

Final Decision

**APA Victorian Transmission System
(VTS)**

Access Arrangement 2023 to 2027
(1 January 2023 to 31 December 2027)

Attachment 4
Regulatory depreciation

December 2022

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Tel: 1300 585 165

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Note

This attachment forms part of the AER’s final decision on the access arrangement that will apply to APA’s Victorian Transmission System (VTS) for the 2023–27 access arrangement period. It should be read with all other parts of the final decision.

As a number of issues were settled at the draft decision stage or required only minor updates, we have not prepared all attachments. The final decision attachments have been numbered consistently with the equivalent attachments to our draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following documents:

Overview

Attachment 2 – Capital 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 – Operating expenditure incentive mechanism

Attachment 10 – Reference tariff variation mechanism

Attachment 12 – Demand

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4 Regulatory depreciation

Depreciation is a method used in our determination to allocate the cost of an asset over its useful life. It is the amount provided so capital investors recover their investment over the economic life of the asset (otherwise referred to as ‘return of capital’). When determining the total revenue for the Victorian Transmission System (VTS), we include an amount for the depreciation of the projected capital base.¹ Under the building block framework, regulatory depreciation consists of the net total of the straight-line depreciation less the indexation of the capital base.

This attachment outlines our final decision on APA’s annual regulatory depreciation amount for the VTS for the 2023–27 access arrangement period (2023–27 period). Our consideration of specific matters that affect the estimate of regulatory depreciation is also outlined in this attachment. These include:

- the standard asset lives for depreciating new assets associated with forecast capital expenditure (capex), including APA’s proposed shortening of standard asset lives for the ‘Pipelines’ asset class to 30 years
- the remaining asset lives for depreciating existing assets in the opening capital base, including APA’s proposed shortening of the remaining asset lives for the ‘Pipelines’ asset class to 30 years.²

4.1 Final decision

We determine a regulatory depreciation amount of \$111.5 million (\$ nominal) for APA for the 2023–27 period. This represents a reduction of \$25.9 million (18.9%) from APA’s revised proposed regulatory depreciation amount of \$137.4 million (\$ nominal). We have accepted all the asset lives as proposed, including the proposed 30 year cap on asset lives of the ‘Pipelines’ asset class. One of the key reasons for the decrease compared to APA’s revised proposal is our higher expected inflation rate for the 2023–27 period, which increases the adjustment for indexation of the capital base that is offset against straight-line depreciation in determining regulatory depreciation. Another factor leading to lower depreciation is that we are not accepting APA’s forecast capex and instead approving a lower amount.

Table 4.1 sets out our final decision on APA’s regulatory depreciation amount for the VTS over the 2023–27 period.

Table 4.1 AER’s final decision on the VTS regulatory depreciation amount for 2023–2027 period (\$ million, nominal)

	2023	2024	2025	2026	2027	Total
Straight-line depreciation	52.7	67.1	73.0	75.4	66.6	334.8
Less: indexation of capital base	41.0	45.2	45.9	45.8	45.5	223.4
Regulatory depreciation	11.7	21.9	27.1	29.6	21.1	111.5

Source: AER analysis.

¹ NGR, r. 76(b).

² The term ‘remaining asset life’ may also be referred to as ‘remaining economic life’ or ‘remaining life’.

4.2 APA’s revised proposal

APA proposed a revised total forecast regulatory depreciation amount of \$137.4 million (\$ nominal) for the VTS for the 2023–27 period, as set out in Table 4.2.

Table 4.2 APA’s revised proposal on the VTS regulatory depreciation amount for 2023–2027 period (\$ million, nominal)

	2023	2024	2025	2026	2027	Total
Straight-line depreciation	51.8	66.6	72.4	75.3	67.7	333.8
Less: indexation of capital base	35.7	39.6	40.3	40.4	40.3	196.4
Regulatory depreciation	16.1	26.9	32.1	34.9	27.4	137.4

Source: APA, Revised proposal PTRM, August 2022.

To calculate the depreciation amount, APA used a similar approach to its initial proposal. It adopted all the draft decision positions in relation to depreciation, with the exception of a reintroduction of a 30 year cap on the asset lives of the ‘Pipelines’ asset class.

4.3 Assessment approach

The AER’s assessment approach was set out in our draft decision.³

4.4 Reasons for the final decision

Our draft decision was to reject APA’s proposed 30 year cap on its asset lives. We also rejected the creation of new ‘WORM’ and ‘SWP_570’ asset classes (reallocating assets back to original existing asset classes) and decided to split the ‘Other’ asset class between short and long life versions due to different asset types being allocated to that class.

APA’s revised proposal adopted most of the draft decision on depreciation but reintroduced a cap of 30 years on the standard and remaining asset lives of the ‘Pipelines’ asset class.⁴ The remaining point of contention regarding depreciation is therefore the proposed 30 year cap on pipelines. The revised proposal asset life cap increases APA’s revenues by \$29 million (4.3%) over the 2023–27 period.

4.4.1 30 year cap on pipelines asset lives

Our final decision is to accept the proposed asset life cap on the ‘Pipelines’ asset class. This was a finely balanced decision for the reasons outlined below.

APA’s revised proposal included a 30 year cap on both the remaining and standard asset lives of the ‘Pipelines’ asset class. This proposal is more modest than APA’s original proposal, which had also extended the cap to the ‘Land’ and ‘Buildings’ asset classes.⁵ We calculate the revenue impact of the original proposal to be 5.0%, compared to 4.3% for the revised proposal.

³ AER, *Draft Decision, APA Victorian Transmission System (VTS), Access Arrangement 2023 to 2027 (1 January 2023 to 31 December 2027)*, Attachment 4, *Regulatory depreciation*, June 2022, pp. 8-13.

⁴ The draft decision maintained the existing standard asset life at 55 years (used for the first 5 years of an asset’s life) and applied a remaining asset life of 34 years.

⁵ The draft decision maintained that land should not be depreciated, and the existing standard asset life of 60 years apply to buildings (used for the first 5 years of the asset’s life).

In accepting the proposed 30 year cap we recognise that the publication of the Gas Substitution Roadmap (the roadmap) since our draft decision was made indicates that the Victorian Government is committed to the net zero emissions target by 2050.⁶ This will likely mean a limited role for gas beyond this date. The roadmap included several initiatives that will reduce the role for gas in Victoria, such as incentives for residential customers to switch to electric appliances, the removal of planning provisions requiring new housing developments to connect to gas, and higher energy efficiency requirements for housing. Residential customers currently make up the largest proportion of demand, but this proportion is likely to decline going forward and may even end by 2050. The demand from industrial customers is uncertain, while the future role for hydrogen is also uncertain at this time.

While these changes are likely to eventuate, the pace of change remains uncertain. Our final decision to accept the proposed cap is guarding against risk of an earlier wind down of the network and the price spike that may result if demand falls faster than expected. As we stated in our draft decision, we have not attempted to resolve the issue of how much stranding risk customers and APA should share during the consideration of this review for the 2023–27 period. The most recent updates to AEMO’s demand forecasts show a decline in demand projections compared to those demand scenarios used in APA’s initial proposal. These were adopted in the draft decision. For the revised proposal, APA submitted the same forecast as its initial proposal for the 2023–27 period, but updated its expectations of significant falls in demand post-2028, when it considers emission reduction policies are expected to ramp up. Our final decision is consistent with this change in expectations.

APA commissioned ACIL Allen (ACIL) to prepare a report on the average tariff impact of three different demand scenarios.⁷ The analysis shows that both accelerating and deferring depreciation is needed to maintain flat prices in the face of fluctuating demand. ACIL concluded that accelerated depreciation was not needed under the ‘progressive change’ scenario, but that it was for the other two scenarios. Given recent updates in the Victorian Roadmap and by AEMO, we consider the ‘progressive change’ scenario will be difficult to achieve longer term, and therefore the case for accelerated depreciation is greater than at the time of the draft decision. Our expectation is that emission reduction policies will have a larger effect on gas demand in the medium to long run, and that there will be a lag period before significant reductions are achieved. We consider ‘progressive change’ is the best forecast of demand for this access arrangement period, while ‘step change’ is more likely once policy changes begin to take effect.

ACIL’s preferred demand scenario is a ‘delayed step change’ scenario which could be a more likely outcome based on the most recent information. ACIL’s analysis suggested that prices need to increase by 27%⁸ from the base case of no accelerated depreciation in 2023 in order to maintain price stability in future. However, APA’s proposal is significantly more modest than that recommended by ACIL and does not have the same price impact for customers.

⁶ Victorian State Government, *Gas Substitution Roadmap*, July 2022.

⁷ ACIL Allen, *VTS accelerated depreciation assessment*, 9 August 2022.

⁸ The straight-line depreciation component needs to rise 43%.

As noted in our information paper on *Regulating gas pipelines under uncertainty*, bringing forward the cost recovery of the efficient investments that regulated businesses have already made would increase the certainty that incurred costs would be recovered, thereby reducing stranded asset risk and the potential need for material upwards price adjustments in the future.⁹

APA's proposal does not promote the perfectly flat prices of ACIL's analysis. However, customers could benefit from reducing the capital base now (by shortening the asset lives), if the achievement of net zero emissions target progresses more quickly than anticipated leading to significant demand reductions. We consider that promoting relatively flat prices will prevent customers leaving gas networks prematurely and creating a so called 'death spiral'.

We are mindful of concerns consumer and user advocates have raised with the proposal. These stakeholders have generally been unsupportive of APA's proposal for accelerated depreciation. CCP28 commented on a lack of meaningful engagement before the revised proposal was submitted.¹⁰ The Brotherhood of St. Laurence discussed a number of concerns with APA's proposal, noting in particular that the high level of capex alone was reason to reject the proposal.¹¹ The EUAA said it understood the reason for the draft decision. It stated it would leave it up to the AER to decide whether the additional ACIL analysis and the Gas Substitution Roadmap policy announcements provide sufficient clarity on the State Government's objectives to support any level of accelerated depreciation.¹² Red Energy was also concerned with the inconsistency between APA's high level of proposed capex and the proposal for accelerated depreciation.¹³ APA could and should have done a better job engaging its stakeholders on this issue.

We still have concerns that the level of analysis presented by APA in its revised proposal has not met the expectation set out in our information paper.¹⁴ The ACIL analysis is informative but does not address specific aspects of the VTS network. However, we do not consider that this lack of specificity is sufficient reason to not take a small step now.

We are also concerned with the inconsistency between APA's high level of proposed capex and the proposal for accelerated depreciation. However, we have approved only a proportion of the capex sought by APA in its revised proposal. In particular, no growth capex was proposed or approved. We have previously observed that it is important to ensure a prudent level of expenditure on network investment or maintenance to maintain safe and reliable gas services for remaining customers, notwithstanding the risk that these expenditures may have economic lives shorter than expected or may not produce a net benefit ultimately.¹⁵

⁹ AER, *Regulating gas pipelines under uncertainty information paper*, November 2021, p. 29.

¹⁰ CCP28, *APA: Victorian Gas Transmission System Access Arrangement 2023–27, CCP28 Advice to the AER - Revised Proposal*, 31 August 2022, p. 14.

¹¹ Brotherhood of St. Laurence, *2023-2028 Victorian Gas Transmission System (VTS) Access Arrangement, Submission from BSL to the AER's Draft Determination and APA's Revised Proposal*, 1 September 2022, pp. 6-11.

¹² EUAA, *Submission, APA Gas Transmission access arrangement*, 7 September 2022, p. 3.

¹³ Red Energy, *Re: Draft decision for APA Victorian Transmission System access arrangement 2023–27*, 14 September 2022.

¹⁴ AER, *Regulating gas pipelines under uncertainty information paper*, November 2021, pp. 29-32.

¹⁵ AER, *Regulating gas pipelines under uncertainty information paper*, November 2021, p. 50.

Accordingly, we consider that those decisions for reducing overall capex (and the types of capex approved) do go a long way to resolving the apparent inconsistency.

Accepting the proposal to accelerate depreciation leaves open the option to change course at future reviews. Although we may be approving acceleration now, reversals at a future date may also be required to promote efficient growth (including negative growth) of the market as required under the NGR.¹⁶ If it becomes apparent that the VTS will still have significant role beyond 2050 then we consider that such a reversal may be required, potentially as soon as the next review.

4.4.2 Asset lives

The standard asset lives for the revised proposal are consistent with those approved for the draft decision and for our final decision on the ‘Pipelines’ asset class as discussed above.

The remaining assets lives for the VTS have been determined for the revised proposal using a weighted average approach, with the exception of the Pipelines asset class as discussed above. We accept that these remaining asset lives have been appropriately determined using our RFM model, although they have been updated due to revisions to the opening capital base as discussed in attachment 2.

Table 4.3 sets out the approved asset lives for each of the VTS asset classes for the 2023–2027 period. We are satisfied the asset lives approved in this final decision will result in a depreciation schedule that reflects the depreciation criteria of the NGR.¹⁷

Table 4.3 Asset lives of the VTS for the 2023–2027 period

Asset class	Remaining asset lives	Standard asset lives
Pipelines	30.0	30.0
Compressors	18.5	30.0
City gates & Field regulators	18.3	30.0
Odourant plants	12.5	30.0
Gas quality	9.1	10.0
Other – short life	3.8	5.0
Other – long life	n/a	15.0
General buildings	48.9	60.0
General land	n/a	n/a
Integrity inspections	n/a	10.0
Equity raising costs ^a	n/a	n/a

Source: APA, *Revised proposal PTRM*, August 2022. AER analysis.

(a) For this final decision, the forecast capex determined for APA does not meet a level to trigger any benchmark equity raising costs.

n/a Not applicable. We have not assigned a standard asset life and remaining asset life to some asset classes either because they have zero capex forecast or existing assets, or because the assets allocated to it are non-depreciating assets.

¹⁶ NGR, r. 89.

¹⁷ NGR, r. 89.

A Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
APA / APA VTS	APA VTS Australia (Operations) Pty Ltd and APA VTS Australia (NSW) Pty Ltd
Capex	capital Expenditure
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
NPV	net present value
Opex	operating expenditure
PTRM	post-tax revenue model
RFM	roll forward model
RIN	Regulatory Information Notice
RPP	revenue and pricing principles
VTS	Victorian Transmission System
WACC	weighted average cost of capital
WARL	weighted average remaining lives