Access arrangement draft decision

Multinet Gas (DB No. 1) Pty Ltd

Multinet Gas (DB No. 2) Pty Ltd

2013–17

Part 1

September 2012

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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 inclusive |
| 2008-12 access arrangement period | 1 January 2008 to 31 December 2012 inclusive |
| 2013-17 access arrangement period | 1 January 2013 to 31 December 2017 |
| 2018-22 access arrangement | Access arrangement for Multinet effective from 1 January 2018 to 31 December 2022 inclusive |
| ACCC | Australian Competition and Consumer Commission |
| AER | Australian Energy Regulator |
| access arrangement information | Multinet, Access arrangement information, 30 March 2012 |
| access arrangement proposal | Multinet, Access arrangement proposal, 30 March 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 pricing principles |
| WACC | weighted average cost of capital |

Summary

This is the AER's draft decision on Multinet's access arrangement for the 2013–17 access arrangement period. It includes the AER's draft decision on reference tariffs as well as terms and conditions for access to Multinet's distribution pipelines. In making its draft decision the AER applied the laws and rules governing gas access arrangements.

The draft decision sets out the AER's assessment of Multinet's access arrangement proposal, and details a number of revisions that AER requires Multinet make to its proposal to make it acceptable under the National Gas Rules. Multinet can lodge a revised proposal following the draft decision, and the AER will make a final decision on the revised proposal.

Draft decision

The AER’s draft decision on the total expected (smoothed) revenue derived from Multinet’s reference services is $781.9 million ($nominal).[[1]](#footnote-1) This is 31.7 per cent lower than Multinet's proposed (smoothed) revenue over the 2013–17 access arrangement period. In addition, the AER's draft decision on Multinet's ancillary reference service revenue is $7.9 million ($nominal) over the 2013–17 access arrangement period.

Indicative tariffs

This draft decision will result in reference tariffs being approximately 34.1 per cent lower on average over the 2013–17 access arrangement period (in nominal dollar terms) compared to Multinet’s proposed tariffs; and 14 per cent lower than average reference service charges per GJ for the
2008–12 access arrangement period. The indicative tariff path arising from the AER's draft decision compared with that in Multinet's proposal is shown in figure 1.

Figure 1 Indicative reference tariff paths for Multinet's reference services from 2013 to 2017 ($/GJ, nominal)

Source: AER analysis.
Note: This chart shows an indicative tariff path, based on forecast revenues and forecast demand for Multinet’s network. Multinet’s actual tariffs will first be updated on 1 July 2013 to reflect the AER’s decision. For this reason, the indicative 2013 tariff above is an average of the higher 2012 tariffs, and lower 2013 tariffs (from 1 July 2013 to 31 December 2013) to reflect the AER’s decision. Because of this mid-year change of tariffs in 2013, the chart above shows a further reduction in indicative tariffs in 2014. However, on 1 January 2014, the AER’s draft decision forecasts that actual tariffs will increase to reflect CPI.

Impact on residential bills

In Multinet's network area, approximately 30 per cent of an average residential gas bill is from gas distribution reference services.[[2]](#footnote-2) If the decrease in distribution tariffs was passed through to consumers, a typical residential bill of $1050 could be expected to reduce by approximately $8 ($nominal) per year. This compares with an increase of $18 ($nominal) per annum that would have resulted from Multinet's proposal.

Key differences between the draft decision and Multinet's access arrangement proposal

Key differences between the draft decision and Multinet's proposal are in regards to the rate of return, forecast capital expenditure (capex) and forecast operating expenditure (opex).

Rate of return

The rate of return relates to the cost of financing capital assets, such as providing a return on equity or paying interest on loans. The draft decision is to set a rate of return of 7.16 per cent (compared with Multinet's proposed 9.06 per cent). While the AER accepts most of Multinet's rate of return proposal, it does not accept Multinet's proposed risk free rate. Multinet proposed adopting a long term historical average risk free rate in the cost of equity. However, the AER's view is that a relatively short averaging period, sampled as close as practicably possible to the commencement of the access arrangement period, would better reflect current market conditions and risks.

Capital expenditure

The draft decision is to approve $179.5 million of the $375.3 million of capex proposed by Multinet (a reduction of approximately 52 per cent). While some proposed capex projects were accepted, the AER rejected aspects of Multinet's proposed mains replacement program and augmentation program where these were assessed as not necessary or prudent and efficient. However, a new mains replacement pass through event is proposed for low pressure (LP) to high pressure (HP) mains replacement. This will provide Multinet the flexibility to access funding where a change in circumstances leads it to undertake addition LP to HP mains replacement above the approved levels. Reductions were also made to direct overheads and IT and overheads capex to bring these in line with industry standards. The projections for customer numbers were also revised.

Operating expenditure

The draft decision is to approve $270.3 million of the $362.7 million of opex proposed by Multinet (a reduction of approximately 25 per cent). Multinet proposed a 'bottom-up' approach to estimating opex that was not based on historical opex. The AER did not accept this approach. Instead, the AER's draft decision is to estimate forecast opex by applying its usual base year forecasting approach.

Next steps

Multinet is given the opportunity to address this draft decision by submitting a revised access arrangement proposal by 9 November 2012.

The AER invites submissions from interested parties in response to its draft decision and Multinet's revised proposal. The deadline for submissions is 7 January 2013. Further information on providing a submission can be found at: <http://www.aer.gov.au/node/4799>

Once the AER has considered submissions and Multinet's revised proposal, it will publish its final decision in March 2013.

1. About the review

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[[3]](#footnote-3) 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.[[4]](#footnote-4)

* 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. DUET is managed jointly by AMP Capital Investors Limited and Macquarie Funds Group.

* + - 1. Map of the Victorian gas distribution networks

* + 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 ESCV 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.[[5]](#footnote-5) 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. The relevant requirements of the NGL and the NGR

This access arrangement draft decision specifies the amendments that the AER considers are required in order for Multinet's access arrangement proposal to be approved. These amendments have been identified by assessing each element of Multinet's 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

(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.[[6]](#footnote-6)

For these reasons, each element of Multinet's 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.[[7]](#footnote-7) 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.[[8]](#footnote-8) Section 23 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.

(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. Access arrangement review process

Under the NGL a service provider must submit an access arrangement proposal to the AER for approval under the NGR.[[9]](#footnote-9) 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:

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 1.3.4 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.[[10]](#footnote-10) 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.[[11]](#footnote-11)

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.[[12]](#footnote-12) The AER must include a statement of the reasons for the draft decision.[[13]](#footnote-13) 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.[[14]](#footnote-14)

* + 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.[[15]](#footnote-15) It follows that, if the AER withholds its approval to any element of an access arrangement proposal, the proposal cannot be approved.[[16]](#footnote-16)

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.[[17]](#footnote-17) 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
* the AER's reasons for refusing to approve that proposal.[[18]](#footnote-18)
	+ 1. 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.[[19]](#footnote-19) 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.[[20]](#footnote-20) The amendments must be limited to those necessary to address matters raised in the access arrangement draft decision unless the AER approves further amendments.[[21]](#footnote-21)

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.[[22]](#footnote-22) 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.[[23]](#footnote-23)

An access arrangement final decision is a decision to approve, or to refuse to approve, an access arrangement proposal.[[24]](#footnote-24) An access arrangement final decision, like an access arrangement draft decision, must include a statement of the reasons for the decision.[[25]](#footnote-25) The final decision must also be published on the AER's website.

* + 1. 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.[[26]](#footnote-26) 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.[[27]](#footnote-27)

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.[[28]](#footnote-28) 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 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.[[29]](#footnote-29)

* + 1. Completeness of Multinet's access arrangement information

The NGR require a service provider to submit, together with an access arrangement proposal, supporting information explaining the basis and derivation of each element of the access arrangement.[[30]](#footnote-30) Incomplete or deficient access arrangement information can impede and delay the AER's consultation and decision making processes.

Prior to receiving Multinet's access arrangement proposal, the AER consulted with Multinet to develop and refine the Regulatory Information Notice (RIN) and regulatory templates. A RIN is a compulsory information gathering notice that the AER prepares and serves on a service provider. A service provider must provide the AER with the information, and prepare, maintain or keep information in the manner and form, specified in a RIN.[[31]](#footnote-31) The purpose of the RIN was to obtain information from Multinet to assist the AER in assessing its access arrangement proposal.

Upon receiving Multinet's access arrangement proposal, the AER conducted a preliminary assessment of the proposal and access arrangement information against the requirements of the NGR. Following this assessment, the AER considered Multinet's access arrangement information to be deficient. Pursuant to r. 43, the AER required Multinet to submit further access arrangement information, as an addendum, in relation to the following issues.

First, during its preliminary examination of the access arrangement proposal, the AER found that Multinet had failed to include a nominated averaging period. The AER requires an averaging period in order to conduct a proper assessment of the proposed weighted average cost of capital.

Second, the AER found that Multinet had not provided sufficient information:

* supporting the basis for its operating expenditure forecasts
* explaining its proposed opening capital base and estimate of taxation.

This lack of information impacted upon the timing of the AER’s assessment of Multinet's proposed capital and operating expenditure.

Deficiencies in Multinet's access arrangement information resulted in the release of the AER's draft decision on Multinet's access arrangement proposal being delayed. Consequently, less time will be afforded to Multinet relative to the other Victorian distribution businesses to submit its revised access arrangement proposal. The time taken to correct the two deficiencies was disregarded for the purposes of calculating the elapsed time relating to the AER's deadline for making the draft decision.

* 1. 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 Multinet's access arrangement proposal. The AER considered all submissions in making this draft decision.

The AER also hosted a workshop on the proposed terms and conditions. The workshop provided retailers and distributors (including Multinet) with a forum to identify and discuss key issues arising from the proposed amendments to the non-price terms and conditions of the distributors’ access arrangements.

Table 1.1 below outlines the various stages of public consultation that the AER has undertaken as part of the review process, and upcoming consultation following this draft decision. The AER may also hold a public forum and industry workshop following the release of the AER's draft decision.

Submissions on Multinet's revised proposal are due 7 January 2013. Further information on providing a submission to the AER can be found at: <http://www.aer.gov.au/node/4799>

* + - * 1. Scheduled dates for 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 |
| Submissions on revised proposal due | 7 January 2013 |
| Release of AER final decision | March 2013 |

* + 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 circumstances.[[32]](#footnote-32) 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.[[33]](#footnote-33)

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.

* 1. Structure of decision paper

The draft decision paper is set out as follows:

* Part 1: AER draft decision—draft decision on access arrangement proposal and summary of reasons
* Part 2: attachments—detailed analysis of the various components of the draft decision (excluding analysis based on confidential information)
* Appendices—detailed discussion of common, technical issues
* Confidential appendices—sections of the AER's analysis that include protected information

In making its draft decision, the AER considered Multinet's access arrangement proposal and supporting information, submissions by interested parties and specialist advice provided to the AER by engineering, financial and economic experts.

The attachments to the AER's draft decision contain the AER's more detailed analysis. AER analysis that refers to protected information is contained in a confidential appendix to the decision.

1. AER approach

As the owner and operator of a gas distribution network, Multinet is required to submit an access arrangement to the regulator for approval. An access arrangement sets out the terms and conditions under which third parties can use a pipeline. It must specify at least one reference service likely to be sought by a significant part of the market, and a reference tariff for that service. As the national energy regulator, the AER is required to assess Multinet’s proposed gas access arrangement for the 2013–17 access arrangement period.

In order to assess Multinet’s proposal, the AER must first identify the covered pipeline that will be regulated through the access arrangement. That is, the 'reference services' covered by the access arrangement. For this draft decision the reference service is essentially the haulage reference services provided by Multinet which provide for the injection, withdrawal and conveyance of gas on its gas distribution network. This is discussed in more detail in chapter 4, attachment 1.

The AER's then undertakes the more substantial task of assessing and providing a draft decision on:

* tariffs for regulated pipeline services (reference services)
* non-tariff terms and conditions for reference and ancillary services.
	1. Tariffs for reference services

Assessing tariffs for reference services involves first assessing the total revenue required to deliver Multinet's distribution services. Consistent with the NGR, the AER uses the building block approach to determine the total revenue allowance. Total revenue under the building block approach is set out in r. 76 of the NGR and comprise of the following capital and non‑capital costs relating to pipeline services:

* a return on the projected capital base incorporating:
* the capital base—chapter 5 and attachment 2
* capital expenditure (which forms part of the capital base)—chapter 6, attachment 3 and confidential appendix A
* a rate of return—chapter 7, attachment 4 and appendix B
* regulatory depreciation of the projected capital base—chapter 8 and attachment 5
* forecast operating expenditure—chapter 9, attachment 6 and appendix C
* increments and decrements resulting from an incentive mechanism[[34]](#footnote-34)—chapter 10 and attachment 7
* corporate income tax[[35]](#footnote-35)—chapter 11 and attachment 8.

This is illustrated in figure 2.1.[[36]](#footnote-36)

* + - 1. Building block approach

Total revenue

Return on capital

(projected capital base × rate of return)

Regulatory depreciation

Operating expenditure

Corporate income tax

Capital costs

Incentive mechanism
(increment or decrement)

These building blocks are taken into account in determining Multinet's total revenue. That total revenue in general terms, is a forecast of its efficient cost of providing gas distribution services. For the AER's draft decision on Multinet's required revenue, see chapter 3.

Once total revenue is determined, revenue is allocated to reference and other pipeline services. The tariffs for the reference services are determined with regard to the recovery of the total revenue required to provide those services and the forecast demand for those services. Hence, demand forecasts are an important component of the AER's draft decision on tariffs for reference services. Demand is discussed in chapter 12 and attachment 9.

In relation to tariffs, the access arrangement also details:

* how tariffs for reference services will be set (chapter 13 and attachment 10 relate to tariff setting)
* the mechanism for varying tariffs annually and arrangements for varying tariffs in certain pre-specified conditions (chapter 14 and attachment 11 discuss the tariff variation mechanism).
	1. Non-tariff terms and conditions

Non-tariff terms and conditions essentially define the commercial relationship between the network service provider and users. In considering Multinet's proposal, the AER assesses whether Multinet's proposed terms and conditions are consistent with the NGO and the broader regulatory framework. While parties can agree on terms that are different to those set out in Multinet’s access arrangement proposal, the AER's approved terms and conditions can act as a starting point for negotiations.

The AER’s consideration of the access arrangement’s non–tariff components is set out in chapter 15, attachment 12, and appendix D.

* 1. What the AER considers in reaching its draft decision

The AER’s draft decision on Multinet's 2013–17 access arrangement has been made in accordance with the relevant sections of the NGL and NGR.

In forming its draft decision, the AER has:

* considered Multinet's access arrangement proposal and supporting information provided by Multinet
* considered information provided by Multinet in response to information requests from the AER
* considered submissions from interested parties
* considered views expressed at stakeholder events
* undertaken its own analysis to verify the information provided by Multinet
* considered expert advice or analysis commissioned in relation to certain aspects of Multinet's access arrangement proposal.

For more on the steps undertaken by the AER in coming to this draft decision, as well as an overview of the regulatory framework, see chapter 1.

There were significant information gaps and inconsistencies in Multinet’s proposal. This meant the AER had to request further information in respect of a number of issues. In many cases, Multinet's responses to the AER's information requests were slow and remained inadequate. This failure to provide information in a timely manner affected the AER’s assessment process and has led to a delay in finalising the draft decision. As a result of the delay, Multinet now has less time to submit its revised access arrangement proposal in response to the draft decision.

1. Total revenue requirements and the impact on price

Multinet's total revenue, in general terms, is a forecast of its efficient cost of providing gas distribution services.

The total revenue set out in this draft decision has been determined by assessing each element of Multinet's access arrangement proposal. These elements include the building blocks, which have been assessed to ensure that they are consistent with the costs that would be incurred by an efficient service provider in providing gas distribution services. This also includes taking into account any relevant interlinkages that exist between the elements of Multinet's access arrangement proposal.

These elements are discussed in more detail in the remainder of the draft decision. Interlinkages between these elements are discussed in chapter 16.

This chapter also includes some analysis on the likely impact of this draft decision on prices for end consumers. This analysis has been undertaken with reference to the AER's draft decision on tariffs.

* 1. Draft decision

The AER’s draft decision on the total (smoothed) expected revenue derived from Multinet’s reference services is $781.9 million ($nominal).[[37]](#footnote-37) This is calculated by smoothing the total building block revenue requirement of $787.6 million ($nominal). [[38]](#footnote-38)

This (smoothed) revenue requirement is 31.7 per cent lower than Multinet's proposed (smoothed) reference services revenue over the 2013–17 access arrangement period. The AER accepts that some aspects of Multinet’s proposal are consistent with the requirements of the NGR. However, the AER has not approved all elements. The key elements of the AER’s draft decision that would reduce Multinet's proposed revenue include:

* the rate of return
* capital expenditure (capex)
* operating expenditure (opex).

Figure 3.1 compares Multinet's proposal with the AER’s draft decision for revenues over the 2013–17 access arrangement period and the revenue approved by the ESC over the
2008–12 access arrangement period. As shown, Multinet's proposed smoothed revenues for the 2013–17 access arrangement period are 34.5 per cent higher than the ESC allowed revenues for the 2008–12 access arrangement period.

* + - 1. AER’s draft decision compared to Multinet's proposed revenue requirement and approved revenue for 2008–12 ($million, nominal)

Source: AER analysis.

The AER's draft decision on Multinet's total revenue is arrived at by summing the 'building blocks' that were set out in section 2.1 of chapter 2 of this document. These building blocks are shown in table 3.1 and are each discussed in greater detail in this draft decision and the attachments to the document.

* + - * 1. AER's draft decision on Multinet's proposed revenue requirements for its reference services ($million, nominal)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **2013** | **2014** | **2015** | **2016** | **2017** | **Total**  |
| Return on capital | 72.7  | 75.3  | 76.3  | 77.3  | 78.3  | 379.9  |
| Regulatory depreciation | 14.9  | 20.7  | 23.5  | 26.2  | 29.1  | 114.3  |
| Operating expenditure | 53.8  | 55.8  | 57.9  | 61.0  | 63.0  | 291.4  |
| Efficiency carryover | –3.9  | –3.1  | –5.4  | –5.4  |  –  | –17.8  |
| Net corporate income tax allowance | 5.0  | 4.6  | 4.9  | 6.0  | 7.2  | 27.7  |
| Less: ancillary reference services revenue | 1.5 | 1.5 | 1.6 | 1.6 | 1.7 | 7.9  |
| Annual building block revenue requirement (unsmoothed) | 141.0  | 151.7  | 155.6  | 163.4  | 175.9  | 787.6  |
| Annual expected revenue requirement (smoothed) | 163.7 | 149.1 | 152.5 | 156.4 | 160.2 | 781.9  |
| X factor | 23.5% | 0.0% | 0.0% | 0.0% | 0.0% | n/a |

Source: AER analysis.

n/a Not applicable.

The effect of the AER’s draft decision on each of the building blocks and on Multinet's proposed total (unsmoothed) revenue requirement is displayed in figure 3.2. This shows that the AER’s draft decision will reduce Multinet’s proposals for the return on capital, opex, depreciation and tax building blocks.

* + - 1. AER’s draft decision and Multinet's proposed revenue requirement (unsmoothed), by building block ($million, nominal)

Source: AER analysis.

* + 1. Sensitivity analysis

This section provides additional analysis to consider how revenue has changed between Multinet's proposal and this draft decision and the key drivers of this.

The AER's draft decision is to approve a smoothed revenue requirement for Multinet's reference services of $781.9 million ($nominal) over the 2013–17 access arrangement period. This is calculated by smoothing the total building block revenue requirement of $787.6 million ($nominal).[[39]](#footnote-39) The AER’s draft decision on smoothed reference service revenue represents a 31.7 per cent reduction of Multinet's proposed smoothed revenue over the 2013–17 access arrangement period.

This reduction is primarily driven by differences between Multinet's proposal and the draft decision on:

* rate of return, which has reduced from 9.06 per cent to 7.16 per cent
* forecast net capex, which has reduced from $409.6 million ($nominal) to $194.7 million ($nominal) (a reduction of approximately 52.5 per cent)
* forecast opex[[40]](#footnote-40), which has reduced from $391.3 million ($nominal) to $273.6 million ($nominal) (a reduction of approximately 30.1 per cent).

Table 3.2 shows that total unsmoothed revenue would be $129.80 million ($nominal) or 11.27 per cent lower than Multinet's proposed total revenue when the AER's draft decision on the rate of return is adopted.

* + - * 1. Changes to Multinet's proposed total unsmoothed revenue, when AER's draft decision WACC parameters are adopted

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|   | Multinet's proposal (per cent) | AER’s draft decision (per cent) | Revenue change ($million, nominal) | Revenue change (per cent)  |
| Risk free rate  | 3.99 (for debt)5.99 (for equity) | 2.98 | –124.63 | –10.83a |
| DRP | 3.92 | 3.76 | –2.75 | –0.24b |
| WACC  | 9.06 | 7.16 | –129.80 | –11.27c |

Source: AER analysis.

Notes: The above scenario analysis was undertaken using the proposed Post-tax Revenue Model, with the formulae in the 'WACC' sheet corrected for the AER's approach.

(a) The AER has accepted Multinet’s proposed method for calculating the risk free rate used to determine the cost of debt. The difference between this risk free rate and the AER’s draft decision, therefore, is due entirely to the AER’s draft decision relying on data from a more recent indicative averaging period. That is, Multinet's proposed rate is based on market data from November–December 2011, whereas the AER's draft decision is based on market data from July–August 2012. The AER will update this data for its final decision to reflect Multinet’s final averaging period. In contrast, the AER has not accepted Multinet’s proposed method for calculating the risk free rate used to determine the cost of equity. Hence, the difference between the AER’s risk free rate and that proposed by Multinet (for equity).

(b) The difference between the DRP proposed by Multinet and the AER’s draft decision predominantly reflects the difference in indicative averaging periods (as explained for the risk free rate). The AER, however, has also amended the bond sample relied on by Multinet to extrapolate the Bloomberg fair value curve. This amendment, albeit minor, is discussed in greater detail in attachment 4 of this draft decision.

(c) The impact from each individual parameter change does not add up to the total impact of the WACC change (last row in the table). This is due to the interaction of individual parameters that contribute to calculating the WACC.

Table 3.3 shows that total unsmoothed revenue, based on the AER's draft decision forecast capex, would be $43.0 million ($nominal) or 3.7 per cent lower than Multinet's proposed total proposed revenue. It also shows that when the AER's draft decision opex is adopted, the total unsmoothed revenue would be around $114.2 million ($nominal) or 9.9 per cent lower than Multinet's proposed total revenue.

* + - * 1. Changes to Multinet's proposed total unsmoothed revenue, when AER's draft decision capex and opex forecasts are adopted

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|   | Multinet's proposal ($million, nominal) | AER's draft decision ($million, nominal) | Revenue change ($million, nominal)  | Revenue change (per cent)  |
| Capex | 409.6 | 194.7  | –43.0 | –3.7 |
| Opexa | 391.3  | 273.6  | –114.2 | –9.9 |

Source: AER analysis.

(a) Includes carryover amounts.

* 1. Impact on prices
		1. Reference tariffs

The effect of the AER’s draft decision on Multinet's forecast reference tariffs for its reference services can be estimated by comparing these with Multinet's forecast reference tariffs. Using this approach the AER estimates that the draft decision will result in reference tariffs being 34.1 per cent lower on average over the 2013–17 access arrangement period in nominal dollar terms than Multinet’s proposed tariffs.

The AER’s draft decision will result in average reference service distribution charges ($/GJ of demand) for the 2013–17 access arrangement period that are 14.0 per cent lower than average reference service charges per GJ for the 2008–12 access arrangement period.

These lower reference tariffs are largely driven by the AER’s draft decision on a lower rate of return, and lower forecast capital and operating expenditure allowances. This is also reflected in no real price increases (known as X factors). The indicative tariff path arising from the AER's draft decision compared with that in Multinet's proposal is shown in Figure 3.3.

* + - 1. Indicative reference tariff paths for Multinet's reference services from 2013 to 2017 ($/GJ, nominal)

Source: AER analysis.
Note: This chart shows an indicative tariff path, based on forecast revenues and forecast demand for Multinet’s network. Multinet’s actual tariffs will first be updated on 1 July 2013 to reflect the AER’s decision. For this reason, the indicative 2013 tariff above is an average of the higher 2012 tariffs, and lower 2013 tariffs (from 1 July 2013 to 31 December 2013) to reflect the AER’s decision. Because of this mid-year change of tariffs in 2013, the chart above shows a further reduction in indicative tariffs in 2014. However, on 1 January 2014, the AER’s draft decision forecasts that actual tariffs will increase to reflect CPI.

* + 1. Average retail customer bill

In Multinet's gas distribution network region, the proportion of the average residential gas bill attributable to gas distribution reference tariffs is estimated to be approximately 30 per cent.[[41]](#footnote-41)

If the decrease in distribution tariffs from the AER’s draft decision was passed through to consumers, a typical residential bill[[42]](#footnote-42) could be expected to reduce by up to $8 ($nominal) per year on average. Multinet’s proposal would have resulted in an average $18 ($ nominal) per annum increase.

The proportion of the average non-residential gas bill attributable to gas distribution reference tariffs in Multinet's region is estimated to be approximately 18 per cent. If the decrease in distribution tariffs from the AER’s draft decision was passed through to consumers, a typical non-residential bill[[43]](#footnote-43) could be expected to reduce by up to $30 ($nominal) per year on average. Multinet’s proposal would have resulted in an average $66 ($ nominal) per annum increase.

1. Services covered by the access arrangement

A service is deemed a reference service if it is a pipeline service that is likely to be sought by a significant part of the market.[[44]](#footnote-44) The full draft decision and the AER's detailed reasons and analysis on the services covered by the access arrangement can be found in attachment 1.

* 1. Draft decision

Multinet provides for three categories of haulage reference services which allow for the injection, conveyance and withdrawal of gas. The AER considers that these services are likely to be sought by a significant part of the market. However, the AER does not consider that Multinet’s qualification that the proposed reference services are likely to be sought by a significant part of the market when sought by a retailer is necessary or consistent with the NGR. Hence, the AER does not approve Multinet’s proposed reference services. Multinet’s proposed ancillary services are carried over from its current access arrangement. The AER considers that these services are likely to be sought by a significant part of the market.

1. Capital base

The capital base is the value of Multinet's capital assets—including gas distribution pipelines, connections, IT systems, plant and equipment, motor vehicles and buildings—that are required to provide reference services. The capital base is the value on which Multinet can earn a rate of return. Further, Multinet is allowed to earn a depreciation allowance (or a return of capital) on assets in its capital base. Hence, the capital base is an important input to the return on capital and depreciation building blocks and accordingly, the revenue requirement.

As part of this draft decision, the AER is required to assess Multinet's proposed opening value for the capital base for each year of the previous (2008–12) and upcoming (2013–17) access arrangement periods. This involves the AER:

* Confirming the value of the opening capital base at 1 January 2008 (the first year of the 2008–12 access arrangement period). This involves assessing whether Multinet's actual capex in 2007 is conforming capex and adjusting for differences between actual conforming capex and estimated capex for 2007.[[45]](#footnote-45) Conforming capex is essentially that which would have been undertaken by an efficient distribution service provider in providing reference services.
* Rolling forward the opening capital base as at 1 January 2008 to determine the closing capital base as at 31 December 2012.[[46]](#footnote-46) This involves, for each year:
* adding conforming actual capex and any speculative capex (which became conforming capex) or redundant assets that were reused during the 2008–12 access arrangement period
* removing forecast depreciation, any capital contributions, any redundant assets and any disposals
* indexing the roll forward for actual inflation.
* Using the AER's draft decision on forecast depreciation, capex, disposals and inflation for the 2013–17 access arrangement period to roll forward Multinet's projected capital base for each year of that access arrangement period. In particular, conforming forecast capex is added to the capital base while forecast depreciation and disposals are removed from the capital base. Forecast inflation is used to index the resulting capital base.

Following this process, the AER's draft decision includes a forecast value of Multinet's capital base as at 1 January 2013 and a forecast closing capital base at 31 December 2017.

The full draft decision and the AER's detailed reasons and analysis on the capital base can be found in attachment 2.

* 1. Draft decision

The AER does not approve Multinet's proposed opening capital base of $1072.9 million as at 1 January 2013 because it considers that some of Multinet's inputs into the capital base roll forward model do not comply with the NGR.[[47]](#footnote-47) These include:

* Multinet's revised estimate for capex in 2012
* formulae and calculation errors in Multinet's proposed capital base models.

After adjusting these inputs, the AER has determined an opening capital base of $1016.5 million ($nominal) as at 1 January 2013, which is approximately $56 million less than that proposed by Multinet. Figure 5.1 shows Multinet's past actual opening capital base values compared to forecast values.

* + - 1. Multinet's past and forecast opening capital base and the AER’s draft decision on the opening capital base ($million, nominal)

Source: AER analysis.

 shows the AER’s draft decision on the roll forward of Multinet’s capital base during the 2008–12 access arrangement period.

* + - * 1. AER's draft decision on Multinet’s 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 |
| Capex | 41.2 | 39.1 | 40.7 | 64.5 | 47.6a |
| Less: customer contributions | 2.4 | 25.9 | 2.4 | 2.2 | 2.0 |
| Less: disposals | 49.1 | 51.8 | 53.6 | 54.3 | 54.9 |
| Less: depreciation | 1071.8 | 1033.1 | 1017.8 | 1025.8 | 1016.5 |
| Closing capital base |  |  |  |  | 1016.5 |
| Opening capital base at 1 January 2013 |  |  |  |  | 1016.5 |

Source: AER analysis.

(a) Based on adjusted benchmark capex.

Based on the above opening capital base for 1 January 2013, and the AER's draft decisions on forecast capex, depreciation, and inflation, the AER has determined a projected closing capital base of $1097.0 million ($nominal) as at 31 December 2017. Table 5.2 sets out the projected roll forward of the capital base during the 2013–17 access arrangement period.

* + - * 1. AER's draft decision on Multinet's projected capital base roll forward for the 2013–17 access arrangement period ($million, nominal)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2013 | 2014 | 2015 | 2016 | 2017 |
| Opening capital base | 1,016.5  | 1,052.1  | 1,065.9  | 1,079.6  | 1,094.2  |
| Net capex | 50.4  | 34.5  | 37.2  | 40.7  | 31.9  |
| Less: depreciation | 40.3  | 47.0  | 50.2  | 53.1  | 56.5  |
| Indexation | 25.4  | 26.3  | 26.6  | 27.0  | 27.4  |
| Closing capital base | 1,052.1  | 1,065.9  | 1,079.6  | 1,094.2  | 1,097.0  |

Source: AER analysis.

* 1. Summary of analysis and reasons

The AER approves some aspects of Multinet's proposal for the opening capital base as at 1 January 2013 including:

* To use the opening capital base at 1 January 2007 as the basis from which to roll forward the capital base (consistent with that adopted in the ESC's final decision for the 2008–12 access arrangement period).
* The use of forecast depreciation for the 2008–12 access arrangement period as approved by the ESC.

However, the AER considers that a number of Multinet's proposed inputs into the capital base roll forward model overstate the value of the opening capital base as at 1 January 2013 and consequently, the projected closing capital base as at 31 December 2017. In particular, the AER does not agree with Multinet’s approach in the following areas:

* Multinet's separate roll forward and depreciation models contained formulae errors. The AER has corrected the errors and adjusted Multinet's two separate models into a combined RFM for determining the opening capital base (including the opening tax asset base and depreciation calculations for the 2008–12 access arrangement period). Further, Multinet's capital base models incorrectly included the benchmark adjustment to 2007 capex and therefore overstated the opening capital base as at 1 January 2008.
* Multinet's 2008–12 access arrangement included a capex incentive scheme. However, Multinet's estimate of 2012 capex was not consistent with the ESC's capex incentive scheme. To make 2012 capex consistent with the ESC's capex incentive scheme the AER has replaced Multinet's estimated 2012 capex with benchmark (forecast) 2012 capex adjusted for actual growth.
* The draft decision on forecast capex and depreciation form inputs into the roll forward for the projected capital base for the 2013–17 access arrangement period. These need to be adopted in place of Multinet's proposed forecast capex and depreciation. See overview sections 5 and 7 and attachments 3 and 5 for more on the AER's draft decision on these matters.

These adjustments add up to a $56 million reduction to Multinet's proposed opening capital base at 1 January 2013. The AER's draft decision is an opening capital base of $1016.5 million ($nominal) as at 1 January 2013. Based on this, and the AER's draft decisions on forecast capex, depreciation, and inflation, the AER has determined a projected closing capital base of $1,097.0 million ($nominal) as at 31 December 2017. See attachment 2 for more on the AER's draft decision on the capital base and reasons for this.

1. Capital expenditure

Forecast capital expenditure (capex) is a forecast of the cost of new assets that are likely to be required by a network business during an access arrangement period for the efficient operation of the network. As well as assessing forecast capex, the AER reviews actual capex undertaken during the previous access arrangement period. The final approved level of capex is used in conjunction with the opening capital base, rate of return and depreciation as an input in the return on capital building block.

Capex is broken down into several categories:

* augmentation capex – assets that expand the capacity of the network or provide connections to new customers
* refurbishment and upgrade capex – used to replace or upgrade aging, obsolete or inefficient assets
* non-network capex – including IT, plant and equipment, motor vehicles and buildings.

An efficient network business will require one or more of these categories of capex during an access arrangement period. Factors that will influence the required level of capex include the age and condition of existing assets, changes in the number of customers connected to the network, changes in the demand profile of customers, and general 'stay in business' requirements of the business.

The AER assesses the capex forecasts of regulated gas network businesses to determine whether they conform to the criteria set out within the NGR. In particular, the forecast capex must:

* be arrived at on a reasonable basis and represent the best forecast or estimate possible in the circumstances
* be expenditure that would be incurred by a prudent service provider acting efficiently, in accordance with good industry practice, to achieve the lowest sustainable cost of providing pipeline services
* be shown that one of the following criteria is met:
* the capex has a positive economic value
* the expected present value of the incremental revenue exceeds the expenditure
* the capex is necessary to either:
* maintain and improve the safety of services
* maintain the integrity of services
* comply with a regulatory obligation or requirement
* maintain capacity to meet levels of demand existing at the time the capex is incurred
* the capex is justifiable as a combination of the preceding two dot points.

Multinet proposed a total forecast capex of $375.3 million ($2012) for the 2013–17 access arrangement period. The AER must accept Multinet’s forecast capex if it is satisfied that it is conforming capex as specified in the NGR.[[48]](#footnote-48)

In assessing Multinet’s proposed capex for both the previous and upcoming regulatory access agreement periods, the AER reviewed Multinet’s proposal and supporting material. This included information on Multinet's reasoning and, where relevant, business cases, audited regulatory accounts, and other relevant information. In addition, the AER engaged consultants to review aspects of Multinet's capex proposals.

The full draft decision and the AER's detailed reasons and analysis on capital expenditure can be found in attachment 3.

* 1. Draft decision

The AER’s draft decision is to approve Multinet's proposed $231.7 million ($2012) total net capex for 2007–11 as conforming capex for the purpose of setting the capital base for 2007–11 (see overview section 4 and attachment 2).[[49]](#footnote-49)

For the 2013–17 access arrangement period, the AER’s draft decision is to approve $177.7 million ($2012) of Multinet's proposed $375.3 million ($2012) total capex.

Figure 6.1 shows actual and ESC approved capex for 2008–11 and Multinet’s proposed capex and the AER’s draft decision on capex for 2012–17.

* + - 1. Comparison of Multinet’s past and forecast total capex and AER draft decision ($million, 2012)

Source: AER analysis.

Table 6.1 is a comparison of Multinet's proposed capex and the AER's draft decision on capex for the 2013–17 access arrangement period by category.

* + - * 1. Comparison of Multinet's proposed and the AER's draft decision on capex for the 2013–17 access arrangement period ($million, 2012)

|  |  |  |  |
| --- | --- | --- | --- |
| Category | Multinet proposed | AER draft decision | Difference |
| Mains replacement | 121.3 | 44.8 | -63% |
| Residential connections | 96.0 | 61.5 | -36% |
| Commercial/industrial connections | 12.7 | 4.2 | -67% |
| Meters | 14.0 | 11.2 | -20% |
| Augmentation | 35.1 | 7.4 | -79% |
| IT | 46.9 | 35.6 | -24% |
| SCADA | 7.4 | 1.0 | -86% |
| Other | 46.1 | 32.4 | -30% |
| Internal direct overheads | 16.4 | – | -100% |
| Indirect overheads | – | – | 0% |
| GROSS TOTAL | 396.0 | 198.4 | -50% |
| Customer contributions | 20.7 | 20.7 | 0% |
| Government contributions | – | – | 0% |
| NET TOTAL  | 375.3 | 177.7 | -53% |

Source: AER analysis

* 1. Summary of analysis and reasons

The AER has made a number of amendments to Multinet's capex proposals. The main amendments are discussed below. For more detail on the AER's draft decision on capex, see attachment 3.

Mains replacements

Distribution mains are the pipes that convey gas to service pipes at each end user point. Multinet proposed mains replacement capex of $121.3 million ($2012, direct costs) for four categories of mains replacement programs. The AER's draft decision makes amendments to each of these programs. The most substantial amendments include changes to:

* Low pressure (LP) mains replacement—the AER draft decision is to reduce Multinet’s proposed scale of works and unit costs:
* In the 2008–11 period Multinet met the relevant safety requirements despite replacing fewer LP mains than what it proposed and what was approved. The AER considers that these volumes provide a robust benchmark for what a prudent and efficient service provider would undertake. Hence, the AER proposes to use historic volumes delivered over the 2008–11 period to set the scale of works for 2013–17. However, to allow for changing circumstances, the AER proposes to allow for a pass through event to apply, where the trigger event is the completion of approved volumes.
* For unit costs, Multinet applied a direct overhead uplift rate to account for overhead costs of contractors. The rate proposed by Multinet was higher than the AER's engineering consultant, Zincara, considered was industry standard practice. The AER therefore reduced this to the industry standard rate. In addition, as works with lower unit rates tend to be undertaken first, the unit rates have been adjusted in line with the volume adjustment discussed above.
* Large diameter cast iron mains replacement—Multinet proposed five replacement projects for the 2013–17 period but failed to demonstrate why these projects were necessary. Multinet also failed to demonstrate that the timing of these projects was prudent and that a proactive rather than reactive program was justified. For these reasons the AER does not approve this program of works in the 2013–17 period.
* Low pressure designated zones—Multinet proposed a program for dealing with LP zones that are not expected to be replaced in the next 20 years. Multinet has not justified why this program is necessary and why it has been proposed outside of the LP mains replacement program. Further, Multinet has not provided any evidence to demonstrate that the current practice for managing gas leaks is inadequate. For these reasons the AER does not approve this program of works in the 2013–17 period.

These amendments result in a 58 per cent reduction in Multinet's proposed mains replacement capex (from $121.3 million to $44.8 million).

Tariff V class customer connections

Tariff V class customer connections relate to residential and commercial/industrial customers who consume less than 10 TJ per year. To estimate the capex for tariff V class customer connections requires estimates of

* the number of new connections for this type of customer; and
* an estimate of the unit rate cost of each connection.

The number of connections is then multiplied by the unit cost to estimate the capex required.

To estimate the number of new connections for the 2013–17 period, Multinet used modelling undertaken by the NIEIR.[[50]](#footnote-50) The NIEIR report did not include the method for forecasting gross customer connections from net customer connections. Multinet advised this was based on a ratio of the historical ratio of abolishments[[51]](#footnote-51) to the total number of connections to forecast abolishments.[[52]](#footnote-52) However, Multinet did not provide the AER with sufficient information to verify this ratio. Given this, the AER does not consider that Multinet's forecast of gross connections was arrived at on a reasonable basis. Instead, the AER proposes to use the 2012 gross connections number Multinet provided in response to the AER's RIN and apply NIEIR's growth rates for 2013–17 to derive estimates of the gross connections numbers for 2013–17.

In relation to the unit cost of connections, Multinet stated that these were based on a recent tender process for the outsourcing of its network operations over 2013–17.[[53]](#footnote-53) However, the AER was unable to reconcile the derived unit rates with the tendered unit rates. The AER instead considers that a weighted average of Multinet's 2008–12 unit rates should be used to estimate unit rates for residential and commercial connections for the 2013–17 period.

Meter replacement

The AER considers that Multinet’s forecast volumes of meter replacement appear commensurate with its historical replacement rate. However, Multinet did not provide sufficient evidence for the AER to establish the reasonableness of Multinet's proposed unit rates. Accordingly, the AER considers that that an average of Multinet's historical expenditure over the 2008–12 period is the best forecast available in the circumstances.[[54]](#footnote-54)

Augmentation

The AER considers that a number of augmentation projects proposed by Multinet are necessary in light of forecast connections growth to address a decline in gas pressure within constrained network areas. However, it does not approve Multinet's forecast input costs for these projects. As with Multinet's unit cost estimates for LP mains replacement, the AER has revised the direct overheads uplift rate down to the industry standard rate.

In addition, the AER draft decision is not to accept Multinet's proposed augmentation projects where either:

* the modelled pressure does not fall below the regulated minimum, meaning the augmentation is not necessary; or
* the solution does not address the capacity issue.

In sum, the AER approves augmentation capex of $7.4 million ($2012, direct costs) but does not approve augmentation capex of $27.6 million ($2012, direct costs).

IT

The AER engaged Nous Group to assess the prudency and efficiency of Multinet's IT programs. Using this advice, the AER's draft decision is to reduce the proposed risk and contingency allowance on a number of IT projects and the cost of the GIS Strategy and GE Smallworld Upgrade, and Data Warehouse Enhancement projects in line with industry standard costs.

Internal capitalised labour - direct overheads

Multinet proposed capitalising $16.4 million ($2012, direct cost) of its labour as direct capital overheads. Ninety-nine per cent of this relates to new staff positions. The AER understands these new positions reflect a shift from out‑sourcing these functions to in-sourcing. The AER considers there should be commensurate cost savings associated with no longer out-sourcing these functions which should at least offset the cost of the new staff positions. Hence, the AER does not approve Multinet's proposed capex for internal labour.

Other projects

Multinet proposed a number of other capex projects. The AER did not approve a number of these because the expenditure forecast by Multinet did not represent the best estimate possible in the circumstances. Other projects were not approved as Multinet did not demonstrate that these were necessary projects. Some projects were approved either in full or in part. In total, the AER approved $32.4 million of Multinet's proposed $46.1 of capex for other projects.

All of the above taken together results in a 52 per cent reduction to Multinet's proposed capex (from $375.3 million to $179.5 million). See attachment 3 for more on the AER's draft decision on forecast capex and reasons for this.

1. Rate of return

The rate of return is one of the inputs to the building block approach used by the AER to determine total revenue for each regulatory year of the access arrangement period. 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.[[55]](#footnote-55)

Multinet's return on capital building block is calculated by multiplying the rate of return with the value of Multinet's capital base. Consistent with Multinet's access arrangement proposal and previous AER gas decisions, the rate of return adopted by the AER is the nominal vanilla WACC formulation.

The AER's detailed reasons for its decision on the rate of return are provided in attachment 4, with additional reasons on some matters set out in appendix B.

* 1. Draft decision

The AER does not approve Multinet's proposed (indicative) rate of return of 9.06 per cent. The AER withholds its approval because, in the AER's opinion, 7.16 per cent (subject to updating) is a preferable alternative that is commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.[[56]](#footnote-56)

Multinet's proposed rate of 9.06 per cent is based on market data from November-December 2011. The AER's draft decision rate of 7.16 per cent is based on market data from July-August 2012. Multinet's proposed rate of return method, if also applied to market data from July-August 2011, would result in a proposed rate of 8.36 per cent.

Both Multinet's proposed rate of return method, and the AER's method in this draft decision, will be updated using market data for the risk free rate and debt risk premium (DRP) updated closer to the time of the final decision. The AER's draft decision method involves updating the risk free rate used in both the cost of equity and cost of debt. Multinet's proposed method involves only updating the risk free rate used in the cost of debt.

The AER considers a 7.16 per cent rate of return (subject to updating) provides Multinet with a reasonable opportunity to recover at least the efficient costs of capital financing. Consequently, the AER expects Multinet will be able to attract funds to support the efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers.

The AER agrees with the following aspects of Multinet's proposed rate of return method:

* adopting the capital asset pricing model (CAPM) to calculate the cost of equity
* adopting the yield on 10 year Commonwealth Government Securities (CGS) as the proxy for the risk free rate
* adopting a market risk premium (MRP) of 6 per cent
* adopting an equity beta of 0.8.
* specifying the cost of debt as the debt risk premium over the risk free rate
* determining the debt risk premium by defining the benchmark bond as a 10 year Australian corporate bond with a BBB+ credit rating and measuring the benchmark bond rate using the extrapolated Bloomberg BBB rated seven year fair value curve
* extrapolating the Bloomberg BBB rated seven year fair value curve to a 10 year maturity (consistent with the definition of the benchmark bond) using paired bond analysis[[57]](#footnote-57)
* adopting a 60 per cent gearing ratio
* adopting the inflation forecasting method based on short term Reserve Bank of Australia (RBA) forecasts and the mid-point of the RBA's inflation targeting band

But the AER does not agree with the following aspect of Multinet's proposal:

* adopting a long term historical average risk free rate in the cost of equity. Rather, the AER adopts a short term averaging period sampled as close as practicably possible to the commencement of the access arrangement period, as explained in section 7.2.1.

Table 7.1 sets out the individual WACC parameters and consequent (indicative) rate of return determined by the AER.

* + - * 1. AER's draft decision on Multinet's rate of return (nominal)

|  |  |  |
| --- | --- | --- |
|  Parameter | Multinet proposal | AER draft decision |
| Nominal risk free rate (cost of equity) | 5.99% | 2.98% |
| Nominal risk free rate (cost of debt) | 3.99% | 2.98% |
| Equity beta | 0.8 | 0.8 |
| Market risk premium | 6% | 6% |
| Debt risk premium | 3.92% | 3.76% |
| Gearing level | 60% | 60% |
| Inflation forecast | 2.51% | 2.5% |
| Gamma | 0.25 | 0.25 |
| Nominal post-tax cost of equity | 10.80% | 7.78% |
| Nominal pre-tax cost of debt | 7.91% | 6.74% |
| Nominal vanilla WACC | 9.06% | 7.16% |

Source: ACCC decision; Multinet, Access arrangement proposal, March 2012 and AER analysis.

(a) Indicative only. The risk free rate, debt risk premium and inflation forecast will be updated closer to the date of the final decision.

The rate of return in this draft decision (7.16 per cent) is similar to the rate of return determined by the AER recently in the APTPPL final decision (7.31 per cent).[[58]](#footnote-58) However, the rate of return in this decision for Multinet is lower than the rate of return determined by the AER in decisions before that time. The fact that the overall rate of return in this decision is lower than in previous decisions does not of itself make it unreasonable. The cost of debt in this decision makes up 60 per cent of the overall rate of return. The AER and Multinet agree on the approach to determining the cost of debt. The cost of debt has fallen by approximately one per cent compared with AER decisions from earlier this year.[[59]](#footnote-59) Hence, the AER and Multinet agree that this reduction reflects changing conditions in the market for funds. This provides the AER with a degree of comfort that a fall in the overall rate of return, in itself, is not unreasonable.

Multinet's concerns surround the cost of equity and the extent to which the cost of equity determined by the AER in this decision is lower than that determined in previous decisions. A lower cost of equity contributes to a lower overall rate of return.

The AER acknowledges that Multinet was concerned with the impact of the lower risk free rate on its overall rate of return. The AER has carefully considered the consequences of the low CGS yields and is confident that CGS yields remain the most appropriate proxy of the risk free rate in Australia. This position is supported by advice from the Reserve Bank of Australia (RBA). The AER has also considered whether or not the MRP should be increased from that used in previous decisions. The AER remains of the view that a 6 per cent MRP is commensurate with prevailing conditions in the market for funds.

* 1. Reasons for draft decision

In forming this draft decision, the AER has considered an extensive range of material on the rate of return. This includes Multinet's access arrangement proposal, the other Victorian gas service providers' proposals, and the submissions into these reviews from users. The AER has also sought a range of expert advice to assist in making these decisions—from the RBA, Treasury, AOFM, Professor McKenzie, Associate Professor Partington and Associate Professor Lally. [[60]](#footnote-60)

In this review, Multinet, proposed a 6 per cent MRP but adopted a long run historical average risk free rate (5.99 per cent) for the cost of equity because it considered the AER's approach to the cost of equity in previous decisions resulted in a cost of equity that is too low in current market conditions. The other Victorian gas distribution service providers also proposed this approach. APA GasNet held a similar concern but proposed a different approach. APA GasNet proposed a higher MRP (8.5 per cent).

On the other hand, BHP Billiton submitted that the MRP is between 5-6 per cent. The Energy Users Coalition of Victoria (EUCV) considered the AER should adopt a 5 year term for the risk free rate and an equity beta of 0.65. The 5 year term and 0.65 equity beta were adopted by the ERA in its access arrangement decision for the Dampier to Bunbury Natural Gas Pipeline (DBNGP). The Tribunal found no error in ERA's position on these matters. Incorporating any of the changes proposed by users to the term, equity beta or MRP would result in a lower cost of equity than applying the AER's approach from previous decisions.

In this draft decision, the AER has maintained its cost of equity approach of adopting a prevailing risk free rate (currently 2.98 per cent), an equity beta of 0.8 and a 6 per cent MRP.

In this review, Multinet proposed adopting the extrapolated Bloomberg fair value curve to estimate the DRP.[[61]](#footnote-61) This results in a DRP of 3.76 per cent based on current market data.[[62]](#footnote-62) The other Victorian gas service providers also proposed this approach.[[63]](#footnote-63) BHP Billiton considered this method was appropriate but also considered there was merit in the AER exploring alternative methods.[[64]](#footnote-64)

On the other hand, the EUCV considered the DRP should be no more than 195 basis points above the risk free rate (based on a 5 year term).[[65]](#footnote-65) The EUCV noted this resulted in a DRP similar to the ERA's approach.

In the ATCO and DBNGP matters, the Tribunal upheld the use of the 'bond yield' approach adopted by the ERA.[[66]](#footnote-66) Under this approach the DRP is estimated by averaging observed bond yields that meet certain criteria.[[67]](#footnote-67) The Tribunal did, however, direct the ERA to amend the simple averaging process used to aggregate these bond yields.[[68]](#footnote-68) The Tribunal also provided guidance on the relevance of various criteria and the use of a more complex weighted average.[[69]](#footnote-69) Such a weighted average was implemented by the ERA on remittal.[[70]](#footnote-70) If the bond-yield approach (with the weighting method adopted in the ERA’s re-determination) was applied to Multinet, the DRP would be 2.72 per cent.[[71]](#footnote-71)

Consistent with the AER’s observations previously, the AER considers that the Bloomberg fair value curve continues to provide DRP estimates which are higher than other potential approaches (such as the ERA’s approach). The Bloomberg fair value curve also provides estimates which are high in comparison to recent bond issuances from firms with similar characteristics to the benchmark firm. For these reasons, the AER has commenced an internal review into alternatives to the Bloomberg fair value curve. The AER will advise of a public consultation process on the development of an alternative in due course. However, the AER does not expect to implement any new method in time for Multinet's forthcoming access arrangement period. This follows the Tribunal's previous comments on the consultation approach that should be adopted in the development of any new approach.[[72]](#footnote-72)

In this draft decision, the AER has maintained adoption of the extrapolated Bloomberg BBB rated fair value curve. This currently provides a cost of debt of 6.74 per cent, or DRP of 3.76 per cent.[[73]](#footnote-73)

Taking Multinet's proposal and the submissions from stakeholders together, the AER considers that the rate of return in this draft decision (subject to updating) satisfies the criterion of the NGR.[[74]](#footnote-74)

* + 1. Risk free rate

The AER does not agree with Multinet's proposed method for estimating the risk free rate used in the cost of equity.

The risk free rate calculated using the method determined in this draft decision is commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services. This method involves estimating the risk free rate by reference to the yield on 10 year CGS bonds sampled over a period as close as practicably possible to the commencement of the access arrangement period.

The AER considers 10 year CGS yields are the most appropriate proxy for the risk free rate because:

* CGS are low risk
* the CGS market is liquid and functioning well, as confirmed by advice from the Reserve Bank of Australia (RBA), the Australian Treasury and the Australian Office of Financial Management (AOFM)[[75]](#footnote-75)
* the RBA advised 'CGS yields are the most appropriate measure of a risk free rate in Australia'.[[76]](#footnote-76)

The AER and Multinet agree on the proxy for the risk free rate.

However, Multinet proposed the risk free rate be calculated using a historical averaging period over the last 20 years. In contrast, the AER considers the most appropriate averaging period for determining the risk free rate is a short period (10-40 business days), as close as practicably possible to the commencement of the regulatory period, because:

* At any point in time, the prevailing risk free rate is the benchmark that the expected return on a risky investment must exceed (by a magnitude equal to the risk premium for the risky investment).
* Prevailing 10 year CGS yields reflect the risk free rate over the appropriate forward looking investment horizon (which is 10 years).
* CGS yields are market determined—that is, prevailing CGS yields reflect the return that investors are willing to receive in current market conditions on an investment that is almost default risk free.
* This approach promotes the regulatory objective that the present value of a service provider's expected revenue should match the present value of a service provider's expected expenditure (plus or minus any efficiency rewards or penalties).
* The use of prevailing CGS yields is consistent with the use of the building block model because this model is designed to uphold the present value principle, as advised by Associate Professor Lally.
* The use of prevailing CGS yields is consistent with the use of the CAPM. In the ActewAGL matter, both the expert for the AER (Associate Professor Lally) and the expert for the service provider (Greg Houston) agreed on this point.[[77]](#footnote-77)
* This approach provides an unbiased method for determining the risk free rate.
* Advice from Professor McKenzie and Associate Professor Partington, and from Associate Professor Lally supported the use of a prevailing risk free rate.[[78]](#footnote-78)

The AER recognises CGS yields are at historical lows, but that fact does not invalidate any of the above reasons. The current historically low CGS yields reflect what would be expected of a well functioning risk free rate proxy in current demand and supply conditions.[[79]](#footnote-79) In the Telstra matter, the Tribunal stated:

...it is not unusual for yields to move from time to time in order to reflect prevailing market conditions and the expectations about the prospect for prices into the future.[[80]](#footnote-80)

See attachment 4 for more on the AER's draft decision on the rate of return and reasons for its decision.

1. Regulatory depreciation

Regulatory depreciation models the nominal value of Multinet's assets over the 2013–17 access arrangement period. It is used to determine the depreciation allowance in Multinet's total revenue requirement under the building block model. Multinet’s annual regulatory depreciation allowance is the net total of the straight-line depreciation (negative) and the annual inflation indexation (positive) on the projected capital base.

As part of its proposed access arrangement Multinet is required to provide a forecast of depreciation for the 2013–17 access arrangement period, setting out a depreciation method and demonstrating how the depreciation method has been applied. The depreciation schedule sets out the basis on which the pipeline assets constituting the capital base are to be depreciated for the purpose of determining a reference tariff.

The AER then assesses whether the proposed depreciation schedule complies with the depreciation criteria set out within the NGR. In particular, the depreciation schedule should be designed:

* so that reference tariffs will vary, over time, in a way that promotes efficient growth in the market for reference services[[81]](#footnote-81)
* so that each asset or group of assets is depreciated over the economic life of that asset or group of assets[[82]](#footnote-82)
* so as to allow, as far as reasonably practicable, for adjustment reflecting changes in the expected economic life of a particular asset, or a particular group of assets[[83]](#footnote-83)
* so that (subject to the rules about capital redundancy), an asset is depreciated only once[[84]](#footnote-84)
* so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs.[[85]](#footnote-85)

Compliance with these criteria may involve the deferral of a substantial amount of depreciation.

The AER must also take into account the depreciation schedule approved in the 2008–12 access arrangement period,[[86]](#footnote-86) the NGO and the revenue and pricing principles.[[87]](#footnote-87)

The full draft decision and the AER's detailed reasons and analysis on regulatory depreciation are in attachment 5.

* 1. Draft decision

The AER's draft decision on Multinet's total regulatory depreciation allowance over the
2013–17 access arrangement period is $114.3 million ($nominal) as shown in . This represents a reduction of $66.7 million ($nominal) or 36.9 per cent of Multinet's proposed total regulatory depreciation allowance.

* + - * 1. AER's draft decision on Multinet's depreciation allowance
				($million, nominal)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
| Straight-line depreciation  | 40.3  | 47.0  | 50.2  | 53.1  | 56.5  | 247.0  |
| Less: indexation on opening capital base | 25.4  | 26.3  | 26.6  | 27.0  | 27.4  | 132.7  |
| Regulatory depreciation | 14.9  | 20.7  | 23.5  | 26.2  | 29.1  | 114.3  |

Source: AER analysis.

* 1. Summary of analysis and reasons

The AER does not approve Multinet's proposed regulatory depreciation allowance of $181.0 million ($nominal) for the 2013–17 access arrangement period. The AER's draft decision is to make amendments in the following areas:

* The AER does not approve Multinet's proposed (accelerated) depreciation allowance for forecast redundant assets for the 2013–17 access arrangement period. During the 2008–12 access arrangement period, Multinet received (accelerated) depreciation allowance for assets that it proposed to replace during the 2008–12 access arrangement period. However, during the period it replaced less assets than the ESC forecast. That is, Multinet has received (accelerated) depreciation for assets that have not been made redundant and are still in service. Due to the AER's adjustment to Multinet's forecast replacement capex, Multinet will replace fewer assets in the next period than is required to 'catch up' with the assets that are still in service but for which it has already received (accelerated) depreciation in the 2008–12 access arrangement period.[[88]](#footnote-88) Therefore, the AER does not approve the proposed depreciation allowance for forecast redundant assets. The AER considers the proposed allowance does not satisfy the NGR requirement because it does not reflect the economic life (or any changes in the economic life) of the assets expected to be made redundant in the 2013–17 access arrangement period. [[89]](#footnote-89)
* The AER considers that the ‘Land & buildings’ asset class should be split into two separate 'Land' and 'Buildings' asset classes from 1 January 2013. This is because land is a non-depreciating asset. The AER considers that the 'Buildings' asset class should be assigned a standard economic life of 50 years[[90]](#footnote-90), and the 'Land' asset class should not be assigned a standard economic life reflecting the non‑depreciating nature of the asset.
* The AER considers that Multinet's proposed standard economic life of 7 years for the 'SCADA' asset class is too short, when compared to the standard economic lives for the ‘SCADA’ asset class approved in previous AER decisions. The AER has determined a standard economic life of 15 years is more appropriate.
* The AER identified a number of errors in the way Multinet calculated its remaining economic lives for depreciating existing assets. The AER requires that Multinet adopt the AER's calculation of remaining economic lives. The AER's adjustments correct the errors in Multinet's calculations, and update the remaining economic lives to reflect the amended opening capital base as at 1 January 2013. The AER also made adjustments to the remaining economic lives for the 'SCADA' and 'IT' asset classes.

See attachment 5 for more on the AER's draft decision on depreciation and reasons for its decision.

1. Operating expenditure

Operating expenditure (opex) refers to the operating, maintenance and other non-capital costs incurred in the provision of reference services.[[91]](#footnote-91) Opex incorporates labour costs and other non–capital costs associated with providing reference services.

The AER is required to assess Multinet’s forecast opex to decide whether it is satisfied that the forecast opex complies with applicable criteria prescribed by the NGL and NGR. In particular, opex must be such as 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. In addition, opex forecasts must be arrived at on a reasonable basis and represent the best forecast or estimate possible in the circumstances.[[92]](#footnote-92)

The regulatory regime provides incentives for Multinet to deliver its required services at least cost. In particular, if Multinet is able to provide its services at a lower cost than what was forecast in its access arrangement, it is able to 'keep the difference' for a period of five years as provided under its opex incentive mechanism (see chapter 10). Given these incentives, actual opex can be used to effectively reveal the efficient level of opex required in providing reference services.

* 1. Draft decision

The AER's draft decision is to approve $270.3 million ($2012) of Multinet’s $362.7 million ($2012) forecast of opex for the 2013–17 access arrangement period. This reduction of $92.4 million ($2012) reflects the AER view that a number of elements of Multinet's forecast opex do not comply with the criteria governing opex or the criteria for forecasts and estimates.[[93]](#footnote-93) This is discussed in more detail in the following section.

Table 9.1 shows how Multinet’s proposed opex compares with the AER’s draft decision on opex.

* + - * 1. Multinet proposed and approved opex ($million, 2012)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|   | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
| Multinet proposal  | 69.4 | 72.2 | 72.7 | 74.1 | 74.4 | 362.7 |
| AER draft decision  | 52.4 | 53.1 | 53.7 | 55.3 | 55.7 | 270.3 |
| Difference | -16.9 | -19.1 | -18.9 | -18.8 | -18.7 | -92.4 |

Source: AER analysis

Figure 9.1 shows how the AER's draft decision for opex compares to Multinet's proposal, its opex in the 2008–12 access arrangement period, and the opex approved by the ESC for this period. In the 2008–12 access arrangement period, Multinet’s proposed total opex represents a 22 per cent real increase on actual expenditure in the current period.

* + - 1. Comparison of Multinet's historical and forecast opex, and AER draft decision ($million 2012)[[94]](#footnote-94)

Source: Multinet's RIN submission.

* 1. Summary of analysis and reasons

Multinet forecast its opex using a bottom-up forecasting approach whereby it has forecast the costs of each of the services it will provide in the 2013–17 access arrangement period. Multinet considers the methodology typically used in regulatory decisions, which bases forecast opex on historical opex, would be inappropriate because of a change in its business model.[[95]](#footnote-95)

The AER first assessed whether or not to accept Multinet's forecast opex against the relevant NGR and NGL criteria. The AER concluded that Multinet’s forecast does not satisfy the relevant criteria.

The AER then made a decision about what forecast of opex to apply in place of Multinet’s forecast. The AER has forecast opex using a base year approach, which is based on the costs incurred by Multinet in 2011, adjusted for labour cost escalation, growth and scope changes.

* + 1. Stage 1 of the AER assessment

The AER's draft decision is not to accept Multinet's forecast opex for the following reasons:

* Multinet's bottom-up forecast does not reflect a forecast that has been arrived at on a reasonable basis or represents the best forecast possible in the circumstances.[[96]](#footnote-96) In particular, Multinet’s in-house cost forecasts are not substantiated. As Multinet does not undertake many of these services currently, Multinet has constructed many of its in-house forecasts without historical costs as a reference point and has not provided detailed information about how a forecast of each cost item has been arrived at and/or why this forecast is prudent and efficient.
* A comparison of historical opex to forecast opex demonstrates Multinet is forecasting a rise in opex in the 2013–17-access arrangement period relative to opex it incurred in the 2008–12 access arrangement period. The AER is not satisfied based on the evidence available to it that there are credible factors likely to explain this forecast increase. As such, relative to Multinet's historical opex, Multinet's forecast of opex is not a forecast of opex that satisfies rr. 74(2) or 91 of the NGR.
* Multinet's bottom-up forecasting methodology is inconsistent with the operation of the opex incentive mechanism that applies to Multinet in the 2008-12 access arrangement period. This is contrary to the transitional provisions under the NGR.[[97]](#footnote-97)

To further test Multinet's proposal the AER analysed benchmarking studies provided by Multinet and undertook its own benchmarking. The results of the benchmarking studies do not suggest that Multinet's historical opex is too low compared to its closest comparators—SP AusNet and Envestra. On some benchmarking indicators, a large rise in Multinet's opex over the 2013–17 access arrangement period relative to its historical costs suggests the gap would widen between Multinet and SP AusNet and Envestra. This suggests that a large rise in opex over the 2013–17 access arrangement period relative to Multinet's historical opex would not reflect the actions of a prudent service provider acting efficiently to achieve the lowest sustainable costs of delivering pipeline services.[[98]](#footnote-98)

The full draft decision and the AER's detailed reasons and analysis on operating expenditure can be found in attachment 6 and appendix C.

* + 1. Stage 2 of the AER’s assessment

The AER's second stage of the assessment process was to consider what forecast of opex to use instead of Multinet's proposal. The AER has used a base year approach to estimate Multinet's forecast opex.

Under a base year approach, forecast opex is based on the historical costs incurred in a recent regulatory year. This is then adjusted for forecast trends and other changes in a business's circumstances beyond its control such as the forecast cost of new regulatory obligations, forecast labour costs and increased customer growth.

To the extent that a regulated business forecasts that changes will lead to increases in efficient costs, the regulator can adjust base year opex with an incremental increase the base year. Any change in costs in relation to historical costs can be addressed under this forecasting methodology, regardless of the circumstances. Therefore, the AER is satisfied that a base year approach is appropriate forecasting methodology, regardless of Multinet's business restructure.

As regulated businesses face strong incentives to undertake opex efficiently, actual opex should reveal the efficient amount opex for that year. Historical costs (i.e. the base year) therefore provide a reliable method to forecasting opex.

The AER is also satisfied that a forecast of opex estimated using a base year approach in combination with an opex efficiency carryover mechanism promotes continuous incentives to achieve efficiency gains. The AER implements this approach across the regulated energy sector. This approach is also consistent with the operation of Multinet's existing opex incentive mechanism under its 2008-12 Access Arrangement. The AER considers that departing from a base year estimate would change the relative rewards and penalties for achieving efficiency gains across regulatory periods. This would promote incentives for perverse outcomes across the regulated energy sector by providing an incentive for regulated businesses across the regulated energy sector to defer efficiency gains or shift expenditure into the base year.[[99]](#footnote-99)

Details of the AER's base year estimate are outlined below.

Base year

The AER considers that actual opex incurred in 2011 is an appropriate basis for forecasting annual efficient opex for the 2013–17 access arrangement period. This year is chosen as it is the most recent year for which audited data is available. Further, a base year of 2011 will ensure symmetry with Multinet's existing opex incentive mechanism.[[100]](#footnote-100)

The AER made some adjustments to opex incurred by Multinet in 2011 to estimate base year opex. These adjustments removed a number of opex items that will not be incurred in the 2013–17 access arrangement period.

Cost trends and step changes

In line with the AER's usual approach, it also considered whether to include any cost trends or step change adjustments to the base year. In considering this, the AER considered Multinet's forecast cost drivers.[[101]](#footnote-101)

The AER provided an additional opex allowance for forecast changes in:

* Labour costs—the AER has accepted a smaller increase than that Multinet indicated was reflected in its forecasts (see appendix D for more on how the AER has determined labour cost escalators).
* Output growth—the AER has accepted a smaller increase than Multinet indicated was reflected in its forecasts (see attachment 6 for more information).
* Scope (usually called step changes)—this provides for additional funding where Multinet faces a new requirement or change in circumstance requiring it to undertake additional expenditure that was not accounted for in the base year level of opex. The AER's estimate of opex included some of the scope changes that Multinet indicated were reflected in its bottom up forecast. Some were approved on a reduced basis. Other scope changes Multinet indicated were included in its forecasts were not included in the AER's estimate as Multinet had not demonstrated why the opex was prudent and efficient.

The AER's draft decision on Multinet's opex for the 2013–17 access arrangement period is provided in table 9.2 below.

* + - * 1. AER draft decision on Multinet’s opex ($million 2012)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|   | 2013 | 2014 | 2015 | 2016 | 2017 |
| Base | 51.6 | 51.6 | 51.6 | 51.6 | 51.6 |
| Labour | 0.5 | 0.9 | 1.4 | 1.8 | 2.3 |
| Scope | -0.3 | -0.3 | -0.3 | 0.7 | 0.5 |
| Growth | 0.2 | 0.3 | 0.5 | 0.7 | 0.8 |
| Debt raising costs | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 |
| Total | 52.4 | 53.1 | 53.7 | 55.3 | 55.7 |

Source: AER analysis.

1. Incentive mechanisms

Incentive mechanisms offer service providers 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 relative to opex or capex 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. This five year period corresponds to the length of the access arrangement period.

The AER is required under transitional arrangements to ensure increments or decrements resulting from the operation of the incentive mechanism in Multinet's current access arrangement are properly reflected in its total revenue.[[102]](#footnote-102)

The AER must also consider whether the incentive mechanism proposed by Multinet will encourage efficiency in the provision of services by the service provider and is consistent with the revenue and pricing principles.[[103]](#footnote-103)

The full draft decision and the AER's detailed reasons and analysis on incentive mechanisms can be found in attachment 7.

* 1. Draft decision

The AER does not approve Multinet's proposal to disregard the negative carryover accrued in the 2008–12 access arrangement period. The NGR transitional rules require that the AER ensure the revenue calculations for the 2013–17 access arrangement period properly reflect increments or decrements resulting from the operation of the incentive mechanism.[[104]](#footnote-104) The AER has calculated that Multinet accrued a total carryover of –$16.7 million ($2012) during the 2008–12 access arrangement period ().

* + - * 1. AER draft decision on Multinet carryover from the 2008­–12 access arrangement period ($million, 2012)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
| Multinet proposed | – | – | – | – | – | – |
| AER draft decision | –3.8 | –2.9 | –5.0 | –4.9 | – | –16.7 |
| Difference  | –3.8 | –2.9 | –5.0 | –4.9 | – | –16.7 |

Source: Multinet Access Arrangement Information, p. 195, Multinet PTRM, AER analysis.

The AER does not approve Multinet's proposed incentive mechanisms. It considers amendments are required to make the opex incentive mechanism consistent with r. 98 of the NGR and the revenue and pricing principles.[[105]](#footnote-105)

The AER considers Multinet's proposed capex incentive mechanism is inconsistent with r. 98 of the NGR and the RRP. In particular, it would not provide effective incentives to promote efficient investment and could lead to underinvestment in or over utilisation of pipeline infrastructure required to deliver pipeline services. Further, the AER does not consider that the inclusion of any alternative capex incentive mechanism would be consistent with the requirements of the NGR. The draft decision is to remove the capex incentive mechanism from the proposed access arrangement.

* 1. Summary of analysis and reasons

Carryover from the 2008–12 access arrangement period

Multinet calculated a total carryover of –$61.4 million from its opex and capex incentive mechanisms for the 2008–12 access arrangement period. Multinet proposed that none of this amount should be carried over because:

* it considered the opex benchmarks were unattainable
* it considered that its circumstances were similar to United Energy's when the AER decided not to carryover United Energy's opex efficiency losses to its 2011–15 regulatory control period.[[106]](#footnote-106)

The AER considers Multinet did not calculate the carryover consistent with its 2008–12 access arrangement. Using the approach set out in Multinet's access arrangement the AER recalculated a total carryover of –$16.7 million.

In deciding whether this efficiency loss should be carried over the AER first assessed Multinet's claim that the opex benchmarks were unattainable. In considering Multinet's opex for the 2008–11 period, the negative opex carryover is largely driven by an efficiency loss in 2011. The AER considers this is primarily due to Multinet's decision to restructure its operations in 2011. The AER does not consider that this demonstrates that the opex benchmarks were unattainable.

The AER also reviewed Multinet's proposal in light of United Energy's circumstances. The AER forecast United Energy’s opex for 2011–15 based on its contractor's costs, including the loss, not the costs actually incurred by United Energy. To use these same costs to calculate United Energy's carryover would have penalised United Energy for an increase in its contractor's costs, not its own. As this would be an anomalous outcome, the AER exercised its discretion not to apply the negative carryover amounts.[[107]](#footnote-107)

There are some similarities between Multinet's circumstances and those of United Energy. However, the AER's draft decision does not calculate Multinet's opex forecasts based on its contractors costs and thus there is no anomalous outcome. Further, as United Energy was only subject to an opex incentive mechanism, this case has no application to Multinet's capex efficiency carryover.

Consistent with the operation of the incentive mechanism in Multinet’s access arrangement and the transitional provisions specific to the NGR, the AER considers the negative amounts should be carried forward to the 2013–17 access arrangement period to ensure effective incentives to pursue efficiencies consistent with the RPP.

Opex incentive mechanism

The AER accepts Multinet's proposal to apply an incentive mechanism to opex. However, there are a number of aspects of Multinet’s proposal that require further clarification in order to make the incentive mechanism consistent with r. 98 of the NGR and the RPP. The AER has sought to clarify these matters in its draft decision (see attachment 7).

Capex incentive mechanism

Multinet also proposed to maintain its ESC approved incentive mechanism for capex for the 2013–17 access arrangement period. This would allow Multinet to retain the benefits of any capex underspend for five years from when the capex was undertaken. Under the regulatory regime there is already an incentive within the access arrangement period to deliver capital projects at a lower cost than that forecast. For example, if a business underspends in year one of a regulatory period it will retain the benefits of the underspend for four years, until the end of the five year access arrangement period (or for one year if the expenditure is in year four).

Multinet's proposal would provide a higher powered incentive to reduce capex, compared with the incentive offered under the regulatory framework. The incentive to reduce capex should be balanced with an equal incentive to maintain and improve service levels. This would encourage efficient capex reductions without a fall in service standards. However service standard obligations are only loosely defined for gas distribution businesses giving rise to potential cost cutting at the expense of service standards rather than efficiency gains.[[108]](#footnote-108)

In addition, Multinet proposed a carryover scheme where capex benchmarks are adjusted to reflect the volume of work undertaken. This would remove the incentive provided by cumulative carryover schemes to defer capex inappropriately, at the expense of service levels. While adjusting capex benchmarks to reflect actual volumes reduces the incentive to defer capex inappropriately, not all capex is volume adjusted.

For these two reasons, the AER's draft decision is not to accept Multinet’s proposal to include a capex incentive mechanism. On balance, the AER considers that the regulatory regime already provides sufficient incentives for Multinet to deliver its capex program efficiently.

See attachment 7 for more on the AER's draft decision on incentive mechanisms and reasons for its decision.

1. Corporate income tax

The estimated cost of corporate income tax is one of the building blocks used to determine the total revenue requirement for Multinet over the 2013–17 access arrangement period.

Multinet adopted the post-tax framework to derive its revenue requirement for the 2013–17 access arrangement period.[[109]](#footnote-109) Under the post-tax framework, a separate corporate income tax allowance is calculated as part of the building block assessment.

The AER uses the PTRM to produce an estimate of the taxable income that would be earned by an efficient company operating Multinet’s business. The AER modelled Multinet’s tax expenses over the access arrangement period using a benchmark of 60 per cent gearing. Tax depreciation is calculated using a separate tax asset base. All tax expenses are offset against the service provider's forecast revenue to estimate the taxable income. The statutory income tax rate of 30 per cent is then applied to the estimated taxable income to arrive at a notional amount of tax payable. The AER then applies a discount to this to account for the assumed utilisation of imputation credits (gamma), which has a value of 0.25. This amount is then included as a separate building block in determining Multinet’s total revenue.[[110]](#footnote-110)

The full draft decision and the AER's detailed reasons and analysis on corporate income tax can be found in attachment 8.

* 1. Draft decision

The AER’s draft decision on Multinet’s corporate income tax allowance allowance over the 2013–17 access arrangement period is $27.7 million ($nominal), a reduction of $26.8 million ($nominal) or 49.2 per cent of Multinet’s proposal (see table 11.1). Based on the approach to modelling the cash flows in the PTRM, the AER has derived an effective tax rate of 31.96 per cent for this draft decision.

* + - * 1. AER's draft decision on corporate income tax allowance for Multinet ($million, nominal)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
| Tax payable |  6.7  |  6.1  |  6.6  |  8.0  |  9.6  |  36.9  |
| Less: value of imputation credits |  1.7  |  1.5  |  1.6  |  2.0  |  2.4  |  9.2  |
| Net corporate income tax allowance |  5.0  |  4.6  |  4.9  |  6.0  |  7.2  |  27.7  |

Source: AER analysis.

* 1. Summary of analysis and reasons

The AER accepts most of Multinet’s methods for calculating its corporate income tax allowance. However, the AER adjusted several of Multinet’s proposed inputs to the PTRM for calculating the corporate income tax allowance, which include:

* The opening tax asset base as at 1 January 2013, including:
* Amendments to tax additions from 2007–12 to be consistent with the AER's draft decision on the roll forward of the capital base (attachment 2).
* Splitting the 'Land & buildings' asset class into two separate asset classes of 'Land' and 'Buildings' as set out in the AER's draft decision on depreciation (attachment 5).
* The tax depreciation approach for the 'Land & buildings' asset classes in group 7 tax assets:
* Consistent with the 2008–12 access arrangement, the AER considers that the 'Buildings' asset class should be depreciated using the straight-line method.
* The AER has not assigned a tax depreciation method for the 'Land' asset class due to the non-depreciating nature of this asset.

In addition, there are various other changes to the building block components in this draft decision that impact forecast revenues (for example, the capital base and opex). These will consequently affect the forecast corporate income tax allowance.

1. Demand forecasts

The NGR requires an access arrangement to include a forecast of pipeline demand (driven by gas demand) over the access arrangement period and the basis on which the forecast has been derived. Demand is an important input into the derivation of Multinet's reference tariffs.

Understanding how much each reference service is likely to be used over the five year period allows the AER to determine the quantum of each tariff and the overall efficient allocation of tariffs. Demand forecasts also affect opex and capex linked to network growth. For example, if gas demand decreases and revenue remains largely unchanged, this is likely to result in higher tariffs. However, lower demand could also be expected to reduce capex and opex, somewhat offsetting this effect. Conversely, higher demand could be expected to reduce tariffs, other things being equal.

The AER is required to assess Multinet's demand forecasts to determine whether they have been arrived at on a reasonable basis and represent the best forecast possible under the circumstances, pursuant to r. 74 of the NGR.

The full draft decision and the AER's detailed reasons and analysis on demand forecasts can be found in attachment 9.

* 1. Draft decision

The AER's draft decision is to approve the proposed demand forecasts under r. 74(2) of the NGR. The AER considers that the forecasting approach is arrived at on a reasonable basis. The AER also considers that the assumptions and data sets used by Multinet result in demand forecasts that are arrived at on a reasonable basis and represent the best forecasts possible in the circumstances.[[111]](#footnote-111)

Multinet forecasts relatively flat demand for tariff V residential and non-residential customers[[112]](#footnote-112) and slightly declining demand for tariff D customers.[[113]](#footnote-113)

* 1. Summary of analysis and reasons

The AER's draft decision is to approve Multinet's demand forecasts and forecasting approach. In making its draft decision the AER assessed the information provided in Multinet's access arrangement proposal and information provided in response to AER information requests.

For more on Multinet's demand forecasts, forecasting approach and the AER's draft decision on Multinet's demand, see attachment 9.

1. Tariff setting – distribution pipelines

An access arrangement must set out how a service provider intends to charge for reference services. The NGR requires that the access arrangement information must include an explanation of the basis for setting reference tariffs, including the method used to allocate costs, and a demonstration of the relationship between costs and tariffs.[[114]](#footnote-114)

The AER is required to assess Multinet's proposed reference tariffs against the provisions established by rules 93 and 94 of the NGR, and the revenue and pricing principles and the NGO, both established by the NGL. In particular, r. 94 requires that:

* Customers must be divided into tariff classes on the basis of what is economically efficient and the need to avoid unnecessary transaction costs.
* For each tariff class, the revenue recovered should be between the total cost of providing that reference service and the avoidable cost of not providing that reference service to those customers.
* Where a tariff consists of two or more charging parameters, each parameter must:
* take into account the long run marginal cost of the reference service (or element of the service to which the parameter relates)
* be determined with regard to the transaction costs associated with the tariff (or each charging parameter) and whether customers belonging to the relevant tariff class are able or likely to respond to price signals.
* However, if the above point means that a service provider may not recover its expected revenue, the tariffs must be adjusted to ensure recovery of expected revenue with minimum distortion to efficient patterns of consumption.

The AER's role also includes an assessment of Multinet's proposed reference services to which the reference tariff applies.

The full draft decision and the AER's detailed reasons and analysis on tariff setting can be found in attachment 10.

* 1. Draft decision

The AER's draft decision is to approve Multinet's proposed structure of reference tariffs for the 2013–17 access arrangement period. The AER is satisfied that the proposed structure of the reference tariffs complies with the requirements under rules 93 and 94 of the NGR.

However, the quantum of the proposed reference tariffs must be amended as set out in attachment 10 of this draft decision to reflect the AER's draft decision on forecast total revenue and forecast demand.

* 1. Summary of analysis and reasons

Multinet proposed to maintain the current structure of its reference tariffs for the 2013–17 access arrangement period.[[115]](#footnote-115) The proposed tariff classes directly reflect Multinet's proposed reference services.[[116]](#footnote-116)

The AER's draft decision is to approve Multinet's proposed structure for reference tariffs. However, the AER's draft decision amends Multinet's proposed forecast total revenue (see chapter 3). Reference tariffs must be amended to reflect these changes.

See attachment 10 for more on the AER's draft decision on tariff setting and reasons for its decision.

1. Tariff variation mechanism

The reference tariff variation mechanism:

* permits building block revenues to be recovered smoothly over the access arrangement period
* 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.

The AER assessed Multinet’s access arrangement proposal against the tariff variation mechanism requirements of the NGL and NGR. The full draft decision and the AER's detailed reasons and analysis on the tariff variation mechanism can be found in attachment 11.

* 1. Draft decision

The AER does not approve Multinet's proposed tariff variation mechanisms 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 alternatives to some elements of Multinet's proposal that better meet the NGO and RPP. In particular, the AER considers:

* the proposed magnitude and level of the rebalancing constraint,[[117]](#footnote-117) the variation process and certain elements in the cost pass through tariff variation mechanism are not consistent with r. 97 of the NGR
* the proposed initial reference tariffs and X factors must be amended to reflect the changes to the forecast total revenue identified in chapter 3 of this draft decision
* the proposed financial failure of a retailer and force majeure events must be removed from the cost pass through mechanism
* two new pass through events should be added:
* a low pressure mains replacement event to allow for additional mains replacement where required, in line with the AER's draft decision on capex (see chapter 6 and attachment 3)
* a National Energy Consumer Framework (NECF) event to provide for related opex once the NECF commences in Victoria
* the proposed cost pass through mechanism should be amended to enable the AER to apply a consistent approach to its assessment of pass through applications.

The reasons for the AER's decision are further discussed below.

* 1. Summary of analysis and reasons

The AER's draft decision is to make a number of amendments to Multinet's proposals regarding the tariff variation mechanism. One amendment is to update the initial reference tariffs and X factors to reflect the AER's draft decision on forecast total revenue. This will ensure revenue equalisation. Other amendments are discussed below.

Rebalancing constraint

The AER's draft decision is not to accept Multinet's proposal to increase its rebalancing constraint from 2014. A rebalancing constraint is a mechanism that restricts the amount that a tariff can vary on an annual basis. The AER is not convinced that the current rebalancing constraint has inhibited Multinet's ability to achieve to cost reflective pricing in previous regulatory periods. Further, a higher rebalancing constraint could lead to increased price volatility and potential price shocks. This could create uncertainty for downstream users which could be detrimental to the efficient investment in and utilisation of pipeline assets. In sum, the AER considers that the current magnitude of rebalancing constraint in combination with the cost pass through provisions provides Multinet with a reasonable opportunity to recover at least its efficient costs, consistent with the RPP.

Cost pass through events

The AER requires two of Multinet's proposed pass through events to be removed:

* Removal of the proposed 'financial failure of a retailer event'—the AER considers that Multinet can mitigate this risk by agreeing appropriate prudential requirements with users. Multinet has proposed detailed credit support requirements in clause 7.8 of its proposed terms and conditions set out in Part C of its access arrangement proposal. The AER considers these requirements provide Multinet with adequate protection against the risk of a retailer failing.
* Removal of the proposed 'force majeure event'—Multinet's proposed force majeure event is not sufficiently specific and is not defined with reference to a material increase or decrease in costs to the service provider. The AER considers that the inclusion of a 'terrorism event' or a 'natural disaster event' could better meet Multinet's objectives while being consistent with the NGR.

Further, two new cost pass through events are proposed, these include:

* A 'low pressure mains replacement event' to allow Multinet to undertake additional low pressure mains replacement where it has exceeded the AER's approved volumes. This relates to the AER's draft decision on capex (chapter 6 and attachment 3).
* A 'NECF event' to allow Multinet to recover any expenditure it incurs in implementing the NECF when it commences in Victoria. The NECF has not yet commenced in Victoria and there is uncertainty about its commencement date. The AER did not approve NECF related opex for the 2013–17 period but considers that Multinet should be able to recover these costs once the NECF commences in Victoria. This pass through allows for this.

See attachment 7 for more on the AER's draft decision on incentive mechanisms and reasons for its decision.

1. Non-tariff components

Non-tariff components refer to the terms and conditions that are not directly related to the nature and level of tariffs paid by users, but which are important to the relationship between the network service provider and users.

The AER has considered the non-tariff components of Multinet's access arrangement proposal including capacity trading requirements, queuing requirements, extension and expansion requirements, and terms and conditions on which the reference service will be provided.

The AER's reasons for its draft decision on the above non-tariff components are provided in attachment 12 and appendix D.

* 1. Draft decision

The AER has decided to accept most of Multinet’s terms and conditions. The AER accepts Multinet's terms and conditions that it considers are consistent with the NGO. The AER received submissions that do not support the AER’s draft decision for some of those terms and conditions. The AER has addressed these submissions and reasons for its decision are provided in attachment 12.

The AER does not accept Multinet’s extensions and expansions policy. The AER requires Multinet to amend its proposal so that all low and medium pressure pipelines are covered by the access arrangement by default. In particular, the AER considers that all extensions to high pressure pipelines should be assessed on a case-by-case basis for coverage—consistent with previous AER decisions.

The AER requires minor amendments to capacity trading requirements and terms and conditions for changing receipt and delivery points. The AER proposes to accept Multinet’s proposal in relation to queuing arrangements and review dates.

* 1. Summary of analysis and reasons

The AER has undertaken significant consultation in the process of assessing Multinet's proposed terms and conditions for this draft decision. The AER held an industry workshop, and considered stakeholder submissions and Multinet's response to those submissions.

The AER sought to facilitate increased engagement between Multinet and retailers on Multinet's proposed terms and conditions. The objective was to foster agreement between Multinet and key users on the proposed terms and conditions prior to the release of the AER's draft decision where possible, and to highlight areas of significant disagreement or particular concern.

As part of this engagement process, the AER hosted a workshop attended by representatives of the three Victorian gas distribution network owners and a number of retailer businesses. This workshop provided each of the parties attending with an opportunity to discuss the network owners' proposed terms and conditions.

Discussion during the workshop centred on the impact that NECF would have on the structure of the proposed terms and conditions. Further, participants highlighted inconsistencies in the terms and conditions across access arrangements, which could increase retailer transaction costs. The minute of the workshop is available on the AER's website at: [http://www.aer.gov.au/node/4799](http://www.aer.gov.au/node/14473)

At the workshop, the gas network owners committed to consider the retailers’ submissions and seek to resolve any disputes prior to the release of the AER’s draft decision in September 2012. They also committed to take steps to minimise inconsistencies across their access arrangements, and clarify any drafting ambiguities.

Following the workshop, the AER received submissions on terms and conditions from some retailers, which identified areas of concern and gave reasons for those concerns. The AER subsequently wrote to Multinet giving it the opportunity to consider the submissions made by stakeholders in response to its proposal.

The AER seeks further feedback from stakeholders on terms and conditions in their submissions to this draft decision. The AER expects that Multinet will undertake further consultation with users before it submits its revised access arrangement to the AER. The AER may hold another terms and conditions workshop to facilitate the parties' understanding of the operation of the terms and conditions.

1. Interlinkages between decision components

In assessing each element of Multinet's access arrangement, the AER has taken into account the interlinkages between the building blocks and between the elements of Multinet's access arrangement proposal. Some examples of interlinkages between these elements include:

* Rate of return and the weighted average cost of capital parameters—there are various interlinkages between these parameters, including that the AER has determined each of them on the basis of a 10 year investment horizon, the 60 per cent gearing ratio affects the estimation of the equity beta, and the debt risk premium and the assumed utilisation of imputation credits (gamma) affects the estimation of the market risk premium.
* Forecast opex allowance and the incentive mechanism—the use of actual opex in establishing the forecast opex allowance and the efficiency carryover resulting from the operation of the efficiency carryover mechanism is necessary to preserve the rewards or penalties associated with the efficiency of a service provider's operations.
* Capex and opex allowances and the cost pass through mechanism—the cost pass through mechanism allows a service provider to recover costs that are uncontrollable and not otherwise provided in the forecast capex and opex allowances. This for example relates to certain costs for additional mains replacement and costs associated with the commencement of NECF in Victoria, which were not included as part of the forecast allowances (see attachments 3, 6 and 11).
* Non price terms and condition and opex—the efficient level of insurance that the AER has allowed for in Multinet's forecast opex is determined to some extent by how risk is allocated through its terms and conditions (see attachments 6 and 12).
* Capex and opex—capex can result in potentially higher or lower opex depending on whether, for example, that capex goes to network augmentation (increased opex could be required to support new systems) or replacement of aging assets (which can reduce the amount of maintenance opex required) (see attachments 3 and 6).
1. The AER's smoothed revenues are derived from the AER's smoothed tariffs. Smoothed tariffs multiplied by forecast demand equals the smoothed revenue. The smoothed revenues are equal in net present value terms to Multinet’s unsmoothed building block revenue requirements. [↑](#footnote-ref-1)
2. The AER derived this estimate based on annual consumption of 60GJ per annum. This is consistent with data sourced from the ESC’s published standing offer bills contained in its Energy retailers comparative performance report - Pricing 2010–11, and Multinet’s approved tariffs for 2010 and 2011. The averages of the tariffs across Multinet's distribution zones applied in the AER’s analysis uses a weighted average of volume by tariff class. [↑](#footnote-ref-2)
3. Under s.8 of the NGL a service provider is a person who owns, controls or operates a gas pipeline. [↑](#footnote-ref-3)
4. 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. [↑](#footnote-ref-4)
5. National Gas (Victoria) Act 2008 (Vic), Part 5. [↑](#footnote-ref-5)
6. NGR, r. 40. [↑](#footnote-ref-6)
7. NGL, s. 28(1). [↑](#footnote-ref-7)
8. NGL, s. 28(2). [↑](#footnote-ref-8)
9. NGL, s. 132. [↑](#footnote-ref-9)
10. NGR, r. 58(1). [↑](#footnote-ref-10)
11. NGR, r. 58(2). [↑](#footnote-ref-11)
12. NGR, r. 59(1); r. 71(2). [↑](#footnote-ref-12)
13. NGR. r. 59(4). [↑](#footnote-ref-13)
14. NGR, r. 59(2). [↑](#footnote-ref-14)
15. NGR, r. 41(1). [↑](#footnote-ref-15)
16. NGR, r. 41(2). [↑](#footnote-ref-16)
17. NGR, r. 64(1). [↑](#footnote-ref-17)
18. NGR, r. 65(2). [↑](#footnote-ref-18)
19. NGR, r. 59(2). [↑](#footnote-ref-19)
20. NGR, r. 60(1). [↑](#footnote-ref-20)
21. 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. [↑](#footnote-ref-21)
22. NGR, r. 59(5)(b) & (c). [↑](#footnote-ref-22)
23. NGR, r. 62(1). [↑](#footnote-ref-23)
24. NGR, r. 62(2). [↑](#footnote-ref-24)
25. NGR, r. 62(4). [↑](#footnote-ref-25)
26. NGR, r. 62(7). [↑](#footnote-ref-26)
27. NGR, r. 11. [↑](#footnote-ref-27)
28. NGR, r. 11(1)(c). [↑](#footnote-ref-28)
29. NGR, r. 13. [↑](#footnote-ref-29)
30. NGR, r. 42(1). [↑](#footnote-ref-30)
31. NGL, s. 46. [↑](#footnote-ref-31)
32. NGL, ss. 324 to 329 (Division 1 of Part 2 of Chapter 10 of the NGR). [↑](#footnote-ref-32)
33. NGL, s. 329(1). [↑](#footnote-ref-33)
34. This may relate to operating expenditure and/or capital expenditure depending on the incentive mechanism. [↑](#footnote-ref-34)
35. This will be included as a building block revenue component in the estimate of corporate income tax payable under the post-tax framework or in the return on the capital under the pre-tax framework. The AER employs the post-tax framework. [↑](#footnote-ref-35)
36. AER, *Access arrangement guidelines*, March 2009, p. 55. [↑](#footnote-ref-36)
37. The AER's smoothed revenues are derived from the AER's smoothed tariffs. Smoothed tariffs multiplied by forecast demand equals the smoothed revenue. The smoothed revenues are equal in net present value terms to Multinet’s unsmoothed building block revenue requirements. [↑](#footnote-ref-37)
38. This is net of ancillary reference service revenue of $7.9 million ($nominal) over the 2013–17 access arrangement period. [↑](#footnote-ref-38)
39. This is net of ancillary reference service revenue of $7.9 million ($nominal) over the 2013–17 access arrangement period. [↑](#footnote-ref-39)
40. Includes carryover amounts. [↑](#footnote-ref-40)
41. The AER derived an estimate of the proportion of distribution charges that contribute to the typical residential and non-residential (businesses) customer bills based on annual consumption of 60GJ and 500 GJ per annum, respectively. This is consistent with data sourced from the ESC’s published standing offer bills contained in its Energy retailers comparative performance report ­– Pricing 2010–11, and Multinet’s approved tariffs for 2010 and 2011. The averages of the tariffs across Multinet's distribution zones applied in the AER’s analysis uses a weighted average of volume by tariff class. [↑](#footnote-ref-41)
42. The AER has calculated a typical residential bill to be $1050 per year. This was calculated as the average standing offer contract for a customer consuming 60 GJ per annum. The average was calculated across each of Multinet's distribution zones. Standing offer prices charged by retailers represent charges applied to those customers who have not switched from their incumbent or local retailer. [↑](#footnote-ref-42)
43. The AER has calculated a typical non-residential bill to be $6084 per year. This was calculated as the average standing offer contract for a customer consuming 500 GJ per annum. The average was calculated across each of Multinet's distribution zones. Standing offer prices charged by retailers represent charges applied to those customers who have not switched from their incumbent or local retailer. [↑](#footnote-ref-43)
44. NGR r. 101(2). [↑](#footnote-ref-44)
45. This is required because the 2008–12 access arrangement was agreed in 2007, and hence capex in 2007 was estimated rather than actual. [↑](#footnote-ref-45)
46. This closing capital base is also used as the value of the opening capital base as at 1 January 2013 for the 2013–17 access arrangement period. [↑](#footnote-ref-46)
47. NGR, r. 77(2). [↑](#footnote-ref-47)
48. NGR, r. 40. [↑](#footnote-ref-48)
49. The AER has not assessed the capex for 2012. The AER is required under the NGR to properly reflect any increments or decrements arising from the operation of the ESC’s capex incentive scheme. The AER has applied the transitional provision. This requires the AER to include in the capital base roll forward benchmark capex for 2012, adjusted for actual growth. At the next access arrangement review, the AER will assess whether Multinet's actual capex for 2012 is conforming capex under the NGR. [↑](#footnote-ref-49)
50. Multinet, AAI, p. 106. [↑](#footnote-ref-50)
51. That is, houses and premises that are knocked down and lost to the system. [↑](#footnote-ref-51)
52. Multinet, Response to Information Request 27, received 7/8/12, Question 1, p. 1. [↑](#footnote-ref-52)
53. Multinet, Access Arrangement Information, 30 March 2012, p. 108. [↑](#footnote-ref-53)
54. Escalated to $2012. [↑](#footnote-ref-54)
55. NGR, r. 87. [↑](#footnote-ref-55)
56. The AER's adoption of this rate is subject to the risk free rate and debt risk premium parameters being updated closer to the date of the final decision. [↑](#footnote-ref-56)
57. The AER agrees with Multinet's proposed paired bonds extrapolation method, including the selection criteria to choose the paired bonds. However, Multinet appears to have incorrectly applied the selection criteria in its proposal. Accordingly, the AER has corrected this error in applying Multinet's proposed paired bonds extrapolation method. [↑](#footnote-ref-57)
58. AER, Final decision: APT Petroleum Pipeline Pty Ltd, Access arrangement final decision, Roma to Brisbane Pipeline 2012–13 to 2016–17, August 2012, p. (AER, Final decision: APTPPL access arrangement, August 2012). [↑](#footnote-ref-58)
59. AER, Final distribution determination, Aurora Energy Pty Ltd 2012–13 to 2016–17, April 2012, p. 29, (AER, Final decision: Aurora distribution determination, April 2012) [↑](#footnote-ref-59)
60. Reserve Bank of Australia, Letter to the ACCC: The Commonwealth Government Securities Market, 16 July 2012; Australian Treasury and Australian Office of Financial Management, Letter to the ACCC: The Commonwealth Government Securities Market, 18 July 2012; M. McKenzie, and G. Partington; Report to the AER: Review of regime switching framework and critique of survey evidence, 7 September 2012; M. McKenzie and G. Partington, Report to the AER: Review of NERA report on the Black CAPM, 24 August 2012; M. Lally, The cost of equity and the market risk premium, 25 July 2012; M. Lally, The risk free rate and the present value principle, 22 August 2012. [↑](#footnote-ref-60)
61. Multinet, Access arrangement submission: Part A, 30 March 2012. [↑](#footnote-ref-61)
62. This estimate reflects the paired bonds sample proposed by Multinet. [↑](#footnote-ref-62)
63. Envestra, Access arrangement information, 30 March 2012; APA GasNet, Access arrangement submission, 31 March 2012; Multinet, Access arrangement information, 30 March 2012. [↑](#footnote-ref-63)
64. BHP Billiton, Submission to the AER: APA GasNet access arrangement proposal, 29 June 2012, p. 17. [↑](#footnote-ref-64)
65. EUCV, Submission to the AER: APA GasNet access arrangement proposal,18 June 2012, p. 50. [↑](#footnote-ref-65)
66. Though the AER and ERA operate under different legislative instruments, the sections relevant to the determination of the rate of return are identical. Australian Competition Tribunal, Application by WA Gas Networks Pty Ltd (No 3) [2012] ACompT 12, 8 June 2012, paragraphs 167, 180; and Australian Competition Tribunal, Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14, 26 July 2012, paragraphs 280–282, 287. [↑](#footnote-ref-66)
67. Specifically, all bonds (sourced from Bloomberg) were from Australian companies, denominated in Australian dollars and issued in Australia. Further, bonds could be either fixed or floating and either bullet, callable or putable. Different scenarios used other slightly different criteria, such as a minimum term (two or five years), and a range of credit ratings (BBB-/BBB/BBB+ or BBB/BBB+). [↑](#footnote-ref-67)
68. Australian Competition Tribunal, Application by WA Gas Networks Pty Ltd (No 3) [2012] ACompT 12, 8 June 2012, paragraphs 176, 180, 187; Australian Competition Tribunal, Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14, 26 July 2012, paragraphs 290, 310–313. [↑](#footnote-ref-68)
69. More specifically, the Tribunal endorsed the use of the ERA’s ‘scenario 2’, which encompassed a minimum credit rating of BBB and a minimum term of two years. It also suggested that it would be appropriate to apportion weight by considering both term to maturity and issuance amount for the relevant bonds. [↑](#footnote-ref-69)
70. ERA, Revised decision, Access arrangement revisions for the Mid-West and South-West Gas Distribution System, 25 June 2012, pp. 5–12. [↑](#footnote-ref-70)
71. Based on Multinet's indicative averaging period, this ‘bond-yield approach’ estimate incorporates 60 bonds with an average term to maturity of 5.94 years. [↑](#footnote-ref-71)
72. Australian Competition Tribunal, Application by Envestra Limited (No 2) [2012] ACompT 3, 11 January 2012, paragraphs 95, 118, 120–121; see also Australian Competition Tribunal, Application by APT Allgas Energy Ltd [2012] ACompT 5, 11 January 2012. [↑](#footnote-ref-72)
73. This estimate reflects an adjustment to Multinet's proposed extrapolation approach. This adjustment is discussed in detail in attachment 4 of this draft decision. [↑](#footnote-ref-73)
74. R. 87, NGR. [↑](#footnote-ref-74)
75. Australian Treasury and Australian Office of Financial Management, The Commonwealth Government Securities Market, July 2012. [↑](#footnote-ref-75)
76. Reserve Bank of Australia, The Commonwealth Government Securities Market, July 2012. [↑](#footnote-ref-76)
77. Federal Court of Australia, ActewAGL Distribution v The Australian Energy Regulator [2011] FCA 639, 8 June 2011, paragraph 148. [↑](#footnote-ref-77)
78. McKenzie, M. and G. Partington, G., Supplementary report on the market risk premium, 22 February 2012, pp. 11–-12; Lally, M., The risk free rate and the present value principle, 22 August 2012, p. 3. [↑](#footnote-ref-78)
79. The Treasury and AOFM advice indicates that the movement in the Australian yield curve reflects a range of factors, including the changed stance of monetary policy and global financial market instability. Australian Treasury and Australian Office of Financial Management, The Commonwealth Government Securities Market, July 2012. [↑](#footnote-ref-79)
80. Australian Competition Tribunal, Telstra Corporation Limited ABN 33 051 775 556 [2010] ACompT 1, 10 May 2010, paragraph 417. [↑](#footnote-ref-80)
81. NGR, r. 89(1)(a). [↑](#footnote-ref-81)
82. NGR, r. 89(1)(b). [↑](#footnote-ref-82)
83. NGR, r. 89(1)(c). [↑](#footnote-ref-83)
84. NGR, r. 89(1)(d). [↑](#footnote-ref-84)
85. NGR, r. 89(1)(e). [↑](#footnote-ref-85)
86. NGR, schedule 1, r. 5(1)(d). [↑](#footnote-ref-86)
87. NGL, s 28; NGR r. 100(1). The NGO is set out in NGL, s. 23. The revenue and pricing principles are set out in NGL, s. 24. [↑](#footnote-ref-87)
88. The AER's adjustment on forecast capex means that by the end of 2017, Multinet will still have received accelerated depreciation for 77 km of low pressure distribution mains, which are still in service. [↑](#footnote-ref-88)
89. NGR, rr. 89(1)(b), 89(1)(c). [↑](#footnote-ref-89)
90. This is consistent with the standard economic life approved by the ESC for 2008–12. See ESC, Multinet GAAR 2008 Revenue Model Further Final Decision, 2008. [↑](#footnote-ref-90)
91. NGR, r. 69. [↑](#footnote-ref-91)
92. NGR, r. 74. [↑](#footnote-ref-92)
93. NGR, r. 91, r. 71. [↑](#footnote-ref-93)
94. Note 2012 is a forecast. Multinet has forecast it will incur $12.7m of opex in 2012 related to metering that it does not forecast to be recurrent expenditure. [↑](#footnote-ref-94)
95. Multinet, Access Arrangement Information, 30 March 2012, p. 63. [↑](#footnote-ref-95)
96. NGR, r. 74(2). [↑](#footnote-ref-96)
97. NGR, Schedule 1, Clause 2, 5(1)9a) [↑](#footnote-ref-97)
98. NGR, r. 91(1). [↑](#footnote-ref-98)
99. The AER discussed the need to provide service providers with continuous incentives to reduce costs and gain efficiencies and the reasons for considering 5 years as the appropriate carryover period in AER, Final decision: Electricity distribution network service providers Efficiency benefit sharing scheme, June 2008. [↑](#footnote-ref-99)
100. That is, to carryover efficiency losses from the 2008-2012 access arrangement period. [↑](#footnote-ref-100)
101. Multinet provided these in response to a request for information about the factors driving their proposed increase in forecast opex compared to historic opex. (see: Multinet, Response to AER information request 10, 20 June 2012, p. 22; Response to AER information request 38, 2 August 2012.) [↑](#footnote-ref-101)
102. NGR, Schedule 1, clause 5(1)(a). [↑](#footnote-ref-102)
103. NGR, rule 98. [↑](#footnote-ref-103)
104. NGR, schedule 1, clause 5(1)(a). [↑](#footnote-ref-104)
105. The revenue and pricing principles are in s. 24 of the NGL. [↑](#footnote-ref-105)
106. Multinet, Gas Access Arrangement Review January 2013–December 2017 Access Arrangement Information, 30 March 2012, pp. 176–177. [↑](#footnote-ref-106)
107. The AER's reasons for setting aside the incentive mechanism for United Energy are in AER, Draft decision – Victorian electricity distribution network service providers distribution determination 2011–2015, June 2010, pp. 560–562; AER, Final decision – Victorian electricity distribution network service providers distribution determination 2011–2015, October 2010, pp. 594–595. [↑](#footnote-ref-107)
108. Under the Gas Industry Act 2001 (Victoria). [↑](#footnote-ref-108)
109. Multinet, Post tax revenue model, March 2012. [↑](#footnote-ref-109)
110. NGR, r. 76(c). [↑](#footnote-ref-110)
111. NGR, r. 74(2)(b). [↑](#footnote-ref-111)
112. Tariff V class customer connections are residential and commercial/industrial customers who consume less than 10 TJ per year. [↑](#footnote-ref-112)
113. Tariff D customers are larger customers. [↑](#footnote-ref-113)
114. NGR, r. 72(1)(j), r. 95(1) and r. 95(3)(a). [↑](#footnote-ref-114)
115. Multinet, Gas access arrangement review January 2013–Decmber 2017, Access arrangement information, 30 March 2012, p. 211. [↑](#footnote-ref-115)
116. Multinet, Gas access arrangement review January 2013–Decmber 2017, Access arrangement information, 30 March 2012, pp. 183–185. [↑](#footnote-ref-116)
117. A rebalancing constraint is a mechanism to restrict the magnitude to which a tariff can vary on an annual basis. [↑](#footnote-ref-117)