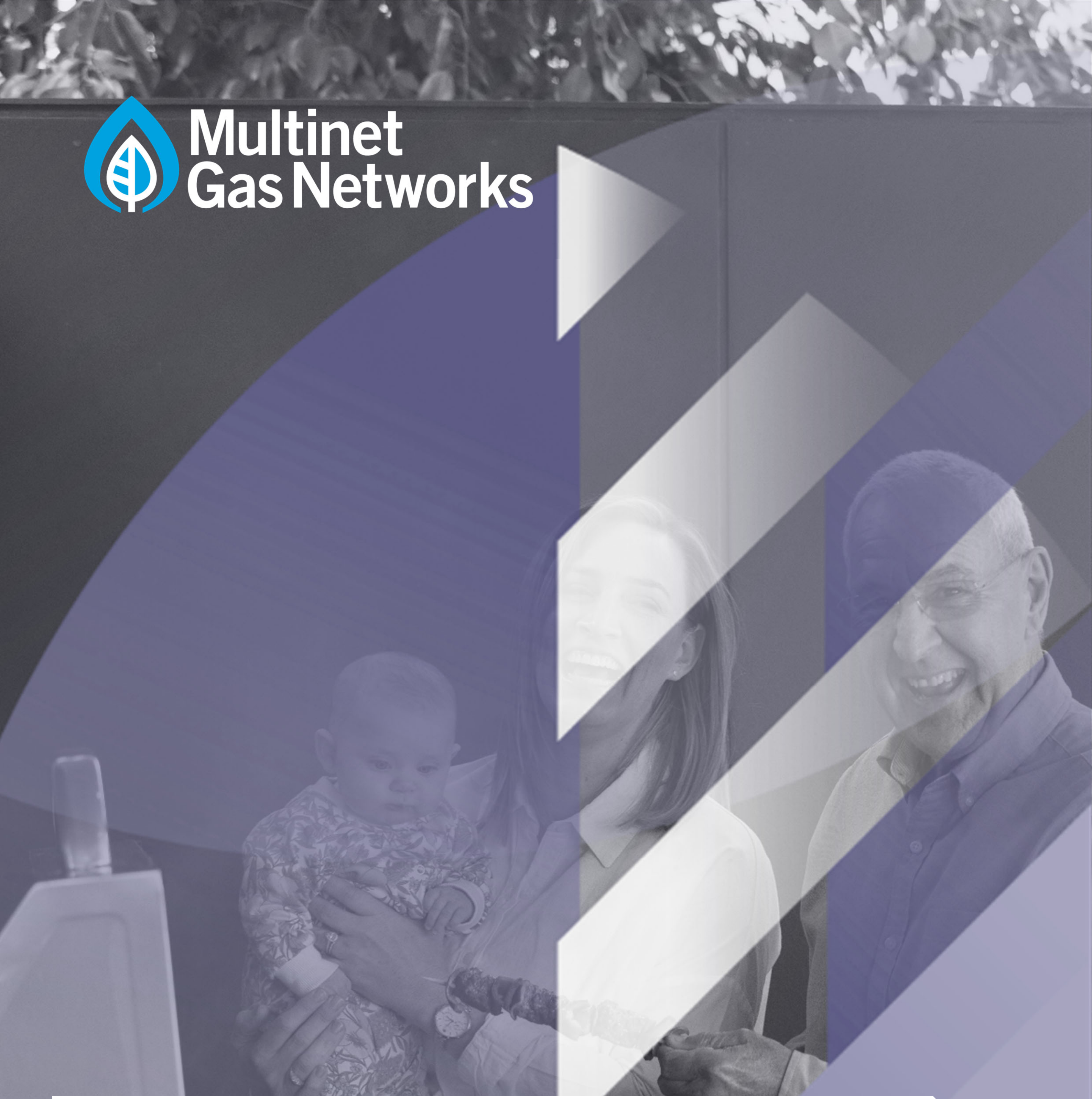


Attachment 8.3

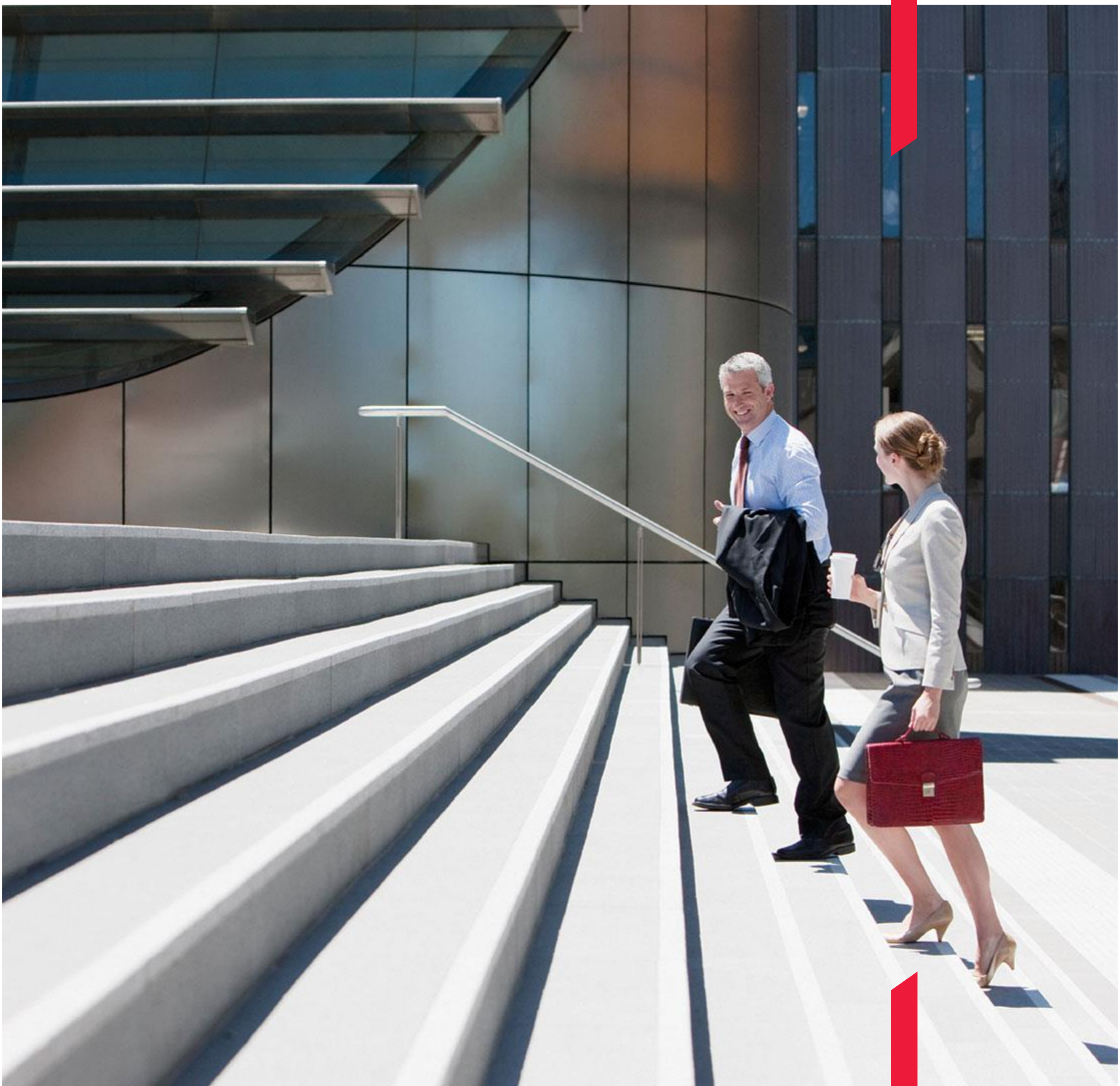
BDO - Reclassification of certain programs to Opex from 2023/24

Final Plan 2023/24 – 2027/28

July 2022

Multinet Gas Networks (MGN) - Victoria Distribution Network

Reclassification of certain programs to Opex from 2023/24



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Introduction

BDO have been engaged by Multinet Gas Networks (MGN) to undertake a review of its proposal to classify certain expenditure as operating expenditure (opex) in the next AA period (AA) for the 5 year period commencing 1 July 2023.

This report documents the scope, agreed approach and our findings.

Scope and Scope Limitations

The assignment is a consulting engagement as outlined in the 'Framework for Assurance Engagements', issued by the Auditing and Assurances Standards Board, Section 10. Consulting engagements employ an assurance practitioner's technical skills, education, observations, experiences and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results, and sometimes implementation and follow-up.

The nature and scope of work has been determined by agreement between BDO and MGN. This consulting engagement does not meet the definition of an assurance engagement, as such we are not proposing an audit in accordance with generally accepted auditing standards.

Except as otherwise noted in this report, we have not performed any testing on the information provided to confirm its completeness and accuracy.

Our report is prepared solely for the use of MGN and its regulatory proposal to the Australian Energy Regulator (AER). No responsibility to any third party shall be accepted, as our report has not been prepared, and is not intended, for any other purpose.

This report is based on the latest information made available to us as at the date of this report and we accept no responsibility to update it for events that take place after the date of its issue.

The following items have been excluded from the scope of this review:

1. Except as otherwise noted, we will not perform any testing on the information provided to confirm its completeness and accuracy.
2. In performing our procedures, we will rely upon certain representations made by MGN and their representatives. We will not perform procedures to verify the accuracy or completeness of such representations.

Approach

Objective

Undertake a review of MGN's proposal to classify certain expenditure as operating expenditure (opex) in the next Access Arrangement period (AA) for the 5 years commencing 1 July 2023.

To address the objectives of this assignment, the following procedures were determined, agreed and undertaken:

Phase 1: Business Understanding

In this phase, BDO engaged with MGN project managers and key business representatives to understand the nature of the activities undertaken in the programs under review, as referred to in Table 1 below[1].

We also reviewed asset strategies which incorporated the High-density polyethylene (HDPE) assessment, reactive mains replacement, marker post replacement and Pipeline Inline Inspections.

Table 1:

Program	Activities	AA forecast $m (June 2023)
Support overhead costs related to capital activities	Indirect Finance and IT program management activities to support the management of capital projects	$3.0
High-density polyethylene (HDPE) assessment	Collaborative program across Victorian gas distribution businesses to collect samples of DN40 and DN50 HDPE 575 mains across targeted areas in each network. The samples will be assessed in conjunction with Deakin University and Future Fuels Cooperative Research Centre and a model estimating the life expectancy of the material created, which will inform ongoing asset management required in future AA periods	$1.2
Reactive mains replacement	Reactive repair or replacement of small sections of mains where needed	$4.3
Marker post replacement	Replacement of marker post signs along transmission pipelines to maintain legible warning signage for buried pipelines	$0.2
Pipeline Inline Inspections	In line inspection of transmission pipelines using a tool called a pig	$6.0
Total proposed to be reclassified to Operating Expenditure (opex)		**$14.7**

[1] Information provided by MGN

Phase 2: Business Information Analysis

In this phase, we conducted a review of the information provided including:

- Reviewed and considered the activities associated with each program of work as provided by MGN.
- Reviewed and considered asset strategies provided by MGN which incorporated the High-density polyethylene (HDPE) assessment, reactive mains replacement, marker post replacement and Pipeline Inline Inspections.
- Reviewed publicly available information relating to the regulatory accounting treatment of overheads, and asset inspection cost by other regulated utilities businesses.
- Considered the reasonableness of expensing the costs associated with these programs for regulatory purposes considering accounting standards and regulatory practice in Australia. Further information in relation to guidance drawn from accounting standards and other relevant Australian Accounting Standards Board (AASB) pronouncements, is provided in Appendix 1.

Phase 3: Report Findings

This report documents a summary of our findings (‘Key Findings’) and a detailed explanation of our findings (provided in Appendix 2).

Summary of Key Findings

Based on the information provided we consider MGN's proposal relating to MGN to treat all of the expenditure listed in Table 1 of this report, as operating expenditure is reasonable with the relevant key points being:

- **Support overhead costs related to capital activities**

  MGN outlays related to 'support overhead costs related to capital activities' encompasses indirect Finance and IT program management activities to support the management of capital projects. The treatment of these outlays as opex is also supported by the AASB 'Framework' in that these activities do not materially add to the value of existing assets by extending their life or increasing their capacity, but rather this expenditure should be classified as operating expenditure. As such, we believe the expenditure associated with these overhead activities should be treated as operating expenditure.

- **HDPE assessment, Reactive mains replacement and Marker post replacement**

  Activities related to HDPE assessment and Reactive Mains Replacement programs do not add to the value of existing assets by extending their life or increasing their capacity but rather are an ongoing program of activities that relate to the safe and reliable operation of MGN's assets. Similarly, Marker Post Replacement costs are also of an ongoing operational nature. These activities are of a relatively low value which supports their treatment as opex. In addition, BDO also understands these activities are ensuring the ongoing safe and reliable operation of MGN's pipeline, which is more related to day-to-day operational and maintenance activities. We therefore consider these programs/costs meet the AASB definition of expense and therefore classified as operating expenditure.

- **Pipeline Inline Inspections**

  Based upon publicly available Australian Regulatory Information Notices (RINs) we note that asset inspection costs are widely accounted for as operating and maintenance expenditure by electricity Distribution Network Service Providers (DNSPs) in multiple regulated jurisdictions across Australia. We also note recently in Western Australia, that the Economic Regulation Authority (ERA) has accepted ATCO's proposal for its next AA period covering 2020-24 (AA5) to account for expenditure associated with gas pipeline, inline inspections as opex. BDO also considered whether the nature or magnitude of these activities were considered as major inspections, and hence capitalised, or were integral to the ongoing operation and maintenance of the assets, and hence expensed as opex. There is sufficient industry practice to suggest this activity is opex.

  As such, we believe the expenditure associated with these activities should be therefore treated as operating expenditure.

We propose the forecast expenditure by MGN as part of undertaking all of these activities and programs in the next AA period as shown in Table 1 and as described to BDO by MGN, meets the definition of an expense as provided in paragraph 69(b) of the *Framework for the Preparation and Presentation of Financial Statements* (*"the Framework"*). See Appendix 1 for relevant extracts from *the Framework*.

Further, given the Inline Inspections and Reactive Mains Replacement are integral to MGN's ongoing business of earning operating revenues from the use of these assets, we believe the expenditure should be recognised at the time incurred in accordance with paragraph 94 of *the Framework* and the matching principles in paragraph 95.

Appendix 1 - Guidance in Accounting Standards, AASB pronouncements and internal policies.

Overarching context:

Australian Accounting Standards, the Australian Accounting Standards Board 'Framework for the Preparation and Presentation of Financial Statements', and MGN Accounting Principles and Policies provide guidance in determining the treatment of capital (capex) and operating (opex) outlays.

The Australian Accounting Standards Board (AASB) is an Australian Government agency constituted under Part 12 of the *Australian Securities and Investments Commission Act 2001 (ASIC Act)*. The functions of the AASB, as reflected in section 227 of the ASIC Act, include the development and maintenance of high quality accounting standards for all sectors of the Australian economy.

Under the ASIC Act, the statutory functions of the AASB are:

- to develop a **conceptual framework** for the purpose of evaluating proposed standards;
- to make **accounting standards** under section 334 of the *Corporations Act 2001*;
- to formulate accounting standards for other purposes;
- to participate in and contribute to the development of a single set of accounting standards for worldwide use;
- and to advance and promote the main objects of Part 12 of the ASIC Act, which include reducing the cost of capital, enabling Australian entities to compete effectively overseas and maintaining investor confidence in the Australian economy.

AASB standards are known as **Australian Accounting Standards** and include Australian equivalents to International Financial Reporting Standards (IFRS). The Australian Accounting Standards prescribe the accounting treatment.

The AASB **Framework for the Preparation and Presentation of Financial Statements (the Framework)** 'sets out the concepts that underlie the preparation and presentation of financial statements for external users.'[2] The Framework provides guidance where there is no specific Accounting Standard applicable.

Specific considerations:

The Accounting Standard considered relevant in reviewing the appropriate treatment of asset inspection costs (e.g. the Pipeline Inline inspections) is AASB 116 – Property, Plant and Equipment[3].

> *Subsequent costs – Paragraph 14 - 'A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.'*

[2] Australian Accounting Standards Board – Framework for the Preparation and Presentation of Financial Statements – prepared on 29 October 2021, for application to annual reporting periods beginning on or after 1 July 2021.

[3] Compiled AASB Standard - AASB 116 Property Plant and Equipment – Compilation no. 4. Compilation date 30 June 2021. Applicable to annual periods beginning on or after 1 July 2021 but before 1 January 2022.

The Framework provides definitions for the elements of financial statements (assets, liabilities, equity, income and expenses), and further guidance in relation to the timing of recognition of expenditure.

- Paragraph 49 defines an asset as:

  'A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

- Paragraph 70 (b) defines an expense as:

  'decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.'

- Paragraph 78 further defines expenses that:

  'encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the entity include, for example, cost of sales, wages and depreciation.'

The Framework also provides further guidance in relation to the timing of recognition for expenditure.

- Paragraph 94 states:

  'Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.'

- Paragraph 95 states:

  '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.'

- Paragraph 97 goes on to state:

  'An expense is recognised immediately in the income statement when an expenditure produces no further economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.'

MGN's Regulatory Accounting Principles and Policy[4] provide additional guidance.

In addition to the Australian Accounting Standards and the Framework, MGN's Accounting Policies underpin statutory reporting and compliance obligations – the following extract is provided.

1. Introduction

Regulatory financial information reported by Multinet Gas Distribution Partnership (MGDP) to the Australian Energy Regulatory (AER) is to be prepared in accordance with the accounting principles and policies that are applied in preparing the MG group's statutory financial statements, with the exception only of specific differences that are noted in this policy.

This regulatory accounting policy requires that in all other respects, MGDP's regulatory financial information will be prepared in a manner that ensures:

a. It is based on a recognisable and rational economic basis;

b. The resultant financial information satisfies the concepts of relevance and reliability;

c. The substance of the underlying transactions and events is reported in the regulatory templates;

d. The regulatory templates can be understood;

e. Consistency is applied allowing for comparisons to be made over time; and that

f. It conforms to the recognition and measurement criteria of Australian Accounting Standards and applicable International Financial Reporting Standards (unless specifically noted otherwise in this policy).

[4] MGN Regulatory Accounting Principles and Policy – updated March 2021.

5. Operating Expenditure (Repairs and Maintenance extract)

Opex is classified into the following RIN categories:

5.1 Repairs and Maintenance

*Repairs and maintenance expenditure are works performed directly on the physical asset and is not capital in nature. Work is predominantly on the Gas Distribution Business however there is a component of Ancillary Reference Services (ARS) and Ancillary Non-Reference Services (NRS). The total repairs and maintenance expenditure are driven by the charge from the Service Providers in accordance with their Agreements (refer Section **Error! Reference source not found.**).*

Appendix 2 - Detailed Findings

Detailed below are our findings and observations from the procedures performed. Dollar amounts shown in this section are in December 2021 $'s consistent with forecast expenditure in the asset strategies provided to BDO by MGN.

Support overhead costs	
Description of activities: Indirect Finance and IT program management activities to support the management of capital projects. Support overhead costs related to capital activities for MGN are $3.0m over the next 5-year access period.	**Findings:** **MGN** propose $3.0m of indirect overhead costs related to Finance and IT program management support activities are expensed over the next AA period. This is consistent with the current treatment of other business support activities in MGN (such as HSE, Procurement, People and Culture and Facilities). This is supported / underpinned by the AASB 'Framework' in that the Finance and IT activities within the indirect supported overhead category do not materially add to the value of existing assets by extending their life or increasing their capacity, but rather this expenditure should be classified as operating expenditure. The AASB Framework and MGN Policies for similar activities support the treatment of these costs as opex. BDO believe that the costs associated with the indirect overheads of Finance and IT as described by MGN are of an ongoing operational nature and are therefore, also operating expenditure. We suggest the forecast expenditure by MGN as part of undertaking all of these activities and programs in the next AA period as described to BDO by MGN, meets the definition of an expense as provided in paragraph 69(b) of the Framework for the Preparation and Presentation of Financial Statements ("the Framework").

HDPE sampling and assessment	
Description of activities: This outlay relates to the collection of samples of High Density Polyethylene (HDPE) mains across targeted areas, from which assessment will be undertaken to model estimated useful life and inform ongoing asset management. This is a collaborative program across Victorian gas distribution businesses to collect samples of DN40 and DN50 HDPE 575 mains across targeted areas in each network. The samples will be assessed in conjunction with Deakin University and Future Fuels Cooperative Research Centre and a model estimating the life expectancy of the material created, which will inform ongoing asset management required in future AA periods MGN proposes expenditure of $1.2m over the next 5-year access period.	**Findings:** Having assessed the underlying objective and outcomes from these activities, BDO considers it is reasonable for this expenditure to be treated as opex from 1 July 2023. The basis of this opinion is the operational nature of this activity and that it is not materially extending the useful life or increasing the capacity of MGN's assets in a measurable way. In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this outlay does not meet the future economic benefit requirement to be classified as an asset, and that the expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. BDO also considers the sampling and assessment activities are not major inspections as contemplated by *AASB* 116 Property Plant and Equipment, and that it is reasonable for this expenditure to be treated as opex from 1 July 2023. Nor do they materially add to the value of existing assets by extending their life or increasing their capacity. BDO consider that this expenditure should be therefore, classified as operating expenditure. Per IAS 38, research outlays should also be expensed.

Reactive mains replacement	
Description of activities: MGN proposes expenditure of $4.3m over the next access period in reactive repair or replacement of small sections of mains where needed.	**Findings:** Having assessed the underlying objective and outcomes from these activities, BDO considers it is reasonable for this expenditure to be treated as opex from 1 July 2023. The basis of this opinion is the ongoing recurrent and operational nature of these activities and that none are materially extending the useful life or increasing the capacity of MGN's assets in a measurable way and that the expenditure is recurrent and operating in nature. Rather BDO understands these activities are ensuring the ongoing safe and reliable operation of MGN's pipeline, which is more related to day-to-day operational and maintenance activities. Further, AGN's South Australian network treats reactive mains replacement as regulatory opex. In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred.

Marker post replacement	
Description of activities: MGN proposes expenditure of $0.2m over the next AA period in relation to replacement of marker post signs along transmission pipelines to maintain legible warning signage for buried pipelines.	**Findings:** Having reviewed the activities proposed under this category of expenditure, BDO considers that it is reasonable for this expenditure to be treated as opex from 1 July 2023. We suggest that the safety signage does not materially add to the value of the existing assets by extending their life or increasing their capacity but rather is an ongoing program of activities that relates to the safe and reliable operation of MGN's assets. We believe this expenditure should be therefore classified as operating expenditure. Costs associated with the safety programs including signage are of an ongoing operational nature and are therefore, also operating expenditure. AGN's networks treat these costs as opex under current policy. In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred.

Pipeline and Inline Inspections (ILI)	
Description of activities: MGN propose opex outlays of $6.0m over the next AA period. These outlays are part of rolling compliance expenditure (opex) to meet compliance (AS2885) and safety requirements.	**Findings:** Having assessed these asset inspection activities, BDO considers the ILI inspection is not a major inspection as referred to in *AASB 116 Property, Plant and Equipment* and that it is reasonable for this expenditure be treated as opex from 1 July 2023. Under the asset recognition criteria at paragraph 7 of AASB 116, subsequent expenditure is only recognised if it is likely to provide the entity with future economic benefits. Under paragraph 12 of AASB 116, servicing items, generally comprising costs of labour and minor parts, are to be expensed. MGN Accounting policies (section 5.1), specify the following: *Repairs and maintenance costs are works performed directly on the physical asset. Work is predominantly on the Gas Distribution Business however there is a component of Ancillary Reference Services (ARS) and Ancillary Non-Reference Services (NRS).* This is consistent with current regulatory practice in Australia. BDO notes that in Western Australia, the ERA approved ATCO's AA proposal for 2020-24 (AA5) which includes expenditure on gas pipeline, inline inspections classified as opex, along with expenditure on leak surveys and other pipeline inspections also treated as opex. The ERA also approved for treatment of these costs as opex in the Dampier to Bunbury Natural Gas Pipeline AA for 2021-25 (Refer ERA decision D226538).

Pipeline and Inline Inspections (ILI)	
	Further, publicly available documents pertaining to Western Power's current AA period as an electricity DNSP, indicate that asset inspection costs are accounted for as operating and maintenance expenditure as part of its reported opex. BDO also notes that other economic regulators require electricity DNSPs to 'expense' asset inspection costs as part of their reported opex. For example, based on publicly available RIN reporting for 2018, SA Power Networks reported $14.2m expenditure as opex in relation to asset inspection activities, Energex reported $22.3m and Jemena reported $2.2m as opex in the same period. The AER approved expensing of pigging and inspection costs in their consideration of Jemena Gas Networks (NSW) determination (reference 63819). These costs were capitalised for the 2015-20 AA period, and approved to be expensed for 2020-25. This policy shift is consistent with national practice, the AER noting that '*we consider that if the 'pigging' and inspection of pipelines do not extend the lives of the pipelines, the cost of these maintenance activities can be reasonably classified as opex.*' BDO understands these activities are ensuring the ongoing safe and reliable operation of MGN's pipeline, which is more related to day-to-day operational and maintenance activities. In accordance with the *AASB's Framework for the Preparation and Presentation of Financial Statements*, and MGN internal policies aligned to Accounting Standards, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred.

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