

Attachment 4.06

Ernst & Young - Advice on movement in provisions

January 2015



Accounting for provisions: Assessing the AER's approach

NSW DNSPs Draft Determinations

19 January 2015



Table of contents

1.	Introduction.....	1
2.	Executive Summary	3
3.	Analysis of AER position	5
4.	Approaches taken in other jurisdictions.....	11
5.	Implications and practical considerations	13
6.	Caveats and limitations	14

Mr Brett Ogier
Financial Controller
Ausgrid
Level 19, 570 George Street
Sydney
NSW 2000

19 January 2015

Private and confidential

Accounting for Provisions - Substantive Revenue Proposal

Dear Brett,

Thank you for choosing Ernst & Young to provide guidance to Ausgrid, Endeavour Energy and Essential Energy (collectively, "the NSW DNSPs") in relation to the AER's approach towards movements in provisions in the draft Determinations issued in November 2014.

This report contains our findings and key observations arising from our work, and considers the methodologies in place across the DNSPs at the time of writing. The specific areas we have covered are described in Section 1.2 of this report.

We thank you for the opportunity to assist you with this matter and if you have any questions or require any further information, please do not hesitate to contact John Askham on (02) 9248 4012.

Yours sincerely



Peter Graham

Partner

Ernst & Young

Abbreviations

AASB	Australian Accounting Standards Board
AER	Australian Energy Regulator
CAM	Cost Allocation Methodology
Capex	Capital expenditure
DNSP	Distribution Network Service Provider
EBSS	Efficiency Benefit Sharing Scheme
EE	Essential Energy
EY	Ernst & Young
FERC	Federal Energy Regulatory Commission (US federal regulator)
NEM	National Electricity Market
NER	National Electricity Rules
NLOB	Network Line of Business
Opex	Operating expenditure
PPE	Property, Plant & Equipment
RAB	Regulatory Asset Base
SCI	Statement of Corporate Intent

1. Introduction

1.1 Background

In their Substantive Revenue Proposals ('Proposals') submitted to the Australian Energy Regulator ('AER') in May 2014¹, Ausgrid, Endeavour Energy and Essential Energy ('the NSW DNSPs') noted that in recent Determinations for other service providers, the AER had reversed 'movements in provisions' from base year opex forecasts used to determine their revenue requirements for upcoming regulatory control periods.

The NSW DNSPs argued that reversing 'movements in provisions' effectively represents 'cash accounting' for regulatory purposes, and would result in amounts which are true costs to the businesses not being taken into account by the AER when setting revenue requirements. The AER has argued that this reversal is appropriate as the movements are largely the result of changes in assumptions that do not represent the actual cost in delivering network services², particularly in relation to employee benefit provisions which are typically recognised over a long period and on a basis which does not necessarily correspond with the associated cash outlay.

The NSW DNSPs' proposals did, however, exclude the effect of certain actuarial adjustments made to employee benefit provisions (such as long service leave) from the remaining years of the forecast on the basis that these adjustments are the result of changes in assumptions rather than an ongoing cost needed to provide standard control services.

The 'accruals' approach maintained by the NSW DNSPs aims to avoid the possible volatility associated with passing cash expenditure directly on to consumers by smoothing the effect of irregular or volatile cash payments over an appropriate period in line with Australian Accounting Standards.

In their draft Determinations issued in response to the proposals, the AER has made a series of adjustments to the proposed opex forecasts and provided revised estimates based largely on the results of its benchmarking exercises, without making explicit reference to the treatment of 'movements in provisions'. However, in their assessment of the Efficiency Benefit Sharing Scheme ('EBSS'), under which the NSW DNSPs must report their actual opex amounts, the AER adjusted for movements in provisions since, in their view, 'increases in provisions do not represent the actual cost incurred in delivering network services when calculating efficiency gains or losses.'

1.2 Scope and objectives

The NSW DNSPs are required to respond to the draft Determination and EY has been engaged to provide support in compiling their Revised Revenue Proposals to be submitted to the AER in January 2015. This report outlines:

- ▶ The supporting arguments for maintaining an accruals-based approach to forecasting opex from the perspective of Australian Accounting Standards;

¹ Ausgrid Revenue Proposal, p53; Endeavour Energy Revenue Proposal, p91; Essential Energy Revenue Proposal, p72

² Ausgrid Draft Determination, Attachment 9 (EBSS), p9-9

- ▶ The limitations of adopting a cash based approach to forecasting opex and possible regulatory implications;
- ▶ The results of our outreach to other EY offices (dealing with the US energy markets) to determine whether this issue has been considered by other regulators; and
- ▶ Possible implications and practical considerations associated with moving to a 'cash based' approach.

2. Executive Summary

- ▶ We consider that the true economic cost to the businesses of providing standard control services and the associated employee benefits includes, in any given period, the cash paid out to employees and an additional non-cash amount representing additional entitlements that will be required to be paid in the future. These additional amounts will be settled in cash in future periods, and the fundamental principles of financial reporting and accounting for provisions require that they are recognised only when they can be estimated reliably.
- ▶ Provisions represent a genuine, present obligation for the NSW DNSPs, and only differ from trade payables and accruals because there is uncertainty around the timing or amount of expenditure that will be required to settle the obligation. However, provisions are only recognised when a reliable estimate can be made, and users of financial statements regularly rely on estimates and constant re-assessments made by management and tested by third party auditors in the recognition of provisions.
- ▶ It is therefore important that customers have confidence in the DNSPs' financial statements. Moving to a 'cash accounting' approach as described below will decrease the relevance of statutory financial statements, and make it more difficult and complicated for customers to be able to understand and evaluate financial performance.
- ▶ We consider that the AER adjusting the NSW DNSPs' proposed forecast costs for 'movements in provisions' would effectively represent a move towards 'cash accounting' for provisions, since this excludes the element of the economic cost that has been deferred to future periods, and that cash payments in a given regulatory period do not represent the full cost incurred by the businesses in the provision of standard control services.
- ▶ The AER has made adjustments to the NSW DNSPs' forecasts in their draft Determinations to exclude 'movements in provisions' for the purposes of calculating EBSS carryover amounts, although no corresponding adjustment has explicitly been made to the underlying opex forecasts.
- ▶ In its assessment of the EBSS carryover amounts, the AER stated that it considers movements in provisions to represent, in essence, changes in estimates for which a business should not be rewarded or penalised. We consider that although movements in provisions do arise from changes in long term estimates and assumptions, they also arise from differences in the rate of accrual recognition under Australian Accounting Standards and physical cash payout, particularly for long term employee benefit provisions.
 - The differences between rates of accrual and cash payout are appropriate, and expected, given the fundamental principles of Australian Accounting Standards and the conceptual requirement to recognise costs over the period to which they relate rather than solely the period in which cash is paid. Typically, for employee benefit costs, the businesses build up provisions using a labour on-cost model, and the cost recognised in a given year includes an incremental 'recovery' of future cash payouts (for example, for employees being paid out long service leave entitlements on exit). Periodic adjustments to these on-cost rates are designed to ensure that there is no excessive under or over recovery of these amounts.
 - Estimates and assumptions relevant to the measurement of longer term provisions such as defined benefit superannuation payments (for example employee demographics, expected returns on assets or salary increases) are typically made by a professional

actuary, and the businesses already exclude the potentially volatile effects of some adjustments to these assumptions from their opex forecasts by taking the movements directly to retained earnings in line with Australian Accounting Standards. However, the AER should consider these movements carefully if moving to a 'cash approach', as over the long term they will affect the level of cash paid out. Excluding these entirely from the regulatory revenue collected by the businesses could result in future consumers being required to fund significant deficits which the AER could consider 'smoothing' using the accounting requirements as a starting point.

- ▶ If the AER excludes both of these types of 'movement in provisions', the impact on pricing is likely to be unpredictable and volatile, as cash costs rather than smoothed accounting costs are passed on to customers.
- ▶ In our experience, regulators in the United States involved in rate setting typically use amounts recognised under the applicable accounting framework as the basis for considering the true cost of providing services, and we have observed a range of surcharge and 'true up' mechanisms in place that are designed to ensure that significant under or over recoveries of uncertain costs are not passed on to consumers. Any such true-up mechanism must be approved by the relevant regulator and be worded specifically to ensure that the entity's financial auditor can concur that there will be no unintended accounting consequences, for example when recognising regulatory assets or liabilities in the financial statements corresponding to costs recovered from or paid to consumers in advance of a provision being settled.
- ▶ In one specific US example, actuarial movements in post-retirement benefit obligations are passed on to customers through rate increases but are smoothed over several years, using the applicable accounting requirements as the basis for designing the recovery mechanism.
- ▶ Moving to a full 'cash accounting' model may also place an additional burden on the DNSPs' financial and regulatory reporting teams on transition, as a number of existing provisions would require detailed analysis to avoid 'double counting' by allowing regulatory revenue for cash expenditure against a provision already recognised.
- ▶ The change is also likely to require substantial modifications to the DNSPs' systems, processes and internal procedures to accommodate different statutory and regulatory bases of accounting. In some cases it is likely that the DNSPs will be required to maintain two separate ledgers, for example if different labour on-cost rates are used for statutory and regulatory purposes.

3. Analysis of AER position

3.1 Adjustments made in draft Determination

3.1.1 *EBSS carryover amounts*

Under the Efficiency Benefit Sharing Scheme ('EBSS') that applies to the NSW DNSPs, the businesses are either rewarded for opex reductions against forecast, or penalised for opex that exceeds forecast. In each year of a regulatory control period, an allowance or penalty is 'carried over' into subsequent years, including into the next period, based on previous comparisons of actual and forecast opex.

The AER is required to assess amounts reported under the EBSS against previous forecasts, since the scheme forms one of the building blocks that make up the businesses' allowed revenues. In its assessment of the carryover amounts to be applied in the 2014-19 regulatory control period, the AER has reduced the amount of actual opex reported primarily due to movements in provisions, stating that (taking Ausgrid as an example):

"The difference between Ausgrid's proposed EBSS carryover amount calculated for the 2009-14 regulatory control period (\$427.5 million) and the EBSS carryover amount we calculated (\$260.3 million) is due to the treatment of provisions.

A provision is a type of accrual accounting practice. A business records an increase in a provision where it expects it will incur a future cost. Increases in provisions are often allocated to expenditure, and in particular, to opex. Accordingly if a business considers it is likely it will incur a future cost, or it expects the future cost will be different to that it has previously recorded, reported actual expenditure will increase. This means a business may sometimes record increases in expenditure when it estimates there is a change in a liability it faces. It may not actually expect to incur the cost for some time and the cost will not necessarily eventuate in the amount predicted.

In the 2009-14 regulatory control period, Ausgrid reported increases in provisions for long service leave, annual leave and workers compensation as actual opex. This affected the reported EBSS carryover amounts - particularly changes in provisions for long service leave. We consider that movements in provisions should be excluded from EBSS calculations. This is because the increases in provisions do not represent the actual cost incurred in delivering network services when calculating efficiency gains or losses. This is consistent with the applicable EBSS.

The EBSS is designed to reward businesses for becoming more efficient over time and penalise them for becoming less efficient. It is the actual costs a service provider incurs that we are concerned about when measuring efficiency improvements. In contrast, provisions are estimates of future costs a business expects to incur. A change in a provision is, in essence, a revised estimate. Estimating future costs usually involves making assumptions. These assumptions often change over time as new information becomes available, creating forecasting uncertainty. The uncertainty about provisions is what distinguishes them from other liabilities in the accounting standards. For example, to calculate the change in provisions for employee entitlements, a business must make assumptions about how much its current workers will be paid in the future, when it expects them to leave or retire, the rate at which they will take leave, as well as the time value of money. Significant discretion and judgment is involved in forming these assumptions. The valuation of the future liability can be very sensitive to small changes in assumptions. Accordingly, the amount charged to opex could change significantly with relatively minor changes in assumptions.

To reward or penalise a service provider for changes in provisions would reward or penalise it for changes in assumptions, not efficiency improvements. This undermines what the EBSS is intended to do, namely reward efficiency improvements and

penalise declines in efficiency. While provisions might need to be treated in a particular way for accounting purposes, for regulatory pricing purposes, treating provisions as actual costs can lead to perverse outcomes.³

Although increases to provisions such as long service leave, annual leave and workers compensation do arise partly as a result of changes in assumptions and estimates (which in the AER's view do not represent true 'costs' to the business for the purposes of the EBSS), increases can also arise as a function of accounting entries being made in order to progressively recognise a cost at a different rate to the associated cash payouts.

For example, the recognition of various provisions for employee benefits such as a superannuation or long service leave liability on an annual basis as a result of existing employees rendering an extra year of service is typically recorded in practice using a labour on-cost model, in which a fixed charge is recognised for each period in which an employee works. The increase to a provision as a result of this charge may not be wholly offset by a cash payout in a given year, since the on-costs are designed to also reflect the cost associated with benefits due to employees but not yet paid out (such as untaken annual leave). This means that the net result of these two movements (the increase in provision due to employment cost recognition and the decrease as cash is paid through payroll systems) may be an increase to the provision. This represents a real economic cost of providing network services without an immediate cash payout.

On-costs rates are set at the beginning of a reporting period and re-assessed as necessary to ensure that the provision at the end of the reporting period will appropriately reflect management's best estimate of the amounts due to employees in the future. Whilst in the short term, the level of cash paid to employees may not equate to the total provision recorded, the provisions are intended to cover, for example, the cost of employees being paid out leave balances on exit. This is a genuine economic cost to the business which, although not reflected in an immediate cash outflow in any given period, is recognised for accounting purposes to match the service rendered with the period in which the employer receives the associated benefit. The estimates made in setting on-cost rates are reflected in the associated provision in the regulatory and statutory accounts of any given reporting period, and are also therefore subject to an external audit by an independent third party that tests their validity.

3.1.2 *Forecast operating expenditure*

As noted above, the AER has adjusted the proposed carryover amount under the EBSS for the 2014-19 period. However, no explicit adjustment has been made to the DNSPs' operating expenditure forecasts relating to movements in provisions. Although this appears inconsistent, the AER has instead adjusted the base year of the DNSPs' opex forecast based on the results of its benchmarking exercises, which may indirectly include adjusting for the effect of movements in provisions.

3.1.3 *Regulatory asset base (Essential)*

We note that the AER has also made a retrospective adjustment to the calculation of Essential Energy's RAB throughout the 2009-14 period to remove the impact of movements in employee entitlement provisions that had previously been capitalised for regulatory purposes.

³ Ausgrid Draft Determination - Attachment 9 (EBSS), p9-9

As discussed previously in relation to opex forecasting, this adjustment effectively results in 'cash accounting' for regulatory purposes, since under this approach the RAB is only increased for cash expenditure incurred. However, we note that only employee entitlement provisions appear to have been considered in the approach adopted. Furthermore, Clause S6.2.2(7) of the National Electricity Rules requires that the AER must have regard to the 'value of the relevant asset as shown in independently audited and published accounts' when calculating the value of the RAB for a given year.

In line with Australian Accounting Standard AASB 116 Property, Plant and Equipment, certain costs are recognised within the cost of an asset when those costs are considered directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The Standard goes on to suggest examples of directly attributable costs, one of which is the cost of providing employee benefits arising directly from the contribution or acquisition of an item of property, plant and equipment.

It is common practice across the NSW DNSPs and wider industry for a portion of labour costs to be attributed to both the statutory and regulatory asset base if the work being performed is capital in nature, and as discussed previously we consider that the true labour cost incurred in a given period includes certain non-cash amounts which will be settled at a future point in time, since a present obligation to provide benefits arises as employment services are rendered.

3.2 Accrual vs cash accounting

Management has advised that it is possible that the AER will require a full 'cash accounting' treatment to be applied to other types of provision, as seen in other recent DNSP and TNSP Determinations across Australia,⁴ and may adjust the base year explicitly for movements in provisions for the same reasons noted in the EBSS assessment above.

3.2.1 Implications

From a customer pricing perspective, the implication of moving from an accruals-based regulatory accounting system towards a 'cash-based' system is that a greater degree of volatility is likely to be introduced as employee behaviour in a certain period (for example, more employees leaving the businesses and being paid out previously accumulated long service leave or untaken leave allowances) affects the level of cash outlay. For example, the following table shows cash payments made by Ausgrid over the 2009-14 regulatory period against the employee sick leave provision:

	2009	2010	2011	2012	2013	2014
Cash payments (\$'000)	3,461	29,834	16,173	9,532	3,554	4,839

The large increase in 2010 is the result of an offer made to employees in 2009 for the payout of previously untaken sick leave. Under a full cash accounting approach, customers may be required to fund this increase immediately, whereas the existing regulatory approach involves a progressive build-up of the provision over time.

⁴ Final Distribution Decision, Aurora Energy 2012-13 to 2016-17; Powerlink, Transmission Determination 2012-13 to 2016-17.

Under cash accounting, future customers may therefore be required to fund expenditure where there has been a significant time lag between the recognition of a provision and the eventual cash outlay. For example, the recognition of an environmental restoration provision over an extended period of time is intended to spread the cost of the restoration throughout the period in which benefits are being derived from the associated assets. Cash expenditure is usually incurred following the decommissioning of an asset and the eventual clean-up of a site, often many years after the recognition of the provision. Allowing the pass through of the cost at the time of cash expenditure as opposed to progressively over the life of the asset is likely to have a significantly more volatile effect on end user prices in the future. This will be the case, for example, for Ausgrid's provision for substation site remediation, which is estimated on an annual basis and results in opex being recognised significantly in advance of cash expenditure.

We consider that increases in provisions do form part of the true economic cost to the business of providing standard control services, and that this does not change because amounts are set aside to be paid in the future. This concept is fundamental to the principles of financial reporting:

"Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods."⁵

This concept illustrates that the recognition of expenses in any given accounting period is required when those costs have been incurred in the process of generating revenue. Employment costs incurred by the NSW DNSPs are therefore recognised by allocating the total cost (including benefits earned by employees as part of their ongoing service and paid in future periods) over the period in which employment services are rendered and used to generate revenues, rather than solely when cash payments are made.

Further impacts of moving to a full cash accounting approach would be wide ranging and require a measured assessment of the implications from both an actuarial and an accounting perspective. This approach would have significant implications for:

- ▶ The efficient base year used in the opex forecast: Selecting a base year with an appropriate level of cash expenditure that represents the ongoing expenditure of the businesses would be more challenging, as cash payments will naturally vary more than accruals;
- ▶ The current forecasting methodology for provisions: Forecasting cash payments rather than accounting accruals would require a more predictive forecasting and modelling capability that is able to anticipate the timing of when large cash payments will be made, for example in which years significant numbers of employees are likely to 'cash out' accrued leave entitlements;
- ▶ The calculation of the efficiency benefit sharing scheme ('EBSS') carryover amount for the current and next period (if the EBSS were to continue to apply): As discussed above, in addition to forecasting opex on an alternative basis, the reporting of actual opex amounts

⁵ IASB Conceptual Framework, 4.49, 4.51 (Recognition of Expenses)

under the EBSS would need to be re-assessed and require further incremental time and effort from the NSW DNSPs' reporting teams. Applying the scheme on a purely cash basis may result in other unintended consequences, such as an EBSS penalty if cash payouts are greater than forecast, for example if employee exits are encouraged in a particular year to create further efficiencies⁶;

- ▶ The calculation of the opening and closing regulatory asset base ('RAB'): Some provision movements, such as those related to employee entitlements for staff working on capital projects, are capitalised for statutory accounting purposes and treated as capex when calculating the value of the RAB. Introducing a cash basis of accounting for RAB items would therefore introduce further potential pricing volatility, as the RAB is increased for cash expenditure, and require further analysis and calculation from the DNSP reporting teams; and
- ▶ Reporting and reconciling regulatory and statutory accounts, as a result of 'permanent differences' which will arise between the accounting and regulatory base of provisions (refer to Section 5 below).

3.2.2 Accounting requirements

A fundamental principle of Australian Accounting Standard AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* is that a provision (a liability of uncertain timing or amount) should be recognised when:

- ▶ An entity has a present obligation (legal or constructive) as a result of a past event;
- ▶ It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- ▶ A reliable estimate can be made of the amount of the obligation⁷.

A provision in the books of the NSW DNSPs therefore represents a genuine, present obligation to pay cash at a point in the future, and only differs from other liabilities such as trade payables or accruals because there is uncertainty around the timing or amount of the future expenditure. By contrast, trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with a supplier, and accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, but all three types of liability are representative of a cost that has been incurred.

Although it is sometimes necessary to estimate the amount or timing of accruals, the degree of uncertainty is generally much lower with accruals than provisions. Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

The uncertainty around the measurement of a provision by the NSW DNSPs does not mean that a cost has not been incurred, but rather that an obligation of uncertain timing or amount has arisen in the process of providing network services.

⁶ We note, however, that the AER has indicated that its draft decision is that no expenditure will be subject to the EBSS during the 2014-19 regulatory period.

⁷ AASB 137.14

Provisions are generally measured in accordance with management's best estimate of the amount required to settle the obligation and require regular re-assessment during the period between initial recognition and cash expenditure. The Standard requires that this estimate must be reliable, and if this is not possible then no provision is recognised. The provisions in the books of the NSW DNSPs will have therefore already undergone a rigorous process of initial estimation and re-assessment by management, followed by external assessments of both statutory and regulatory accounts by independent third party auditors. The financial statements of most corporate entities include provisions, and shareholders, corporate regulators and other stakeholders often place reliance on these types of estimates.

Provisions involving a significant degree of estimation are usually those associated with employee benefits. Employees are typically provided with benefits under their employment contract, for example in the form of a salary, associated annual and long service leave entitlements or bonuses. Additionally, employees often receive post-employment benefits, for example under defined benefit superannuation schemes.

The employer therefore has a liability to make payments to employees, either in the short term as base salary costs (typically recognised as a monthly accrual), or in the longer term as long service leave benefits or contributions into a defined benefit fund on behalf of its employees.

In the cases of long term employee benefit provisions, Australian Accounting Standard AASB 119 Employee Benefits requires an entity to recognise⁸:

- ▶ A liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
- ▶ An expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Cash payments in relation to employee benefits (for example, long service leave payouts either in service or when an employee exits the business) reduce the provisions as they are made.

⁸ AASB 119.11

4. Approaches taken in other jurisdictions

4.1 United States

4.1.1 *Background*

In the United States, the electricity industry comprises several thousand public, private and cooperative utility entities in the generation, transmission, distribution and retail sectors. Some aspects of the industry, such as interstate electricity transmission and wholesale electricity sales, are regulated at the federal level by the Federal Energy Regulatory Commission ('FERC') while others such as retail sales and distribution activities are regulated at a state level by a Public Utilities/Service Commission (e.g. the New York State Public Service Commission).

Some functions, such as customer billing, are treated as monopoly services in many jurisdictions, but are treated as competitive in others, following partial privatisations in many states of the retail sides of utility companies.

In general, rates and other terms of service for distribution entities are set by the relevant state-level commission as part of a rate case and are designed to allow utilities an opportunity to earn a reasonable rate of return after expenses. Commissions therefore need to determine the relevant utility's costs for providing services in their state, in the same way that the NSW DNSPs' expenditure is assessed by the AER.

4.1.2 *Assessment of expenditure*

Typically, the starting point for assessing the operating expenses of a utility in a rate case is the level of operating expenses recorded under the applicable statutory accounting framework.

For certain sporadic or non-recurring expenditure, the relevant commission may approve an adjustment clause to the rate case, which allows base year accounting entries to be removed and replaced with a cash surcharge designed to allow the entity to recover the costs associated with a major event over a pre-determined period.

This means that, for example, for exceptional and unexpected costs such as storm damage repair, the utility may receive cash from customers that it is required to accumulate in a reserve for future expenditure. As part of this surcharging mechanism, the commission will require the utility to periodically 'true up' the account (for which a regulatory liability is recognised in the statutory accounts in the short term, representing the difference between the accounting and regulatory 'base' of the cash) and either return the cash to customers if an excess has been collected, or file for permission to increase the surcharge if actual costs are under-recovered.

In relation to employee benefit provisions, the following extract from a rate case issued to Massachusetts Electric shows how a short term recovery mechanism functions in practice:

"...the Company proposes to remove the pension and PBOP ('post-employment benefits other than pensions') expense from rate base and collect the expenses through a fully reconciling mechanism. The proposed pension and PBOP adjustment mechanism would be reset before the beginning of each calendar year to collect the base year amount plus one third of the cumulative over/under collection balance from prior periods and the carrying charge or credit on its average net prepaid pension asset and deferred PBOP liability, net of deferred taxes.

The Company argues that, without a pension and PBOP adjustment mechanism, it will be unable to recover pension expenses over what is included in revenue requirement and, therefore, it will be prone to large shifts in earnings that harm ratepayers as well as shareholders.

Rate reconciling tariffs are used to recover costs that are: (1) objectively ascertainable; (2) over which the company has very little control; and (3) may materially affect a company's operations. In evaluating the merits of collecting pension and PBOP expenses through a reconciling mechanism, the Department has specifically considered: (1) the magnitude and volatility of the pension and PBOP costs; (2) the role of accounting requirements; and (3) the effectiveness of the reconciling mechanism in avoiding the negative effects of the pension and PBOP volatility.

The Department notes that the Company must adhere to Financial Accounting Standards Board ("FASB") rules, Internal Revenue Service ("IRS") requirements, and the Employee Retirement Insurance Security Act ("ERISA") law which are not always fully compatible. As a result there exists the risk of a significant and negative financial impact to the Company. Under Statement of Financial Accounting Standard No. 87 ("SFAS 87") regulated companies are required to compare the actuarial present value of the total cost of pension benefits with the fair market value of the assets of the plan.

A fully reconciling mechanism guarantees recovery of the pension and PBOP deferral within three to five years satisfies the requirements of SFAS 71, and dispels the risk that a mismatch between a company's pension and PBOP assets and liabilities will cause serious financial disruption⁹*

**SFAS 71 is a US accounting standard requiring the recognition of an asset for the difference between amounts recorded for accounting purposes and the amount to be collected in customer rates.*

This shows the key role that Accounting Standards play in the development of customer rates, and a possible mechanism under which potentially volatile movements in a provision, which are considered part of the economic cost to the entity of providing employment benefits, and consequently their regulated services.

In situations such as these, where the rate case approved by the relevant commission differs from the expected accounting treatment under the relevant framework, the language used in the rate case must be sufficiently specific for the financial auditors of the utility entity to concur that no unintended accounting consequences will arise.

In other cases, such as accelerated tax depreciation allowed by taxation authorities, the utility is required to normalise any benefit and establish a tax expense for regulatory purposes that smooths out the benefit over the expected book depreciation period of the related asset.

Both of these examples avoid the utility having to immediately pass on 'lumpy' expenditure to consumers. In the case of the accelerated tax depreciation, federal rules prevent the immediate pass through of a benefit, and require normalisation across the book depreciation period.

⁹ Massachusetts Electric Co 2009 Rate Case Final MADPU Order, p216

5. Implications and practical considerations

5.1 Additional monitoring

A transition to a full cash based approach towards provisions would create several 'permanent differences' between the accounting and regulatory base of the provisions, and likely require significant monitoring and incremental time and effort on the part of the businesses.

If required to transition, it is critical that certain types of provision are monitored closely, as the effect of transitioning will be more prevalent for some types of liability than others:

- ▶ Short term balances such as trade payables and accruals should not be affected if a cash-based approach is required, since the recognition of an accrual and the subsequent cash outlay occur in a short timeframe and should be of approximately the same amount.

For instance, we understand that in recent years, Ausgrid's forecast self-insurance opex has been sufficiently accurate and has closely matched the cash payments made to claimants. As such, it is likely that the forecast opex over the regulatory period will approximately equal the cash payments required and a change in approach should not have a significant effect.

- ▶ The issue is likely to be more prevalent for long term provisions which are inherently judgemental such as long service leave and defined benefit superannuation, for which in any given period there is likely to be a significant difference between the cash payments and provision increases. From a cash perspective, amounts paid are inherently unpredictable as they are likely to depend on employee behaviour.

Additionally, revenue may have already been received for the recognition of some provisions under the existing AER framework for which no cash expenditure has yet occurred. On transition to a cash approach, the AER may require additional reporting from the DNSPs in relation to cash payments to avoid 'double counting' the expenditure. Balances of this nature include site remediation provisions for work at the end of assets' lives, and preserved sick leave and maturing allowance balances which are fully vested and expected to be 'cashed out' by employees over the regulatory period, with no further increases in the provision.

To avoid this 'double counting', the AER may request, for example, that management monitor untaken annual leave provisions at the individual employee level and only claim as a regulatory cost the cash payments in relation to employees accruing additional leave since the beginning of the 2014-19 regulatory period. This will add significant complexity to the accounting and reporting burdens on the NSW DNSPs, and result in two sets of detailed records being maintained, which we consider is not consistent with the principles of financial reporting.

If further reversals for 'movements in provisions' are made in the final Determinations, it will therefore be critical to understand exactly which provisions the AER has considered.

6. Caveats and limitations

The management of the DNSPs is ultimately responsible for the selection and application of accounting and regulatory policies in the preparation and presentation of financial reports and regulatory forecasts in accordance with Australian Accounting Standards and AER requirements. The guidance we have expressed in this report is given in the context of assisting the DNSPs in concluding on the appropriateness of the 2014-19 regulatory submission. We have not taken into account any other regulations or statutory requirements in expressing our views.

The information in this report is based solely on the information presented to us as summarised in this report. We have not performed audit or review procedures on the transactions or balances underlying the issues described in this report. Our engagement was not intended to be an assurance engagement, and we are unable to and do not express an opinion or make a statement about the underlying transactions or balances. Had we performed additional procedures or had we performed an audit or review in accordance with Australian Auditing Standards, other matters might have come to our attention that would have been reported to you.

The interpretation of Australian accounting and regulatory pronouncements involves the exercise of professional judgement. Accordingly, the facts, circumstances, assumptions and conclusions described herein may be viewed differently by others. The information provided in this report is based on our interpretations of Australian Accounting Standards and AER requirements as at the date of this report and on the facts provided to us as described above. Should these facts and circumstances differ, our conclusion may change.

This report could be affected by the future amendments to Australian Accounting Standards or AER requirements, interpretations issued by standard setters or through the evolution of generally accepted practice or other authoritative guidance or reporting requirements. Unless agreed otherwise, we do not take responsibility for advising of changes in our guidance that may arise from any such change subsequent to the date of this report, nor are we under any obligation to update our conclusion herein for information provided further to the date of this report, or other future events. You have not asked for, nor do we express, an opinion on the tax consequences or any other matters relating to the matters discussed herein.

This report has been prepared for the information and sole internal use of the DNSPs in concluding on the appropriateness of the 2014-19 regulatory submission. This report should not be provided to any other party without our prior knowledge and consent, unless required by court order or regulatory authority. This report may not be used for any purposes other than those specified herein, nor may extracts or quotations be made without our expressed prior approval. We disclaim any assumption of responsibility for any reliance on this report to any party other than the DNSPs, or for any purpose other than that for which it was prepared.

This report has been provided in accordance with our engagement agreement dated 19 December 2014, and all of the terms set out in that agreement also apply to this report.

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organisation, please visit ey.com.

© 2015 Ernst & Young Australia.

Adelaide

Ernst & Young Building
121 King William Street
Adelaide SA 5000
Tel: +61 8 8417 1600
Fax: +61 8 8417 1775

Brisbane

1 Eagle Street
Brisbane QLD 4000
Tel: +61 7 3011 3333
Fax: +61 7 3011 3100

Canberra

Ernst & Young House
51 Allara Street
Canberra ACT 2600
Tel: +61 2 6267 3888
Fax: +61 2 6246 1500

Gold Coast

12-14 Marine Parade
Southport QLD 4215
Tel: +61 7 5571 3000
Fax: +61 7 5571 3033

Melbourne

Ernst & Young Building
8 Exhibition Street
Melbourne VIC 3000
Tel: +61 3 9288 8000
Fax: +61 3 8650 7777

Perth

Ernst & Young Building
11 Mounts Bay Road
Perth WA 6000
Tel: +61 8 9429 2222
Fax: +61 8 9429 2436

Sydney

Ernst & Young Centre
680 George Street
Sydney NSW 2000
Tel: +61 2 9248 5555
Fax: +61 2 9248 5959