FINAL DECISION

Energex
Distribution Determination
2020 to 2025

Attachment 4
Regulatory depreciation

June 2020

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 Energex for the 2020–25 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

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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 Energex, we make determinations on the indexation of the regulatory asset base (RAB) and depreciation building blocks for Energex's 2020–25 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 Energex's regulatory depreciation allowance. It also presents our final decision on the proposed depreciation schedules, including an assessment of the proposed standard asset lives used for forecasting depreciation.

4.1 Final decision

Our final decision is to determine a regulatory depreciation allowance of $882.5 million ($ nominal) for Energex for the 2020–25 regulatory control period. This amount represents an increase of $60.4 million (or 7.4 per cent) to the $822.0 million ($ nominal) in Energex's revised proposal.[2] It is $126.3 million (or 16.7 per cent) higher than the regulatory depreciation allowance determined in the draft decision. In coming to this decision:

- We accept Energex's revised proposed straight-line method to calculate the regulatory depreciation, which is consistent with our draft decision.
- We accept Energex's revised proposal to apply the year-by-year tracking approach to implement straight-line depreciation of existing assets, consistent with our draft decision. However, we have updated the inflation input in the year-by-year tracking calculations with actual consumer price index (CPI) for 2019–20 which is now available.
- We accept Energex's revised proposed asset classes and standard asset lives, which are consistent with our draft decision.
- We also accept Energex's revised proposal to reallocate all of the forecast capital expenditure (capex) that was previously in the 'Buildings' asset class to the 'Office equipment & furniture' asset class.

We have also made determinations on other components of Energex's revised proposal, which affect the RAB and in turn impacts the forecast regulatory depreciation allowance. The increase to the regulatory depreciation allowance from the revised proposal primarily reflects our final decision expected inflation rate for the 2020–25 regulatory control period. Our final decision for Energex's straight-line depreciation

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1 NER, cll. 6.12.1, 6.4.3.

2 Energex, *4.002 PTRM - SCS,* 10 December 2019.

component of regulatory depreciation is lower than the revised proposal by $5.6 million due to our determination of the opening RABs (attachment 2). However, this reduction is offset by our final decision on the indexation of the RAB, which is $66.0 million lower than the revised proposal. This is largely due to applying a lower expected inflation rate of 2.27 per cent per annum in this final decision (attachment 3) compared to Energex's revised proposal of 2.37 per cent per annum. Subsequently, the net effect is an increase in the regulatory depreciation allowance of $60.4 million.

Table 4.1 sets out our final decision on the forecast regulatory depreciation allowance for Energex over the 2020–25 regulatory control period.

Table 4.1 AER's final decision on Energex's depreciation allowance for the 2020–25 regulatory control period ($ million, nominal)

	2020–21	2021–22	2022–23	2023–24	2024–25	Total
Straight-line depreciation	451.0	446.2	474.5	503.5	532.5	2407.7
Less: inflation indexation on opening RAB	292.8	298.9	305.3	311.4	316.9	1525.2
Regulatory depreciation	**158.2**	**147.3**	**169.3**	**192.1**	**215.6**	**882.5**

Source: AER analysis.

Year-by-year tracking approach

For this final decision, we accept Energex's revised proposal to use the year-by-year tracking approach to calculate the forecast straight-line depreciation amounts for its asset values as at 1 July 2020. This approach (in addition to grouping assets by type via asset classes) tracks the asset classes on a year-by-year basis to implement straight-line depreciation. This is consistent with Energex's initial proposal and our draft decision.

In the draft decision, we required various minor modelling adjustments to the depreciation model used for implementing the year-by-year tracking approach.[3] Energex's revised proposal adopted all our draft decision changes. It also updated the 2018–19 and 2019–20 capex, and 2019–20 expected inflation figures in the revised proposed depreciation model to be consistent with its revised proposed roll forward model (RFM).[4]

For the reasons discussed in attachment 2, we accept the updated 2018–19 and 2019–20 capex inputs to the RFM. As a result, we also accept these updates for the year-by-year tracking depreciation model. However, we have updated the depreciation model for the actual CPI for 2019–20 to be consistent with the final decision RFM, which became available after Energex submitted its revised proposal.

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3 AER, *Energex 2020–25 – Draft decision – Attachment 4 – Regulatory depreciation*, November 2019, p. 13.

4 Energex, *1.003 Revised Regulatory Proposal 2020–2025*, 10 December 2019, pp. 16–17.

Reallocation of capex between asset classes

For this final decision, we accept Energex's revised proposal to reallocate its forecast capex that was previously in the 'Buildings' asset class to the 'Office equipment & furniture' asset class. This is because we are satisfied that the assets associated with this forecast capex have economic lives that are consistent with that assigned to the 'Office equipment & furniture' asset class.

In the draft decision and consistent with Energex's initial proposal, there was no forecast capex allocated to the 'Office equipment & furniture' asset class, while some forecast capex associated with property were allocated to the 'Buildings'[5] asset class.

In its revised proposal, Energex has reallocated all of the forecast capex that was previously in the 'Buildings' asset class with a standard asset life of 40 years, to the 'Office equipment & furniture' asset class with a standard asset life of 7 years. Energex submitted that this expenditure largely relates to office fit-out and fixtures, and the 'Office equipment & furniture' asset class was more reflective of the economic lives of these assets.[6]

We are satisfied that the standard asset life of 7 years for the 'Office Equipment & Furniture' asset class reflects the economic lives of furniture and fixture assets. We therefore consider that Energex's reallocation is appropriate.

Standard asset lives

For this final decision, we accept Energex's revised proposed standard asset lives for its asset classes in respect of the forecast capex to be incurred for the 2020–25 regulatory control period. They are consistent with our draft decision.

Energex's revised proposal did not forecast any benchmark equity raising costs for the 2020–25 regulatory control period, based on the method employed in the post-tax revenue model (PTRM). Consistent with this, for the final decision PTRM we estimate zero equity raising costs. Accordingly, we do not need to set a standard asset life for the 'Equity raising costs' asset class.

Table 4.2 sets out our final decision on Energex's standard asset lives for the 2020–25 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 is equivalent to the value at which the assets was first included in the RAB for Energex.[7]

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5 This is the proportion of property capital expenditure that is depreciated under the diminishing value method for tax purposes.

6 Energex, *Response to AER information request #65*, 22 January 2020, p. 5.

7 NER, cll. 6.5.5(b)(1)–(2).

Table 4.2 AER's final decision on Energex's standard asset lives for the 2020–25 regulatory control period (years)

Asset class	Standard asset life
OH sub-transmission lines	50.5
UG sub-transmission cables	45.0
OH distribution lines	45.0
UG distribution cables	60.0
Distribution equipment	35.0
Substation bays	45.0
Substation establishment	57.6
Distribution substation switchgear	45.0
Zone transformers	50.0
Distribution transformers	40.6
Low voltage services	35.0
Load control & network metering devices	15.0
Communications - pilot wires	29.3
Street lighting (residual rate 2 assets)	n/a
Systems buildings	60.0
Systems easements	n/a
System land	n/a
Control centre - SCADA	12.0
IT systems	5.0
Office equipment & furniture	7.0
Motor vehicles	9.0
Plant & equipment	6.8
Buildings	40.0
Land	n/a
Legacy ICT	n/a
Buildings - capital works	40.0
In-house software	5.0
Equity raising costs[a]	n/a

Source: AER analysis.

(a) For this final decision, the forecast capex determined for Energex does not meet a level to trigger any benchmark equity raising costs.

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 or not have any future assets being allocated to them.

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.[8]

[8] AER, *Energex 2020–25 – Draft decision – Attachment 4 – Regulatory depreciation,* November 2019, pp. 7–10.

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