, broker WACC estimates of themselves do not demonstrate the

[664] AER, *Final decision: Electricity transmission and distribution network service providers: Review of the weighted average cost of capital (WACC) parameters*, 1 May 2009, p. 126.
[665] Multinet, *Revised Access Arrangement Proposal*, 9 November 2012, p. 138.
[666] AER analysis based on Goldman Sachs, *APA Group: Non cash significant item leads to FY13 EBITDA guidance upgrade*, 24 October 2012, p. 2.

overall rate of return is unreasonable, given this is the only aspect of the reasonableness check that has indicated a potential concern.

- While the overall rate of return is lower than AER decisions from more than a year ago, it is in line with recent regulatory decisions made by other Australian regulators (5.78–8.65 per cent). It is also in line with other recent AER decisions.
- The cost of equity determined by the AER is greater than the cost of debt. This accords with what is expected according to finance theory, given investment in equity is more risky than investment in debt.

Appendix B.7.2 explores each overall rate of return reasonableness check technique in detail.

5.4 Revisions

The AER proposes the following revisions to make the access arrangement acceptable.

Revision 5.1

Make all necessary amendments to reflect the AER's final decision on the rate of return on capital for the access arrangement period, as set out in Table 5.1 of this attachment.

6 Regulatory depreciation

When determining the total revenue for Multinet, the AER must decide on the depreciation for the projected capital base (or return of capital).[667] Regulatory depreciation is used to model the nominal asset values over the access arrangement period and represents the depreciation allowance in the total revenue requirement. In this attachment, the AER outlines its final decision on Multinet's annual regulatory depreciation allowance.[668] The AER also sets out its consideration of specific matters that affect the estimate of regulatory depreciation over the 2013–17 access arrangement period. These include:

- the standard economic lives for depreciating new assets associated with forecast net capex
- the remaining economic lives for depreciating existing assets in the opening capital base.

6.1 Final decision

The AER does not approve Multinet's revised proposed regulatory depreciation allowance of $150.6 million ($nominal) for the 2013–17 access arrangement period. This is because the AER's adjustments to other building block components have had a consequential effect on the forecast regulatory depreciation allowance. These are discussed in other attachments and include:

- the roll forward of the opening capital base (attachment 3)
- forecast capex (attachment 4).

The AER's final decision on Multinet's total regulatory depreciation allowance over the 2013–17 access arrangement period is $121.2 million ($nominal) as shown in table 6.1. This represents a reduction of $29.4 million ($nominal) or 19.5 per cent of Multinet's revised proposed regulatory depreciation allowance.

The AER approves Multinet's proposed depreciation allowance for redundant assets up to 2012 only. The AER in its draft decision did not approve Multinet's proposed depreciation allowance for forecast redundant assets for the 2013–17 access arrangement period.[669] This was because the AER considered that the proposed depreciation allowance for forecast redundant assets in Multinet's initial proposal was inconsistent with certain requirements of the NGR.[670] Multinet's revised proposal adopted the AER's draft decision.[671]

The AER accepts Multinet's revised proposed standard economic lives and revised method for calculating the remaining economic lives as at 1 January 2013. Due to the AER's final decision on the roll forward of the opening capital base (discussed in attachment 3), the AER has updated Multinet's remaining economic lives for this final decision.

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667 NGR, r. 76(b).

668 Regulatory depreciation allowance is the net total of the straight-line depreciation (negative) and the annual inflation indexation (positive) on the projected capital base.

669 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 119-121.

670 NGR, rr. 89(1)(b), 89(1)(c).

671 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 121.

Table 6.1 AER's final decision on Multinet's depreciation allowance ($million, nominal)

	2013	2014	2015	2016	2017	Total
Straight-line depreciation	40.3	49.5	52.9	56.1	60.0	258.8
Less: indexation on opening capital base	25.6	27.1	27.6	28.2	29.1	137.6
Regulatory depreciation	14.7	22.3	25.3	28.0	30.9	121.2

Source: AER analysis.

6.2 Revised proposal

In its revised proposal, Multinet proposed a forecast regulatory depreciation allowance over the 2013–17 access arrangement period of $150.6 million ($nominal).[672] To calculate the revised proposed regulatory depreciation allowance, Multinet proposed:[673]

- to adopt the AER's draft decision not approving its proposed depreciation allowance for forecast redundant assets for the 2013–17 access arrangement period
- to apply the standard economic lives and remaining economic lives as set out in the AER's draft decision.

Table 6.2 Multinet's revised proposed depreciation allowance ($million, nominal)

	2013	2014	2015	2016	2017	Total
Straight-line depreciation	47.3	55.3	59.2	62.9	67.6	292.3
Less: indexation on opening capital base	26.2	27.8	28.4	29.1	30.2	141.7
Regulatory depreciation	21.2	27.5	30.8	33.8	37.4	150.6

Source: Multinet, *Revised proposal PTRM*, November 2012.
Note: total may not add up due to rounding.

6.3 Assessment approach

The AER's assessment approach for the regulatory depreciation allowance is set out in its draft decision. See section 5.3, attachment 5 of the draft decision for a detailed explanation of the assessment approach.

The AER received a submission from the Energy Users Coalition of Victoria (EUCV) commenting on Multinet's depreciation approach.

6.4 Reasons for decision

The AER's final decision on Multinet's regulatory depreciation allowance for the 2013–17 access arrangement period is $121.2 million ($nominal). This represents a reduction of $29.4 million ($nominal) or 19.5 per cent of Multinet's revised proposed regulatory depreciation allowance.

The AER approves Multinet's proposed depreciation allowance for redundant assets up to 2012. The AER does not approve Multinet's proposed depreciation allowance for forecast redundant assets for

[672] Multinet, *Revised proposal and response to draft decision*, November 2012, p. 124.
[673] Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.

the 2013–17 access arrangement period. The AER accepts Multinet's revised proposed standard economic lives and revised proposed method for calculating the remaining economic lives as at 1 January 2013. As a result of the AER's final decision on the roll forward of the opening capital base (discussed in attachment 3), the AER has updated Multinet's remaining economic lives.

These allowances reflect the AER's final decision on other elements of Multinet's revised proposal that impact on the proposed regulatory depreciation allowances (discussed in the relevant attachments).

6.4.1 Redundant assets

Consistent with its draft decision, the AER's final decision is to approve Multinet's proposed depreciation allowance for redundant assets up to 2012. The AER also accepts Multinet's revised proposal on forecast redundant assets for the 2013–17 access arrangement period.

In the draft decision, the AER approved Multinet's proposed depreciation allowance for redundant assets up to 2012.[674] This depreciation allowance is consistent with the ESC's decision for the 2008–12 access arrangement period, for which the depreciation allowance was approved as part of Multinet's Pipeworks program. However, the AER did not approve Multinet's proposed (accelerated) depreciation allowance for forecast redundant assets for the 2013–17 access arrangement period. The AER considered that Multinet's proposed depreciation allowance for forecast redundant assets is not consistent with the requirements of the NGR. This was because it does not reflect the economic life (or changes in the economic life) of the forecast redundant assets (as approved by the AER in its draft decision).[675]

In the 2008–12 access arrangement period, Multinet's actual replacement of assets (in kilometres) was less than half of the ESC's approved replacement.[676] Therefore, Multinet received excess (accelerated) depreciation allowance in respect of assets that were not redundant and are still in service.[677] For the 2013–17 access arrangement period, Multinet again proposed forecast replacement capex for the Pipeworks Program (attachment 4).[678] The AER in its draft decision reduced Multinet's proposed forecast replacement capex. This meant that Multinet would replace fewer assets in the next period than was required to 'catch up' with the assets that are still in service, but for which it received accelerated depreciation in the previous period. On this basis, the AER considered that Multinet's proposed depreciation allowance for forecast redundant assets was not consistent with the requirements of the NGR.[679] The EUCV submitted that the AER should require Multinet to maintain the same depreciation approach as set out in the draft decision.[680]

Multinet's revised proposal adopted the AER's draft decision on its proposed depreciation allowance for redundant assets.[681]

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674 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 119-121.

675 NGR, rr. 89(1)(b), 89(1)(c).

676 Multinet's actual replacement of low pressure distribution mains during the 2008–12 access arrangement period was 240 km, less than half of the ESC's approved replacement of 557 km for that period.

677 Multinet has received accelerated depreciation for 317 kilometres of low pressure distribution mains in the 2008–12 access arrangement period.

678 In its revised proposal, Multinet proposed to replace 274 kilometres of low pressure distribution mains for the 2013–17 access arrangement period.

679 NGR, rr. 89(1)(b), 89(1)(c).

680 EUCV, *Victorian gas distribution revenue reset, AER draft decision and revised applications from Envestra, Multinet and SP AusNet: A response*, January 2013, p. 41.

681 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 121. The AER's final decision on Multinet's forecast replacement capex for the 2013–17 period is 255 kilometres of low pressure distribution mains. This means that

6.4.2 Standard economic lives

The AER accepts Multinet's revised proposed standard economic lives. These revised proposed standard economic lives reflect the revisions proposed by the AER in the draft decision.[682]

The AER's draft decision accepted most of Multinet's proposed standard economic lives (except for the 'Land & buildings' and the 'SCADA' asset classes).[683] The AER considered that these lives are consistent with the ESC's approved standard economic lives in the 2008–12 access arrangement period.[684] However, as a result of the AER's draft decision to split the 'Land & buildings' asset class into two separate asset classes to apply from 1 January 2013, the AER assigned a standard economic life of 50 years to the 'Buildings' asset class. The AER did not assign a standard economic life to the 'Land' asset class.[685] In relation to the 'SCADA' asset class, the AER's draft decision determined that the proposed standard economic life of 7 years be increased to 15 years. The AER considered that a standard economic life of 15 years for the 'SCADA' asset class is consistent with the requirement of the NGR.[686]

Multinet, in its revised proposal, adopted the standard economic lives as set out in the AER's draft decision.[687]

The AER's final decision on Multinet's standard economic lives is set out in Table 6.3.

6.4.3 Remaining economic lives

The AER accepts Multinet's revised proposed method for calculating the remaining economic lives as at 1 January 2013. The revised proposed method reflects the AER's proposed method as set out in the draft decision.[688] Due to the AER's final decision on the roll forward of the opening capital base (discussed in attachment 3), the AER has updated the remaining economic lives for this final decision.

In the draft decision, the AER did not accept Multinet's proposed remaining economic lives.[689] Due to some modelling errors, the AER considered that Multinet's proposed remaining economic lives were not consistent with the requirements of the NGR.[690] Therefore, the AER in its draft decision required Multinet to adopt the AER's calculation of the remaining economic lives.

Multinet's revised proposal[691] adopted the AER's draft decision adjustments to the remaining economic lives as at 1 January 2013.[692]

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by the end of 2017, the amount of low pressure distribution mains for which excess (accelerated) depreciation has been received is forecast to reduce to 62 kilometres.

682 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 122.

683 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 121-123.

684 ESC, *Multinet GAAR 2008 Revenue Model Further Final Decision*, 2008.

685 Because land is a non-depreciating asset, for modelling purposes, the AER used a term of 'n/a' as the standard economic life input for the 'Land' asset class to apply from 2013.

686 NGR, r. 89(1)(b).

687 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 122.

688 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 123-126.

689 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 123-126.

690 NGR, rr. 74(2)(a) and 74(2)(b).

691 Multinet, *Revised proposal PTRM*, November 2012; Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.

692 Due to Multinet's revised proposed roll forward of its capital base (discussed in attachment 3), Multinet updated the remaining economic lives as at 1 January 2013 in its revised proposed roll forward model (RFM). However, Multinet did not correctly input these updated remaining lives into its revised proposed PTRM by replacing the AER's draft decision

The AER's final decision on Multinet's standard economic lives and remaining economic lives as at 1 January 2013 is set out in Table 6.3.

Table 6.3 AER's final decision on Multinet's standard economic lives and remaining economic lives as at 1 January 2013 (years)

Asset class	AER final decision – standard economic life	AER final decision – remaining economic life
Transmission and distribution	50.0	33.5
Services	50.0	30.6
Cathodic Protection	50.0	45.5
Supply Regs/Valve stations	50.0	18.4
Meters	30.0	10.5
Land	n/a	n/a
IT	5.0	5.0
SCADA	15.0	0.0
Other	10.0	6.0
Buildings	50	n/a

Source: AER analysis.
n/a Not applicable.

6.5 Revisions

The AER proposes the following revisions to make the revised access arrangement proposal acceptable:

Revision 6.1: Make all necessary amendments to reflect the AER's final decision on the regulatory depreciation allowance for the 2013–17 access arrangement period, as set out in table 6.1.

Revision 6.2: Make all necessary amendments to reflect the AER's final decision on the remaining economic lives as at 1 January 2013, as set out in Table 6.3.

remaining lives. The AER considers this to be a minor error. For this final decision, the AER has updated the remaining lives in the PTRM due to the AER's final decision on the roll forward of the opening capital base.

7 Operating expenditure

Operating expenditure (opex) refers to the operating, maintenance and other non-capital costs incurred in providing pipeline services.[693] It incorporates labour costs associated with operating the gas distribution network.

The AER is required to assess whether Multinet's forecast opex complies with applicable criteria prescribed by the NGL and NGR.[694] This includes that expenditure is to be prudent and efficient and any forecast or estimate must be arrived at on a reasonable basis and represent the best forecast or estimate possible in the circumstances.[695]

7.1 Final decision

The AER's final decision is to not approve Multinet's revised total forecast opex of $346.1 million ($2012) for the 2013–17 access arrangement period for Multinet.[696] The AER proposes forecast opex of $316.5 million ($2012) for the 2013-17 access arrangement period.

Multinet used a bottom-up forecasting approach, as distinct from a revealed cost approach based on historical expenditure. Multinet's forecast is mostly composed of outsourcing costs and in-house costs that it forecast would be incurred under a new business model.

The AER is not satisfied that several components of Multinet's forecast are prudent and efficient costs. This includes some inhouse direct costs (e.g. network development expenditure, bonuses included in the forecast fee paid to the Energy Partnership Group Pty Ltd. ('EPG fee')).

The AER is also not satisfied that other components of Multinet's forecast is the best forecast possible in the circumstances and/or that the forecast was arrived at on a reasonable basis.[697] This includes forecasts for inhouse labour costs, some inhouse direct costs (e.g. consulting costs), and some volumes for outsourced network operations and maintenance costs.

For these reasons, the AER is not satisfied that the total forecast of opex satisfies the criteria for forecasts and estimates, or is a forecast of opex that complies with the NGL and NGR requirements.[698]

The AER compared Multinet's bottom-up forecast to a forecast based predominantly on Multinet's historical opex ('a base year forecasting approach'). As opex is largely recurrent, the AER considers a base year forecasting approach is a robust methodology for determining what opex should be incurred by Multinet in the 2013-17 access arrangement period. Multinet's bottom-up estimate was 9.4 per cent higher than the AER's base year estimate.

On the basis of a base year approach, the AER proposes opex of $316.5 million ($2012). The AER's forecast:

- includes the costs incurred by Multinet's current outsourced provider, Jemena Asset Management (JAM), in 2011 in its base year estimate. This is in place of the fee JAM received from Multinet in

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693 NGR, r. 69.
694 NGR, r. 91, r. 74(2), r 100.
695 NGR, r. 91, r 74(2).
696 NGR, r. 91, 74(2).
697 NGR, r. 74(2).
698 NGR, r. 91, r. 74(2).

2011 for delivering these services. The AER's opex forecast does not apply a margin to JAM's opex.

- includes costs for non-recurrent metering and an increased Energy Safe Victoria (ESV) levy
- excludes costs relating to the transition to Multinet's new business structure from its base year estimate
- does not include costs for additional network development expenditure.

Table 7.1 compares the AER's final decision to Multinet's initial and revised proposal and the AER's draft decision for each year of the 2013–17 access arrangement period.

Table 7.1 Comparison of Multinet's initial and revised proposals, and AER draft and final decisions ($m, $2012)

	2013	2014	2015	2016	2017	Total
Multinet initial proposal	69.4	72.2	72.7	74.1	74.1	362.7
AER draft decision	52.4	53.1	53.7	55.3	55.7	270.3
Multinet revised proposal	65.0	69.7	71.1	70.4	69.8	346.1
AER final decision	57.5	63.0	65.3	64.9	65.8	316.5

Source: AER analysis

7.2 Revised proposal

Multinet's revised proposal forecasts total opex of $346.1 million ($2012) (see Table 7.2) for the 2013-2017 access arrangement period. This is a reduction of $16.6 million ($2012) from Multinet's initial proposal of $362.7 million ($2012).

Multinet's revised proposal used the bottom up forecasting approach it used in its initial proposal. Multinet adopted a bottom-up forecasting approach because it considered it would be more representative of its new business structure than a forecast based on its historical costs.[699]

Under its existing structure, most of Multinet's services are provided by a single outsourced provider, Jemena Asset Management (JAM). Under the new structure, Multinet has re-tendered for several of its services and re-established other services in-house.

Its restructure has already begun in advance of the expiry of Multinet's Operating Service Agreement (OSA) with JAM on 30 June 2013. The majority of the restructure takes effect from 1 July 2013.

The revised forecast reflects a combination of the remaining payments to be made under Multinet's OSA with JAM, and the new mix of outsourced and inhouse services.

Table 7.2 Multinet's revised proposal ($m, $2012)

	2013	2014	2015	2016	2017	Total
Network operations and	33.7	37.8	39.1	38.4	37.9	186.9

699 Multinet, *Access Arrangement Information*, 30 March 2012, p. 63.

maintenance						
Customer and market services	10.2	9.5	9.3	9.3	9.2	47.6
I.T	7.9	8.1	8.0	8.0	7.9	39.8
Corporate services	13.2	14.4	14.7	14.7	14.7	71.7
Total	65.0	69.7	71.1	70.4	69.8	346.1

Source: AER analysis.

Of Multinet's revised forecast, 53.6 per cent of the cost relates to services provided by Multinet's outsourced providers.

Of the remaining 46.4 per cent of Multinet's forecast costs, most of the costs relate to Multinet's forecast of its direct costs and in-house labour costs. It also includes forecast payments to Energy Partnership Group Pty Ltd (EPG) to recover a portion of the cost of overheads incurred by Multinet's owner, the DUET Group.

Multinet submitted that the base year estimate used by the AER in its draft decision did not reflect its change in circumstances, and would lead to a forecast of opex that was unsustainably low. The AER's base year estimate used the historical costs incurred by Multinet in 2011, adjusted for 'step changes' and escalation in real costs over the 2013-17 access arrangement period. Multinet submitted additional consultant reports from Grant Thornton, AECOM and Frontier Economics in support of its position.[700]

As part of Multinet's revised proposal it also re-submitted a base year estimate to test its forecasts. Multinet's base year estimate was $19 million ($2012) above Multinet's revised bottom-up opex forecast over the 2013-17 access arrangement period.[701] Multinet considered this to be an indication of the cost reductions that it will achieve as a result of moving to its new business model, and demonstrates that its bottom-up forecast satisfies the opex criteria.[702]

7.3 Assessment approach

The AER’s assessment approach for opex is set out in attachment 6 of the AER’s draft decision.[703] Where the AER considered additional material to inform this final decision, this is noted in its reasons for this decision.

The AER notes it used a two stage assessment process in its draft decision. The same process has been used for the final decision. The analyses undertaken by the AER in the final decision reflects its response to new information provided in response to the AER's draft decision. The AER's change in position reflects a change in its conclusions after undertaking Stage 2 of the assessment process.

Two written submissions on Multinet's revised access arrangement made comment on the revised opex. The AER took submissions into account in forming its final decision on Multinet’s proposed opex.

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700 Grant Thornton, Review of Multinet's Operating Expenditure Forecasts, 9 November 2012; Frontier Economics, *Multinet Operating Expenditure Forecast - A Report Prepared For Johnson Winter Slattery*, November 2012; AECOM, *Review of Network Operating Expenditure*, 9 November 2012.
701 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 74.
702 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 76.
703 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, pp. 133–134.

The Energy Users Coalition of Victoria (EUCV) submission set out its concerns about the Victorian Distribution businesses' proposals. The EUCV considers the outcome of the AER's draft decision analysis is consistent with the long term growth in opex and has resulted in an appropriate outcome.[704]

The Hon. Michael O'Brien, MP, Victorian Minister for Energy and Resources provided a submission supporting the AER's approach to assessing the Victorian distribution businesses' opex proposals. The Minister notes that the assessment of step changes in operating expenditure tends to be focused on increases in expenditure and not on decreases in expenditure. As there are variations in expenditure from year to year, the Minister submits that the AER needs to consider the extent to which small increases in expenditure will be offset by small decreases in expenditure that have not been forecast.[705]

The AER's consideration of specific comments made in submissions is discussed in the relevant sections of this chapter.

In forming its views the AER has also considered advice from Deloitte Access Economics (DAE) on labour cost escalators.[706]

7.4 Reasons for determination

The AER's analysis of Multinet's opex involved a comprehensive assessment of individual components of Multinet's bottom-up forecast, and a comparison of Multinet's proposed opex against a base year forecast that uses the historical costs of delivering Multinet's reference services.

After examining Multinet's revised forecast from the bottom-up by assessing individual components of Multinet's forecast, the AER does not approve Multinet's forecast. This is because the AER is not satisfied that some components of Multinet's forecast reflect opex that would be incurred by a prudent service provider acting efficiently in accordance with good industry practice to achieve the lowest sustainable costs of delivering pipeline services.[707] This includes:

- expenditure for network development for which Multinet has failed to establish that there is a reasonable expectation that customers will obtain a net benefit
- part of the forecast costs underlying a fee Multinet forecasts to pay to the Energy Partnership Group Pty. Ltd. ('EPG fee') which will not be incurred in the 2013–17 access arrangement period.

With several other elements of Multinet's forecasts, including some inhouse direct costs, as well as inhouse labour costs, and certain outsourcing costs for network operations and maintenance volumes, the AER is not satisfied that the forecasts are arrived at on a reasonable basis and/or represent the best forecast possible in the circumstances.[708] In particular:

- several direct costs forecasts have been estimated without an explanation of the process Multinet has undertaken to derive the forecast and are thus unsubstantiated.[709]

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704 Energy Users Coalition of Victoria, *Submission to the AER: AER draft decision and revised applications from Envestra, Multinet and SP AusNet*, January 2013, p. 23.
705 Minister for Energy and Resources, *Victorian Gas Access Arrangement Review – Victorian Government Submission*, 14 January 2012, pp. 3–4.
706 Deloitte Access Economics, *Forecast growth in labour costs in Victoria –report prepared for the AER*, 4 February 2013.
707 NGR, r. 91.
708 NGR, r. 74(2).
709 NGR, r. 74(2).

- labour costs are based on external benchmarks for determining employee numbers and advice from a remuneration consultant about forecast salaries but Multinet has not demonstrated:
    - the benchmarks used to forecast employee numbers are comparable to its own circumstances
    - that forecast employee bonuses warrant an increase in opex.

In isolation, some of the issues the AER has identified with Multinet's forecast may not have a significant impact on total opex. However, as the AER has a number of different concerns about aspects of the forecasting approach, in total, it relates to a material proportion of Multinet's forecast. Therefore the AER is not satisfied after its review of Multinet's bottom-up forecast that it is a forecast of opex that would be incurred by a prudent service provider acting efficiently in accordance with good industry practice to achieve the lowest sustainable cost of delivering pipeline services.[710] The AER's detailed assessment of Multinet's bottom-up forecast is in appendix D.

As opex is, in general, a recurrent expense, the AER also assessed Multinet's forecast using a base year approach which forecasts opex based on the historical costs of providing Multinet's pipeline services. This forecast has been adjusted for the forecast incremental cost of implementing step changes, forecast escalation in labour costs and forecast cost increases due to network growth. The AER considers this test provides an additional robust measure for assessing Multinet's forecasts. In undertaking this assessment, the AER acknowledges that Multinet's model for delivering services will change in the 2013-17 access arrangement period as a result of Multinet's business restructure. However, the AER considers that it is important to note that the services themselves will not materially change between access arrangement periods.

The AER estimates that under the AER's base year approach, Multinet's opex will be $316.5 million ($2012). Multinet's forecast of $346.1 million ($2012) exceeds the AER's estimate by $29.6 million ($2012). As the AER's estimate is based on the actual historical costs incurred in delivering Multinet's reference services in 2011, the AER considers this is to be a robust estimate of what Multinet's efficient opex will be in the 2013-17 access arrangement period. For this reason, this estimate has been used as the basis for the AER's proposed opex for 2013-17.

The AER has predominantly based its opex forecast on the costs incurred by JAM in 2011 in providing these services instead of the fee Multinet paid to JAM.[711] This differs to the AER's base year assessment in its draft decision (which was based on the fee Multinet paid to JAM). In its draft decision the AER concluded, on balance, that there was not sufficient evidence that Multinet's opex would be materially greater than the historical costs it incurred.

The AER is now of the view that a base year estimate that is predominantly based on the costs incurred by JAM, rather than the fee JAM received from Multinet, provides a better forecast of what the efficient costs are likely to be in delivering Multinet's reference services in the 2013-17 access arrangement period. JAM reported a loss in delivering these services in each year of the current access arrangement period. The AER considers an estimate largely based on the fee specified in JAM's contract (that is to expire on 30 June 2013) may not lead to the best forecast of Multinet's efficient opex in the future.

710 NGR, r. 91.

711 The AER's forecast of opex uses the fee paid to JAM in part of its forecast for 2013. This is to reflect the fact that until 1 July 2013, most of Multinet's forecast opex will be for this fee.

The AER's final decision also reflects the AER's consideration of additional information submitted by Multinet in its revised proposal to support its forecast. In particular, the AER notes that the Grant Thornton review provided greater transparency about the individual components underlying Multinet's forecast than was made available to the AER in making its draft decision.[712] As indicated above, the AER does not consider the information demonstrates that Multinet's forecast, as a whole, is the best in the circumstances or was arrived at on a reasonable basis.[713] However, in combination with the reasons above, the AER considers the information helped to demonstrate that it is likely that the best forecast of Multinet's efficient costs will be higher than the opex Multinet incurred in the current access arrangement period.

The remainder of this attachment sets out the AER's assessment of Multinet's proposed opex using the AER's base year forecasts. It is structured as follows:

- forecasting base year opex
- escalation of base year opex
- step changes
- debt raising costs

Further reasoning to support the AER's decision is provided in appendix A and appendix D.

7.4.1 Forecasting base year opex

As outlined above, the AER considered Multinet's opex forecast for the 2013-17 access arrangement period should be based on the historical costs incurred in providing these services in 2011. This methodology is known as a base year approach. This is different to the bottom-up approach proposed by Multinet (which is assessed by the AER in appendix D). A bottom-up approach forecasts the individual cost of each of the different elements of the services to be provided.

Since the draft decision, the AER has made the following changes to its base year estimate:

- used the costs incurred by Multinet's current services provider, JAM in providing the reference services in place of the fee Multinet paid to JAM
- increased the allowance for the fee paid to the Energy Partnership Group (EPG) Pty Ltd.
- excluded costs incurred by Multinet in 2011 relating to the transition to its new business model
- applied a higher allowance for cost escalation between 2011 and 2012.

The AER does not approve Multinet's proposal to add a margin to the costs incurred by JAM in 2011.

The AER's position on these base year issues is outlined below. Further detail about the AER's position on the EPG fee is provided in appendix D.

Table 7.3 illustrates the difference between the AER's final decision, the draft decision, and Multinet's view on how a base year approach should be correctly applied.

712 Grant Thornton, *Review of Multinet's Operating Expenditure Forecasts*, 9 November 2012.
713 NGR, r. 74(2).

Table 7.3 Comparison of AER draft and final decisions and Multinet's proposed base year estimate ($m, $2012)

	Draft decision	Multinet base year estimate	Final decision
Multinet opex in 2011	57.6	57.6	57.6
Additional opex incurred by JAM in 2011 related to reference services	-	5.2	5.2
Proposed margin	-	2.4	-
EPG fee adjustment	-3.0	-	-2.3
UAFG adjustment	-2.6	-2.6	-2.6
Licence fee adjustment	-0.1	-0.1	-0.1
Transition cost adjustment	-	-	-1.8
Escalation in base year opex between 2011 and 2012	-0.3	1.3	1.0
Base year opex in 2012	51.6	62.6	57.0

Source: AER analysis.

Establishing the base – Multinet's contract with JAM, or JAM's costs?

The AER's forecast of opex for the final decision is based mainly on the costs incurred by Multinet's main outsourced provider JAM, in 2011, instead of the fee Multinet paid to JAM in 2011. The AER considers this provides the best estimate of what Multinet's efficient opex is likely to be in the 2013-17 access arrangement period.

Since July 2003, Multinet has contracted JAM, under an Operating Service Agreement (OSA) to provide most of Multinet's reference services. In the 2008-12 access arrangement period, the fee Multinet paid JAM to undertake opex did not recover the opex JAM reported it incurred in delivering opex services for Multinet. Multinet submitted that this was because the fee was below what was required to provide the services. As a result, Multinet maintained that the cost it incurred in the base year - inclusive of the fee it paid JAM - would not be appropriate to use in a forecast of Multinet's future opex.

In its draft decision, the AER used the fee Multinet paid to JAM, not JAM's actual costs. The AER considered that while the fee JAM received for providing the service may not have been sufficient, it is possible that JAM may not have been as efficient as alternative providers. That is, the loss would have been smaller, or may not have been incurred if the services were performed by a more efficient service provider. The AER concluded on the basis of all the evidence available to it, that there was not sufficient evidence to conclude that Multinet's historical opex (inclusive of Multinet's contract price with JAM) was too low.[714]

For this reason, and several other reasons outlined in attachment 6 of the draft decision, the AER considered that a forecast based on Multinet's actual costs incurred in the base year to be the best

[714] AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 140-142.

estimate possible in the circumstances. One such reason was that Multinet had not provided information to substantiate significant components of its opex forecast. For instance, the AER considered Multinet had not adequately explained how it had arrived at its forecasts for the services it will deliver inhouse from 1 July 2013.

Since the draft decision, in its revised proposal, Multinet submitted additional information about how its opex forecast is constructed. In particular, the AER notes that the Grant Thornton review provided greater transparency about the individual components underlying Multinet's forecast than was made available to the AER in making its draft decision.[715] Overall, the AER has fewer concerns about Multinet's forecast than it did prior to the draft decision.

The AER's final decision reflects the AER's consideration of that additional information. As indicated above, the AER considers the information does not demonstrate that Multinet's forecast, as a whole, is a forecast of opex that satisfies the opex criteria or the criteria for forecasts and estimates.[716] However, taking into account this information, the AER considers it is likely that Multinet's efficient opex will rise in the 2013-17 access arrangement period when compared to the 2008-12 access arrangement period.

Therefore the AER now considers that it is likely that a forecast largely based on Multinet's expiring contract with JAM will underestimate Multinet's opex in the forthcoming period. As Multinet must be given a reasonable opportunity to at least recover the efficient costs it incurs in providing reference services, the AER considers it is appropriate to use an estimate based predominantly on JAM's costs rather than one predominantly based on the fee Multinet paid to JAM.[717]

In reaching this position, the AER remains of the view that there is sufficient information to indicate that JAM was not the most efficient service provider of Multinet's reference services in 2011.

In particular, the AER notes that Multinet is moving to a different business model. The model utilises several specialised contractors to provide outsourced services while a greater proportion of services will be delivered inhouse. Given that Multinet is not continuing with the current arrangement or even a variation of the current arrangement, these developments raise some questions as to whether JAM was the most efficient provider of these services in 2011.

For this reason a forecast based on JAM's costs in 2011 may not result in the most efficient costs. If JAM was the most efficient provider of the services it provided for Multinet under the OSA, then the AER considers it very likely that Multinet would have continued to outsource the same services to JAM in the 2013-17 access arrangement period. The AER notes that Multinet has referred to the efficiency of its new business model.[718]

However, the AER has no robust methodology to estimate the relative efficiencies of Multinet's new business model and therefore no reasonable basis for choosing an estimate of opex lower than the opex incurred by JAM in the base year. As such, Multinet will recover "at least" its efficient costs and will not recover less than its efficient costs which may have been the case if the AER had used the fee Multinet paid to JAM in 2011.

715 Grant Thornton, *Review of Multinet's Operating Expenditure Forecasts*, 9 November 2012.
716 NGR, r. 91, r. 74(2).
717 NGL, s. 24(2).
718 Multinet, *Access arrangement information*, 30 March 2012, pp. 19, 20, 45–46, 59–61, 67.

The AER has also considered the EUCV's submission that the AER's draft decision was consistent with the long term growth in opex.[719] However, as discussed above, the AER no longer considers Multinet's revealed costs or historical opex to be the best guide to Multinet's efficient opex in the future. Therefore, in this instance, the AER has set a forecast that deviates from the long term trend in Multinet's opex. By basing the forecast on JAM's costs, the AER's final decision does however remain consistent with the long term trend of the costs of delivering the services provided to Multinet's customers.

Margin

The AER does not accept Multinet's proposal to add a margin to the opex JAM incurred in 2011.

The AER considers that to add a hypothetical profit margin to JAM's actual costs in 2011 would not lead to a forecast of total opex arrived at on a reasonable basis or the best estimate of total opex in the circumstances.[720] Thus the AER does not consider a forecast of opex that includes such a margin would be reflective of a prudent and efficient level of opex. This is for the following reasons:

- The proposed margin is based on a margin which is partly for overheads yet JAM's costs in 2011 already include overheads.
- One of Multinet's justifications for its new business model, - to attain efficiency improvements - does not support including a margin. Multinet has referred to the efficiency of its new business model. One would expect this would result in a lower cost than the costs incurred by JAM. The AER's forecast does not deduct amounts for these expected efficiencies. Adding a margin for profit to a forecast which does not deduct efficiencies would lead to an upwardly biased opex forecast.

Taking the above into account, the AER considers that a forecast based on JAM's actual costs in 2011, will allow Multinet to recover at least its efficient costs for providing the reference services.

The AER's reasons are set out in further detail below.

Margins are common as part of outsourced arrangements. However, the reasons why margins are paid to outsourced providers depend on the circumstances. Possible reasons why a margin might be paid to an outsourced provider include:

- to pay a return on assets
- to provide an allowance to recover indirect or common costs
- for self insurance against asymmetric risks posed by a contract

The actual margin which is paid under an outsourcing arrangement will depend on how the contract is defined. For instance, under a cost pass-through contract, the margin will normally be defined explicitly in the contract. In a fixed price contract the margin is equal to the difference between the actual direct expenditure the outsourced provider earns and the fixed fee the provider receives for delivering those services.

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[719] Energy Users Coalition of Victoria, *Submission to the AER: AER draft decision and revised applications from Envestra, Multinet and SP AusNet*, January 2013, p. 23.

[720] NGR, r. 74(2).

When a margin is part of an actual outsourcing arrangement, the AER's approach is to apply a two stage process to assess the margin. Firstly the AER assesses whether the outsourcing arrangement can be presumed to be efficient and prudent (presumption threshold). Secondly for outsourcing arrangements that fail the presumption threshold, the AER will assess whether the total cost of the arrangement is prudent and efficient.

The margin proposed by Multinet is, according to Multinet, an estimate of a reasonable profit margin.[721] It was based on the margin bid by one of the successful bidders in Multinet's recent network operations tender. The proposed margin adds $2.4 million ($2012) to Multinet's 2011 base year estimate.[722] The margin proposed by Multinet is not part of any outsourcing arrangement but is a hypothetical estimate of what a reasonable profit margin an outsourced provider should earn if it incurred the same costs as JAM did in 2011.

As the margin is not part of any contractual arrangement, the AER cannot apply the first stage of its assessment approach. Therefore its assessment is limited to the second stage. However, Multinet's proposal relates to a hypothetical situation. Therefore, the AER's assessment is limited to examining whether a forecast based on JAM's opex in 2011 is likely to have been below an efficient level of opex and whether Multinet's change in circumstances would warrant a margin added to the opex incurred by JAM in 2011.

The AER considers there is not sufficient evidence to conclude that adding a hypothetical margin would lead to the best estimate possible of the efficient costs of providing Multinet's reference services. This is for two reasons.

Firstly, Multinet considers its estimate to be an estimate of a reasonable profit margin. However, the margin bid in Multinet's network operations tender was not only for profit, but also for pre-existing corporate overheads.[723] There is no basis to provide Multinet with an allowance for overheads additional to that already provided.

JAM's costs include both the direct costs JAM incurred in providing the reference services, as well as additional indirect costs it incurred in providing the services. These additional costs were a portion of the costs JAM's parent company, Jemena, incurred across multiple assets and contracts across the Jemena business.[724] That is, JAM's costs include an allocation of Jemena's corporate costs. Therefore, an allowance for Jemena's overheads is already included in JAM's costs. The AER has not been provided with any information from Multinet to estimate the overheads implicit in JAM's costs.

If the AER added Multinet's margin estimate to JAM's costs, it will provide an additional allowance for the recovery of an outsourced provider's overheads. But Multinet has not provided the AER with any information to estimate the overheads implicit in JAM's costs. Therefore, the AER is not satisfied that adding a hypothetical margin to JAM's costs would lead to the best estimate possible of the efficient costs of providing the reference services.

Secondly, even if the AER could form a robust estimate of what a reasonable profit margin should be, there are other factors to consider. These factors create additional doubt as to whether a margin added to JAM's costs would lead to the best forecast possible of Multinet's efficient opex.

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[721] Multinet did not identify any other reasons why the margin should be included – for instance for asymmetric risks.
[722] Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 38.
[723] Multinet, *Network Operations Request for Proposal*, 20 June 2011, p. 21.
[724] Multinet Gas Distribution Partnership Regulatory Accounting Statements 2011, p. 49. p. 54-59.

The relevant test in considering whether a margin needs to be added is whether the total opex incurred by JAM in 2011 is likely to have been sufficient for an equivalent efficient service provider to deliver the reference services. As discussed above, the AER remains of the view that there is sufficient information to indicate that JAM was not the most efficient service provider of Multinet's reference services in 2011. If the more efficient model of providing the reference services was to use JAM in the 2013-17 access arrangement period, arguably, Multinet would have re-engaged JAM to provide the same services it provided under the OSA.

As it is, Multinet has decided to deliver an increased number of services in-house. Of Multinet's outsourced network operations services, JAM will only undertake half from 1 July 2013.[725] Multinet has also engaged new specialised providers to provide IT and customer and market services.[726] JAM is providing substantially fewer services for Multinet from 1 July 2013 than it did under the OSA. The AER also notes that Multinet has also referred to the efficiency of its new business model.[727]

The AER considers that given JAM will not be providing the same services for Multinet as it did under the OSA, and Multinet expects its new business model to be efficient, there is considerable doubt as to whether JAM was the most efficient provider of these services in 2011. Therefore the AER is not satisfied that adding a hypothetical profit margin to JAM's actual costs in 2011 would lead to a better forecast of the total efficient costs of delivering the reference services in 2013-17. As such, the AER considers that adding an estimate of a profit margin to JAM's historical costs would not reflect the efficient cost of providing those services or would not be in the long term interests of consumers.[728]

Also, Multinet stated that the proposed margin was within a normal range of margins observed in the marketplace. To support its position, it referred to a study by NERA undertaken on behalf of Envestra, and a study by Ferrier Hodgson for United Energy.[729]

The AER considered the NERA study in its draft decision for Envestra Victoria and Envestra Albury.[730] In this decision, the AER noted that there were a wide range of margins considered in the NERA study. For this reason the AER considered it was likely that the terms and price structures of the contracts studied may have varied. Therefore, the comparison of margins may not have been done on a like for like basis. It also considered that the large volatility in the range of margins in NERA's sample indicates that the margins in the sample may be for different purposes. It therefore did not place significant weight on this study's findings in reaching its draft decision for Envestra Victoria and Envestra Albury. The AER considers the same criticisms apply to the analysis in the Ferrier Hodgson report. Therefore, the AER considers that neither report provides any additional persuasive evidence that the AER should add a margin to JAM's costs.

725 JAM will provide network operations and maintenance services for Multinet in the Northern region of Multinet's area of operations. Comdain will undertake network operations and maintenance services for Multinet in the Southern region.

726 From 1 July 2013 Skilltech and Aegis will undertake customer and market services for Multinet. Accenture and Logica will undertake IT services.

727 Multinet, *Access arrangement information*, 30 March 2012, pp. 19, 20, 45–46, 59–61, 67.

728 NGR, r 91, r. 100(a); NGL, s. 23.

729 NERA, *Benchmarking study of contractor profit margins (2002–2011)*, March 2012; Ferrier Hodgson, United Energy Distribution Pty Ltd - Advanced Interval Metering Price Review, 12 June 2008.

730 AER, *Draft decision, Envestra access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 3, September 2012, p. 106.

Comparison with approach in Envestra Victoria and Envestra Albury draft decision.

In support of its proposal, Multinet submitted a report by Frontier Economics.[731] Frontier Economics considered the approach the AER adopted for Envestra Victoria and Envestra Albury was different to the approach it has adopted for Multinet.

The approach the AER has adopted in assessing Envestra and Multinet's proposed opex reflects the different circumstances facing each of the businesses.

The AER typically sets an opex forecast based on actual expenditure in the base year - regardless of whether the services were outsourced or provided in-house. This was the approach the AER adopted for Envestra Victoria and Envestra Albury after a review of the margin Envestra pays to the APA Group.

This margin is part of an actual contract Envestra has with the APA Group which has been in place since 2007. The AER reviewed whether this margin satisfied the relevant NGR criteria because the contract was not determined through a competitive process. The AER considered the most relevant assessment tool was to review Envestra's performance compared to the performance of similar providers to assess whether opex inclusive of the margin reflected an efficient amount.[732]

Envestra's historical performance was, on the whole, reasonable when compared to similar providers. Envestra paid a margin to the APA Group during this period. Therefore, the AER was reasonably satisfied that a forecast of opex that included a robust forecast of the actual margin that would be paid to the APA Group in the 2013-17 access arrangement period satisfied the opex criteria.[733]

In Multinet's case, as discussed above, the AER has found that the actual costs Multinet incurred in 2011 would lead to a forecast that is too low. The AER therefore has used the costs Multinet's outsourced provider, JAM, incurred. This leads to a higher forecast than the opex Multinet incurred in the base year.

Unlike for Envestra, Multinet's proposed margin is not part of a current contract, nor is it part of a future contract. It is hypothetical. Multinet has proposed it be added to JAM's historical costs to arrive at an estimate of what Multinet considers its opex should be if it continued to outsource to a single provider. Given the hypothetical nature of the estimate, benchmarking is not an appropriate tool to assess whether adding a margin to JAM's opex would lead to the best possible forecast in the circumstances. Therefore, the AER has considered other information to determine whether it should add a margin to the forecast.

As identified above, in part, the AER considers that to include Multinet's proposed margin in its base year estimate would lead to an upwardly biased forecast without an efficiency adjustment. In part, the AER also considers that this margin would lead to an upwardly biased forecast because it would double count overheads already reflected in JAM's costs in 2011. Therefore, the AER does not accept Multinet's proposal to include a margin in its base year estimate.

In both cases the AER has only made a decision about the total amount of opex required for Multinet and Envestra to be able to efficiently deliver the reference services. The AER considers that both

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731 Frontier Economics, *Multinet Operating Expenditure Forecast - A Report Prepared For Johnson Winter Slattery*, November 2012

732 AER, AER, *Draft decision, Envestra access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 3, September 2012,, p. 101-114.

733 NGR, r. 91.

Multinet's and Envestra's allowances are sufficient to efficiently deliver all reference services, whether those services are delivered by outsourced providers or inhouse.

EPG fee

The AER proposes to include an estimate of $3.32 million ($2012) of the fee paid to Energy Partnership (Gas) Pty Ltd (EPG) in its base year estimate. The AER's estimate is based on Multinet's audited EPG costs from 2010 and 2011. This amount reflects what would be incurred by a prudent service provider acting efficiently. The reasons for this position are set out in appendix D.

Costs relating to the transition to Multinet's new business model

In its base year estimate the AER has removed the costs that Multinet incurred in 2011 that relate to the transition from Multinet's current business model to its new business model.

The AER considers that where an opex incentive mechanism does not provide for a negative carryover (of an efficiency loss), costs incurred in the base year should reflect an estimate of the efficient annual recurrent costs Multinet is likely to incur in delivering the reference services. Transition costs reported to be incurred by Multinet in 2011 are a material non-recurrent cost so the AER considers these costs need to be removed from its base year estimate.

The AER notes that this is a different approach to its draft decision.[734] This reflects the AER's decision not to apply penalties from the operation of the 2008-12 opex incentive mechanism. The reasons for this decision are discussed in attachment 8.

The AER has considered Multinet's forecast transition costs separately as a step change in section 7.6.

Escalation in base year opex between 2011 and 2012

For the final decision on opex, the AER considers the best approach for escalating base year opex between 2011 and 2012 is to apply the AER's best estimate of labour cost escalation in 2012. The AER's approach to labour cost escalation is discussed below and in appendix A. The effect of this position is to escalate base year opex by $1.0 million ($2012) between 2011 and 2012.

The AER notes that this is a different approach to its draft decision where it applied the forecast change in operating expenditure between 2011 and 2012 approved in the 2008-12 access arrangement. This reflected the AER's application of a negative carryover in the draft decision. This had the effect of reducing base year opex by $0.3 million ($2012) between 2011 and 2012. However, as discussed in attachment 8, the AER's final decision is not to apply negative carryover from the 2008-12 access arrangement period. This impacts on the AER's decision on the escalation of base year opex between 2011 and 2012.

7.4.2 Escalation of base year opex

Labour cost escalation

The AER is not satisfied Multinet's proposed real labour cost escalators have been arrived at on a reasonable basis or represent the best possible forecast of labour cost escalation over the 2013–17

734 Multinet were informed of this change in approach. See 'Opex base year - transition costs and escalation (Email)', 25 February 2013.

access arrangement period. Appendix A contains the AER's consideration of the real cost escalators proposed by Multinet in its base year estimate.

Output growth escalation

In its base year estimate Multinet adopted the methodology used in the AER's draft decision on output growth escalation where a one per cent increase in customer numbers was assumed to result in a 0.38 per cent increase in total operating expenditure.[735] For the reasons set out in its draft decision uses this escalation methodology for the final decision.[736]

However, the total forecast output growth escalation is determined by the average cost per customer in the base year multiplied by the output growth escalation rate. Therefore the AER has updated its output growth forecast from the draft decision to reflect its updated base year forecast.

7.4.3 Step changes

Multinet proposed the following seven step changes as part of a base year estimate it submitted to the AER after its initial proposal: [737]

1. Network development
2. Increase in maintenance (metering) costs
3. Energy Efficiencies Opportunities (EEO)
4. Carbon tax administration
5. Compliance reporting
6. GAAR costs
7. New connections function

Multinet's revised proposal adopted the AER's draft decision on five of these step changes (EEO, carbon tax administration, compliance reporting, GAAR costs, new connections function) in its base year estimate. It resubmitted proposed step changes for network development and metering.

In its revised proposal Multinet also proposed additional step changes to cover the cost of claimed under-servicing by JAM and a proposed Energy Safe Victoria levy increase.

The impact of the AER's final decision on Multinet's proposed step changes is set out in Table 7.4.

For those step changes where Multinet has adopted the AER's draft decision, the AER approves expenditure for those step changes for the reasons set out in its draft decision.[738]

The following sections discuss the AER's final decision and reasons for the decision for each step change where Multinet in its revised proposal did not adopt the AER's draft decision. It also includes

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735 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 55.

736 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012,, pp. 166–167.

737 Multinet, *Response to AER information request 10*, 20 June 2012

738 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, pp. 128-169.

the AER's assessment of Multinet's forecast transition costs which the AER has considered as a step change.

Table 7.4 Impact of step changes ($m, 2012)

	Total
Multinet base year estimate	32.9
AER final decision	22.4
Difference	-10.5

Source: AER analysis.

In general, step changes fall into three categories:

1. regulatory change
2. non-recurrent expenditure
3. discretionary expenditure

These categories are indicative of how the AER is able to assess whether expenditure meets the applicable criteria prescribed by the NGL and NGR.[739]

Regulatory change

The AER generally considers an increase in opex to meet an existing regulatory requirement would be an efficiency loss as it would cost a business more to meet the same requirement. Consequently a step change would not be required.

However, the AER also recognises a gas service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in complying with a regulatory obligation or requirement.[740] In some circumstances there may be external factors, beyond its control as to why a gas service provider might require an increase in expenditure to meet an existing regulatory requirement. In these circumstances, a step change may be required.

Non-recurrent expenditure

A gas service provider's opex program will not be exactly the same from year to year. Actual opex in the base year reflects both recurrent expenditure and non-recurrent expenditure. Consequently base year opex will include non-recurrent expenditure that will not be required in the next access arrangement period for the same activities. However, non-recurrent expenditure incurred in the base year is not typically removed from base year opex. Consequently, the fact a particular activity was not undertaken in the base year is not sufficient evidence to demonstrate a step change is required. Instead, whether base year opex will be sufficient to fund the proposed activity, or whether a step up in opex is required, needs to be considered on a case by case basis.

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[740] NGR, r. 91, r. 74(2). NGL, s. 24(2)(b).

The Hon. Michael O'Brien, MP, Victorian Minister for Energy and Resources made the same point in his submission:[741]

> The assessment of step changes in operating expenditure tends to be focused on increases in expenditure and not on decreases in expenditure. There will be some variation in expenditure from year to year—the AER needs to consider the extent to which small forecast increases in expenditure will be offset by small decreases in expenditure that have not been forecast.

The AER considers there could be reasons where a significant increase in non-recurrent expenditure is required. In some cases a gas service provider may have relatively limited discretion in whether or not to undertake this expenditure. For example, some maintenance costs may be lumpy. As a result, base year opex may be insufficient to cover the costs of the new program of expenditure. In this case a step change in opex may be required.

Discretionary expenditure

The AER does not typically consider an incremental increase above base year opex is required for discretionary expenditure.

For instance, a gas service provider might propose step changes above base year opex for projects or programs it stated would increase productivity. However, if a new program of expenditure delivers productivity savings those cost savings should also be factored into the forecast of total opex. Adding a step change above base year opex to total opex will not produce an efficient forecast if the cost savings resulting from the step change are not taken into account.

Similarly, if a project or program is undertaken at a gas service provider's discretion on productivity grounds then it is only prudent if the cost savings outweigh the costs. Consequently a step change is not required because, all else equal, total opex will be reduced by the project or program.

In some limited circumstances the benefits of a discretionary project may not be productivity gains, but the project is expected to lead to lower prices to customers. If there are few benefits to the gas service provider, the benefits of undertaking the project to the gas service provider may not outweigh the cost of the project. Therefore it may not undertake the project without an increase in opex. A step change in opex may be necessary so that customers benefit in the long term.

The AER's assessment of each step change is considered below.

Assessment of proposed step changes

Network development expenditure

The AER's final decision is not to approve Multinet's proposed expenditure of $10 million ($2012) for its network development plan. This is because the expenditure is not prudent and efficient as it is not in accordance with accepted good industry practice and would not lead to achieving the lowest sustainable cost of delivering pipeline services.[742] Appendix D sets out in more detail the AER's assessment of Multinet's proposed expenditure for its network development plan.

In particular, the AER considers:

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741 Minister for Energy and Resources, *Victorian Gas Access Arrangement Review – Victorian Government Submission*, 14 January 2012, pp. 3–4.

742 NGR, r. 91(1).

1. Multinet has not demonstrated that a prudent and efficient service provider would undertake the proposed network development activities as it has failed to establish that there is a reasonable expectation that customers will obtain a net benefit (as described below) from these activities.

2. A step increase in Multinet's total operating expenditure is not required for this discretionary expenditure.

3. Multinet's cost build-up is insufficiently detailed and therefore is not a reasonable basis for its forecast expenditure.[743]

In its draft decision the AER did not accept Multinet's proposed step change relating to the introduction of a network development plan. The AER considered network development expenditure can be prudent and efficient where the projects are expected to be net present value positive and the expected long term benefit outweighs the shorter term costs. However, the AER considered that Multinet had not provided any evidence that the proposed network development activities would provide a long term benefit to Multinet or its customers.[744] Without meeting this fundamental requirement, such expenditure would not be incurred by a prudent and efficient service provider.

Multinet's revised proposal did not adopt the AER's draft decision. Multinet's revised proposal re-proposed a step change of $10 million ($2012) for network development expenditure. This is the same as Multinet’s initial proposal. Multinet did not agree with the AER's approach to assessing research and development expenditure with respect to the feasibility studies and proposed an alternative test. Multinet's revised proposal also included further information about the proposed activities included in its network development plan.[745]

Multinet's network development plan includes two components:

1. two feasibility studies relating to the use of existing electricity AMI infrastructure and designing new time-of-use tariffs – $8 million ($2012).

2. a network development plan developing a detailed customer data warehouse to target marketing of gas appliances – $2 million ($2012).[746]

The AER is required to assess whether the proposed network development expenditure is expenditure that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services.[747] In assessing whether proposed expenditure would be undertaken by a prudent service provider acting efficiently, the AER considers that it must be satisfied that there is a reasonable expectation that the proposed expenditure will deliver a net benefit to the consumer. In measuring a net benefit in this context, the AER considers it must be satisfied there is a reasonable basis on which to expect:

1. the study will deliver a benefit, in the form of identifying a means to lower the sustainable cost of delivering the pipeline services

2. this benefit will outweigh the costs of the study and implementation of the proposal.

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743 NGR, r. 74(2).

744 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017,* September 2012, pp. 159–160.

745 Multinet, *Revised access arrangement proposal*, 9 November 2012, pp. 47–48.

746 Multinet *Access arrangement information*, 30 March 2012, p. 78.

747 NGR r 91(1).

The term "net benefit" is used to refer to this weighing up exercise.

Relevantly, in the context of a feasibility study, being an evaluation and analysis of a proposed project, the AER considered the benefits and costs of the study by reference to the potential outcomes of the study, not just the study itself.

As well as being satisfied that the expenditure is consistent with that undertaken by a prudent service provider acting efficiently, the AER must be satisfied that the expenditure is consistent with the NGO.[748] The NGO is concerned with delivering services that are in the long term interests of consumers, in terms of price, quality safety, reliability and security of supply of natural gas. Accordingly, the AER considers that, in determining whether there is a net benefit, it must have regard to the potential for the study to deliver a lower sustainable cost through such means as improving quality, reliability or the other considerations identified by the NGO.

The AER must also be satisfied that the proposed forecast expenditure has been arrived at on a reasonable basis and is the best forecast possible in the circumstances.[749]

In its assessment, the AER considered the submission made by the Victorian Minister for Energy and Resources in which the Minister did not support a step change for the proposed feasibility studies. The Minister noted there is no obligation for distributors to introduce AMI infrastructure (smart meters) for gas metering or introduce time of use pricing for small gas consumers. Therefore, the Minister considers the AER needs to be convinced there are compelling efficiency benefits resulting from Multinet's proposed expenditure and mechanisms to ensure that customers benefit to allow the step change.[750]

The AER agrees with the Minister that Multinet is not required to undertake these feasibility studies or introduce AMI infrastructure or time of use tariffs. As such, it considers the proposed step change is discretionary expenditure. Therefore, the AER has assessed whether a prudent and efficient service provider would undertake the expenditure. In making this assessment, the AER has considered the efficiency of the expenditure in the context of what is accepted good industry practice, and the long term interests of consumers.

The AER's detailed considerations of the feasibility studies and the data warehouse are set out in Appendix D.

Increase in maintenance (metering) costs

The AER's final decision is not to approve Multinet's proposed step change of $13.5 million ($2012) for the following reasons:

- unit rates—the transition costs in Multinet's proposed unit rates should be excluded as the AER has assessed these as a separate step change.
- volumes—Multinet's revised proposal is not arrived at on a reasonable basis because it does not reflect, in its allocation of capex to opex, the manner in which Multinet actually performs its meter replacement program.

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748 NGR r 91(1); r 100(a).
749 NGR r 74(2).
750 Minister for Energy and Resources, *Victorian Gas Access Arrangement Review – Victorian Government Submission*, 14 January 2012, p. 4.

- Multinet's revised proposal contained a calculation error (the contents of some cells were hardcoded rather than updated appropriately).

The AER proposes to amend Multinet's proposed maintenance (metering) costs to comply with the relevant NGL and NGR criteria. The AER considers an opex allowance of $10.8 million ($2012) is the best forecast possible in the circumstances.

Table 7.5 AER approved step change for 2013–17 ($million, 2012)

Category	2013	2014	2015	2016	2017	Total
Multinet initial proposal	2.0	2.0	2.0	2.0	2.0	10.0
AER draft decision	-	-	-	-	-	-
Multinet revised proposal	2.7	2.7	2.7	2.7	2.7	13.5
AER final decision	1.0	2.2	3.8	1.7	2.0	10.8

Source: AER analysis.

In the AER's draft decision the AER considered that Multinet's bottom up forecast was not consistent with the requirements of r. 74(2). Without a robust forecast the AER could not be satisfied that Multinet would incur an increase in costs in the 2013–17 access arrangement period. As such, the AER did not approve a step change.[751] Instead, the AER considered that the actual costs incurred in 2011 provided a reasonable basis and the best estimate possible in the circumstances for forecasting opex.[752]

In Multinet's revised proposal, Multinet submitted that using a single year of actual expenditure is not appropriate in this circumstance. Multinet submitted that:[753]

> Metering maintenance is a specialist activity which exhibits significant work volume fluctuations from year to year, based on the life cycle of meters.... The total cost of the program therefore also fluctuates significantly from year to year... the volume of work undertaken in 2011 is not representative of average annual levels, and it therefore does not provide a sound basis for deriving forecasts of future volumes.

Multinet further submitted that:[754]

> It is noted that when measured over a 5 year interval, the program for the forthcoming access arrangement period is of a similar size to the program that was completed in the current period. It is noteworthy, however that the actual volume of work completed in 2011 (year 4 of the current period) is significantly below the average annual volume for the whole 5-year period. In other words, the volume of work undertaken in 2011 is not representative of average annual levels, and it therefore does not provide a sound basis for deriving forecasts of future volumes. By the same token, had the 2012 metering program been completed in 2011 the AER‟s "year 4 forecasting" approach would have significantly over-compensated Multinet for the costs of the metering program over the forthcoming access arrangement period.

Finally, in its revised proposal Multinet provided:

- a revised bottom-up cost build-up of its opex forecast;[755] and

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751 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017,* September 2012, p. 165.

752 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017,* September 2012, p. 165.

753 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 50.

754 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 52.

- an independent expert report from Asset Integrity Australasia, which supported its opex forecast.[756]

The AER notes that this is a recurrent and ongoing expenditure program and generally the AER would not approve a step change for this type of expenditure. However, on considering Multinet's revised proposal, the AER accepts that the volume of meter replacements that Multinet will undertake is largely driven by the age and profile of Multinet's installed meter base and that there can be large fluctuations in Multinet's meter replacement program on an annual basis.

The AER has also considered Multinet's submission that expenditure in 2011 was below the average over the 2008-12 access arrangement period and below the average forecast for the 2013–17 access arrangement period. The AER has considered this submission taking into account the incentive mechanism that applied to Multinet for the 2008-12 access arrangement period. The purpose of the efficiency carryover mechanism is to ensure that short term fluctuations in the expenditure on a program such as the fluctuation in 2011 on meter maintenance are smoothed and that the combination of the base year opex and carryover amount are sufficient to undertake the program. However, as discussed in attachment 8, the AER's final decision is not to apply a negative carryover from Multinet's efficiency carryover mechanism for the 2008–12 period. The effect of this is that the carryover arising from the lower expenditure in 2011 is not reflected in Multinet's 2013–17 opex allowance. Therefore, the AER accepts that in this case, in the absence of a negative carryover and without a step change, Multinet would not have sufficient opex in its base year to fund the proposed activity if the AER were to base the costs on 2011 costs.

The AER accepts that a bottom-up build, as submitted by Multinet, is the best methodology to forecast these meter replacement costs and on which to forecast the step change. However, in its draft decision, the AER considered that Multinet's bottom-up build was not sufficiently substantiated. Multinet in its revised proposal has submitted a revised cost build-up which has allowed the AER to consider both the unit rates and volumes for the meter replacement program. The AER identified and Multinet accepted that it had made a calculation error in its revised opex forecast.[757] This error was as a result of several cells being hardcoded. As such, the AER considers the forecast provided as part of Multinet's forecast has not been reached on a reasonable basis and is not the best forecast possible in the circumstances.[758]

The AER has assessed the updated model subsequently provided to the AER to determine if it is the best forecast possible in the circumstances.[759]

The AER's consideration of the cost build-up in Multinet's revised proposal is set out below.

Unit rates

The AER initially was unable to reconcile Multinet's revised cost build-up against the unit rates in the contracts Multinet entered into with its contractors Jemena and Comdain. However, Multinet has now demonstrated that its revised forecast unit rates are consistent with its contracts.[760] Multinet adjusted these contracted unit rates for the Limb 2 payments[761], inflation and transition costs. The transition

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755 Multinet, *Appendix 2-6 Metering profile.xlsx, 9 November 2012..*
756 Multinet, *Appendix 2-8 Multinet operating forecast.docx*, 9 November 2012.
757 Multinet, *Response to AER information request FD10a,* 7 January 2013. p. 3.
758 NGR, r. 74(2), r. 91(1).
759 Multinet, Response to AER information request FD10a, *Opex Meters v2.xlsx*, 7 January 2013.
760 Multinet provided the AER with further information in response to information requests FD10a, FD10b and FD10c.
761 Multinet has adopted a three limb structure in its contracting arrangements. The forecast unit cost is equal to — tendered cost (limb 1) plus contractor profit margin (limb 2) plus incentive payments (limb 3).

costs are costs Multinet considers it will incur in transitioning to its new business model. As discussed below, the AER has assessed Multinet's transition costs as a separate step change. As such, these costs have been removed from Multinet's proposed meter replacement step change.

Volumes

Prior to its draft decision the AER received a number of different sets of information from Multinet regarding the volume of meters to be serviced under the meter replacement program. Multinet acknowledged inconsistencies in this data and provided updated meter volumes prior to the draft decision.[762] In its draft decision the AER indicated that it considered Multinet's revised volume forecast appeared appropriate.[763] However, in its revised proposal Multinet submitted that the AER had made several errors in manipulating the information provided. Multinet stated:[764]

> Although the data in the table above [base data used to derive the higher level forecasts] has been accepted by the AER, in manipulating the information provided by Multinet, the AER has made several errors. As well as not properly accounting for unrepairable meter families, refurbishment of test meters and faults, Table A.15 AER draft decision on Multinet’s meter replacement volumes assumes 80 per cent of meter families can be refurbished. Multinet‟s experience is that 90 per cent of repairable families can be refurbished.

The AER therefore examined the volumes in Multinet's revised proposal as well as Multinet's updated model and re-examined the information it received prior to the draft decision.

Following this assessment, the AER generally accepts the basis for forecasting the volumes provided in Multinet's revised proposal and most aspects of the way in which Multinet calculated its revised proposal. However, Multinet made an error in the manner in which it calculated the number of repairable meters. The AER has corrected this in its assessment. Further, the AER considers that Multinet's revised proposal incorrectly takes into account abolished meters. Multinet's revised proposal assumes that Multinet needs to replace all meters which it removes from abolished premises. However, based on correspondence with Multinet the AER understands that Multinet refurbishes some of these meters. The AER has adjusted Multinet's volumes to account for this. In making this adjustment the AER has assumed that the same proportion of meters removed because the connection is abolished, are refurbished under the meter replacement program. Multinet indicated that it agreed with the AER's adjustment to account for these abolished meters.[765]

The AER's approach reduces the forecast number of meters Multinet needs to purchase, which reduces Multinet's capex allowance. Conversely, the forecast number of meters that Multinet needs to refurbish will increase. This increases Multinet's opex allowance. The AER considers this better reflects the manner in which Multinet operates its network and undertakes this meter replacement program.

Levels of service under Multinet's current business model

The AER's final decision is not to approve Multinet's proposed step change for increased levels of service. The AER considers that to provide a step change above base year opex for a forecast cost of under servicing is not consistent with operating expenditure that would be incurred by a prudent

762 Multinet, *Response to AER information request 35, 20 July 2012*.
763 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, September 2012, p. 164.
764 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 98.
765 Multinet, *Response to AER information request FD10e*, 25 February 2013.

service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services.[766]

In its initial proposal Multinet outlined that there was evidence of 'cost overshooting' by its service provider JAM and this was a reason why its costs would be expected to rise in the 2013-17 access arrangement period. Cost overshooting was identified as minimising opex below a sustainable level.[767] Multinet did not submit an estimate for the expected cost increase attributable to this factor.

Despite requests by the AER for information to support this claim of cost overshooting, Multinet could not provide evidence to support its claims.[768] Therefore, in its draft decision the AER concluded that the level of service delivered by JAM did not explain or account for the higher forecast of efficient opex in the 2013–17 access arrangement period relative to Multinet's actual opex in the 2008–12 access arrangement period. The AER also noted that Multinet referred to its superior service performance in the last ten years, which appeared inconsistent with its claims of cost overshooting.[769]

Multinet's revised proposal stated the incentive properties of the OSA and its expiry in only a few months time should have been sufficient evidence for the AER to conclude that cost overshooting is highly likely.[770] Multinet also acknowledged that it had previously been unable to provide substantiation of JAM's cost overshooting.

In its revised proposal, Multinet provided a statutory declaration from a current staff member who was previously employed by JAM in the role of Multinet Asset Manager.[771] The manager identified several functions that were not being performed by JAM. These functions include updating engineering standards, maintenance studies, network planning reports and reductions in other areas such as network modelling and technical compliance.[772] This was reflected in Multinet's base year estimate which included a step change of $500,000 per annum to undertake the functions not undertaken by JAM.[773]

The AER notes United Energy raised the same concerns regarding the incentives under its previous contract with JAM for electricity network operations.[774] These claims were made as part of publicly available information United Energy submitted in its previous electricity distribution regulatory proposal. United Energy and Multinet are both owned by DUET. United Energy and Multinet share many of the same staff.

The AER considers it is a prudent service provider's responsibility to ensure its contractors' obligations are met, and for ensuring those contractors provide an expected level of service to customers. The AER considers that since the possibility of cost-overshooting was raised by United Energy in November 2009, it would have been very likely that Multinet would have been aware of the possibility of cost over-shooting by JAM. There would have been time for Multinet to devote sufficient resources to address the possibility of under-servicing under the OSA.

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766 NGR, r. 91(1).
767 Multinet, *Access arrangement information*, 30 March 2012, p. 66.
768 AER, *Multinet - information request 1*, 26 April 2012; AER, *Multinet - information request 1 - follow up*, 11 May 2012; Multinet, *Summary of 26th April letter,* 11 May 2012; AER, *Multinet - information request 1 - follow up*, 15 May 2012; AER, *Multinet - information request - follow up*, 31 May 2012.
769 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, September 2012, p. 143.
770 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 56.
771 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 56.
772 Multinet, *Revised access arrangement proposal*, 9 November 2012, p. 56.
773 United Energy *Distribution, Regulatory proposal for distribution prices and services January 2011 – December 2015,* 30 November 2009, p. 18.
774 United Energy *Distribution, Regulatory proposal for distribution prices and services January 2011 – December 2015,* 30 November 2009, p. 18.

Given the claims made by United Energy some years earlier, the AER is of the view that either it must have been efficient for Multinet not to address the cost over-shooting, or it has overstated the impact of under-servicing in the base year. On this basis, the AER considers providing a step change above base year opex for the forecast cost of under servicing is not consistent with operating expenditure that would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services.[775] The AER notes its position is consistent with the position advocated by the Hon. Michael O'Brien, MP, Victorian Minister for Energy and Resources.[776]

Energy Safe Victoria (ESV) levy

The AER's final decision is to approve a step change for a forecast ESV levy increase. The AER's forecast is based on the information provided by the ESV.

Multinet proposed a step change in opex linked to an Energy Safe Victoria (ESV) levy rise in the 2013–14 financial year. Multinet was formally advised of the increase in levies on 30 July 2012.[777]

In its draft decision, the AER proposed to address the increase in the ESV levy through Multinet's annual tariff variation mechanism.[778] This was because it was thought at that time that the levy could not be determined before the final decision was made.

Since its initial proposal Multinet has been provided with information on the proposed levy. As the levy can now be quantified, Multinet proposed to treat it as a step change rather than a cost pass through.[779]

The AER agrees that an increase in opex for an ESV levy rise in 2013-14 should be reflected as a step change in Multinet's forecast opex for the 2013–17 access arrangement period. The increase in the levy relates to a change in regulatory requirements, and therefore a prudent service provider would require an increase in opex.[780]

However, the AER considers that Multinet's forecast costs for the change in the ESV levy are not the best forecast or estimate possible in the circumstances. After Multinet lodged its revised proposal, the AER obtained more detailed information on how the ESV calculates the levy. Based on this information, the AER considers Multinet's forecast step change is less than necessary to meet the cost of the levy increase. The AER considers that the ESV estimates represent the best forecast in the circumstances. As a result, in the final decision the AER has used the ESV's estimate rather than Multinet's estimate.

Transition costs

The AER's final decision is not to include a step change in its forecast for forecast transition costs.

Multinet submitted forecast transition costs that relate to the following costs:[781]

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775 NGR, r. 91(1).

776 Department of Primary Industries, *Victoria gas access arrangement review - Victorian Government submission*, 14 January 2013, p. 4.

777 Multinet, *Revised access arrangement proposal*, November 2012, p. 56.

778 AER, *Access arrangement draft decision, Multinet Gas Pty Ltd: 2013-17*, September 2012, Attachment 6, p. 222.

779 Multinet, *Revised access arrangement proposal*, November 2012, pp. 56-58.

780 NGR, r. 91(1).

781 Grant Thornton, *Review of Multinet's Operating Expenditure Forecasts*, 9 November 2012 p. 70-78.

- payment of JAM's redundancies and staff entitlements as a result of Multinet's decision to change the way it delivers its reference services
- additional forecast recruitment costs incurred by Multinet prior to the employment of new staff
- additional training costs forecast to be incurred by Multinet prior to the changeover from Multinet's current business model to its new model
- other staff and consultancy expenses forecast by Multinet to smooth the transition between Multinet's existing model and its new model.

As the AER's final decision on opex removes Multinet's actual transition costs incurred in 2011 from its base year estimate, it assessed Multinet's forecast transition costs as a step change to base year opex.

However, a new business model only reflects a change in how the services are delivered to consumers and not a change in the underlying services that are to be delivered to the consumer. The AER expects there would be net cost savings as a result of Multinet implementing its new business model. This is consistent with Multinet's claims about the efficiency of its new business model.[782]

Similar observations were made by Frontier Economics.

> Over the longer term, it would be reasonable to expect that Multinet would only introduce a new business model if it generated cost savings in excess of the one-off implementation costs...Therefore the overall long term impact of the new business model ought to reduce costs.[783]

As discussed above, the AER considers a forecast based on the opex incurred by JAM in 2011 will recover at least Multinet's efficient recurrent opex. The AER would expect Multinet's business restructure would result in lower costs to deliver the same services. Therefore it considers an incremental increase in opex for transition costs above the costs JAM incurred in 2011 would not lead to a forecast of total opex arrived at on a reasonable basis nor would it represent the best estimate possible of opex in the circumstances.[784]

In any case, part of Multinet's forecast transition costs relate to payment of JAM's redundancies and staff entitlements, which is required through Multinet's OSA with JAM.[785] This agreement was not determined through a competitive process. For this reason the AER is also not satisfied that payment of redundancy costs and staff entitlements after JAM ceases to provide services for Multinet is a prudent and efficient contractual arrangement. It is therefore not satisfied for this reason that these costs would also represent opex that satisfies the opex criteria.[786]

Debt raising costs

In its draft decision, the AER determined benchmark debt raising costs using its established approach. The AER outlined this approach in its draft decision.[787]

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782 Multinet, *Access arrangement information*, 30 March 2012, pp. 19, 20, 45–46, 59–61, 67.
783 Frontier Economics, *Multinet operating expenditure forecast - a report prepared for Johnson Winter Slattery*, November 2012, p. 22.
784 NGR, r. 74(2).
785 Grant Thornton, *Review of Multinet's Operating Expenditure Forecasts*, 9 November 2012, p. 70.
786 NGR, r. 91.
787 AER, AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, September 2012, p. 168-9. The debt raising costs (as expressed in dollar amount) in this final decision differs from that in Multinet's revised proposal because of the updated RAB and WACC inputs.

Multinet's revised proposal incorporated the benchmark debt raising cost allowance (as expressed in basis points per annum) determined by the AER in its draft decision.[788] Multinet provided no additional information on debt raising costs. Therefore, the AER agrees with Multinet's revised proposal regarding the approach to determine Multinet's debt raising cost allowance.

Benchmark debt raising costs

As flagged in the AER's draft decision, the AER has updated the benchmark allowance for Multinet's final RAB and WACC values.[789] The AER's benchmark allowance provides for three standard sized bond issues. The unit costs and the benchmark debt raising cost are shown in Table 7.6.

Table 7.6 AER's final decision on debt raising costs for Multinet based on a nominal WACC of 7.03 per cent

Value	Explanation	1 issue	2 issues	3 issues
Opening RAB	The AER accepted Opening RAB ($m, 2012)			1024.93
Total amount raised	Multiples of median MTN ($250m)	$250m	$500m	$750m
Gross underwriting fee	Median gross underwriting spread, upfront per issue, amortised	6.42	6.42	6.42
Legal and roadshow	$195 000 upfront per issue, amortised	1.11	1.11	1.11
Company credit rating	$55 000 per annum	2.20	1.10	0.73
Issue credit rating	4.5 basis points upfront per issue, amortised	0.64	0.64	0.64
Registry Fees (Startup)	$4 000 upfront per issue, amortised	0.02	0.02	0.02
Registry Fees (Ongoing)	$9 000 per issue per annum	0.36	0.36	0.36
Total	Basis points per annum	**10.8**	**9.7**	**9.3**

Source: AER analysis

The debt raising cost benchmark for Multinet is 9.3 bppa of total debt raised. This has resulted in the debt raising costs for Multinet outlined below in tTable 7.7.

788 MultiNet, PTRM 'input tab', cell G194.

789 AER, AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, September 2012, p. 168-9. The debt raising costs (as expressed in dollar amount) in this final decision differs from that in Multinet's revised proposal because of the updated RAB and WACC inputs.

Table 7.7 Debt raising costs for Multinet ($million, 2012)

	2013	2014	2015	2016	2017
Debt raising costs	0.56	0.58	0.57	0.57	0.57

Source: AER analysis

7.5 Revisions

The AER proposes the following revisions to make the access arrangement acceptable:

Revision 7.1 - Make all necessary amendments to reflect the AER's final decision on the proposed opex allowances for the 2013–17 access arrangement period, as set out in Table 7.1.

8 Incentive mechanisms

Incentive mechanisms are an important tool to provide service providers continuous incentives to reduce costs and increase efficiency in the provision of pipeline services. Incentive mechanisms provide a financial reward (or penalty) for efficiency gains (or losses) achieved compared to expenditure benchmarks for the access arrangement period. Any rewards (or penalties) for efficiency gains (or losses) are added to the service provider's total revenue and carried forward for five years after the year in which the efficiency gain (or loss) is made. Five years corresponds to the length of the access arrangement period.

This attachment presents the AER's assessment of Multinet's proposed:

- carryovers from the operation of the incentive mechanism in the 2008–12 access arrangement period, namely the benefit sharing allowance
- incentive mechanism for the 2013–17 access arrangement period.

8.1 Final decision

8.1.1 Carryover from the 2008–12 access arrangement period

The AER approves Multinet's proposed carryover of zero from the 2008–12 access arrangement period.

8.1.2 Incentive mechanism for the 2013–17 access arrangement period

The AER does not approve Multinet's proposed opex incentive mechanism. It considers amendments are necessary to ensure the incentive mechanism will encourage efficiency in the provision of services by Multinet.[790] The AER's proposed amendments will encourage efficiency in the provision of services by Multinet[791] and will provide more effective incentives in order to promote economic efficiency with respect to those services.[792]

The AER approves Multinet's proposal to not include a capex incentive mechanism.

8.2 Revised proposal

8.2.1 Carryovers accrued in the 2008–12 access arrangement period

Multinet's revised proposal excluded the negative carryover amounts accrued in the 2008–12 access arrangement period from the calculation of its total revenue for the 2013–17 access arrangement period.[793] Multinet considered the incentive mechanism in its current access arrangement does not operate to result in revenue decrements. In addition, it considered section 8.44 of the Gas Code makes no statutory provision for such decrements.[794]

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790 NGR, r. 98(1).
791 NGR, r. 98(1).
792 NGR, r. 98(3); NGL, s. 24(3).
793 Multinet, *Access arrangement information*, 30 March 2012, p. 181.
794 Multinet, *Access arrangement information*, 30 March 2012, pp. 175–181.

8.2.2 Incentive mechanism for the 2013–17 access arrangement period

Multinet did not adopt the revisions to the opex incentive mechanism required by the AER in its draft decision.[795] As in its initial proposal, Multinet proposed to retain the opex incentive mechanisms in its current access arrangement for the 2013–17 access arrangement period.

Multinet adopted the AER's draft decision to not include a capex incentive mechanism in its revised access arrangement proposal.[796]

8.3 Assessment approach

The AER’s assessment approach for incentive mechanisms is set out in its draft decision. See attachment 7 of the draft decision for a detailed explanation of the assessment approach.[797]

The Victorian Minister for Energy and Resources' written submission on the draft decision and revised proposals commented on the proposed incentive mechanisms. The AER took this submission into account in forming its final decision on Multinet's proposed incentive mechanisms.

8.4 Reasons for decision

8.4.1 Carryover from the 2008–12 access arrangement period

The AER approves the proposed zero carryover from the 2008-12 access arrangement period because there is no provision under the Gas Code that allows for the application of negative carryovers.

Under clause 5(1)(a) of the NGR transitional provisions, the AER must take into account the operation of an incentive mechanism approved 'under section 8.44 of the Gas Code and ensure, in particular, that revenue calculations made for the next access arrangement period properly reflect increments or decrements resulting from the operation of the incentive mechanism'.

The AER therefore applied a decrement accrued by Multinet in the 2008–12 access arrangement period in its draft decision.[798] However, Multinet objected to this approach in its revised proposals on the basis that an ESC appeal panel decision in 2008 had broader application than recognised by the AER in its draft decisions.[799] Envestra also raised the same objection in its revised proposal.[800]

In that appeal, Envestra Albury objected to the application of a negative carryover it accrued during its 2003–08 access arrangement period.[801] Its access arrangement was approved by the ESC under the Gas Code, as was Multinet's access arrangement. The Essential Services Commission Appeal Panel upheld the appeal and varied the carryover to zero on the basis that there is 'no power or discretion' provided by the Gas Code, under section 8.44 or other of the Gas Code provisions, which enabled the

[795] Multinet, *Revised access arrangement information*, 9 November 2012, p. 189.
[796] Multinet, *Revised access arrangement information*, 9 November 2012, p. 190.
[797] AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2—Attachments, September 2012, pp. 172–173.
[798] AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2—Attachments, September 2012, pp. 170–184.
[799] Envestra, *Revised access arrangement information*, 9 November 2012, Attachment 11-1; Multinet, *Revised access arrangement information*, 9 November 2012, pp. 175–181.
[800] Envestra, *Revised access arrangement information*, 9 November 2012, Attachment 11-1, pp. 4–7.
[801] Essential Services Commission Appeal Panel, Application by the Albury Gas Company (Envestra Albury), E2/2008, 11 November 2008.

ESCV to make provision for negative carryovers in Envestra Albury's access arrangement.[802] Section 8.44 of the Gas Code provides:

> The Reference Tariff Policy should, wherever the Relevant Regulator considers appropriate, contain a mechanism (an Incentive Mechanism) that permits the Service Provider to retain all, or any share of, any returns to the Service Provider from the sale of the Reference Service:
>
> (a) during an Access Arrangement Period, that exceed the level of returns expected for that Access Arrangement Period; or
>
> (b) during a period (commencing at the start of an Access Arrangement and including two or more Access Arrangement Periods) approved by the Relevant Regulator, that exceed the level of returns expected for that period, particularly where the Relevant Regulator is of the view that the additional returns are attributable (at least in part), to the efforts of the Service Provider. Such additional returns may result, amongst other things, from lower Non Capital Costs or greater sales of Services than forecast.

The ESCV Appeal Panel held that section 8.44 was limited to sharing extra returns resulting from reduced costs but did not extend to imposing penalties for efficiency losses.[803]

On review, the AER accepts the position submitted by Multinet as to the broader application of the ESCV Appeal Panel Decision specifically its findings that 'only positive incentive mechanisms were contemplated and intended by the Code'.[804]

For this reason, the AER considers Multinet's carryover should be revised from –$16.7 million ($2012) to zero.

8.4.2 Incentive mechanism for the 2013–17 access arrangement period

Opex incentive mechanism

The AER does not approve the opex incentive mechanism proposed by Multinet because it does not encourage efficiency in the provision of services by Multinet[805] and does not provide effective incentives in order to promote economic efficiency with respect to those services.[806]

In its draft decision, the AER considered there were five issues that need to be addressed with respect to Multinet's proposed opex incentive mechanism:

1. the calculation of efficiency gains or losses for 2013

2. forecast opex applicable for the purposes of calculating efficiency carryover from the fourth access arrangement period (2013–17)

3. adjustments to forecast opex for the purposes of calculating efficiency carryover from the fourth access arrangement period (2013–17)

4. whether and how to account for changes in classification of costs to opex

5. the symmetrical nature of the mechanism.

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802 Essential Services Commission Appeal Panel, Application by the Albury Gas Company (Envestra Albury), E2/2008, 11 November 2008, paragraph 177.

803 Essential Services Commission Appeal Panel, Application by the Albury Gas Company (Envestra Albury), E2/2008, 11 November 2008, paragraph 175.

804 Essential Services Commission Appeal Panel, Application by the Albury Gas Company (Envestra Albury), E2/2008, 11 November 2008, paragraphs 173–175.

805 NGR, r. 98(1).

806 NGR, r. 98(3); NGL, s. 24(3).

Multinet did not adopt any of the revisions to its opex incentive mechanism required by the AER in its draft decision. On the first issue, Multinet in its revised proposal queried why the AER's draft decision formula referred to actual and forecast values of operating expenditure in 2011 and 2012.[807] Multinet did not respond to the four other issues raised by the AER in its draft decision. It did include submissions on these issues in response to subsequent AER information requests.

Calculation of efficiency gains or losses for 2013

For the reasons set out below, the AER accepts Multinet's calculation of efficiency gains or losses for 2013 under its proposed incentive mechanism.

The AER's acceptance of clause 3 of Multinet's proposed opex incentive mechanism is made on the basis that in this final decision the AER has used the costs of Multinet's main outsourced provider to determine the best estimate of efficient opex (see attachment 7). By determining opex based on its outsources provider's costs, no issue arises with the carryover of 2012 efficiency gains (losses) such as would have arisen if Multinet's actual costs were used (see discussion below).

Consequently the AER is satisfied the efficiency gain for 2013 under clause 3 is best calculated without reference to 2011 and 2012 opex.

This is different to the AER's draft decision. If the AER had used Multinet's actual opex in 2011 to forecast opex for the 2013-17 access arrangement period (as it did in the draft decision) the AER would not have accepted Multinet's calculation of efficiency gains or losses for 2013.[808] In its draft decision, the AER had required an opex incentive mechanism that determined the opex annual efficiency gain or loss for 2013 by reference to, in part, actual and forecast values of opex in 2011 and 2012.[809] This was to prevent efficiency gains (losses) made in 2012 being carried over for six years instead of five years—five years implicitly through the opex forecasts and for a sixth year through the efficiency carryover payment in 2018. This was because where an efficiency gain is achieved in other years of the access arrangement period, this is accounted for in a lower forecast opex for the next access arrangement period (that is, the efficiency gains are passed on to consumers through reduced tariffs) if Multinet's actual costs in 2011 are used to forecast opex. While this might normally diminish the incentive to make efficiency savings, the operation of the incentive mechanism increases this incentive by allowing Multinet to retain savings for five years. However, efficiency gains (losses) made in 2012 are not factored into the forecast opex for the next access arrangement period because they are not known at the time. Multinet could therefore have retained any efficiency savings achieved in the last year of the access arrangement period for the five years of the following access arrangement period through the higher opex allowance.[810]

In its revised proposal, Multinet also questioned the equation for calculating the deemed actual opex for 2017 in clause 5. Clause 5 deems actual opex for 2017 to be the amount that would yield an efficiency gain of zero. Since actual opex for 2017 will be unknown when forecast opex for the 2018–22 access arrangement period is determined, those forecasts will not incorporate efficiency gains made in 2017. Thus clause 5 ensures Multinet would retain efficiency gains made in 2017 for five years, the same as for the first four years of the access arrangement period. However, unlike other years, the efficiency gain (loss) in 2017 is retained in the opex forecast rather than through a carryover payment. Consequently, the AER considers the equation in clause five will encourage

807 Multinet, *Revised access arrangement information*, 9 November 2012, p. 189.

808 The AER's draft decision removed the incremental efficiency gain (loss) made in 2012 from the calculation of the efficiency gain (loss) for 2013, thus ensuring any efficiency gain (loss) made in 2012 was carried over for five years only.

809 Clause 3 of the AER's required incentive mechanism in its draft decision.

810 This is recognised in clause 6.4(b) of Multinet's proposed incentive mechanism.

efficiency in the provision of services by Multinet[811] and will provide more effective incentives in order to promote economic efficiency with respect to those services.[812]

Clause 5 is consistent with the intention of the scheme as proposed by Multinet. Clause 6.4(b) of its proposed scheme provides that the scheme should provide the same reward for efficiency gains made in the last year as if actual expenditure for that year was known.[813] The reward is the amount from retaining an efficiency gain for five years after the year in which the gain was achieved.[814]

Opex forecasts for calculating efficiency carryovers for the 2013–17 access arrangement period

The AER does not accept Multinet's non-inclusion of the table of forecast opex amounts.

Revision 7.3 of the AER's draft decision required Multinet to include a table in its access arrangement specifying the forecast opex amounts to be used in calculating efficiency gains (losses). Clause 11 of the incentive mechanism required by the AER's draft decision stated the opex forecasts in this table be used as the basis for measuring efficiencies under the scheme. The purpose of this revision was to remove any potential uncertainty as to which values should be used when efficiency gains (losses) are calculated at the end of the access arrangement period.

Multinet did not include this table in its revised proposal.

The AER considers clarifying the values to be used to calculate efficiency gains will encourage efficiency in the provision of services by Multinet[815] and will provide more effective incentives in order to promote economic efficiency with respect to those services.[816]

Forecast opex adjustments for calculating efficiency carryovers for the 2013–17 access arrangement period

The AER does not accept Multinet's inclusion of certain costs in the operation of the efficiency carryover mechanism.

Clause 10 of the opex incentive mechanism in the AER's draft decision requires the following costs be excluded from the operation of the efficiency carryover mechanism:

1. costs associated with complying with any retailer of last resort requirements
2. amounts for approved Cost Pass Through Events
3. unaccounted for gas expenses
4. licence fees
5. movements in provisions
6. debt raising costs

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811 NGR, r. 98(1).
812 NGR, r. 98(3); NGL, s. 24(3).
813 Multinet, *Revised access arrangement proposal: Part B –Reference tariffs and reference tariff policy*, 9 November 2012, clause 6.4(b).
814 Multinet, *Revised access arrangement proposal: Part B –Reference tariffs and reference tariff policy*, 9 November 2012, clauses 6.4(b),6.4(a)(1)(B)
815 NGR, r. 98(1).
816 NGR, r. 98(3); NGL, s. 24(3).

7. any other activity that Multinet and the Regulator agree to exclude from the operation of the efficiency carryover mechanism.

Multinet did not address this issue in its revised proposal. However, in response to an information request, Multinet stated it agreed 'the costs in clause 10 should be excluded from the carry-over mechanism'.[817]

The AER considers that in order for the opex incentive mechanism to provide effective incentives, the actual opex used to calculated efficiency gains (losses) should be based on the same costs included in the opex forecast. If this approach is not taken the service provider may benefit from (or incur) efficiency gains (or losses) under the incentive mechanism which do not reflect true efficiency gains (or losses), given the costs upon which such gains (or losses) are determined do not reflect the opex forecast which forms the relevant benchmark.

The first five excluded costs listed above are not included in the opex forecast and therefore should be excluded from actual opex also. Debt raising costs are included but are forecast based on a benchmark firm rather than Multinet's actual costs. Consequently, Multinet retains all efficiency gains (losses) made for debt raising costs even without the incentive mechanism. If it were to also receive carryover rewards (penalties) under the incentive mechanism, the reward (penalty) for reducing (increasing) debt raising costs would be greater than the efficiency gain (loss). Thus applying the mechanism as well would not encourage efficiency in the provision of services by Multinet,[818] nor would it provide more effective incentives in order to promote economic efficiency with respect to those services.[819]

The AER considers that clause 11 is necessary because it allows forecast opex to be adjusted to take account of any change in the scale of the activities which form the basis of the determination of the original benchmarks. Clause 6.6(b)(1)(B) of Multinet's proposed incentive mechanism included an adjustment to allow for changes in scale.[820] However, the adjustment method proposed by Multinet is not consistent with the method used to forecast opex. The opex benchmarks should be adjusted consistent with the way in which the benchmark was determined. This ensures the benchmark opex used to calculate efficiency will be the same as it would have been had the actual changes in scale been known.

Changes in classification of costs

The AER does not accept Multinet's non-inclusion of an adjustment for capitalisation policy changes.

Clause 12 requires that if Multinet changes its approach to classifying costs as either capex or opex during the access arrangement period, then it must adjust forecast opex so that the forecast expenditures are consistent with the capitalisation policy changes.

Multinet did not address this issue in its revised proposal. However, in response to an information request, Multinet agreed the carry-over calculation should be adjusted to account for changes to its capitalisation policy.[821]

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817 Multinet, Response to AER information request FD20a, 1 February 2013.
818 NGR, r. 98(1).
819 NGR, r. 98(3); NGL, s. 24(3).
820 Multinet, *Revised access arrangement proposal: Part B –Reference tariffs and reference tariff policy*, 9 November 2012.
821 Multinet, Response to AER information request FD20a, 1 February 2013.

The AER considers that if forecast opex is not adjusted for capitalisation policy changes, then Multinet would be provided an incentive to capitalise expenses previously recognised as opex. If it did so, Multinet could receive a positive carryover for 'reducing' opex by reclassifying it as capex, without improving efficiency. Consequently the AER considers the opex forecast used to calculate efficiency gains under the incentive mechanism should be adjusted for capitalisation policy changes to encourage efficiency in the provision of services by Multinet[822] and to provide more effective incentives in order to promote economic efficiency with respect to those services.[823]

Symmetry

The AER considers it important that both positive and negative carryovers accrued under the opex incentive mechanism are applied for the scheme to encourage efficiency in the provision of services by Multinet[824] and to provide effective incentives in order to promote economic efficiency with respect to those services.[825]

Multinet did not adopt the revisions in the AER's draft decision requiring both positive and negative carryover amounts to be applied under the incentive mechanism. It did not provide any reasons for this in its revised proposal.

However, in response to an information request, Multinet stated:[826]

> The current mechanism established for over 15 years has operated in a way that provides strong incentives for businesses and does not require amendments to reflect clauses 7 and 9. An overall negative carry-over would set revenue benchmarks below the costs required to operate an efficient business and is therefore inconsistent with the Rules.

The AER disagrees that the current mechanism has provided strong incentives, particularly in the current access arrangement period. As discussed in the AER's draft decision, Multinet's opex increased in the last two years of the 2008–2012 access arrangement period.[827] This is not consistent with a firm facing strong incentives to minimise opex. It is consistent with the incentives that prevail with an efficiency carryover mechanism that does not apply negative carryovers. That is, in the absence of negative carryovers, Multinet had an incentive to increase opex in the base year to increase opex forecasts in the following access arrangement period.

Further, negative carryovers are not inconsistent with the NGR which explicitly allows for decrements to carryover efficiency losses from one access arrangement period to the next.[828]

Moreover, with reference to the revenue and pricing principles, Multinet will be provided a reasonable opportunity to recover at least its efficient costs since it will only incur a negative carryover if it makes efficiency losses. Given benchmark opex must meet the opex criteria it is reasonable to assume an efficient firm would not accrue a negative carryover. The mechanism also allows any other activity that Multinet and the Regulator agree to be excluded from the operation of the incentive mechanism.

822 NGR, r. 98(1).
823 NGR, r. 98(3); NGL, s. 24(3).
824 NGR, r. 98(1).
825 NGR, r. 98(3); NGL, s. 24(3).
826 Multinet, Response to AER information request FD20a, 1 February 2013.
827 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2—Attachments, September 2012, pp. 135–137.
828 NGR, r.98(2).

Given this, the AER is satisfied Multinet will be provided a reasonable opportunity to recover at least its efficient costs.[829]

Applying only positive carryovers would not provide effective incentives to promote economic efficiency. If negative efficiency carryovers were not applied, then Multinet would have an incentive to increase opex in the base year (2016) for the next access arrangement period. The benefits associated with the increased opex forecast for the following access arrangement period would outweigh the cost of the increased expenditure. For this reason, the opex incentive mechanism required by the AER's draft decision required both positive and negative carryovers be applied. For example, clause 7 of the incentive mechanism provides:

> The annual efficiency gain or loss will be added to Multinet's Total Revenue for five years after the year in which the efficiency gain (or loss) was achieved.

Similarly, clause 9 provides:

> Increments or decrements from the summation of annual efficiency gains or losses calculated in accordance with the approved incentive mechanism in the Access Arrangement Period will give rise to an additional 'building block' in the calculation of the Total Revenue amounts.

To ensure clarity as to the ability to apply a negative carryover under the opex incentive mechanism, the AER considers that proposed fixed principle at clause 7.2(f) should be removed from Multinet's access arrangement.

Multinet retained fixed principle clause 7.2(f) in its revised proposal. Clause 7.2(f) provides:

> To the extent that the application of clause 6.4 results in a positive efficiency carryover at the end of the Fourth Access Arrangement Period, the reward earned in the Fourth Access Arrangement Period is to be added to the Total Revenue and carried forward into the Fifth Access Arrangement Period, until it has been retained by the Service Provider for a period of a full five years, in accordance with clause 6.4.

Although this clause would not preclude the application of negative efficiency carryovers, the AER considers this clause is not required because clause nine of the incentive mechanism proposed by the AER in this final decision clearly states increments (or decrements) arising from the application of the opex incentive mechanism will result in an additional 'building block' in the calculation of the total revenue amount.

The AER asked Multinet whether it considered proposed clause 7.2(f) was necessary if the mechanism included a clause requiring increments (or decrements) arising from the application of the mechanism to result in an additional 'building block'.[830] Multinet stated it did not advocate the introduction of such a clause and therefore had no comment in relation to clause 7.2(f).[831] The AER proposes to remove clause 7.2(f).

Capex incentive mechanism

The AER accepts that Multinet's revised proposal does not include a capex incentive mechanism.

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829 NGL, cl. 24(2).
830 AER, AER information request FD20a, 25 January 2013.
831 Multinet, Response to AER information request FD20a, 1 February 2013.

In its revised proposal, Multinet did not include a capex incentive mechanism. This reflected the AER's draft decision which did not approve Multinet's mechanism as submitted in its initial proposal.[832]

The Victorian Minister for Energy and Resources subsequently noted the concerns raised by AER in its draft decision with the incentive arrangements that applied to capex previously. Given these concerns, the Minister considered a capex incentive mechanism should not be included in an access arrangement until the AER's review of expenditure incentives is completed and the guidelines released.[833] This work will be completed by the end of 2013. The AER notes its assessment is based on the current NGR and the information before it. The forthcoming review has not been a factor in its consideration of whether to apply a capex incentive mechanism or not in this final decision

8.5 Revisions

The AER proposes the following revisions to make the access arrangement acceptable:

Revision 8.1: deletion of clause 6.4 of Part B of Multinet's access arrangement and replacing it with the opex incentive mechanism set out below.

Revision 8.2: deletion of clause 7.2(f) of Part B of Multinet's access arrangement.

Revision 8.3: amendment of the access arrangement to include Table 8.1.

Table 8.1 Forecast operating expenditure for incentive mechanism purposes ($million, 2012)

	2013	2014	2015	2016
Controllable opex	57.0	62.5	64.8	64.3

Source: AER analysis.

Opex incentive mechanism

1. The incentive mechanism should only apply to operating expenditure.
2. The incentive mechanism provides Multinet a continuous incentive to find operating expenditure efficiencies through a combination of:
    - an ex ante forecast of operating expenditure in Multinet's Total Revenue
    - increments or decrements from the operation of this incentive mechanism that allow Multinet to retain efficiency gains or losses for five years.
3. The operating expenditure annual efficiency gain (or loss) for 2013 will be calculated as:

$$E_{2013} = (F_{2013} - A_{2013})$$

where:

[832] AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, Part 2—Attachments, September 2012, pp. 183–184.

[833] Hon. Michael Obrian MP, Minister for Energy and Resources, Victorian gas access arrangement review—Victorian Government submission, 14 January 2013, p. 5.

E_{2013} is the efficiency gain in 2013

F_{2013} is the forecast opex for 2013

A_{2013} is the actual opex for 2013

4. The operating expenditure annual efficiency gain (or loss) for 2014 to 2017 will be calculated as:

   $E_i = (F_i – A_i) – (F_{i–1} – A_{i–1})$

   where:

   E_i is the efficiency gain in year i of the access arrangement period

   F_i is the forecast opex in year i of the access arrangement period

   A_i is the actual opex in year i of the access arrangement period

   F_{i-1} is the forecast opex in year i–1 of the access arrangement period

   A_{i-1} is the forecast opex in year i–1 of the access arrangement period

5. Deemed actual opex for 2017 is to be calculated using the following equation:

   $A_{2017}{*} = A_{2016} + F_{2017} – F_{2016}$

   where:

   $A_{2017}{*}$ is the actual opex deemed for 2017

   F_{2017} is the forecast opex for 2017

   F_{2016} is the forecast opex for 2016

   A_{2016} is the actual opex for 2016

6. For the avoidance of doubt, the operating expenditure annual efficiency gain (or loss) for 2017 will be assumed to equal zero.

7. The annual efficiency gain or loss will be added to Multinet's Total Revenue for five years after the year in which the efficiency gain (or loss) was achieved. If necessary, the annual efficiency gain or loss will be carried forward into the access arrangement period commencing 1 January 2018 until it has been retained by Multinet for a period of five years.

8. To ensure efficiency gains or losses made in 2017 are retained for five years, opex for the access arrangement period commencing in 2018 should be forecast in a manner consistent with the deemed actual opex for 2017, $A_{2017}{*}$, in clause 5. This provides Multinet the same reward had the expenditure level in 2017 been known.

9. Increments or decrements from the summation of annual efficiency gains or losses calculated in accordance with the approved incentive mechanism in the Access Arrangement Period will give rise to an additional ‘building block’ in the calculation of the Total Revenue amounts.

10. The following costs will be excluded from the operation of the efficiency carryover mechanism:

a. costs associated with complying with any retailer of last resort requirements

b. amounts for approved Cost Pass Through Events

c. unaccounted for gas expenses

d. licence fees

e. debt raising costs

f. movements in provisions

g. any other activity that Multinet and the Regulator agree to exclude from the operation of the efficiency carryover mechanism.

11. For the avoidance of doubt, the forecast expenditure amounts that are used as the basis for measuring efficiencies are equal to the forecast operating cost for that year as shown in Table X.X[834] in Multinet's Access Arrangement Information, with the following exception:

    a. costs listed in clause 10

    b. the carryover of cost-related efficiency gains will be calculated in a manner that takes account of any change in the scale of the activities which form the basis of the determination of the original benchmarks. The opex benchmarks will be adjusted consistent with the way in which the benchmark was determined.

12. Where Multinet changes its approach to classifying costs as either capex or opex during the access arrangement period, Multinet will adjust the forecast opex in table X.X[835] in Multinet's Access Arrangement Information so that the forecast expenditures are consistent with the capitalisation policy changes.

13. If there is a change in Multinet’s approach to classifying costs as either capex or opex, Multinet must provide to the AER a detailed description of the change and a calculation of its impact on forecast and actual opex.

834 This should refer to the table in Multinet's Access arrangement 2013–2017 that replicates Table 8.1.
835 This should refer to the table in Multinet's Access arrangement 2013–2017 that replicates Table 8.1.

9 Corporate income tax

When determining the total revenue for Multinet, the AER must estimate Multinet's cost of corporate income tax.[836] Multinet has adopted the post-tax framework to derive its revenue requirement for the 2013–17 access arrangement period.[837] Under the post-tax framework, a separate corporate income tax allowance is calculated as part of the building blocks assessment.

9.1 Final decision

The AER does not approve Multinet's forecast corporate income tax allowance of $40.5 million ($nominal)[838] for the 2013–17 access arrangement period. This is because the AER's adjustments to other building block components have had a consequential effect on the forecast corporate income tax allowance. These are discussed in other attachments and include:

- forecast capex (attachment 4)
- forecast opex (attachment 7).

These adjustments result in an estimated cost of corporate income tax allowance of $26.3 million ($nominal) as shown in table 9.1. This represents a reduction of $14.2 million ($nominal) or 35.1 per cent of Multinet's revised proposed corporate income tax allowance. Based on the approach to modelling the cash flows in the post-tax revenue model (PTRM), the AER has derived an effective tax rate of 30.1 per cent for this final decision.

The AER does not approve Multinet's revised proposed opening tax asset base as at 1 January 2013 of $369.9 million ($nominal). The AER's final decision on the opening tax asset base as at 1 January 2013 is $343.7 million ($nominal). This is due to the AER's adjustment for 2012 tax additions.

The AER accepts Multinet's tax depreciation approaches to group 7 tax assets and standard tax asset lives for group 7 tax assets. The group 7 tax assets relate to forecast capex for the 2013–17 access arrangement period. In its draft decision, the AER accepted most of Multinet's proposed tax depreciation approaches and standard tax asset lives for group 7 tax assets (except for the 'Land & buildings' asset class).[839] Due to land being a non-depreciating asset, the AER split the 'Land & buildings' asset class into separate asset classes. The AER assigned a standard tax asset life of 40 years to the 'Buildings' asset class and did not assign a standard tax asset life to the 'Land' asset class. Multinet's revised proposal adopted all of these draft decision adjustments.[840]

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836 NGR, r. 76(c).
837 Multinet, *Revised Proposal – Post Tax Revenue Model (PTRM)*, November 2012.
838 All dollar amounts are in nominal dollar terms in this attachment because corporate income tax is an output of the post-tax revenue model (PTRM). The output of the PTRM such as tax allowance and regulatory depreciation are expressed in nominal dollar terms, whereas the inputs of the PTRM such as forecast opex and capex are expressed in real dollar terms.
839 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 192-193.
840 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.

Table 9.1 AER's final decision on corporate income tax allowance for Multinet ($million, nominal)

	2013	2014	2015	2016	2017	Total
Tax payable	6.3	5.9	6.4	7.4	9.1	35.0
Less: value of imputation credits	1.6	1.5	1.6	1.9	2.3	8.8
Net corporate income tax allowance	4.7	4.4	4.8	5.6	6.8	26.3

Source: AER analysis.

9.2 Revised proposal

In its revised proposal, Multinet proposed a total corporate income tax allowance for the 2013–17 access arrangement period of $40.5 million ($nominal) as set out in Table 9.2.

The AER in its draft decision accepted Multinet's approach to using a combination of the ESC’s tax asset base roll forward model and the AER’s PTRM to calculate the corporate income tax allowance for the 2013–17 access arrangement period.[841] In estimating its revised proposed corporate income tax allowance, Multinet used:[842]

- an opening tax asset base of $369.9 million ($nominal) as at 1 January 2013
- an expected statutory income tax rate of 30 per cent per year
- a value for the assumed utilisation of imputation credits (gamma) of 0.25
- the standard tax asset lives and tax depreciation approaches set out in the AER's draft decision.

Table 9.2 Multinet's revised proposed corporate income tax allowance ($million, nominal)

	2013	2014	2015	2016	2017	Total
Tax payable	10.0	9.4	10.1	11.4	13.1	54.0
Less: value of imputation credits	2.5	2.3	2.5	2.8	3.3	13.5
Net corporate income tax allowance	7.5	7.0	7.6	8.5	9.8	40.5

Source: Multinet, *Revised proposal PTRM*, November 2012.
Note: Total may not add up due to rounding.

9.3 Assessment approach

The AER's assessment approach for the corporate income tax allowance is set out in its draft decision. See section 8.3, attachment 8 of the draft decision for a detailed explanation of the assessment approach.

841 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 185.

842 Multinet, *Revised Proposal PTRM*, November 2012.

There were no submissions that commented on Multinet's corporate income tax allowance.

9.4 Reasons for decision

The AER's final decision on Multinet's forecast corporate income tax allowance for the 2013–17 access arrangement period is $26.3 million ($nominal). This represents a reduction of $14.2 million ($nominal) or 35.1 per cent of Multinet's revised proposed corporate income tax allowance.

The AER does not accept Multinet's revised 2012 tax additions based on its 2012 capex estimate, and consequently does not approve the revised proposed opening tax asset base of $369.9 million ($nominal) as at 1 January 2013. The AER's final decision on the opening tax asset base as at 1 January 2013 is $343.8 million ($nominal).

The AER accepts Multinet's revised proposed tax depreciation approaches to groups 1–7 tax assets and the standard tax asset lives for group 7 tax assets.[843]

In this final decision, the AER has adjusted other building block components that impact on forecast revenues. These adjustments will consequently affect the forecast corporate income tax allowance.

9.4.1 Opening tax asset base as at 1 January 2013

The AER does not approve Multinet's revised proposed opening tax asset base of $369.9 million ($nominal) as at 1 January 2013. The AER's final decision on the opening tax asset base as at 1 January 2013 is $343.7 million ($nominal).

In the draft decision, the AER accepted Multinet's proposed method for establishing the opening tax asset base as at 1 January 2013.[844] However, the AER made a number of adjustments to the opening tax asset base, including proposed tax additions for 2007–12, and corrected some minor errors. Multinet's revised proposal adopted these draft decision adjustments, except for the adjustment to the 2012 tax additions.[845] In its revised proposal, Multinet's roll forward of the capital base used an estimate of 2012 capex instead of the Essential Services Commission's (ESC) benchmark for 2012 capex. Multinet updated its tax additions for 2012 in tax asset base roll forward to be consistent with the revised 2012 capex. However, consistent with the AER's final decision on the capital base roll forward (attachment 3), the AER does not accept this revised estimate of 2012 tax additions for rolling forward the tax asset base. The AER's roll forward of the tax asset base uses the 2012 benchmark capex as tax additions.

The AER's final decision on Multinet's tax asset base roll forward for the 2008–12 access arrangement period is set out in Table 9.3.

[843] Group 7 tax assets relate to forecast capex for the 2013–17 access arrangement period. Groups 1–6 relate to capex from previous periods.

[844] AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, pp. 189-191.

[845] Multinet, *Revised Proposal – Roll Forward Model (RFM)*, November 2012.

Table 9.3 AER's final decision on Multinet's tax asset base roll forward for the 2008–12 access arrangement period ($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	47.6
Less: tax depreciation	33.8	33.28	33.5	36.58	39.3
Closing tax asset base	301.7	304.8	309.6	335.4	343.7

Source: AER analysis.

9.4.2 Tax depreciation approaches

The AER accepts Multinet's revised proposed tax depreciation approaches to groups 1–7 tax assets. These revised proposed tax depreciation approaches reflect the revisions proposed by the AER in its draft decision.[846]

In its draft decision, the AER accepted Multinet's proposed tax depreciation approaches to groups 1–6 tax assets.[847] These approaches are consistent with the ESC's decision for the 2008–12 access arrangement period.[848] The AER also accepted most of Multinet's proposed tax depreciation approaches to group 7 tax assets for the 2013–17 access arrangement period (except for the proposed 'Land & buildings' asset class). The AER considered land is a non-depreciating asset under the Australian taxation law. On the other hand, the AER considered that new tax additions (capex) for the 'Buildings' asset class should be depreciated using the straight-line method. Therefore, the AER split the 'Land & buildings' asset class into two separate asset classes and applied different tax depreciation approaches.[849]

Multinet's revised proposal adopted all of these adjustments.[850]

The AER's final decision on Multinet's tax depreciation approaches to group 7 tax assets is set out in Table 9.4.

846 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.
847 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 192.
848 ESC, *Multinet GAAR 2008 revenue model further final decision*, 2008.
849 For modelling purposes, the AER used a term of 'n/a' as the tax depreciation method for the 'Land' asset class to apply from 2013.
850 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.

Table 9.4 AER's final decision on Multinet's tax depreciation approaches to group 7 tax assets

Group 7 tax asset class	Tax depreciation approach (2013–17 tax additions)
Mains and services	Declining balance
Meters domestic	Declining balance
Meters industrial & commercial	Declining balance
Land	n/a
Buildings	Straight line
Other assets	Declining balance
Repairs	Fully deductible

Source: AER analysis.
Note: 'n/a' is not applicable.

9.4.3 Standard tax asset lives

The AER accepts Multinet's revised proposed standard tax asset lives for group 7 tax assets. These revised proposed standard tax asset lives reflect the revisions proposed by the AER in its draft decision.[851]

The AER in its draft decision accepted most of Multinet's proposed standard tax asset lives for group 7 tax assets (except for the 'Land & buildings' asset class).[852] The AER considered that these proposed standard tax asset lives are consistent with Tax Ruling 2012/2[853] and the ESC's approved standard tax asset lives in earlier access arrangement periods. However, as a result of the AER's draft decision to split the 'Land & buildings' asset class into two separate asset classes to apply from 1 January 2013, the AER assigned a standard tax asset life of 40 years to the 'Buildings' asset class. The AER did not assign a standard tax asset life for the 'Land' asset class.[854]

Multinet's revised proposal adopted all the standard tax asset lives for group 7 tax assets as set out in the draft decision.[855]

The AER's final decision on Multinet's standard tax asset lives for group 7 tax assets for the 2013–17 access arrangement period is set out in Table 9.5.

851 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.
852 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, pp. 192-193.
853 Australian Taxation Office, *Tax Ruling 2012/2- Income tax: effective life of depreciating assets*, 1 July 2012.
854 Because land is a non-depreciating asset, for modelling purposes, the AER used a term of 'n/a' as the standard tax asset life input for the 'Land' asset class to apply from 2013.
855 Multinet, *Revised proposal and response to draft decision*, November 2012, p. 123.

Table 9.5 AER's final decision on Multinet's standard tax asset lives for group 7 tax assets

Group 7 tax asset class	Standard tax asset lives
Mains and services	20
Meters domestic	4
Meters industrial & commercial	15
Land	n/a
Buildings	40
Other assets	10
Repairs	Fully deductible [a]

Source: AER analysis.
(a) 'Repairs' is a deduction under s. 25-10 of the ITAA. For modelling purposes, the tax depreciation rate used to depreciate expenditure associated with repairs is 100 per cent.
n/a Not applicable.

9.4.4 Remaining tax asset life

Multinet did not propose any remaining tax asset lives in its original proposal as a result of the approach it took to calculating tax depreciation. The AER in its draft decision accepted that remaining tax asset lives were not necessary for calculating Multinet's tax depreciation.[856] The AER noted that Multinet's assets have been depreciated under separate tax groups reflecting the different historical tax depreciation approaches that have been applied.

9.5 Utilisation of imputation credits (gamma)

Consistent with its draft decision, the AER accepts Multinet's proposed value for the utilisation of imputation credits (gamma) for this final decision.

In the draft decision, the AER accepted Multinet's proposal to adopt the value of 0.25 for gamma.[857] As part of the post-tax nominal framework, the value of gamma must be applied to calculate the net corporate income tax allowance.

9.6 Revisions

The AER proposes the following revisions to make the revised access arrangement proposal acceptable:

Revision 9.1: Make all necessary amendments to reflect the AER's final decision on the proposed corporate income tax allowance for the 2013–17 access arrangement period, as set out in table 9.1.

Revision 9.2: Make all necessary amendments to reflect the AER's final decision on the opening tax asset base as at 1 January 2013, as set out in Table 9.3.

856 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 194.

857 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 194.

10 Demand

This attachment sets out the AER's assessment of the demand forecasts proposed by Multinet for the 2013–17 access arrangement period. Demand is an important input into the derivation of Multinet's reference tariffs. It also affects opex and capex linked to network growth.

10.1 Final decision

The AER accepts the demand forecasts proposed by Multinet for the 2013–17 access arrangement period for the reasons set out in its draft decision. The AER considers that the proposed demand forecasts are arrived at on a reasonable basis and represent the best forecasts possible in the circumstances.[858]

In its draft decision, the AER accepted Multinet's proposed demand forecasts.[859] The reasons for the AER decision are set out in Attachment 9 of the draft decision. In its revised proposal, Multinet adopted the AER's draft decision. The AER did not receive submissions on Multinet's proposed demand forecasts. Table 10.1 to Table 10.3 sets out the AER's final decision.

Table 10.1 AER final decision on Multinet's demand forecasts tariff V (2013–17)

	2013	2014	2015	2016	2017
Residential tariff V					
Customer numbers	665 666	671 349	676 996	682 434	687 629
Demand (TJ)	39 074	38 753	38 592	38 519	38 446
Non–residential tariff V					
Customer numbers	16 478	16 381	16 298	16 291	16 296
Demand (TJ)	5 564	5 515	5 487	5 472	5 457

Source: Multinet's revised PTRM

[858] NGR, r. 74(2).
[859] AER, Access arrangement draft decision, Multinet (DB No.1) Pty Ltd, Multinet (DB No.2) Pty Ltd, 2013 –17, Part 2, September 2012, pp.195–202.

Table 10.2 AER final decision on Multinet's demand forecasts tariff D (2013–17)

	2013	2014	2015	2016	2017
Tariff D					
Customer numbers*	264	260	258	256	255
Demand - MHQ (GJ)**	3 441	3 386	3 343	3 310	3 279

Source: *Multinet RIN; ** Multinet's revised PTRM

Table 10.3 AER final decision on Multinet's demand forecasts tariff L (2013–17)

	2013	2014	2015	2016	2017
Tariff L					
Customer numbers*	28	34	41	47	54
Demand (TJ)**	192	236	276	317	359

Source: *Multinet RIN; ** Multinet's revised PTRM

11 Tariff setting

This attachment outlines the AER’s assessment of the reference tariffs proposed by Multinet against the requirements of the NGR, specifically rr. 93 and 94. The AER's assessment takes into account the revenue and pricing principles, including ss. 24(2) and 24(5) of the NGL, and the NGO.

11.1 Final decision

The AER does not accept the reference tariffs proposed by Multinet for the 2013–17 access arrangement period. Consistent with r 93, the revenue and pricing principles and the NGO, the AER considers that Multinet must amend the quantum (level) of the proposed reference tariffs to reflect the forecast total revenue approved in this final decision. The AER's final decision on Multinet's revised forecast total revenue is set out in chapter 2 of this final decision (Part 1).

The AER accepts that the proposed structure of Multinet reference tariffs complies with the requirements under rr. 93 and 94 of the NGR.[860]

The reasons for the AER's decision are set out in detail below.

11.2 Revised proposal

Multinet adopted the AER's draft decision in relation to the structure of its proposed reference tariffs.[861] However, Multinet did not adopt the AER's draft decision in relation to the level of its proposed reference tariffs. This is because Multinet did not accept other elements of the AER's draft decision, such as on opex, capex and the rate of return.

11.3 Assessment approach

The AER's approach to assessing Multinet's proposed reference tariffs is set out in Attachment 10 of the AER's draft decision.[862]

The AER did not receive submissions on Multinet's revised reference tariffs.

11.4 Reasons for decision

The AER does not approve the reference tariffs proposed by Multinet for the 2013–17 access arrangement period. Consistent with r 93, the revenue and pricing principles and the NGO, the AER considers that the quantum of the proposed reference tariffs must reflect the forecast total revenue approved in this final decision.

In its draft decision, the AER determined that the structure of Multinet's proposed reference tariffs complies with the requirements of the NGR. However, the AER required Multinet to amend the level of its proposed reference tariffs to reflect the AER's draft decision on forecast total revenue.[863]

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[860] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, pp.203–212.

[861] Multinet, Gas access arrangement review - January to December 2012: Revised proposal and response to draft decision, 9 November 2012, p.186.

[862] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, pp.205–207.

[863] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p.203.

Multinet, instead, revised its proposed reference tariffs in line with the forecast total revenue in its revised access arrangement.[864]

In this final decision, the AER does not approve Multinet's revised forecast total revenue (see chapter 2 (Part 1) of this final decision).

Multinet stated that its revised access arrangement implements the structure of reference tariffs as approved in the AER's draft decision.[865] The AER has reviewed Multinet's application of the revised reference tariffs and is satisfied that the structure of the revised reference tariffs complies with the requirements of the NGR as set out in Attachment 10 of the draft decision.[866]

11.5 Revisions

The AER proposes the following revisions to make the revised access arrangement proposal acceptable:

Revision 11.1: All necessary amendments to reference tariffs to reflect the AER's final decision on forecast total revenue as set out in the revisions section of Attachment 12 of this final decision.

[864] Multinet, Gas access arrangement review - January to December 2012: Revised proposal and response to draft decision, 9 November 2012, p.186.

[865] Multinet, Gas access arrangement review - January to December 2012: Revised proposal and response to draft decision, 9 November 2012, p.186.

[866] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, pp.203–212.

12 Tariff variation mechanism

This attachment sets out the AER's consideration of Multinet's proposed reference tariff variation mechanism. The reference tariff variation mechanism:

- permits building block revenues to be recovered smoothly over the access arrangement period, subject to any differences between forecast and actual demand
- accounts for actual inflation
- accommodates other tariff adjustments that may be required, such as for an approved cost pass through event
- sets administrative procedures for the approval of any proposed changes to tariffs.

12.1 Final decision

The AER does not approve the tariff variation mechanism proposed by Multinet for the 2013–17 access arrangement period. The AER considers that some elements of Multinet's proposed tariff variation mechanism are not consistent with the NGL and the NGR or that there are preferable alternatives to some elements of Multinet's proposal. In particular, the AER considers that the following elements must be amended as set out in section 12.5 of this attachment:

- the initial reference tariffs
- the proposed x factors
- the annual tariff variation formula for ancillary reference services
- the UAFG tariff and true up mechanism are not approved and the AER proposes to delete them
- the Financial Failure of a Retailer event is not approved and the AER proposes to delete it
- the AER proposes amendments to the following cost pass through event definitions to make Multinet's access arrangement acceptable
    - Change in Taxes Event
    - Mains Replacement Event
    - Insurance Cap Event
    - Disaster Event
- the process for approving cost pass through applications must be amended to achieve a consistent approach to cost pass through events and assessment of pass through applications
- timeframes for notifying the AER in respect of any variation of reference tariffs.

The reasons for the AER's decision are discussed in detail below.

12.2 Revised proposal

In its revised proposal, Multinet adopted some elements of the AER's draft decision. These elements included the following: a reduction of the rebalancing constraint from five to two per cent; the inclusion of several pass through events (terrorism, natural disaster, NECF, and low pressure mains replacement); an amendment to the insurance cap event; and an adjustment formula for ancillary reference services.[867]

Multinet did not adopt other elements of the AER's proposed revisions. Instead, Multinet: [868]

- revised its initial reference tariffs in line with its revised access arrangement proposal rather than the AER's draft decision
- revised the x factors in line with its revised access arrangement proposal rather than the AER's draft decision
- maintained its financial Failure of a Retailer pass through event
- retained its carbon tariff formula with respect to the recovery of the carbon tax as initially proposed
- retained its timeframes for notifying the AER in respect of variation mechanism process as initially proposed
    - 35 business days for annual tariff variation
    - 60 business days for the cost pass through.

12.3 Assessment approach

The AER's approach to assessing Multinet's proposed tariff variation mechanism is set out in Attachment 11 of the AER's draft decision.[869]

The AER also took into account submissions received in relation to its draft decision in forming its final decision on Multinet's proposed tariff variation mechanism.[870] It has also considered information provided by SP AusNet as part of its revised proposal that is relevant to the annual tariff variation process for Multinet.[871] Where relevant, the AER's consideration of submissions is set out below in its reasons for the decision.

12.4 Reasons for decision

The AER does not approve Multinet's revised tariff variation mechanism for the 2013–2017 access arrangement period. The AER considers that some elements of Multinet's proposed tariff variation mechanism are not consistent with the NGL and the NGR or there are preferable alternatives to some elements of Multinet's proposal.[872]

This section sets out the reasons behind the AER's decision under the following headings:

- annual tariff variation mechanism
- cost pass through tariff variation mechanism

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867 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, pp.187–188.
868 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, pp.187–188.
869 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2012 – 31 December 2017*, Part 2, September 2012, pp. 216–217.
870 Origin Energy Victoria Pty Ltd, *Submission to the Victorian gas access arrangement review*, 7 January 2013.
871 NGR, r. 97(3)(d).
872 NGR, rules 92(2) and 97(3).

- procedures for oversight and approval of tariff variation.

12.4.1 Annual tariff variation mechanism

Revenue equalisation

In its draft decision, the AER determined that Multinet's proposed annual tariff variation formula complies in principle with r. 92(2) of the NGR.[873] However, the AER requested Multinet to amend the level of its proposed reference tariffs to reflect changes to forecast total revenue and demand forecasts.

Multinet did not amend its proposed level of reference tariffs in line with the AER's draft decision.[874] Rather, Multinet's revised the level of its proposed reference tariffs in line with its revised access arrangement.[875]

The AER's final decision is that Multinet's revised annual tariff variation formula complies in principle with r. 92(2) of the NGR. However, the AER considers the level of reference tariffs must be amended to reflect changes to the revised forecast total revenue as shown in section 12.5 of this Attachment. The changes to the revised forecast total revenue are outlined in chapter 2 (Part 1) of this final decision.

Annual tariff variation formula

In its draft decision, the AER accepted the structure of Multinet's proposed formula for the annual variation of reference service tariffs.[876] However, the AER did not accept some elements of that formula, particularly:[877]

- the magnitude of the rebalancing constraint
- the x factors
- other technical issues.

The rebalancing constraint

In its revised proposal, Multinet adopted the AER's draft decision on the magnitude of the rebalancing constraint.[878] Multinet revised the proposed rebalancing constraint to two per cent.[879]

Origin Energy (Origin) in its submission supported the AER's draft decision to not accept Multinet's proposal to increase the rebalancing constraint from two to five per cent over the 2013–17 access arrangement period.[880] Origin stated that changes to the rebalancing constraint can have significant

873 AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p.218.
874 Multinet, Revised proposal and response to draft decision, 9 November 2012, p.195.
875 Multinet, Revised proposal and response to draft decision, Part B – Reference Tariffs and Reference Tariff Policy, Schedule 1, 9 November 2012, pp.29–35.
876 AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p.218.
877 AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, pp.218–219.
878 Multinet, Revised proposal and response to draft decision, 9 November 2012, p.187.
879 Multinet, Revised proposal and response to draft decision, 9 November 2012, p.187.
880 Origin Energy Victoria Pty Ltd, Submission to the Victorian gas access arrangement review, 7 January 2013, p.2.

and unpredictable impacts on end prices, a risk that is faced primarily by the retailer.[881] Origin's submission is in line with the AER's reasoning set out in Attachment 11 of the draft decision.[882]

The AER's final decision is to approve Multinet's revised rebalancing constraint of two per cent over the 2013–17 access arrangement period for the reasons set out in its draft decision.

The x factors

In its revised proposal, Multinet did not adopt the AER's draft decision on x factors.[883] Specifically, Multinet amended the proposed x factors in line with its revised access arrangement, which did not accept certain elements of the AER's draft decision that impact the x factors (e.g. capex, opex and forecasts total revenue).[884] In this final decision, the AER has not accepted some of these elements of Multinet's revised access arrangement.

The AER considers that the proposed x factors must be amended in line with all changes to the revised access arrangement proposed in this final decision.

Other technical issues

In its draft decision, the AER required Multinet to correct inconsistencies in its revised access arrangement proposal in respect of the definition of some variables of the tariff variation mechanism (p_t^{ij}, p_{t-1}^{ij}, and q_{t-2}^{ij}).[885] Multinet adopted the AER's draft decision on this matter. The AER has reviewed the revised access arrangement proposal and is satisfied that Multinet rectified all the relevant inconsistencies.

Energy Safe Victoria levy

In its draft decision, the AER proposed that gas distribution businesses include an additional element in the annual tariff variation mechanism to recover the incremental amount of the Energy Safe Victoria (ESV) levy.[886] This is because during the draft decision process the ESV was consulting on a proposal to change the level of gas industry levies that it charges to the Victorian gas distribution businesses.

In its revised proposal, Multinet proposed to account for the incremental increase in the ESV levy as a step change in forecast opex.[887] The AER has confirmed the incremental amount of the levy with the ESV. The AER considers that it is reasonable to account for this increase in the ESV levy as a step change in forecast opex rather than in the annual tariff variation mechanism as indicated in the draft decision. The AER decision on forecast opex is set out in Attachment 7 of this final decision.

Control formula for ancillary services

The AER’s final decision on the 2013–17 access arrangement for the Victorian gas service providers is due to be made in March 2013. Taking r. 92(3) of the NGR into account, the AER’s draft decision

[881] Origin Energy Victoria Pty Ltd, Submission to the Victorian gas access arrangement review, 7 January 2013, p.2.
[882] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, pp.219–220.
[883] Multinet, Revised proposal and response to draft decision, Part B – Reference Tariffs and Reference Tariff Policy, Appendix 1, 9 November 2012, p.42.
[884] Multinet's revised access arrangement did not accept certain changes.
[885] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p.220.
[886] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p.220.
[887] Multinet, Revised proposal and response to draft decision, 9 November 2012, pp.56–57.

considered that the 2013 reference tariffs under the 2013–17 access arrangement should take effect from 1 July 2013 until 31 December 2013.

To account for this delay for haulage reference service tariffs, the AER, in its draft decision, made the relevant revenue adjustment via the revenue smoothing mechanism in the revenue model. However, for the 2013 ancillary reference service tariffs, the AER considered that the relevant revenue adjustment should be given effect via an additional element in the tariff adjustment formula.[888] The AER proposed that Multinet include an additional element in its revised tariff adjustment formula to make the access arrangement acceptable.

In its revised proposal, Multinet did not address this matter. The AER sought clarification.[889] In response, Multinet proposed a revised formula for the variation of ancillary services tariff, which included an additional element to account for the six month delay.[890] Multinet's revised formula is set out below.[891]

The ancillary reference tariff to apply for the six month period from 1 July 2013 is based on the following formula:

$$ART_t = ART_{t-1} + (ART_{t-1} * CPI)*2$$

The ancillary reference tariff control formula for the calendar year 2014 is:

$$ART_t = ART_{t-2} * (1+CPI_{t-1}) * (1+CPI_t)$$

The ancillary reference tariff control formula for the calendar year 2015 to 2017 is:

$$ART_t = ART_{t-1} * (1 + CPI)$$

where:

ART_t is the ancillary reference tariff that applies in calendar Year t;

ART_{t-1} is the ancillary reference tariff that applies in calendar Year t-1;

CPI_t is the CPI for calendar year t, as defined in the access arrangement.

CPI_{t-1} is the CPI for calendar year t-1, as defined in the access arrangement.

The AER has reviewed Multinet's revised formula for varying reference tariffs for ancillary reference services and it is satisfied that it correctly accounts for the six month delay.

Carbon tax tariff true up

In its access arrangement submission of March 2012, Multinet proposed to recover its carbon tax costs for the 2013–17 access arrangement period by:

888 AER's email to Multinet in response to Multinet's email to the AER of 28 August 2012 – Reference tariffs for 2013, sent on 25 September 2012.
889 AER, Information request to Multinet FD12a, 10 December 2012.
890 Multinet, Response to AER information request to Multinet FD12a of 10 December 2012, 13 December 2012.
891 Multinet, Response to AER information request to Multinet FD12a of 10 December 2012, 13 December 2012.

- including an opex allowance made up of the costs of administering the carbon tax scheme[892]
- setting a separate carbon tax tariff intended to recover its carbon tax liability costs with a true up mechanism each year.[893]

The proposed true up mechanism is in effect a reconciliation mechanism to ensure that Multinet's carbon costs are recovered with no scope for windfall gain or loss.[894] It incorporates two stages:

  - an adjustment in the regulatory year after carbon costs are incurred
  - another adjustment in the second year after carbon costs are incurred.[895]

As proposed by Multinet, the first stage of the true up would be undertaken using largely estimated carbon costs. The second stage would be undertaken using actual carbon costs. The second stage of the proposed true up would only be necessary because the first would be undertaken using estimated costs. Multinet's proposed true up mechanism accounts for the time value of money.[896]

In its draft decision:

- the AER accepted the true up concept to recover carbon costs. However, the AER did not accept the proposed two–step true up mechanism and required Multinet to amend its proposal by incorporating a single step true up mechanism.[897] The AER considered that under the carbon tax legislation, liable entities may not know their final actual carbon unit costs until up to eight months after the end of the regulatory year to which these costs relate. Due to this delay in actual data being available, the AER's single step true up mechanism would be implemented in the second regulatory year after the year in which carbon costs are incurred, thus reducing complexity.[898]
- the AER did not accept Multinet's incorporation of the time value of money in the proposed true up mechanism.[899]

In its revised proposal, Multinet did not adopt the AER's draft decision on the carbon tax tariff true up mechanism.[900] However, Multinet did not provide any reasons for rejecting the AER's draft decision on this matter. The AER sought clarification.[901] In response, Multinet submitted that the AER's draft decision does not account for the time value of money and it does not give effect to the timing.[902] Multinet further explained that there is a lag between the reporting requirement under the National Greenhouse and Energy Reporting legislation, payment and true up and the AER formulation did not allow sufficient time to account for this lag.[903]

892 Multinet, Access arrangement information, 30 March 2012, p.22.
893 Multinet, Access arrangement information, 30 March 2012, p.22 and 215.
894 Multinet, Access arrangement information, Part B – Reference Tariffs and Reference Tariff Policy, 30 March 2012, pp. 37–38.
895 Multinet, Access arrangement information, Part B – Reference Tariffs and Reference Tariff Policy, 30 March 2012, pp. 37–38.
896 Multinet, Access arrangement information, Part B – Reference Tariffs and Reference Tariff Policy, 30 March 2012, pp.37–38.
897 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2 , September 2012, p.223.
898 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2 , September 2012, p.223.
899 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2 , September 2012, pp.239–240.
900 Multinet, Revised proposal and response to draft decision, 9 November 2012, p.197.
901 AER, *Information request to Multinet FD12a*, 10 December 2012.
902 Multinet, *Response to AER information request to Multinet FD12a of 10 December 2012*, 13 December 2012.
903 Multinet, *Response to AER information request to Multinet FD12b – Follow up of 18 December 2012*, 28 December 2012.

As part of its final decision process, the AER engaged with the Victorian gas distribution businesses regarding the design and implementation of the carbon tax tariff true up mechanism given the uncertainty surrounding the clean energy legislation. The AER also considered a policy change recently announced by the Australian government. The Australian government outlined its plan to remove the carbon price floor of $15 per tonne when the carbon trading scheme starts from 2015 and to link the Australian carbon market to the European Union carbon market.[904] Initially, the government intended this price floor to apply from 2015 to 2018, fixing a lower bound to price movements over that period. The removal of the price floor is likely to result in substantial carbon price volatility in the last two years of the access arrangement period. Such volatility could translate into larger variations in the difference between forecasts carbon costs and actual costs,

Given this change in policy and the resulting uncertainty for liable entities, the AER considers that the implementation of a single–stage true up mechanism lagged by two years could result in outcomes that are not consistent with the NGO. If the difference between estimated carbon costs and actual costs is large, it implies that the true up would apply to a larger amount of money, leading to additional price volatility particularly in the last two years of the access arrangement period,

For the above reasons the AER's final decision is to approve the carbon tax tariff true up mechanism as proposed by Multinet for the 2013–17 access arrangement period.

The AER acknowledges that this approach is different from that of its final decision on carbon tax costs pass through decision for AllGas Energy and Envestra for its Queensland and South Australian distribution networks. The AER made its decision for these businesses prior to the change in the Australian government policy.

12.4.2 Costs pass through mechanism

The AER does not approve SP AusNet's revised cost pass through mechanism. The reasons for the AER's final decision are set out below.

Unaccounted for gas

In its draft decision the AER concluded that it could not set Unaccounted for Gas (UAFG) benchmarks, as proposed by Multinet.[905]

In its revised proposal, Multinet has proposed to recover its UAFG costs for the 2013–17 access arrangement period by setting a separate UAFG tariff intended to recover its UAFG costs with a true up mechanism each year.[906]

Multinet has included a formula in Part B of its access arrangement to calculate whether expected revenue for UAFG is less than or equal to the maximum UAFG revenue.[907]

Multinet submitted that a UAFG pass through event be defined to enable the recovery of all costs incurred by Multinet as a result of the operation of a UAFG scheme.[908]

1 [904] Department of Climate Change and energy Efficiency, Price floor for Australia's carbon pricing mechanism, http://www.climatechange.gov.au/government/submissions/closed-consultations/price-floor-carbon-pricing.aspx (accessed on 26 February 2013).

[905] AER, Access arrangement draft decision Multinet Gas Pty Ltd, 2013–17, Part 2 Attachments, September 2012, p. 156.

[906] Multinet, *Access arrangement information*, 30 March 2012, p. 61.

[907] Multinet, revised access arrangement proposal, Part B, p.43.

[908] Multinet, *Access arrangement information*, 30 March 2012, p. 61.

On 24 December 2012, a ministerial order made by the Victorian Minister for Energy and Resources was gazetted.[909] The ministerial order amends the Code to set UAFG benchmarks for the 2013–17 period. These benchmarks follow the existing 2012 benchmarks.

The Essential Service Commission (ESC) is currently in the process of establishing new UAFG benchmarks to apply for the 1 July 2013–17 period.[910] The AER understands that the ESC will amend the Code to reflect the benchmarks.

The AER considers that allowing a cost pass through for UAFG benchmark costs would be inconsistent with the the regulation of UAFG under the current Victorian framework. The AER therefore does not approve this proposed unaccounted for gas approach.

12.4.3 Cost pass through events

Financial failure of a retailer

This proposed event would allow Multinet to pass through any loss of revenue where a Network User is subject to an insolvency event, which is broadly defined.

The AER does not approve Multinet's proposed financial failure of a retailer event.

In its draft decision the AER did not approve Multinet's proposed financial failure of a retailer event.[911] The AER considered this event was unnecessary and did not satisfy the assessment criteria set out by the AER.[912] The AER considered that the credit support requirements set out in clause 7.8 of Part C of Multinet's access arrangement proposal provided adequate protection against the risk of a retailer failing.[913]

In its revised proposal, Multinet submitted that the existing terms of its access arrangement only allow it to require credit support in limited circumstances.[914] Multinet submitted that it is therefore not in a position to mitigate the risk it faces.

Multinet submitted that clause 7.8 of its access arrangement does not allow the provision of credit support from all retailers. It gives the example that Origin and AGL would not be required to provide credit support.[915] Multinet submitted that where a retailer is in default it is impossible for the Service Provider to cease supply to its customers, and once NECF commences the Service Provider may be further exposed.[916] Multinet contends that because it operates in a regulated market it is denied the ability to replicate competitive behaviour such as charging less reliable customers higher rates.[917]

909 http://www.gazette.vic.gov.au/gazette/Gazettes2012/GG2012S460.pdf
910 http://www.esc.vic.gov.au/Energy/Review-of-Unaccounted-for-Gas-Benchmarks/publications
911 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 226.
912 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 226.
913 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 226.
914 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 3.
915 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 3.
916 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 4.
917 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 4.

Multinet further submitted that “these credit arrangements do not provide full coverage, rather they are currently risk based, based on credit ratings...”. Multinet also submitted that this event should be allowed because it is in its current access arrangement and NECF will have this event.[918]

Multinet submitted that the design of a reference tariff variation mechanism is focused on revenue, not costs and that to ignore its exposure to retailer default would be inconsistent with s. 24(2) of the NGL.[919]

Multinet submits that it ‘understands that the AER staff’s current view is that a cost pass through mechanism cannot be provided to cover the losses that would arise from a retailer default.[920]

As a general point, the AER notes that each access arrangement decision may result in changes from previous access arrangements. Under the NGL and NGR, each decision by the AER is made following the application of the appropriate criteria and assessment of the proposal against the NGO. The AER further notes that Multinet’s 2008-12 access arrangement was made under the Gas Code.

The AER in deciding whether a particular reference tariff variation mechanism is appropriate to a particular access arrangement must have regard to the regulatory arrangements applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism.[921] The AER has therefore considered to what extent the removal of the event would impact on Multinet.

The AER considers that Multinet has scope to negotiate adequate prudential requirements for its particular circumstances. This scope is sufficient to address the risk set out by Multinet. The AER considers that the removal of this pass through event will not significantly increase the risk to Multinet. In particular, Multinet’s prudential requirements in its terms and conditions recognise that for users with a high credit rating or for users with a guarantor, no undertaking can be required. This indicates that for those users the risks to Multinet are lower. Where there is a higher risk, Multinet can utilise its prudential requirements to address that risk.

The AER must also have regard to the desirability for consistency between regulatory arrangements.[922] The AER did not approve an analogous financial failure of a retailer event in its Victorian electricity distributor decision nor did it approve a similar pass through for Envestra’s South Australian and Queensland gas businesses. In each of these decisions the AER considered that prudential obligations provided sufficient protection.[923] The AER considers that is it desirable to align Multinet’s access arrangement with the outcome in these decisions. In relation to this, the AER notes that Envestra Albury and Envestra Victoria have not proposed such an event and the AER is not approving a similar event for SP AusNet as part of this current review.

Multinet refers to the retailer insolvency event in NECF in r. 531 of Part 12 of the NGR. [924] Rule 531 is yet to take effect. Rule 531 defines a retailer insolvency event as occurring when an insolvency official has been appointed in respect of the retailer, and the distributor is not entitled to payment under the terms of any credit support.[925] When a retailer insolvency event occurs, a distributor may apply to the

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918 Multinet, email dated 5 March 2013.
919 Multinet, email dated 5 March 2013.
920 Multinet, email dated 5 March 2013.
921 NGR. 97(3)(c).
922 NGR. 97(3)(d).
923 Victorian distribution determination final decision 2011–15, p. 791; Envestra Ltd Access arrangement proposal for the SA gas network 2011–16, p.127; Ltd Access arrangement proposal for the Queensland gas network 2011–16, p.114.
924 R. 531 of National Gas (Retail Support) Amendment Rules 2012.
925 National Gas (National Energy Retail Law) Amendment Rules 2012, r. 531(4).

AER to vary one or more tariffs.[926] The distributor must propose and the AER must determine a retailer insolvency pass through amount that “reflects the increase in costs of providing reference services that the distributor has incurred or is likely to incur until the end of the applicable access arrangement period”.[927]

This insolvency event will be introduced along with other reforms that establish credit support rules.[928] The AER therefore considers that the introduction of the insolvency event is therefore part of a balanced framework made in consultation with retailers and distributors. As Envestra observed in it submission:

> Rule 515 of the NGR states that a distributor may only require a retailer to provide credit support in accordance with the credit rules. The credit support rules define the amount of credit support which Envestra can require retailers to provide. It is unlawful for Envestra to negotiate additional credit support to protect itself from loss of revenue following retailer insolvency. This is why the NGR includes rule 531, so that distributors can recover cost of lost revenue (ie bad debts) by way of a pass-through under rule 531.[929]

The AER considers that once NECF is adopted in Victoria, Parliament will have expressed its intention in relation to the management of the risk of default. NECF contains a balanced mechanism with a pass through for specified costs (r. 531). The AER considers that where Parliament has provided for a balanced mechanism, it has expressed an intention that matters beyond that mechanism should not be covered. Accordingly, the AER considers that it would be inconsistent with Parliament’s intention for a cost pass through process to go beyond what is provided for under NECF.

The AER acknowledges that these provisions will revise current prudential requirements that are in place now. However, these rules are yet to take effect. The AER considers that their expected implementation is not a basis for retaining this event in part because the credit support rules that will apply under NECF do not apply now.

In any case, the AER notes that NECF will not have this event. NECF will have a retailer insolvency event in r. 531. This is not the same as the financial failure of a retailer event proposed by Multinet. The retailer insolvency event is triggered by the failure of a retailer to pay an amount to which the service provider is entitled and provides for the pass through of increased costs. Multinet’s proposed financial failure of a retailer event provides for the pass through of revenue that it does not receive. The AER considers Multinet’s proposed event is much broader than the retailer insolvency event in r. 531.

The AER therefore considers it would not be in the interests of customers for this pass through to be included. This is because it is inconsistent with the requirement that a reference tariff variation mechanism may provide for variation of a reference tariff as a result of a cost pass through for a defined event.[930] The AER’s general view is that pass through events should be symmetric, such that users will benefit from unexpected or uncontrollable events that materially reduce the costs faced by a service provider. This was set out in the AER’s draft decision.[931] This event is not symmetric and does not provide for the return of excess revenue.

The AER notes Multinet’s comment in relation to the AER’s view of revenue and costs.[932] To clarify, the AER considers that revenue that has accrued to a distributor but remains unpaid will be

[926] R. 531(1) of National Gas (Retail Support) Amendment Rules 2012.
[927] r. 531 of National Gas (Retail Support) Amendment Rules 2012.
[928] rr. 515 and 531 of National Gas (Retail Support) Amendment Rules 2012.
[929] Envestra, email dated 5 March 2013.
[930] NGR. 97(1)(c).
[931] AER, Access arrangement draft decision, SPI Networks (Gas)Pty Ltd, 2013–17, Part 2, September 2012, p. 221.
[932] Multinet, Email dated 5 March 2013, p. 2.

accounted for as a debt. The non recovery of or writing-off of a debt is a cost to a business. To the extent that revenue has accrued and is not recovered, it will be a cost (and thus, under r 531 it is costs that will be recovered). However, revenue and costs are not the same thing. The AER considers that revenue that is not received (and has not accrued) does not amount to a cost.

Further the AER notes that Multinet's financial failure of a retailer event is not analogous to the retailer insolvency event in r. 531. "Insolvency event", as defined, covers circumstances that are considerably broader than the appointment of an insolvency official. Multinet's definition of an insolvency event covers circumstances where a party to an agreement stops or suspends the conduct of all or a substantial part of its business. The AER considers that there could be any number of reasons for a retailer to cease its retail business, including sale of the business or a decision to cease competing in gas retail. These circumstances do not involve insolvency and Multinet would most likely have a cause of action for breach of contract. To permit Multinet to pass any loss of revenue on to consumers in this circumstance would act as a disincentive to it pursuing its legal rights.

Declared retailer of last resort event

The AER approves Multinet's declared retailer of last resort event. In its draft decision the AER approved a declared retailer of last resort event.[933]

In its revised proposal Multinet has not made any amendments to the event as approved by the AER.

Following the draft decision, the AER considered amending the event so that it would cease to apply upon the commencement of NECF in Victoria. The AER sought comments on this proposal from the distributors. Following an assessment of the distributors' responses, and the relevant provisions of the NECF, namely Part 6, Division 9 and r 531, the AER considers that it is appropriate for the Declared Retailer of Last Resort Event to continue to apply following the commencement of NECF in Victoria. The AER has reached this conclusion based on the following analysis.

When a gas retailer fails, a distributor could incur costs when customers of the failed retailer are transferred to the declared retailer of last resort (RoLR). This is the circumstance dealt with by SP AusNet's proposed Declared Retailer of Last Resort Event. The AER approved an analogous event–Network User Failure Event–for Envestra's South Australian and Queensland businesses.

However, under NECF, once implemented through the National Energy Retail Law (South Australia) Act 2011 (Retail Law), it will be possible for a distributor to recover costs that it has incurred due to the occurrence of a RoLR event. Under the RoLR provisions of the Retail Law, upon application by a RoLR, the AER must make a RoLR cost recovery scheme determination (Part 6, Division 9).[934] This scheme is designed for the RoLR to recover its applicable RoLR scheme costs. As part of the RoLR cost recovery scheme determination, the AER must make a distributor payment determination that one or more distributors are to make payments towards the cost of the scheme.[935] A distributor payment determination allows the RoLR to recover its RoLR scheme costs through payments by the distributor.

933 AER, Access arrangement draft decision, Multinet, 2013–17, Part 2, September 2012, p. 222.
934 *National Energy Retail Law (South Australia) Act 2011*, s. 166.
935 *National Energy Retail Law (South Australia) Act 2011*, s. 167.

Distributors are required to make payments to a RoLR in accordance with their liability under a distributor payment determination. Under s 167(4)(b) of the Retail Law, such payments are approved cost pass throughs allowing variation of the distributor's reference tariffs.[936]

Moreover, as part of the NECF a new pass through event, a 'retailer insolvency event' is introduced under r. 531 of the National Gas (Retail Support) Amendment Rules 2010, as referred to above. This event broadly provides for the recovery of an amount "that reflects the increase in the costs of providing reference services that the distributor has incurred and is likely to incur until the end of the applicable access arrangement"[937] due to a retailer's insolvency.

It is possible that other costs a distributor incurs in relation to a RoLR event, such as preparing for or responding to the event, may not be covered by r 167 and r 531. To the extent that a distributor's RoLR costs are not recoverable under either of the above mechanisms, the AER considers such costs may be recoverable under the distributors' revenue allowances and existing cost pass through provisions, subject to the materiality threshold.[938]

The AER sought comment from Multinet on the need for the RoLR event to cease once NECF commences. Multinet responded that if the AER proposed to limit the application of the designated retailer of last resort event upon the commencement of NECF, it expected the AER's final decision to clearly state that the AER regards a RoLR event as coming within a service standard event or a regulatory change event and that the removal of the declared retailer of last resort event is simply the matter of ensuring regulatory consistency with the NERL.[939]SP AusNet made a similar submission.[940] Envestra submitted that a RoLR type event would not constitute either a service standard event or regulatory change event and for this reason it was necessary to retain such an event post-NECF.[941]

The AER notes that disconnections, reconnections and meter reading are ancillary reference services under Multinet's access arrangement. As such, the costs of transferring a customer to a RoLR would ordinarily be recovered from the RoLR. If a RoLR event occurs under the NECF provisions, these costs may possibly be recovered via the r. 167 pass through. The AER also notes that the retailer insolvency event broadly covers costs associated with the insolvency of a retailer.

However, these provisions have not yet been implemented. Given this, the AER acknowledges that there is some uncertainty.

The AER cannot conclusively determine at this stage, in the absence of a specific cost pass through application, whether a distributor's RoLR costs that are not recovered under rr 167 or 531 will be recoverable under the existing cost pass through provisions.

Taking this uncertainty into account as a relevant factor, the AER considers that it is appropriate for the Designated Retailer of Last Resort Event to continue to apply for the duration of this access arrangement including for the period following the commencement of NECF in Victoria.[942]

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936 NERL. s. 167(4)(b).
937 NGR 531(3).
938 AER, Aurora 2012–17 draft distribution determination, November 2011, p. 289.
AER, Retailer of Last Resort (RoLR) guidelines, RoLR statement of approach, July 2011, pp. 46–47.
939 Multinet, email dated 5 March 2013.
940 SP Ausnet, email dated 4 March 2013.
941 Envestra, email dated 5 March 2013.
942 NGR. 97(3)(e).

Change in taxes event

The AER does not approve Multinet's proposed definition of a change in taxes event. The AER proposes the definition set out in its draft decision in order to make Multinet's access arrangement acceptable. That definition provided for the pass through of additional costs arising from a change in taxes event.

In its revised proposal, Multinet largely adopted the AER's required definition of a change in taxes event. However, Multinet has proposed an additional factor that there is a material increase or reduction to the revenue received

Multinet submitted that it has concerns with referring to a relevant tax without defining that term. Multinet contends that just referring to "tax" raises questions about whether a particular payment is a "tax", or whether it is a "levy" or a "fee". Multinet states that it is not consistent with the NGO to leave it unable to recover costs because of uncertainties regarding definitions or semantics.[943] Notwithstanding this submission, the AER notes that Multinet's access arrangement proposal contains a definition of tax in the glossary to Part A. That definition is carried over from Multinet's previous access arrangement.

In relation to Multinet's first proposed amendment, the AER considers that the impact on revenue is not a relevant consideration and therefore does not accept Multinet's proposed additional factor. The purpose of a cost pass through mechanism is to protect Service Providers from uncontrollable events that impact on the costs to the business.[944] The rationale focuses on increased or decreased costs. The impact on revenue is not a relevant consideration for the purposes of approving a cost pass through event.

In relation to Multinet's second proposed amendment, the AER considers that a definition of tax will add clarity, avoid uncertainty and aid in interpretation. This is likely to avoid disputes and promote certainty which is in the long term interests of consumers with respect to price, an aspect of the NGO. As Multinet's access arrangement already contains a definition of tax, the AER approves that definition for the purposes of the changes in taxes event.

Insurance cap event

The insurance cap event operates to permit Multinet to pass through costs that exceed the level of coverage when an insured risk eventuates.

The AER does not approve Multinet's definition of an insurance cap event. The AER proposes a number of amendments to make Multinet's access arrangement acceptable.

Multinet submitted that it has adopted the AER's proposed definition of an insurance cap event in substance. However, Multinet states that it has made some drafting amendments to the definition.[945] Multinet has made amendments to paragraphs (a),(c) and (d) and deleted paragraph (e).

The AER proposes the definition of an Insurance Cap Event that is the same as that proposed in its draft decision, except that paragraph (a) is amended to refer to 'claims' as well as a 'claim, and the

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943 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, p. 8.

944 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 225.

945 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, p. 9.

nomenclature is amended to reflect Multinet's proposed nomenclature. In particular, as in the draft decision, the insurance cap event provides that:

- the policy limit is defined with reference to the forecast operating expenditure allowance for the 2013-17 access arrangement period, approved by the AER in its Final Decision. This is to address the risk that Multinet might under-insure by obtaining a level of insurance cover lower than that contemplated in the forecast operating expenditure allowance determined in the AER's access arrangement final decision, and then pass through any costs to consumers that exceed its insurance cap. In these circumstances, customers are effectively paying twice—for the premiums of an efficient level of insurance as reflected in the forecast operating expenditure allowance, and through the cost pass through mechanism for costs that should have otherwise been covered by that efficient level of insurance. As Multinet's base forecast operating expenditure allowance includes a component for insurance coverage, in acting efficiently and prudently in managing its risks, it is expected to take out an insurance policy that provides an efficient level of insurance coverage.

- an assessment of Multinet's decisions and actions in relation to the pass through event—including whether the event which was the subject of the relevant insurance claim was within Multinet's control—is relevant to the AER's decision whether or not to approve the Relevant Pass Through Event. For this reason, the pass through event includes an additional factor which the AER must consider when assessing whether to approve a proposed Relevant Pass Through Event. This factor would require the AER to consider the efficiency of Multinet's decisions, actions and omissions in relation to the risk of a pass through event, including whether Multinet has taken action to mitigate the risk of the pass through event occurring or the magnitude of the costs of the event. This assessment is not limited to those actions that concern the taking out of an appropriate insurance policy to cover particular risks, but also extends to the actions taken by Multinet, or not taken, to mitigate the risk of the event which is the subject of the relevant insurance claim and which has resulted in the pass through event application being made. The AER will assess the extent to which this was within Multinet's control. The AER considers that this will incentivise Multinet to take mitigating action to reduce the likelihood of the risk of an Insurance Event eventuating and the extent of costs associated with the occurrence of this pass through event. These circumstances will inform the AER's assessment of what was within the service provider's control. This is both with respect to the insurance that it obtained and the cause of the claim that led to incurring the excess above the insurance cap.

- Under the additional factor, the AER considers that its enquiry will necessarily encompass any claims or findings of negligence in the context of the specific regulatory framework which empowers the AER to make a pass through determination. Information concerning the circumstances of the event may include negligence as determined by a court of law. As part of its broad enquiry, the AER may also consider claims of negligence that have not been proved or made in a court of law. For example, there may be claims of negligence but no public admission of negligence, or a confidential settlement that prevents public disclosure. It is also possible that what constitutes negligence may not be settled. The NGL and NGR do not limit the AER in taking such information into account. The AER will consider all such information available to it. Such information may or may not be determinative of whether the event was in the service provider's control for the purposes of the AER's decision on the pass through application. The AER further notes that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence could not trigger this pass through event.

Multinet amended paragraph (a) to provide that an insurance cap event is an event whereby the Service Provider makes a claim or claims on an insurance policy. The AER definition only referred to 'a claim'.

The AER understands that, in general, insurance policy limits are cumulative over the insurance period and not limited to each claim. This means that, regardless of the number of claims, the policy limit will only be exceeded once. The AER considers that the exceeding of the policy limit is the circumstance that meets the factors set out in the draft decision, against which cost pass through events are assessed.[946] It is this circumstance that should trigger the event, regardless of the number of claims that lead to the exceeding of the policy limit. Accordingly, the AER considers it is appropriate to refer to 'claims' in the definition. The AER approves paragraph (a), as amended by Multinet.

Multinet has proposed to include an example under paragraph (c) of when costs would exceed the relevant policy limit. The AER does not consider that it is necessary to provide an example of where paragraph (c) will apply, or that the example aids in explaining the operation of the clause. The remaining Victorian gas distribution and transmission businesses have not proposed an example. The AER has had regards to the desirability of consistency under r. 97(3)(d) and considers that the example should be deleted.

Multinet has rephrased paragraph (d). Multinet's rephrasing refers to the AER determining 'the amount of insurance costs it would approve as expenditure'. The AER's final decision does not approve individual elements of opex. It approves a single opex allowance. This is the reason that he AER's drafting of paragraph (d) referred to the forecast opex allowance. The AER considers that this paragraph should refer to the forecast opex allowance. The AER does not approve Multinet's amendment and proposes to amend paragraph (d) to reflect the AER's draft decision.

Multinet also contends that it does not understand the need for paragraph (e) and submits that the definition of "relevant insurance policy" is not required.[947] Multinet has not included paragraph (e).

Paragraph (e) provides that a relevant insurance policy is an insurance policy held during the 2013–17 access arrangement period or a previous period in which access to the pipeline services was regulated.

The purpose of paragraph (e) is to allow a Service Provider to apply for a cost pass through when costs have been incurred in the current access arrangement period that relate to an insured event that occurred in the previous access arrangement period. Without this subparagraph, Multinet would not be able to apply to pass through such costs. The AER considers that paragraph (e) is essential to the effective operation of this event and proposes that paragraph (e), as set out in its draft decision, be reinserted.

Multinet has made minor changes to nomenclature. The AER does not consider these changes affect the operation of the definition and approves these changes.

Disaster Event

The AER does not approve Multinet's disaster event. The AER proposes that this event be amended to make Multinet's access arrangement acceptable.

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946 AER Access arrangement draft decision, Multinet, 2013–17, Part 2, September 2012, pp. 224–25.
947 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, p. 9.

The disaster event provides for the pass through of costs arising from any major fire, flood, earthquake or other natural disaster.

In its revised proposal, Multinet proposed two amendments to address its concerns that:

1. events, such as major explosions or industrial fires, might be inadvertently caused by third parties and would not fall within the definition of a natural disaster event.[948]

2. serious civil unrest may result in damage to its network but may not be linked to terrorism and as such, would not trigger the terrorism event (which is a seperate event).[949]

In relation to the first proposed amendment, the AER considers that it is not necessary to amend the definition as suggested by Multinet. The AER considers that in the event of the circumstances suggested by Multinet arising, a Service Provider will already be protected. This is because any damage caused by a third party will likely amount to negligence, giving the Service Provider the option of suing for damages.

The AER considers that allowing Multinet to pass through costs where it had the option of seeking damages would have two potential negative effects. First, it could act as a disincentive to take legal action. Second, it could amount to a windfall gain for Multinet if costs were recovered under this provison and through legal action against the third party. The AER considers that these outcomes would not be in the long term interests of consumers with respect to price.

In relation to the second proposed amendment, the definition of terrorism event proposed by the AER is not linked to terrorists, as suggested by Multinet.[950] Rather, the terrorism event is triggered by acts that from their context or nature are done for or in connection with a number of specific reasons. These include political and ideological reasons and the intention to influence or intimidate any government or put the public, or any section of the public, in fear.

The AER considers that riots and civil commotion are rare occurrences in Australia. The likelihood of a major riot or civil commotion occurring, and causing damage to Multinet's network is extremely remote.

The AER considers that in the event that a riot or civil commotion occurred the definition of a terrorism event is broad enough to cover many instances of riots or civil commotions. If the riot or civil commotion is connected to political or ideological reasons it will generally be covered by the terrorism event.

The AER notes that s. 322 of the NGR permits parties to enter into agreements for access to pipelines that are different to the applicable access arrangement. If Multinet is concerned about the remote risk of a riot or civil commotion occurring that is not covered by the definition of a terrorism event, the AER considers that this is a matter that it may wish to negotiate at a commercial level.

A natural disaster event limited to any major fire, flood, earthquake or other natural disaster, as proposed by the AER, has been adopted by Envestra, SP AusNet and APA GasNet. Natural disaster

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948 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 10.
949 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 10.
950 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 10.

events covering these specified disasters were also adopted in the five most recent gas determinations[951] and the two most recent electricity determinations.[952]

In assessing the appropriateness of a particular tariff variation mechanism the AER must have regard to the desirability of consistency between regulatory arrangements for similar services.[953] The AER considers that achieving consistency between gas access arrangements is beneficial and consistent with the NGO. It leads to similar factual circumstances being assessed in a similar fashion, does not advantage or disadvantage any particular business and allows businesses to predict how the AER is likely to decide when faced with similar facts. These factors are likely to reduce administrative costs and promote the efficient operation and use of natural gas services in the long term interests of consumers with respect to price.

National energy customer framework event (NECF Event)

The AER approves Multinet's amendments to the national energy customer framework event (NECF Event). The AER proposed this event in its draft decision so as to permit Multinet to pass through any costs it incurs in implementing NECF once it is adopted in Victoria.

In its revised proposal, Multinet largely adopted the AER's definition of a NECF event, proposed in its draft decision. However, Multinet made an amendment, adding a final phrase 'including any amendment, withdrawal or introduction of any associated Victorian legislation, regulations or rules'.

Multinet submitted that, when NECF was considered for adoption in Victoria in 2012, the Victorian government was preparing specific Victorian derogations and energy rules to govern the implementation of NECF in Victoria. These derogations and energy rules should also be reflected in the definition.[954]

The AER proposed the NECF event because it considered that it was appropriate for SP AusNet to recover any expenditure it incurs in implementing NECF.[955] The implementation of NECF will involve new legislation, regulations or rules that adopt and give effect to the national Energy Retail Law (South Australia) Act 2011, the National Energy Retail Regulations (South Australia) and the National Energy Retail Rules (South Australia). However, the implementation of NECF may also involve the withdrawal or amendment of existing Victorian legislation, regulations or rules. This may particularly be the case if any of these instruments are inconsistent with NECF.

The amendment proposed by SP AusNet acts to make it clear that where the withdrawal or amendment of legislation, regulations or rules occurs in order to give effect to the relevant NECF instruments, the NECF event will cover it. The AER considers that this proposed amendment acts to clarify the meaning of the types of instruments that may give effect to NECF. This adds greater clarity and reduces the risk of disputes. The AER considers that this is in the long term interests of consumers with respect to price.

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951 Envestra South Australia;Envestra Queensland; Amadeus; Roma to Brisbane; APT Allgas.
952 Aurora Energy; Victorian DNSP decision.
953 NGR. 97(3)(d).
954 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, Appendix 13.1, p. 10.
955 AER, Draft decision, SP AusNet access arrangement proposal 2013–17, p. 224.

Mains replacement event

In the draft decision the AER proposed a pass through to address any change in circumstances which requires the distribution business to undertake mains replacement beyond the volume considered to be conforming capex by the AER in its decision.

The AER considers the merits of a proposed pass through on a case by case basis.

The AER considers that the capex mains replacement pass through reflects the AER's conceptual criteria. Furthermore, the AER considers that, given the specific circumstances, the pass through promotes the NGO.

The mains replacement program accounts for a significant proportion of the total capex allowance. The key driver for the program is to address longer term safety and this is undertaken through a proactive program where the distributions businesses have some discretion around the timing of volumes replaced.

All distribution businesses have a statutory general obligation under s.32 of the *Gas Safety Act* to "manage and operate each of its facilities to minimise as far as practicable" the hazards and risks to the safety of the public and customers arising from gas, interruptions to the conveyance or supply of gas and the reinstatement of an interrupted gas supply. The obligation also includes minimising hazards and risks of damage to public property and the property of customers arising from gas. The *Gas Safety Act* requires a distributor in deciding what is "practicable" to have regard to a number of factors: the severity of the hazard or risk in question; the state of knowledge about the hazard or risk and any ways of removing or mitigating the hazard or risk; the availability and suitability of ways to remove or mitigate the hazard or risk; and the cost of removing or mitigating the hazard or risk.

Therefore, the distributions businesses have a high level safety obligation. Furthermore, the distributions businesses have discretion in how they meet this high level safety obligation. As discussed in attachment 4, the distribution businesses, in practice, have number of different processes and mechanisms by which to mitigate safety risk, including proactive mains replacement. The optimal mix of processes and mechanisms may change over time given the above factors recognised in the *Gas Safety Act*.

The mains replacement pass through has been introduced by the AER to balance the risks which are borne by the distribution business and gas consumers under these circumstances:

- Where there is a change in circumstances which requires the distribution business to undertake greater than historical volumes of mains replacement, the distribution business should be provided with the opportunity to recover the cost of meeting its safety and regulatory obligations through efficient investment in gas infrastructure, and
- Where undertaking mains replacement greater than historical volumes is prudent and efficient and necessary to meet safety and reliability obligations, it is in the long term interests of consumers to pay higher tariffs; and conversely, where circumstances do not warrant such expenditure, consumers should not pay higher tariffs than necessary.

The AER considers that the mains replacement pass through enables these risks to be balanced.

In this final decision, the AER has revised the operation of the pass through. The pass through differs to that proposed by the AER in its draft decision. It takes into account consultation with and information provided by Multinet and the other distribution businesses following the draft decision.

The pass through will apply only to low pressure to high pressure block rollout mains replacement and medium pressure supply mains replacement that is necessary for carrying out of the proposed low pressure to high pressure block rollout in the 2013-17 access arrangement period.

Only one pass through application will be accepted during the 2013-17 access arrangement period.

No materiality threshold will apply. No volume cap will apply to the pass through. For the suburb/postcode areas where mains replacement was initially proposed, the AER will assess and pre-approve the unit rate in the AER's final decision (see further discussion below).

The trigger event for the pass through is completion of 207 kilometres of mains replacement. The 207 kilometres has been calculated by deducting 9 months worth of mains replacement from the historical volume over the 2008-12 access arrangement period. This is calculated using the mains replacement schedule provided by the distribution business in its revised proposal.

Where volumes are undertaken in suburbs where unit rates have not been approved in the AER's final decision, the distribution business will be required to submit a proposal to the AER for those unit rates as part of its pass through application. The evidence that the AER will consider in assessing the efficiency of the proposed unit rates may include but shall not be limited to:

- whether the unit rate is an awarded tender rate and whether the rates were determined through a competitive tender process.

In the instance where the approved volumes of mains replacement for a particular suburb or suburbs have not been carried out, and are resubmitted as part of the pass through application, the expenditure differential only will be approved. This will be calculated by:

- Calculating the difference between the total capex for mains replacement approved by the AER in its final decision, and the total area adjusted actual expenditure[956] undertaken by Multinet to complete the approved volumes.
- Subtracting this difference from the total approved pass through expenditure.

If approved, the pass through expenditure will consist of:

- The expenditure incurred or to be incurred in order to undertake the approved volumes, less any adjustment amount.
- An adjustment for the difference between:
    - the time value of money allowed for the expenditure approved in the AER's final decision for completion of historical volumes (as per the blue hatched area in Figure 1-4), and
    - the time value of money for the expenditure approved in the AER's final decision but undertaken in the timeframe that the volume was actually completed (as per the orange shaded area).[957] This ensures that from a time value of money perspective the business is

956 This is the sum of the volume multiplied by pre-approved unit rate for suburbs/postcodes where the AER has approved a unit rate plus the volume multiplied by the actual unit rate for suburbs/postcodes where the AER has not approved a unit rate (subject to the AER assessing that the unit rate actually incurred was prudent and efficient).

957 Where volumes have been undertaken in suburbs/postcodes where the AER has not pre-approved a unit rate, the AER will apply a residual unit rate to these volumes. The residual unit rate will be calculated as the total approved expenditure for historical volumes less the expenditure incurred for mains replacement actually undertaken in the suburbs/postcodes

neutral as to whether the volume of mains replacement was approved entirely upfront (as per the orange shaded area in Figure 1-4) or via a combination of upfront funding plus the pass through.

For the purposes of assessing a cost pass through application under this event under clause 8 of Part B of Multinet's access arrangement, the AER will consider these factors to be other factors that the AER considers relevant (factor (g)).

Material

The AER approves Multinet's definition of material.

Multinet adopted the AER's required definition of "Material", subject to some drafting variations. Multinet's proposed definition of Material is:

> For the purpose of these definitions Material means an increase or decrease in the costs of provision of Reference Services by an amount equal to or more than one per cent of the smoothed forecast revenue specified in the AER's final decision (in respect of the relevant Access Arrangement period) for the years in that Access Arrangement period in which those costs are incurred.

This definition is included in clause 8 of Part B of Multinet's revised access arrangement. This is different to the approach proposed by the AER, where it was a seperate definition. However, the AER considers that the definition of material has the same effect as the definition it proposed in its draft decision.

12.4.4 Procedure for oversight and approval of tariff variation

Part year tariffs

The AER's final decision on the 2013–17 access arrangements for the Victorian gas service providers is due to be made in March 2013. This is after the 1 January 2013 revision commencement date specified in the 2008–12 access arrangements for these service providers. Taking into account r. 92(3), the AER considers that the 2013 reference tariffs under the 2013–17 access arrangements should take effect from 1 July 2013 until 31 December 2013.[958]

In its revised proposal, Multinet did not address this matter. The AER sought clarification.[959] In response, Multinet submitted that it adopts the AER's adjustment of reference tariffs to account for the six month delay.[960]

The AER's final decision is to accept the timing of the implementation of Multinet's reference tariffs for 2013; that is, Multinet's reference tariffs for 2013 will take effect on 1 July 2013. The AER proposes that Multinet amend the proposed access arrangement (Part B) to reflect the implementation timing for 2013 reference tariffs as set out in section 12.5 of this final decision.

Annual and within year variations

The AER's final decision is to not approve Multinet's revised proposal for a 35 business day notice. The AER's preferred 50 business day requirement facilitates earlier market notification of approved

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included in the AER's approved historical expenditure, divided by, the total approved historical volume less the volume undertaken in the suburbs/postcodes included in the AER's approved historical expenditure.

958 AER, Access arrangement draft decision, SPI Networks (Gas)Pty Ltd, 2013–17, Part 2, September 2012, p.230.

959 AER, Information request to Multinet FD12a, 10 December 2012.

960 Multinet, Response to AER information request to Multinet FD12a of 10 December 2012, 13 December 2012.

tariffs, providing greater certainty to retailers and consumers. This is a material benefit to market participants.

In its access arrangement submission of March 2012, Multinet proposed to notify the AER in respect of any reference tariff variations at least 35 business days prior to the next calendar year.[961] In its draft decision, the AER did not accept Multinet's proposal.[962] The AER's draft decision established a 50 business day requirement. The AER considered that Multinet's proposed timeframe does not provide the AER adequate oversight over the annual tariff variation process, and accordingly considers its 50 business day requirement preferable.[963] The reasons for the AER's decision are set out in Attachment 11 of the draft decision.[964]

In its revised proposal, Multinet did not adopt the AER's draft decision.[965] However, Multinet did not provide any reasons for rejecting the draft decision on the matter.

In making its final decision for Multinet, the AER took into account information submitted by SP AusNet as part of its revised proposal.[966] SP AusNet submitted that 35 business day notice is preferable, because this shorter period will allow for use of the most recent inputs and minimises its own administrative costs.[967] SP AusNet also submitted that a 50 business day requirement creates risk of the AER setting rather than approving tariffs.[968]

Origin Energy Victoria (Origin) submitted that from a retailer's perspective, at least 20 business days should be allowed for retailers to prepare for implementation.[969] Origin's submission is consistent with the AER's approach to implementing an adequate period for oversight in the reference tariff variation mechanism which allows 30 business days for the AER's approval and 20 business days for retailers to prepare for implementation.

The AER considers that SP AusNet's objections to the 50 business day requirement, raised in its access arrangement proposal, to be relatively minor or readily overcome. To facilitate use of the most recent inputs in reference tariff variation determinations the AER will accept updates for incorporation in Multinet's tariff model where specific inputs become available after submission. Such updates do not change tariff structures. A specific input update generally requires manual change to a single spreadsheet input value where models are well designed.

SP AusNet submitted that some gas network service providers also operate electricity networks and are subject to a 50 day requirement for electricity tariff variations.[970] It also submitted that staggering required submission dates across sectors would mitigate service provider workload related costs.[971] The AER considers, however, that the rationale for earlier tariff submission for both sectors is equally

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961 Multinet, Gas Access arrangement proposal:, Part B: - Reference Tariffs and Reference Tariff Policy 30 March 2012 p.14.
962 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p.235.
963 NGR, r. 97(4).
964 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p.235.
965 Multinet, *Revised proposal and response to draft decision*, 9 November 2012, p.197.
966 NGR, r. 62(1) and r. 97(3)(d).
967 SP AusNet, Revised access arrangement proposal, RAAP Chapter 8, Tariffs and Tariff Variation Mechanism, 9 November 2012, p. 6.
968 SP AusNet, Revised access arrangement proposal, RAAP Chapter 8, Tariffs and Tariff Variation Mechanism, 9 November 2012, p. 6.
969 Origin Energy Victoria Pty Ltd, Submission to the Victorian gas access arrangement review, 7 January 2013, p.3.
970 SP AusNet, Revised access arrangement proposal, RAAP Chapter 8, Tariffs and Tariff Variation Mechanism, 9 November 2012, p. 5.
971 SP AusNet, Revised access arrangement proposal, RAAP Chapter 8, Tariffs and Tariff Variation Mechanism, 9 November 2012, p. 5.

strong. Earlier provision to the market of approved tariffs is a significant benefit, outweighing potential marginal workload management issues for network service providers.

In response to SP AusNet's suggestion that the AER may become a tariff setter and therefore act beyond its scope, the AER considers that tariff models will be constructed by the gas network service provider, and submitted by the gas network service provider to the AER. The structure of the tariff will, therefore, also remain the responsibility of gas network service provider. Acceptance by the AER of updated tariff model inputs does not change the respective roles of network service providers and the AER.

The AER does not approve Multinet's proposed procedures on the timeframe of the assessment by the regulator. Multinet submitted that the proposed haulage reference tariffs will be deemed to have been verified as compliant in writing by the regulator by the end of 25 business days from the date on which the regulator received the service provider's notification unless the regulator has notified the service provider of its decline to verify the proposed tariffs.[972] Based on the above reasoning, the AER considers that 30 business days will provide the AER adequate oversight over the annual tariff variation process. The AER's final decision is that the proposed haulage reference tariffs be deemed to have been verified as compliant in writing by the regulator by the end of 30 business days from the date on which the AER received the service provider's notification.

Procedures for cost pass through variation in reference tariffs

The AER does not approve Multinet's procedure for pass through event variations. The AER proposes that the procedure be amended to make Multinet's access arrangement acceptable.

Multinet has largely adopted the AER's required procedures for approving cost pass through event variations to reference tariffs. However, it has made a number of changes.

The AER stated in its draft decision that it considered that a consistent approval process is desirable from the perspective of transparency and administrative efficiency.[973] In setting out the proposed approval process the AER had regard to its recent decisions and sought to achieve consistency with them.

The AER remains of the view that a consistent approach for approving pass through applications for all gas distributors is desirable and will be beneficial.[974] As discussed in its draft decision[975] the AER considers that a consistent approach will lead to administrative efficiency.[976]

The AER's proposed approach aligns with the approach it has approved in recent gas decisions.[977] The AER considers that this approach is preferable to following the NER. This is because aligning the process across the gas industry creates a level playing field where each business is assessed against the same criteria. It also allows entities with multiple gas businesses greater certainty of outcomes in like for like circumstances and reduces the risk of such entities following the incorrect process. These factors promote the efficient operation and use of natural gas services.

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972 Multinet, Access arrangement proposal: Part B - Reference tariffs and reference tariff policy, 9 November 2013, section 4.2(b), p. 14.
973 AER, Access arrangement draft decision, SPI Networks (Gas)Pty Ltd, 2013–17, Part 2, September 2012, p.233.
974 NGR r. 97(3)(d)
975 AER, Access arrangement draft decision, SPI Networks (Gas)Pty Ltd, 2013–17, Part 2, September 2012, p.233.
975 AER, Access arrangement draft decision, SPI Networks (Gas)Pty Ltd, 2013–17, Part 2, September 2012, p.233.
976 NGR r. 97(3)(b)
977 Amadeus Gas Pipeline: Roma to Brisbane pipeline 2012–2017.

The following sets out the AER's consideration of Multinet's particular amendments to the drafting of the event.

Service Provider may notify a positive pass through event

The AER proposed that it be notified of all pass through events.[978] Multinet submitted that there may be positive events where it does not wish to make an application because the cost does not warrant the administrative burden of doing so.[979] Therefore it proposed that it may notify the AER of positive pass through events and must notify it of negative pass through events.

The AER considers that it is reasonable to allow Multinet to make its own choice about whether it wishes to apply for a cost pass through that is to its benefit. This approach permits flexibility and aids in administrative efficiency by avoiding the need to consider applications that SP AusNet considers are unnecessary.

60 business days

The AER proposed a procedure that gave it 90 business days to approve or reject the pass through application.[980] Multinet has not adopted this time frame and has proposed 60 business days.[981] The AER does not approve this timeframe. Each business has proposed a different timeframe.[982] The AER considers that having separate timeframes may cause confusion. Such an outcome would not promote the efficient operation and use of natural gas services or promote administrative efficiency.[983]

Multinet notes that its 2008–2012 access arrangement provides for a total of 90 days (60 business days to make the application and 30 business days for the AER to make its determination). Multinet submits that this timeframe is achievable.[984] Multinet submitted that the AER is proposing a 9 month timeframe for a single event.[985]

This 9 month figure is incorrect. The AER's proposal allows Multinet 90 days in which to notify it of the event. Multinet does not have to use the full timeframe. Unless the application is such that an extension is required, the AER must then notify Multinet of its decision within 90 business days. Accordingly, the process provides for the AER to make a decision within 90 business days of receipt of the application, subject to there being no need for an extension.

In its two most recent gas access arrangement decisions[986] the AER approved mechanisms providing for a 90 day review period. Consistency with these decisions will not advantage or disadvantage any particular stakeholder. For these reasons, the AER considers that 90 business days is a preferable alternative.[987]

Reason for the extension

The AER approves the amendment requiring it to give reasons for an extension.

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978 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 244.
979 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
980 AER, *Draft decision: Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, Part 2, September 2012, p. 244.
981 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
982 Envestra has proposed 90 business days, Multinet has proposed 60 business days.
983 NGR. 97(3)(b).
984 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
985 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
986 Roma to Briabane, Amadeus.
987 NGR. 97(3)(d) & (e).

Multinet has proposed that the AER give reasons for its decision to extend the time period for making a decision.

The AER considers that this amendment is reasonable. The AER considers that it should be required to give reasons for an extension. This will act to keep Service Providers and other stakeholders informed as well as placing a constraint on the AER. The AER considers that this will promote the efficient operation and use of natural gas services, an aspect of the NGO, through increased administrative efficiency.[988] [989]

Deemed decision

Multinet has proposed that if the AER fails to make a decision in the time allowed, the proposed variation will be deemed to have approved.[990] Multinet submitted that a Service Provider has a critical interest in knowing within a reasonable period whether a cost recovery application is allowed and the amount approved.[991]

The AER considers that the application of a consistent mechanism in gas decisions is desirable and contributes to consistency with the NGO. The AER's previous gas decisions do not contain this provision and not all Victorian businesses have proposed it.[992] The AER considers that approval of this deeming provision would create inconsistency and could potentially lead to confusion.[993] This would not be consistent with the NGO because it would create administrative inefficiency[994] and impede the efficient operation and use of natural gas services.[995]

Materiality

Multinet has made an amendment to specify which cost pass through events are subject to the materiality threshold.

The AER considers that this is a reasonable approach. The mains replacement event and the national energy customer framework event are not subject to a materiality threshold. Multinet's amendment makes this clear. If this amendment was not included, the approval mechanism would act to add the materiality requirement to those two events. The AER did not intend this.

Reduced revenue

The AER does not approve the paragraph referring to reduced revenue in respect to the change in taxes event. The AER proposes an amendment to delete this paragraph to make Multinet's access arrangement acceptable.

Multinet has inserted a new paragraph which specifies that in the case of a change in taxes event a reference to costs will read as a reference to reduced revenue. Multinet has not given any reasons for this amendment.

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988 NGR r. 100(a).
989 NGR r. 97(3)(b).
990 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
991 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 35.
992 NGR r97(3)(d).
993 NGR. 97(3)(d).
994 NGR r. 97(3)(b)
995 NGR r. 100(a)

The AER considers that the impact on revenue is not a relevant consideration. The purpose of a cost pass through mechanism is to protect Service Providers from uncontrollable events that impact on the costs to the business. The rationale focuses on increased or decreased costs. The impact on revenue is not a relevant consideration for the purposes of approving a cost pass through event.[996]

Effective date

Multinet has proposed two additional dates for any variation to take effect from – at the Service Provider's option or 1 July. The AER does not approve this amendment.

Multinet submitted that a 1 July commencement date reduces the risk to the Service Provider of delays in the assessment process and avoids the risk of costs being recovered the calendar year two years after the event occurred.[997]

The AER considers that variations should take effect from 1 January. This aligns with the tariff review. The AER considers that it is reasonable to vary tariffs once each year. Multiple or random variations may lead to price shocks and make comparisons by consumers more difficult. This would not be in the long term interests of consumers with respect to price, an element of the NGO.[998]

Building block components

Multinet has not included factor (c) which provides that the total costs to be passed through are building block components of total revenue.

The AER approves Multinet's removal of factor (c) as proposed by the AER.

Multinet did not include factor (c) proposed by the AER. Factor (c) requires the AER to take into account whether the total costs to be passed through are building block components of total revenue. Multinet did not give any reasons for not including this factor.

However, upon further consideration the AER, the AER considers that the factors (c) and (d) have substantially the same effect. Factor (d) requires the costs to meet the relevant NGR criteria for determining the building block for total revenue. This, both factors refer to assessing the costs against the building block approach for total revenue.

However, factor (d) refers to the NGR criteria for determining the building blocks. The AER considers that this is the preferable factor because it makes it clear that the building block approach is the one set out in the NGR. Factor (c) is less specific about what the building block approach is.

For these reasons the AER considers that it is not necessary to have both factors and approves the removal of factor (c).

Time cost of money & economic neutrality

Multinet proposed two additional factors – (e) and (f). The AER proposes to remove these factors to make Multinet's access arrangement acceptable.

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996 NGR, r. 97(1)(c) and r. 97(3)(e).
997 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 36.
998 NGR. 97(3)(e).

Factor (e) refers to the time cost of money based on the weighted average cost of capital for the Service Provider.

Factor (f) refers to the need to ensure that the financial effect of the Relevant Pass Through Event on the Service Provider is economically neutral.

Multinet submitted that its factor (e) applies to cover the fact that there will be a delay between when the relevant costs are incurred and when it receives the tariff revenue.[999] Multinet then submitted that the purpose of factor (f) is to note that the intent is to ensure that the Service Provider is economically neutral.[1000]

Multinet's proposed adjustment factor set out in formula 3 Adjustment factor A[1001] has the effect of adjusting tariffs for those costs associated with the cost pass through process. Within the adjustment factor, the WACC accounts for the cost of raising the funds, and the CPI accounts for inflationary effects. The determined amount is then discounted to its present value. Therefore, the time value of money is already accounted for.

Further, as discussed above, the lack of consistency is likely to create complexity and confusion. This does not promote the efficient operation and use of natural gas services, aspects of the NGO. The AER has also had regard to the desirability of consistency between regulatory arrangements.[1002]

The economic neutrality test goes beyond what is required by the RPP. The RPP only require that a Service Provider be able to recover at least their efficient costs. There is no requirement for economic neutrality. Accordingly, the AER does not consider factor (f) to be consistent with the NGO.[1003]

Further requirements

The AER approves Multinet's inclusion of two additional factors.

Multinet has proposed that a pass through amount not be taken into account:

- when deciding its haulage reference tariffs or components thereof; or
- in deciding whether its haulage reference tariffs or components thereof comply with the tariff control formula; and
- that the pass through amount is not subject to the procedures in clause 4.

Multinet submitted that these factors were included in the approval mechanism in its 2008-2012 access arrangement. Multinet stated that it sees nothing objectionable in this clause and considers it should remain because it explains the relationship between the two processes.[1004]

The AER considers that this proposed amendment does not affect the operation of the cost pass through mechanism. Rather, they serve to make the relationship with the price control formulae absolutely clear. This adds clarity and limits the scope for disputes to arise.

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999 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 36.
1000 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 36.
1001 Multinet, *Revised Access Arranagement*, 9 November 2012, Part B – Reference Tariffs and Reference Tariff Policy, p. 40.
1002 NGR. 97(3)(d).
1003 NGR. 97(3)(e).
1004 Multinet, Revised proposal and response to draft decision, 9 November 2012, Appendix 13.1, Attachment 2, p. 36.

12.5 Revisions

The AER proposes the following revisions to make the revised access arrangement acceptable:

Revision 12.1: Make all necessary amendments to reflect the AER's final decision on the reference tariffs for 2013 in Part B of the proposed access arrangement as set out in **Table 12.1**to Table 12.3.

Table 12.1: Multinet - Haulage Reference Tariffs - Metropolitan Zone

Tariff V Residential				
Distribution Fixed Tariff Component		$0.1500		
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
0-0.05	5.6949	6.5231	6.3647	6.3647
> 0.05 - 0.1	4.0726	4.6655	4.5517	4.5517
> 0.1 - 0.15	2.1063	2.4121	2.3541	2.3541
> 0.15-0.25	1.0656	1.2208	1.1910	1.1910
> 0.25	0.8014	0.9060	0.8956	0.8956
Tariff V Non–residential				
Distribution Fixed Tariff Component		$0.2465		
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
0-0.05	2.5346	3.0455	2.7949	2.7949
> 0.05 - 0.1	1.6751	1.9274	1.7347	1.7347
> 0.1 - 0.15	1.0026	1.1565	1.0987	1.0987
> 0.15-0.25	0.6076	0.6436	0.6271	0.6271
> 0.25	0.1716	0.2148	0.1932	0.1932

Tariff L
Distribution demand tariff components

12 month rolling maximum demand ($/GJ per day)				0.4725
Peak maximum demand ($/GJ per day)				1.4138
Distribution Volume Tariff Component				
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
< 5	0.3574	0.5082	0.4506	0.4506
> 5	0.0812	0.1090	0.1024	0.1024

Tariff D	
MHQ (GJ)	**12 month rolling maximum demand ($/GJ per day)**
All demand 0-50	474.4634
Any demand > 50	80.7258

Table 12.2: Multinet - Haulage Reference Tariffs - Yarra Valley Towns Zone

Tariff V Residential				
Distribution Fixed Tariff Component		$0.1528		
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
0-0.05	8.4890	9.4354	9.1199	9.1199
> 0.05 - 0.1	6.9614	7.6382	7.4126	7.4126
> 0.1 - 0.15	5.1097	5.4598	5.3431	5.3431
> 0.15-0.25	4.1297	4.3069	4.2478	4.2478
> 0.25	3.8808	4.0141	3.9696	3.9696
Tariff V Non–residential				
Distribution Fixed Tariff Component		$0.2509		

Consumption Range (GJ/day)	Off peak period ($/GJ)	Peak period ($/GJ)	May shoulder period ($/GJ)	October shoulder period ($/GJ)
0-0.05	5.5752	6.0689	5.8267	5.8267
> 0.05 - 0.1	4.7447	4.9885	4.8023	4.8023
> 0.1 - 0.15	4.0949	4.2437	4.1877	4.1877
> 0.15-0.25	3.7133	3.7481	3.7321	3.7321
> 0.25	3.2920	3.3337	3.3129	3.3129

Table 12.3: Multinet - Haulage Reference Tariffs - Gippsland Towns Zone

Tariff V Residential				
Distribution Fixed Tariff Component		$0.1528		
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
0-0.05	9.2638	10.2687	9.9336	9.9336
> 0.05 - 0.1	7.6415	8.3602	8.1207	8.1207
> 0.1 - 0.15	5.6752	6.0470	5.9230	5.9230
> 0.15-0.25	4.6344	4.8226	4.7599	4.7599
> 0.25	4.3701	4.5117	4.4645	4.4645
Tariff V Non–residential				
Distribution Fixed Tariff Component		$0.2575		
Consumption Range (GJ/day)	**Off peak period ($/GJ)**	**Peak period ($/GJ)**	**May shoulder period ($/GJ)**	**October shoulder period ($/GJ)**
0-0.05	6.1695	6.6938	6.4366	6.4366
> 0.05 - 0.1	5.2876	5.5465	5.3487	5.3487
> 0.1 - 0.15	4.5975	4.7555	4.6961	4.6961
> 0.15-0.25	4.1923	4.2293	4.2122	4.2122

> 0.25	3.7449	3.7892	3.7670	3.7670

Tariff D	
MHQ (GJ/hr)	**12 month rolling maximum demand ($/GJ per day)**
All demand 0-50	608.6116
Any demand > 50	103.5439

Revision 12.2: Make all necessary amendments to reflect the AER’s final decision on the x factors for the 2013–17 access arrangement period in Part B of the proposed access arrangement as set out below:

Xt = 13.28% for the calender year 2013

Xt = 5.00% for the calender year 2013

Xt = -2.00% for the calender year 2013

Xt = -2.50% for the calender year 2013

Xt = -2.50% for the calender year 2017

Revision 12.3: Make all necessary amendments to reflect the AER’s final decision on the value of pre–tax WACC in Part B of the proposed access arrangement as set out below:

Real pre-tax WACC = 5.32

Revision 12.4: Make all the necessary amendments to reflect the AER's final decision on the timing for the the implementation of the 2013 reference tariffs in Part B of the proposed access arrangement. In particular:

Replace section 1.1(a) of the Access arrangement Part B with the following:

For the period 1 January to 30 June 2013, the haulage Reference Tariffs will remain unchanged from 2012. The haulage reference tariffs to apply from 1 July to December 2013 are the tariffs set out in Schedule 1 adjusted to comply with the tariff control formula and rebalancing control formula in clause 3 and verified by the Regulator as if clause 4 applied (but not for the timing requirements of clause 4.1).

Revision 12.5: Make all necessary amendments to reflect the AER’s final decision on the timeframe for notifying the AER in respect of the annual reference tariff variation process in Part B of the proposed access arrangement. In particular:

Replace section 4.1(a) with the following:

The Service Provider will, at least 50 Business Days prior to the commencement of the next Calendar Year submit proposed Haulage Reference Tariffs to apply from the start of the next Calendar Year for verification of compliance by the Regulator, in accordance with clauses 4.2(a), (b), (c) and (d).

Replace section 4.2(b) with the following:

The proposed Haulage Reference Tariffs will be deemed to have been verified as compliant in writing by the Regulator by the end of 30 Business Days from the date on which the Regulator received the Service Providers notification under clauses 4.1(a), (b) or (c) unless the Regulator has notified the Service Provider in writing that it has declined to verify the proposed Haulage Reference Tariffs as compliant. The AER will notify Multinet of the extension and its duration within 30 business days of receiving a notification from Multinet.

Revision 12.6: Make all necessary amendments to reflect the AER's final decision on the annual tariff variation formula for ancillary reference services in Part B of the proposed access arrangement. In particular, amend section 2 as set out in page 192 of this Attachment.

Revision 12.7: Amend the definition of Relevant Pass Through Event in the glossary of Part A by deleting the Financial Failure of a Retailer Event.

Revision 12.8: Make the following amendment to the Glossary in Part A of Multinet's access arrangement proposal:

Delete the Financial Failure of a Retailer Event.

Revision 12.9: Make the following amendment to the definition of insurance cap event in the Glossary in Part A of Multinet's access arrangement proposal:

Under paragraph (c), delete the following phrase (for example the Service Provider must incur costs in repairing the Distribution System which costs are above the relevant insurance policy limit).

Insert a new paragraph (d):

The relevant policy limit is the greater of Multinet's actual policy limit at the time of the event that gives rise to the claim and its policy limit at the time the AER made its Final Decision on Multinet's access arrangement proposal for the period 2013-17, with reference to the forecast operating expenditure allowance approved in the AER's Final Decision and the reasons for that decision; and

Insert a new paragraph (e):

A relevant insurance policy is an insurance policy held during the 2013-17 Access Arrangement Period or a previous period in which access to the pipeline services was regulated.

Revision 12.10: Make the following amendment to the Glossary in Part A of Multinet's access arrangement proposal:

Delete factors (b) and (c) from the definition of a Disaster Event.

Revision 12.11: Make the following amendment to the Glossary in Part A of Multinet's access arrangement proposal:

Under factor (b) in the Change in Taxes Event, delete factor (2)

Revision 12.12: Make the following amendment to the Glossary in Part A of Multinet's access arrangement proposal:

Insert the following definition of a Mains Replacement Event:

A Mains Replacement Event means the event whereby Multinet:

A Mains Replacement Event means the event whereby Multinet:

(a) completes 207 kilometres of its planned total completion of Historical Volumes of Mains Replacement during the course of the 2013–17 access arrangement period; and

(b) costs are incurred, or are to be incurred, by Multinet in the remainder of the 2013-17 access arrangement period to complete a volume of Mains Replacement in excess of the Historical Volumes.

For the purposes of the Mains Replacement Event:

Historical Volumes means 255 km being the volume of mains replacement completed by Multinet for the 2008 to 2012 access arrangement period, with reference to the AER’s decision to approve the 2013-17 access arrangement and its reasons as set out in its Final Decision; and

Mains Replacement means mains replacement for low pressure to high pressure block rollout, which involves the replacement of:

(i) low pressure distribution mains with high pressure polyethylene mains through a process of dividing a low pressure region into smaller areas (referred to as blocks) which are then subject to systematic low pressure to high pressure replacement, and

(ii) includes the minimum amount of replacement of medium pressure supply mains necessary to undertake the proposed low pressure mains replacement in the 2013-2017 access arrangement period, as specified in (i)

Costs are to be determined in accordance with the pre-approved unit rates set out in the AER’s decision to approve the 2013-17 access arrangement and its reasons as set out in its Final Decision or, where unit rates have not been pre-approved, are to be determined as otherwise set out in its Final Decision.

Revision 12.13: Make the following amendments to section 8 of Part B of Multinet's access arrangement:

Replace each reference to '60 business days' with '90 business days'.

Delete the 4th paragraph

In the 9th paragraph, remove the phrase 'or, at the Service Provider's option' and '(or, if applicable, deemed decision)'.

Delete factores (e) and (f).

Delete the final paragraph commencing 'A Pass Through amount applied...' and the two points beneath it.

Revision 12.14: Make the following amendments to Appendix 1 in Part B of Multinet's revised access arrangement proposal:

Delete the unaccounted for gas tariff.

Delete formula 5.

Revision 12.16: Make the following amendment to clause 1.5 in Part B:

Delete the second paragraph.

13 Non-tariff components

Multinet's access arrangement proposal sets out terms and conditions that are not directly related to the nature or level of tariffs paid by users, but which are important to the relationship between the Service Provider and users. These are referred to by the AER as non-tariff components of the access arrangement.

This attachment sets out the AER's consideration of the non-tariff components of Multinet's revised access arrangement proposal. These include Multinet's proposed capacity trading requirements,[1005] queuing policy,[1006] extension and expansion requirements,[1007] and the terms and conditions on which the reference service will be provided.[1008]

13.1 Final decision

The AER does not approve Multinet's terms and conditions in Part C. It approves most of the non-tariff components of Multinet's revised proposal.

The AER does not approve the following aspects of Multinet's non-tariff components:

- Terms and conditions in Part C of Multinet's revised access arrangement proposal.

The AER approves the following aspects of Multinet's non-tariff components:

- Queuing arrangements.
- Extensions and expansions policy.
- Capacity trading requirements.
- Terms and conditions for changing receipt and delivery points.
- Review dates.

13.2 Terms and Conditions

13.2.1 Final decision

The AER does not approve the terms and conditions as certain terms and conditions are not consistent with the NGO. Provisions, such as the following, require correction or amendment to make Part C of Multinet's access arrangement proposal acceptable:

- 3A(g)–Indemnity
- 13.6–Exemption of Liability
- 7.4(g)–Distribution Services - Invoicing, Payment and Interest
- 9.1(j)–Notification to customers
- 13.5(c)–indemnity

[1005] NGR, r. 105.
[1006] NGR, r. 103.
[1007] NGR, r. 104.
[1008] NGR,r. 48(1)(d)(ii).

- 19.2(c)–Amendment

13.2.2 Revised proposal

Multinet's terms and conditions are set out in Part C of its revised access arrangement proposal. Part A of the revised access arrangement proposal also includes some non-tariff terms. Multinet's revised proposal adopts most of the changes required by the AER in its draft decision. Multinet also proposed new clause 3A to adapt the terms and conditions to Users who are not retailers. This addition also required minor amendments to some of the existing terms and conditions.

13.2.3 Assessment approach

The AER's assessment approach is set out in 12.1.3 in chapter 12 of part 2 of the draft decision.

The AER received submissions form AGL[1009] and Origin.[1010]

13.2.4 Reasons for decision

Where Multinet has not adopted the AER's draft decision, Multinet has proposed additional amendments or submissions have been received on a particular term or condition, or the AER has considered other relevant information, the AER's assessment is set out below.

For all other terms and conditions, the AER approves these for the reasons set out in its draft decision.[1011]

Application of Terms and Conditions

With the exception of clause 3A(g) of Part C (an indemnity clause), the AER approves the amendments Multinet has made to its proposal in order to tailor it to End-Users.

Multinet adopted the AER's required revision that clause 5.3.1 of Part A of its proposal no longer state that the terms and conditions in Part C only apply to retailers. However, Multinet also inserted a number of new clauses into Part C (principally clause 3A) to in order to allow the terms and conditions to apply to Users who are non-retailers.

These terms are briefly discussed below.

- Clause 3A(a) and (c) have the effect of providing that for the purposes of the Access Arrangement an "End-User" is to be treated as operating in two capacities—as a party acquiring haulage services and then as a party taking gas at the distribution supply point. Therefore where a clause obliges the User to ensure that the Customerfulfils or complies with a particular obligation or requirement the clause is to be interpreted as meaning the User itself must fulfill or comply with that particular obligation or requirement.

- The insertion of clause 3A in the Access Arrangement avoids the need t do a major rewrite of Part C whilst also ensuring that the Access Arrangement does specify the terms on which Reference Services will be provided to non-retailer Users in accordance with r. 48(1)(d) (ii) of the NGR.

1009 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2013, Attachment A.

1010 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2013, p.3.

1011 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012,

- Clause 3A(b) sets out the circumstances when a User will be an End-User as follows:

  a. Where the User is itself consuming the gas (a true "End-User")

  b. Where the operator of an embedded distribution network is buying gas and supplying it to the customers located off the network.

  c. Where the User is buying the gas and haulage services but then providing the gas to someone else who consumes it. A possible scenario is where a subsidiary within a corporate group buys the gas and haulage services and then gives it to a second subsidiary which uses the gas in its plant.

- Clause 3A(d) makes clear that where a specific clause deals with End-User issues it does not derogate from the application of clause 3A to the remainder of the terms.

- Clause 3A(e) provides that persons to whom an End-User provides gas are not capital "C" customers for the purposes of Part C. Customers as used in the terms refers to customers of a retailer and which persons are connection to the Distribution System. Clause 3A(e) makes clear that references to a capital "C" Customer is to the End-User and not to its own customers.

- Clause 3A(f) provides that the End-User warrants that it holds all required licences and exemptions to lawfully on-supply gas (if it does this) and operate / own an embedded network (if it does this). Clause 3A(f) makes clear that the access arrangement does not allow the connection of an embedded network to the Distribution System. If this were to occur, the AER acknowledges that another agreement would be required to deal with such matters as the procedures for "tie-in", co-ordination of operations and maintenance, pressure between the networks, controlling gas between the networks and ensuring the embedded network does not jeopardise the operation of the Service Provider's system.

- The AER considers clauses 3A(a)-(f) of Multinet's revised terms and conditions (together with Multinet's other amendments to Part C - discussed below) are consistent with the NGO and r. 48(1)(d)(ii) of the NGR. In particular, the AER considers that with the exception of clause 3A(g), the revised terms and conditions provide that Reference Services are not limited to retailers. Further, that the terms clearly set out the basis on which access to the Reference Services will be supplied to non-retailer Users.

Clause 3A(g)

The AER does not approve clause 3A(g) of Part C of Multinet's revised proposal.

Clause 3A(g) of Part C of Multinet's revised proposal provides:

> that where the User is acquiring Distribution Services as an End-User, then the User indemnifies the Service Provider against any claims, actions or proceedings against the Service Provider (irrespective of the basis on which the claim, action or proceeding is brought against the Service Provider) made by a person to whom the User on-supplies Gas which is taken by the User as an End-User at a Distribution Supply Point.

Clause 3A(g) of Multinet's revised proposed includes a carve out so that it does not apply to claims, actions or proceedings:

- for losses suffered by natural persons due to personal injury or death. Multinet submitted that it considers that this carve out is appropriate as Multinet can insure against this instance.[1012]

- by persons using gas solely for personal, domestic or household use.

- Further, to the extent any such persons seek to recoup the costs of repairing property damage caused by the Service Provider, Multinet's liability would not exceed $100 000.

Multinet submitted that this carve out would result in Multinet accepting liability for property damage for most small businesses but not for large scale businesses with whom it does not deal directly beyond .[1013] Multinet submitted that businesses of that size should be able to insure against such risks (with the $100 000 covering all or part of their deductible). Multinet submitted that if a large business wants a better liability regime then it can contract with Multinet as an End-User rather than relying on another entity to do so.[1014]

Multinet submitted that the purpose of proposed clause 3A(g) is to indemnify Multinet against any consequential loss claims.[1015] Multinet submitted that the indemnity clause is driven by the scenario where one subsidiary in a corporate group is acquiring gas to be used by a second subsidiary in a major industrial facility.[1016] Multinet submitted that the risk it faces is that of a negligence claim by the second subsidiary in the case of a gas supply failure. If the second subsidiary is an industrial plant owner / operator these losses could be very significant.[1017] In this case, the corporate group's splitting of its procurement structure off from the entity which actually uses the gas would in effect allow the corporate group to side step the protections in clause 13.6 (exemption of liability).[1018] Multinet submitted that this would not be consistent with the NGO because it would expose Multinet to the risk of a major claim by a single party, with whom Multinet does not have a contractual relationship.[1019] Multinet also submitted that it does not consider it should be liable for consequential loss claims by customers on embedded networks because it does not deal with these customers, does not know their consumption requirements, and has no means of assessing the extent risk of claims by these persons.[1020]

The AER considers that the scope of clause 3A(g) of Multinet's revised proposal is too wide. It essentially indemnifies Multinet against any claim (including a negligence claim) for damage over $100 000 where an End-User on-supplies gas to another entity. The AER considers that this clause is inconsistent with the NGO because it would pass the cost of the Service Provider's negligence (or insuring against this risk) onto the End-User (or the entity which ultimately consumes the gas if that is another entity) when those parties have no ability to mitigate the risk of the Service Provider's negligence.

The AER considers that it is more appropriate and consistent with the NGO to amend clause 13.6 of Multinet's revised proposal so that it applies to End-Users who on-supply gas. Under clause 13.6 of Multinet's revised proposal, the Service Provider is not liable for costs and damages resulting from failures that are not within the Service Provider's control. Where a failure is not within a party's control, the AER considers that it is appropriate that that party is able to indemnify against losses resulting

1012 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1013 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1014 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1015 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 29.
1016 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1017 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1018 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1019 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.
1020 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 30.

from that failure. The AER approves the other amendments that Multinet has made to Part C to adapt its access arrangement proposal to End-Users.

Multinet has proposed a number of further revisions to Part C of its proposal to clarify how it would apply to End-Users:

- Clause 4.1(d) clarifies that clause 4.1(c) does not apply to the extent the User is not acquiring Distribution Services as a retailer. Clause 4.1(c) concerns the Service Provider's obligations under Part 21 of the National Gas Rules ("Retail support obligations between distributors and retailers") and would not make sense when applied to End-Users.[1021]
- Clause 4.3(a) clarifies that in the case of the End-User, AEMO transferring the financial responsibility for the MIRN to the End-User does not bring the provision of distribution services to the End-User to an end.
- Clause 4.7(d) clarifies that the User must ensure its Customers do not exceed their Customer MHQ. As this is a very material clause, this clause makes clear that when applied to the End-User it means the End-User must make sure it does not exceed the Customer MHQ.
- Clause 6.2(c) relieves a retailer of the obligation to pay for gas taken by its customers where the Service Provider has failed to disconnect. This is because a retailer cannot stop its customers taking gas. The retailer must therefore bear the cost of gas consumed by the customer. Where this arises due to the Service Provider's failure to disconnect, the cost is moved to the Service Provider. However in the case of an End-User the application of this clause would be inappropriate since the End-User is the one taking the gas. Clause 6.2(c)(3) therefore clarifies that this clause does not apply where a User is acquiring gas an End-User.
- Clause 7.1(b) provides that the User does not have to pay a charge to the Service Provider when the Customer is obliged to pay the charge directly to the Service Provider. By virtue of clause 3A, in the case of an End-User it is treated as both a "Customer" and "User". This "two-hat" solution would create some confusion in clause 7.1(b) and should therefore be amended to provide that it does not apply to End-Users.
- Clause 7.1(c) provides that the User must pay the Charges for services the Service Provider provides to the User in respect of the Customer. In the case of an End-User, the Customer and the User are the same person. For clarity, it is expressly provided in clause 7.1(c) that the End-User must pay the charges it acquires as an End-User.
- Clause 7.4(e) provides that charges for haulage reference services included in an invoice for Distribution Services must only be in relation to Customers whose meters were due to be read in the period of an invoice. It is clarified that this applies to Users acquiring gas as an End-User.
- Clause 7.6(e) deals with the co-ordination between the User and Service Provider in respect of GSL payments made to a third party, the "Customer". However, in the case of an "End-User", it is the Customer, so any GSL payments would be made directly to it. Therefore clause 7.6 would not apply to the case of an "End-User" and clause 7.6(e) makes this clear.
- Clause 7.8(n) specifies that the credit support provisions will continue to apply to End-Users post the commencement of NECF. This is because these provisions will cease to apply to retailers on the commencement of NECF in Victoria and the Service Provider will rely on the provisions of

[1021] See *National Gas (Retail Support) Amendment Rules 2010,* which inserts Part 21, Division 4 into the NGR.

Division 4 of Part 21 for credit support. However in the case of End-Users who are not retailers, the Service Provider cannot rely on Division 4 of Part 21 because it does not apply to them (the provisions only apply to "Retailers" as defined in the NGR).[1022]

- Clause 8.2 (b) relates to the provision of information / privacy laws and contemplates that the Service Provider, User and Customer are three separate entities. This clause does not make sense when the User and the Customer are effectively the same entity so this clause should amended to make clear that it does not apply to End-Users.

- Clauses 9.1(a), 9.2(e), 9.3(f), 9.7(d) and 9.12(f) all address how the Service Provider and the User manage their relationship with the Customer, on the assumption the Customer is a third person. This is not the case with an End-User and the clauses are irrelevant and do not make sense when applied to a Service Provider / End-User relationship. These clauses therefore make clear that these clauses to not apply where a User is acquiring gas as an End-User.

- Clause 9.4(c) clarifies that an End-User must provide the information referred to in clause 9.4(a) in respect of its own consumption.

- Clause 9.8(d) clarifies that clause 9.8 does not apply to the User to the extent it is acquiring Distribution Services from the Service Provider as an End-User. This is because this clause relates to the Service Provider and User's obligations when a person makes a complaint or enquiry relating to the Service Provider. It assumes that the person making the complaint is not the User so it does not make sense where the User is an End-User.

- Clause 9.10(a) clarifies that a Service Provider must assign a Reference Tariff to a Distribution Supply Point, including where the User is taking gas as an End-User.

- Clause 9.10(i) clarifies that the End-User is obliged to notify the Service Provider if there are changes to its use of gas such that its existing tariff ceases to be appropriate.

- Clause 11 regulates the procedures a Service Provider must follow before disconnecting a Customer and is written on the assumption the Service Provider, User and Customer are all separate entities. This is not the case for an End-User and clause 11 would be irrelevant where the Service Provider was considering disconnecting an End-User for something it had done wrong (that is the End-User will not be co-ordinating with the Service Provider about how to disconnect itself because it is in default). The Service Provider must continue to provide services to the End-User until the Agreement is terminated under clause 12 or until a specific right to suspend service arises. Clause 11.6 therefore clarifies that clause 11 does not apply where a User is acquiring gas as an End-User.

- Clause 12.5 provides that the User may terminate the Agreement if it has no Customers. It has been amended to make clear the User may not terminate if it is still taking gas as an End-User.

- Clause 13.2 relates to indemnities provided by the Services Provider to the User against claims by Customers. This clause is not applicable when the User and the Customer are the same entity. Therefore clause 13.2(g) has been added to state that this clause does not apply to the extent that the User is acquiring gas as an End-User.

- Clause 13.5(b) has been inserted to clarify that where the User is taking delivery of Gas as an End-User at a Distribution Supply Point the User indemnifies the Service Provider against any

[1022] See *National Gas (Retail Support) Amendment Rules 2010,* which inserts Part 21, Division 4 into the NGR.

liability incurred by the Service Provider for damage to the Distribution System caused by anyone to whom the User on-supplies the Gas to. As the Service Provider cannot act to prevent damage to the distribution system that is caused by an entity to which an End-User on-supplies gas, the AER considers that this indemnity is appropriate and consistent with the NGO. This is because it would reduce the Service Provider's risk, its insurance costs and therefore the long-term costs to consumers, an aspect of the NGO. The AER considers it appropriate that the party that can act to prevent a failure / accident be liable for any costs associated with that failure / accident.

- Clause 13.5(d) has been inserted and provides that the End-User indemnifies the Service Provider where the End-User exceeds its own MHQ. This is important because persons exceeding MHQ pose a significant threat to the ongoing reliability of the distribution system.

- Clause 15.1(c) has been inserted to clarify that clause 15.1(a) does not apply to End-Users where the law does not require them to hold retail licences / authorisations. (Clause 15.1(a) provides that the User represents and warrants that it holds and will continue to hold the appropriate retail licence /authorisation).

The AER considers that the above changes are relatively minor, technical in nature and appropriately tailor the proposal to End-Users where a User takes gas from the Service Provider as an End-User.

The AER approves the minor changes Multinet has made to Part A of its proposal in relation to End-Users. These changes are consistent with the changes to Part C and are as follows:

- Additional wording has been included in section 5.1.1 (Services Policy) of Part A to explain the End-User concept.

- Changes to the following definitions:

  - Charges: now includes the amount determined from the application of Reference Tariffs in respect of the Reference Services provided to the User where acquiring Reference Services as an End-User.

  - Connection: now includes a physical link between the Distribution System and a premise at which the User takes Gas as an End-User.

  - Distribution Supply Point: now includes a reference to the User as an End-User.

  - Gas Installation: 'Customer's premises' has been replaced by 'premises which utilises Gas'.

Payment and Invoicing for Services - Charges

The AER approves clause 7.1(b) of Multinet's revised terms and conditions. Clause 7.1(b) provides that the User is not obliged to pay a specific Charge to the Service Provider in respect of a Customer where that Customer is contractually obliged to pay that Charge directly to the Service Provider.

The AER considers that this amendment is consistent with the NGO because it improves the clarity of the clause which will reduce the probability of disputes. This will promote the efficient operation and use of natural gas services and be in the long term interests of consumers with respect to price.

The AER in its draft decision considered that Multinet's original proposal was unclear and that the second part of clause 7.1(b) went beyond the scope of r. 504 of the NGR (which is part of NECF).[1023] The AER was concerned that this clause could potentially be inconsistent with NECF once it was adopted in Victoria.[1024]

Multinet submitted that the purpose of clause 7.1(b) is to provide clarity and certainty that the User (retailer) does not have to pay a charge to the Service Provider in respect of a Customer where the Customer is required to pay that charge directly to the Service Provider.[1025]

Multinet submitted that the effect of the AER's amendment would be to prevent the Service Provider commencing to bill the retailer on expiry of the direct customer contract. SP AusNet stated that it does not consider that it is desirable to leave uncertain what happens on expiry of a direct customer contract.[1026]

In the alternative, Multinet replaced the phrase '...has entered into a contract with the Service Provider (which contract has commenced operation) under which the Customer agrees to pay that type of charge...' with the new phrase '...is contractually obliged to pay that Charge.'

The AER considers that its drafting, as set out in its draft decision, would not prevent Multinet from commencing to bill the retailer. Both drafting options, in effect, would cover a contractual obligation to pay a charge. However, the AER considers that the amended clause proposed by Multinet provides greater clarity. The AER considers that this clarified wording is consistent with the NGO because it promotes the efficient operation and use of natural gas services.

Title to Gas

The AER approves clause 4.8.

Clause 4.8 provides that the User must have good title to the gas it injects and indemnify the Service Provider against any loss from a breach of this provision.

AGL queried why an indemnity is included in this clause and why clause 13.5 (indemnity by the user) is not sufficient.[1027] AGL notes that the AER did not provide a view on this in its draft decision.

The AER notes that it discussed this clause on page 88 of Part 3 of its draft decision.

As discussed in the draft decision,[1028] the general indemnity in clause 13.5 only covers situations where the User causes damages to the distribution system or where a customer withdraws a quantity

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1023 AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 251.
Rule 504(1) provides that "Where a distributor and a shared customer agree that the customer will be responsible for paying distribution service charges directly to the distributor (a direct billing arrangement), the distributor may issue a bill to that customer for the services provided to that customer's premises. Rule 504(3) provides that 'A retailer has no liability to pay distribution service charges that have been, or are to be, billed to the shared customer under a direct billing arrangement.'

1024 AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, p. 251.

1025 SP AusNet, *Access arrangement information*, 9 January 2012, RAAP Chapter 9: Non-tariff components, p. 20.

1026 SP AusNet, *Access arrangement information*, 9 January 2012, RAAP Chapter 9: Non-tariff components, p. 21.

1027 [1027] AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

of gas that exceeds the customer's MHQ. It does not afford an equivalent protection as that provided under clause 4.8, which covers situations where the User causes gas to be injected into the distribution system to which it does not have good title.[1029]

The AER considers that this clause acts to protect the Service Provider from risk that could arise if the User did not have good title to the gas it injects. This reduction in risk potentially leads to reduced costs, which is in the long term interests of consumers, an aspect of the NGO.

Disconnection at the request of the user

The AER approves clause 6.2(c)(3)

Clause 6.2(c)(3) provides that clause 6.2(c) does not apply to Distribution Supply Points at which the User is acquiring Distribution Services from the Service Provide as an End-User.

AGL sought justification around why a retailer should be treated differently to any other customer. AGL submitted that it believed if a Service Provider fails to disconnect when it was obliged to so, it should waive its rights, regardless of who the End customer is.[1030]

The AER considers that this subclause is appropriate because clause 6.2(c) refers to Customers and End-Users do not have Customers (only retailers have Customers).

Disconnection at the request of the User

The AER approves clause 6.2(j).

Clause 6.2(j) provides that the User indemnifies the Service Provider against all claims arising as a consequence of disconnection of a Customer by the Service Provider pursuant to a disconection request.

AGL queried why clause 13.5 (Indemnity by the User) isn't sufficient. AGL submitted that if this clause was to remain, the Service Provider should also indemnify the User for any claims that are brought against the User for the Service Provider's actions or omissions.[1031]

AGL submitted that the AER did not provide a view in its draft decision.[1032]

The AER notes that it discussed this clause on page 91 of Part 3 of its draft decision.

As discussed in the draft decision, the AER does not agree with AGL's proposed deletion of clause 6.2(j).[1033] The AER considers that the general indemnity in clause 13.5 only covers situations where the User causes damage to the distribution system or where a customer withdraws a quantity of gas

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1028 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, Part 3, p. 88..

1029 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, Part 3, p. 88.

1030 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1031 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1032 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1033 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013-31 December 2017, September 2012, Part 3,p. 91.

that exceeds the customer's MHQ. It does not afford an equivalent protection as that provided under clause 6.2(j), which covers situations where a claim is brought against the Service Provider as a consequence of a customer disconnection pursuant to a disconnection request.[1034]

The AER considers that it is necessary to include clause 6.2(j) to protect a Service Provider where a claim is brought against it for disconnecting a premises pursuant to a request by the User. The AER considers that deleting this indemnity could lead to increased charges by the Service Provider. This would not be in the long term interests of consumers with respect to price, an aspect of the NGO.

This clause deals with disconnection at the request of the user. The indemnity in this clause relates specifically to disconnections at the request of the User. The Service Provider is carrying out an act for and requested by the User. The AER considers that in this context it is appropriate for the Service Provider to be indemnified. The AER considers that the indemnities in this agreement are reasonable and are balanced so that the party best suited to avoid or mitigate risk bears it. There are no broad indemnities of the type proposed by AGL.

Further, the AER considers that Users will not be liable for any acts or omissions by the Service Provider. If such a claim is brought against a User, it will be in a position to raise that it is not the appropriate party to claim against.

Assistance

The AER approves clause 6.5.

Clause 6.5 provides that the User must give to the Service Provider any assistance that the Service Provider reasonably requests in relation to curtailment, interruption, disconnection or reconnection of Customers.

AGL submitted that it is unreasonable for the contract to state that a User 'must' give the service Provider any assistance reasonably requested. AGL contended that any such request should be performed only after it has been agreed to by the User and the Service Provider. Retailers recognise the importance of assisting Service Providers in the maintenance of Supply, and in all cases where a request for assistance is reasonable, a User will perform the actions required. AGL does not consider it necessary to mandate this provision of assistance within the Access Arrangement, particularly without a giving the User any right of refusal. AGL also believes that the User should have the ability to recover any fair and reasonable costs incurred in the provision of assistance, from the Service Provider.[1035]

AGL recommends that 'by agreement' is inserted within this clause.[1036]

As discussed in the draft decision, the AER does not consider that clause 6.5 should be amended as proposed by AGL. The AER considers that to ensure that a Service Provider can efficiently operate its network, it should be permitted to request assistance from Users with respect to curtailment,

1034 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, Part 3, p. 91.

1035 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1036 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

interruption, disconnection or reconnection of customers. The functions are critical to the efficient and safe operation of a Service Provider's network.[1037]

The AER notes that this clause is limited to the extent that the request must be reasonable. The AER considers that the reference to reasonableness provides sufficient protection to the User as it limits the ambit of the Service Provider's discretion. The AER considers that this clause promotes the efficient operation and use of gas services, aspects of the NGO.[1038]

The AER notes that AGL submitted that 'in all cases where a request for assistance is reasonable, a User will perform the actions required'. The AER considers that this supports the argument that it is appropriate that such an obligation to assist, where it is reasonably requested, be included in the proposal (to ensure that such assistance is in fact provided).

Distribution services - Invoicing, Payment and Interest

The AER approves clause 7.4(a) of Part C of Multinet's revised proposal.

Clause 7.4(a) of Multinet's revised proposal provides that the Service Provider may render invoices no more frequently than twice per month. This is changed from clause 7.4(a) of the initial proposal which provided that the 'Service Provider may render invoices on a monthly basis.'

The AER in its draft decision concluded that clause 7.4(a) as it was drafted in Multinet's initial proposal (providing for monthly billing) was consistent with the NGO and should therefore be retained.[1039]

Multinet submitted that it varied clause 7.4(a) to provide for monthly billing in anticipation of the commencement of NECF in Victoria (the 2008-12 Access Arrangement provides that the Service Provide may render invoices no more frequently than twice a month).[1040] However, given the delay in the implementation of NECF, Multinet submitted that it wishes to retain fortnightly billing until such time as NECF commences because the move to monthly billing has an adverse cash flow impact on Multinet and requires a reworking of Multinet's IT systems.[1041]

Multinet submitted that 'the AER considers the change from fortnightly billing to monthly billing is consistent with the National Gas Objective but the AER has not outlined why it considers this to be case'.[1042] Multinet submitted that it is not consistent with the NGO to reduce the overall standing of the Service Provider as to do so potentially adversely affect issues such as quality of service or security of supply.[1043]

Multinet also submitted that the SP AusNet terms as approved by the AER continue to allow for fortnightly billing and that it is not clear to Multinet how it is consistent with the NGO that where two

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1037 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, Part 3,p. 91.
1038 AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, p. 99-100.
1039 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, Part 3, p. 93..
1040 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 20.
1041 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 20.
1042 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 21.
1043 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 21.

Service Providers are in identical situations one Service Provider should be allowed one provision and consequent cash flow advantage and the other not.[1044]

The AER notes that Multinet's initial proposal was for monthly rather than fortnightly billing. The AER approved this clause as consistent with the NGO (as opposed to requiring that Multinet change its proposal from fortnightly to monthly billing).

The AER considers that fortnightly billing is also consistent with the NGO. Where Users are invoiced regularly the probability of disputes will be reduced which is in the long term interests of consumers with respect to price, an aspect of the NGO.

The AER notes that clause 7.4(a) of Multinet's revised proposal provides that 'the Service Provider may render invoices no more frequently than twice per month' and therefore allows Multinet to bill on either a monthly or fortnightly basis.

Clause 7.4(g)

The AER does not approve Multinet's deletion of clause 7.4(g) of its initial proposal in its revised proposal.

Clause 7.4(g) of Multinet's terms and conditions in its initial proposal dealt with situations where Metering Data is not available for a Customer. The AER in its draft decision required Multinet to amend clause 7.4(g) so that it would invoice Users no later than the second period after the Metering Data becomes available.[1045]

The AER was concerned that clause 7.4(g) of Multinet's initial proposal did not specify a limitation on how soon after the first invoice the 'subsequent invoice' could be. The AER considered that this could potentially allow a payment to be included many months in arrears, rendering reconciliation by the User difficult.[1046]

Multinet submitted that under NECF the invoice is due by the 10th business day but it only receives data from AEMO on around the 18th day.[1047] Multinet submitted that because the drafting appeared problematic and it cannot bill all customers in one invoice for a calendar month, it deleted clause 7.4(g).[1048]

The AER did not approve SP AusNet's initial proposal for similar reasons.[1049] In its revised proposal SP AusNet has amended the same clause in its proposal to state that where Metering Data is not available for a Customer, the Service Provider may either:

- issue an invoice based on an Estimated Meter Reading; or
- issue an invoice as soon as reasonably practicable after the Metering Data becomes available.[1050]

1044 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 21.
1045 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013-31 December 2017, September 2012, Part 2 : Attachments, p. 255
1046 AER, Draft decision, Multinet access arrangement proposal for 1 January 2013-31 December 2017, September 2012, Part 2 : Attachments, p. 255
1047 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 21.
1048 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 21.
1049 AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013-31 December 2017, September 2012, Part 2 : Attachments, p. 251-252.
1050 SP AusNet, *Access arrangement proposal: Part C – Terms and conditions*, 9 November 2012, clause 7.4(g).

The AER considers that SP AusNet's revised proposal is consistent with the NGO. The AER considers that the phrase 'as soon as reasonably practicable' imposes an objective element to prevent unnecessary delay. This is consistent with the NGO as it will increase efficiency and reduce costs. This will be in the long term interests of consumers with respect to price, an element of the NGO.

The AER considers that it would be appropriate for clause 7.4(g) to be reinstated into Multinet's proposal but amended to require that the Service Provider be required to invoice as soon as reasonably practicable after the metering data becomes available.

The AER informed Multinet of its proposed amendment[1051] and Multinet agreed to this amendment.[1052]

Clause 7.4 (j)

The AER approves clause 7.4(j) of Multinet's revised proposal.

Clause 7.4(j) of Multinet's revised proposal states that '...the User must pay the amount specified in each invoice rendered to it in accordance with this Agreement within 10 Business Days from the date specified on the invoice.'

AGL submitted that it is concerned that the date of issue specified on the statement of charges will not always align with the date the invoice is sent or received by the User.[1053] AGL considers that the drafting of this clause may have unintentionally limited the amount of time a User will have to pay and consequently, to dispute, an invoice.[1054] AGL has therefore proposed that the due date for the invoice be 10 Business Days from the date that the statement of charges is first sent to the User (rather than from the date specified on the invoice).[1055]

The AER considers that providing for 10 business days from the date of the statement of charges creates certainty. Amending this clause as proposed by AGL could potentially lead to uncertainty as the date the invoice was sent would not be apparent to the recipient of the invoice. The AER considers that uncertainty such as this would not promote the efficient operation and use of natural gas services.

Customer communications

The AER does not approve clause 9.1(j).

Clause 9.1(j) provides that:

> The User is responsible for providing Customers with information relating to any interruption or curtailment or irregularity in the supply of Gas which is caused by factors upstream of the Distribution System or caused by the act or omission of the User

The AER proposes amendments to clause 9.1(j) to make Multinet's access arrangement acceptable.

1051 AER information request Fd31a, 20 February 2013.
1052 Multinet response to information request Fd31a, 28 February 2013.
1053 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2012, Attachment A.
1054 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2012, Attachment A.
1055 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2012, Attachment A.

In submissions on Multinet's original access arrangement proposal, Origin stated that this clause is not relevant to the haulage agreement and is unnecessary as upstream outages and shortages of supply are managed via AEMO and Energy Safe Victoria across the whole industry.[1056]

In its draft decision the AER approved clause 9.1(j).[1057]

The AER has reassessed clause 9.1(j). The AER considers that this clause comprises two requirements:

- To notify customers of interruption or curtailment of supply caused by factors upstream of the distribution system
- To notify customers of interruption or curtailment of supply caused by an act or omission by the User.

With respect to the first requirement, the AER considers that these are factors that relate to the relationship between the User and a producer or transmission service provider. They do not relate to the distribution system or the provision of reference services by Multinet. Accordingly, they are not relevant to the terms and conditions on which reference services will be supplied.[1058] For this reason, the AER considers that it is inappropriate to include such a requirement in the access arrangement.

With respect to the second requirement, the AER considers that the User is best placed to inform customers of delays or curtailment arising from its acts or omissions. The AER considers that such an obligation acts to keep customers informed and provides for the party responsible for the delay or curtailment to inform the cusomers.

Customer details

The AER approves clause 9.4.

Clause 9.4(a)(8) provides that in respect of each Customer the User must provide for a typical 24 hour operation the estimated loads expected for each hour of that day.

AGL submitted that this requirement is not consistent with the National Gas Objective, as it may result in the placing of unnecessary costs and impacts on all participants, including customers.[1059]

AGL submitted that the existing (B2B) Customer Details Transactions do not contain a relevant field or even the ability to communicate the information being sought, from the retailer to the distributor.

AGL consider that Access Arrangements are not the correct forum within which this information can be requested. Changes to transactions should be discussed at AEMO working groups to develop an acceptable solution between Industry Participants. This transaction will not only require Industry Participants to amend information technology systems, but will also require changes to the transaction which is sent between Industry Participants.[1060]

1056 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, , 28 June 2012, p. 6.
1057 AER, Draft decision, SP AusNet access arrangement proposal, part 3, p. 109.
1058 NGR. 48(1)(d)(ii).
1059 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2014, Attachment A.
1060 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2013, Attachment A.

AGL submitted that, clause 9.4(a)(8) should be removed.[1061]

The AER does not agree with AGL's proposed deletion of clause 9.4(a)(8).

The AER considers that is it reasonable for the Network User to provide an estimate of loads to the Service Provider. This subclause was included in the previous access arrangement and only requires the retailer to provide an estimated load for a customer's 'typical 24 hour day' rather than an estimate for each 24 hour period. If the Network Users look at how much gas is typically consumed by its customers the retailer is likely to be able to estimate how much gas its customers are likely to consume in a typical 24 hour period (noting this may vary significantly depending on the season).

New Distribution Supply Points

Clause 9.5 lists certain information that the user must provide to the Service Provider for each New Distribution Supply Point that it wishes to have connected.

Clause 9.5(i)

The AER approves clause 9.5(i) of Multinet's revised proposal. The AER notes that Multinet has amended this clause to correct a spelling mistake in its initial proposal.

Clause 9.5(j)

The AER approves clause 9.5(J) of Multinet's revised proposal.

Clause 9.5(j) provides that for each New Distribution Supply Point it wishes to have connected, a User must provide the licence or registration number for any plumber proposed to be responsible for the work at the customer's premises.

Multinet submitted that during the consultation process it undertook with retailers, one retailer raised that the plumbers licence number is required where the works are proposed to be carried out, or where the works have already been undertaken and the retailer requests a meter fix / energisation.[1062] Multinet submitted that it has therefore replaced the phrase 'perform work' in clause 9.5(j) with the words 'be responsible for the work' to reflect this.[1063]

The AER considers that this amendment clarifies the clause and is consistent with the NGO.

Force majeure

The AER approves clause 10.3(b) of Multinet's revised proposal.

The AER, in its draft decision, did not approve clause 10.3(b) of Multinet's proposed terms and conditions. Clause 10.3(b) provided that where a Regulatory Instrument required Multinet to give a force majeure notice (for example s. 100 under the NERR) and the circumstances requiring that notice are likely to constitute a Force Majeure Event, Multinet could issue a notice that complies with the requirements of the regulatory Instrument and is not required to issue a separate notice under clause 10.3(b).

1061 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1062 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 23

1063 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 23

The AER considered that where a r. 100[1064] notice (unplanned interruption) is intended to act as a force majeure notice, the Service Provider should make this clear in the notice.[1065] The AER also considered that such a notice should contain the same details as a force majeure notice. The AER considered that this requirement would make it clear that the notice was issued to comply with two separate obligations. The AER considered that this would make it clear to the recipient of the notice that it was served two purposes.[1066]

In its revised proposal Multinet submitted that 'as clause 10.3(b) has created issues for the AER and retailers, Multinet considers it preferable to delete the clause.' Multinet submitted that if affected by force majeure, Multinet will issue a force majeure notice under clause 10.3(a) as per the current access arrangement.[1067]

The AER notes that SP AusNet also submitted that it would be preferable to delete clause 10.3(b) of its proposal (which was the same as clause 10.3 of Multinet's proposal) and leave the obligation on the parties to notify each other of a force majeure event.[1068] SP AusNet submitted that this was a clearer way forward than trying to amalgamate a force majeure notice within a regulatory requirement that does not yet exist and which in any event is intended to achieve a different purpose.[1069]

The AER considers that this amendment addresses the AER's concerns in relation to the initial proposal. The approach suggested by Multinet's will reduce the likelihood of disputes and is therefore in the long term interests of consumers with respect to price. The AER notes that SP AusNet has made the same change to its proposal.

Service Provider's indemnity to the User

The AER approves clause 11.3.

Clause 11.3 provides that:

> the Service Provider shall indemnify the User against Claims arising from, or incurred by the User as a consequence of, any action taken by the User under this clause 11 to enforce the Service Provider's rights at the request of the Service Provider, except to the extent that the Claim arises from the negligent or reckless act or omission of the User or from any breach or non-observance by the User of this Agreement or the Regulatory Instruments.

AGL submitted that it queries why clause 13.5 (Indemnity by the User) isn't sufficient. AGL submitted that if this clause was to remain, the Service Provider should also indemnify the User for any claims that are brought against the User for the Service Provider's actions or omissions. AGL submitted (incorrectly) that the AER did not provide any view upon this in their Draft Determination. AGL therefore requests that the AER review this clause during this current round of consultation.[1070]

1064 NERR, r. 100.
1065 AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, p. 257.
1066 AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, p. 257.
1067 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 23
1068 SP AusNet, *Access arrangement information*, 9 November 2012, RAAP Chapter 9: Non-tariff Components, p. 31.
1069 SP AusNet, *Access arrangement information*, 9 November 2012, RAAP Chapter 9: Non-tariff Components, p. 31.
1070 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

As discussed in the draft decision,[1071] the AER considers that clause 11.3 benefits the User. This clause requires the Service Provider (Multinet) to indemnify the User (for example, AGL).

Clause 13.5 relates to indemnities the User gives to the Service Provider and therefore benefits the Service Provider. Accordingly, clause 11.3 is not covered by clause 13.5.[1072] Each clause requires a different party to provide an indemnity.

The AER considers that it is reasonable for the Service Provider to indemnify the User against any loss the User incurs as a result of enforcing the Service Provider's rights. If this indemnity was not in place, the User could suffer loss as a result of enforcing the Service Provider's rights. This loss would be likely to be passed on to consumers. This would not be in the long term interests of consumers with respect to price, an aspect of the NGO. Therefore, the AER considers that it should be retained.

Indemnity by the User

The AER does not approve clause 13.5(c).

Multinet's proposed amendment to clause 13.5(c) provides that:

> The User indemnifies the Service Provider against any:
>
> (c) revenue which, by virtue of clause 508(1) of the National Gas Rules, the Service Provider is unable to collect because of the User s failure to issue invoices to Customers in accordance with the requirements of good industry practice (unless that failure was in turned caused by the Service Provider's failure to comply with good industry practice).

The AER does not approve this proposal.

In its draft decision, the AER did not approve clause 13.5(c) [1] because this clause would allow SP AusNet to circumvent the operation of r. 508(1) of the NGR once NECF was adopted in Victoria.[2]

Multinet submitted that r. 508(1) still operates, but the User must compensate Multinet for having triggered its operation and that its revised clause is consistent with the NGO.[1073] Multinet submitted that it is not consistent with the NGO that the Service Provider be exposed to a permanent loss of revenue by the act or omission of the User and be denied any means of recovering this. Multinet submitted that such a consequence threatens quality and security of supply because it jeopardises the ability of the Service Provider to cover efficient cost.[1074]

The AER notes that due to the addition of provisions that relate to End-Users in Multinet's revised proposal, the amended version of clause 13.5(c) of Multinet's initial proposal has been relabelled as clause 13.5(e) in the revised proposal.

[1071] AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, Part 3, p. 104.

[1072] AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, Part 3, p. 110

[1] AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 258.

[2] AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 258-259.

AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 258-259.

Origin submitted that it does not support amendments that would allow SP AusNet to recover revenue from retailers that the retailers are precluded from recovering from their customers under the energy law or rules.

The AER considers r.508 to be clear in preventing distributors from recovering distribution service charges from retailers that retailers are not permitted to recover from shared customers under the NERL or the NERR. The AER acknowledges the arguments raised by SP AusNet, but considers that Parliament has expressed its clear intention.

The AER notes that in response to the Second Exposure Draft of the National Energy Customer Framework, energy distributors raised concerns that:

> distributors should be able to recover amounts from the retailer where the undercharge was caused by the retailer or customers [sic] act or omission, regardless of whether the retailer can recover the amount from the customer (emphasis added).

The Ministerial Council on Energy Standing Committee of Officials responded "Not agreed. Distributors cannot recover amount from retailers which retailers are not permitted to recover from customers."[1075] Only minor changes were made to r. 508 since the second exposure draft.[1076] Accordingly, the AER does not approve inclusion of clause 15.5(c) as redrafted by SP AusNet. The AER notes that its inclusion would be contrary to r. 100(b) once NECF commences in Victoria.

Exemption of liability

The AER approves clause 13.6(b) of Multinet's revised proposal.

Clause 13.6(b) provides that:

> (b) A Party (First Party) is not liable to the other Party (Second Party) for:
>
> (1) any loss of revenue or profit suffered or incurred by the Second Party;
>
> (2) any special loss suffered or incurred by the Second Party;
>
> (3) any indirect loss suffered or incurred by the Second Party;
>
> (4) any liability incurred by the Second Party to a third party (other than a Customer);
>
> (5) any additional expenses suffered or incurred by the Second Party under any gas purchase contract or haulage agreement (other than this Agreement),
>
> whether arising due to the First Party's breach of this Agreement, tortious (including negligent) act or omission or any other act or omission of any nature whatsoever provided that nothing in this clause 13.6(b) limits:
>
> (6) any liability the First Party has to reimburse the Second Party for liability the Second
>
> Party incurs to a Customer under the National Energy Retail Law or under clause 13.2 of this Agreement;
>
> (7) the scope of, or liability under, any indemnity in this Agreement;
>
> (8) the User's obligation to pay to the Service Provider Charges and any other amounts payable by the User under this Agreement;
>
> (9) the User's liability for breach of clause 4.7(a).

[1075] Ministerial Council on Energy Standing Committee of Officials, MCE Energy Market Reform Bulletin No. 183, 10 September 2010: Responses to Key Issues Raised by Stakeholders on the Second Exposure Draft of the National Electricity Customer Framework, Attachment 1, page 28, Item 16

[1076] See Ministerial Council on Energy Standing Committee of Officials, National Energy Customer Framework Second Exposure Draft Explanatory Material, 27 November 2009, page 11.

The AER in its draft decision concluded that no change was required to clause 13.6(b)(8) of Multinet's initial proposal.

Multinet submitted that in the course of its consultation with retailers, two retailers submitted that they would prefer that the bracketed text in this clause - "(for example GST)" - be removed. Multinet submitted that it is indifferent to whether the example is retained and has removed the example.[1077] The AER accepts this minor amendment.

AGL queried the necessity of this new sub-clause. AGL submitted that it appears to limit previous indemnities and liabilities.

AGL submitted that the AER did not provide any view upon this in their Draft Determination. AGL therefore requests that the AER review this clause during this current round of consultation.[1078]

The AER notes that it discussed clause 13.6(b) in its draft decision.[1079]

As discussed in the draft decision, the AER does not agree with AGL's interpretation of clause 13.6(b). Sub-clause 13.6(b)(7) specifically provides that nothing in clause 13.6(b) limits the scope of, or liability under, any indemnity in this Agreement. The AER therefore considers that clause 13.6(b) would not operate to limit previous indemnities and liabilities under the access arrangement terms and conditions.[1080]

The AER considers that clause 13.6(b) should be included in the access arrangement terms and conditions, as it is common industry practice to exclude indirect or consequential liability under a haulage agreement. The AER also notes that a similar exclusion of liability clause was included in the Jemena and Envestra access arrangements. The AER therefore considers clause 13.6(b) to be consistent with the NGO, as it reflects current industry practice, which in turn promotes the efficient operation of natural gas services.The AER notes that Multinet has removed the reference to (for example, (GST) from clause 13.6(b)(8). The AER does not consider that this amendment affects the meaning or operation of the clause and approves the amendment.

Amendment to the Agreement

The AER does not approve clause 19.2(b) of Multinet's revised terms and conditions. The AER proposes amendments to clause 19.2(b) to make Multinet's access arrangement acceptable.

The AER considers that, subject to any other agreement between the Service Provide and the User, it is desirable for the haulage agreements to be updated to reflect updated Reference Tariffs following an Access Arrangement Review. The AER considers that this provides clarity about which terms and conditions apply at any given time and avoids the need to manually update each haulage agreement. This would likely reduce disputes and cost and is therefore in the long term interests of consumers with respect to price, an aspect of the NGO.

[1077] Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 25.

[1078] AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

[1079] AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, Part 3, p. 106.

[1080] AER, Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017, September 2012, p. 112.

The AER in its draft decision did not approve clause 19.2(b) of Multinet's initial proposal because it restricted the ability of parties to negotiate and limited their commercial flexibility.[1081] The AER considered that this could impede competition at a retail level and was therefore, in the AER's view, not consistent with the NGO.[1082]

Origin submitted that it supports the AER's amendment whereby SP AusNet must seek approval from the network user before it changes the terms of the agreement over terms and conditions and acknowledges SP AusNet's amendment in this respect.[1083]

In its revised proposal Multinet has revised clause 19.2(b) to state that 'It is the intention of the Service Provider and the User that the terms of this Agreement reflect so far as possible the Reference Service Terms.'

Multinet submitted that it did not agree with the changes proposed by the AER to clauses 19.2(b) and 19.2(c) of its terms and conditions. Multinet submitted that Users receive the benefit of changes in reference tariffs from time to time and that the reference tariffs are based on a number of factors including the terms on which services are provided.[1084] Multinet submitted that if reference tariffs change at an Access Arrangement review but the non-price terms do not change the Users are getting a reference tariff that is not applicable to the terms and conditions they have.[1085]

Multinet submitted that its proposed wording is consistent with the NGO as it matches tariffs to the non- price terms against which they are set.[1086] Multinet submitted that Users and Multinet are always free to negotiate terms and are free to negotiate changes to clause 19.2(b) and (c), including their deletion.[1087] Multinet submitted that there is no inconsistency with s. 322 of the NGL because if the parties wish to depart from the reference service terms, then they would negotiate both those departures but also the required amendments to clause 19.2 (c).[1088] Multinet has amended clause 19.2 (c) to make clear that the parties may agree to override its operation if they so choose.

Multinet submitted that it has revised clause 19.2(b) to clarify that whilst the intention is for haulage agreements to reflect the access arrangements terms and conditions, this is always subject to the User and Service Provider negotiating terms outside the framework.[1089]

The AER considers that it is important that the parties have the flexibility to adopt different terms if they choose. In particular, the parties may not want their agreement (or particular clauses in that agreement) to be updated automatically. The AER considers that the parties should be free to expressly agree on clauses that will not be automatically updated.

For this reason, the AER considers that clause 19.2(b) should be amended to provide that the terms and conditions will be varied in accordance with any new access arrangement approved by the AER, except for clauses that expressly provide that they will not be varied or clauses where the parties agree in writing that the variation will not apply. The AER considers that this approach is consistent

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1081 AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 261.
1082 AER, *Draft decision, SP AusNet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 261.
1083 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement proposals, 7 January 2013, p.5.
1084 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 26.
1085 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 26.
1086 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 26.
1087 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 26.
1088 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 27.
1089 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 27.

with the NGO because it balances commercial flexibility with the interconnection between terms and conditions, and tariffs.

General

Terminology

The AER approves Multinet's revised proposal that legislative instruments now include their year of enactment.

Multinet submitted that one retailer requested that there be consistent reference to various Acts. Multinet submitted that some clauses of its original proposal included the year in references to Acts, whereas others did not. Consistent with this request, and only where Part A does not give a short form description to an Act, Multinet has added to the end of the Act their year of enactment.[1090]

The AER considers that this is a minor amendment that will add clarity and consistency.

Regulatory instrument

AGL notes that in certains terms and conditions, SP AusNet has used the defined term 'Regulatory Instrument' and then proceeded to clarify which of the regulatory instruments included is relevant. AGL seeks clarification around the need for this additional information where only using the term ‘Regulatory Instruments’ would be sufficient.[1091]

The AER considers that this drafting adds some clarity and does not impact upon the meaning of any particular term or condition. The AER therefore considers that it is unnecessary to make any amendments.

Commercial matters

Origin referred to clauses 7.3 (d), 7.3 (e), 8.2, 9.1(j) and 13.3(b)(8).

Origin submitted that the AER has determined that these matters are best left to commercial negotiation between the parties. Origin questions whether this is a workable approach to the regulation of monopoly assets.[1092]

Origin understands that the AER is seeking to move to more of a collaborative approach to the negotiation of terms and supports greater collaboration in principle. Origin welcomes in particular the AER's finding that nothing in the rules precludes a distributor from negotiating terms with individual retailers that differ from the overall access arrangement.

Origin stated that in its experience distributors have at times asserted that the rules preclude negotiation of different terms, since this would create preferential treatment for one user or would create retailer-specific rates.[1093]

1090 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 27.

1091 AGL, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 7 January 2013, Attachment A.

1092 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2013, p. 4.

1093 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2013, p. 4.

Origin supports flexibility but does not support an approach where the AER leaves significant terms (such as the details of terms of payment) up to negotiation between service providers and users where negotiation in the workshop has proven unsuccessful. If commercial negotiation was sufficient to resolve points of difference over haulage terms then the current costly open access regime currently in place. The balance of interests between service providers and is such that the service provider can refuse an amendment and the user has no choice but to accept this. This leaves little scope for genuine negotiation. While a service provider has from time to time conceded on minor points, it has little incentive to concede on any point of commercial significance, and perhaps cannot be expected to do so within the existing rules framework.[1094]

For these reasons, Origin considers that investigating differences of opinion between service providers and users about haulage terms and adjudicating on these rules remains a primary responsibility of the AER under the NGL and NGR. Origin considers that terms noted in the draft decision as left to commercial negotiation should be those whose agreement has already been reached in the course of workshops.[1095]

The AER in its draft decision did not limit its consideration to whether terms and conditions, including those referred to by Origin, were "commercial matters". Instead, the AER made an assessment about the consistency of each proposed clause with the NGO. The AER considers that this approach is consistent with the requirements of the NGL and NGR.[1096]

The AER's assessment of each of the clauses referred to by Origin,and as previously set out in its draft decision, is summarised below:

1. In relation to sub-clauses 7.3(d) and (e), the AER approved Multinet's clause on the basis that it is consistent with the NGO to include provisions for GST. Beyond this, the AER concluded that it remained open to Origin to seek amendments.

2. In relation to clause 8.2, the AER approved Multinet's clause on the basis that it is consistent with the NGO taking into account that retailers are presently able to follow the process set out in that clause. Beyond this, the AER concluded that it remained open to Origin to seek amendments.

3. In relation to clause 9.1(j), the AER has proposed amendments to make Multinet's access arrangement acceptable. See the discussion under clause 9.1(j), above.

4. In relation to clause 13.3(b)(8), the AER notes that Multinet has now accepted the change proposed by Origin - see discussion under clause 13.6(b)

In effect, the AER determines whether the proposal is consistent with the NGO. What is approved by the AER therefore will provide the fundamental basis and be sufficiently comprehensive to establish the requirements for accessing the reference services, subject to any further negotiations between the parties.

13.3 Queuing arrangements

Queuing arrangements can be used to determine access to a pipeline that is fully, or close to being fully utilised.

1094 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2013, p. 4.

1095 Origin, Submission to the AER: SP AusNet, Envestra and Multinet access arrangement revised proposals, 8 January 2013, p. 4.

1096 Application by WA Gas Networks Pty Ltd (No 3) [2012] ACompT 12 (8 June 2012) para 276.

13.3.1 Final decision

The AER approves Multinet's revised access arrangement proposal insofar as it does not include any queuing requirements.[1097]

13.3.2 Revised proposal

Multinet's revised access arrangement proposal did not include queuing requirementsl. This is consistent with the AER's draft decision.[1098]

13.3.3 Assessment approach

The AER's assessment approach is set out in section 12.3.3 in chapter 12 of part 2 of the draft decision.

13.3.4 Reasons decision

As the capacity of Multinet's distribution pipeline is managed by AEMO, queuing requirements are not applicable for Multinet. On that and the AER approves Multinet's revised proposal insofar as it does not include any queuing requirements.

13.4 Capacity trading requirements

13.4.1 Final decision

The AER approves Multinet's capacity trading requirements.

13.4.2 Revised proposal

Multinet has revised its access arrangement proposal in accordance with the AER's draft decision which required it to state that:

There are no applicable capacity trading requirements for the purposes of Rules 48(1)(f) or Rule 105(1) of the NGR.

13.4.3 Assessment approach

The AER's assessment approach is set out in section 12.2.3 in chapter 12 of part 2 of the draft decision.

13.4.4 Reasons decision

Multinet has adopted the change required by the AER. Multinet's access arrangement now provides that there are no applicable capacity trading requirements.

13.5 Extension and expansion requirements

13.5.1 Final decision

The AER approves clause 5.5.1 of Part A of Multinet's revised proposal.

1097 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 265.

1098 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 265.

13.5.2 Revised proposal

Multinet's revised access arrangement proposal adopted the amendments required in the AER's draft decision.[1099] Multinet proposed that its extension and expansion plocy apply to all low and medium pressure extensions. Multinet proposed that it apply to the AER for approval of extensions to high pressure pipelines. Multinet defined high pressure as 1050 kPa.

13.5.3 Assessment approach

The AER's assessment approach is set out in 12.4.3 in chapter 12 of part 2 of the draft decision.

13.5.4 Reasons for decision

Multinet accepted the AER's required amendment to the extension and expansion requirements in its proposal. However, Multinet submitted that it is desirable to define what is meant by a high pressure extension, and to define it as a pipeline extension with a maximum allowable operating pressure of greater than 1050 kPa gauge.[1100]

The AER considers that it is appropriate to define a high pressure pipeline as any pipeline which has a maximum allowable operating pressure of greater than 1050 kPa gauge. The AER notes that this is the maximum pressure for a 'High Pressure 2' pipeline under the Victorian Gas Distribution Code,[1101] and that Envestra has proposed the same definition for a high pressure pipeline extension. For consistency and efficiency the AER considers that 1050 KpA is an appropriate definition for a high pressure pipeline in clause 5.5.1 of Part A of Multinet's revised proposal.

The AER considers that including this definition will reduce disputes and costs, and is therefore in the long term interests of consumers with respect to price, an element of the NGO.

The AER notes that following the draft decision it considered the possible inclusion of certain assumptions in Multinet's extension and expansion requirements. The intention was for such assumptions to apply for the purpose of rule 119M(2)(c) of Part 12 of the NGR which is to commence on the implementation of NECF.[1102] Rule 119M concerns the connections charges criteria and any assumptions included in an access arrangement would assist in determining the appropriate connection charge. Such assumptions may be about, for example, the connection assets required, the discount rate or the expected life of the connection. The AER sought to include the following assumptions:

For Tariff V and Tariff D customers, the discount rate as “the pre tax real WACC included in the distributor’s approved access arrangement”.

For Tariff V customers, for the expected life of the connection, an assumption of 20 years for domestic customers and 15 years for commercial industrial customers with the qualification that a different life for commercial and industrial customers may be used if there are grounds to consider that the life of the connection may be less than 15 years.

1099 AER, *Draft decision, Multinet access arrangement proposal for 1 January 2013 – 31 December 2017*, September 2012, p. 266.

1100 Multinet, *Access arrangement information*, 9 November 2012, Appendix 13.1 p. 2.

1101 Essential Services Commission, Victorian Gas Distribution Code, p. 37. The Code is available at: http://www.esc.vic.gov.au/getattachment/21ffea1a-d308-4baa-9d8d-4589fd999e08/Gas-Distribution-System-Code-version-9.pdf

1102 Part 12A was added to the NGR to regulate the connection process and how DNSPs may charge for new connections and is included in the National Gas (Retail Connection) Amendment Rules 2010.

For Tariff D customers, for the expected life of the connection, an assumption of 15 years, although a different life may be used if there are grounds to consider that the life of the connection may be less than 30 years.

Currently such assumptions are included in Schedule 2 to the Gas Distribution System Code (Victoria) (Code) but the intention is for the Code to cease to apply on commencement of NECF.

The AER sought comment from Multinet, and the other gas distribution businesses, on the need to include the assumptions as set out above.[1103]

The AER notes that Multinet agreed, subject to amendments being made to the AER's draft provision, to the inclusion of certain assumptions for the purpose of r 119M. SP AusNet also agreed subject to amendments being made to the AER's draft provision. SP AusNet specifically sought inclusion of more assumptions than had been proposed by the AER because "without firm rules on how these will be determined, there could be disputes with customers and so SP AusNet would request that they be included."[1104]

However, both Multinet and SP AusNet expressed concern that it was late in the AER's decision-making process to make this substantial change to the access arrangement.[1105] To achieve a satisfactory outcome would require further consultation on possible amendments to the drafting.

Envestra did not agree to inclusion of assumptions for the following reasons.[1106] First, it maintained that it would be inappropriate to preserve elements of the Victorian Gas Distribution System Code when on the commencement of NECF it is the intention for the Code to no longer apply. Second, it submitted that Schedule 2 of the Victorian Gas Distribution System Code is not relevant to the extension and expansion policy. Moreover, Schedule 2 covers the same ground as Part 12 of the National Gas Rules and this is why the Victorian Government has deemed that Schedule 2 (and the remainder of the Code) will no longer apply when NECF commences in Victoria. Furthermore, Envestra notes that under Part 12 of the National Gas Rules, the AER will approve Envestra's connection charges under model standing offers for connection services. That is, this provides a further degree of oversight by the AER.

The AER has considered Envestra's submission but considers that the inclusion of assumptions would provide greater certainty around the calculation of connection charges. Moreover, rule 119M(2)(c) specifically allows for their inclusion.

Nonetheless, taking into account the need for further consultation, at this stage the AER has determined not to include any assumptions in the 2013-17 access arrangements for each of the distributors. Further consultation is required in order to fully assess what assumptions should be included in access arrangements and to draft any such amendment to an access arrangement.

1103 AER information request Fd17a, 20 February 2013.

1104 Multinet, email dated 28 February 2013.

1105 Multinet, email dated 28 February 2013; SP AusNet, email dated 1 March 2013.

1106 Envestra, response to information request Fd17a, 27 February 2013.

13.6 Terms and conditions for changing receipt or delivery points

13.6.1 Final decision

The AER approves Multinets terms for changing receipt or delivery points.

13.6.2 Revised proposal

Multinet has adopted the amendment required by the AER in its draft decision and provided that the Service Provider will not withhold its consent under clause 5.4.2 or 5.4.3 unless it has reasonable grounds, based on technical or commercial considerations, for doing so.

13.6.3 Assessment approach

The AER's assessment approach is set out in section 12.5.3 in chapter 12 of part 2 of the draft decision.

13.6.4 Reasons for decision

Multinet has adopted the amendments proposed by the AER. The AER now considers that Multinets policy for changing receipt or delivery points is consistent with the rules.

13.7 Review dates

13.7.1 AER decision

The AER approves Multinet's review submission date and review commencement date.

13.7.2 Assessment approach

The AER's assessment approach is set out in 12.6.3 in chapter 12 of part 2 of the draft decision.

13.7.3 Reasons for decision

Multinet in its revised proposal adopted the review submission date determined by the AER in its draft decision. The AER considers that Envestra's review submission date and revision commencement date are now consistent with the general rule in r. 50(1) of the NGR. [1107]

13.8 Revisions

The AER proposes the following revisions to make Multinet's access arrangement acceptable.

Part C **Revision 12.1:** Delete clause 3A(g). **Revision 12.2:** Add the following to clause 13.6: (c) For the avoidance of doubt, this clause 13.6 applies where the User is acquiring Distribution Services as an End-User, including where an End-User on-supplies Gas to another entity.

1107

Revision 12.3: Re-insert and amend clause 7.4(g) of Multinet's initial access arrangement proposal as follows:

Where Metering Data is not available for a Customer for a period as at the time the invoice relating to that period is being prepared then the Service Provider may either:

(1) issue an invoice based on an Estimated Meter Reading; or

(2) include the Charges for that Customer for that period in a subsequent invoice issued by the Service Provider after the time the Metering Data for that Customer and Period becomes available. Where the Service Provider chooses to include the Charges in a subsequent invoice, it must issue such invoice as soon as reasonably practicable after the Metering Data becomes available.

Revision 12.4: Amend clause 9.1(j) as follows:

Delete the following phrase between the words 'caused' and 'by':

by factors upstream of the Distribution System (for example an interruption or curtailment in the supply of Gas by Gas producers due to faults in or failures of the Gas producers' production facilities) or caused

Revision 12.5: Amend clause 9.5 as follows:

Delete clause 9.5(c).

Revision 12.6: Amend clause 19.2(c) as follows:

It is therefore agreed that if there is any change to the Reference Service Terms then the terms of this Agreement will, subject to any agreement in writing between the parties, and excluding clauses that state that they are not subject to this clause 19.2(c), be automatically amended (without the requirement for the parties to execute any form of documentation) such that they are same as the Reference Service Terms.