Final decision

Electricity distribution network service providers

Roll forward model

June 2008

Contents

Shortened forms

AER	Australian Energy Regulator
capex	capital expenditure
CPI	consumer price index
DNSP	distribution network service provider
NER	National Electricity Rules
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
TNSP	transmission network service provider

1 Introduction

The Australian Energy Regulator (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 1 April 2008, the AER released and invited submissions on the following proposed 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
- service target performance incentive scheme.

In addition, the AER held a public forum in Melbourne on 23 April 2008 relating to its proposed guidelines, schemes and models and to receive comments from stakeholders.

The AER received 16 written submissions on its proposed guidelines package. This final decision sets out the AER's consideration of comments raised in these submissions in relation to the proposed RFM and the resulting final RFM and the associated handbook. Stakeholders that provided submissions in relation to the proposed RFM are listed in Appendix A of this final decision. In some instances stakeholders raised issues that are more appropriately addressed in the preparation and assessment of regulatory proposals. These issues are noted throughout this decision document.

This final decision, RFM and the associated handbook have been prepared in accordance with the AER's obligations under clause 6.16(e) of the NER.

This final decision considers the main issues raised in submissions to the proposed RFM and the AER's response. The RFM handbook at Appendix C of this final decision provides a detailed description of how the RFM operates and is to be applied. For additional background information regarding the development of the RFM, interested parties are encouraged to review the AER's previous decision documents on the RFM to be applied to both the regulation of electricity distribution networks in New South Wales and the Australian Capital Territory and to the regulation of electricity transmission networks nationally.[1] These decision documents, the supporting consultation papers and the related submissions made by stakeholders are available on the AER's website at www.aer.gov.au.

[1] See Australian Energy Regulatory, *Final Decision, Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-14, Roll forward model*, January 2008 and *Final Decision, Electricity transmission network service providers, Roll forward model*, September 2007.

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. The distribution consultation procedures set out at clause 6.16 of the NER require the AER to consider any submissions made on its proposed RFM when publishing its decision on the final RFM. The AER's final decision must also set out the reasons for the RFM, a summary of the main issues raised in submissions and the AER's response to each of these issues.

3 Reasons for the roll forward model

Under clause S6.1.3(10) of the NER, each DNSP is required to submit a completed version of the AER's RFM as part of its building block proposal.

The AER recognises that there may be a need for some flexibility in applying the RFM in order to account for the particular circumstances a DNSP may face. A number of elements of the RFM where this may be the case have been identified in the RFM handbook. A DNSP will need to propose and justify a departure from any element of the RFM for the purposes of addressing its specific circumstances as part of its revenue proposal, which will be considered and assessed by the AER on a case-by-case basis in making its distribution determination.

The RFM sets out the calculation of the regulatory asset base (RAB), that is, how capital expenditure (capex) and depreciation are to be treated from the beginning of one regulatory control period to the next regulatory control period, as well as between each regulatory year within each period.

The RAB values from the RFM form inputs into the PTRM, where they are rolled forward from year to year using forecast data. The RFM performs calculations using (predominantly) actual data.

4 Proposed roll forward model

The proposed RFM released for comment by the AER on 1 April 2008 was designed to comply with the requirements of Chapter 6 of the NER. Given the similarities between these requirements and those in Chapter 6A, the AER considered it appropriate to base the proposed PTRM on the model it published in September 2007 to be applied to electricity transmission network service providers (TNSPs).

Key features of the proposed RFM for DNSPs were:

- an incentive framework that uses ‘actual’ depreciation in rolling forward RAB values which also provided the flexibility for a DNSP to propose a ‘forecast’ depreciation approach depending on the circumstances
- a roll forward calculation over a six regulatory year period, which provides for adjustments for forecast capex used in the final regulatory year of the previous regulatory control period
- calculations for 20 asset classes
- a full as-incurred approach to recognising capex
- the use of straight-line depreciation as a default method, which could be amended depending on whether alternative methods formed part of the distribution determination for the relevant regulatory control period.

5 Main issues raised in submissions and the AER response

5.1 Actual and forecast depreciation

In its explanatory statement on the proposed RFM, the AER indicated its preference to apply an 'actual depreciation' incentive framework to DNSPs and developed the proposed RFM to accommodate this framework. The explanatory statement stated that DNSPs would be able to propose forecast depreciation as an alternative, depending on their particular circumstances.

5.1.1 Stakeholder comments

Ergon Energy sought confirmation of its understanding of actual and forecast depreciation approaches with respect to roll forward calculations, including whether the latter approach involved the rolling in of capex in excess of the allowance at its undepreciated value. Ergon Energy also questioned whether other options were available, such as using the depreciation reported in its regulatory accounts, and whether the RFM currently accommodates such alternatives.

Most stakeholders supported the RFM incorporating an actual depreciation framework. Alinta and United Energy, however, indicated a strong preference for using forecast depreciation as a central feature of the RFM given that:

- they were expecting a considerable increase in their capex requirements
- they perceive a risk that the AER may set capex allowances too low
- the likely overspending of allowances would involve an undesirable double penalty under an actual depreciation framework, in terms of returns foregone on the amount of the overspend, and higher depreciation in the subsequent roll forward.

5.1.2 AER conclusion

The AER considers clause S6.2.1(e)(5) of the NER provides for the possibility of actual and forecast depreciation to be part of the capex incentive framework. The AER acknowledges that, while only forecast and actual depreciation have been used by the AER and jurisdictional regulators, this clause does not prevent the use of any other alternatives.

The use of forecast depreciation involves using the amount of depreciation specified in the regulatory determination (which is based on forecast capex and forecast inflation) and adjusting this for actual inflation during the relevant regulatory control period. The RFM does not accommodate this approach, nor alternatives such as the direct input of depreciation as reported in regulatory accounts, and this is noted in the RFM handbook. The AER has not considered whether such alternatives would incorporate a specific treatment of returns on capital associated with capex that is below or in excess of allowances for the regulatory control period as such incentives are not required to be provided for under Chapter 6.

The AER notes the general support for utilising actual depreciation in the RFM and has maintained this in the final model. The AER will further consider views of the type presented by Alinta and United Energy, having regard to any specific circumstances raised, during the process of making a distribution determination for each DNSP.

5.2 Points of clarification

5.2.1 Stakeholder comments

Ergon Energy requested that the AER clarify:

- its interpretation of inflation and indexation, including whether actual inflation can be interpreted to mean inflation as it relates to the use of actual capex and actual depreciation in roll-forward calculations
- that data for the RFM can be reported in end of year terms (i.e. with no mid-year adjustments)
- the need for DNSPs to input certain data where adjustments for the previous regulatory control period are already incorporated into RAB values
- the AER's approach to asset categorisation and the relationship between asset classes used in the RFM and in the PTRM.

Ergon Energy also suggested various minor changes to the RFM handbook, as well as some recognition that the asset lives in the RFM may differ from the previous determination, including because of changes to asset classes.

Energex sought clarification that capex used to populate the RFM is to reflect the cost allocation method approved for that period. It also considered that indexation in the RFM should reflect the cost components of its RAB and prevailing market conditions, rather than changes in the generic consumer price index (CPI).

5.2.2 AER conclusion

Regarding the points of clarification sought by Ergon Energy, the AER notes clause 6.5.1(e)(3) of the NER requires the RFM to contain an adjustment to the RAB (i.e. indexation) by the rate of actual (observed) inflation over the period. The value of this increase, and thus satisfaction of the respective NER requirement, is separate to the adjustments for actual capex and actual depreciation over the period.[2]

Data reported in the RFM should be for the entire regulatory year for which it is being reported, in terms of 'dollars on the day'. The RFM performs calculations as if this value was spent in the middle of the relevant regulatory year (i.e. capex is actually spent throughout the regulatory year, approximated by a middle of the regulatory year assumption when the RFM accounts for inflation).

The RFM is configured to perform calculations which include the final regulatory year of the previous regulatory control period, however the model should be able to accommodate circumstances where these final regulatory year adjustments are not

2 Each adjustment to be made to the RAB is prescribed in clause S6.2.1(e) of the NER.

required. The AER will consult further with DNSPs as appropriate regarding specific requirements on a case-by-case basis which may involve specific amendments to the model or adjustments to certain inputs.

The AER has commented on the number of asset classes and requirements for categorising assets in its final decision for the PTRM. As noted in that decision,[3] the NER require depreciation in the RFM to be calculated using the same lives and methods that formed part of the distribution determination for the relevant regulatory control period. DNSPs may only propose changes to depreciation schedules on a prospective basis.

Regarding the points of clarification raised by Energex, the AER considers capex reported in the RFM should reflect the approved cost allocation method for the relevant regulatory control period. The RFM must index the RAB using actual inflation that is calculated consistent with the approach used to escalate the form of control mechanism over the regulatory control period. This is required by clause 6.5.1(e)(3) of the NER. In turn, the form of control mechanism for standard direct control services must incorporate a CPI measure as required under clause 6.2.6 of the NER. On this basis, the AER does not consider that an indexation approach which reflects the cost components of its RAB and prevailing market conditions, rather than changes in the generic CPI, meets the requirements of these provisions.

5.3 Other issues

5.3.1 Stakeholder comments

United Energy stated that valuing asset disposals at their sale value in the RFM (i.e. instead of their depreciated value) is a significant impediment to the operating and capital efficiency of the business. It argued that businesses should not be forced to return any gains or losses from disposals to consumers (i.e. where the sale price of an asset is greater than or less than its depreciated regulatory value), as this would remove any incentive to dispose of unwanted assets and use the proceeds for more productive purposes.

5.3.2 AER conclusion

Clause S6.2.1(e)(6) requires the RAB to be reduced by the ‘disposal value’ of assets which is not defined in the NER. For the purposes of the RFM, the AER accordingly considers that using the sale or depreciated value as the disposal value of an asset may be acceptable. The AER will assess the appropriateness of either of these approaches as proposed by a DNSP on a case-by-case basis. In either case the AER also notes that the approach adopted in the RFM must be consistent with that applied on a forecast basis in the PTRM.

[3] AER, *Final Decision, Post-tax revenue model for electricity distribution network service providers*, June 2008, p. 6.

6 AER final decision

The AER has decided to publish the RFM at Appendix B in accordance with the consultation procedures in clause 6.16(e)(1) of the NER. The AER has also published a RFM handbook to accompany this model at Appendix C. The RFM and handbook reflect the AER's conclusions in this final decision.

Appendix A: Submissions received on the roll forward model

The following interested parties provided submissions to the AER's proposed RFM and explanatory statement published on 1 April 2008:

- ActewAGL
- Alinta
- Aurora Energy
- Energex
- Ergon Energy
- United Energy Distribution

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

Appendix B: Roll forward model

Appendix C: Roll forward model handbook