FINAL DECISION

Ergon Energy
Distribution Determination
2020 to 2025

Attachment 2
Regulatory asset base

June 2020

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165
Email: EnergyQueensland2020@aer.gov.au

AER reference: 62728

Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ergon Energy 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

Attachment 12 – Classification of services

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2 Regulatory asset base

Our distribution determination includes Ergon Energy's opening regulatory asset base (RAB) value as at 1 July 2020 and the projected RAB value for the 2020–25 regulatory control period.[1] The value of the RAB substantially impacts Ergon Energy's revenue requirement, and the price consumers ultimately pay. Other things being equal, a higher RAB would increase both the return on capital and return of capital (depreciation) components of the distribution determination.[2] This final decision sets out:

- the opening RAB as at 1 July 2020
- the forecast closing RAB as at 30 June 2025
- that the depreciation based on forecast capital expenditure is to be used for establishing the RAB as at the commencement of the 2025–30 regulatory control period.[3]

2.1 Final decision

Opening RAB as at 1 July 2020

Our final decision is to determine an opening RAB value of $11533.8 million ($ nominal) as at 1 July 2020 for Ergon Energy. This amount is $20.6 million (or 0.2 per cent) higher than Ergon Energy's revised proposed opening RAB of $11513.2 million ($ nominal) as at 1 July 2020.[4] It reflects our update to the roll forward model (RFM) for 2019–20 actual inflation that is now available and the updating of the value of legacy ICT assets to be rolled into the opening RAB. This final decision is $18.9 million (or 0.2 per cent) lower than our draft decision value for Ergon Energy's opening RAB of $11552.8 million ($ nominal).

To determine the opening RAB as at 1 July 2020, we have rolled forward the RAB over the 2015–20 regulatory control period to determine a closing RAB value as at 30 June 2020 in accordance with our RFM.[5] This roll forward includes an adjustment at the end of the 2015–20 regulatory control period to account for the difference between actual 2014–15 capex and the estimate approved in the 2015–20 determination.[6]

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1 NER, cl. 6.12.1(6).

2 The size of the RAB also impacts the benchmark debt raising cost allowance. However, this amount is usually relatively small and therefore not a significant determinant of revenues overall.

3 NER, cl. 6.12.1(18).

4 Ergon Energy - *Distribution roll forward model, ERG 4.003 RFM - SCS DEC19 PUBLIC*, December 2019.

5 AER, *Electricity distribution network service providers Roll forward model (version 2)*, 15 December 2016.

6 The end of period adjustment will be positive (negative) if actual capex is higher (lower) than the estimate approved at the 2015–20 determination.

In the draft decision, we reduced Ergon Energy's proposed opening RAB as at 1 July 2020 by updating various inputs such as the actual 2018–19 consumer price index (CPI) in the RFM.[7] We noted the roll forward of Ergon Energy's RAB included estimated capex for 2018–19 and 2019–20, and estimated inflation for 2019–20, because these actual values were not yet available.[8] Our draft decision noted, that 2018–19 capex would be reviewed for the final decision when the audited regulatory accounts for 2018–19 would be available.[9]

In its revised proposal, Ergon Energy adopted our draft decision changes. It also updated the 2018–19 estimated capex with actuals and revised the 2019–20 estimate of capex with the latest figures.[10]

We have checked the 2018–19 actual capex in the revised proposal and identified an error in the allocation of under and over recoveries of corporate overheads between capital and operating expenditures. This also affected the capex for 2015–16 to 2017–18. Our correction for this error resulted in a reduction to the 2015–16 to 2018–19 actual capex by $4.5 million ($ nominal).[11]

We accept Ergon Energy's revision to the 2019–20 net capex estimate of $550.1 million ($ nominal).[12] This amount is lower than we approved in our draft decision, reflecting more recent data. We note that the financial impact of any difference between actual and estimated capex for 2019–20 will be accounted for at the next reset. Our final decision also updates the 2019–20 inflation input in the RFM with actual CPI for this year, which became available after Ergon Energy submitted its revised proposal.

We have adjusted the value of legacy ICT assets to be rolled into the RAB as at 1 July 2020. The amount has been affected by updates to the capex spent on these assets in the final two years of the current (2015–20) regulatory control period and a revised CPI escalator (Discussed further below). Our final decision is to approve $130.2 million to be added to the RAB as at 1 July 2020 for these assets.

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7 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 2 – Regulatory asset base*, October 2019, pp. 10-11.

8 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 2 – Regulatory asset base*, October 2019, p. 16.

9 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 2 – Regulatory asset base*, October 2019, p. 16.

10 *Ergon Energy Revised regulatory proposal*, December 2019, pp. 15

11 Our assessment found that there were under and over recoveries of corporate overheads in relation to Ergon Energy's 2015–20 Cost Allocation Method (CAM). We consider that instead of allocating these balances to opex, they should be allocated across the relevant services on the basis of proportional direct costs percentages, consistent with the method under Ergon Energy's CAM. This led to revision of actual capex reported for the years 2015–19. Ergon Energy's restated annual reporting RIN for its actual gross capex is now $4.5 million lower compared to its revised proposed gross capex over these four years. Further details of our assessment is set out in section 6.4.1 attachment 6 of this final decision.

12 This amount includes a half-year WACC allowance to compensate for the six month period before capex is added to the RAB. The 2019–20 net capex in this final decision is $550.4 million due to updates for actual rather than estimated CPI in 2019–20.

We also consider the extent to which our roll forward of the RAB to 1 July 2020 contributes to the achievement of the capital expenditure incentive objective.[13] As discussed in the draft decision, the review period for this distribution determination is limited to 2014–15, 2015–16, 2016–17 and 2017–18 capex.[14] , After our adjustment to correct for the allocation error of under and over recoveries of corporate overheads between capital and operating expenditures, Ergon Energy's aggregated actual capex incurred for the four year period of 2014–18 is below the forecast allowance set for that period at the previous distribution determinations. Therefore, the overspending requirement for an efficiency review of past capex has not been satisfied.[15] Given this, we consider the capex incurred in those years to be consistent with the capital expenditure criteria and can therefore be included in the RAB.[16]

For this final decision, we have included Ergon Energy's actual capex for 2018–19 and estimated capex for 2019–20 in the RAB roll forward to 1 July 2020. At the next reset, the 2018–19 and 2019–20 actual capex will form part of the review period for whether past capex should be excluded for inefficiency reasons.[17] Our RAB roll forward applies the incentive framework approved in the previous distribution determination, which included the use of a forecast depreciation approach in combination with the application of the capital expenditure sharing scheme (CESS).[18] As such, we consider that the 2015–20 RAB roll forward contributes to an opening RAB (as at 1 July 2020) that includes capex that reflects prudent and efficient costs, in accordance with the capital expenditure criteria.[19]

Table 2.1 sets out our final decision on the roll forward of Ergon Energy's RAB for the 2015–20 regulatory control period.

Table 2.1 AER's final decision on Ergon Energy's RAB for the 2015–20 regulatory control period ($ million, nominal)

	2015–16	2016–17	2017–18	2018–19	2019–20 [a]
Opening RAB	9873.0	10226.0	10501.0	10806.7	11141.8
Capital expenditure[b]	620.4	511.8	498.9	552.1	550.4
Inflation indexation on opening RAB	166.7	150.9	200.5	192.8	205.1

14 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 2 – Regulatory asset base*, October 2019, p. 16.

15 NER, cl. S6.2.2A(c).

16 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 5 – Capital expenditure*, October 2019, pp. 85-86; NER, cl. S6.2.1(f).

17 Here, 'inefficiency' of past capex refers to three specific assessments (labelled the overspending, margin and capitalisation requirements) detailed in NER, cl. S6A.2.2A. The details of our ex post assessment approach for capex are set out in AER, *Capital expenditure incentive guideline*, November 2013, pp.12–20.

18 AER, *draft decision Ergon Energy distribution determination - Attachment 2 - Regulatory Asset Base* 2015–20, April 2015, p. 18.

19 NER, cll. 6.4A(a), 6.5.7(c) and 6.12.2(b).

	2015–16	2016–17	2017–18	2018–19	2019–20 [a]
Less: straight-line depreciation[c]	434.1	387.7	393.6	409.8	423.7
Interim closing RAB	10226.0	10501.0	10806.7	11141.8	11473.7
Difference between estimated and actual capex in 2014–15					–54.2
Return on difference for 2014–15 capex					–15.8
Roll-in of legacy ICT assets					130.2
Closing RAB as at 30 June 2020					**11533.8**

Source: AER analysis.
(a) Based on estimated capex provided by Ergon Energy. We will true-up the RAB for actual capex at the next reset.
(b) Net of disposals and capital contributions, and adjusted for actual CPI and half-year WACC.
(c) Adjusted for actual CPI. Based on forecast capex.

Legacy ICT assets

In the draft decision, we determined a value of $121.2 million ($ nominal) associated with Ergon Energy's legacy ICT assets to be included in the opening RAB as at 1 July 2020.[20] We noted that the 2018–19 and 2019–20 capex amounts used to calculate the opening value for these assets were based on estimates. We expected Ergon Energy to provide the 2018–19 actual capex and an update to the 2019–20 estimated capex in its revised proposal for these assets.[21]

Ergon Energy's revised proposal adopted our draft decision but did not provide an update to the draft decision value for the legacy ICT assets as at 1 July 2020.[22] We made inquiries with Ergon Energy on this matter.[23] In its response, Ergon Energy updated the estimated value of these assets to $130.1 million based on the actual capex for 2018–19 and a revised estimate of the capex for 2019–20.[24] For this final decision we accept the actual 2018–19 and revised estimate of 2019–20 legacy ICT capex provided in Ergon Energy's response.[25] We note that any difference between

[20] AER, *Ergon Energy 2020–25 Distribution Determination – Draft Decision – Attachment 2 – Regulatory asset base*, 8 October 2019, p. 17.

The legacy ICT assets were previously owned by a third party entity SPARQ (which was part of Energy Queensland) but used to provide ICT services for Ergon Energy and Ergon Energy in the 2015–20 regulatory control period. With the merger of the two entities to Energy Queensland in 2017, these functions will be performed by Ergon Energy going forward.

[21] AER, *Ergon Energy 2020–25 Distribution Determination – Draft Decision – Attachment 2 – Regulatory asset base*, 8 October 2019, p. 18.

[22] Ergon Energy, *Revised proposal*, 10 December 2019, p. 15.

[23] AER, *Information request IR#080*, 21 January 2020.

[24] AER, *Information request IR#012*, 4 April 2019.

[25] We have substituted the estimated 2019–20 inflation rate used by Ergon Energy to convert the 2018–19 capex into 2019–20 real dollar terms by the actual 2019–20 (December to December) CPI, as it is now available for the final decision. This resulted in a minor increase in the value of the legacy ICT assets by $0.1 million as at 1 July 2020.

the estimate and actual capex for 2019–20 will be corrected at the next reset through the RFM. Our final decision is to include $130.2 million ($ nominal) of legacy ICT assets in the opening RAB as at 1 July 2020. This is $9.0 million higher than the draft decision.

Forecast closing RAB as at 30 June 2025

Once we have determined the opening RAB as at 1 July 2020, we roll forward that RAB by adding forecast capex and inflation, and reducing the RAB by depreciation to arrive at a forecast closing value for the RAB as at the end of the 2020–25 regulatory control period.[26]

A few submissions on Ergon Energy's revised proposal raised concerns regarding the increase to the size of Ergon Energy's RAB over the 2020–25 regulatory control period and its impact on RAB per customer.[27] Our final decision projects the RAB to decrease by 0.1 per cent in real terms over the 2020–25 regulatory control period. This compares to the historical increase of 23.1 per cent for the 2010–15 period and 7.2 per cent growth over the current 2015–20 period.

Such movements in the RAB were driven largely by the higher capex spend in previous periods. The other drivers of the change in the size of the RAB depends on our assessment of its various components including expected inflation (section 2.2 of the Overview), forecast depreciation (attachment 4) and forecast capex (attachment 5). Inflation and capex increase the RAB, while depreciation and disposals reduce it.

For this final decision, we determine a forecast closing RAB value at 30 June 2025 of $12892.3 million ($ nominal) for Ergon Energy. This is $622.6 million (or 4.6 per cent) lower than Ergon Energy's revised proposal of $13514.9 million ($ nominal). We are not satisfied that Ergon Energy's revised proposal total forecast capex of $2816.8 million ($2019–20)[28] for the 2020–25 regulatory control period reasonably reflects the capex criteria. For this reason, we have reduced the revised proposal capex by $540.6 million to $2276.2 ($2019–20) for the 2020–25 regulatory control period. Refer to section 5.4 of attachment 5 for the discussion on forecast capex.[29]

Table 2.2 sets out our final decision on the forecast RAB for Ergon Energy over the 2020–25 regulatory control period.

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[26] NER, cl. S6.2.3.

[27] CCIQ, *Submission on Ergon Energy's draft decision and revised proposal 2020–25* - January 2020, pp. 6; CCP14, *Submission on Ergon Energy's draft decision and revised proposal 2020–25 – revised* – February 2020 pp.7; QFF, *Submission on Ergon Energy's draft decision and revised proposal 2020–25* - January 2020, p. 6

[28] This amount is net of capital contributions, disposals and equity raising costs, and excludes the half-year WACC adjustment.

[29] Capex enters the RAB net of forecast disposals. It includes equity raising costs (where relevant) and the half-year WACC to account for the timing assumptions in the PTRM. Therefore, our final decision on the forecast RAB also reflects our amendments to the rate of return for the 2020–25 regulatory control period (section 2.2 of the Overview).

Table 2.2 AER's final decision on Ergon Energy's RAB for the 2020–25 regulatory control period ($ million, nominal)

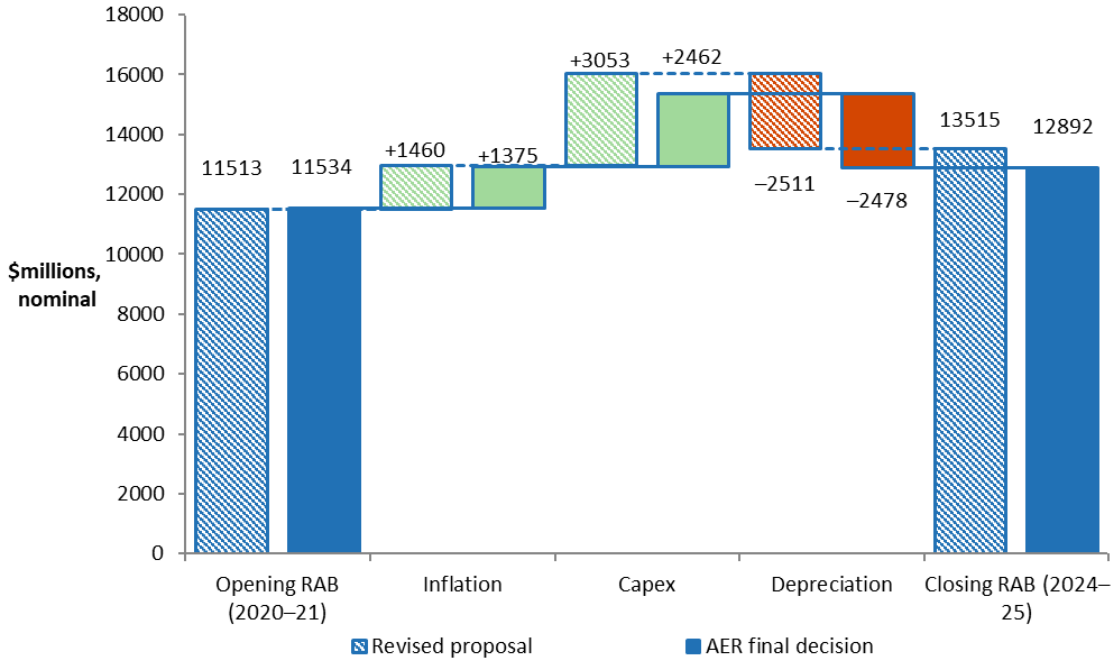
	2020–21	2021–22	2022–23	2023–24	2024–25
Opening RAB	11533.8	11818.9	12100.1	12378.1	12634.4
Capital expenditure[a]	473.4	488.3	500.2	489.3	510.3
Inflation indexation on opening RAB	262.3	268.8	275.2	281.5	287.3
Less: straight-line depreciation	450.6	475.9	497.4	514.5	539.7
Closing RAB	**11818.9**	**12100.1**	**12378.1**	**12634.4**	**12892.3**

Source: AER analysis.

(a) Net of forecast disposals and capital contributions. In accordance with the timing assumptions of the post-tax revenue model (PTRM), the capex includes a half-year WACC allowance to compensate for the six-month period before capex is added to the RAB for revenue modelling.

Figure 2.1 shows the key drivers of the change in Ergon Energy's RAB over the 2020–25 regulatory control period for this final decision. Overall, the closing RAB at the end of the 2020–25 regulatory control period is forecast to be 11.8 per cent higher than the opening RAB at the start of that period, in nominal terms. The approved forecast net capex increases the RAB by 21.3 per cent, while expected inflation increases it by 11.9 per cent. Forecast depreciation, on the other hand, reduces the RAB by 21.5 per cent.

Figure 2.1 Key drivers of changes in the RAB—Ergon Energy's revised proposal compared with AER's final decision ($ million, nominal)



Source: AER analysis.

Note: Capex is net of forecast disposals and capital contributions. It is inclusive of the half-year WACC to account for the timing assumptions in the PTRM.

Application of depreciation approach in RAB roll forward for next reset

When we roll forward Ergon Energy's RAB for the 2020–25 regulatory control period at the next reset, we must adjust for depreciation. For this final decision, we determine that the depreciation approach to be applied to establish the RAB at the commencement of the 2025–30 regulatory control period will be based on the depreciation schedules (straight-line) using forecast capex at the asset class level approved for the 2020–25 regulatory control period.[30]

As discussed in section 2.7 of the final decision Overview, we will also apply the CESS to Ergon Energy over the 2020–25 regulatory control period. We consider that the CESS will provide sufficient incentives for Ergon Energy to achieve capex efficiency gains over that period. We are satisfied that the use of a forecast depreciation approach in combination with the application of the CESS and our other ex post capex measures are sufficient to achieve the capex incentive objective.[31] Further, this approach is consistent with our *Framework and approach*.[32]

2.2 Assessment approach

We did not change our assessment approach for the RAB from our draft decision. Attachment 2 (section 2.3) of our draft decision.

30 NER, cl. 6.12.1(18).

31 Our ex post capex measures are set out in the capex incentive guideline, AER, *Capital expenditure incentive guideline for electricity network service providers,* November 2013, pp. 13–19 and 20–21. The guideline also sets out how all our capex incentive measures are consistent with the capex incentive objective.

32 AER, *Ergon Energy 2020–25 – Draft decision – Attachment 2 – Regulatory asset base*, October 2019, pp. 21-22; AER, *Final framework and approach for Energex and Ergon Energy – Regulatory control period commencing 1 July 2020*, July 2018, pp. 70-72.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
ICT	Information and communication technology
NER	National Electricity Rules
PTRM	post-tax revenue model
RAB	regulatory asset base
RFM	roll forward model
RIN	regulatory information notice
WACC	weighted average cost of capital