Multinet Gas’ 2018 to 2022 Access Arrangement Proposal

AER Public Forum

1 February 2017

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1. Parts A, B and C

Minimal change to the terms and conditions:

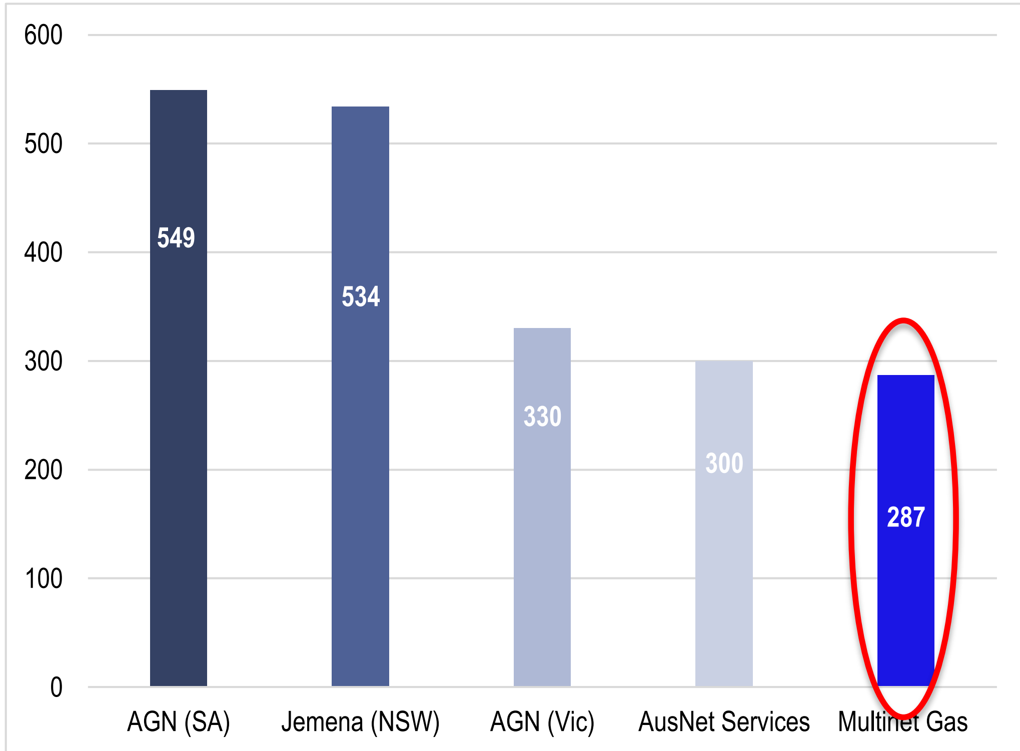
- Part A - Principal Arrangements:
  - Replaced weighted average price cap with a revenue cap
  - Pass-throughs: Removed Mains Replacement event, included a Force Majeure and Retailer Insolvency Event
  - Updated CPI to June quarter
- Part B - Reference Tariff Policy:
  - Introduced a new fixed principle to address revenue cap roll forward in 2023
  - Reflected changes to pass though events as per Part A
  - Amended tariff control formula – replaced formulae 1 to 4 with a revenue cap formula consistent with the electricity formula, including carbon scheme adjustment
  - Update tariffs
- Part C – Terms and Conditions:
  - Minor changes to customer details reflecting changing customer expectations
  - Introduced a new non-reference service “removal of service”

2. Proposal highlights

- We are responding to market changes:
  - Declining demand
  - Rising wholesale gas prices
  - Competition from alternative energy sources
  - Customer behavioral changes
- We will promote the competitiveness of natural gas by:
  - Growing our demand and customer base including through a joint gas marketing campaign
  - Moving from a weighted average price cap to a revenue cap
  - Investing in targeted innovation including through a digital metering trial and a Network Innovation Competition scheme
- We will continue to pass through the benefits of our efficient operating model – we benchmark at the efficient frontier of gas distributors
- We will invest in the long term future of our network, including by continuing our 30 year mains replacement program. This will ensure that we maintain our high levels of safety and reliability

3. Customers' prices

- In 2017, our distribution component will be 22% of average residential customer bill.
- 94% of our revenue comes from residential customers.
- We are proposing a 9.12% real price increase in 2018 across all customer. This will increase our share of the average residential bill to 24% in 2018. We are then proposing annual real price increase of 2.00% for 2019 to 2022.
- Multinet has the **lowest prices** of all the Victorian Distributors and will continue to offer low prices.



4. Stakeholder engagement

We engaged with our stakeholder to inform our proposal:

- GAAR Reference Group
- Joint Victorian distributor stakeholder forums
- Eight focus groups
- Tariff D customer Survey
- Retailer consultation

Issue	Stakeholder views
Mains replacement	Strong general support for our LP to HP Mains Replacement capex program.
Incentives	General support for capex incentive scheme.
Marketing step change	Need further information before supporting the proposed step change.
Control mechanism	General support for moving to a revenue cap.
Demand	Customer sentiment is generally consistent with our forecast decline in gas demand.
Digital meters	Strong general support for a controlled pilot program.
GSL	General support for retaining the current GSL payments and adjusting for CPI.
Tariffs	General support for tariff stability between periods.
Network KPIs	General support for our proposed Network KPIs.
Communications	Strong support for more information on GSLs, Mains Replacement capex and emergency matters.
Retail issues	Retailer request for the introduction of a new service “installation of a service valve”

5. What we will deliver

KPI	Outputs	Outcomes
Safety	○ Replace 625 km of LP mains ○ Reactive mains replacement ○ Unplanned service renewals	○ < 25 leak escapes /1,000 customers p.a. ○ Respond within 60 minutes for 95% of Priority 1 events ○ LTIFR targets of 0.9 and SIFR of 5.7 million hours worked
Reliability	○ Survey customers during priority works ○ Connect 8,550 gross new connections p.a	○ Fully understand our customers' needs and expectations ○ High customer satisfaction by exceeding SAIFI and SAIDI targets
Efficiency	○ Deliver expenditure efficiently ○ Leverage competitive service provider model ○ Competitively tender large projects	○ Efficient prices ○ Benchmark at efficient frontier ○ Maximise price competitiveness of natural gas
Growth	○ Connect 8,550 gross new connections p.a	○ Growing customer base ○ Lower average gas prices

6. Demand forecasts

- Continuing to use NIEIR to prepare demand forecasts
- History shows NIEIR's forecasts are credible and accurate – less than 1% difference between actual total Tariff V consumption and NIEIR's forecast that AER accepted for current period

Customer type	Marketing campaign	Customer Numbers (average % p.a.)	Total consumption/ MHQ (average %)
Residential	No marketing	0.50	(1.25)
	Marketing	0.54	(0.99)
Small business	No marketing	(.94)	(2.47)
Large industrial (Tariff D and Tariff L) (MHQs - GJ/hr)	No marketing	(1.17)	(0.88)

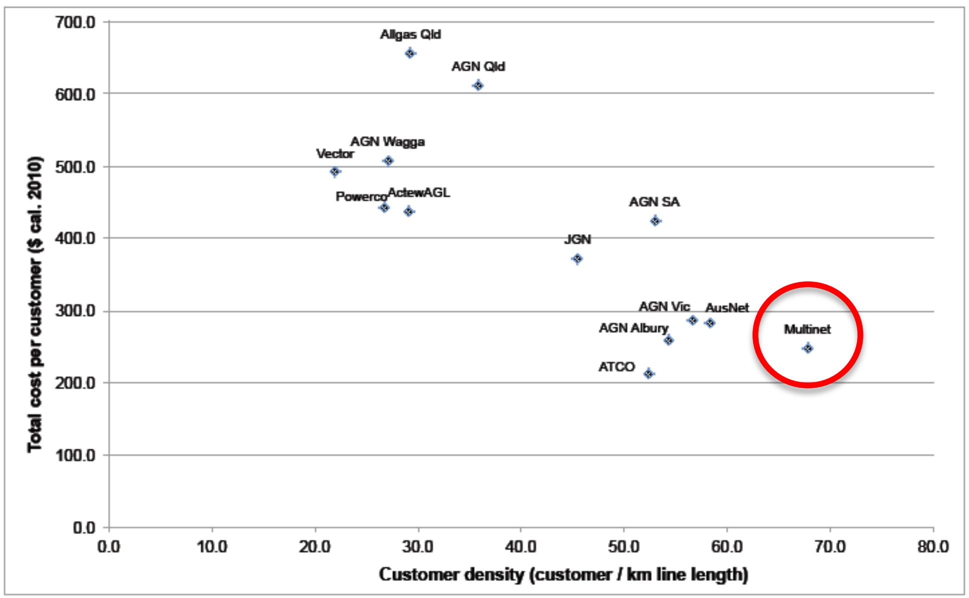
7. Reference tariff variation mechanism

- Move from WAPC to revenue cap for HRS
- Use revenue cap formulae approved for Victorian electricity DNSPs
- More appropriate given declining demand
- Consistent with AER’s treatment of electricity DNSPs
- Complements marketing step change

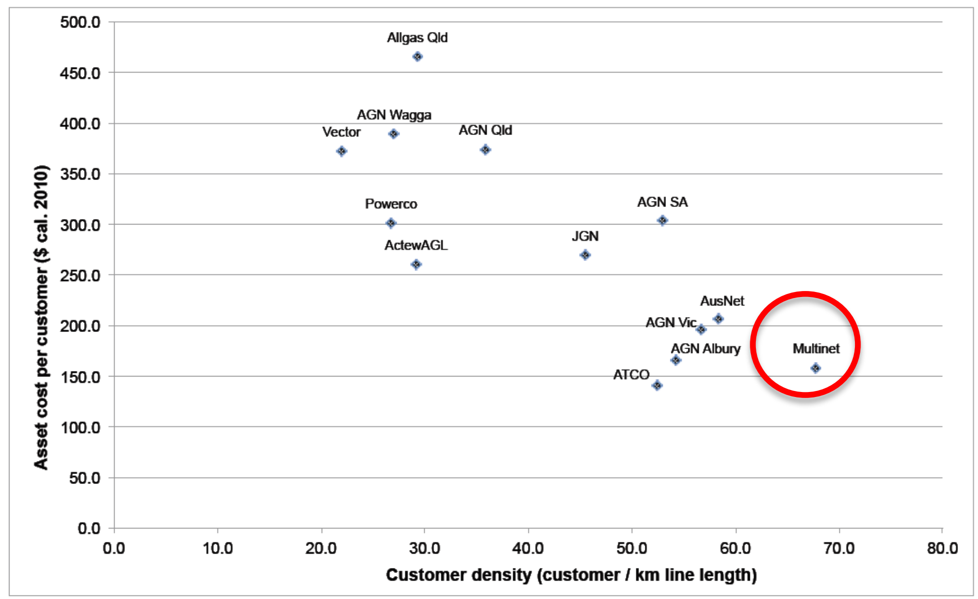
8. Benchmarking

- Economic Insight's analysis shows our capex and opex is efficient
  - We operate at or close to efficient frontier of gas distributors
  - We have 2nd lowest overall cost efficiency per customer

Total cost per customer relative to customer density (av. 2011–15)*



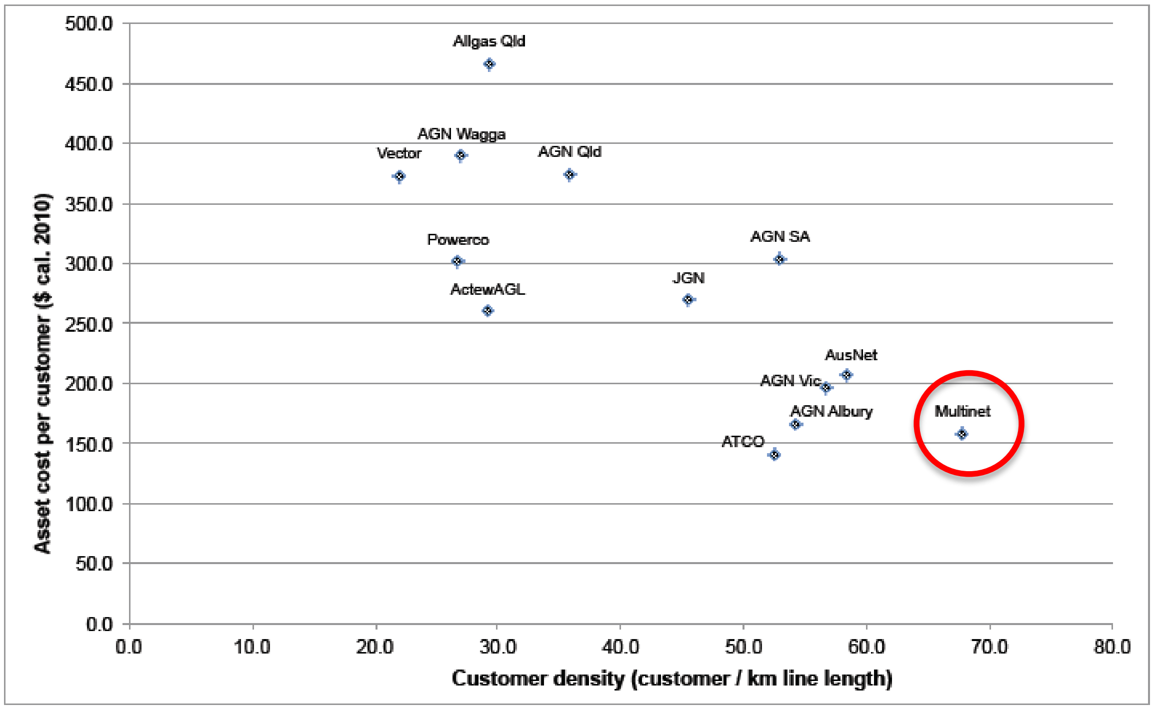
Asset cost per customer relative to customer density (av. 2011–15)



*In terms of gas throughput we are the third largest distributor

- Economic Insights found our average annual capital asset cost of $158 per customer (2011-15) was lowest in Victoria and second lowest of 13 gas distributors.

Asset cost per customer relative to customer density (avg. 2011–2015)

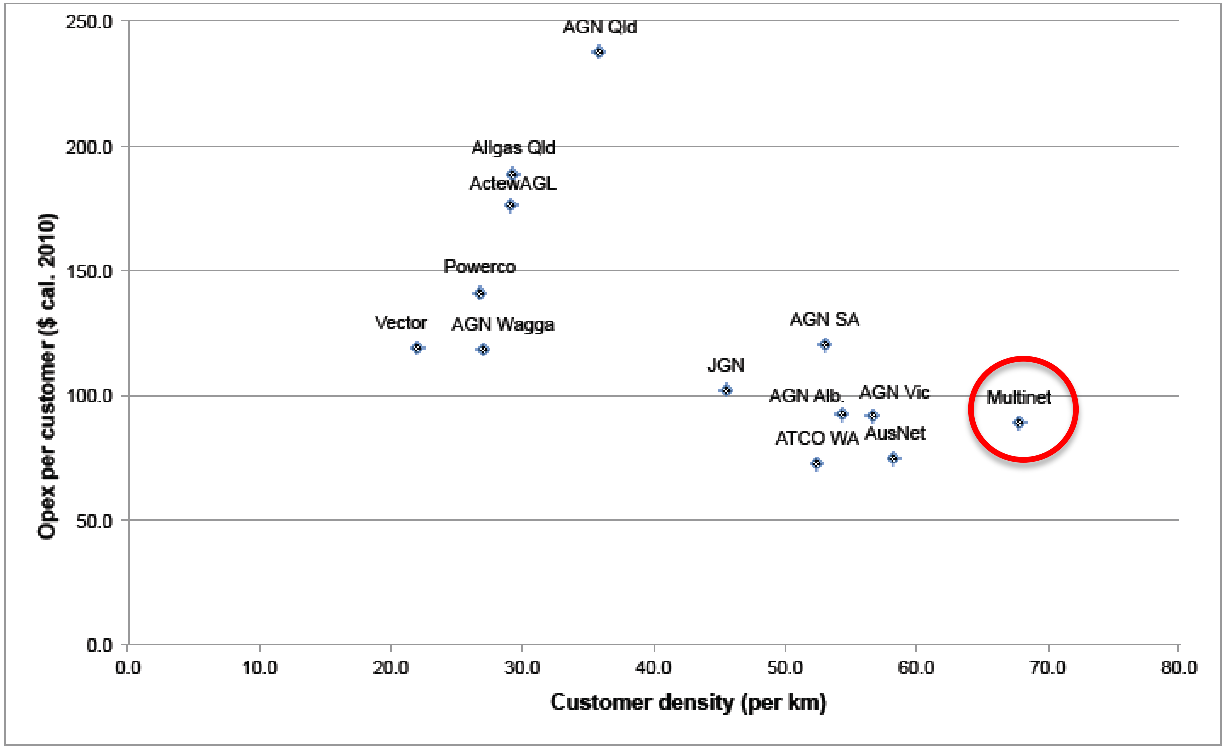


Source: Economic Insights gas utility database. Asset cost is defined as real revenue minus real opex.

8. Benchmarking - average opex per customer

- Economic Insights found our average opex per customer of $89 (2011-15) was third lowest of 13 gas distributors

Opex per customer relative to customer density (avg. 2011–2015)



Source: Economic Insights gas utility database.

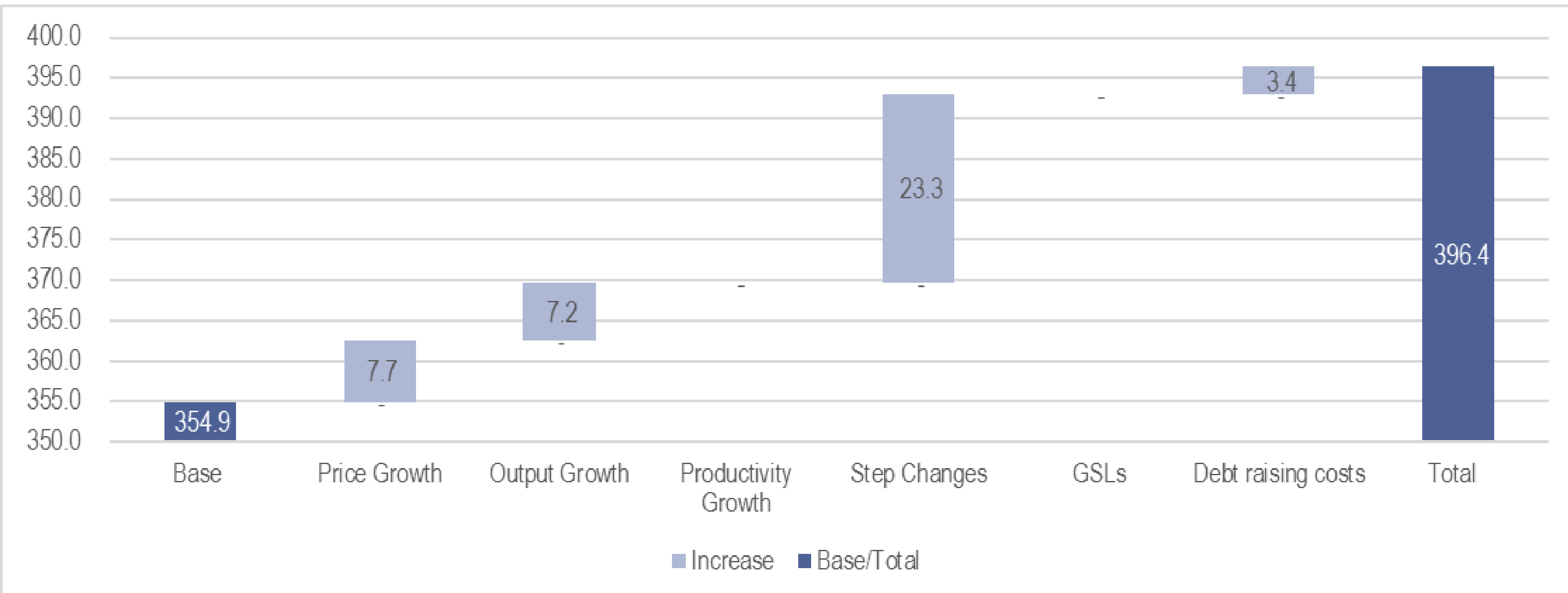
9. Forecast Capex

- Key driver is mains replacement capex which continues to deliver 30 year replacement program

($M, Real 2017)	2013 to 2017 actual / estimated	2018 to 2022	% change	Share of increase	Primary driver
Mains replacement	139.2	266.9	92%	87.5%	Safety
Residential connections	89.0	94.0	6%	3.5%	Compliance
C&I connections	16.4	21.6	32%	3.6%	
Meters	9.5	10.6	12%	0.8%	Compliance
Augmentation	8.0	17.3	115%	6.3%	Capacity
IT	44.3	48.8	10%	3.1%	Service integrity
SCADA	2.5	7.1	179%	3.1%	Service integrity
Other	45.2	48.7	8%	2.4%	Varies by program
Internal Direct Overheads	9.5		(100%)	(6.5%)	
Energy For the Regions NGEP	5.7		(100%)	(3.9%)	
Gross total capex	**369.2**	**515.0**	**40%**	**100%**	
Less customer contributions	(47.8)	(45.6)			
Net total capex	**321.4**	**469.4**	**31%**		

10. Forecast Opex

- 2016 efficient base year of $71.0m compares to AER's allowance of $70.9m
- Step change of $23.3m for joint gas marketing step change



11. Depreciation

- Applied “year-by-year tracking” – consistent with AER’s recent Final Decision for the Victorian electricity distribution businesses

- Forecast regulatory depreciation includes allowance for:
    - Additional LP mains (and services) replaced in current period that were subject to AER’s 2015 cost pass through decision
    - Replacing 625 kilometres of mains and services

- Consistent with ATO’s ruling TR 2016/1, we have reduced our standard asset lives for:
    - Buildings from 50 years to 35 years
    - New meters from 30 years to 15 years

- We will fully depreciate our existing meters in period that only have 6.62 years of remaining life

12. Cost of capital, inflation and gamma

Parameter	2013 to 2017	AER Guideline	MG Proposal	Driver of difference
Nominal vanilla WACC	**7.03%**	**5.29%**	**6.13%**	
Return on debt	6.44%	4.50%	4.67%	Thompson Reuters 52 basis points higher than the Reserve Bank and Bloomberg indices in August
Return on equity	7.92%	6.47%	8.31%	
Risk-free rate	3.12%	1.92%	1.92%	
Market risk premium	6.00%	6.50%	7.50%	Based on Frontier report which updates the AER Guideline approach based on both historical MRP and dividend growth model (DGM). Since publishing the Guideline the DGM has increased.
Equity beta	0.8	0.7	0.7	
Alpha		n/a	1.14%	Addressed bias in SL CAPM estimation of beta
Gearing	60%	60%	60%	
Value of imputation credits (gamma)	0.25	0.4	0.25	
Inflation	2.5%	2.39%	1.68%	Adopted the "breakeven approach" compared to the AER's average the RBA's short term forecast and the mid-point of the targeting band

13. Incentives

- Retain current EBSS
- Propose new Gas Network Innovation Competition - similar to Ofgem's
- We consulted on new CESS and CSIS but concluded there is no existing "problem" that needs to be fixed