13 February 2015

Ms Paula Conboy
Chair
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Ms Conboy

Re: Supplementary Submission on the Australian Energy Regulator's (AER's) Essential Energy draft distribution determination 2015-16 to 2018-19

Essential Energy is pleased to provide this supplementary submission on the AER's retrospective adjustment for capitalised provisions to actual audited capital expenditure incurred in the 2008-09 to 2013-14 period as contained in the Australian Energy Regulator's (AER) draft determination in relation to Essential Energy.

Essential provides this submission in the context of the AER's public consultation on its draft distribution determination released on 27 November 2014. This submission should be read in conjunction with the Essential Energy revised proposal submitted on 20 January 2015.

The attachment to this document contains further detail on our submission and will assist stakeholders to gain a more thorough understanding of our revised regulatory proposal and responses to matters raised by the AER in its draft decision.

Summary

Essential Energy does not agree with the AER's retrospective adjustment for capitalised provisions to our actual audited capital expenditure incurred in the 2008-09 to 2013-14 period as:

> The adjustment is inconsistent Australian Accounting Standards, as well as Essential Energy's audited accounts and forecasting method, and will misrepresent true capital expenditure costs in the regulatory asset base (RAB); and

> The move from an accrual based method to a cash based method would burden Essential Energy with additional regulatory compliance costs and result in volatility in charges for our customers.

Should the AER persevere in adjusting the actual audited capital expenditure, its calculations need to be adjusted to accurately reflect the cash payments portion of capitalised provisions.

Background

The AER contended that movements in provisions should be excluded from the actual audited capital expenditure included in the RAB from 2008-09 to 2013-14, on the basis that increases in provisions do not represent actual costs incurred in delivering network services as the expenses have not been paid out.

We consider that increases in provisions do represent costs incurred in providing standard control services. Employee provisions are calculated in accordance with Australian Accounting Standards and are represented in Essential Energy's profit and loss statement. That the provision allows for future payments does not change the nature of it being a cost incurred in providing the services. Our independently audited and published accounts show the actual capital expenditure incurred in each year, which includes some movement in provisions related to employees. These audited amounts were used by Essential Energy in Attachment 5.1 to our revised regulatory proposal.

We engaged Ernst & Young (EY) to review the AER's adjustments and outline the benefits and costs of adopting the AER approach. We also had EY review the AER calculations for correctness. The EY report is attached to this submission and finds that:

> The move to a cash based accounting approach would bring about volatility in charges and make regulatory forecasting more difficult – employees do not give up to five years notice if they intend to take leave
> Substantial modifications to systems and processes would be required to accommodate two separate sets of calculations and data.
> The AER adjustment calculation has removed the non-cash movement in the capital expenditure provision along with the original increase in provisions allocated to capital expenditure without taking the associated cash outlay into account.
> Subtracting the non-cash portion and correctly adding back the cash payments reduces the total adjustment amount from $73 million to $10 million.

Purpose of provisions
Provisions are recognised in the actual audited capital expenditure consistent with Australian Accounting Standards as they:

> Provide an accurate picture of a business's balance sheet position by including all legally binding obligations at a specific point in time; and
> Recognise that liabilities should be expensed as they are incurred, not when the cash payment necessarily arises; and
> Ensure that an asset cost comprises all costs incurred in bringing that asset into operation (regardless of whether such costs have physically been paid).

Employee costs
In order to provide standard control services, Essential Energy employs staff. The cost to the business of retaining an employee does not equal the base salary of that employee. The true cost of an employee necessarily comprises the other costs to which employees are legally entitled through Legislation or Enterprise Bargaining Agreements (namely annual leave, sick leave, superannuation and long service leave), as well as the other costs incurred by the business in having those staff including workers compensation insurance.

These costs are known as on-costs and are a facet of every business that employs staff. At Essential Energy, an on-cost rate is budgeted annually for each labour dollar spent. As work in undertaken, the on-costs are spread across operating and capital expenditure projects respectively.
Many on-costs may not be physically paid out in cash for some time. This is the case with, say, annual leave. For example, assume an employee receives four weeks annual leave a year, but does not take their leave until two years after it accrues.

> The on-cost calculation will ensure an even spread of the accruing annual leave across all projects the employee works on for those two years – some costs may be capitalised into assets, some may be expensed through the profit and loss
> The annual leave provision will increase evenly over the two year time period.
> The profit and loss impact will also be (generally) smoothed over the two year period.
> Any assets worked on by the employee and brought into commission will have been correctly valued as they will include a relevant portion of the employee's on-costs.
> When the leave is physically paid out in two years' time, the provision is reversed against the cash paid. There is no additional profit and loss impact.

Definition of incurred
The AER interpretation seems to hinge on the definition of when the cost is incurred. Is it incurred over time as the employee works for the employer, or is it incurred when the employee actually takes the leave? Australian Accounting Standards deem an obligation for employers to compensate employees for their services as those services are consumed by the employer. As employees undertake work for their employer they are necessarily accumulating their entitlement to annual leave and long service leave.

Essential Energy agrees with this accrual accounting definition as it is correctly recognises that the liability to compensate the employee for these costs, arises as the employee's services are undertaken. It is also consistent with financial reporting concepts. The timing of the cash outlay does not of itself change the nature of the cost (whether it has been capitalised or expensed) or the purpose for which it is was incurred.

Retrospective adjustment to data
Essential Energy believes the AERs retrospective adjustment to the RFM is inconsistent with clause 6.5.1(e) of the NER which requires the published RFM to set out the method for determining the roll forward of the regulatory asset base. There was no direction explaining that capital expenditure required adjustment for any provision movements in the published RFM method for the 2008-09 to 2013-14 period.

The provision adjustments for an attempted move to a cash based method would create large inconsistencies between the audited accounts, regulatory accounts and the AER's roll forward model.

Burden of moving to a cash based method of reporting
Moving to a cash based accounting method for reporting provisions would significantly burden the business as it would require two separate ledgers using two separate sets of on-costs. It seems an unnecessary waste of time and effort with minimal (if any) gain for customers from the change. Additional time would be required to reconcile the two ledgers and additional audit fees would be incurred in reviewing the additional data set.

Forecasting under a cash based method would also be particularly complex and give rise to potentially significant additional regulatory true-ups at the end of the period. Staff are generally entitled to take leave with minimal notice and it would be difficult to accurately predict the payments that would need to be made up to five years in advance.

As previously mentioned, provisions smooth the impacts of actual cash expenditure on revenues and customer charges by correctly recognising that liabilities for payments arise over time as employees complete services. It would be a backward step to move to a less superior cash accounting method.

AER's calculation of the capital expenditure adjustment for provisions
As mentioned above, Essential Energy does not agree with the AER's subtraction of provision movements from the actual capital expenditure incurred. However, if the AER continue to push for a retrospective adjustment, our review of the AER calculations has found that:

- The AER has removed the entire non-cash capital expenditure component related to employee provisions, but with no corresponding adjustment for cash payments made.
- Subtracting the non-cash portion and correctly adding back the cash payments reduces the total adjustment amount from $73 million to $10 million.
- Only employee entitlements have been considered by the AER. To accurately undertake the calculation, all relevant capitalised provisions would need to be considered.

We look forward to further engagement with the AER and our customers on our revised regulatory proposal and submissions. If you have any questions in relation to our revised regulatory proposal and submissions, please contact Natalie Lindsay, Manager Network Regulation 02 6589 8419.

Yours sincerely

p.p.

Vince Graham
Chief Executive Officer

Attachment1: Essential Energy – AER treatment of provisions – adjustments to 2009-14 RAB