**8-1 Response to Draft Decision: Capital Base**

**1. Introduction**

The AER’s Draft Decision did not approve Envestra’s opening capital base as at 1 January 2013 of $1,116.3 million ($nominal) for Victoria and $35.2 million ($nominal) for Albury, instead determining opening asset bases of $1,109.7 million ($nominal) for Victoria and $34.6 million ($nominal) for Albury. The AER also did not accept:

* the projected capital bases for Victoria and Albury for the 2013 to 2017 Access Arrangement period; and
* the proposed use of actual depreciation in favour of forecast depreciation to determine the opening capital bases at 1 January 2018.

The AER did however accept Envestra’s proposed change to the life of the “Meters” asset class and also proposed a change of its own to the life of the “SCADA” asset class.

Envestra accepts the AER’s Draft Decision opening capital bases as at 1 January 2013 of $1,109.7 million ($nominal) for Victoria and $34.6 million ($nominal) for Albury as well as the proposed change to the life of the “SCADA” asset class.

Envestra however does not accept the projected capital bases for the 2013 to 2017 Access Arrangement period as Envestra has not accepted the AER’s Draft Decision capital expenditure forecast (refer attachment 7.7). Envestra also does not accept the AER’s proposal to use forecast deprecation when determining the opening capital bases at 1 January 2018.

This attachment provides a revised projected capital base for Victoria and Albury during the 2013 to 2017 Access Arrangement period. It also explains why actual depreciation should be used when determining the opening capital bases at 1 January 2018.

**2. Projected Capital Base Roll Forward 2013 to 2017**

Table 1 below presents the projected capital base for Victoria over the 2013 to 2017 period, which reflects Envestra’s revised capital expenditure forecasts.

**Table 1: Roll-forward of the Capital Base 2013 to 2017 - Victoria**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **$m Nominal** | **2013** | **2014** | **2015** | **2016** | **2017** |
| Opening Capital Base  | 1,109.7 | 1,228.8 | 1,354.5 | 1,468.2 | 1,559.3 |
| Plus Conforming Capital Expenditure | 131.2 | 140.2 | 131.9 | 111.7 | 72.6 |
| Less Depreciation  | 39.8 | 45.3 | 52.0 | 57.3 | 62.0 |
| Inflation Adjustment | 27.7 | 30.7 | 33.9 | 36.7 | 39.0 |
| **Closing Value** | **1,228.8** | **1,354.5** | **1,468.2** | **1,559.3** | **1,608.9** |

Table 2 below presents the projected capital base for Albury over the 2013 to 2017 period, which reflects Envestra’s revised capital expenditure forecasts.

**Table 2: Roll-forward of the Capital Base 2013 to 2017 - Albury**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **$m Nominal** | **2013** | **2014** | **2015** | **2016** | **2017** |
| Opening Capital Base  | 34.6 | 35.3 | 36.2 | 36.9 | 37.3 |
| Plus Conforming Capital Expenditure | 1.3 | 1.6 | 1.4 | 1.3 | 2.0 |
| Less Depreciation  | 1.4 | 1.5 | 1.7 | 1.8 | 1.9 |
| Inflation Adjustment | 0.9 | 0.9 | 0.9 | 0.9 | 0.9 |
| **Closing Value** | **35.3** | **36.2** | **36.9** | **37.3** | **38.3** |

**3. Opening Asset Base as at 1 January 2018**

Rule 90(2) requires Envestra to nominate a depreciation approach to be used to establish the opening capital base for the next access arrangement period, in this case the 1 January 2018 opening asset base. Envestra nominated in its submission of 30 March 2012 that actual depreciation be used. In its draft decision the AER rejected Envestra’s proposal to use actual depreciation in favour of forecast depreciation largely on the basis that:

* gas distribution networks differ from electricity networks; and
* actual depreciation would provide Envestra with a perverse incentive to defer efficient capital expenditure.

The use of actual depreciation compared to forecast depreciation when establishing opening capital bases provides a capital efficiency incentive. This is because a distributor would gain a benefit by applying actual depreciation where actual capital expenditure is less than the benchmarks set by the regulator. The incentive is symmetrical, where a distributor would incur a penalty by applying actual depreciation where actual expenditure is greater than the benchmarks.

The AEMC discussed the relative power of actual depreciation as a capital incentive in its review into the Economic Regulation of Network Service Providers[[1]](#footnote-1).

As with Envestra’s South Australian and Queensland reviews, the AER continues to make the incorrect assumption that the dynamics of gas and electricity networks differ. The AER claims that a gas distributor has greater scope to defer replacement capital expenditure as it does not result in significant interruptions to supply, unlike an electricity network where delays to replacement capital expenditure will cause total disruptions to services[[2]](#footnote-2).

Envestra submits that this is incorrect. Envestra has as much, if not more, of a requirement to repair assets when compared against an electricity distributor for the following reasons:

1. *Safety* – leaking gas has the potential to cause a catastrophic event that could be fatal, which safety issue does not exist for an electricity distributor;
2. *Increased UAFG* – Envestra is liable for any increase in UAFG above the benchmark (i.e. operating expenditure is higher than what it otherwise should be). An electricity distributor on the other hand is not liable for the equivalent distribution losses and therefore has no incentive to minimise those losses; and
3. *Quality and reliability of supply* – Gas is a fuel of choice unlike electricity. A gas distributor that provides poor supply will lose customers. An electricity distributor never confronts this issue as gas can only replace electricity for a limited range of appliances and not the entire electrical load.

Envestra also notes that replacement capital expenditure only forms a third of the entire capital expenditure forecast while connection expenditure forms approximately half. Both gas and electricity face the same circumstances when connecting a new customer to their respective networks. As the circumstances are the same, Envestra believes that both gas and electricity distributors should face the same incentive to be efficient.

The AER has publicly stated concerns regarding “gold plating” of networks (i.e. inefficient capital expenditure). However, the AER appears steadfast in its refusal of the obvious solution to this problem, which is to apply capital expenditure incentive schemes and use actual depreciation in order to drive efficiency. Envestra notes the application of capital incentives is consistent with the outcomes of both the AEMC and Productivity Commission inquiries into network regulation, which inquiries identified the need for the AER to provide greater incentives to networks to expend capital efficiently (see attachment 11-1 for further discussion on this).

Envestra’s preferred position is for the AER to provide both a capital expenditure incentive mechanism and use actual depreciation to establish the asset base at 1 January 2018. However, were the AER to reject the application of capital expenditure incentive mechanism, then the application of actual depreciation is required.

1. *Draft Rule Determinations - Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012* issued by the AEMC on 23 August 2012, section 9.7 [↑](#footnote-ref-1)
2. AER Access Arrangement Draft Decision Envestra 2013-17, Part 2 Attachments, Section 2.4.5 p 35 [↑](#footnote-ref-2)