



**FINAL DECISION**  
**Essential Energy distribution**  
**determination**  
**2015–16 to 2018–19**

**Attachment 2 – Regulatory**  
**asset base**

April 2015

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## Note

This attachment forms part of the AER's final decision on Essential Energy's regulatory proposal 2015–19. It should be read with other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 - Annual revenue requirement

Attachment 2 - Regulatory asset base

Attachment 3 - Rate of return

Attachment 4 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

Attachment 9 - Efficiency benefit sharing scheme

Attachment 10 - Capital expenditure sharing scheme

Attachment 11 - Service target performance incentive scheme

Attachment 12 - Demand management incentive scheme

Attachment 13 - Classification of services

Attachment 14 - Control mechanism

Attachment 15 - Pass through events

Attachment 16 - Alternative control services

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## Shortened forms

| Shortened form                   | Extended form  |
|----------------------------------|--|
| AEMC                             | Australian Energy Market Commission                                    |
| AEMO                             | Australian Energy Market Operator                                      |
| AER                              | Australian Energy Regulator  |
| augex                            | augmentation expenditure   |
| capex                            | capital expenditure  |
| CCP                              | Consumer Challenge Panel   |
| CESS                             | capital expenditure sharing scheme                                     |
| CPI                              | consumer price index   |
| DRP                              | debt risk premium  |
| DMIA                             | demand management innovation allowance                                 |
| DMIS                             | demand management incentive scheme                                     |
| distributor                      | distribution network service provider                                  |
| DUoS                             | distribution use of system   |
| EBSS                             | efficiency benefit sharing scheme                                      |
| ERP                              | equity risk premium  |
| Expenditure Assessment Guideline | expenditure forecast assessment Guideline for electricity distribution |
| F&A                              | framework and approach   |
| MRP                              | market risk premium  |
| NEL                              | national electricity law   |
| NEM                              | national electricity market  |
| NEO                              | national electricity objective   |
| NER                              | national electricity rules   |
| NSP                              | network service provider   |
| opex                             | operating expenditure  |
| PPI                              | partial performance indicators   |
| PTRM                             | post-tax revenue model   |
| RAB                              | regulatory asset base  |
| RBA                              | Reserve Bank of Australia  |
| repex                            | replacement expenditure  |
| RFM                              | roll forward model   |

|        |   |
|--------|---|
| RIN    | regulatory information notice               |
| RPP    | revenue and pricing principles              |
| SAIDI  | system average interruption duration index  |
| SAIFI  | system average interruption frequency index |
| SLCAPM | Sharpe-Lintner capital asset pricing model  |
| STPIS  | service target performance incentive scheme |
| WACC   | weighted average cost of capital            |

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## 2 Regulatory asset base

We are required to make a decision on Essential Energy's opening regulatory asset base (RAB) as at 1 July 2014.<sup>1</sup> We use the RAB at the start of each regulatory year to determine the return of capital (regulatory depreciation) and return on capital building block allowances. This attachment presents our final decision on the opening RAB value as at 1 July 2014 for Essential Energy and roll forward of the forecast RAB values over the 2014–19 period.

### 2.1 Final decision

We do not accept Essential Energy's revised proposed opening RAB value of \$6787.6 million (\$ nominal) as at 1 July 2014. We instead determine an opening RAB as at 1 July 2014 of \$6774.2 million (\$ nominal). This is because we amended Essential Energy's proposed actual capex values to reverse the movements in capitalised provisions from 2009–2014. This amendment reduced the opening RAB as at 1 July 2014 by \$13.4 million (or 0.2 per cent) compared to that in the revised proposal.

We note Essential Energy's revised proposal adopted our draft decision on the use of forecast depreciation for establishing the RAB at the commencement of the regulatory control period from 1 July 2019.<sup>2</sup> We therefore maintain our draft decision position on this issue for this final decision.

Table 2.1 sets out our final decision on the roll forward of the RAB values for the 2009–14 regulatory control period.

We determine a forecast closing RAB value at 30 June 2019 of \$8720.4 million (\$ nominal). This is \$278.4 million (or 3.1 per cent) lower than the amount of \$8998.8 million (\$ nominal) in Essential Energy's revised proposal. Our final decision on the forecast closing RAB reflects our adjustments to Essential Energy's opening RAB at 1 July 2014 (section 2.4.1) forecast capex (attachment 6), forecast regulatory depreciation (attachment 5) and the forecast inflation rate (attachment 3.)

Table 2.2 sets out our final decision on the forecast RAB values for Essential Energy over the 2014–19 period.

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<sup>1</sup> NER, cl. 6.12.1(6).

<sup>2</sup> Essential Energy, *Revised regulatory proposal*, January 2015, p. 82.

**Table 2.1 AER's final decision on Essential Energy's RAB for the 2009–14 regulatory control period (\$ million, nominal)**

|   | 2009–10 | 2010–11 | 2011–12 | 2012–13 | 2013–14       |
|---|---------|---------|---------|---------|---------------|
| Opening RAB   | 4319.4  | 4819.5  | 5379.1  | 6050.1  | 6505.3        |
| Capital expenditure   | 687.3   | 720.1   | 760.4   | 657.4   | 587.7         |
| Inflation indexation on opening RAB   | 78.6    | 137.1   | 182.3   | 106.6   | 159.4         |
| Less: straight-line depreciation  | 265.8   | 297.6   | 271.8   | 308.8   | 333.4         |
| Closing RAB   | 4819.5  | 5379.1  | 6050.1  | 6505.3  | 6918.9        |
| Difference between estimated and actual capex (1 July 2008 to 30 June 2009) |         |         |         |         | -31.0         |
| Return on difference for 2008–09 capex                                      |         |         |         |         | -18.9         |
| Closing RAB as at 30 June 2014  |         |         |         |         | 6869.1        |
| Meters moved to alternative control services                                |         |         |         |         | -94.9         |
| <b>Opening RAB as at 1 July 2014</b>  |         |         |         |         | <b>6774.2</b> |

Source: AER analysis.

(a) Net of disposals and capital contributions, and adjusted for CPI.

**Table 2.2 AER's final decision on Essential Energy's RAB for the 2014–19 period (\$ million, nominal)**

|                                     | 2014–15       | 2015–16       | 2016–17       | 2017–18       | 2018–19       |
|-------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Opening RAB                         | 6774.2        | 7187.4        | 7592.8        | 7981.8        | 8362.6        |
| Capital expenditure <sup>a</sup>    | 516.5         | 527.3         | 527.1         | 510.9         | 496.7         |
| Inflation indexation on opening RAB | 161.2         | 171.1         | 180.7         | 190.0         | 199.0         |
| Less: straight-line depreciation    | 264.6         | 293.0         | 318.7         | 320.2         | 337.9         |
| <b>Closing RAB</b>                  | <b>7187.4</b> | <b>7592.8</b> | <b>7981.8</b> | <b>8362.6</b> | <b>8720.4</b> |

Source: AER analysis.

(a) Net of forecast disposals and capital contributions.

## 2.2 Essential Energy's revised proposal

Essential Energy's revised proposal submitted an opening RAB value as at 1 July 2014 of \$6787.6 million (\$ nominal). Essential Energy did not adopt our draft decision amendment to the roll forward of the opening RAB from 1 July 2009 to 30 June 2014, which adjusted gross capex for the movements in capitalised provisions. Essential



Energy also updated the revised proposed opening RAB to reflect actual capex for 2013–14.<sup>3</sup>

Table 2.3 presents Essential Energy's revised proposed roll forward of its RAB for the 2009–14 regulatory control period.

**Table 2.3 Essential Energy's revised proposed RAB roll forward for the 2009–14 regulatory control period (\$ million, nominal)**

|   | 2009–10 | 2010–11 | 2011–12 | 2012–13 | 2013–14       |
|---|---------|---------|---------|---------|---------------|
| Opening RAB   | 4319.4  | 4820.6  | 5383.9  | 6066.0  | 6518.5        |
| Capital expenditure   | 688.3   | 723.8   | 771.5   | 654.7   | 582.9         |
| Inflation indexation on opening RAB   | 78.6    | 137.2   | 182.5   | 106.9   | 159.7         |
| Less: straight-line depreciation  | 265.8   | 297.6   | 271.9   | 309.2   | 333.7         |
| Closing RAB   | 4820.6  | 5383.9  | 6066.0  | 6518.5  | 6927.4        |
| Difference between estimated and actual capex (1 July 2008 to 30 June 2009) |         |         |         |         | –27.7         |
| Return on difference for 2008–09 capex                                      |         |         |         |         | –16.9         |
| Closing RAB as at 30 June 2014  |         |         |         |         | 6882.7        |
| Meters moved to alternative control services                                |         |         |         |         | –95.1         |
| <b>Opening RAB as at 1 July 2014</b>  |         |         |         |         | <b>6787.6</b> |

Source: Essential Energy, *Revised regulatory proposal*, January 2014, Attachment 5.1.

Essential Energy's revised proposal submitted a forecast closing RAB as at 30 June 2019 of \$8998.8 million (\$ nominal). This value reflects its revised opening RAB, forecast capex and forecast depreciation (based on forecast capex) over the 2014–19 period. Essential Energy's projected RAB over the 2014–19 period is shown in Table 2.4.

<sup>3</sup> Essential Energy, *Revised regulatory proposal*, January 2014, pp. 85–86.

**Table 2.4 Essential Energy's revised proposed RAB for the 2014–19 period (\$ million, nominal)**

|                                     | 2014–15       | 2015–16       | 2016–17       | 2017–18       | 2018–19       |
|-------------------------------------|---------------|---------------|---------------|---------------|---------------|
| Opening RAB                         | 6787.6        | 7240.0        | 7696.1        | 8140.9        | 8580.1        |
| Capital expenditure                 | 551.2         | 569.9         | 574.5         | 561.0         | 548.9         |
| Inflation indexation on opening RAB | 166.3         | 181.0         | 192.4         | 203.5         | 214.5         |
| Less: straight-line depreciation    | 265.1         | 294.8         | 322.1         | 325.3         | 344.8         |
| <b>Closing RAB</b>                  | <b>7240.0</b> | <b>7696.1</b> | <b>8140.9</b> | <b>8580.1</b> | <b>8998.8</b> |

Source: Essential Energy, *Revised regulatory proposal*, January 2014, Attachment 5.5.

(a) Net of forecast disposals and capital contributions.

## 2.3 AER's assessment approach

We did not change our assessment approach for the RAB from our draft decision. Section 2.3 of our draft decision details that approach.<sup>4</sup>

## 2.4 Reasons for final decision

We have determined an opening RAB value for Essential Energy of \$6774.2 million (\$ nominal) as at 1 July 2014, a reduction of \$13.4 million (\$ nominal) or 0.2 per cent from the revised proposed value. Based on this opening RAB value we forecast a closing RAB value of \$8720.4 million (\$ nominal) by 30 June 2019. This represents a reduction of \$278.4 million, or 3.1 per cent compared to the revised proposal. The reasons for our decision are discussed below.

### 2.4.1 Opening RAB as at 1 July 2014

We do not accept Essential Energy's revised proposal opening RAB of \$6787.6 million (\$ nominal) as at 1 July 2014. We instead determine an opening RAB as at 1 July 2014 of \$6774.2 million (\$ nominal). This represents a reduction of \$13.4 million (\$ nominal) or 0.2 per cent from Essential Energy's revised proposal. While this adjustment is small, we consider it necessary to comply with the NER requirement to increase the RAB by the amount of capex incurred during the previous regulatory control period.<sup>5</sup> As such, capitalised provisions should not increase the RAB until they are paid out (incurred) as expenses.

In the draft decision, we made adjustments to Essential Energy's gross capex to account for the net movements in capitalised provisions. We noted the roll forward of

<sup>4</sup> AER, *Draft decision - Essential Energy distribution determination attachment 2 - Regulatory asset base*, November 2014, pp. 10–13.

<sup>5</sup> NER, S6.2.1(e)(1)(i).

Essential Energy's RAB included an estimated capex value for 2013–14. We stated we would update the 2013–14 estimated capex value for the final decision.

Essential Energy's revised proposal updated the 2013–14 estimated capex adopted in the draft decision to reflect actual capex for that year. We have reconciled the 2013–14 actual capex in the revised proposal against Essential Energy's audited annual reporting RIN for 2013–14. We therefore accept the actual capex for 2013–14.

However, Essential Energy's revised proposal did not adopt our draft decision approach to adjusting its gross capex for the net movements in capitalised provisions.<sup>6</sup> It raised a few concerns with the approach, in particular:

1. Whether we are able to retrospectively adjust figures reported as actual in the previous regulatory control period under the NER. The NER provides that Essential Energy's RAB value as at 1 July 2009 must be increased by the amount of all capex incurred during the 2009–14 regulatory control period.<sup>7</sup>
2. The inconsistency of the approach with standard accounting practices.
3. The regulatory burden of the approach.

We have considered each of these concerns in previous decisions. These matters were discussed extensively in our transmission determination for ElectraNet.<sup>8</sup> In summary, our positions on these matters are:

1. The NER requires us to adjust capex for the net movement in capitalised provisions to reflect when these costs are actually 'incurred'.<sup>9</sup> We consider the net increase in capitalised provisions should not be included in the RAB as such provisions have not yet been paid out (incurred) as expenses. Net decreases to capitalised provisions indicate that expenses have been paid out and are therefore added to the RAB at that time.
2. Accounting systems may be indicative, but not determinative of whether the capex has been incurred or not during the 2008 to 2014 period for the purposes of determining the opening RAB as at 1 July 2014.<sup>10</sup> The economic regulation of service providers requires an approach that differs from the accounting standards in this matter.
3. The regulatory burden of our approach is minimal. The movement in provisions are records that are maintained under usual accounting systems. The reporting requirements for capitalised provisions to the AER have also been in place for some time in the annual reporting RINs that service providers complete.

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<sup>6</sup> Essential Energy, *Revised regulatory proposal*, 20 January 2014, pp. 85–86.

<sup>7</sup> NER, S6.2.1(e)(1)(i).

<sup>8</sup> AER, *Final decision: ElectraNet transmission determination 2013–14 to 2017–18*, April 2013, pp. 196–202. For an earlier example of the AER's considerations on this matter refer to: AER, *Draft Decision: Draft Distribution Determination Aurora Energy Pty Ltd, 2012–13 to 2016–17*, November 2011, pp. 197–201.

<sup>9</sup> NER, clause S6A.2.1(f)(3). Relevant High Court considerations are discussed in the ElectraNet final decision. AER, *Final decision: ElectraNet transmission determination 2013–14 to 2017–18*, April 2013, pp. 197–198.

<sup>10</sup> AER, *Final decision: ElectraNet transmission determination 2013–14 to 2017–18*, April 2013, pp. 198–199.

Essential Energy also submitted our approach could introduce further potential price volatility. We do not consider the movement in provisions causes price volatility as the roll forward occurs at the end of the regulatory control period (not on an annual basis) and is generally small compared to other end of period adjustments.

We do agree with Essential Energy's concern with the calculation of the movement in capitalised provisions in the draft decision.<sup>11</sup> Instead of removing only the net movement in provisions allocated to capex in the draft decision calculation, we also removed the increase to provisions allocated to capex. The draft decision calculation also only included the movement in the 'employee entitlements capitalised provision' and not the movement in other capitalised provisions such as 'workers compensation'. We have corrected these adjustments for this final decision. We are satisfied that these corrections address the calculation matters identified by Essential Energy in its submission.<sup>12</sup>

Table 2.5 sets out our final decision adjustment for the net movement in capitalised provisions, which reduces Essential Energy's 2008–14 gross capex by \$11.0 million (\$ nominal), other things being equal.

**Table 2.5 Essential Energy's movement in capitalised provisions (\$ million, nominal)**

|  | 2008–09 | 2009–10 | 2010–11 | 2011–12 | 2012–13 | 2013–14 |
|--|---------|---------|---------|---------|---------|---------|
| Net movement in capitalised provisions | 3.1     | 1.0     | 3.6     | 10.5    | -2.6    | -4.6    |

A number of submissions raised concerns with the size of Essential Energy's opening RAB and suggested a write down of asset values.<sup>13</sup>

The opening RAB reflects the capex incurred during the previous regulatory control periods. In the previous two regulatory control periods there was a significant increase in capex that only began to tail off in more recent years. We have no ability to adjust for past capex or to optimise/write down the opening RAB for efficiency considerations. Under the transitional rules, the review of past capex does not apply to Essential Energy prior to 1 July 2015.<sup>14</sup> Therefore, for the purposes of this final decision, we are required to add Essential Energy's actual capex from the 2009–14 regulatory control period to the RAB. However, with rule changes in 2012, we will have the ability to exclude inefficient capex incurred during the 2015–19 regulatory control period in future resets if it exceeds the approved forecast and if we consider it does not

<sup>11</sup> Essential Energy, *Supplementary Submission on draft decision - AER treatment of provisions*, 13 February 2015, pp. 4–8.

<sup>12</sup> Essential Energy, *Supplementary Submission on draft decision - AER treatment of provisions*, 13 February 2015, pp. 7.

<sup>13</sup> PIAC, *Submission on NSW draft decisions*, 14 February 2015, p. 60–61; Cotton Australia, *Submission on Essential Energy draft decision*, 13 February 2015, p.10–11; NSW Irrigators Council, *Submission on Essential Energy draft decision*, 13 February 2015, p. 10–11.

<sup>14</sup> NER, cl. 11.56.5.

reasonably reflect the capital expenditure criteria.<sup>15</sup> The details of our assessment approach for inefficient capex are set out in the *Capital expenditure incentive guideline*.<sup>16</sup>

## 2.4.2 Forecast closing RAB as at 30 June 2019

We forecast a closing RAB value of \$8720.4 million by 30 June 2019 for Essential Energy. This represents a reduction of \$278.4 million, or 3.1 per cent to Essential Energy's revised proposal. This reduction reflects our final decision on the required inputs for determining the forecast RAB in the post-tax revenue model (PTRM). To determine the forecast RAB value, we amended the following PTRM inputs:

- We reduced Essential Energy's revised proposed opening RAB as at 1 July 2014 by \$13.4 million or 0.2 per cent (section 2.4.1)
- We reduced Essential Energy's revised proposed forecast capex for the 2014–19 period by \$227.0 million or 8.1 per cent (attachment 6).
- We increased Essential Energy's revised proposed forecast regulatory depreciation for the 2014–19 period by \$38.0 million or 6.4 per cent (attachment 5).
- We reduced Essential Energy's revised proposed forecast inflation rate of 2.50 per cent per annum to 2.38 per cent per annum (attachment 3).

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<sup>15</sup> Under the NER, cl S6.2.2A(b), the exclusion of inefficient capex could only come from three areas including overspend in capex, margin paid to third party and capitalisation of opex as defined in cl S6.2.2A(c), (d) and (e) of the NER.

<sup>16</sup> AER, *Capital expenditure Incentive guideline*, November 2013, pp. 12–20.