Explanatory Statement

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

AUSTRALIAN ENERGY REGULATOR

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Amendment Record

Version	Date	Pages
1.0	27 October 2020	9

Contents

Shortened Forms

Shortened form	Extended form
2018 Instrument	2018 Rate of return instrument
AER	Australian Energy Regulator
CY	Calendar year (i.e. from 1 January to 31 December)
Determination extension period	The extension period from 1 January 2021 to 30 June 2021 of the 2016-2020 distribution determinations for the Victorian electricity distribution network service providers
DNSPs	Distribution network service provider
FY	Financial year (i.e. from 1 July to 30 June)
NEL	National Electricity Law
NELA	National Energy Legislation Amendment Act 2020 (Vic)
NEVA	National Electricity (Victoria) Act 2005 (Vic)
OIC	Order in Council made on 27 October 2020 under section 16VE of the National Electricity (Victoria) Act 2005 (Vic)
RBA	Reserve Bank of Australia
Vic	Victoria

1 Overview

This is the explanatory statement to the modified 2018 Rate of Return Instrument (2018 Instrument) as it applies to the 6 month extension period of the 2016–2020 distribution determinations for the Victorian electricity distribution networks (the Modified Instrument).[1] It should be read in conjunction with that document.

We explain the following:[2]

- the move from a calendar year regulatory period to a financial year regulatory period for the Victorian electricity distribution businesses
- the policy intent for application of the 2018 Instrument to these businesses and required modifications
- how the Modified Instrument was developed
- how the modifications are likely to contribute to the achievement of the National Electricity Objective and are consistent with the revenue and pricing principles.

1 AER, *Modified rate of return instrument for the Victorian electricity distribution networks during the extension period of 1 January 2021 to 30 June 2021*, 27 October 2020.

2 This document does not explain the content of the original 2018 Instrument. See AER, *Explanatory statement, Rate of return Instrument*, December 2018. Available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-instrument-2018.

2 Move to financial year regulatory period

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.[3]

This means the next regulatory control period for the Victorian electricity distribution businesses will commence on 1 July 2021. The National Energy Legislation Amendment Act 2020 (Vic) extends the end date of the regulatory control period for the 2016-2020 distribution determinations for the Victorian electricity distribution businesses from 31 December 2020 to 30 June 2021. The six month period of 1 January 2021 to 30 June 2021 is taken to be an extra regulatory year of the 2016-2020 distribution determinations (determination extension period).[4]

The 2018 Instrument was developed on the basis of consecutive 12-month regulatory years, and does not contemplate an intervening six month extension period when moving from calendar years to financial years. The use of consecutive 12 month regulatory years is important for the calculation of the trailing average portfolio return on debt under the Instrument. The 2018 Instrument also did not contemplate the nomination of averaging periods for a six month extension period.

Therefore, we have modified the application of the 2018 Instrument to the six month determination extension period to allow correct application of the methods set out in the instrument to the period. This is explained in more detail in the next section.

The reasoning behind the 2018 Instrument is set out in the explanatory information for that Instrument.[5] We have not repeated this reasoning in this document. The effect of the modifications is that the substance of the 2018 Instrument continues to apply to the six month determination extension period.

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3 Victorian Government, *Intention to change the timing of annual Victorian network price changes*, April 2019, available at https://www.aer.gov.au/system/files/VIC%20DELWP%20letter%20to%20AER%20re%20intention%20to%20change%20the%20timing%20of%20annual%20Victorian%20network%20price%20changes%20-%20April%202019_0.pdf

4 This period was referred to as a 'mini year' in consultation on the modifications to the 2018 Instrument.

5 See AER, *Explanatory statement, Rate of return Instrument*, December 2018. Available at https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/rate-of-return-instrument-2018.

3 Legal Framework

The transition to a FY regulatory control period is provided under the National Energy Legislation Amendment Act 2020 (Vic) (NELA Act), which amends the National Electricity (Victoria) Act 2005 (Vic) (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[6]
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[7]
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[8]
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.[9]

An Order in Council (Order) was made under section 16VE of the NELA on 27 October 2020. The Order allows the application of placeholder averaging periods to the six month extension period instead of the nominated and accepted averaging periods, if we consider it necessary or expedient for making the variation decision.[10] The Order also provides for making appropriate adjustments in the 2021–2026 regulatory period for the difference between applying the nominated and accepted averaging period and applying the placeholder averaging period.[11]

6 National Electricity (Victoria) Act 2005 (Vic), section 16VB.
7 National Electricity (Victoria) Act 2005 (Vic), section 16VC.
8 National Electricity (Victoria) Act 2005 (Vic), section 16VJ.
9 National Electricity (Victoria) Act 2005 (Vic), section 16 VJ.
10 Order in Council made on 27 October 2020 under section 16VE of the NEVA, cl. 5(b).
11 Order in Council made on 27 October 2020 under section 16VE of the NEVA, cl. 8.

4 Developing the modifications

We commenced discussion on modifying the 2018 Instrument after the Victorian government announced the move to a financial year regulatory period. The Victorian government's stated policy intent was that the 2018 Instrument would apply from 1 January 2021.[12]

The discussion involved the five Victorian electricity distribution businesses[13] and a consumer representative organisation, the Brotherhood of St Laurence. In our correspondence, we referred to the 6 month extension period as the 'mini year'. The 'mini year' is equivalent to the determination extension period in the modified rate of return Instrument.

Table 1 Timeline of stakeholder consultation

Date	Key actions
July 2019	• Discussed our proposal to apply the 2018 Instrument from 1 January 2021 in accordance with the Victorian government direction. • Circulated our proposed approach and undertook further explanation and discussions. • Circulated modelling of several alternative debt trailing average options.
August 2019	• The Brotherhood of St Laurence indicated support for our proposed approach • The five Victorian DNSPs proposed an alternative response and we discussed their response with them • We proposed options for determining the return on debt and return on equity: ○ A 6 month period to be used in the trailing average debt portfolio for the period from 1 Jan 2021 to 30 June 2021 ○ The return on equity to be set separately for the 6 month transition period and the 5 regulatory years (FY basis) • We circulated a spreadsheet to the five Victorian DNSPs that set out the trailing average debt option using a 6 month period and a 12 month period
September 2019	• Notified the Brotherhood of St Laurence of the proposed modifications in setting the allowed rate of return ○ They indicated general support with some reservations about hedging costs and the potential for gaming averaging periods • We proposed to substantively apply the 2018 Instrument to the five Victorian electricity distribution businesses from 1 January 2021
October 2019	• Notified businesses about the agreed implementation of the 2018 Instrument.

12 Hon Lily D'Ambrosio MP, *Letter to AER, Changes to timing of annual Victorian network price updates*, October 2019, p. 1.

13 The Victorian electricity distribution businesses are CitiPower, Powercor, United Energy, Jemena Electricity Networks and AusNet Services.

5 The modified Instrument for the six month period

The rate of return Instrument sets out the methodology to calculate the rate of return on capital and states the value of imputation credits.[14]

In accordance with section 16VJ of the amended National Electricity (Victoria) Act 2005 (Vic), we modify the 2018 Instrument for Victorian electricity distribution businesses, as it applies to the 6 month extension period (i.e. the determination extension period) added to the 2016–20 regulatory period.

We note that the six month extension period has implications for the calculation of a trailing average return on debt in ten subsequent regulatory years (i.e. as long as the six month period stays in the trailing average). The Order provides for a separate modified Instrument to apply to the regulatory control period commencing on 1 July 2021.

Table 2 sets out the modifications and we explain them in more detail in the sections below.

Table 2 Summary of modifications in the modified Instrument

Clauses in the 2018 Instrument	Summary of the modifications
3	• Conversion of an effective annual (12 month) rate of return into a six month rate of return.
7, 8, 23 and 24	• The six month determination extension period is treated as a regulatory year, labelled the determination extension period. • Criteria for the debt and equity averaging periods have been adjusted for the six month extension period. • Averaging periods may be periods nominated by the service providers before March 2020 that meet the criteria, or may be default averaging periods. • The averaging periods are subject to the Order, which provides for the use of placeholder averaging periods.
9	• All years (including the six month determination extension period) feed into the trailing average. • Future weightings applied to historically set annual return on debt numbers have been adjusted in the trailing average

14 AER, *Rate of return instrument*, December 2018, p. 3.

5.1 Six month rate of return

We have modified clause 3 in the 2018 Instrument to be explicit on the conversion of the effective annual (12 month) rate of return into the 6 month rate of return that will apply to the determination extension period. This is because the determination extension period is for a period of 6 months so we need to estimate and apply a rate of return for six months that accounts for the semi-annual compounding that occurs where returns are paid twice per year.

5.2 Risk free rate averaging period

We have modified clauses 7 and 8 in the 2018 Instrument to allow for the return on equity for the six month determination extension period (from 1 January 2021 to 30 June 2021) to be set separately from both:

- The earlier five year regulatory control period based on calendar years (even though the determination extension period is a part of an extended regulatory control period under the NEVA changes).
- The following regulatory control period based on financial years (i.e. starting from 1 July 2021).

We have also modified clauses 7 and 8 in the 2018 Instrument to specify the criteria for the risk free rate averaging period. The key rationale for this approach is to determine a risk free rate close to the commencement of each respective regulatory time period, and that the averaging period is nominated in advance of the period commencing. All else equal, the separate return on equity averaging periods are:

- Consistent with the direction of the Victorian government to apply the 2018 Instrument from 1 Jan 2021, and
- Consistent with correct net present value (NPV) compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NEL and likely to contribute to the achievement of the National Electricity Objective (NEO) to the greatest degree.

The nominated and accepted risk free averaging period is subject to the Order, which allows the application of a placeholder risk free rate averaging period to the determination extension period instead of the nominated and accepted risk free rate averaging period, if we consider it necessary or expedient for making the variation decision.[15]

5.3 Return on debt averaging period

We have modified clauses 23 and 24 in the 2018 Instrument to allow for the return on debt to be set separately for the six month determination extension period (from 1 January 2021 to 30 June 2021). This will be followed by FY regulatory years, each 12 months long, with the first of these regulatory years commencing on 1 July 2021.

In total, service providers are therefore required to nominate six return on debt averaging periods for the following regulatory 'years':

15 Order in Council made on 27 October 2020 under section 16VE of the NEVA, cl. 5(b).

1. 1 Jan 2021 to 30 June 2021 (the determination extension period)
2. Then as part of the following five year regulatory control period:
   (a) 1 July 2021 to 30 June 2022
   (b) 1 July 2022 to 30 June 2023
   (c) 1 July 2023 to 30 June 2024
   (d) 1 July 2024 to 30 June 2025
   (e) 1 July 2025 to 30 June 2026

Only the first of these debt averaging periods is directly required for the determination extension period.[16] We have modified clauses 23 and 24 in the 2018 Instrument to specify the criteria for the debt averaging period. The key rationale for this approach is that the averaging period is nominated in advance of the period commencing. All else equal, this approach to setting debt averaging periods is:

- Consistent with the direction of the Victorian government to apply the 2018 Instrument from 1 Jan 2021, and
- Consistent with correct net present value (NPV) compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NEL and likely to contribute to the achievement of the National Electricity Objective (NEO) to the greatest degree.

As with the risk free rate averaging period, the nominated and accepted debt averaging period is subject to the Order. This allows the application of a placeholder debt averaging period to the determination extension period instead of the nominated and accepted debt averaging period, if we consider it necessary or expedient for making the variation decision.[17]

5.4 Return on debt trailing average

We have modified the method for estimating the return on debt trailing average portfolio (clause 9 in the 2018 Instrument) so that all years (including the determination extension period) feed into the trailing average.

In particular:

- Future weightings applied to historically set annual return on debt numbers (as set out in clause 9) have been adjusted so that there is no change in aggregate future weightings relative to the status quo.
- The weighting adjustment to the 10 year trailing average portfolio is to accommodate the return on debt for the six month extension period.

16 The remaining debt averaging periods are specified under the modified Instrument for the five year period commencing 1 July 2021 made as part of the Order.

17 Order in Council made on 27 October 2020 under section 16VE of the NEVA, cl. 5(b).

- In future years the six month return on debt gets reduced weight relative to a full year return on debt. This means there may be up to 11 periods included in the trailing average.[18]
    - By financial year 2030-31, the six month return on debt exits the trailing average and it returns to a simple ten year trailing average with 10% weight on each year.
- The debt averaging periods must comply with the clauses 23 and 24 in the 2018 Instrument which have also been modified

The key rationale for the changes to clause 9 is that the approach is approximately NPV neutral (relative to maintaining the status quo of calendar year regulatory periods). As a result, all else equal, this approach is:

- Consistent with the direction of the Victorian government to apply the 2018 Instrument from 1 Jan 2021.
- Consistent with correct NPV compensation to the regulated businesses over the life of their investments, and therefore consistent with the revenue and pricing principles in the NEL and likely to contribute to the achievement of the NEO to the greatest degree.

In addition, secondary considerations in support of this approach are:

- It is relatively simple to implement, effectively transitioning the trailing average to FY through the use of an appropriately weighted 6 month determination extension period, and
- It is relatively close to the prior trailing average approach.

In the modified clause 9, 'transition period' retains essentially the same meaning as in the 2018 Instrument, which is to refer to the transition from an on-the-day debt approach to a trailing average debt portfolio approach.

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18 The trailing average formulas for future years are specified in the Order in Council made on 27 October 2020 under section 16VE of the NEVA (*Attachment A - Modified rate of return instrument for the regulatory control period commencing on 1 July 2021 for the Victorian DNSPs*).