Lease Capitalisation

2024-29 Regulatory Proposal

Endeavour Energy

POWER together

1. Introduction

Leasing is an important activity for entities including electricity distribution businesses as it provides a means of gaining access to assets whilst reducing exposure to the risks of asset ownership.

The previous accounting standard for leases AASB 117 Leases was often criticised because it did not always provide a true representation of leasing transactions. In particular, it did not require lessees to recognise assets and liabilities arising from operating leases. That is, operating lease payments were reported as operating expenditure over the lease period with no recognition of a corresponding asset or a liability.

This standard was subsequently replaced by AASB 16 Leases which includes a new requirement for a lessee to recognise assets and liabilities for the rights and obligations created by leases. This approach is considered to provide a more faithful representation of a lessee's assets and liabilities and greater transparency of a lessee's financial leverage and capital employed.

Specifically, AASB 16 Leases requires lease liabilities and the corresponding right of use asset to be capitalised and recognised in the balance sheet. In the income statement, lease payments are replaced by a depreciation expense on the asset and an interest expense on the lease liability. The new standard applied to annual reporting periods beginning on or after 1 January 2019.

For financial accounting purposes, Endeavour Energy adopted the changes from this date with operating lease contracts recognised in the balance sheet as an asset and liability to be amortised over the life of the lease contract. Consistent with the approach taken in our statutory accounts, we intend to apply this approach in our regulatory accounts and have the value of leases reflected in our Regulatory Asset Base (RAB). The leased asset will be depreciated at a rate equivalent to the term of the contract (or remaining term of the contract in the case of existing leases).

Importantly, our intent to adopt the new accounting standard has been discussed with our Regulatory Reference Group (RRG) and accepted on the provision adopting the changes does not deliver any unintended windfall gains at the expense of customers.

The AER has since advised that opportunities for windfall gains purely from movement of expenditure between operating expenditure (opex) and capital expenditure (capex) due to mid-period accounting changes would be avoided if the accounting treatment of expenditure within a period was aligned with the approved expenditure treatment for that period. Accordingly, from a regulatory perspective we will continue to treat lease costs as opex for the remainder of the 2019–24 regulatory control period and commence reporting them as capex from 1 July 2024.

Adopting AASB 16 Leases will affect our 2024-29 capex and opex forecasts as well as the opening value of the RAB. The purpose of this document is to explain:

- the impact of these accounting changes on our 2024-29 capex forecast.
- the corresponding adjustments we have made to our 2024-29 opex forecast.
- how the opening value RAB will be adjusted for the value of existing leases.
- the adjustments required to opex reported during the 2019-24 regulatory period to avoid Endeavour Energy accruing unintended Efficiency Benefit Sharing Scheme (EBSS) windfall gains or losses.

2. Endeavour Energy's leasing arrangements

Endeavour Energy currently has leasing arrangements relating to the use of particular classes of motor vehicles and office premises. Specifically, we lease our passenger and light commercial motor vehicles and have a lease contract for our compact Sydney CBD office. The lease contracts for vehicles and the Sydney CBD office cover a right of use period of five and three years respectively. The cost of these leases has historically been reported in our regulatory accounts as operating expenditure and expensed in accordance with the conditions set out in the respective leasing contracts. We will continue to apply this approach for the remainder of the 2019-24 regulatory control period.

Additionally, we expect to relocate to our new head office in Parramatta CBD in H1 2023 following the sale of our existing corporate site at Huntingwood in Western Sydney. The terms of the occupancy were negotiated in a lease agreement which has a 10 year 3 months term with an option for two five-year extensions after the initial expiry. No decision has yet been made on whether this option will be taken up. The costs of each of these lease agreements up to 30 June 2024 are outlined in Table 1 below.

Table 1: Lease opex ($m; real 2024)

Lease Type	FY20 (a)	FY21 (a)	FY22 (a)	FY23 (f)	FY24 (f)	FY20-24
Motor Vehicles	7.22	5.10	4.66	5.02	4.89	**26.89**
Sydney CBD Office	0.16	0.15	0.12	0.12	0.13	0.68
Parramatta Office				0.72	2.11	2.83
Property Lease	0.16	0.15	0.12	0.84	2.23	**3.51**
Total	**7.38**	**5.25**	**4.78**	**5.86**	**7.13**	**30.40**

Accounting for leases entered into before 1 July 2024

The effect of adopting *AASB 16 Leases* is that from 1 July 2024, we will commence recognising the remaining value of these leases as capital expenditure and include this amount in the opening RAB value for the 2024–29 regulatory period. This requires us to calculate the present value of existing leases (using an appropriate discount rate)[1] at the end of the 2019–24 period and roll this amount into the RAB through an end-of-period adjustment. This is consistent with the approach applied by the AER in their 2021-26 distribution determination for AusNet Services which adopted *AASB 16 Leases* and commenced capitalising leases for both statutory and regulatory reports from 1 July 2019.

We have included these final year adjustments in the 2024-29 roll-forward model (RFM) under new asset categories. For depreciation purposes, we have assigned remaining asset lives to reflect the average remaining term of the relevant contract irrespective of whether the contract will be renewed of not.

These RFM adjustments are outlined in Table 2 and include only the portion of the outstanding lease payments attributed to providing standard control services.

[1] AASB 16 specifies that outstanding lease payments should be discounted using the interest rate implicit in the lease if that rate can be readily determined. Otherwise, the lessee's incremental borrowing rate can be applied. Accordingly, we have applied a 5.88% discount rate to determine the present value of future lease payments.

Table 2: End of period RFM asset adjustments

RFM Asset Category	Opening RAB ($m; nominal)	Opening TAB ($m; nominal)	Standard life (yrs)	Standard tax life (yrs)
Short Term Leases*	16.7	11.4	5.0	5.0
Long Term Leases	28.1	22.7	10.0	10.0

3. Accounting for new leases from 1 July 2024

The value of any new lease contracts commencing from 1 July 2024 will be added as part of the respective property or fleet capital expenditure forecast for the 2024–29 period. That is, the full amount of a lease will be capitalised up-front when it is first entered into, or renewed, and amortised over its lease term.

We propose to reflect these capital costs in the Post-tax Revenue Model (PTRM) under the same asset categories used in the RFM. This is required as the duration of the lease agreements differ from the standard lives of the existing fleet and property categories which applies to purchased (or non-leased) fleet or property assets. Assigning newly capitalised leases a useful life equivalent to the underlying lease terms rather than the pre-existing life currently set out for the respective asset in the PTRM is required to maintain an accurate depreciation profile.

Table 3 below outlines our forecast of capitalised leases being entered into or renewed during the 2024-29 regulatory control period. We note that the 10-year lease term for our Parramatta head office means no capex will be incurred over the 2024-29 and included in the PTRM category dedicated to this lease. Rather, the remaining value of this lease (which was paid for up-front in the 2019-24 period and initially included in opex) will have been rolled into the RAB and depreciated in accordance with 10 year life set out in the RFM.

Table 3: 2024-29 capitalised leases forecast ($m; Real 2024)

Lease Type	2025	2026	2027	2028	2029	Total
Total Fleet	1.99	5.36	2.35	6.78	1.27	17.75
Sydney CBD Office	*0.00*	*0.00*	*0.35*	*0.00*	*0.00*	*0.35*
Parramatta Office						
Total Property	0.00	0.00	0.35	0.00	0.00	0.35
Total	**1.99**	**5.36**	**2.70**	**6.78**	**1.27**	**18.10**

Totals may not sum 100% due to rounding.

Similar to existing leases, only the portion of newly capitalised leases allocated to standard control services will be included in the respective fleet or property capex forecast and included in the PTRM.

4. Adjustments to our 2024-29 opex forecasts

Adopting *AASB 16 Leases* should have a neutral impact on customers as we will only be recovering the present value of opex lease payments via the capex forecast. To facilitate the change in accounting treatment and ensure lease costs are not double counted, we propose to make the appropriate corresponding adjustments to our opex forecast for 2024-29. There are two methods these adjustments could be applied in our 2024-29 opex model. These include making:

- a negative step change for each year of the 2024-29 period; or
- a reduction to opex reported in base year FY23.

We note there has been some inconsistency in how DNSPs have adjusted their opex forecast to account their implementation of the AASB 16 standard. For instance Essential Energy proposed a negative step change in their 2019-24 proposal. This contrasts with the approach taken by AusNet Services which proposed to adjust its base year opex amount. In both cases, the AER accepted the proposed approach and included the reductions in their alternative opex forecast.

We consider a base year adjustment is the most appropriate approach. This is because the presence of leasing costs which are now considered non-recurrent due to the change in accounting standard, means our revealed base year opex is not suitable to be used as a foundation to establish our opex requirements for 2024-29. The AER's Expenditure Forecasting Assessment Guideline suggests a base year adjustment should apply in these circumstances and is more appropriate than a step change approach which is confined to efficient opex/capex trade-offs or costs from new regulatory obligations.

We have determined that an opex base year adjustment of -$5.65m nominal (Real FY$24 -$5.86m) is required to account for the reduction in opex from 1 July 2024 resulting from *AASB 16 Leases*. We note that our base year opex will only be changed for opex forecasting purposes and will remain unadjusted when the AER assesses the efficiency of our opex in the base year.

5. Updating opex for EBSS purposes

As aforementioned, the AER has clarified that from a regulatory perspective the reporting of expenditure within a period should be aligned with the approved expenditure for that period. This has implications for calculating financial payments accrued under the EBSS during 2019-24 in that actual opex for EBSS purposes should include lease costs until the end of the 2019-24 regulatory control period.

Although we have adopted *AASB 16 Leases* for our statutory accounts from the start of the 2019-24 period, we had not reported leasing costs in our regulatory accounts for FY20 and FY21. This was partially due to uncertainty about the appropriate reporting of these costs following the commencement of *AASB 16 Leases*. Whilst we understood leases were no longer to be reported as opex, there was no appropriate asset category in the PTRM to enable these costs to be attributed. Consequently, lease costs incurred in FY20 and FY21 were accounted for as adjustments which capture cost discrepancies between our statutory and regulated accounts.

In accordance with the AER's subsequent clarification on the appropriate treatment of these costs, we will include leases in our regulated opex from FY22 until FY24. Nevertheless, the absence of these costs in FY20 and FY21 understates our actual opex and could imply the lower opex spend observed in these years was achieved through an efficiency gain.

To avoid potentially accruing an EBSS reward for this opex underreporting, we propose to have the lease opex omitted from our FY20 and FY21 regulated opex be included in our EBSS calculations. To be clear, we confirm lease opex reported in Table 1 (with the exception of FY24 opex as per EBSS convention) will be included in our actual opex for EBSS purposes.

endeavourenergy.com.au

Endeavour Energy

POWER together