**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 forecast depreciation in adjusting the regulatory asset base (RAB) rather than actual depreciation, a decision it also took for the next regulatory period. The AER also amended the manner by which inflation was applied to adjust the RAB.

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 Essential Services Commission of South Australia (ESCOSA) was most likely to also apply forecast depreciation over the current period, although it did not specifically state that it would. This is supported by the inclusion by ESCOSA of capex in the efficiency carryover mechanism (ECM) for the current regulatory period.

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 capex in the ECM to apply over the next regulatory period.

Envestra notes that it does not accept the manner by which the AER has applied inflation to put the opening RAB as at 1 July 2011 in March 2011 dollar terms. This matter is explained in more detail in this attachment.

1. **Application of Inflation up to 30 June 2011**

The AER has expressed a preference for the opening RAB as at 1 July 2011 to be expressed in March 2011 dollar terms. This value is then used as an input into the post-tax revenue model and adjusted over the next regulatory period in accordance with, among other things, the AER preferred approach to applying inflation (which is the relevant March quarter index value for each year)).

The AER has however sought to introduce its preferred approach to inflation into the ESCOSA RAB roll forward model. Envestra submits that the AER should not have changed the manner that inflation is applied in this model. Similar to the reason for accepting forecast inflation, Envestra believes that the ESCOSA model should be applied in a consistent manner through to 30 June 2011.

There are several advantages in not altering the manner by which inflation is applied over the course of the current regulatory period, including:

* ensuring that inflation is applied consistently, thereby satisfying principles of financial capital maintenance;
* Envestra receives neither a windfall gain or loss stemming from changes to inflation; and
* provides for a far simpler calculation and method for transitioning over to the AER preferred roll forward approach.

With regard to the last point, the ESCOSA roll forward model was calculated in December 2005 dollar terms (that is, in real terms). ESCOSA applied what is referred to as a 9 month lag in inflation, such that December 2005 was proxied by inflation up to March 2005 (i.e. 9 months prior to December 2005).

The ESCOSA RAB model therefore determines the closing RAB as at 30 June 2011 in December 2005 dollar terms. This means that the closing RAB has been inflated up to March 2005 (pursuant to actual inflation used been 9 months prior to December 2005). To convert this value into March 2011 dollar terms simply requires applying the change in the March quarter index values over this period to the closing RAB value determined by the ESCOSA RAB model.

Envestra has undertaken this calculation in its RAB roll forward model by determining:

* the closing RAB as at 30 June 2011 in December 2005 dollar terms, which is $867.5m;
* the inflator as the March 2011 index value divided by the March 2005 index value, which is 1.19; and
* multiplying the closing RAB value by the inflator, which provides a closing RAB as at 1 July 2011 of $1031.1m.

Envestra has clearly set this calculation out in the ESCOSA RAB roll forward model. This value is then taken into the AER’s PTRM and rolled forward according to its preferred approach. Envestra notes that this issue reflects one of the key matters required in not only transitioning over to a new regulator but in moving from a “real” regulatory regime to a “nominal” regulatory regime.

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 capex.

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 capex 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 Dec 2005** | **2006-07** | **2007-08** | **2008-09** | **2009-10** | **2010-11** |
| Opening Capital Base | 815.9 | 826.5 | 839.8 | 848.9 | 853.5 |
| *Less* Depreciation | 18.7 | 20.2 | 22.0 | 23.2 | 24.1 |
| *Plus* Conforming Capital Expenditure | 29.3 | 33.6 | 31.0 | 27.9 | 38.0 |
| **Closing Value** | 826.5 | 839.8 | 848.9 | 853.5 | 867.5 |

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 | 1,031.1 | 1,144.9 | 1,258.3 | 1,369.2 | 1,490.4 |
| *Less* Depreciation | 27.5 | 42.1 | 46.5 | 51.3 | 54.4 |
| *Plus* Conforming Capital Expenditure | 115.3 | 126.6 | 125.7 | 138.0 | 141.0 |
| *Plus* Indexation | 26.0 | 28.9 | 31.7 | 34.5 | 37.6 |
| **Closing Value** | 1,144.9 | 1,258.3 | 1,369.2 | 1,490.4 | 1,614.6 |