



**DRAFT DECISION**

**Directlink**

**Transmission Determination**

**2020 to 2025**

**Attachment 2**

**Regulatory asset base**

October 2019

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## Note

This attachment forms part of the AER's draft decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

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## Shortened forms

Shortened form	Extended form
ABS	Australian Bureau of Statistics
AER	Australian Energy Regulator
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
F&A	framework and approach
MAR	maximum allowed revenue
NER	national electricity rules
NPV	net present value
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
SL	straight-line
TNSP	transmission network service provider
WACC	weighted average cost of capital

## 2 Regulatory asset base

The regulatory asset base (RAB) is the value of the assets used by Directlink to provide prescribed transmission services.<sup>1</sup> Our revenue determination specifies the RAB as at the commencement of the regulatory control period and the appropriate method for the indexation of the RAB.<sup>2</sup> The indexation of the RAB is one of the building blocks that form the annual building block revenue requirement for each year of the 2020–25 regulatory control period.<sup>3</sup> We set the RAB as the foundation for determining a transmission network service provider's (TNSP's) revenue requirements, and use the opening RAB for each regulatory year to determine the return on capital and return of capital (regulatory depreciation) building block allowances.<sup>4</sup>

This attachment presents our draft decision on the opening RAB value as at 1 July 2020 for Directlink and our forecast RAB values for Directlink over the 2020–25 regulatory control period. It also presents our draft decision for establishing the RAB as at the commencement of the 2025–30 regulatory control period using depreciation that is based on forecast capital expenditure.<sup>5</sup>

### 2.1 Draft decision

We determine an opening RAB value of \$145.1 million (\$nominal) as at 1 July 2020 for Directlink. This value is \$3.3 million (or 2.3 per cent) lower than Directlink's proposed opening RAB of \$148.4 million (\$nominal) as at 1 July 2020.<sup>6</sup> While we largely accept the proposed opening RAB, we made the following revisions:

- corrected minor input issues in Directlink's proposed roll forward model (RFM)
- updated inputs to the RFM as newer information has become available since Directlink submitted its proposal. These updates include:
  - actual CPI input for 2018–19 and updated inflation estimate for 2019–20
  - actual capital expenditure (capex) for 2018–19
  - weighted average cost of capital (WACC) input for 2019–20 following the return on debt update for that year in the 2015–20 post-tax revenue model (PTRM)
  - forecast straight-line (SL) depreciation for 2017–18 to 2019–20 following the return on debt updates to the 2015–20 PTRM.

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<sup>1</sup> NER, cl. 6A.6.1(a).

<sup>2</sup> NER, cl. 6A.4.2(3A) and (4).

<sup>3</sup> NER, cl. 6A.5.4(a)(1) and (b)(1).

<sup>4</sup> NER, cl. 6A.5.4(a)(2) and (3).

<sup>5</sup> NER, cl. 6A.14.1(5F).

<sup>6</sup> Directlink, *Revenue proposal 2020-25*, 31 January 2019, p. 44. This RAB value is based on as-incurred capex.

To determine the opening RAB as at 1 July 2020, we have rolled forward the RAB over the 2015–20 regulatory control period to determine a closing RAB value at 30 June 2020 in accordance with our RFM.<sup>7</sup>

Table 2-1 sets out our draft decision on the roll forward of the RAB values for Directlink over the 2015–20 regulatory control period.

**Table 2-1 AER's draft decision on Directlink's RAB for the 2015–20 regulatory control period (\$million, nominal)**

	2015–16	2016–17	2017–18	2018–19	2019–20 <sup>a</sup>
Opening RAB	129.4	130.8	130.9	138.2	141.4
Capital expenditure <sup>b</sup>	4.0	3.4	10.2	6.4	7.7
Inflation indexation on opening RAB <sup>c</sup>	2.2	1.9	2.5	2.5	2.8
Less: straight-line depreciation <sup>d</sup>	4.9	5.3	5.4	5.6	5.8
Interim closing RAB	130.8	130.9	138.2	141.4	146.1
Difference between estimated and actual capex in 2014–15					–0.9
Return on difference for 2014–15 capex					–0.2
<b>Closing RAB as at 30 June 2020</b>					<b>145.1</b>

Source: AER analysis.

- (a) Based on estimated capex provided by Directlink. We expect to update the RAB roll forward with a revised capex estimate in the final decision, and true-up the RAB for actual capex at the next reset.
- (b) As-incurred, net of disposals, and adjusted for actual CPI and half-year WACC.
- (c) We will update the RAB roll forward for actual CPI for 2019–20 in the final decision.
- (d) Adjusted for actual CPI. Based on forecast as-commissioned capex.

We determine a forecast closing RAB value at 30 June 2025 of \$156.4 million (\$nominal). This is \$12.8 million (or 7.6 per cent) lower than the amount of \$169.2 million (\$nominal) proposed by Directlink. Our draft decision on the forecast closing RAB reflects the amended opening RAB as at 1 July 2020, and our draft decisions on the expected inflation rate (attachment 3), forecast depreciation (attachment 4) and forecast capex (attachment 5).<sup>8</sup>

Table 2-2 sets out our draft decision on the forecast RAB values for Directlink over the 2020–25 regulatory control period.

<sup>7</sup> AER, *Electricity transmission network service providers: Roll forward model (version 3)*, 23 October 2015.

<sup>8</sup> Capex enters the RAB net of forecast disposals. It includes equity raising costs (where relevant) and the half-year WACC to account for the timing assumptions in the PTRM. Therefore, our draft decision on the forecast RAB also reflects our amendments to the rate of return for the 2020–25 regulatory control period (attachment 3).

**Table 2-2 AER's draft decision on Directlink's RAB for the 2020–25 regulatory control period (\$million, nominal)**

	2020–21	2021–22	2022–23	2023–24	2024–25
Opening RAB	145.1	152.5	155.7	156.6	157.3
Capital expenditure <sup>a</sup>	10.8	7.1	5.2	5.5	4.3
Inflation indexation on opening RAB	3.6	3.7	3.8	3.8	3.9
Less: straight-line depreciation <sup>b</sup>	6.9	7.6	8.1	8.6	9.0
Closing RAB	152.5	155.7	156.6	157.3	156.4

Source: AER analysis.

(a) As-incurred, and net of forecast disposals. In accordance with the timing assumptions of the post-tax revenue model (PTRM), the capex includes a half-year WACC allowance to compensate for the six-month period before capex is added to the RAB for revenue modelling.

(b) Based on as-commissioned capex.

We determine that the forecast depreciation approach is to be used to establish the opening RAB at the commencement of the 2025–30 regulatory control period for Directlink.<sup>9</sup> We consider this approach is consistent with the capital expenditure incentive objective in that it will provide sufficient incentives for Directlink to achieve capex efficiency gains over the 2020–25 regulatory control period.

## 2.2 Directlink's proposal

Directlink used our RFM to establish an opening RAB as at 1 July 2020 and our PTRM to roll forward the RAB over the 2020–25 regulatory control period.

Directlink proposed an opening RAB value as at 1 July 2015 of \$129.4 million (\$nominal). Rolling forward this RAB and using depreciation based on forecast capex (approved for the 2015–20 regulatory control period), Directlink proposed a closing RAB as at 30 June 2020 of \$148.4 million (\$nominal). Table 2-3 sets out Directlink's proposed roll forward of its RAB during the 2015–20 regulatory control period.

**Table 2-3 Directlink's proposed RAB for the 2015–20 regulatory control period (\$million, nominal)**

	2015–16	2016–17	2017-18	2018–19 <sup>a</sup>	2019–20 <sup>a</sup>
Opening RAB	129.4	130.8	130.9	138.2	144.2
Capital expenditure <sup>b</sup>	4.0	3.4	10.2	8.3	7.7
CPI indexation on opening RAB	2.2	1.9	2.5	3.3	3.5

<sup>9</sup> AER, *Final framework and approach for Directlink – Regulatory control period commencing 1 July 2020*, July 2018, p. 23.



Less: straight-line depreciation <sup>c</sup>	4.9	5.3	5.4	5.6	5.8
Interim closing RAB	130.8	130.9	138.2	144.2	149.5
Difference between estimated and actual capex in 2014–15					-0.9
Return on difference for 2014–15 capex					-0.2
<b>Closing RAB as at 30 June 2020</b>					<b>148.4</b>

Source: Directlink, *Revenue proposal 2020-25, Attachment 7-1 - Transmission roll forward model - Public*, 31 January 2019.

- (a) Based on estimated capex.
- (b) As-incurred, net of disposals, and adjusted for actual CPI and half-year WACC.
- (c) Adjusted for actual CPI. Based on forecast as-commissioned capex.

Directlink proposed a forecast closing RAB as at 30 June 2025 of \$169.2 million (\$nominal). This value reflects its proposed opening RAB, forecast capex, expected inflation, and depreciation (based on forecast capex) over the 2020–25 regulatory control period. Its projected RAB over the 2020–25 regulatory control period is shown in Table 2-4.

**Table 2-4 Directlink's proposed RAB for the 2020–25 regulatory control period (\$million, nominal)**

	2020–21	2021–22	2022–23	2023–24	2024–25
Opening RAB	148.4	156.9	161.6	164.9	169.3
Capital expenditure <sup>a</sup>	12.1	8.8	7.8	9.5	5.6
Inflation indexation on opening RAB	3.6	3.8	3.9	4.0	4.1
Less: straight-line depreciation <sup>b</sup>	7.1	7.9	8.5	9.1	9.7
Closing RAB	156.9	161.6	164.9	169.3	169.2

Source: Directlink, *Revenue proposal 2020-25, Attachment 12-1 - Post Tax Revenue Model - Public*, 31 January 2019.

- (a) As-incurred, and net of forecast disposals. Inclusive of the half-year WACC to account for the timing assumptions in the PTRM.
- (b) Based on as-commissioned capex.

## 2.3 Assessment approach

We roll forward Directlink's RAB during the 2015–20 regulatory control period to establish the opening RAB at 1 July 2020. This value can be adjusted for any differences in estimated and actual capex.<sup>10</sup> It may also be adjusted to reflect any

<sup>10</sup> NER, cl. S6A.2.1(f)(3).

changes in the use of the assets. The Australian Energy Regulator (AER) may remove assets from the RAB in appropriate circumstances where they are no longer contributing to the provision of prescribed transmission services.<sup>11</sup>

To determine the opening RAB, we developed an asset base RFM that a TNSP must use in preparing its revenue proposal.<sup>12</sup> We used the RFM to roll forward Directlink's RAB from the beginning of the final year of the 2006–15 regulatory control period,<sup>13</sup> through the 2015–20 regulatory control period, to the beginning of the 2020–25 regulatory control period.

The roll forward for each year of the above period occurs by:

- adding actual inflation (indexation) adjustment to the opening RAB for the relevant year. This adjustment is consistent with the inflation factor used in the annual indexation of the maximum allowed revenue (MAR)<sup>14</sup>
- adding actual or estimated capex to the RAB for the relevant year.<sup>15</sup> We review a TNSP's past capex and may exclude past capex from being rolled into the RAB where total capex exceeds the regulatory allowance.<sup>16</sup> The details of our assessment approach for capex overspend are set out in the *Capital expenditure incentive guideline*.<sup>17</sup> We note that under the transitional rules, our review of past capex does not apply to Directlink prior to 1 July 2014.<sup>18</sup> Also, we have not applied the review of past capex to 2014–15 as there was no allowance for capex approved for Directlink for the 2006–15 regulatory control period.<sup>19</sup> Further, the review of past capex does not include the last two years of the 2015–20 regulatory control period—these will instead be reviewed at the next reset.<sup>20</sup> We check actual capex amounts against audited regulatory accounts data and generally accept the capex reported in those accounts in rolling forward the RAB.<sup>21</sup> However, there may be instances where adjustments are required to the annual regulatory accounts data<sup>22</sup>

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<sup>11</sup> NER, cl. S6A.2.1(f)(7)–(8) and S6A.2.3.

<sup>12</sup> NER, cl. 6A.6.1(b), 6A.6.1(e) and S6A.1.3(5).

<sup>13</sup> The roll forward commences in the final year of the 2006–15 regulatory control period to allow us to adjust for the difference between actual 2014–15 capex and the estimated 2014–15 capex used in our 2015 transmission determination. This adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved in the 2015 determination. See NER, cl. S6A.2.1(f)(3).

<sup>14</sup> NER, cl. 6A.6.1(e)(3).

<sup>15</sup> NER, cl. S6A.2.1(f)(4).

<sup>16</sup> NER, cl. S6A.2.2A. Under the NER, cl S6A.2.2A(b), the exclusion of inefficient capex could only come from three areas: overspend in capex, margin paid to third party and inappropriate capitalisation of opex as defined in cl. S6A.2.2A (c), (d) and (e) of the NER.

<sup>17</sup> AER, *Capital expenditure incentive guideline*, November 2013, pp. 12–20.

<sup>18</sup> NER, cl. 11.63.

<sup>19</sup> AER, *Directlink Joint Venturers' Application for Conversion and Revenue Cap Decision*, 3 March 2006, p. v.

<sup>20</sup> NER, cl. S6A.2.2A(a1). The two year lag ensures that actual capex (instead of estimated capex) is available when the review of past capex commences.

<sup>21</sup> We will update any estimated capex with actual capex at the time of the next reset.

<sup>22</sup> For example, we make adjustment for movements in provisions if the actual capex amounts reported in the regulatory accounts include capitalised provisions.

- subtracting depreciation from the RAB for the relevant year, calculated in accordance with the rates and methodologies allowed (if any) in the transmission determination for Directlink's 2015–20 regulatory control period.<sup>23</sup> Depreciation based on forecast or actual capex can be used to roll forward the RAB.<sup>24</sup> For this draft decision, we use depreciation based on forecast capex for rolling forward the RAB for Directlink's 2015–20 regulatory control period.<sup>25</sup> Depreciation based on forecast capex will also be used for the 2020–25 regulatory control period RAB roll forward at the next reset<sup>26</sup>
- subtracting any gross proceeds for asset disposals for the relevant year from capex to be added to the RAB.<sup>27</sup> We check these amounts against audited regulatory accounts data.

These annual adjustments give the closing RAB for any particular year, which then becomes the opening RAB for the following year. Through this process, the RFM rolls forward the RAB to the end of the 2015–20 regulatory control period. The PTRM used to calculate the annual building block revenue requirement for the 2020–25 regulatory control period generally adopts the same RAB roll forward approach as the RFM although the adjustments to the RAB are based on forecasts, rather than actual amounts.<sup>28</sup>

The opening RAB for the 2025–30 regulatory control period can be determined using depreciation based either on forecast or actual capex incurred during the 2020–25 regulatory control period.<sup>29</sup> To roll forward the RAB using depreciation based on forecast capex, we would use the forecast depreciation contained in the PTRM for the 2020–25 regulatory control period, adjusted for actual inflation. If the approach to roll forward the RAB using depreciation based on actual capex was adopted, we would recalculate the depreciation based on actual capex incurred during the 2020–25 regulatory control period.

Our decision on whether to use actual or forecast depreciation must be consistent with the capex incentive objective. This objective is to ensure that increases to the RAB through capex only occur where that capex reasonably reflects the capital expenditure criteria.<sup>30</sup> In deciding between actual and forecast depreciation, we have regard to:<sup>31</sup>

- the incentives the service provider has to undertake efficient capex

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<sup>23</sup> NER, cl. S6A.2.1(f)(5).

<sup>24</sup> NER, cl. 6A 4.2(a1).

<sup>25</sup> The use of forecast depreciation is consistent with the depreciation approach established in the transmission determination for the 2015–20 regulatory control period for Directlink. See AER, Directlink transmission determination 2015–20, April 2015, p. 10.

<sup>26</sup> Refer to section 2.4.3 for the reasons.

<sup>27</sup> NER, cl. S6A.2.1(f)(6).

<sup>28</sup> NER, cl. S6A.2.4(c).

<sup>29</sup> NER, cl. S6A.2.2B(a).

<sup>30</sup> NER, cl 6A.5A(a).

<sup>31</sup> NER, cl. S6A.2.2B(b) and (c).

- substitution possibilities between assets with different lives and the relative benefits of each
- the extent of overspending and inefficient overspending relative to the allowed forecast
- the capex incentive guideline
- the capital expenditure factors.

### 2.3.1 Interrelationships

The RAB is an input into the determination of the return on capital and depreciation (return of capital) building block allowances.<sup>32</sup> Factors that influence the RAB will therefore flow through to these building block components and the annual building block revenue requirement. Other things being equal, a higher RAB increases both the return on capital and depreciation allowances.

The RAB is determined by various factors, including:

- the opening RAB (meaning the value of existing assets at the beginning of the regulatory control period)
- net capex<sup>33</sup>
- depreciation
- indexation adjustment – so the RAB is presented in nominal terms, consistent with the rate of return.

The opening RAB depends on the value of existing assets and will depend on actual net capex, actual inflation outcomes and depreciation in the past.

The RAB when projected to the end of the regulatory control period increases due to both forecast new capex and the indexation adjustment. The size of the indexation adjustment depends on expected inflation (which also affects the nominal rate of return or WACC) and the size of the RAB at the start of each year.

Depreciation reduces the RAB. The depreciation allowance depends on the size of the opening RAB, the forecast net capex and depreciation schedules applied to the assets. By convention, the indexation adjustment is also offset against depreciation to prevent double counting of inflation in the RAB and WACC, which are both presented in nominal terms. This reduces the depreciation building block that feeds into the annual building block revenue requirement.

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<sup>32</sup> The size of the RAB also impacts the benchmark debt raising cost allowance. However, this amount is usually relatively small and therefore not a significant determinant of revenues overall.

<sup>33</sup> Net capex is gross capex less disposals. The rate of return or WACC also influences the size of the capex. This is because capex is not depreciated in the year it is first incurred, but added to the RAB at the end of the year. Instead, the capex amount is escalated by half-year WACC to arrive at an end of year value. It then begins depreciating the following year.

We maintain the RAB in real terms by indexing for inflation.<sup>34</sup> A nominal rate of return (WACC) is multiplied by the opening RAB to produce the return on capital building block.<sup>35</sup> To prevent the double counting of inflation through the nominal WACC and indexed RAB,<sup>36</sup> the regulatory depreciation building block has an offsetting reduction for indexation of the RAB.<sup>37</sup> Indexation of the RAB and the offsetting adjustment made to depreciation results in smoother revenue recovery profile over the life of an asset than if the RAB was un-indexed. If the RAB was un-indexed, there would be no need for an offsetting adjustment to the depreciation calculation of total revenue. This alternative approach provides for overall revenues being higher early in the asset's life (as a result of more depreciation being returned to the TNSP) and lower in the future—producing a steeper downward sloping profile of total revenue.<sup>38</sup> The implications of an un-indexed RAB are discussed further in attachment 4.

Figure 2-1 shows the key drivers of the changes in the RAB over the 2020–25 regulatory control period as proposed by Directlink. Overall, the closing RAB at the end of the 2020–25 regulatory control period would be 14 per cent higher than the opening RAB at the start of that period based on the proposal, in nominal terms. The proposed forecast net capex increases the RAB by 29 per cent, while expected inflation increases it by 13 per cent. Forecast depreciation, on the other hand, reduces the RAB by 28 per cent.

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<sup>34</sup> NER, cl. 6A.5.4(b)(1) and 6A.6.1(e)(3).

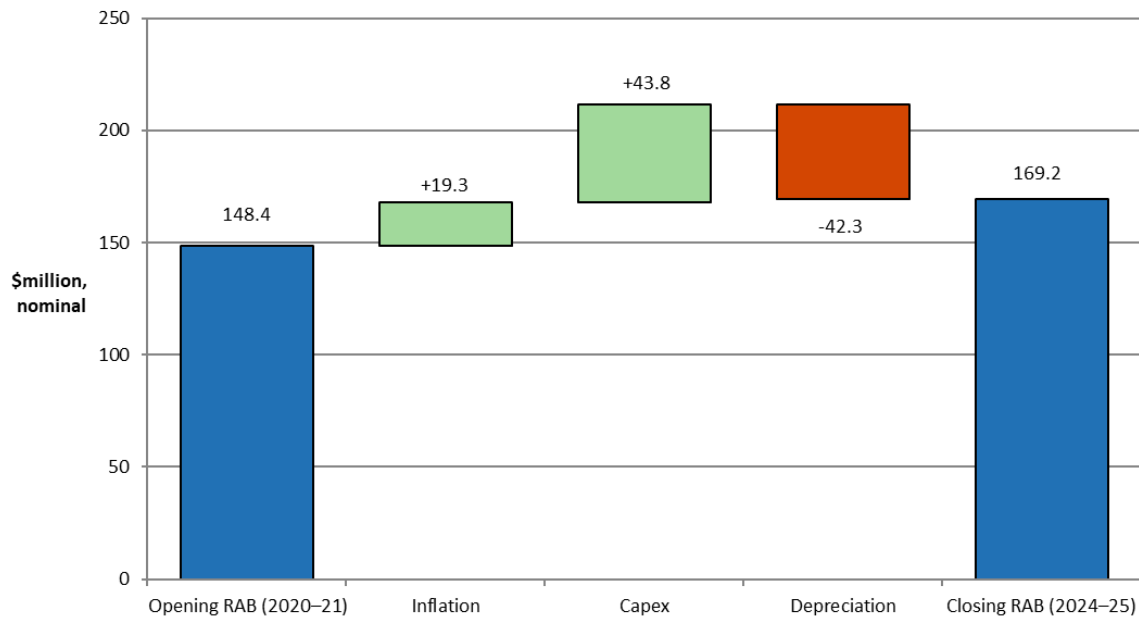
<sup>35</sup> AER, *Rate of return instrument*, cl. 1, cl. 3(a), cl. 36(c), December 2018.

<sup>36</sup> NER, cl. 6A.5.4(b)(1)(ii).

<sup>37</sup> If the asset lives are extremely long, such that the RAB depreciation rate is lower than the inflation rate, then negative regulatory depreciation can emerge. The indexation adjustment is greater than the RAB depreciation in such circumstances. Please also refer to section 4.3.1 of attachment 4 of this draft decision for further explanation of the offsetting adjustment to the depreciation.

<sup>38</sup> A change of approach from an indexed RAB to an un-indexed RAB would result in an initial step change increase in revenues to preserve NPV neutrality.

**Figure 2-1 Key drivers of changes in the RAB (\$million, nominal)**



Source: Directlink, *Revenue proposal 2020-25, Attachment 12-1 - Post Tax Revenue Model - Public*, 31 January 2019.

Directlink's proposed forecast depreciation for the 2020–25 regulatory control period is \$22.9 million (\$nominal). We have largely accepted Directlink's depreciation proposal as it satisfies the requirements of the NER in terms of the assigned asset lives. However, we have created a non-depreciating asset class into which we have allocated Directlink's land assets. We have also created separate asset classes for 'Easements' and 'Buildings'. This is discussed in attachment 4. The depreciation amount largely depends on the opening RAB, which in turn depends on capex in the past.<sup>39</sup>

However, we do have concerns with the size of the forecast capex proposed by Directlink. It is the largest driver of the increase in the RAB over the 2020–25 regulatory control period. The submission from the Public Interest Advocacy Centre (PIAC) also raised concerns over the potential size of the RAB should Directlink's RAB grow as proposed.<sup>40</sup> In this draft decision, we have reduced Directlink's proposed forecast capex by \$9.9 million (\$2019–20), or 24.4 per cent over the 2020–25 regulatory control period.<sup>41</sup> Our review of Directlink's forecast capex (including contingent projects) is set out in attachment 5 of this draft decision.

<sup>39</sup> At the time of this draft decision, the roll forward of Directlink's RAB includes estimated capex values for 2018–19 and 2019–20. We will update the 2018–19 estimated capex with actuals in the final decision. We may also update the 2019–20 estimated capex with a revised estimate in the final decision.

<sup>40</sup> Public Interest Advocacy Centre, *Submission to Directlink 2020-25 revenue proposal*, 16 March 2019, p. 7.

<sup>41</sup> This amount is net of asset disposals and equity raising costs and excludes half-year WACC adjustment.

A 10 per cent increase in the opening RAB causes revenues to increase by about seven per cent. However, the impact on revenues of the annual change in RAB depends on the source of the RAB change, as some drivers affect more than one building block cost.<sup>42</sup>

## 2.4 Reasons for draft decision

We determine an opening RAB value for Directlink of \$145.1 million (\$nominal) as at 1 July 2020, a reduction of \$3.3 million (\$nominal) or 2.3 per cent from the proposed value. We forecast a closing RAB value of \$156.4 million by 30 June 2025. This represents a reduction of \$12.8 million, or 7.6 per cent compared with Directlink's proposal. The reasons for our draft decision are discussed below.

### 2.4.1 Opening RAB at 1 July 2020

We determine an opening RAB value of \$145.1 million (\$nominal) as at 1 July 2020 for Directlink. This value is \$3.3 million (or 2.3 per cent) lower than Directlink's proposed opening RAB of \$148.4 million (\$nominal) as at 1 July 2020.<sup>43</sup>

To determine the opening RAB for Directlink as at 1 July 2020 we have rolled forward the RAB over the 2015–20 regulatory control period to determine a closing RAB value as at 30 June 2020. In doing so, we reviewed the key inputs of Directlink's proposed RFM, such as actual inflation, rate of return, gross capex values, asset disposal values, forecast depreciation amounts and asset lives. We found these were generally correct and they reconcile with relevant data sources such as Australian Bureau of Statistics (ABS) data, regulatory accounts and the 2015–20 decision models.<sup>44</sup> However, we identified some of the proposed inputs for 2017–18 capex required corrections. We also consider some of Directlink's proposed RFM inputs require updating with newly available data.

Therefore, we have made the following amendments to Directlink's proposed RFM inputs:

- corrected the actual 2017–18 capex in the RFM to align with the values reported in Directlink's 2017–18 regulatory accounts. Directlink has confirmed that the values

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<sup>42</sup> If capex causes the RAB increase—return on capital, depreciation, and debt raising costs all increase too. If a reduction in depreciation causes the RAB increase, revenue could increase or decrease. In this case, the higher return on capital is offset (perhaps more than offset) by the reduction in depreciation allowance. Inflation naturally increases the RAB in nominal terms. However, the real impact from changing the inflation forecast is inconsequential as revenues are updated annually by actual inflation and the X factor, which is generally unaffected by the assumed forecast inflation rate.

<sup>43</sup> Directlink, *Revenue proposal 2020-25*, 31 January 2019, p. 90; This RAB value is based on as-incurred capex.

<sup>44</sup> At the time of this draft decision, the roll forward of Directlink's RAB includes estimated capex values for 2018–19 and 2019–20. We will update the 2018–19 estimated capex with actuals in the final decision. We may also update the 2019–20 estimated capex with a revised estimate in the final decision.



in the regulatory accounts are appropriate to use in its response to our information request<sup>45</sup>

- updated Directlink's 2018–19 estimated capex with actuals as they have become available since the submission of the proposal.<sup>46</sup> We will reconcile Directlink's inputs for the 2018–19 actual capex against the audited 2018–19 regulatory accounts at the final decision stage and make any updates if required
- updated the forecast straight-line depreciation inputs for 2017–18 to 2019–20 to be consistent with values calculated in our 2018–19 return on debt update in the 2015–20 PTRM. Directlink supported this approach in its response to our information request<sup>47</sup>
- updated the inflation input for 2018–19 using the actual December 2018 consumer price index (CPI) published by the ABS
- updated the December to December inflation estimate for 2019–20<sup>48</sup>
- updated the 2019–20 WACC input following the return on debt update for that year in the 2015–20 PTRM.

We also consider the extent to which our roll forward of the RAB to 1 July 2020 contributes to the achievement of the capital expenditure incentive objective.<sup>49</sup> Under the transitional rules, in making this transmission determination, the review of past capex does not apply to Directlink prior to 1 July 2014.<sup>50</sup> Also, we have not applied the review of past capex to 2014–15 as there was no allowance for capex approved for Directlink for the 2006–15 regulatory control period. Therefore, there is no forecast capex allowance to compare the actual capex with, prior to 1 July 2015. Given this, the review period for this transmission determination is limited to 2015–16, 2016–17, and 2017–18 capex.<sup>51</sup>

Directlink's aggregated actual capex incurred from 2015–16 to 2017–18 is above the forecast allowance set at the 2015–20 transmission determination. Therefore, the overspending requirement for an efficiency review of past capex has been satisfied.<sup>52</sup> However, for the reasons discussed in attachment 5, we consider the capex incurred in those years is consistent with the capital expenditure criteria and can therefore be included in the RAB.<sup>53</sup>

For the purposes of this draft decision, we have included Directlink's estimated capex in 2018–19 and 2019–20 in the RAB roll forward to 1 July 2020. At the next reset, the

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<sup>45</sup> Directlink, *Response to AER Information Request #001 - Initial proposal modelling issues*, 22 February 2019, p. 1.

<sup>46</sup> Directlink, *Response to AER Information Request #012 - Capital expenditure sharing scheme*, 5 August 2019, p. 1.

<sup>47</sup> Directlink, *Response to AER Information Request #001 - Initial proposal modelling issues*, 22 February 2019, p. 1.

<sup>48</sup> In our final decision, we will update the estimate for 2019–20 expected inflation with actual CPI.

<sup>49</sup> NER, cl. 6A.14.2(b) and 6A.5A(a).

<sup>50</sup> NER, cl. 11.63.

<sup>51</sup> NER, cl. S6A.2.2A(a1).

<sup>52</sup> NER, cl. S6A.2.2A(c).

<sup>53</sup> NER, cl. S6A.2.2A(f).



2018–19 and 2019–20 capex will form part of the review period for assessing whether past capex should be excluded for inefficiency reasons.<sup>54</sup> Our RAB roll forward applies the incentive framework approved in the previous transmission determination, which included the use of a forecast depreciation approach in combination with the application of the capital expenditure sharing scheme (CESS).<sup>55</sup> As such, we consider that the 2015–20 RAB roll forward contributes to an opening RAB (as at 1 July 2020) that includes capex that reflects prudent and efficient costs, in accordance with the capital expenditure criteria.<sup>56</sup>

## 2.4.2 Forecast closing RAB at 30 June 2025

We forecast a closing RAB value of \$156.4 million by 30 June 2025 for Directlink, which represents a reduction of \$12.8 million (or 7.6 per cent) to Directlink's proposal. This reduction reflects our draft decision on the inputs for determining the forecast RAB in the PTRM.

The submission from PIAC on Directlink's proposal raised concerns with the increase to the size of Directlink's RAB over the 2020–25 regulatory control period.<sup>57</sup> The change in the size of the RAB depends on our assessment of its various components including forecast capex (attachment 5), expected inflation (attachment 3) and forecast depreciation (attachment 4). Inflation and capex increase the RAB, while depreciation and disposals reduce it.

To determine the forecast RAB value for Directlink, we amended the following PTRM inputs:

- we reduced Directlink's proposed opening RAB as at 1 July 2020 by \$3.3 million (\$nominal) or 2.3 per cent (section 2.4.1)
- we reduced Directlink proposed forecast capex<sup>58</sup> for the 2020–25 regulatory control period by \$10.9 million (\$nominal) or 25.0 per cent (attachment 5)
- we updated Directlink's proposed expected inflation rate of 2.41 per cent per annum to 2.45 per cent per annum (attachment 3). This results in an increase to the indexation of the RAB component for the 2020–25 regulatory control period by \$0.3 million or 0.2 per cent (\$nominal), all else being equal<sup>59</sup>

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<sup>54</sup> Here, 'inefficiency' of past capex refers to three specific assessments (labelled the overspending, margin and capitalisation requirements) detailed in NER, cl. S6A.2.2A. The details of our ex post assessment approach for capex are set out in AER, *Capital expenditure incentive guideline*, November 2013, pp. 12–20.

<sup>55</sup> AER, *Directlink transmission determination 2015–20*, April 2015, p. 10.

<sup>56</sup> NER, cll. 6A.5A(a), 6A.6.7(c) and 6A.14.2(b).

<sup>57</sup> Public Interest Advocacy Centre, *Submission to Directlink 2020-25 revenue proposal*, 16 March 2019, p. 7.

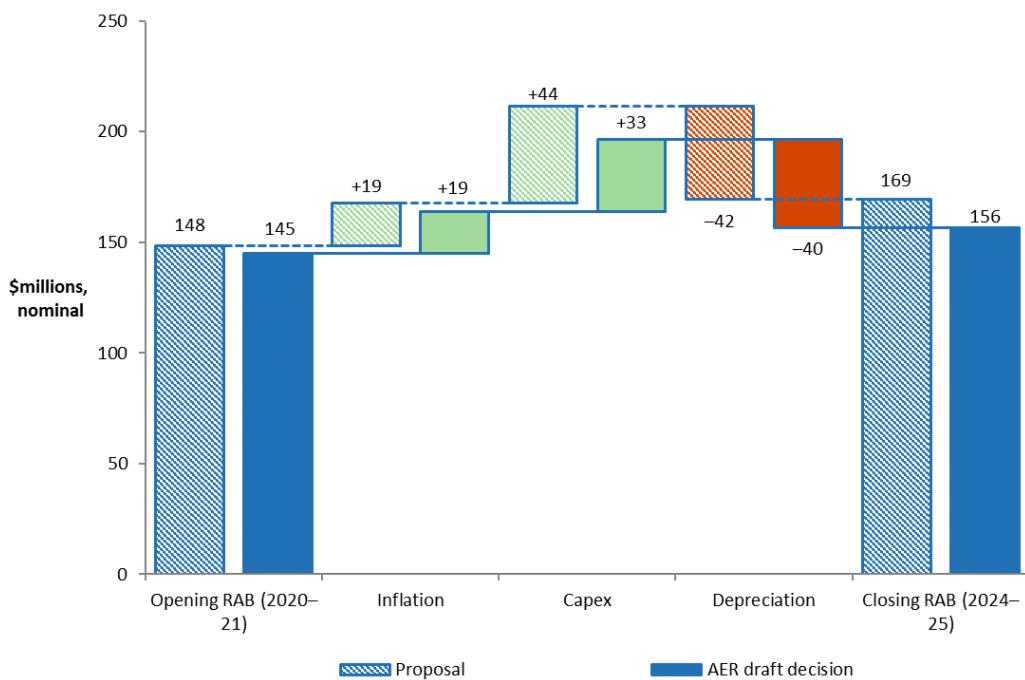
<sup>58</sup> As-incurred capex net of disposals and inclusive of half-year WACC adjustment.

<sup>59</sup> Compared to the proposal, our draft decision results in a decrease to the indexation of the RAB by \$0.5 million or 2.7 per cent (\$nominal). The decrease in the indexation to the RAB despite the increase in the inflation rate is due to the lower opening RAB and lower forecast capex in our draft decision.

- we reduced Directlink's proposed forecast straight-line depreciation for the 2020–25 regulatory control period by \$2.0 million (\$nominal) or 4.8 per cent (attachment 4).

Figure 2-2 shows the key drivers of the change in Directlink's RAB over the 2020–25 regulatory control period for this draft decision. Overall, the closing RAB at the end of the 2020–25 regulatory control period is forecast to be 8 per cent higher than the opening RAB at the start of that period, in nominal terms. The approved forecast net capex increases the RAB by 23 per cent, while expected inflation increases it by 13 per cent. Forecast depreciation, on the other hand, reduces the RAB by 28 per cent.

**Figure 2-2 Key drivers of changes in the RAB – Directlink's proposal compared with AER's draft decision (\$million, nominal)**



Source: AER analysis.

Note: Capex is net of forecast disposals. It is inclusive of the half-year WACC to account for the timing assumptions in the PTRM.

### 2.4.3 Application of depreciation approach in RAB roll forward for next reset

We determine that the depreciation approach to be applied to establish Directlink's opening RAB at the commencement of the 2025–30 regulatory control period will be based on the depreciation schedules (straight-line) using forecast capex at the asset class level approved for the 2020–25 regulatory control period. We consider this

approach will provide sufficient incentives for Directlink to achieve capex efficiency gains over the 2020–25 regulatory control period.<sup>60</sup>

Directlink has not specified in its proposal what depreciation approach to use in the roll forward of the RAB for the commencement of its 2025–30 regulatory control period. However, we consider that the forecast depreciation approach should be used to establish the opening RAB as at 1 July 2025. We note that this approach is consistent with the AER's *Framework and approach*.<sup>61</sup>

We stated in the *Framework and approach* that depreciation used to roll forward the RAB could be based on either:<sup>62</sup>

- actual capex incurred during the regulatory control period (actual depreciation). We roll forward the RAB based on actual capex less the depreciation on the actual capex incurred by the TNSP, or
- the capex allowance forecast at the start of the regulatory control period (forecast depreciation). We roll forward the RAB based on actual capex less the depreciation on the forecast capex approved for the regulatory control period.

We have used forecast depreciation for this draft decision when rolling forward the opening RAB at the commencement of the 2020–25 regulatory control period (section 2.4.1). The use of forecast depreciation to establish the opening RAB for the commencement of the 2025–30 regulatory control period at the next reset therefore maintains the current approach.

As discussed in attachment 9, Directlink is currently subject to the capital expenditure sharing scheme (CESS) for the 2015–20 regulatory control period. We will continue to apply the CESS to Directlink over the 2020–25 regulatory control period. We consider that the CESS will provide sufficient incentives for Directlink to achieve capex efficiency gains over that period. We are satisfied that the use of a forecast depreciation approach in combination with the application of the CESS and our other ex post capex measures are sufficient to achieve the capex incentive objective.<sup>63</sup>

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<sup>60</sup> NER, cl. 6A.14.1(5F) and S6A.2.2B.

<sup>61</sup> AER, *Final framework and approach for Directlink – Regulatory control period commencing 1 July 2020*, July 2018, p. 23.

<sup>62</sup> AER, *Final framework and approach for Directlink – Regulatory control period commencing 1 July 2020*, July 2018, p. 22.

<sup>63</sup> Our ex post capex measures are set out in the capex incentives guideline, AER, *Capital expenditure incentive guideline for electricity network service providers*, November 2013, pp. 13–19, 20–21. The guideline also sets out how all our capex incentive measures are consistent with the capex incentive objective.