Explanatory Statement

Proposed

Electricity distribution network service providers roll forward model

April 2008

AUSTRALIAN ENERGY REGULATOR

Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) on the issues discussed in this paper by the close of business 14 May 2008. Submissions can be sent electronically to AERInquiry@aer.gov.au.

Alternatively, written submissions can be sent to:

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The AER prefers that all submissions be in an electronic format and publicly available, to facilitate an informed, transparent and robust consultation process. Accordingly, submissions will be treated as public documents and posted on the AER's website, www.aer.gov.au except and unless prior arrangements are made with the AER to treat the submission, or portions of it, as confidential.

Any enquiries about this issues paper, or about lodging submissions, should be directed to the AER's Network Regulation South Branch on (03) 9290 1444 or at the above email address.

Contents

Shortened forms

AER	Australian Energy Regulator
capex	capital expenditure
C&P	CitiPower and Powercor
CPI	consumer price index
DNSP	distribution network service provider
MEU	Major Energy Users Inc.
NER	National Electricity Rules
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model

1 Introduction

The AER is responsible for the economic regulation of distribution network service providers (DNSPs) in the National Electricity Market, in accordance with the National Electricity Rules (NER).

Under the NER, the AER is required to develop and publish certain models, guidelines and schemes. On 30 November 2007, the AER released an issues paper on the following guidelines, schemes and models that are required to be published under Chapter 6:

- post tax revenue model (PTRM)
- roll forward model (RFM)
- cost allocation guidelines
- efficiency benefit sharing scheme.

The AER also released a separate issues paper on the development of a service target performance incentive scheme. These issues papers formed part of a national consultation process that is separate to consultation specific to transitional guidelines, models and schemes for DNSPs in the ACT and NSW.

The AER received 14 submissions on its issues paper. This explanatory statement sets out the AER's consideration of comments raised in these submissions and the resulting proposed RFM and handbook. In some instances stakeholders raised concerns that need to be addressed in the preparation and assessment of regulatory proposals. These concerns are noted throughout this explanatory statement.

This explanatory statement, proposed RFM and associated handbook have been prepared to satisfy the AER's obligations under clause 6.16(b) of the NER.

2 Rule requirements

Clause 6.5.1(d) of the NER requires the AER to publish a RFM within 6 months of the commencement of that clause, that is, by 30 June 2008. In doing so, the distribution consultation procedures in Part G require the AER to publish a proposed RFM, explanatory statement and invitation for submissions. Stakeholders must be allowed at least 30 business days to make submissions to the AER. Within 80 business days of publishing the proposed RFM, the AER must publish its final decision and RFM.

3 Reasons for the roll forward model

Under clause S6.1.3(10), each DNSP is required to submit a completed RFM to the AER as part of its building block proposal. The RFM sets out the calculation of the regulatory asset base (RAB) from the beginning of one regulatory period to the beginning of the next period, as well as from year to year within each period. The RAB values from the RFM form inputs into the PTRM, where they are rolled forward from year to year on an indicative basis, and are used in the calculation of annual revenue requirements. The RFM performs these calculations using actual data whereas the PTRM uses forecast data provided in a DNSP's revenue proposal.

4 Issues raised in submissions and the AER response

4.1 Consistency with RFM for transmission

In its issues paper released in November 2007, the AER noted the commonality between the requirements of chapter 6 and 6A regarding the RFM. In this context the AER suggested using the RFM it had developed for electricity transmission as a basis for the electricity distribution RFM. Key elements of the transmission RFM include:

- the use of actual depreciation as per the incentive arrangements in chapter 6A
- the use of a straight-line depreciation method (following from that in the PTRM)
- allowances for the hybrid approach to recognising capital expenditure (capex), as per the PTRM
- a tax asset roll forward calculation
- adjustments for forecast inflation and capex in the final year of the previous period, and the removal of any associated benefits or penalties.

4.1.1 Stakeholder comments

Stakeholders generally noted that the RFM developed for transmission could be used as a basis for the distribution RFM. Many stakeholders commented that the RFM must be able to accommodate the ability to use actual or forecast depreciation under clause S6.2.1(e)(5), as well as transitional roll forward methods (eg. as might be required under chapter 11).

While also suggesting flexibility to use either forecast or actual depreciation, ETSA Utilities favoured the use of actual depreciation on the basis that there appeared to be no justifications for differences between the approaches used in transmission and distribution regulation. It supported the use of existing jurisdictional models for transitional purposes, provided these were free of errors and published.

United Energy Distribution and Alinta suggested that the RFM would also require amendment to account for different approaches to recognising capex (i.e. they considered the “hybrid” approach may not be suitable) and to incorporate capital contributions.

The Major Energy Users Inc (MEU) noted that the asset calculations for DNSPs were likely to be more complex and detailed than for TNSPs, however, it suggested the AER seek more detail rather than too little in developing the RFM.

Energex requested that the RFM be expanded to incorporate 50 asset classes to reflect the varied mix of assets owned by DNSPs. It also noted that the transmission RFM calculates indexation of the RAB as part of regulatory depreciation, and sought clarification on how and when the RAB calculations in the distribution PTRM and RFM would be reconciled.

Aurora Energy noted that certain elements of its current determination, specifically metering revenues, may not be amenable to a RFM and therefore require specific consideration by the AER.

4.1.2 AER conclusion

The AER has adopted the transmission RFM as a basis for the proposed distribution RFM. In accordance with the AER's decision to implement a full as-incurred approach and to recognise capital contributions in the proposed distribution PTRM, the proposed distribution RFM will incorporate these features.

The AER notes that clause S6.2.1(e)(5) envisages the application of alternative capex incentive frameworks in distribution determinations, in the form of actual or forecast depreciation. However, the AER prefers the use of actual depreciation as it provides a stronger capex incentive framework and has retained this as a default method in the proposed RFM. DNSPs will be able to suggest the use of forecast depreciation as it may be required under transitional provisions or otherwise suit the particular characteristics of the business.

The AER will consider the use of existing jurisdictional models in the context of each individual DNSP. The AER will consult with the relevant DNSP and jurisdictional regulator on this and other transitional issues. The AER notes Aurora Energy's comments and anticipates that some DNSPs will require RAB adjustments in relation to service classifications under the new chapter 6 definitions.

In response to Energex's comments, the proposed RFM and PTRM are currently configured to perform calculations using 20 asset categories, but can be amended to accommodate more if desired. The models require assets to be grouped according to common lives. It is unclear whether 50 classes would be necessary for most DNSPs such that the generic models would require amendment. Such amendment could be made at the request of stakeholders as part of this consultation. The AER notes that the RAB calculations in the PTRM are based on forecast values of capex and inflation and therefore will necessarily differ from the calculations in the RFM, which are based on actual values. Accordingly, there is no intention or NER requirement to reconcile the RAB values from the two models.

4.2 Adjustments for final year of previous period

4.2.1 Stakeholder comments

C&P noted an inconsistency between the adjustments for forecast capex in the final year of the previous period in relation to the regulatory asset base and the tax asset base. It considered that the tax asset base should also be adjusted to ensure DNSPs are no worse or better off from the correction for forecast error in this year.

4.2.2 AER conclusion

The AER notes that the use of forecast depreciation in the final year of the previous period is applied to the RAB in order to ensure there is no incentive to under or over-forecast values in that year. That is, the DNSP's RAB will be reduced in accordance with the amount of capex it forecasts for that year.

The AER acknowledges that the RFM applies different adjustments to the RAB and tax asset values to account for forecast capex in the final year of the previous period. The adjustments applied to the RAB are required under clause S6.2.1(c)(2) and S6.2.1(e)(3) to neutralise any incentives on DNSPs to under or over-forecast capex for that final year. Part of this adjustment is to apply the depreciation associated with the forecast capex amount. Such an adjustment is not applied to the roll forward of tax values because these assets must be calculated using actual values of capex and depreciation.

4.3 Inflation

4.3.1 Stakeholder comments

Ergon Energy sought clarification as to the role of actual inflation in the RFM, specifically whether this relates to the use of actual capex and actual depreciation.

Energex also questioned the relationship between clause 6.5.1(e)(3) and S6.2.3(4), which both relate to indexation of the RAB, and stated that the RFM does not appear to identify indexation of the RAB but is a component of regulatory depreciation. Energex stated that the AER should have regard to the return on capital, estimated cost of corporate income tax and forecast capital expenditure when developing the RFM.

4.3.2 AER conclusion

The requirement of clause 6.5.1(e)(3) requires indexation of the RAB in the RFM to be done in a manner that is consistent with the indexation of the form of control for that period. This must be consistent in order to avoid distortions to asset values arising from different inflation values.

In the AER’s PTRM the indexation of the RAB is deducted from nominal depreciation to derive a “regulatory depreciation” building block. This is done to avoid confusion that may arise by explicitly listing a building block that is negative, which, while correct, appears counter-intuitive. Since the asset calculations in the PTRM necessarily dictate those in the RFM, the combination of indexation and nominal depreciation is also done in the RFM.

The PTRM incorporates forecast calculations of the RAB using the method outlined in clause S6.2.3, which are necessary for the calculation of several building blocks, including indexation of the RAB under clause 6.4.3(b)(1), which is equivalent to the amount under clause S6.2.3(c)(4).

In developing the RFM, the AER has had regard to the need to account for the effects of forecast capex and related return on capital calculations. These are reflected as part of the adjustments made in the final year of the previous period.

4.4 Linkages with information requirements

4.4.1 Stakeholder comments

Energex commented generally that the AER should consider current reporting arrangements and that imprudent deviations from these could result in additional costs to the business.

4.4.2 AER conclusion

The AER intends to undertake a separate consultation process with businesses regarding the development of DNSP information requirements under the National Electricity Law, including for annual performance reporting. The relationship between these requirements and the PTRM will be taken into account in recognition of the need to streamline requests and avoid duplication where appropriate.

5 AER preliminary positions

In response to stakeholder comments and in the context of the AER's conclusions listed in previous sections, the AER has decided to publish the proposed RFM at Appendix B under the consultation procedures in clause 6.16(b)(1). The AER has published a proposed RFM handbook at Appendix C to accompany this model.

Appendix A: Submissions received on the roll forward model

The following interested parties provided submissions on the AER's issues paper that was released in November 2007:

- ActewAGL
- Alinta
- Aurora Energy
- CitiPower and Powercor
- Country Energy
- Energex
- Energy Networks Association
- Ergon Energy
- Essential Services Commission of South Australia
- ETSA Utilities
- Integral Energy
- Major Energy Users Inc.
- SP AusNet
- United Energy Distribution.

Copies of these submissions are available on the AER's website at www.aer.gov.au.

Appendix B: Proposed roll forward model

Appendix C: Proposed roll forward model handbook