FINAL DECISION
Essential Energy
Distribution Determination

2019 to 2024

Attachment 4
Regulatory depreciation

April 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Essential Energy for the 2019–2024 regulatory control 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 attachments have been numbered consistently with the equivalent attachments to our longer draft decision. In these circumstances, our draft decision reasons form part of this final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 4 – Regulatory depreciation

Attachment 7 – Corporate income tax

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

Attachment 15 – Alternative control services

Attachment 18 – Tariff structure statement

Attachment A – Negotiating framework

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CPI	consumer price index
NER	National Electricity Rules
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
WACC	weighted average cost of capital

4 Regulatory depreciation

Depreciation is the allowance provided so capital investors recover their investment over the economic life of the asset (return of capital). In deciding whether to approve the depreciation schedules submitted by Essential Energy (Essential), we make determinations on the indexation of the regulatory asset base (RAB) and depreciation building blocks for Essential's 2019–24 regulatory control period.[1]

The regulatory depreciation allowance is the net total of the straight-line depreciation less the indexation of the RAB.

This attachment sets out our final decision on Essential's regulatory depreciation allowance, including an assessment of the proposed standard and remaining asset lives used for forecasting depreciation.

4.1 Final decision

Our final decision is to determine a regulatory depreciation allowance of $695.4 million ($nominal) for Essential over the 2019–24 regulatory control period. This amount represents a reduction of $2.8 million (or 0.4 per cent) on the $698.3 million ($nominal) in Essential's revised proposal.[2] It is $20.7 million (or 2.9 per cent) lower than the regulatory depreciation allowance determined in the draft decision. In coming to this decision:

- We accept Essential's revised proposed straight-line method to calculate the regulatory depreciation allowance, which is consistent with our draft decision.
- We accept Essential's revised proposed asset classes and standard asset lives subject to a change arising from the tax review (attachment 7).
- We accept Essential's revised proposed weighted average method to calculate the remaining asset lives as at 1 July 2019, which is consistent with our draft decision. In accepting the weighted average method, we have updated Essential's remaining asset lives as at 1 July 2019 to reflect our update to the RAB roll forward for the 2014–19 regulatory control period for 2018–19 actual inflation (attachment 2).
- We made determinations on other components of Essential's revised proposal, which affects the RAB and in turn impacts the forecast regulatory depreciation allowance. The decrease to the regulatory depreciation allowance from the revised proposal reflects our adjustments to the opening RAB as at 1 July 2019 and projected RAB over the 2019–24 regulatory control period (attachment 2).[3]

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[1] NER, cll. 6.12.1, 6.4.3.

[2] Essential Energy, *Revised proposal – 8.1 standard control service PTRM*, December 2018.

[3] Capex enters the RAB net of forecast disposals and capital contributions. It includes equity raising costs (where relevant) and the half-year WACC to account for the timing assumptions in the PTRM. We have accepted Essential's revised proposed forecast capex for the 2019–24 regulatory control period (section 2.4 of the overview). However we have amended the revised proposed rate of return (section 2.2 of the overview). Therefore,

Table 4.1 sets out our final decision on the forecast regulatory depreciation allowance for Essential over the 2019–24 regulatory control period.

Table 4.1 AER's final decision on Essential's forecast regulatory depreciation for the 2019–24 regulatory control period ($million, nominal)

	2019–20	2020–21	2021–22	2022–23	2023–24	Total
Straight-line depreciation	286.1	327.2	358.5	392.3	399.1	1763.2
Less: inflation indexation on opening RAB	196.5	206.9	214.5	221.7	228.2	1067.8
Regulatory depreciation	**89.6**	**120.4**	**144.1**	**170.5**	**170.9**	**695.4**

Source: AER analysis.

Standard asset lives for 2019–24

For this final decision, we accept Essential's revised proposed standard asset lives for its asset classes in respect of the forecast capex to be incurred for the 2019–24 regulatory control period subject to a change arising from the tax review (attachment 7).

The change relates to different methods of calculation of tax depreciation for different asset classes, which resulted in the addition of a new ‘In-house software’ asset class to the PTRM and a reallocation of forecast capex from the existing IT systems’ asset class. However, this change does not impact the regulatory depreciation allowance because we assign the same standard asset life as the class for which the forecast capex was originally allocated. Specifically, we have assigned a standard asset life of 5 years for the ‘In-house software’ asset class that is consistent with the ‘IT systems’ asset class from which the forecast capex was reallocated. In response to an information request, Essential stated that it has no concerns with this approach.[4]

Our final decision also confirms the standard asset life of the new asset class for ‘Capitalised property leases’ and the standard asset life of the ‘Equity raising costs’ asset class. This is consistent with the approach in our draft decision and adopted in Essential’s revised proposal. In our draft decision, we accepted Essential’s proposed standard asset life for the ‘Capitalised property leases’ because it reflected the expected average economic life of the leases to be capitalised in the asset class for the 2019–24 regulatory control period. However, we amended the standard asset life for the ‘Equity raising costs’ asset class to reflect the lives of the mix of assets making up the approved forecast net capex because the equity raising cost benchmark is associated with that forecast. We noted that these standard asset lives should be reviewed at each reset.

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our final decision on the forecast RAB also reflects our amendments to the rate of return for the 2019–24 regulatory control period (attachment 2).

4 Essential Energy, *Email: Updated capex model*, dated 11 March 2019.

Table 4.2 sets out our final decision on Essential's standard asset lives for the 2019–24 regulatory control period. We are satisfied the standard asset lives would lead to a depreciation schedule that reflects the nature of the assets over the economic lives of the asset classes. Further, the sum of the real value of the depreciation attributable to the assets would be equivalent to the value at which the assets were first included in the RAB for Essential.[5]

Remaining asset lives as at 1 July 2019

For this final decision, we accept Essential's revised proposed weighted average method to calculate the remaining asset lives as at 1 July 2019. Essential's revised proposal adopted our draft decision, where we accepted its initial proposal's application of the approach as set out in our roll forward model (RFM). In accepting the weighted average method, we have updated Essential's remaining asset lives to reflect our adjustment to the revised proposed RFM for 2018–19 actual CPI. As discussed in attachment 2, we made an update to inputs in Essential's revised proposed RFM and accordingly updated the remaining asset lives as at 1 July 2019. This is because some of the inputs in the RFM, such as actual inflation, affect the value of assets in the RAB and in turn, the calculation of the remaining asset lives as at 1 July 2019. Our approach to updating is consistent with our draft decision.

For the new 'In-house software' asset class we have not assigned remaining asset lives as there is no opening asset value for this asset class, only forecast capex is being allocated to this asset class over the 2019–24 regulatory control period. We therefore record 'n/a' in the PTRM for this asset class.

Table 4.2 sets out our final decision on remaining assets lives as at 1 July 2019 for Essential.

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5 NER, cll. 6.5.5(b)(1)-(2).

Table 4.2 AER's final decision on Essential's standard and remaining asset lives as at 1 July 2019 (years)

Asset class	Remaining asset life as at 1 Jul 2019	Standard asset life
Sub-transmission lines and cables	35.4	54.9
Distribution lines and cables	41.2	53.8
Substations	23.4	40.2
Transformers	25.9	45.8
Low voltage lines and cables	32.9	51.5
Customer metering and load control	20.0	25.9
Communications	5.4	7.0
Land	n/a	n/a
Easements	n/a	n/a
IT systems	4.2	5.0
Furniture, fittings, plant and equipment	5.5	13.0
Motor vehicles	7.3	8.0
Land (non-system)	n/a	n/a
Other non-system assets	8.4	15.0
Capitalised property leases	n/a	8.0
Buildings	44.9	50.0
In-house software	n/a	5.0
Equity raising costs	37.0	39.5

Source: AER analysis.

n/a not applicable. We have not assigned a standard asset life to some asset classes because the assets allocated to those asset classes are not subject to depreciation. The asset classes for 'Capitalised property leases' and 'In-house software' are new, so they have no remaining asset life at this time.

4.2 Assessment approach

We did not change our assessment approach for regulatory depreciation from our draft decision. Attachment 4 (section 4.3) of our draft decision details that approach.[6]

6 AER, *Essential Energy 2019–24 – Draft decision – Attachment 4 – Regulatory depreciation*, November 2018, pp. 7–8.