**Attachment 8-2 Draft Decision Response: Capital Base**

*This attachment sets out:*

* *amendments made by Envestra consequential to the Draft Decision; and*
* *where the AER has set out required amendments that Envestra does not accept, this attachment sets out the reasoning for the rejection of the AER’s amendments.*
1. **Introduction**

In its Draft Decision, the AER did not accept Envestra’s determination of the opening asset base as at 1 July 2011. This primarily reflected the AER decision to use forecasting depreciation in adjusting the regulatory asset base (RAB) rather than actual depreciation, a decision it also took for the next regulatory period.

1. **Response to Draft Decision**

Envestra has accepted the decision to apply forecast depreciation in rolling forward the RAB over the current regulatory period. This reflects that the Queensland Competition Authority (QCA) was most likely to also apply forecast depreciation over the current period, although it did not specifically state that it would. Envestra has accepted the 1 July 2011 opening asset value of $316.4 million as determined by the AER.

Envestra however maintains its position that actual depreciation should be applied to adjust the RAB from 1 July 2011, unless the AER accepts Envestra’s proposal to include capital expenditure in the efficiency carryover mechanism (ECM) to apply over the next regulatory period.

1. **Actual versus Forecast Depreciation from 1 July 2011**

As already noted, Envestra has accepted the AER preference to apply forecast depreciation in rolling forward the RAB over the current regulatory period.

Despite this, Envestra has a strong preference to apply actual depreciation to adjust its RAB and proposed that this approach be applied in rolling forward the RAB from 1 July 2011. This primarily reflects that the use of actual depreciation in adjusting the RAB strengthens the incentives to improve efficiencies, particularly in cases where capital expenditure is not included in the ECM.

This section addresses the matters raised by the AER in support of applying forecast depreciation as opposed to actual depreciation.

* 1. **Differences between Gas and Electricity Networks**

The AER applies actual depreciation to adjust the RAB for electricity distributors. However, the AER has argued in its Draft Decision that forecast depreciation is more appropriate for the gas sector because ‘gas distributors generally operate in a less dynamic market, which can give them scope to defer expenditure as the situation allows’.

The AER has also pointed to the absence of a formal service quality incentive scheme in the gas sector, implying that there is less incentive to direct expenditure towards improving service quality. On this basis, the AER considered that the forecast depreciation approach is neutral in terms of its impact on a businesses spending on capital expenditure.

Envestra disagrees with these assertions because gas, unlike electricity, is a fuel of choice. Whilst no formal service quality incentive regime is in place, if consumers are dissatisfied with the level of Envestra’s service, they have the option of reverting to electricity in place of gas for their energy requirements. This provides a continuous incentive for Envestra to direct expenditure towards improving its level of service.

* 1. **Consistency Across Jurisdictions**

The AER has supported its decision to apply forecast depreciation to Envestra on the basis that this approach is consistent with its previous decisions for gas distributors, namely ActewAGL, Country Energy (Wagga Wagga) and Jemena NSW. However, each of these networks elected, under rule 90(2) of the NGR, to use a forecast depreciation approach.

While other distributors may have elected to use forecast depreciation, Envestra elects to use actual depreciation, which is the approach applied to electricity distributors. Not accepting Envestra’s proposal to use actual depreciation can not therefore be based on consistency grounds. In any event, there is no reason as to why depreciation needs to be applied consistently across gas businesses.

* 1. **Negative Asset Base**

Envestra notes that the use of forecast depreciation can result in negative asset values, which is inconsistent with normal accounting practice. Incorporating negative RAB values is contrary to section 24(2) of the National Gas Law (NGL), which section states that Envestra must be provided with a reasonable opportunity to recover its efficient costs. Including negative asset values is contrary to this requirement.

* 1. **Concluding Remarks**

Envestra notes that r. 90(2) of the National Gas Rules (NGR) requires that, in calculating depreciation for rolling forward the opening asset base from one access arrangement period to the next, ‘the provisions must resolve whether depreciation of the capital base is to be based on forecast or actual capital expenditure’. Envestra has elected to apply actual depreciation to adjust the RAB from 1 July 2011.

The primary reason for adopting actual depreciation is that it strengthens the incentives on Envestra to incur efficient expenditure, particularly where capital expenditure is not included in the efficiency carryover mechanism. Envestra considers that the arguments to apply forecast depreciation do not outweigh the benefits of applying actual depreciation.

Envestra therefore considers that applying actual inflation is more likely to be consistent with the National Gas Objective (section 23 of the NGL) in promoting efficient investment in the network that is in the long term interests of consumers. Envestra also notes that actual depreciation is more consistent with an approach that allows Envestra to recover its efficient costs, as required by section 24(2) of the NGL.

1. **Summary: Opening Asset Base as at 1 July 2011**

The table below details the opening asset base as at 1 July 2011.

Table 8.1 Roll Forward of the Capital Base 2006-07 to 2010-11

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **$m Nominal** | **2006-07** | **2007-08** | **2008-09** | **2009-10** | **2010-11** |
| Opening Capital Base | 230.5 | 249.9 | 269.4 | 283.8 | 299.3 |
| *Less* Depreciation | 4.9 | 5.5 | 6.3 | 7.1 | 7.7 |
| *Plus* Conforming Capital Expenditure | 18.4 | 14.1 | 13.8 | 14.2 | 17.0 |
| *Plus* Indexation | 5.8 | 10.9 | 6.8 | 8.4 | 7.8 |
| **Closing Value** | 249.9 | 269.4 | 283.8 | 299.3 | 316.4 |

1. **Summary: Opening Asset Base as at 1 July 2016**

The table below details the opening asset base as at 1 July 2016.

Table 8.2 Roll Forward of the Capital Base 2011-12 to 2015-16

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **$m Nominal** | **2011-12** | **2012-13** | **2013-14** | **2014-15** | **2015-16** |
| Opening Capital Base |  316.4  |  347.0  |  382.1  |  411.2  |  441.0  |
| *Less* Depreciation | 10.8  | 12.2  | 13.4  | 13.9  | 15.1  |
| *Plus* Conforming Capital Expenditure |  33.4  |  38.6  |  32.9  |  33.4  |  36.7  |
| *Plus* Indexation |  8.0  |  8.7  |  9.6  |  10.4  |  11.1  |
| **Closing Value** |  347.0  |  382.1  |  411.2  |  441.0  |  473.7  |