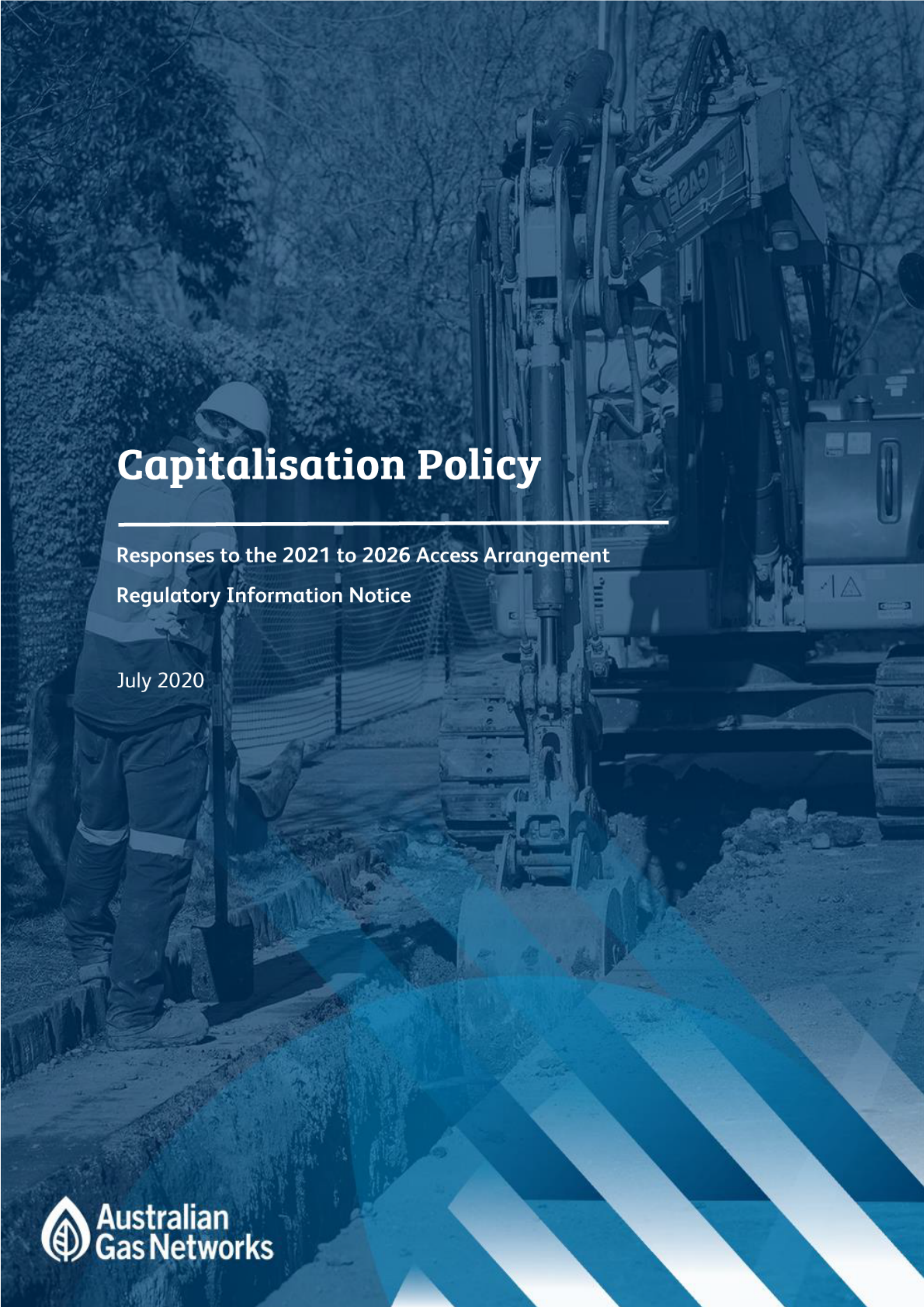

Capitalisation Policy

Responses to the 2021 to 2026 Access Arrangement

Regulatory Information Notice

July 2020

Australian Gas Networks

Enquiries concerning the currency of this policy should be addressed to:

Australian Gas Networks
Level 6, 400 King William Street
Adelaide SA 5001
Phone: (08) 8227 1500
Email: paul.may@agig.com.au

AMENDMENT RECORD

Version	Date	Author	Description of Changes
1.0	30 June 2020	Mark McAra	Final for AGN (SA) AA RIN

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1. Introduction and Purpose

Guidance about the capitalisation of expenditure and the recognition and measurement of assets can be found in the Australian Accounting Standards (e.g. *AASB 116 Property, Plant and Equipment, AASB 101 Presentation of Financial Statements*) and the Australian Accounting Standard Board's *Framework for the Preparation and Presentation of Financial Statements ("the Framework")*.

This policy is consistent with the requirements of Australian Accounting Standards and applicable International Financial Reporting Standards.

Its purpose is to help guide Australian Gas Networks Limited (AGN Limited) personnel with the processes of recording financial transactions and in the preparation of financial statements, including regulatory financial information for the Australian Energy Regulator (AER). It is also to assist external auditors with the process of providing assurance over the accounting information being reported to the AER.

This policy has been prepared for submission to the AER as a requirement of the Access Arrangement Regulatory Information Notice (RIN) dated 28 February 2020. The policies and practices have been applied for all of the periods reported, unless specifically noted otherwise.

2. Scope

The scope of this policy is expenditure related to property, plant and equipment and the capitalisation of overheads, due to these categories of expenditure being disclosed in AGN Limited's regulatory accounting information reported to the AER.

AGN Limited’s regulatory accounting information is prepared based on the accounting policies set out in its annual financial statements, except as set out in Section 4.3.

3. Capitalisation of Expenditure

In accordance with the Australian Accounting Standard Board's *Framework*, expenditure can be capitalised and recognised as an asset *"when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably"* (paragraph 89).

Further, the *Framework* states that *"an asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the income statement"* (paragraph 90).

Paragraph 90 of the *Framework* goes on to state *"this treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset"*.

The following section sets out the specific capitalisation policies related to expenditure on property, plant and equipment and the capitalisation of overheads.

4. Property, Plant and Equipment

4.1. Policy

Property, plant and equipment are tangible items with useful lives beyond 1 year. These expenditures are capitalised and are classified as non-current assets.

Expenditure on property, plant and equipment is to be initially recorded at the cost of acquisition.

4.2. Practice

4.2.1. Land and buildings

Land and buildings includes:

1. Freehold land;
2. Commercial buildings; and
3. Structures housing items of plant

4.2.2. Plant and equipment

Plant and equipment includes:

1. Gas distribution system; and
2. Miscellaneous plant and equipment

4.2.3. Corporate plant and equipment

Corporate plant and equipment includes:

1. Office furniture and fittings; and
2. Office machines and computer equipment (hardware and software)

4.2.4. Fixed asset registers

Fixed asset registers are maintained for each company for all land and buildings and plant and equipment to facilitate the physical identification of the assets capitalised in the accounting records.

The asset registers record for each asset, the cost, amount of depreciation charges for the current period, accumulated depreciation and written down value.

4.2.5. Cost

The cost of an item of property, plant and equipment is comprised of the following elements:

1. Purchase price;
2. Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating; and
3. The initial estimate of the costs of restoring the site on which an item is located.

4.3. Capex and related regulatory accounting policies

Due to historical regulatory submissions by AGN Limited and associated Access Arrangement (AA) decisions by the AER (or earlier regulators), there can be differences in the treatment or classification of expenditure between statutory accounting and regulatory accounting practices as applied in the financial information provided to the AER.

The following sections detail the differences in the treatment of Capex for regulatory reporting purposes relative to statutory accounting. Other than for the items set out below, Capex reported in the AA RIN templates are consistent with AGN Limited's statutory accounts.

<u>RIN categories of expenditure</u>

In respect of the categories of expenditure shown in the AA RIN templates (e.g. Direct Internal Labour, Direct Contractor Expenditure, Other Direct Expenditure, Overhead Expenditure and Related Party Margin Expenditure), given the contracting arrangements with APA for the delivery of AGN Limited's capital program, capital expenditure reported by AGN Limited is almost exclusively Direct Contractor Expenditure and Overhead Expenditure.

AGN Limited also receives Capital Contributions (see section 4.3.5 and 4.3.6) which for regulatory accounting purposes are deducted from the gross expenditure, resulting in the net capital expenditure being recorded in the Regulatory Asset Base (RAB).

4.3.1. Heat shrinking sleeves

For statutory accounting purposes, this expenditure is treated as Capex in accordance with AGN Limited's interpretation of relevant Australian Accounting Standards (e.g. *AASB 116 Property, Plant and Equipment*) and the Accounting Standard Board's *Framework for the Preparation and Presentation of Financial Statements* ("*the Framework*").

Regulatory Accounting Practice

In the AER's draft decision for the 2016/17-2020/21 SA AA, expenditure relating to 'transmission pressure pipeline corrosion under heat shrink sleeves (SA21a)', was determined to be an operating item (see Attachment 7 – Operating expenditure, section 7.4.3.6 - Capex projects reclassified as Opex, page 29). Therefore, since 1 July 2016, AGN Limited classifies this expenditure as operating expenditure (repairs and maintenance) in its regulatory reporting to the AER.

4.3.2. Piecemeal mains replacement

For statutory accounting purposes, AGN Limited treats this expenditure as Capex in accordance with its interpretation of relevant Australian Accounting Standards (e.g. *AASB 116 Property, Plant and Equipment*) and the Accounting Standard Board's *Framework*.

Regulatory Accounting Practice

Consistent with its treatment during prior regulatory access arrangement periods, piecemeal mains replacement (relating to small sections of mains replacement) is reported as operating expenditure (repairs and maintenance) for regulatory purposes.

4.3.3. Capitalised Interest

In accordance with AGN Limited's interpretation of accounting standard *AASB 123 Borrowing Costs*, borrowing costs incurred for the construction of any qualifying asset are to be capitalised during the period of time that is required to complete and prepare the asset for its intended use. Other borrowing costs are expensed.

AGN's statutory accounting policy, which commenced on 1 January 2016, is that capital expenditure projects that are expected to take longer than six months to complete and for amounts greater than $500,000 are considered qualifying assets. A capitalisation rate (based on the weighted average of borrowing costs applicable) will be applied to expenditure on the qualifying asset incurred during the period, to the extent that the funds are borrowed.

The amount of borrowing costs capitalised and the capitalisation rate must be disclosed in the financial statements.

Regulatory Accounting Practice

For regulatory accounting purposes, AGN Limited removes capitalised interest from regulatory capital expenditure, as these costs are calculated as part of the AER's post tax revenue model (PTRM) and are deemed to be operating in nature.

4.3.4. Marketing rebates

AGN Limited provides marketing rebates to certain customers in the form of a cash payment, as an incentive to have gas connected and to take up gas appliances (i.e. gas hot water, gas central heating etc.).

Until the reporting period ended 31 December 2015, AGN Limited treated all of these marketing rebates as operating expenditure in its statutory financial statements.

From 1 January 2016, AGN Limited changed its policy to capitalise the expenditure on rebates specifically relating to new customers with existing homes that have previously been all electric, to the service asset category (Inlets).

Regulatory Accounting Practice

For regulatory accounting purposes, this expenditure is accounted for as operating expenditure, which is consistent with SAIPAR's 2002 AA final decision (page 99). This treatment for regulatory accounting purposes has not been changed since.

4.3.5. Capital Contributions

Capital works

AGN Limited performs alteration and construction works on its distribution network at the request of customers. These works are funded by the customer. Where the contract only allows for capital works there is one performance obligation and revenue is recognised when the service is provided. The customer receives the benefit of the service as the work is performed therefore the performance obligation is satisfied "over time". As the contribution to the capital works is received from the customer it is recognised as a contract liability on balance sheet and taken to revenue over time using an output method, either percentage of completion or milestones reached as specified in the contract.

Some contracts will include more than one deliverable, being the capital works and the subsequent provision of haulage services and/or maintenance services:

- Where the performance obligations are determined to be distinct, the contract price is allocated to each performance obligation using estimated or actual construction costs, an estimation of maintenance costs if applicable and commercial tariffs for haulage revenue. Revenue is then recognised as each performance obligation is satisfied; or
- Where the performance obligations are determined to not be distinct, the total contract price is recognised over the life of the contract.

Statutory Accounting Practice

Extensions or modifications of the network required by customers that are outside of the prescribed requirements of the AAs are capitalised as assets and then invoiced to customers.

Where extensions or modifications of the network are made under a specific agreement that involves contributions from a customer to the cost, then if the extensions or modifications meet the definition of an asset under the accounting standards, the costs are capitalised as assets, and the contribution recognised as revenue. These contributions are recognised as revenue under AASB 15 Revenue since 1 January 2018 and Interpretation 18 Transfers of Assets from Customers and AASB 118 Revenue until 31 December 2017. There has been no change in accounting treatment resulting from the adoption of the new standard AASB 15 in respect of customer contributions.

Regulatory Accounting Practice

For regulatory accounting purposes, the revenue is removed and the value of customer contributions received is deducted from the cost, to ensure that only that part of Capex which was funded by the business (total Capex less customer contribution) is included in the RAB.

Within the RIN templates Capex for regulatory accounting purposes is reported both on a gross basis and net of any customer contributions received in relation to capital projects. The value of customer contributions is also reported separately in the RIN templates.

4.3.6. Government contributions or grants

Statutory and Regulatory Accounting Practice

Where extensions or modifications of the network that meet the definition of an asset under the accounting standards, are made under an agreement that involves contributions from a Government department, the costs are capitalised as assets, and the government contribution received is recognised as a reduction to this cost, thereby reducing depreciation charged over the life of the asset.

5. Capitalisation of Overheads

5.1. Policy

AGN Limited capitalises a proportion of the overhead costs of its principle operating and management contractor, APA Asset Management, which can be directly attributed to capital activities. These overhead costs includes a share of the Network Management Fee (NMF) which represents APA's margin under the OMA. Currently 65% of the total NMF paid to APA is capitalised for statutory accounting purposes.

This policy is in accordance with AGN Limited's interpretation of relevant accounting standards (i.e. *AASB 116 Property, Plant and Equipment*) and the Accounting Standard Board's *Framework.*

Only internal overhead costs of AGN Limited that can be specifically linked to a capital activity (e.g. a corporate IT project) are to be capitalised. Otherwise, all other overhead costs of AGN Limited are to be treated as operating expenditure.

5.2. Practice

5.2.1. Overhead costs

The share of APA's overhead costs that are allocated to capital expenditure are initially collected into an 'overhead cost pool' based on a proportion of APA's selected department costs. There is effectively two overhead cost pools, with state and national overheads captured and allocated separately.

State based cost centres that are included in the state overhead pool are as follows:

- Network planning and asset strategy;
- Operations management;
- Regional operations;
- Operations administration; and
- Stores

National based cost centres that are included in the national overhead pool are as follows:

- Network engineering;
- Technical support services;
- Training;
- Property; and
- Shared Services

As stated above, APA's overhead costs that are capitalised for statutory accounting purposes also includes 65% of the NMF paid by AGN.

These overhead cost pools are allocated to relevant activities of capital expenditure based on a percentage uplift rate set each year, by dividing the total capitalised overhead cost pool into the budgeted capital expenditure for each of the states in which AGN operates. This initial allocation is based on the budgeted expenditure for the year. At mid-year and year-end a 'true-up' process is undertaken to reconcile budgeted costs to actual costs, with year-end allocations representing actual costs.

Prior to 2015-16 IT capex also received a proportion of the overhead cost pool.

Major IT projects are excluded from this method as a direct allocation of time spent is used to transfer time and associated costs from activities (or departments) thereby reducing the overhead cost pool.

Direct capital overheads, for example the Planning department and certain Operations departments, are also allocated directly to capital expenditure rather than included in the capitalised overhead pool.

Regulatory Accounting Practice

For regulatory reporting purposes all NMF is treated as operating expenditure, consistent with the Access Arrangement Information (amended by order of the Australian Competition Tribunal) issued by the AER on 10 February 2012.

6. Application and effective date

This capitalisation policy document:

a Applies to the preparation of regulatory financial information to be provided to the AER by AGN Limited and is current at the date of approval;

b Is applicable to all AGN Limited personnel involved in the preparation of regulatory financial reporting to the AER;

c Incorporates all capitalisation policies applied for the relevant reporting periods included in the AER's AA Regulatory Information Notice dated 28 February 2020 (i.e. 2014-15 to 2018-19); and

d Remains effective for future regulatory reporting periods, subject to amendment.

Approved by:

[redacted]

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Paul May

Chief Financial Officer

[redacted]

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Peter Bucki

Head of Regulation

Date: 30 June 2020