Rate of Return Instrument Amendment

Explanatory note

March 2024

AUSTRALIAN ENERGY REGULATOR

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Contents

1 Background

The Rate of Return Instrument (**RORI** or **Instrument**) sets out the approach by which we will estimate the allowed rate of return for network businesses and includes the methodology for calculating the return on debt and the return on equity. We are required to publish a new Instrument every 4 years that will bind all regulatory determinations made over the subsequent 4 years. On 24 February 2023 we published the latest RORI (2022 RORI).[1] In August 2023 we amended this instrument due to the RBA ceasing to publish its F16 Statistical Table.[2] The explanatory statement and submission on the proposed amendment made in August 2023 are available on our website.[3] Our next Instrument is expected to be published in December 2026.

Originally, the Victorian electricity distribution network service providers (DNSPs) previous regulatory control period (RCP) and Victorian gas DNSPs previous access arrangement period ended on 31 December 2020 and 31 December 2022, respectively.

In April 2019, the Victorian Government announced its intention to align the regulatory control periods of the state's electricity distribution businesses with other National Electricity Market states. That is, they will move from a calendar year (CY) regulatory period to a financial year (FY) basis.[4] The move to financial years for gas businesses was discussed between the AER and the network business between July and September 2021.

To facilitate the change, Victorian legislation (covered below) provided the original 5-year regulatory periods were extended by 6 months creating determination extension periods. In addition, it made the determination extension period of 6 months be taken as an extra regulatory year of the previous RCP and access arrangement period for electricity and gas DNSPs, respectively. Consequently:

- Victorian electricity DNSPs' previous RCP ended on 30 June 2021 resulting in a 5 ½ year RCP; and
- Victorian gas DNSPs' previous access arrangement period ended on 30 June 2023 resulting in a 5 ½ year access arrangement period.

The modifications to the 2018 RORI to facilitate the six month regulatory period

The RORI applies to determinations made while it is in force. The 2018 RORI was applicable to both the electricity and gas 6 month extension period regulatory decisions given it was in force when the AER made its decisions for the determination extension periods.

1 The Instrument was originally scheduled for 2022 but was delayed to February 2023 due to unanticipated further stakeholder engagement on important advice from the Australian Government Treasury advice.

2 AER, Rate of Return Instrument (version 1.1), August 2023.

3 AER, *Explanatory note - Rate of Return Instrument amendment*, August 2023 available; The Consultation paper on the proposed amendment and submissions on this are available here .

4 Victorian Government, Intention to change the timing of annual Victorian network price changes, April 2019, is available here .

The 2018 Instrument was developed based on consecutive 12-month regulatory years and did not contemplate an intervening six-month extension period when moving from calendar years to financial years. Our 10-year simple trailing average for calculating the return on debt is based on 10 consecutive 12-month regulatory years.[5] This meant the 2018 RORI trailing average approach was not workable once the six month regulatory year was created absent modifications to the 2018 RORI.

The Victorian legislation provided that, for the purposes of giving effect to the change from calendar to financial year basis, the AER may modify the application of the 2018 Instrument.[6] The 6-month gap period was defined as a “regulatory year” for these purposes.[7] Under these powers we made two modified 2018 Instruments, one for Victorian electricity DNSPs and one for Victorian gas DNSPs, so that they correctly applied the methods set out in the original 2018 Instrument to the determination extension period, which was 6 months but taken to be a regulatory year.[8]

Why we modified the 2018 RORI in the way we did

The move to financial years had the potential to make consumers better or worse off by virtue of having a 6-month long regulatory year between full 12-month regulatory years. How the allowed return on capital was set in that 6-month regulatory year, including how the trailing average return on debt was determined taking this period into account, had the potential to cause wealth transfers between consumers and DNSPs.

We determined a method to limit wealth transfers between consumers and DNSPs from the change to financial years by:

- Having a transition for the return on debt that incorporated the return for the 6-month regulatory year in the trailing average (half weighting relative to other years given it was half the length).
- Setting an ‘on-the-day’ return on equity for the 6-month regulatory year.

Our method of transitioning the return on debt that incorporated the return for the 6-month regulatory year in the trailing average meant that the weight we give to the first regulatory year in the *transition period* would change every year, relative to the original weightings in the unmodified 2018 RORI, until the 6-month regulatory year drops out of the trailing average.

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5 AER, *Rate of return instrument*, December 2018, clause 9 and definitions of regulatory year and transition period.

6 National Electricity (Victoria) Act 2005 (Vic), section 16VJ; Order in Council made under section 64 of the National Gas (Victoria) Act 2008 (Vic) on 30 September 2021, clause 6.

7 National Electricity (Victoria) Act 2005 (Vic), section 16VC; Order in Council made under section 64 of the National Gas (Victoria) Act 2008 (Vic) on 30 September 2021, clause 5.

8 AER, *Modified rate of return instrument for the Victorian electricity distribution networks during the extension period of 1 January 2021 to 30 June 2021*, October 2020*;* AER, *Modified Rate of Return Instrument for the Victorian gas distribution networks during the extension period of 1 January 2023 to 30 June 2023*, October 2021.

Our modified 2018 RORI for Victorian electricity DNSPs applied to the Victorian electricity DNSPs' 6-month transitional determinations made in October 2020. Substantively the same modifications applied to the current Victorian electricity DNSPs determinations we made in April 2021 via a modified 2021-26 RORI made by the Victorian government.[9] Given the 2022 RORI would not apply to the 2021–26 RCP, the Victorian legislation set out how the weights in our trailing average changes until the 6-month gap period drops out.[10] In summary, for Victorian electricity DNSPs, our modified 2018 RORI sets out the trailing average method for the 6 months from 1 January 2021 to 30 June 2021 and Victorian legislation sets out how it will apply from 1 July 2021 to 30 June 2026.

We made a second modified 2018 RORI that applied to the Victorian gas DNSPs' 6-month transitional determinations made in October 2022.[11] However, neither this modified RORI nor the Victorian legislation set out the future weights to apply in the trailing average until the 6-month gap period drops out. This absence was driven by both an expectation that our 2022 RORI would include the required weights to apply to the trailing average in it and the fact we could not bind ourselves in what would be included in the 2022 RORI. We note that the 2022 RORI was published before we made our regulatory determination for the Victorian gas DNSPs in April 2023, therefore the 2022 RORI applies to the 2023-2028 regulatory control period for Victorian gas DNSPs.

By an oversight, the 2022 RORI did not include the modifications to adjust the trailing average weights to accommodate the 6-month regulatory year as intended and consulted on by us at the times we made the modified 2018 Rate of return instruments. No stakeholders raised this as part of the process when we made 2022 RORI. However, this oversight has created a need to amend the 2022 RORI because it has become unworkable for affected NSPs and incapable of achieving its purpose.

We note that it was always expected by the AER and other stakeholders that the modified trailing average would apply until the return on debt for the 6 month regulatory year dropped out of the trailing average. Therefore, it was expected these changes would be incorporated into the 2022 RORI. This expected future application in the 2022 RORI was set out in a number of documents including:

- A spreadsheet of implementation options provided to Victorian electricity DNSPs in August 2019 and the Brotherhood of St Laurence in Sept 2019 prior to making the modified 2018 RORI with agreed implementation notified to all stakeholders in October 2019.[12]
- The Victorian Government Order in Council applicable to Victorian electricity DNSPs.[13]

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9 Victorian Government Gazette No S 549, 27 October 2020, p2.

10 Victorian Government Gazette No S 549, 27 October 2020, pp8-12.

11 AER, *Modified Rate of Return Instrument for the Victorian gas distribution networks – during the extension period of 1 January 2023 to 30 June 2023,* October 2021.

12 AER, *Explanatory statement – Modified Rate of Return Instrument for the Victorian gas distribution networks – during the extension period of 1 January 2023 to 30 June 2023,* October 2021, P5.

13 Victorian Government Gazette No S 549, 27 October 2020, pp8-12.

- The spreadsheet published with the 2023 modified rate of return instrument for Victorian gas DNSPs.[14]
- The WACC spreadsheet submitted by AusNet Services with its gas regulatory proposal.[15]

Key elements of the Victorian legislation relating to the extension determination period and the modifications to the 2018 RORI

The transition to a FY regulatory control period for Victorian electricity DNSPs was provided under the *National Energy Legislation Amendment Act 2020 (Vic)* (the "NELA Act"), which amended the *National Electricity (Victoria) Act 2005 (Vic)* (the "NEVA"). The NELA Act came into effect on 27 October 2020.

The NELA Act includes the following key changes relating to the application of the rate of return instrument:

1. amend the regulatory period to commence on 1 July and regulatory years to run on a financial year basis[16]
2. extend the current regulatory control period (2016–2020) to allow the 6 month extension period (1 Jan 2021–30 Jun 2021) to be treated as a regulatory year of the current regulatory period[17]
3. provide that the AER may make a variation to the 2016–2020 distribution determination that it considers necessary to be made as a consequence of the extension of the current regulatory control period[18]
4. provide that the 2018 Instrument applies to the determination extension period, subject to the AER's modifications of the Instrument to give effect to the extension of the current regulatory control period.[19]

An Order in Council (Order) was made under section 16VE of the NELA Act on 27 October 2020. The Order set out how the trailing average would apply in the 2021-2026 regulatory period.[20]

For Victorian gas DNSPs the transition to a FY access arrangement period was provided under the NELA Act, which amends the *National Gas (Victoria) Act 2008 (Vic)* (the "NGVA").

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

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14 AER, *Illustrative example – Vic gas regulatory period change – trailing average weights*, 2021.

15 AusNet Services, *ASG – GAAR 2024-28 – Rate of Return Build Up Model*, July 2021.

16 National Electricity (Victoria) Act 2005 (Vic), section 16VB.

17 National Electricity (Victoria) Act 2005 (Vic), section 16VC.

18 National Electricity (Victoria) Act 2005 (Vic), section 16VJ.

19 National Electricity (Victoria) Act 2005 (Vic), section 16 VJ.

1. amend the access arrangement period to commence on 1 July on a financial year basis[21]
2. extend the current access arrangement period (2018–2022) to allow the 6 month extension period (1 Jan 2023–30 Jun 2023) to be treated as a regulatory year of the current access arrangement period[22]
3. provide that the AER may make a variation to the 2018–2022 access arrangements that it considers necessary to be made as a consequence of the change of the access arrangement period from the CY to FY basis[23]
4. provide that the 2018 Instrument applies to the applicable access arrangement extension period, subject to the AER's modifications of the Instrument to give effect to the change of the access arrangement period from a CY to a FY basis.[24]

The inability to apply the 2022 RORI as drafted to Vic DNSPs prior to this amendment

The 2022 Instrument as drafted prior to the current amendments had a simple 10 period trailing average with a transition to this from a spot (or on-the-day) rate over 10 years.[25] The simple trailing average approach was identical to the original 2018 RORI.

The Instrument prior to amendment relied on the definitions of *Regulatory year* and *Transition period* within the Rate of Return Instrument to apply the trailing average.[26]

- Regulatory year is defined as:

  Regulatory year refers to each consecutive period of 12 months in a regulatory control period, the first such 12 month period commencing at the beginning of the regulatory control period and the final 12 month period ending at the end of the regulatory control period.

- Transition period is defined as:

  Transition period refers to the period commencing at the start of the first regulatory year for which the return on debt is calculated using a trailing average for the first time for the relevant regulated service and ends after 10 regulatory years.

Because prior to amendment the trailing average required consecutive 12 month regulatory years and the Victorian DNSPs by virtue of the six month regulatory year do not have this, our view was the 2022 RORI could not be applied to the Victorian DNSPs absent this amendment.

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

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

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

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

25 AER, *Rate of Return Instrument,* February 2023, clause 9.

26 AER, *Rate of Return Instrument*, February 2023, Glossary.

2 Stakeholder consultation

On 15 December 2023, we published our proposed amendments with a consultation paper for stakeholder submissions. We proposed amendments to the 2022 RORI to give effect to the previously expected amendments to the trailing average for Victorian DNSPs.

We note the amendments consulted on were tracked against the original version of the 2022 RORI (version 1.0). However, there was no intention to alter modifications previously made in version 1.1 made in August 2023. The changes made in version 1.1 of the 2022 RORI related to data sources and contingencies and are unchanged in version 1.2 of the RORI.

In considering the amendment process under the revisiting clause covered below, in consultation we noted that the amendments are necessary to allow the 2022 RORI to apply to all NSPs. The amendments we have made were discussed with stakeholders when we made the amendments to the 2018 RORI. The amendments will only vary how the 2022 RORI apply to the Victorian DNSPs which have transitioned from calendar year to financial year regulatory years.

We received 2 submissions from Australian Gas Infrastructure Group (AGIG) and Energy Networks Association (ENA).[27] The ENA stated that it supported the proposed amendments to remain consistent with the Victorian Government Gazette and the modified 2018 Instruments.[28] AGIG also supported the proposed amendments.[29]

3 Legal power to amend the 2022 Instrument

The National Electricity Legislation (**NEL**) and the National Gas Legislation (**NGL**) provide the AER the power to make the RORI. The NEL and NGL are clear that the AER must apply the RORI that it has published, and that the AER has no discretion around its application. In particular, the NEL and the NGL state:

- the RORI has the force of law[30]
- the RORI is binding on the AER and NSPs[31]
- the methodology in the RORI must apply automatically without the exercise of any discretion by the AER[32]
- the RORI applies for the purpose of any AER economic regulatory decision, including distribution and transmission determinations.[33]

27 AGIG, *Submission - Proposed Instrument Amendment*, 24 January 2024; ENA, *Submission - Proposed Instrument Amendment*, 26 January 2024, available here.

28 ENA, *Submission - Proposed Instrument Amendment*, 26 January 2024, p1.

29 AGIG, Submission - *Proposed Instrument Amendment*, 24 January 2024, p1.

30 NEL, s.18G and NGL, s. 30B

31 NEL, s.18H and NGL, s. 30C

32 NEL, s.18J(2)(b) and NGL, s. 30E(2)(b)

33 NEL, s.18V and NGL, s. 30Q

The RORI, which is binding, directs the NSPs and us on how to calculate the rate of return for each business. However, the inclusion of a six month regulatory period for Victorian DNSPs means certain elements of the rate of return calculation cannot be completed as directed in the 2022 RORI. As set out above, the legislation also specifically states that the RORI must be capable of applying automatically without exercising discretion. Therefore, it would be inconsistent with the legislation for us to use our discretion in determining how to apply the 2022 RORI.

Given the circumstances, we consider compliance with the 2022 RORI to determine the rate of return is now no longer possible for the affected NSPs.

Neither the NEL nor NGL specifically provide the power to amend the RORI once it has been made. However, both provide a general power to amend or repeal instruments and decisions. Section 20 of Schedule 2 to the NEL (and section 20 of Schedule 2 to the NGL) states that where the NEL (or NGL) provides the power to make an instrument, decision or determination, the power includes power to amend or repeal the instrument, decision or determination. We have referred to this power as the ‘revisiting provision’.

Section 41 of schedule 2 to the NEL (Clause 51 of schedule 2 to the NGL) makes clear that schedule 2 to the NEL (and NGL) would apply to the rate of return instrument. It was introduced to the NEL at the same time the binding rate of return was introduced to the NEL. It notes that schedule 2 of the NEL (and NGL) applies to “statutory instruments”. It then provides a definition of “statutory instrument” which specifically includes the “rate of return instrument”.

The present scenario is similar although not identical to our decision to amend the 2022 RORI last year.[34] This is not a typographical error or a clerical error. It does not arise from the provision of inaccurate or misleading information. The present problem arises because we omitted to consider the six month regulatory period when making the 2022 RORI, which makes the instrument unworkable for affected NSPs.

Given the circumstances, we considered the revisiting provision allowed for amending the Instrument as it had become unworkable for affected NSPs and incapable of achieving its purpose.

4 Amendment to the 2022 Instrument

The amendments to clause 9 introduce a change in the return on debt calculation methodology for the Victorian gas and electricity DNSPs for certain regulatory years consistent with Victorian government legislation and the modified 2018 Instruments. This consequently impacts the calculation of the overall rate of return for those regulatory years under clause 3 of the RORI.

We have made an amendment to replace clause 9 of the 2022 RORI with clause 9’ for any service provider that had moved from calendar year regulatory years to financial year regulatory years before 1 January 2024. We have also modified the definition of *Regulatory Year* and *Transition Period* to allow for the modified trailing average containing the six month

[34] AER, *Explanatory note – Rate of Return Instrument amendment*, August 2023.

regulatory year. These were the proposed amendments we consulted on and no other changes to version 1.1 of the 2022 RORI have been made.

The amendments continue to apply the modified trailing average that has been applied to Victorian gas DNSPs under the modified 2018 RORI. They will impact the Victorian gas DNSPs from 1 July 2024 until 30 June 2028. They are also likely to impact the Victorian gas DNSPs from 1 July 2028 to 30 June 2033 assuming they are maintained in the next RORI expected to be made in December 2026.

The amendments continue the modified trailing average in the 2022 RORI that is currently being applied to the Victorian electricity DNSPs under the modified 2021-26 RORI. They will impact the Victorian electricity DNSPs from 1 July 2026 for 4 years.

Published with this explanatory note is a ‘track change’ version of the 2022 Rate of Return Instrument. The track change version shows changes tracked against version 1.1 of the 2022 RORI published in August 2023.

Glossary

Term	Definition
Instrument	Rate of Return Instrument
NEL	National Electricity Legislation
NGL	National Gas Legislation
RBA	Reserve Bank of Australia
RORI	Rate of Return Instrument
ENA	Energy Networks Association
AGIG	Australian Gas Infrastructure Group

Links to documents cited

Document	Link
AER, *Explanatory statement, Rate of return Instrument*, December 2018	Available here
AER, *Rate of return instrument*, December 2018	Available here
Victorian Government, *Intention to change the timing of annual Victorian network price changes*, April 2019	Available here
Victorian Government Gazette No S 549, 27 October 2020.	Available here
AusNet Services, *ASG – GAAR 2024-28 – Rate of Return Build Up Model*, July 2021	Available here
AER, *Modified Rate of Return Instrument for the Victorian gas distribution networks – during the extension period of 1 January 2023 to 30 June 2023,* October 2021	Available here
AER, *Illustrative example – Vic gas regulatory period change – trailing average weights*, 2021	Available here
AER, *Rate of Return Instrument (version 1.1)*, August 2023	Available here

Document	Link
AER, *Explanatory note - Rate of Return Instrument amendment*, August 2023	Available here
The Consultation paper on the proposed amendment and submissions 2023	Available here