



Multinet gas mains replacement cost pass thorough

AER decision

September 2015

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1 Summary

On 12 June 2015 we, the Australian Energy Regulator (AER), received an application for a mains replacement cost pass through event from Multinet Gas Distribution Partnership (Multinet) for its Victorian gas distribution network.¹

Multinet's application is for costs to complete 272 km of mains replacement in addition to that approved in its 2013–17 access arrangement. Multinet is replacing low pressure distribution mains with high pressure polyethylene mains. The replacement is expected to mitigate safety risk, reduce operating costs and improve supply reliability. This is consistent with Multinet's Asset Management Plan approved by Energy Safe Victoria.²

We must approve a proposed cost pass through if it satisfies the access arrangement's requirements. We have assessed Multinet's pass through application in accordance with the procedures set out in its access arrangement.

We consider Multinet's proposed pass through event variation satisfies the requirements of its access arrangement. We approve:

- an additional 272 km of mains replacement, which takes the total volume to 527 km over the 2013–17 access arrangement period
- an additional \$51.6 million (\$2012) in capital expenditure to complete the additional 272 km of mains replacement
- recovering the additional capital expenditure by increasing reference tariffs by an additional 1.4 per cent (around 140 basis points) per annum for 2016 and 2017.³

¹ Multinet is a fully owned subsidiary of DUET.

² *Multinet Gas Network Asset Management Plan 2012/13 – 2017/18*, March 2012, p. 102..

³ To bring the total expected annual tariff increase to an average of 3.4 per cent across 2016 and 2017, excluding inflation.

2 Background

We regulate gas distribution businesses in Victoria. We do so under the National Gas Law (NGL) and the National Gas Rules (NGR). We made our final decision on the 2013–17 access arrangement for Multinet's Victorian Gas Distribution System on 15 March 2013.⁴ As part of that decision we approved a mains pipeline replacement cost pass through provision. If we approve the cost pass through proposed by Multinet under that provision, Multinet may raise reference tariffs to pass through the event's costs to customers.

This pass through provision was implemented in the context of the Victorian gas distribution businesses receiving funding for mains replacement during the previous access arrangement period but not completing the work. For the current access arrangement period we approved mains replacement based on the amount of mains replacement undertaken in the previous period. We approved expenditure for Multinet to undertake 255 km of mains replacement—the 'historical volumes'. This is less than Multinet had proposed. Multinet was given funding for this amount of mains replacement through the 2013–17 reference tariffs we approved.

In setting the allowance for a lower volume, we acknowledged that the objective of the mains replacement program is to remove all cast iron mains over the longer term, consistent with the Victorian gas distribution businesses' Asset Management Plans approved by Energy Safe Victoria (ESV). We therefore provided for a pass through to enable the gas distribution businesses to receive further funding, once they had delivered a specified volume of mains replacement.

In addition to the mains replacement we approved, we provided a pass through so Multinet may receive further funding if it showed it could achieve additional mains replacement during the 2013–17 period. Our decision provided for Multinet to apply for a mains replacement cost pass through once it completed 207 km of its 2013–17 access arrangement period mains replacement program. Multinet must also demonstrate its intention to complete the total 255 km of mains replacement we approved in the 2013–17 access arrangement and the additional volume of mains replacement proposed in the pass through application.

⁴ AER, *Access Arrangement Final Decision – Multinet Gas (DB no. 1) Pty Ltd – 2013–17– Parts 1, 2 and 3*, 15 March 2013.

3 Regulatory requirements

The NGR allows a reference tariff variation mechanism to vary reference tariffs due to a cost pass through for a defined event.⁵ Detailed provisions for cost pass through events and how we must assess them are provided in each service provider's access arrangement. In this case, clause 8 of Part B of Multinet's access arrangement⁶ and in the Glossary of Part A of Multinet's access arrangement⁷.

Subject to our approval, reference tariffs may be varied after one or more cost pass through event/s occurs. One of those events is a mains replacement event.⁸

A mains replacement event is defined as an event in which Multinet:

- completes 207 km of mains replacement during the course of the 2013–17 access arrangement period, and
- costs are incurred, or are to be incurred, by Multinet in the remainder of the 2013–17 access arrangement period to complete a mains replacement in excess of the historical volumes.

Historical volumes means 255 km, being the volume of mains replacement completed by Multinet for the 2008–2012 access arrangement period.

Mains replacement means replacement of low pressure distribution pipeline with high pressure polyethylene pipeline. This is done by dividing a low pressure region into smaller areas (blocks) which are then systematically replaced.

Approved unit rates (cost per metre of mains replaced) are set out in our decision to approve Multinet's 2013–17 access arrangement. Where unit rates have not been pre-approved for an area in which Multinet now proposes to undertake mains replacement, unit rates must be determined as set out in our final decision.

In determining whether to approve the proposed cost pass through event variation, we must take into account the following:

- (a) whether the costs to be passed through are for the delivery of Pipeline Services;
- (b) whether the costs are incremental to costs already allowed for in Reference Tariffs;
- (c) whether the costs to be passed through meet the relevant National Gas Rules criteria for determining the building block for total revenue in determining Reference Tariffs;
- (d) the efficiency of the Service Provider's decisions and actions in relation to the risk of the Relevant Pass Through Event occurring, including whether the Service Provider has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the Relevant Pass Through Event and whether the Service

⁵ Rule 97(1)(c) of the NGR.

⁶ *Multinet Access Arrangement Information: Part B – Reference Tariffs and Reference Tariff Policy*, October 2013. p.24.

⁷ *Multinet Access Arrangement Information: Part A – Principal Arrangements*, October 2013, p. 23.

Provider has taken or omitted to take any action where such action or omission has increased the magnitude of the costs; and

(e) any other factors the AER considers relevant and consistent with the NGR and NGL.

The other factors we consider relevant to our assessment of Multinet's proposed reference tariff variation are those set out in the mains replacement section (section 4.4.1) of part 2 of our final decision for Multinet's 2013–17 access arrangement.⁹

Under AGN's access arrangement, we must notify AGN of our decision to approve or reject the proposed variation within 90 business days of receiving its application and all necessary supporting information.¹⁰

Where we approve the variation, it is to take effect from 1 January of the next regulatory year unless we agree otherwise.

⁹ AER, *Access Arrangement for Multinet's Victorian Gas Distribution System 2013 – 2017, Final Decision, Part 2, Section 4.4.1 Mains Replacement*, April 2013, pp. 41-69.

¹⁰ AER, *Access Arrangement for Multinet's Victorian Gas Distribution System 2013 – 2017*, p. 24. 90 business days from AGN's application date of 12 June 2015 is 19 October 2015.

4 Multinet's application

AGN submitted its application for a mains replacement pass through tariff variation on 12 June 2015. The key features of its pass through application are:

- Multinet submitted the mains replacement event was triggered on or around 13 April 2015 when it completed 207 km of its mains replacement program.
- Multinet intends to replace 527 km of mains during the 2013–17 arrangement period, which it stated is consistent with eliminating all low pressure mains in its network by 2033 (consistent with its *Asset Management Plan for 2011/12-2015/16*, submitted to Energy Safe Victoria in June 2011).
- The pass through application is to fund 272 km of mains replacement in excess of the 255 km we approved in the 2013–17 access arrangement.
- The additional capital expenditure to replace the additional 272 km of mains is \$51.6 million (\$2012).
- Multinet proposed to recover the additional costs by increasing reference tariffs by an average of 3.4 per cent (excluding inflation) on both 1 January 2016 and 1 January 2017. This is an increase of around 1.4 per cent per annum compared to our final decision.

Table 1 summarises AGN's proposed expenditure in each regulatory year during 2013–17.

Table 1 Multinet proposed revised total capital expenditure

2013	2014	2015	2016	2017	Total
11.9	22.8	32.4	20.9	22.6	110.5

Source: Multinet, Cost pass through application: Mains replacement event, p. 14.

With its cost pass through application, Multinet submitted:

- Evidence it has completed 207 km of mains replacement in the current access arrangement period, which is the trigger point for Multinet to apply for funding to complete additional mains replacement km.
- Evidence for the intended completion of volumes in excess of the mains replacement allowance we have already approved (255 km).
- Details of the calculation of the additional capital expenditure and reference tariff adjustments.

5 Occurrence of the pass through event

We are satisfied Multinet's pass through application meets the definition of a mains replacement event as specified in section 4.5 of its access arrangement. This is because Multinet provided evidence:

- it has completed 207 km of mains replacement during the current access arrangement period, which constitutes the trigger event
- it has, or will, incur costs in the remainder of the access arrangement period to complete a volume of mains replacement in excess of the historical volumes (255 km).

5.1 Completion of 207 km of mains replacement

We are required to verify Multinet has triggered the mains replacement event. The trigger event is defined as Multinet completing 207 km of mains replacement during the 2013–17 access arrangement period. As evidence of triggering the mains replacement event, Multinet submitted:

- our mains replacement pass through model
- a report by Advisian verifying the volume of mains replacement undertaken by Multinet.

Advisian's report provides third party verification that the pass through event occurred. To form its view, Advisian reviewed Multinet's actual cost data, monthly mains replacement reports and business case reports.¹¹

5.2 Intent to complete mains replacement in excess of historical volumes

We are required to verify Multinet intends to incur costs to:

- complete the outstanding mains replacement for which we approved an allowance in its 2013–17 access arrangement (255 km)
- complete the total of 527 km reflected in its cost pass through application during the 2013–17 access arrangement period.

Multinet submitted that, of the 255 km for which we have already provided funding, 15 km has been deferred to the next access arrangement period. Nonetheless, Multinet submitted it expected to complete 255 km of mains replacement by 30 June 2015—the 15 km of deferred volumes being replaced by new projects. The Advisian report submitted by Multinet states Multinet completed 215 km by 30 April 2015.

Multinet submitted an extract of minutes from a Multinet Board meeting, held 26 May 2015, in which additional expenditure to complete the proposed mains replacement was

¹¹ Advisian, *AER Pipework Projects – Independent Validation Report*, p. 4.

approved.¹² Multinet also submitted that it had built up its workforce to undertake its proposed mains replacement works during the current access arrangement period.¹³

Based on this information we are satisfied Multinet intends to complete its proposed volumes of mains replacement in excess of the historical volumes during the remainder of the access arrangement period.

¹² The extract of minutes from Multinet's Board meeting was provided separately to Multinet's cost pass through application, on 29 July 2015.

¹³ Multinet, *Response to AER queries*, emailed to AER staff 14 July 2015.

6 Approved costs to be passed through

Once we determine a mains replacement pass through event has occurred we must approve:

- the additional mains replacement volume
- the additional capital expenditure to complete the additional mains replacement
- the tariff variation to recover the additional capital expenditure.

We approve the proposed additional mains replacement of 272 km and an increase in capital expenditure of \$51.6 million (\$2012) to complete that mains replacement. We consider this expenditure meets the capital expenditure criteria under the NGR.

The costs will be passed through by increasing reference tariffs by an additional 1.4 per cent per annum for 2016 and 2017.

6.1 The costs to be passed through are for the delivery of pipeline services

We are satisfied the costs to be passed through are for delivery of pipeline services. The costs relate to capital expenditure on gas pipeline mains infrastructure.

6.2 The costs are incremental to costs already allowed for in reference tariffs

We are satisfied the costs are incremental to costs already allowed for in reference tariffs. The costs relate to mains replacement in addition to volumes approved in Multinet's access arrangement.

6.3 The total costs to be passed through are building block components of total revenue

We are satisfied the total costs to be passed through are building block components of total revenue related to:

- return on the capital base
- depreciation of the capital base
- cost of corporate income tax.

6.4 The costs to be passed through meet the relevant NGR criteria for determining the building blocks

We are satisfied Multinet's proposed cost of \$51.6 million (\$2012) to undertake additional mains replacement meets the capital expenditure criteria under cl. 79(1) of the NGR. The key elements of the total costs to be passed through are:

- the mains kms to be replaced, or volumes

- the per kilometre costs, or unit rates, for each area in which mains will be replaced.

Total costs are derived by multiplying the volume (kms) by the unit rates. In the sections below we set out our considerations for Multinet's proposed volumes and unit rates.

Volumes (kms)

We are satisfied Multinet's proposed additional 272 kms of mains replacement is consistent with the capex criteria under cl. 79(1) of the NGR. In reaching this view we have had regard to:

- Multinet's Asset Management Plan and Multinet's submission that its proposed mains replacement align with the Asset Management Plan
- the views of Energy Safe Victoria on Multinet's proposed volumes, given the underlying safety driver for the mains replacement program
- Multinet's current level of completed mains replacement in the 2013–17 access arrangement period and its evidence of future works to be undertaken.

We note that AGN has a general statutory obligation under s.32 of the Gas Safety Act to "manage and operate each of its facilities to minimise as far as practicable" the hazards and risks to the safety of the public and customers arising from gas, interruptions to the conveyance or supply of gas and the reinstatement of an interrupted gas supply. The obligation also includes minimising hazards and risks of damage to public property and the property of customers.

Multinet's Asset Management Plan has been approved by Energy Safe Victoria.¹⁴ As the main driver of Multinet's mains replacement program is safety, we consider mains replacement volumes consistent with the Asset Management Plan are also consistent with safe operation of its network. We note Multinet's current Asset Management Plan is due to expire at the end of the 2015–16 financial year. Nonetheless, Multinet's proposed volumes are consistent with the Asset Management Plan currently in place.

Under Multinet's Asset Management Plan it is scheduled to complete its mains replacement work program over a 30 year period, concluding in 2033. This end date is a critical factor in considering what is an efficient and prudent volume of mains replacement under r.79(1) given the long term safety objective of removing all cast iron and unprotected steel mains from Multinet's network. We noted in our final decision that the mains replacement pass through provides a means by which Multinet can complete the mains replacement program by 2033. Therefore we have had regard to Multinet's ability to meet this timeframe for completing its mains replacement in considering the efficiency and prudence of the proposed volumes.

Multinet has acknowledged its mains replacement volumes undertaken in the previous access arrangement period fell short of the Asset Management Plan work program.

¹⁴ In addition to its Asset Management Plan, Multinet is required to submit to a Gas Safety Case to Energy Safe Victoria every five years, setting out the system and processes to identify and mitigate network risks. Energy Safe Victoria must accept a Gas Safety Case if satisfied it is appropriate and complies with the Victorian Gas Safety Act and regulations. Energy Safe Victoria has advised us Multinet's current Gas Safety Case is currently overdue for revision.

Multinet's reasons for the shortfall included the impact of the global financial crisis which impacted its ability to secure financing. It was that shortfall which led us to approve the cost pass through mechanism for Multinet's mains replacement work in the current access arrangement period. Multinet has submitted that the volumes proposed in its current cost pass through application will bring it back into line with the mains replacement schedule set out in its Asset Management Plan. In considering Multinet's application, we have consulted with Energy Safe Victoria. Energy Safe Victoria is supportive of Multinet's approach.

In considering the proposed volumes we have also had regard to the information Multinet provided on its rate of mains replacement to date. Also, to evidence it intends to complete the outstanding mains replacement it proposed over the remainder of the access arrangement period. Based on this information, we consider Multinet has the intention and processes in place to undertake the proposed volumes of mains replacement in the remainder of the access arrangement period.

Unit rates

Unit rates are the per km costs of undertaking mains replacement work. In our final decision on Multinet's current access arrangement we determined unit rates for the areas in which Multinet proposed, at that time, to undertake mains replacement work during the current access arrangement period. For those areas, Multinet is required to use the already approved unit rates for any additional kms proposed in the current pass through application. However, Multinet's pass through application is not limited to the areas for which we have already approved unit rates. Multinet may propose mains replacement work in other areas, for which we have not yet approved unit rates.

For areas we have not approved unit rates, Multinet must propose new unit rates for our assessment. We must be satisfied Multinet's proposed new rates are prudent and efficient.¹⁵

Multinet's cost pass through application sets out proposed unit rates for three new areas of mains replacement. To appropriately assess these new unit rates we requested additional details of the methodology used by Multinet to derive the new rates. Multinet submitted details of its methodology on 13 July 2015.¹⁶ We have assessed this additional material.

Multinet based its new proposed unit rates on rates we have previously approved for adjacent areas. In one case Multinet used the same approved rate for a project which overlaps with the area of newly proposed mains replacement works.¹⁷ In another case Multinet used the average of unit rates previously approved for two adjacent areas.¹⁸ And in the third case Multinet used the mean of unit rates previously approved for projects in a number of adjacent areas.¹⁹

¹⁵ AER, Access Arrangement for *Multinet's* Victorian Gas Distribution System 2013 – 2017, *Final Decision, Part 2*, April 2013, p. 57.

¹⁶ Multinet, *Response to AER queries*, 13 July 2015.

¹⁷ Project name: Kew East.

¹⁸ Project name: Grid Main North, Greythorn Rd & Prospect Hill Rd to Elgar Rd.

¹⁹ Project name: Oakleigh / Oakleigh South.

We consider the methodology used by Multinet to derive unit rates for the new areas of mains replacement work is reasonable. On the basis of the information provided to us by Multinet we are satisfied its proposed unit rates for new areas of mains replacement are prudent and efficient.

Building block costs

Multinet used our capital expenditure model to determine the capex required to complete the additional mains replacement.

Table 3 sets out Multinet's revised total capex resulting from its mains replacement cost pass through application.

Table 2 Multinet's proposed total mains replacement capex (\$m 2012)

	2013	2014	2015	2016	2017	Total
Capex included in access arrangement	12.6	3.6	12.3	22.6	5.7	56.7
Multinet's revised total proposed capex	11.9	22.8	32.4	20.9	22.6	110.5
Variance	-0.7	19.2	20.1	-1.7	16.9	53.8

Source: Multinet, Cost pass through application: Mains replacement event, table 5.

We assessed and verified the inputs and adjustment Multinet made to the capex model.

The increase in capex will impact several building blocks:

- return on capital (rate of return or weighted average cost of capital (WACC))
- depreciation (return of capital)
- corporate income tax.

The scale of the building block impacts is determined by incorporating Multinet's revised total proposed capex within our post tax revenue model (PTRM).

Tariff variation calculation

Our PTRM from our final decision on Multinet's current access arrangement also determines the annual change in Multinet's network tariffs during the access arrangement period. With its cost pass through proposal Multinet submitted a revised PTRM. This shows:

- X factors for 2013, 2014 and 2015 are unchanged²⁰

²⁰ X factors are the PTRM output. These are in turn used to convert tariffs from the year ending to tariffs for the year beginning. A negative X factor translates into a year on year tariff increase. A positive X factor translates into a year on year tariff decrease.

- revised X factor for 2016 is -3.38 per cent
- revised X factor for 2017 is -3.38 per cent.

The revised X factors for 2016 and 2017 are around 140 basis points higher (more strongly negative) than the X factors from our access arrangement final decision.

We have assessed the inputs and operation of Multinet's revised PTRM.