Jemena Gas Networks (NSW) Ltd - Initial response to the draft decision

Appendix 3b.10

Overview of regulatory precedent - Capitalisation of overheads - March 2010

19 March 2010

1 Summary

The AER has not approved JGN's inclusion of an allowance of 6 per cent of direct capital costs as an allocation of Jemena Asset Management's overhead costs. JGN has surveyed regulatory decisions to determine what allowances for overheads other regulators have approved. This demonstrates that inclusion of overhead costs as part of capital expenditure is both reasonable and prudent.

It also enables benchmarking of JGN's capitalised overhead allowance against allowances proposed by other businesses and approved by regulators, including the AER and its predecessor the ACCC.

The following conclusions can be drawn from the survey results:

- regulators have universally accepted that capitalisation of overhead is reasonable and an economically efficient practice; and
- capitalised overhead allowances have varied between 4.7% and 30%.

Table 1 Survey of capitalisation of overheads by regulated gas and electricity networks

Network and relevant decisions and documents	Proposed %	Approved %	Key considerations	Relevant quotes
New South Wales				
Network Wagga Wagga Natural Gas System Regulator IPART Relevant decisions/documents Final Decision – Access Arrangement Great Southern Energy Gas Networks Pty Limited (March 1999)	-	15%	In its draft decision on the Depreciated Actual Cost to be applied to Great Southern Energy's (GSE) gas network, IPART estimated that an additional 15% should be added to take into account the capitalisation of overheads. This decision was based on an assessment undertaken by the consultant Kinhill Pty Ltd, which concluded that an appropriate overhead rate lay between 14% and 16%. The Gross Actual Cost of GSE's initial capital base was estimated at $21.7m. An additional $3.255m was added to account for the capitalisation of overheads.	*"As part of its asset valuation review, the Tribunal obtained an independent assessment of the rate of capitalisation of overheads. Consultant, Kinhill Pty Ltd, concluded that an appropriate overhead rate is 14-16 percent."* IPART (1999), pg 181.
Networks Electricity distribution networks – EnergyAustralia (EA), Integral Energy and Country Energy Regulator AER Relevant decisions/documents Draft decision – New South Wales draft distribution determination 2009-10 to 2013-14: Alternative control (public lighting) services (March 2009)	Materials: EA – 20%; Country Energy – 56%; Integral Energy – NA Plant: EA – NA; Country	Materials: EA – 20%; Country Energy – 30%; Integral Energy – NA Plant: EA – NA; Country	The AER acknowledged the need for the inclusion of overhead costs in the efficient cost bases of the DNSPs. In its draft decision, the AER highlighted that it expected the overhead allocation to alternative control services to be consistent with the cost allocations methods of the DNSPs as approved by the AER. In response to Country Energy's proposed overhead rates of 56% for materials and 48% for existing plant, the AER commented that while there was a case for Country Energy's overhead premium to be higher given the nature of its network, the difference was not as significant as was indicated by the proposal. In its supplementary draft decision the AER determined	*"With respect to overhead rates for materials, the AER accepts that some quantum of general overhead is appropriate to reflect general support activities such as corporate finance and human resources. The AER expects that the overhead allocation to alternative control services to be consistent with each DNSP's cost allocation method approved by the AER".* AER (2009) Draft decision – New South Wales draft distribution determination 2009-10 to 2013-14: Alternative control

Network and relevant decisions and documents	Proposed %	Approved %	Key considerations	Relevant quotes
Final decision – New South Wales distribution determination 2009-10 to 2013-14 (April 2009)	Energy – 48%; Integral Energy – NA	Energy – 30%; Integral Energy – NA	that a 5% premium on the rates applied by the other DNSPs was reasonable. On this basis the AER required Country Energy to recalculate its charges by applying an overhead rate of 25% for both plant and materials. Country Energy maintained its initial position in its revised proposal, commenting that the length of its network and the diversity of its assets had significant implications on the costs of managing its public lighting inventory. In its final decision, the AER determined that a premium of 10% would more than reasonably reflect the costs associated with Country Energy's operating environment and therefore an overhead rate of 30% should be applied to its plant and materials.	(public lighting) services, pg 27. *"The AER acknowledged that as a rural distribution business, Country Energy faces costs that would not be experienced by an urban counterpart.* *…* *For this reason, the AER considers that a premium of 10 per cent would more reasonably reflect the costs associated with operating in its environment. The AER considers a plant overhead rate of 30 per cent and materials overhead rate of 30 per cent for Country Energy is reasonable."* AER (2009). Final decision – New South Wales distribution determination 2009-10 to 2013-14, pg 375.
Victoria				
Networks Envestra gas networks (Albury and Victoria) Multinet gas network SP AusNet gas network Regulator	15% (SP AusNet) 17% (Envestra)	16% base rate & 10% for >$36.3m (Envestra) 15% base rate & 10%	SP AusNet and Envestra both submitted proposals to include capital overhead costs in their capex allowances. Multinet advised that it did not incur any capital overhead costs. SP AusNet proposed the following: a rate of 15% be applied to all non-IT capex, based on	*"The Commission considers that taking into account the variable nature of capital overheads and Envestra's acceptance of a reduced overhead rate (of 10 per cent) for increasing levels of capital expenditure, a threshold level of $36.3 million and base overhead rate of 16 per*

Network and relevant decisions and documents	Proposed %	Approved %	Key considerations	Relevant quotes
ESC Relevant decisions/documents Final Decision – Gas Access Arrangement Review 2008-2012 (March 2008)		for >$40m (SP AusNet) Based on direct capex allowances, the average rates for capitalised overheads were: 12.5% for Envestra 13.5% for SP AusNet.	calculations suggesting that the level of its overheads applicable to gas-related projects is 15% of expenditure; and a rate of 10.7% be applied for IT projects. Envestra proposed the following: a rate of 17% be applied to all categories of capex except augmentations to determine the allowance for capitalised overhead costs; a rate of 10% be applied for augmentation capex; and no overhead allowance be applied for IT and other capex. The ESC did not consider it appropriate to appropriate to apply a flat rate to account for capitalised overhead costs. It proposed that capitalised overhead allowances be calculated using the following methodology: a rate of 15% be applied for gross direct capex of up to $40m per annum; and a rate of 10% be applied for any additional capex. The ESC accepted SP AusNet's proposed rate for capital overheads relating to IT capex of 10.7% and Envestra's proposed rate of 10% for augmentation capex on its Victorian network. For Envestra's Albury network, the ESC considered it appropriate for capital overheads to be calculated at rates of 15% for normal capex and 10% for augmentation capex. In its revised proposal Envestra submitted that its overhead	*cent is reasonable for Envestra's Victorian network."* ESC (2008), pg 414. *"The Commission considers SP AusNet's 2006 regulatory accounts demonstrate that a rate of 15 per cent for the first $40 million allows for incremental economies of scale. The regulatory accounts indicate that the rate may reduce earlier than the $40 million proposed by the Commission. Therefore, on balance, the Commission considers that its proposed draft decision for SP AusNet that includes a base overhead rate of 15 per cent for direct (non IT) capital expenditure up to $40 million and a 10 per cent rate thereafter is appropriate and reasonable."* ESC (2008), pg 415.

Network and relevant decisions and documents	Proposed %	Approved %	Key considerations	Relevant quotes
			rate should be based on 2006 gas regulatory accounts data, which indicated that an appropriate overhead rate was 16%. For its Albury network, Envestra submitted that its capital overhead rate should be increased to 23%. SP AusNet did not accept the ESC's draft decision, and proposed that a flat overhead rate of 15% should be applied to its non-IT capex. The details of the ESC's final decision were as follows. For Envestra: a base overhead rate of 16% for its Victorian network, with a rate of 10% for increasing levels of capex (over $36.3m per annum); and a flat rate of 16% for the Albury network. For SP AusNet – the approach adopted in the draft decision was considered to be appropriate and reasonable – base rate of 15% for non-IT capex up to $40m and a rate of 10% for additional capex.	
Networks Victorian Distribution Network Service Providers – Citipower, Powercor, Jemena (AGLE), SP AusNet and United Energy Regulator ESC Relevant decisions/documents Final Decision, 'Electricity Distribution Price	AGLE – 8.3% Citipower – 18.9% Powercor – 13.3%	AGLE – 4.7% Citipower – 16.8% Powercor – 8.1%	Three of the DNSPs submitted allowances for capitalised overhead costs – AGLE, Citipower and Powercor. The other DNSPs opted to expense these costs. The initial proposals for capitalised indirect corporate overheads were as follows: AGLE - $16.6m; Citipower - $74m; and Powercor - $98.2m.	*"…the Commission has adjusted the amount of indirect (corporate) overhead costs included in the capital expenditure forecasts by an amount equal to the difference between the indirect (corporate) overhead costs forecast by the distributors over the 2006-10 regulatory period and those calculated in accordance with the Commission's*

Network and relevant decisions and documents	Proposed %	Approved %	Key considerations	Relevant quotes
Review 2006-10 – Final Decision Volume 1: Statement of Purpose and Reasons.' (October 2005)			The ESC ruled that it was appropriate to apply downward adjustments to each of these proposed allowances. The approved allowances for capitalised indirect corporate overheads in the ESC's draft decision were as follows: AGLE - $9.1m; Citipower - $52.8m; and Powercor - $56.9m. In its final decision the ESC stated that it considered that capitalised overhead costs should be assessed in the same way as opex and maintenance expenditure forecasts. It was based on this consideration that the ESC determined, in its final decision, to adjust the proposed overheads allowances by an amount equal to the difference between the proposals and the allowance calculated in accordance with this methodology. The capitalised indirect corporate overheads allowances approved by the ESC in its final decision were as follows: AGLE - $9.5m (4.7% of rest of capex); Citipower - $66m (16.8% of rest of capex); and Powercor - $59.6m (8.1% of rest of capex).	*operating and maintenance expenditure framework and approach based on 2004 reported indirect (corporate) overheads."* ESC (2005), pg 274. *"The adjustment between the distributors' proposed capitalised indirect (corporate) overheads and the Commission's view of an appropriate level of capitalised indirect (corporate) overheads for the 2006-10 regulatory period has been prorated across the asset categories, based on the level of indirect (corporate) overheads allocated to each capital expenditure asset category by the relevant distributor."* ESC (2005), pg 275.
South Australia				
Networks South Australian Distribution Systems Regulator	23%	17.5%	SAIPAR requested that Envestra, as part of the 2000 review of its access arrangement, provide additional information relating to the level of overheads included in its valuation of the initial capital base. This request was a	*"…SAIPAR recognised and accepted that on-costs are an appropriate component in determining the overall value of the network. In addition, based*

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South Australian Independent Pricing & Access Regulator (SAIPAR) Relevant decisions/documents Draft decision – Access Arrangement for the South Australian Distribution Systems (April 2000) Final decision – Access Arrangement for Envestra Limited's South Australian Natural Gas Distribution System (December 2001)			result of the regulator holding concerns over the initial proposal of an overhead rate of 25%. Envestra engaged GHD to undertake a more detailed assessment of overhead costs. GHD estimated that a rate of 23% was appropriate. In its draft decision, SAIPAR acknowledged that on-costs were an appropriate component in determining the overall value of the network, but proposed to reduce the rate to apply to "on-costs" from 23% to 20%. Envestra objected to this decision, claiming that the regulator had based its decision on incorrect data and that, based on advice provided by GHD, unit rates for distribution businesses included an overhead of 25%. In spite of the evidence provided by Envestra in its revised proposal, SAIPAR determined that there was sufficient evidence to demonstrate that other networks were able to function appropriately with an on-cost rate for construction of below 20%. SAIPAR subsequently formed the view that an appropriate range for the on-cost rate was 14-18%. It was then determined that the appropriate on-cost rate to be applied to Envestra's distribution system was 17.5%.	*on the analysis carried out and on available information, SAIPAR concluded that the rate applicable to on-costs should be reduced to 20% from 23%."* SAIPAR (2001), pg 60. *"Giving due consideration to all information submitted and consultation with Envestra and the Technical Regulator, SAIPAR has formed the view that an appropriate range to consider would be reflected by a minimum of 14% and maximum of 18% in this case. In determining the final level, relevant information must be balanced against code requirements, and as far as possible to reflect an appropriate on-cost for the specific distribution assets being considered. SAIPAR has formed the view that an appropriate on-cost rate to be applied to the South Australian Envestra distribution system is 17.5%."* SAIPAR (2001), pg 62.