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

Thank you for choosing Ernst & Young ("EY" or "us") to provide guidance to Essential Energy ("Essential", "you" or "client") on the proposed treatment adopted by the Australian Energy Regulator ("AER") in relation to movements in provisions and the associated adjustments made to Essential's 2009-14 Regulatory Asset Base ("RAB") and 2014-19 regulatory forecasts.

1. Background

Every five years, Essential and other Network Service Providers ("NSPs") across Australia are required to submit a regulatory proposal to the AER to set appropriate network charges, metering charges, ancillary network services charges and public lighting charges. The AER's determination depends on the accuracy of certain financial models, including the Roll Forward Model ("RFM") for the Regulatory Asset Base ("RAB").

In their Substantive Revenue Proposals ('Proposals') submitted to the Australian Energy Regulator ('AER') in May 2014[1], 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.

In their draft determinations issued in response to the Proposals, the AER has made a series of adjustments to the forecasts, and, for Essential, to historic capex information in the previous (2009-14) RAB, relating to movements in provisions. We understand that these adjustments are intended to rebase the revenue allowances to reflect a 'cash accounting' approach.

Essential has advised us that it considers the adjustments, in particular those made to the historic RAB information, contain errors and inaccuracies which have unfairly affected Essential's determination, and has engaged EY to analyse these adjustments.

2. Accruals vs. cash accounting for regulatory purposes

The NSW DNSPs argued in their original Proposals that reversing 'movements in provisions' effectively represents 'cash accounting' for regulatory purposes, and would result in amounts which are true economic costs to the businesses not being taken into account by the AER when setting revenue requirements. The AER has argued however 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 services[2], 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.

[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 '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.

As previously discussed with the NSW DNSPs, we also consider that the AER adjusting proposed forecast costs for movements in provisions and the move towards 'cash accounting' for provisions excludes from revenue allowances an element of the true economic cost (the portion deferred to future periods) of providing standard control services.

For example, the true economic cost of providing standard control services and associated employee benefits includes, in any given period, the cash paid out to employees in that period and an additional non-cash amount representing additional entitlements that the employee has earned in the period but will be required to be paid at some point in the future. These additional amounts represent a genuine obligation to the business that 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.

Although movements in provisions do arise from changes in long term estimates and assumptions, which the AER has raised concerns about businesses being compensated for, 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. If the AER excludes both of these types of movement in provisions rom regulatory allowances, the impact on pricing is likely to be unpredictable and volatile, as cash costs rather than smoothed accounting costs are passed on to customers.

The proposed 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. The additional cost associated with this extra work is likely to be significant, and may not result in meaningful gains for customers.

3. Capitalisation of certain provision movements

In line with Australian Accounting Standard AASB 116 Property, Plant and Equipment, the cost of an asset includes any costs which 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[3].

AASB 116 also lists 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.

Essential and the other NSW DNSPs therefore recognise a portion of labour costs in both the statutory and regulatory asset bases if the work being performed by an employee is capital in nature. 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 Essential incurs a present obligation to provide benefits as employment services are rendered. Introducing a cash basis of

[3] AASB 116.16(b)

accounting for RAB items would therefore introduce further potential pricing volatility, as the RAB is increased for cash expenditure rather than amounts recognised under Australian Accounting Standards, and require further analysis and calculation from the DNSP reporting teams.

4. Adjustments made to 2009-14 RAB

We note that in addition to making adjustments to opex forecasts and amounts reported under various incentive schemes (for example the Efficiency Benefit Sharing Scheme) in relation to the 2014-19 proposals, for Essential the AER has also retrospectively adjusted amounts previously reported and agreed in the 2009-14 roll forward model used to calculate the value of the opening RAB in the 2014-19 forecasts.

Essential has provided us with a copy of the workings produced by the AER and the adjusted 2009-14 roll forward model and identified a number of weaknesses and errors in the way that the cash accounting approach has been applied. Essential has also raised the issue of whether the AER is able, under the National Electricity Rules ("NER"), to retrospectively adjust figures reported as actual in the previous regulatory control period.

We understand that the AER has attempted to undertake the following analysis using data submitted by Essential in its May 2014 Regulatory Information Notices ("RINs"):

- Analyse the increases in key provisions throughout the 2009-14 period that were allocated to capex;
- Compare this amount with the associated cash paid against these provisions; and
- Reduce the 2009-14 RAB by the difference between these two amounts (representing the non-cash capex movement in provisions across the period).

The actual adjustments made do not appear to follow this approach, and in fact not only disallow the non-cash movement in provisions (which would be expected under a move to cash accounting for provisions), but also the full cash expenditure which we would expect to be allowable under the revised approach.

The steps below show the adjustments, as calculated by the AER, and highlight a number of issues, both with the calculations performed and the theory behind the approach taken:

Step 1: Establish amounts previously reported increases to provisions

(a) Movements allocated to opex

The following table is an extract from the Reset RIN submitted by Essential to the AER in May 2014 and shows the amounts reported as increases in provisions allocated to opex throughout the 2009-14 regulatory control period:

Figure 1: Reset RIN Table 2.13.2 (opex section)

Allocation of movement in total provisions incl. RPM	Previous period	Current regulatory control period				
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Actual	Actual	Actual	Forecast/ Estimate	Forecast/ Estimate
	Nominal	Nominal	Nominal	Nominal	Nominal	Nominal
Movement in provisions allocated to opex	$'000	$'000	$'000	$'000	$'000	$'000
Dividend provision	0	0	0	0	0	0
Provision for employee entitlements	-43,228	-32,283	-48,584	-85,986	-31,595	-33,524
Provision for environmental remediation	-124	-1,446	-4,866	-512	-4,084	-958
Provision for business restructuring	0	0	0	-2,358	-1,235	0
Provision for worker's compensation	0	0	-4,165	-4,834	-1,718	-631
Provision for defined benefit superannuation	1,781	-2,722	-1,749	1,759	-626	-4,777
Other provisions	0	-13,488	-3,061	-403	233	6
Total movement in provisions allocated to opex	- 41,571	- 49,939	- 62,426	- 92,333	- 39,026	- 39,883

We note that the opex movements in only the provision for employee entitlements ($43.2m in 2008-09, and $275.2m in total (pre inflation)) have been considered further, rather than the total movements in provisions allocated to opex as we would expect (refer to Section 5 below).

(b) Movements allocated to capex

The following table shows movements in provisions across the same regulatory control period that were allocated to capex and therefore recognised as an increase to the RAB in previous years ($9.0m in 2008-09, and $63.1m in total (pre inflation)):

Figure 2: Reset RIN Table 2.13.2 (capex section)

Allocation of movement in total provisions incl. RPM	Previous perioc	Current regulatory control period				
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Actual	Actual	Actual	Forecast/ Estimate	Forecast/ Estimate
Movements in provisions allocated to as-incurred capex by asset class						
Sub-transmission lines and cables	-634	-551	-661	-1,308	-431	-802
Distribution lines and cables	-5,705	-3,771	-6,622	-11,537	-4,440	-7,744
Substations	-1,490	-1,189	-1,788	-3,825	-1,121	-1,213
Transformers	-13	-32	-24	-1	-1	-1
Low voltage lines and cables	-607	-593	-864	-1,152	-356	-571
Customer metering and load control	-413	-274	-510	-712	-286	-654
Total communication	0	0	0	0	0	0
Land	-30	-12	-62	-109	-22	0
Easements	-111	-82	-157	-370	-99	0
Emergency spares (major plant, excludes inventory)	0	0	0	0	0	0
Alternative control services	-20	-41	-30	-17	-5	-5
Total movement in provisions allocated to as-incurred capex	- 9,022	- 6,545	- 10,716	- 19,033	- 6,759	- 10,990

It therefore appears that the AER has adopted an inconsistent approach by taking the movements in all provisions (i.e. the total movements in the above table) when considering the capex movements, but only the employee entitlements provision when considering opex movements.

The total increase in provisions taken forward by the AER for further analysis as shown below is therefore the sum of the opex (Step 1a) and capex (Step 1b) amounts, i.e. $52.3m in 2008-09 and $338.3m in total (pre inflation).

Step 2: Compare increases in provisions with corresponding cash amounts paid out

The following table is an extract from a larger table showing the total movements in all major provisions during the regulatory period, including the cash paid against each provision. We note again that the AER has selected only the employee entitlements provision for further analysis ($34.3m paid in 2008-09 and $275.6m in total (pre inflation)):

Figure 3: Reset RIN Table 2.13.1 (employee entitlement section)

Changes in total provisions incl. RPM	Previous period	Current regulatory control period				
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Actual	Actual	Actual	Actual	Forecast/ Estimate	Forecast/ Estimate
	Nominal	Nominal	Nominal	Nominal	Nominal	Nominal
	$'000	$'000	$'000	$'000	$'000	$'000
Provision for Employee Entitlements						
The carrying amount at the beginning of the period	- 157,424	- 175,381	- 181,515	- 197,373	- 253,081	- 236,456
Increases to the provision	-52,250	-38,828	-58,393	-103,984	-38,003	-44,312
Amounts used (that is, incurred and charged against the provision) during the period	34,293	32,693	42,534	48,276	54,628	63,185
Unused amounts reversed during the period	0	0	0	0	0	0
The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.	0	0	0	0	0	0
The carrying amount at the end of the period	- 175,381	- 181,515	- 197,373	- 253,081	- 236,456	- 217,583

The difference between these cash amounts and the total increase in provisions identified in Step 1 above is $18.0m in 2008-09 and $62.7m in total (pre inflation) and is the true non-cash 'movement in provisions' – i.e., the amount that under the AER's revised approach to provisions is not allowable for regulatory purposes as there is no associated cash outlay.

Step 3: Allocate non-cash movement across opex and capex

Of the amount identified in Step 2 above, a portion is allocated to opex (in theory, under this approach this should be a retrospective adjustment to amounts previously reported as opex), and capex (for adjustment in the RAB).

This allocation has been made, for each individual year, on a pro-rata basis using the provision increases identified in Step 1a and Step 1b above.

Taking 2008-09 as an example, the opex adjustment is calculated as $14.9m ($18.0m x ($43.2m / $52.3m)), and the capex portion is $3.1m ($18.0m x ($9.0m / $52.3m)):

Figure 4: Proposed opex and capex adjustments (extract from AER workings)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Total (pre-inflation)
Suggested adjustment for movement in provisions - opex ($m)	(14,856.3)	(5,100.2)	(13,736.4)	(46,458.7)	13,405.6	14,060.4	(52,685.6)
Suggested adjustment for movement in provisions - capex ($m)	(3,100.7)	(1,034.0)	(3,029.9)	(10,283.5)	2,867.9	4,609.5	(9,970.7)

Under this approach, we would therefore expect to see a reduction to the RAB value of $3.1m for 2008-09 and a total of $10.0m (pre inflation).

Step 4: Adjust amounts reported in RAB

As noted above, under this approach the capex adjustment identified in Step 3 should cause the RAB value to decrease by a total of $10.0m (pre inflation). However in the AER's workings (shown overleaf), the actual adjustment is a total of $72.9m (pre inflation):

Figure 5: Original capex per roll forward model and proposed adjustment (extract from AER workings)

	Capex per original roll forward model ($m)							Proposed adjustment (AER workings) ($m)						
	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Total (pre-inflation)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Total (pre-inflation)
Sub-transmission lines and cables	15.5	65.6	97.5	84.2	95.9	58.2	416.8	(0.9)	(0.6)	(0.8)	(2.0)	(0.2)	(0.5)	(5.1)
Distribution lines and cables	245.2	240.8	309.0	339.2	283.2	253.6	1671.0	(7.7)	(4.4)	(8.5)	(17.8)	(2.6)	(4.5)	(45.3)
Substations	153.6	148.1	109.0	117.3	120.4	103.8	752.1	(2.0)	(1.4)	(2.3)	(5.9)	(0.6)	(0.7)	(12.9)
Transformers	35.2	46.6	50.8	67.0	35.8	57.5	293.0	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)
Low voltage lines and cables	24.0	38.4	56.3	69.5	78.1	38.3	304.6	(0.8)	(0.7)	(1.1)	(1.8)	(0.2)	(0.3)	(4.9)
Customer metering and load control	35.1	24.5	9.3	8.2	13.9	26.6	117.7	(0.6)	(0.3)	(0.7)	(1.1)	(0.2)	(0.4)	(3.2)
Communications	5.5	5.9	10.3	8.9	7.7	12.0	50.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Land	6.2	8.1	0.3	4.2	2.9	0.2	21.9	(0.0)	(0.0)	(0.1)	(0.2)	(0.0)	0.0	(0.3)
Easements	4.9	14.0	11.4	8.8	12.9	5.1	57.2	(0.1)	(0.1)	(0.2)	(0.6)	(0.1)	0.0	(1.1)
Emergency spares (major plant, excludes inventory)	0.0	0.0	0.0	0.0	0.0	0.3	0.3							
Work in Progress @ 30 June	0.0	0.0	0.0	0.0	0.0	0.0	0.0							
IT systems	54.5	29.9	30.1	37.8	13.6	34.0	200.0							
Furniture, fittings, plant and equipment	16.6	11.7	13.8	19.1	15.9	4.6	81.7							
Motor vehicles	51.9	79.3	52.7	53.6	20.8	26.1	284.5							
Buildings	0.0	0.0	15.6	14.9	8.9	25.7	65.1							
Land	6.6	10.6	4.3	0.2	0.1		21.8							
Other non-system assets	0.0	0.3	0.8	0.0	4.1		5.2							
RAB adjustment	0.0	0.0	0.0	0.0	0.0		0.0							
Deferred depreciation	0.0	0.0	0.0	0.0	0.0		0.0							
Equity raising costs	0.0	14.4	0.0	0.0	0.0		14.4							
Total	**654.8**	**738.4**	**771.2**	**832.8**	**714.4**	**646.0**	**4,357.7**	**(12.1)**	**(7.5)**	**(13.7)**	**(29.3)**	**(3.9)**	**(6.4)**	**(72.9)**

The discrepancy between the expected adjustment ($3.1m in 2008-09, and $10.0m in total) and the actual adjustment shown above ($12.1m in 2008-09, and $72.9m in total) appears to arise because in this final step of the calculation, the AER has also removed from the RAB both the non-cash movement in provisions and the original increase in provisions allocated to capex identified in Step 1b above ($9.0m in 2008-09, and $63.1m in total), for which there was an associated cash outlay.

This appears to not only disallow the non-cash movement in provisions (which would be expected under a move to cash accounting for provisions), but also the cash capex which we would expect to be allowable under the revised approach.

The following section discusses this and other issues identified in the calculations.

5. Issues with AER calculations

The following issues are noted in relation to the calculations discussed above:

- The net effect of the adjustment made is to remove from the 2009-14 RAB not only the non-cash amounts accrued under Australian Accounting Standards, but also the full cash payments made against those provisions.

  Effectively the calculation removes the full movement in provisions allocated to capex, but does not add cash expenditure back into the RAB. This means that throughout the 2009-14 regulatory period, Essential's RAB does not reflect any capital expenditure as a result of amounts charged to provisions, for example, the capital component of labour on-costs. For example, the cost of employee leave that is both accrued (capitalised) and subsequently taken during the 2009-14 regulatory period would not be reflected in the RAB under this approach.

- Only the employee entitlements provision is considered when analysing amounts recorded as an increase to provisions.

  As noted in Step 1a above, when establishing the amounts recorded as an increase to provisions recorded as opex, only the employee entitlements provision is included in the calculation. Although this is the most significant movement, it appears that the principles behind moving to a cash accounting model should be applied to all provisions, including the additional workers compensation and defined benefit superannuation costs included in the labour on-cost model.

- In order to properly transition from an accruals to a cash accounting approach, monitoring of some provisions may be required at a detailed level, for example by individual employee for annual leave balances, in order only increase the RAB by the cash payments in relation to leave accrued since the beginning of the regulatory period. This would avoid, for example, a regulatory cost being added to the RAB twice for leave accrued (capitalised) prior to 2008-09 that was taken in the 2009-14 regulatory period.

  This is likely to place an additional burden on the DNSPs' financial and regulatory reporting teams on transition, and 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.

6. Caveats and limitations

The management of Essential 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 Essential in concluding on the appropriateness of the AER adjustments.

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.

This report has been prepared for the information and sole internal use of Essential in concluding on the appropriateness of the AER adjustments. 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 Essential, or for any purpose other than that for which it was prepared.

This report has been provided in accordance with our engagement agreement dated 3 February 2015, and all of the terms set out in that agreement also apply to this report.

Yours sincerely

PGraham

Peter Graham

Partner, Ernst & Young