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16 December 2019

Accounting advice in relation to costs incurred for regulatory approval

Opinion

In our opinion, the major types of costs incurred by Energy Infrastructure Investments ("EII") to prepare the proposal of its Transmission Determination to the Australian Energy Regulator ("AER") for revenue determination are directly attributable costs incurred to obtain a legal right which satisfies the definition and recognition criteria in accordance with AASB 138 Intangible assets (**AASB 138**). Therefore, these costs, where incremental and directly attributable, can be capitalised as the initial cost of an intangible asset being a legal right to charge at agreed revenue.

Background information

EII owns electricity transmission interconnectors which are revenue regulated by the AER under the National Electricity Rules ("NER"). APA Group which comprises Australian Pipeline Trust and APT Investment Trust, holds 20% ownership interest in EII and accounts for it as an associate. Every five years, EII submits a proposal of its Transmission Determination to the AER on behalf of Directlink for a revenue determination for the next regulatory control period. AER determines the expected revenue that EII should recover from customers and EII has to obtain AER approval for the next regulatory control period. We understand from management that the incremental costs of preparing such a proposal are incurred to satisfy the requirements of submitting an electricity transmission determination, and comprise the following:

- professional fees for engineers / consultants / lawyers to provide technical advice on the submission;
- professional fees for an external consultant to prepare the submission;
- professional fees to determine the next 5 years of insurance and end of life cost allowance. The proposal is required to demonstrate that forecasted insurance costs and end of life cost allowance are compliant with NER, therefore external advice is sought; and
- professional fees for stakeholder engagement experts' advice to include regulatory stakeholders, which is broader than EII's normal engagement programme.

Reasons for our opinion

We considered whether an intangible asset arises from the AER's approved revenue for the next regulatory control period in accordance with AASB 138 which provides the criteria for assessing the definition and recognition of intangible assets.

We have also considered the accounting treatment for similar regulatory costs under AASB 138, together with the views from other accounting firms.

We further evaluated whether the major types of costs incurred by EII for the submission were incremental and directly attributable costs of the intangible asset, and therefore could be capitalised in accordance with AASB 138.

1. *Definition and recognition of intangible assets*

AASB 138, par.8 outlines three key characteristics of an intangible asset as follows:

- a resource controlled by the entity from which the entity expects to derive future economic benefits
- lacks physical substance
- identifiable to be distinguished from goodwill

AASB 138, par.12 further articulates the identifiability criteria of an intangible asset

- is separable (that is, it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability), or
- arises from contractual or other legal rights, regardless of whether the rights are transferable or separable from the entity or from other rights and obligations.

AASB 138, par.18 sets out recognition criteria as follows:

- it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

In this case, there may be two alternative views regarding whether there is an intangible asset arising from the AER's approved revenue for the next regulatory control period.

One view is that the regulatory approval is only for EII to continue its operations. The regulatory approvals do not add value to EII's existing business but rather enable EII to continue its existing operations. Therefore, there is no intangible asset arising from AER and the related costs should be recognised as an expense as incurred.

Alternatively, it could be argued that the AER's approved revenue for the next regulatory control period gives EII a legal right which can generate future economic benefit. By submitting the Transmission Determination to AER and obtaining approval, EII obtains a legal right to charge its customers the approved revenue which will generate future economic benefits for EII. Such a legal right therefore meets the identifiability criteria for an intangible asset and gives rise to future economic benefits. In other words, upon approval, AER effectively grants EII the right to access expected revenue.

In our view, the second view is more appropriate in this case. Preparing a proposal for Transmission Determination and obtaining AER approval give rise to a legal right over the next regulatory control period which generates future economic benefit flown to EII. This satisfies the definition and recognition criteria of an intangible asset under AASB 138 and represents value added to EII as opposed to continuing existing operations. Therefore, we believe the second view is more appropriate and EII could recognise an intangible asset for AER's approved revenue for the next regulatory control period.

2. Treatment of other similar regulatory costs

We have also considered the accounting treatment of other similar regulatory costs. We note that the accounting treatment for registration and authorisation costs incurred under the REACH (registration, evaluation, authorisation and restriction of chemicals) EU regulation has been dealt with in practice and discussed by the global accounting firms in their published accounting manuals. While not the exact same fact pattern, this outlines the principle that costs incurred to satisfy regulation or regulatory requirements can be capitalised where there is expected future economic benefit which would have not been available otherwise.

Under the REACH regulation, an entity is not permitted to manufacture or import a chemical that is not registered or authorised under the REACH regulation. It is an accepted view in practice (see the summary in section 3 below) that the registration and authorisation fees meet the definition of an intangible asset and could be capitalised, provided the costs incurred are directly attributable to registration and are reliably measurable. The costs incurred by an entity under REACH result in the entity obtaining legal rights for the commercial use of specific chemical substances that are necessary to earn economic benefits from that substances.

The similarity between entities subject to REACH regulation and EII is that they both need to obtain regulatory approval to generate future economic benefit. Such regulatory approval is effectively a legal right which satisfies the definition and recognition criteria of an intangible asset under AASB 138 as per analysis in section 1 above.

3. Views from other firms on registration and authorisation fees under the REACH regulation

In the section, we summarised the views on the treatment of registration and authorisation fees under the REACH regulation from different accounting firms.

KPMG	Similar to the analysis in the above section 2. Cost incurred should be capitalised to the extent that they are directly attributable to the regulatory approval.
Deloitte	Deloitte divided the views into two different scenarios • Existing chemical substances The preferred treatment is to expense the REACH costs relating to existing chemical substances as these costs are incurred for the entity to continue its operations. However, due to the lack of clear guidance, it is acceptable to capitalise those costs if the recognition criteria under AASB 138 are met. • New chemical substances The REACH costs incurred to register new chemical substances are necessary for the development of new products. Therefore, the costs can be capitalised if the recognition criteria under AASB 138 are met.
EY	EY divided the views into three different scenarios • New chemical substance

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	The cost can be capitalised if the related development project is at a sufficiently advanced stage and the cost is directly attributable. • Acquiring test data from an existing registrant The cost can be capitalised as a separately acquired intangible asset. • Existing substance The cost of registering an existing substance can be either capitalised or expensed. Both treatments are acceptable. If the costs of obtaining a REACH registration for existing substances used in existing processes are regarded as subsequent expenditure on an existing intangible asset, the related cost should be recognised as an expense as incurred. Alternatively, the cost of registering existing substances should be regarded as no different to the cost of registering a new product. Therefore, such costs should be capitalised.

4. Measurement - cost directly attributable

The principle in AASB 138 is that only directly attributable costs are included in the initial measurement of an intangible asset. Any expenditure incurred by EII that is directly attributable to preparing the proposal should be included in the measurement of the legal rights.

Based on this principle, we evaluate the below major types of cost incurred by EII for the submission.

- **Professional fees for engineers / consultants / lawyers to provide technical advice on the submission**
  Such costs are incurred for preparing the proposal to be submitted, indicating that it is directly attributable to obtaining the legal right as an intangible asset. Therefore, it can be capitalised.
- **Professional fees for an external consultant to prepare the submission**
  Same as above, external consultant fees are directly attributable to preparing the proposal and therefore can be capitalised.
- **Professional fees to determine the next 5 years of insurance and end of life cost allowance**
  Professional fees are incurred to engage insurance experts for preparing the proposal. There are rules under NER requiring the proposal to demonstrate that insurance costs would change by more than CPI and end of life costs allowance would be compliant over the next transmission period. Unlike yearly insurance quote for day-to-day operations, insurance experts are engaged to ensure the proposal are prepared in compliant with NER requirements and are distinguished from day-to-day insurance expenditures. Therefore, the cost is directly attributable and can be capitalised.
- **Professional fees for stakeholder engagement experts' advice on the design and execution of a stakeholder engagement framework**
  NER sets out requirements for the design and execution of a stakeholder engagement framework. EII engaged experts to broaden the stakeholder engagement to include regulatory stakeholders for the proposal. Costs are incurred to meet the requirements of NER, rather than stakeholder engagements for day-to-day operations. Therefore, the cost is directly attributable and can be capitalised.

Based on the analysis above, in our view, the costs incurred by EII are directly attributable to preparing a proposal to obtain a legal right, therefore those costs can be capitalised.

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Basis of our opinion

Our opinion is based primarily on:

- *Discussions held and documentation provided by APA Group management in October / November 2019.*

In developing our opinion, we referred to the following official pronouncements:

- *AASB 138 Intangible assets*

Terms of reference

Our terms of reference for this accounting advice in relation to the costs incurred for regulatory approval are described in our engagement letter dated 3 December 2019.

Disclaimer

Any change in the facts, official pronouncements or circumstances on which our opinion is based could affect our conclusions. We therefore recommend that if there are any such changes, you consult with us again to ensure our opinion continues to be appropriate and valid.

We are not commenting on the commercial or other desirability of the transaction. Nor have we reviewed the relevant documentation from a tax or legal viewpoint; such a review would be more appropriately performed by your tax and legal advisers.

Management is responsible for the accounting treatment adopted for this transaction. This opinion has been prepared for APA and its controlled entities for the sole purpose of assisting management in formulating the accounting treatment for the costs incurred for regulatory approval. It should not be used or relied on by any other person for any purpose.

It should not be communicated to, used or relied on by any other person for any purpose, but we acknowledge that you will provide a copy of this letter to your auditor, as agreed.

The opinion we have given does not prevent your auditor from assessing the transaction differently in the context of the financial statement audit as a whole. We have not performed any verification procedures and do not give any assurance on the underlying transaction or balances.

Contact

If you would like to discuss any aspect of this letter, please contact Erica Birchall on +_____ at any time.

Erica Birchall
Partner

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Appendix 1 - Reference

Extracts from AASB 138 *Intangible assets*

8.The following terms are used in this Standard with the meanings specified:

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An asset is a resource:

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

Carrying amount is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Australian Accounting Standards, eg AASB 2 Share-based Payment.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Entity-specific value is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See AASB 13 Fair Value Measurement.)

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount.

An intangible asset is an identifiable non-monetary asset without physical substance.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money. Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

The residual value of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

9. Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

12.An asset is identifiable if it either:

(a) is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

18 The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

(a) the definition of an intangible asset (see paragraphs 8–17); and

(b) the recognition criteria (see paragraphs 21–23).

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

66. The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

- (a) costs of materials and services used or consumed in generating the intangible asset;
- (b) costs of employee benefits (as defined in AASB 119) arising from the generation of the intangible asset;
- (c) fees to register a legal right; and
- (d) amortisation of patents and licences that are used to generate the intangible asset.

AASB 123 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

67. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset