Attachment 9.2

Response to Draft Decision: Regulatory Asset Base

2016/17 to 2020/21 Access Arrangement Information Response to Draft Decision

Australian Gas Networks

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1 Response to Draft Decision on Regulatory Asset Base

1.1 Introduction

This attachment sets out Australian Gas Networks Limited's (AGN's) response to the Australian Energy Regulator's (AER's) Draft Decision in respect of the Regulatory Asset Base (RAB) over the next (2016/17 to 2020/21) Access Arrangement (AA) period. This includes both the opening RAB as at 1 July 2016 and the forecast RAB for the next AA period.

The AER did not accept AGN's proposed opening RAB, adjusting the inflation indices used over the current (2011/12 to 2015/16) AA period by AGN to inflate the RAB. The AER also did not accept AGN's forecast RAB for the next AA period, primarily reflecting the adjustment to capital expenditure (capex) forecast in the AER's Draft Decision relative to that proposed by AGN.

AGN has accepted the AER's proposed changes to the opening RAB as at 1 July 2016 but does not accept the AER's forecast RAB for the next AA period as AGN has further revised its capex forecast.

1.2 AER Draft Decision

The AER assessed our RAB proposal against the criteria set out in rule 77(2)[1] of the National Gas Rules (NGR). The AER did not approve AGN's proposed opening RAB of $1,429 million ($nominal) as at 1 July 2016, instead determining an opening RAB of $1,414 million ($nominal), which is 1.0% less than AGN's proposal. This decision reflected amendments made by the AER in respect of the inflation indices proposed by AGN to adjust the RAB.

The AER also did not approve AGN's proposed closing RAB at 30 June 2021 of $2,116 million ($nominal), determining a closing RAB of $1,768 million ($nominal), which is 17% less than AGN's proposal. The lower RAB reflected the reductions made by the AER in the Draft Decision to AGN's capex forecast. The AER did however accept the methodology used by AGN to adjust the RAB over the next AA period.

Table 1.1 below summarises the AER's Draft Decision for each element of AGN's RAB proposal.

[1] National Gas Rules, Rule 77(2)

TABLE 1.1: SUMMARY OF AER'S DRAFT DECISION ON RAB

	AER Draft Decision	AER Comment
Opening RAB 1 July 2016	Reject AGN Proposal	The AER adjusted the opening RAB as at 1 July 2016 for the use of different inflation indices over the current AA period.
Forecast Capex	Reject AGN Proposal	The AER did not approve AGN's proposed closing RAB primarily due to its proposed reduction in forecast capex.
Depreciation	Modify AGN Proposal	The AER accepted AGN's methodology used to determine the depreciation schedule, however the AER applied its own depreciation schedule reflecting its Draft Decision capex forecast.
Indexation & Financeability	Reject AGN Proposal	The AER did not accept AGN's proposal for a financeability adjustment to the indexation of the RAB to deliver the required credit metrics in a low rate of return environment.
Inflation	Reject AGN Proposal	The AER did not accept AGN's proposal to adopt a market-based approach to forecast inflation if actual inflation persisted at levels below the average of the RBA's target range of 2% to 3%.
Closing RAB 30 June 2021	Reject AGN Proposal	For those reasons described in the table above, the AER did not accept AGN's proposed closing RAB at 30 June 2021.
Opening RAB 1 July 2021	Accept AGN Proposal	AER accepted AGN's proposal to use forecast depreciation to establish the opening RAB at 1 July 2021.

1.3 AGN Response to the Draft Decision

AGN has accepted the AER's Draft Decision in respect of the opening RAB as at 1 July 2016, other than to update for actual 2014/15 capex. AGN has not accepted the AER's Draft Decision in respect of the capex forecast (refer Attachment 8.9 of this revised AAI Proposal), and related to this the amount of depreciation, the approach to forecasting inflation and the need for an adjustment to indexation to take account of financeability requirements.

Table 1.2 summarises the AER's Draft Decision and AGN's response to the Draft Decision:

TABLE 1.2: SUMMARY OF AGN'S RESPONSE TO THE AER DRAFT DECISION ON RAB

	AER Draft Decision	AGN Response	AGN Comment
Opening RAB 1 July 2016	Reject AGN Proposal	Modify Draft Decision	AGN has accepted the AER's revisions to its opening RAB, however AGN has updated for actual 2014/15 capex.
Forecast Capex	Reject AGN Proposal	Respond to Draft Decision	AGN has revised its capex proposal for the next AA period (refer Attachment 8.9 of this revised AA proposal)
Depreciation	Modify AGN Proposal	Modify Draft Decision	AGN has modified the depreciation schedule to account for the revised capex forecast, however the methodology used to calculate remaining asset lives is as approved by the AER in its Draft Decision.
Indexation & Financeability	Reject AGN Proposal	Respond to Draft Decision	AGN considers the AER must ensure its decisions deliver credit metrics consistent with the AER's assumed benchmark entity credit rating of BBB+. AGN will propose an adjustment to the indexation of the RAB in order to ensure the appropriate credit metrics are met in the event the AER applies its Draft Decision WACC of 6.02% (or similar) in the Final Decision.
Inflation	Reject AGN Proposal	Respond to Draft Decision	AGN has revised its forecast of inflation over the next AA period due to persistently low actual inflation by adopting a market-based approach.
Closing RAB 30 June 2021	Reject AGN Proposal	Respond to Draft Decision	For those reasons described in the table above, AGN will propose a different closing RAB at 30 June 2021.
Opening RAB 1 July 2021	Accept AGN Proposal	Accept Draft Decision	AER approved AGN's proposal to use forecast depreciation to establish the opening RAB at 1 July 2021.

Further detail on key elements of our response follows in Sections 1.3.1 and 1.3.2.

1.3.1 Regulatory Asset Base as at 1 July 2016

AGN has accepted the AER's adjustments to its opening RAB, including the adjustment for actual capex incurred in 2010/11, conforming capex and the depreciation amounts in the current AA period. AGN has also accepted the adjustments to actual inflation rates and the adjustment to the 2010/11 forecast inflation value in the proposed Roll Forward Model (RFM). AGN has however updated the opening RAB for actual 2014/15 capex which results in an opening RAB as at 1 July 2016 of $1,412 million, or $2 million less than the AER Draft Decision opening RAB.

Table 1.3 shows the build up of the revised opening RAB as at 1 July 2016:

TABLE 1.3: ROLL-FORWARD OF THE REGULATORY ASSET BASE IN THE NEXT AA PERIOD

$ million (nominal)	2011/12 actual	2012/13 actual	2013/14 actual	2014/15 forecast	2015/16 forecast
Opening Capital Base	1023.9	1070.7	1140.0	1230.9	1303.1
Net Capex	58.0	83.9	102.9	105.8	124.3
Indexation of capital base	16.2	26.8	33.4	16.4	32.6
Depreciation	-27.5	-41.4	-45.4	-49.9	-51.9
Closing capital base	1070.7	1140.0	1230.9	1303.1	1408.1
Adjustment for difference between estimated and actual capital expenditure in 2010-11					-6.7
Opening Capital Base at 1 July 2016					1401.3

1.3.2 Forecast Regulatory Asset Base

The revised forecast RAB for the next AA period has been determined by adjusting the Closing Capital Base 30 June 2016 (set out in Table 1.3 above) for the revised forecast capital expenditure, depreciation and inflation. Each of these matters is addressed in this section.

1.3.2.1 Capital Expenditure

The revised forecast capex for the next AA period is summarised in Table 1.4 below. The forecast capex has been allocated to the categories that are required to roll forward the RAB. Capex is also expressed in end of year terms as required by the AER post-tax revenue model (and for this reason differs from that set out in Attachment 8.9).

TABLE 1.4: FORECAST CAPEX FOR THE NEXT AA PERIOD

$ million (nominal)	2016/17	2017/18	2018/19	2019/20	2020/21
Mains	84.5	90.5	82.8	111.2	74.0
Inlets	11.6	11.0	11.7	12.3	13.1
Meters	8.1	7.7	7.6	6.8	6.3
Telemetry	0.4	0.3	0.2	0.2	0.2
Information Technology Systems	10.2	19.3	16.0	9.1	8.4
Other Distribution System	7.4	7.3	7.5	7.4	7.4
Other	1.5	1.2	1.0	1.0	1.0
Equity Raising Costs	0.0	0.0	0.0	0.0	0.0
Total Capital Expenditure	123.6	137.2	126.8	148.0	110.2

1.3.2.2 Forecast Depreciation

The AER accepted AGN's approach to determining straight-line deprecation, which approach reflects the AER's preferred method. The amount of depreciation in this revised AA proposal however varies from the AER's Draft Decision in line with AGN's revised capex forecast. The straight-line depreciation over the next AA period is set out in table 1.5 below.

TABLE 1.5: STRAIGHT-LINE DEPRECIATION FOR THE NEXT AA PERIOD

$ million (nominal)	2016/17	2017/18	2018/19	2019/20	2020/21
Straight-line Depreciation	44.6	50.4	58.4	65.8	68.1

1.3.2.3 Inflation

In its Initial AA proposal, AGN had proposed the current AER method for forecasting inflation, which resulted in a forecast of inflation of 2.5%, subject to a review of the approach for forecasting inflation if current market conditions persisted. The low inflation environment has indeed persisted, and AGN has therefore, as advised, reviewed and altered its approach to inflation in order to procure a more accurate inflation forecast. AGN's proposed approach is summarized below, however greater explanation is provided in Attachment 9.3 to this Revised AA Proposal.

Forecast inflation is used to index the RAB over an AA period. Forecast inflation is also used to determine the annual benchmark revenue requirement over an AA period through, for example, the determination of regulatory depreciation, which is calculated as straight-line depreciation less the inflation adjustment that is applied to the RAB. It is therefore important to ensure that the inflation forecast used is accurate, otherwise:

- In the event inflation is too high, regulatory depreciation (and hence benchmark revenue) will be lower than it otherwise should be; and

- In the event inflation is too low, regulatory depreciation (and hence benchmark revenue) will be higher than it otherwise should be.

An accurate forecast of inflation is therefore necessary to ensure that businesses have a reasonable opportunity to recover their efficient costs over the long term. In the Draft Decision, the AER adopted an inflation forecast of 2.5 per cent for the next AA period. This is based on the methodology that has been adopted by the AER since 2008, which involves:

- For the first two years of the AA period, taking the mid-point of the RBA forecast range, which for the first two years of the next AA period is between 2 to 3 per cent (with a mid-point of 2.5%); and

- For the remaining years, taking the mid-point of the RBA target range, which is also between 2 to 3 per cent (with a mid-point of 2.5%).

Recent market evidence however demonstrates that the AER's current forecasting method is currently over-estimating inflation. In particular, the most recent Australian Bureau of Statistics (ABS) data shows that actual inflation is well below the RBA's forecasts and target range, with year-end inflation for the June and September quarters of 1.5 per cent per annum, while for the March quarter it was 1.3 per cent.

AGN's Revised AA Proposal is to adopt a market based forecast of inflation, described as the Fisher equation method (refer Attachment 9.4), which forecast is derived from the difference between yields on nominal and inflation indexed commonwealth government securities (CGS). The AER had previously used the Fisher equation method to forecast inflation, but changed from this approach in 2008 as a result of the scarcity of CGS at that time. A scarcity of CGS no longer exists, therefore enabling a reversion to the Fisher equation method.

The Fisher equation method results in forecast inflation of 2.01 per cent[2] over the next AA period. The resultant indexation to the RAB is set out in Table 1.6.

[2] Attachment 9-4, *Measuring expected inflation for the PTRM*, CEG January 2016 Table 2, pg 15

TABLE 1.6: INDEXATION FOR THE NEXT AA PERIOD

$ million (nominal)	2016/17	2017/18	2018/19	2019/20	2020/21
Indexation	28.2	30.4	33.0	35.2	37.9

1.3.2.4 Financeability

AGN noted in its Initial AA Proposal that a consideration of financeability was required to ensure that the AER Draft Decision provided sufficient cash flow such that the benchmark entity could maintain the credit rating assumed by the AER in setting the cost of debt. AGN demonstrated that the then most recent AER decision on rate of return would lead to credit metrics that would result in a lower credit rating than assumed by the AER in setting the rate of return, which would lead to a credit downgrade for the benchmark entity.

To address these impacts and promote the long term interests of consumers, AGN proposed an adjustment to the depreciation schedule in the terms contemplated by rule 89(1)(e) of the National Gas Rules (NGR). That is, an adjustment to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs. This adjustment is to vary the level of inflation applied to the RAB so as to increase cash flow.

The AER did not accept this approach for a number of reasons. These reasons included that the AER viewed the approach as an attempt to increase the rate of return. The AER also considered that, in its opinion, its decision on rate of return complied with the rate of return requirements of the National Gas Rules and its decision on depreciation complied with the depreciation requirements of the National Gas Rules that this was the end of the matter.

Such an approach is, in AGN's view, an incorrect application of the National Gas Law. Section 28 of the National Gas Law requires the AER to take into account the manner in which constituent components of a decision relate to each other and outline the manner in which that interrelationship has been taken into account.

In the event the AER continues to maintain its rate of return of 6.02 per cent (or similar), AGN re-iterates the need to make a financeability adjustment[3] to ensure sufficient cash flows to meet the required credit metrics assumed by the AER in setting the rate of return. The need for the financeability adjustment, and response to the AER's concerns raised in the Draft Decision, is detailed further in Attachment 9.5

1.3.2.5 Forecast Regulatory Asset Base Roll Forward

The forecast RAB over the next AA period, taking into account forecast regulatory depreciation, capex and inflation, is set out in Table 1.7. This shows a closing RAB of $2,003.6 million as at 30 June 2021 in nominal dollar terms. AGN also accepts the use of forecast depreciation to establish the opening RAB as at 1 July 2021.

[3] A financeability adjustment is not required in the event of the AER approving AGN's Revised AA Proposal.

TABLE 1.7: ROLL-FORWARD OF THE REGULATORY ASSET BASE IN THE NEXT AA PERIOD

$ million (nominal)	2016/17	2017/18	2018/19	2019/20	2020/21
Opening Capital Base	1,401.3	1,514.4	1,640.9	1,753.4	1,886.7
Net Capex	129.5	146.5	137.9	163.8	124.3
Indexation of capital base	-44.6	-50.4	-58.4	-65.8	-68.1
Depreciation	28.2	30.4	33.0	35.2	37.9
Closing capital base	1,514.4	1,640.9	1,753.4	1,886.7	1,980.8

1.4 Summary

AGN has determined an opening RAB as at 1 July 2016 of $1,412 ($ nominal) and a forecast closing RAB as at 30 June 2021 of $2,004 ($ nominal).

TABLE 1.8: REVISED CLOSING VALUE OF REGULATORY ASSET BASE AS AT 30 JUNE 2021

Closing Value of Capital Base	$ million
Nominal	1980.8
Real ($2015/16)	1793.2