Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Executive Summary

RSM Bird Cameron (RSMBC) has been engaged by the Australian Energy Regulator (AER) to assist in their responsibilities under the National Gas Law (NGL) and the National Gas Rules (NGR) to review and respond to the APT Petroleum Pipelines Limited (APTPPL) external consultant's report, prepared by KPMG. The external consultant's report discusses the capitalisation of costs incurred by APTPPL for the buyout of their Pipeline Management Agreement (PMA) with Agility Asset Management (Agility).

APTPPL, a member of the APA Group, previously outsourced the pipeline construction, operation and maintenance services under a PMA to Agility, a member of the Alinta Group. In 2007, the APA group had grown considerably due to a number of strategic business acquisitions, where this provided them with sufficient resources to construct, operate and maintain pipelines in-house. As a result, in 2007, APTPPL acquired Agility and terminated their outsourced arrangement under the PMA for all pipelines for a total cost of $206.2 million, this included $190.1 million of goodwill.

This transaction is under scrutiny by the AER as the expenditure incurred on the buyout has been included in the APTPPL's opening capital base of the 2012-2017 access arrangement period, in respect to the Roma to Brisbane Pipeline (RBP).

With direct reference to our scope we can comment as follows:

1) We were requested to assess whether KPMG's report on the capitalisation of the PMA was consistent with overall Australian Accounting Standards. From our review of the external consultant's report, and in conjunction with AASB 3 Business Combinations, we are of the opinion that the goodwill incurred on acquisition of Agility is capital in nature, and as a result, the allocation made to the RBP and conclusions drawn in the KPMG report are reasonable.

2) In respect to providing advice on the limitations of the accounting methodology within the regulatory framework under which the AER operates, we considered Part 9 *Price and Revenue Regulation* of the National Gas Rules. This assisted us in drawing conclusions as to whether the goodwill allocation to the RBP can be deemed "capital" under the AER's regulatory framework. Specifically, we focussed on paragraph 69 of Division 9, being the definitions driving key rules– Rule 77 (2) and Rule 79. This area was one in which we spent a considerable amount of time on.

   We determined that the costs incurred under goodwill would fall under Rule 77 (2), which documents the requirements of how the opening capital base is to be derived if an access arrangement period follows immediately on the conclusion of a preceding access arrangement period as is the case for APPTL. We identified that the goodwill component could be considered as "confirming capital expenditure", to be included in the capital base. As a result, we focussed on whether the costs incurred by APTPPL met the criteria of "conforming capital expenditure" under Rule 79.

   Rule 79 (2) is an "or" test, which means that only one of the conditions (a) to (d) is required to be met for the this to be determined as conforming capital expenditure. In respect to APTPPL's case, we have determined that condition (a) and (b) are the only conditions relevant to their capital costs.

   Condition (a) was ruled out, based on an analysis provided from AER showing that, if the goodwill was to be included in the opening capital base then the tariff would be higher than under the old outsourcing

arrangement. As this result, the capital spend proved to be “negative”, not meeting the requirements of this rule being *“the overall economic value of the expenditure is positive”.*

We then reviewed condition (b) “*the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure”*, where we have raised a point for investigation by AER. When reviewing the condition, in conjunction with sub-rule (4) of Rule 79, one would assume that for the costs to be recognised as “conforming capital expenditure” , the capital spend should lead to an expansion of services to be provided in the market place, that would, in turn, increase the revenue generated from their capital base.

When we considered the case of the business acquisition of APTPPL acquiring Agility, no incremental services were identified as being provided, nor was additional gross revenue being generated from the costs incurred on goodwill. The only benefit assumed as a result of the business acquisition was the cost savings anticipated to be generated from running the management service contract in-house. Rule 79(4)(b) does define incremental revenue as *“the gross revenue derived from incremental services less incremental operating expenditure for the incremental services”.* There is an argument that incremental revenue could be considered to represent the cost of savings achieved through running the management services agreement in-house as incremental expenditure is actually a negative number hence a positive result when calculating incremental revenue according to the formula above at 79(4)(b). As a result, we have noted that AER should investigate further their interpretation of “incremental revenue” and associated “incremental services”, to determine whether this rule is applicable in this instance. Our preliminary view is that it is not applicable.

3) We were also asked to provide advice in relation to the context in which any adjustments can be made to the PMA contract buyout. We reviewed the valuation analysis and logic of the KPMG valuation and agreed with the overall approach and calculations adopted.

4) We also have identified a number of areas that we believe AER can establish lines of inquiry in relation to the capitalisation of the PMA, which have been detailed in Scope 4 of this paper, surrounding obtaining further financial data from APTPPL, requesting letters of comfort of the financial data from APTPPL and engage a consultant to detailed review over the underlying assumptions and methodology applied to APTPPL forecasts.

5) We are yet to be provided with AER’s preliminary views in relation to the PMA, hence have not addressed this term of reference.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Background information on the transaction

APTPPL, a member of the APA Group, previously outsourced the pipeline construction, operation and maintenance services under a Pipeline Management Agreement (PMA) to Agility Asset Management (Agility), a member of the Alinta Group.

This outsourced arrangement spanned the period from 2000 to 2007 and not only covered the parameters of the RBP pipeline, but other pipelines, being:

- Moomba Sydney Pipeline.
- Central West Pipeline.
- Carpentaria Gas Pipeline.
- Gorodock Gas Pipeline.
- Parmelia Gas Pipeline.

In 2007, the APA group had grown considerably due to a number of strategic business acquisitions, where this provided them with sufficient resources to construct, operate and maintain pipelines in-house. As a result, in 2007, APTPPL acquired Agility and terminated their outsourced arrangement under the PMA for all pipelines.

The total payment provided for the acquisition of Agility totalled $206.226 million. Of this $206.226 million, $190.094 million related to goodwill on acquisition of the business, as follows:

Table A– Purchase Price for Agility Asset Management

Component	Item	$ ‘000
Assets	Property, plant and equipment $4.6 million	4.6
	Deferred tax asset $1.7 million	1.7
	Intangible assets $15.5 million	15.5
	Other non-current assets $0.6 million	0.6
	Total	**22.4**
Liabilities	Employee Entitlements (for staff acquired under the acquisition)	6.3
	Total	**6.3**
Net Assets	Total assets less total liabilities	**16.1**
Purchase Price	Consideration provided for Agility Management Pty Ltd	**206.2**
Goodwill	Difference between Purchase Price of the business and net asset position of the business	**190.1**

Source: Page 13 of “Regulatory accounting treatment of Pipeline Management Agreement termination payment”, October 2011

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The significant goodwill component paid for in the acquisition of Agility was predominantly due to the cessation of the PMA and can be considered as a "premium" paid on the purchase of the business as a result of termination to the agreement. As discussed in the external consultants report, APTPPL entered into this transaction, which incurred a significant goodwill component, as, based on their forecast analysis, the economics of funding acquisition costs of $206.2 million for the business were more favourable than the future outsourcing costs that would have been incurred by them if the PMA had remained in place.

The goodwill component on acquisition was then allocated to each pipeline that existed under the PMA, based on a proportion to the present value of the expenditure savings that APTPPL anticipated to accrue from the goodwill known as their "commercial valuation". This equated to [redacted] million for the RBP.

Then, for the purposes of APTPPL proposing to include this amount of goodwill as a component of the opening capital base in the new access arrangement period, they derived a "regulatory valuation". This was calculated based on the commercial valuation, less any management fees payable to Agility that were deemed not allowable to be included in a reference tariff calculation. The valuation, comprising the future cash flows, was then discounted by a weighted average cost of capital of 8.84% (a previously approved rate in the 2006 revised Access Arrangement). This then reduced the allocation of goodwill to the RBP to $30.1 million.

This regulatory valuation was reviewed in the KMPG report via an independent valuation conducted over the available financial data from APTPPL. We reviewed the logic of the KPMG valuation and agreed with the overall approach adopted (without review over the veracity of the financial data utilised in the valuation model).

The $30.1 million has been proposed by APTPPL to be included in the opening capital base for the 2012-2017 access arrangement period, of which RBP is the first regulated pipeline impacted by this transaction.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Scope 1 Review and provide advice on the APTPPL's external consultant's report on the capitalisation of the Pipeline Management Agreement contract buyout for overall consistency with the Australian Accounting Standards.

Section 3 and 4 of the KPMG report outlines the criteria relevant in determining whether the premium, or part thereof, should be treated as capital expenditure. For the purposes of Scope 1 of our engagement "*Review and provide advice on APTPPL's external consultant's report on the capitalisation of the PMA contract buyout for overall consistency with Australian Accounting Standards*", we have reviewed this section of the report.

The fundamental arguments used within the KPMG report in concluding that the premium is of capital nature, in accordance with Australian accounting standards, are based on the definition of an asset in the Australian Accounting Standards Board's Framework for the Preparation and Presentation of Financial Statements, released in July 2004. Paragraph 49 of this framework defines an asset as:

"(a) An asset is 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."

This has been applied to the facts of the transaction, by the external consultant, on the following basis:

controls the resource	*"…the APA Group controls the resource. That is to say that in accordance with the description of control set out in AASB 138 Intangible Assets, the APA Group has the power to obtain the future economic benefits flowing from the resource and access to those benefits (i.e. the expenditure savings) are restricted to the APA Group;"*
past event	*"…it arose from a past event, the execution of the Contract Termination and Contract Novation Agreement dated September 2007, explained in Section 2.3 of this report and;"*
future economic benefit	*"…future economic benefits were and are expected to flow to the APA Group as a consequence"*

Discussion around AASB 3 *Business Combinations* and AASB 138 *Intangible Assets* is then further referenced to support the distinction of this expenditure as capital throughout section 4 of the report.

Our assessment on the capitalisation of the Pipeline Management Agreement contract buyout for overall consistency with the Australian Accounting Standards is as follows:

Under Australian accounting standards, an acquisition such as APTPPL acquiring Agility services needs to be assessed, as to whether it is a business combination, where goodwill can be recognised at acquisition, or merely as a straight asset purchase. *AASB 3 Business Combinations* governs the accounting requirements for this assessment and subsequent recognition of a business combination.

AASB 3 was made applicable to annual reporting periods beginning on or after 1 January 2005 to general purpose financial reports of reporting entities, including entities required to prepare financial reports in accordance with Part 2M.3 of the *Corporations Act, 2001.* In this case, APTPPL is required to comply with AASB 3 from an accounting perspective.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

We have looked at the facts regarding this transaction in the external consultants report and have considered whether the costs incurred constitute a business combination or an asset purchase. To determine if a transaction is a business combination and within the scope of AASB 3, it is necessary to consider whether the acquired entity, or group of assets, constitutes a business. For this to be determined, we had to consider whether Agility met the definition of a business and whether the transaction met the definition of a business combination.

A business is defined under AASB 3 as:

"an integrated set of activities and assets conducted and managed for the purpose of providing (a) a return to investors or (b) lower costs or other economic benefits directly and proportionately to policy holders or participants. A business generally consists of inputs, processes applied to those inputs and resulting outputs that are, or will be, used to generate revenue. If goodwill is present in a transferred set of activities and assets the transferred set shall be presumed to be a business."

A business combination can be defined as the *bringing together of separate entities or businesses into one reporting entity.*

It is clear from the facts that Agility Management Services constitutes a business, as per the definition above, and that the transactions can be determined as a business combination as APTPPL has acquired Agility into their organisation, hence *bringing together* the two entities into one reporting entity.

AASB 3 requires all business combinations to be accounted for using the "purchase method" and specifies how the purchase method be applied. The purchase method involves identification of the acquirer, which in this case is APTPPL, measurement of the cost of the business combination and allocation, at acquisition date, of the cost of the combination to the assets acquired and liabilities assumed. The measurement and recognition of the goodwill has been included in the financial statements of APTPPL, since acquisition. We note that unmodified audit opinions have been provided annually. This prima facie indicates that, in the opinion of the external auditors, of APTPPL, Deloitte, that the goodwill on acquisition has been correctly treated under the requirements of Australian Accounting Standards. As a result, we have not gone through an analysis as to whether the recognition of the goodwill meets the measurement requirements. We have merely considered its nature, and concluded that the premium paid on acquisition of Agility is capital in nature and therefore correctly classed as goodwill under AASB 3.

Goodwill is defined in Appendix A of *AASB 3 Business Combinations* as:

"an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised".

Goodwill is a type of intangible business asset and is calculated as the difference between the fair market value of a company's net assets, being their total assets less their total liabilities, and the market price or asking price for the overall company. In other words, goodwill is the amount paid by APTPPL in excess of the book value of Agility Asset Management net assets, as follows:

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Table B– Purchase Price for Agility Asset Management

Component	Item	$ '000
Assets	Property, plant and equipment $4.6 million Deferred tax asset $1.7 million Intangible assets $15.5 million Other non-current assets $0.6 million **Total**	4.6 1.7 15.5 0.6 **22.4**
Liabilities	Employee Entitlements (for staff acquired under the acquisition) **Total**	6.3 **6.3**
Net Assets	Total assets less total liabilities	**16.1**
Purchase Price	Consideration provided for Agility Management Pty Ltd	**206.2**
Goodwill	Difference between Purchase Price of the business and net asset position of the business	**190.1**

The $190.1 million of goodwill on acquisition of the net assets of Agility was allocated to each individual pipeline based on a direct proportion to the present value of the expenditure savings it anticipated it would accrue to each pipeline. This allocation was prepared by the APA Group and audited by Deloitte. KPMG discussed in their report, as per page 15, that, as calculated by APTPPL at the date of the transaction, the present value of the future benefits equated to ████ million an amount greater than the $190.1 million paid and accounted for on the balance sheet.

The goodwill portion has been represented as future cost savings by each pipeline, which is considered to be an asset representing future economic benefit to APTPPL, as they have shown that it is more cost effective for them to run the capital and operating services in-house rather than to outsource.

The goodwill is deemed an intangible asset under AASB 3 which is known as being capital in nature. As a result, the allocation made to the RBP and conclusions drawn in the KPMG report are reasonable.

Research

Although, not specifically related to the applicable accounting framework, to assist moving through the next terms of reference, we turned to research of other industries and other jurisdictions to assess whether goodwill was allowable in regulatory capital bases. Whilst limited anecdotal evidence exists, we found some reports that addressed the issue, as per the table below. However, these reports were not detailed in respect to their reasoning as to why the goodwill should be excluded from a regulatory capital base as some claimed that goodwill costs did not relate to the regulatory business. This is different when compared to APTPPL's case, as they only incurred the expenditure in relation to the regulatory business, being their pipeline, to reduce costs of providing the services.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Table– C Assessment of whether goodwill is included in regulatory capital bases of other industries or other jurisdictions

Source	Relevance to the APTPPL regulatory capital asset base including goodwill
IPART, *"The treatment of net working capital in establishing the regulatory asset base for AGL Gas Networks Limited",* October 1999.	In October 1999, IPART published a report that argued that the certain items should be excluded from a regulatory capital base, including goodwill. This determination resulted as KPMG concluded that if goodwill was included, investors would earn returns in excess of the fair value of their underlying identifiable assets. Whilst theoretically, this is correct, the circumstances of the APTPPL acquisition of goodwill are different as the costs associated were incurred in direct relation to the regulated activities of the business and to reduce the cost of providing those activities. Expenditure on the goodwill has been made by APTPPL specifically for the purposes of the RBP and the regulated business, reducing costs to benefit them and savings to be on-passed to the end user. APTPPL would not have incurred the goodwill expenditure under any other circumstance than for the reduction in costs incurred as a result of bringing services in-house.

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Table– C Assessment of whether goodwill is included in regulatory capital bases of other industries or other jurisdictions (cont'd)

Source	Relevance to the APTPPL regulatory capital asset base including goodwill
Page 3 of "Comparison of New Zealand and Australian regulation of electricity transmission networks– report prepared for Transpower New Zealand, August 2010". Harding Katz– Economic and Regulatory Consultants.	This assessment stated that: *"Transpower may included in the RAB value only those intangible assets that meet the GAAP standard NZ IAS 38, using the cost model of recognition, with the exception of goodwill which must be excluded."* No further discussion was provided in this paper- merely a precedent laid down in that industry.
Page 4 of "Issue Paper–Determination of the Regulatory Asset Base –Energy Regulators Regional Association, September 2009". KEMA International B.V.	This paper stated a similar conclusion to the IPART determination that: *"Regulators do not generally recognise intangible assets in the regulatory asset base of regulated companies, such as goodwill. For example, because goodwill may be largely associated with asset transaction prices, recognising goodwill would likely lock in some degree of excess returns going forward The assets included in the RAB should be the assets used for the provision of the regulated services."* This however is not the case in this situation, as the capital expenditure associated with goodwill was specifically incurred to reduce the cost associated with the regulated business.
Page 24 of "Bulletin of Acts and Decrees for the operation of Amsterdam Airport, 2006". Bulletin of Acts and Decrees, 2006.	This paper stated: *"For proper determination of the regulatory asset base, goodwill should not be included."* No further discussion was provided in this paper- merely a precedent laid down in that industry.
Gas Industry Guidelines– Regulatory Accounting Information Requirements from ESC Victoria. ESC Victoria.	In Section 3.7.3 of the guidelines it states: *"Goodwill is not permitted in Gas Regulatory Accounts. It must be eliminated as an Adjustment between Base Accounts and Gas Regulatory Accounts."* These guidelines were also discussed in the KPMG report from ESC. Goodwill was specifically excluded under this paper as it was determined it was not relevant to regulatory business. Again, this is different to the nature of this situation.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Scope 2 Provide advice on the limitations of the accounting methodology as prescribed by the Australian Accounting Standards within the regulatory framework under which the AER operates.

Regulatory Framework

The regulatory framework under which the AER operates is the National Gas Objective and the National Gas Rules. The national gas objective, as documented in the National Gas Law, is to:

“promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.”

The National Gas Rules were established to enable the AER to govern access to natural gas pipeline services and elements of broader natural gas markets. The Rules have been established under the National Gas Law.

Whilst the cost incurred for the goodwill, which terminated the PMA upon acquisition of Agility, is capital in nature under Australian Accounting standards, for it to be allowable to be included in the regulatory opening capital base in the access arrangement for 2012-2017, it must meet the requirements of “capital expenditure” under the National Gas Rules.

We have considered Part 9 *Price and Revenue Regulation* of the National Gas Rules to assist in determining whether the goodwill allocation to the RBP can be deemed “capital” under the AER’s regulatory framework.

Application of the National Gas Rules

Division 4, “The Capital Base” in Part 9 documents the requirements of how the opening capital base is to be derived if an access arrangement period follows immediately on the conclusion of a preceding access arrangement period in Rule 77 (2), as is the case for APPTL:

(a) The opening capital base as at the commencement of the earlier access arrangement period (adjusted for any difference between estimated and actual capital expenditure included in that opening capital base); plus;

(b) confirming capital expenditure made or to be made, during the earlier access arrangement period; plus;

(c) any amounts to be added to the capital base under rule 82, 84 or 86; less

(d) depreciation over the earlier access arrangement period (to be calculated in accordance with any relevant provisions of the access arrangement governing the calculation of depreciation for the purpose of establishing the opening capital base);

(e) redundant assets identified during the course of the earlier access arrangement period; and

(f) the value of pipeline assets disposed of during the earlier access arrangement period.

From the explanation of the opening capital base derivation, we assume that the goodwill component cost incurred by APTPPL would need to be assessed against item Rule (79) (2) (b). As a result, we have considered what “capital expenditure” and “confirming capital expenditure” means as per the definition in Rule 69 and applied these definitions to the circumstances of this transaction.

“Capital expenditure: means the costs and expenditure of a capital nature incurred to provide, or in providing pipeline services.”

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Scope 1 determined that the cost incurred on the goodwill from acquisition of Agility was capital in nature, where the cost was incurred by APTPPL to deliver their pipeline services. In proving that this relates to delivering pipeline services, it is clear that the circumstances under which the costs were incurred relate directly to APTPPL deciding that it was more economically viable to bring the conduct of pipeline services in-house, rather than retain them under an outsourcing arrangement. We therefore conclude that this definition is met. The determination now lies with whether the expenditure can be classed as "conforming capital expenditure" or not, to therefore be allowable to be recognised in the opening capital base of the RBP 2012-2017 access arrangement period as per Rule (79 (5).

National Gas Rule 69 refers to the definition of "conforming capital expenditure" which is the following:

"(1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:

*(a) the capital expenditure **must be such as** would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;*

*(b) the capital expenditure **must be justifiable on a** ground stated in sub-rule (2)."*

In reference to clause (a), the cost of goodwill was incurred by APTPPL to reduce the costs associated with the construction and management of the pipeline, by bringing these services in-house as opposed to having these services outsourced.

The cost savings are documented in the KPMG report, on page 15 as follows:

"*…I have inspected a spreadsheet prepared by the APA Group which shows that the APA Group allocated the premium to the different pipelines in direct proportion to the present value of the expenditure savings it anticipated would accrue to each pipelines from the premium. This spreadsheet also disclosed that the APA Group anticipated that the present value of the future benefits would exceed [redacted] an amount in excess of the $190.1m that the APA accounted for on its balance sheet".*

It is assumed that this analysis would have been prepared by APTPPL at the time of the transaction, and reviewed by their external auditors, Deloitte, in the external audit of the 2007-08 financial statements.

Under Australian auditing and accounting standards, Deloitte are required to audit the calculation above, known as an "impairment test". An impairment test is governed by AASB 136 *Impairment of assets,* and focuses on management testing determining whether the carrying amount of the goodwill exceeds the recoverable amount expected to be generated from this goodwill as an asset.

AASB 136 states that if there is any indication that an asset may be impaired, the recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs; the asset's cash-generating unit. A cash generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. In this case, assessment of the recoverable amount would have to be the present value of the future cost savings that the RBP operation would generate.

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The excerpt from the KPMG report above clearly shows that the cost savings that APTPPL expect to generate from incurring the capital expenditure on the goodwill, resulted in them attempting to achieve the lowest sustainable cost of providing their services on the RBP, as not only do they represent lower costs than outsourcing, but that the cost savings exceed the total amount of goodwill recognised on the balance sheet.

An important point to note is that the external auditors, Deloitte, provided an unmodified audit opinion in 2007-08 and in subsequent reporting periods, which encompasses their assessment of the impairment testing above, covering the [redacted] million goodwill valuation for the RBP. The credibility of the clear audit opinions needs to be highlighted here, as this provides the AER with comfort over the nature and valuation of the goodwill in respect to this transaction.

Rule 79 goes on to discuss that the above clause (a), however needs to be "justifiable" as per clause (b), which is addressed in sub-rule (2) of Rule 79.

Sub-rule (2) explains that capital expenditure is justifiable if it meets one of the recognition criteria from (a)-(d) as follows:

"(2) Capital expenditure is justifiable if:

(a) the overall economic value of the expenditure is positive; ***or***
(b) the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure; ***or***
(c) the capital expenditure is necessary:

(i) to maintain and improve the safety of services; or
(ii) to maintain the integrity of services; or
(iii) to comply with a regulatory obligation or requirement; ***or***
(iv) to maintain the service provider's capacity to meet levels of demand for services existing at the time the capital expenditure is incurred (as distinct from projected demand that is dependent on an expansion of pipeline capacity); ***or***

(d) the capital expenditure is an aggregate amount divisible into 2 parts, one referable to incremental services and the other referable to a purpose referred to in paragraph (c), and the former is justifiable under paragraph (b) and the latter under paragraph (c)."

This sub-rule is an "or" test, which means that only one of the conditions (a) to (d) is required to be met for the expenditure incurred by APTPPL to be determined as conforming capital expenditure as per sub-rule (5) of Rule 79. In respect to this circumstance we have determined that (a) and (b) are the only conditions relevant to the APTPPL transaction.

Condition (a)

In respect to condition (a) and assessing whether the expenditure is *positive*, consideration is required to the points raised in sub-rule 3:

(3) In deciding whether the overall economic value of capital expenditure is positive, consideration is to be given only to economic value directly accruing to the service provider, gas producers, users and end users.

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Due to the fact that there has been no impairment of goodwill in the audited accounts and from the facts presented in the external consultants report, it has been proven that the expenditure incurred on the goodwill represents significant future cost savings, over and above the costs incurred from running the services in-house. Thus clearly showing that the cost incurred is positive to the service provider.

To determine, however, whether this expenditure is positive to the gas producers, users and end users, an analysis is required to be conducted based on what the tariff would have been under the old arrangement (whereby the services were outsourced) to the estimated tariff cost under the new arrangement (where APTPPL acquired Agility). If the tariff under the old arrangement is higher, then it would be reasonable to suggest that the expenditure incurred has been positive for all stakeholders involved.

AER provided us with preliminary calculations on the comparison of what the assumed tariff would be when including the goodwill and then compared this to the tariff if the old arrangement was still in place. The financial data used to conduct this analysis by AER was based on APTPPL's proposed models and assumptions made in the KPMG report.

The results of this analysis indicate that the tariff would be higher under the inclusion of the goodwill in the opening capital base, as opposed to the previous arrangement of outsourcing.

On discussions with AER, it was concluded that, as this analysis resulted in a negative conclusion, the condition under clause (a) could not be met for the costs incurred on goodwill to be identified as "conforming capital expenditure".

Condition (b)

As condition (a) under Rule 79 (2) has not been met, the only other condition that may be applicable here, to conclude that the costs incurred on the goodwill are "conforming capital expenditure", is clause (b):

(b) the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure;

When considering this rule you also need to refer to the detail of sub-rule (4) Clause (a)-(c) of sub-rule (4) is shown below:

(4) In determining the present value of expected incremental revenue:

- *(a) a tariff will be assumed for incremental services based on (or extrapolated from) prevailing reference tariffs or an estimate of the reference tariffs that would have been set for comparable services if those services had been reference services;*
- *(b) incremental revenue will be taken to be the gross revenue to be derived from the incremental services less incremental operating expenditure for the incremental services; and*
- *(c) a discount rate is to be used equal to the rate of return implicit in the reference tariff.*

Clause (a) and (c) would assume that additional supporting calculations, based on prospective financial information, would need to be provided from APTPPL to assess if this condition has been met, however, before this information could be requested, clause (b) needs to be considered carefully.

Incremental is a key word in this rule and is defined in the dictionary as *"increasing or adding on, especially in a regular series".*

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Prima facie, looking at the terminology in this clause, one would assume that incremental revenue would imply that additional gross revenue should be generated from incremental (increased) services conducted by the service provider in incurring confirming capital expenditure. Thus implying, that the capital spend should lead to an expansion of services to be provided in the market place, that would, in turn, increase the revenue generated from their capital base.

When considering the case of the business acquisition APTPPL acquiring Agilty, no incremental services are being provided, nor is any additional gross revenue being generated from the goodwill. The only benefit assumed as a result of the business acquisition are the cost savings anticipated to be generated from running the management service contract in-house.

Accordingly, in our view after consideration of the wording of rule 79 (2)(b) and rule 79 (4) there is no incremental revenue as such and there are no incremental services. There is an agreement that incremental revenue could be considered to represent the cost savings achieved through running the management services in-house as incremental expenditure is actually a negative number hence a positive result when calculating incremental revenue according to the formula above at 79 (4)(b). However, this would not be our interpretation of this Rule. If it was argued that the condition of Rule 79 (4)(b) was met then consideration to the rule at 79 (4)(a) and (c) would need to be given where incremental calculations would need to be performed or, if not required, whether the KPMG valuation report could support the notion of the value of “incremental revenue”. Given the obvious greyness around the interpretation of these rules we would, however, suggest that the definition of incremental revenue be further explored to determine from a legal perspective whether it would include the circumstances relating to this particular case.

Amortisation Charge

Amortisation is an expense charge applied to the comprehensive operating statement (profit and loss) annually, representing a reduction in the value of an intangible asset by prorating its cost over a period of years– similar to the concept of depreciation over tangible assets.

An interesting point of discussion that has arisen from our research, and correspondence with AER, is this concept of amortisation and the fact that assets that are recognised in the opening capital asset base of an access arrangement period have a finite life. Accordingly, they are amortised or depreciated, whereby the value of the asset reduces annually, until it is written down to zero.

Under Australian accounting standards, goodwill is exempt from being amortised, as highlighted in Appendix B, B69 (d) of AASB 3 *Business Combinations.*

AER have noted, however, that, in the access arrangement submission provided by APTPPL, that a definite life has been applied to the goodwill, being 12 years; the residual portion of the PMA that would have been in place to 2020. This concept adopted by APTPPL is inconsistent with Australian accounting standards.

If the goodwill is to be recognised in the opening capital base, based on APTPPL applying a definite life to it, then this implies that by 2020, the $30.1 million included within the opening capital base, will be reduced to zero.

If, however, AER wish to adopt the accounting treatment prescribed per Australian Accounting Standards, in respect of goodwill added to the opening capital base, then there would be no amortisation charge to the profit and loss as goodwill if considered to have an indefinite useful life. This logic would imply that the total asset value will remain the same over future access periods. This may be considered as "overstating" the base, inappropriately resulting in a higher reference tariff applied to the market and charged to the end user indefinitely, as evidenced in the following example.

Consider the two instances above:

- Goodwill of $30.1 million, where APTPPL have applied an estimated useful life of 12 years
- Goodwill of $30.1 million, with an indefinite useful life in accordance with Australian Accounting Standards

If we were to look at both situations over the 12 year period, you can see that where a definite life has been applied to the goodwill, the asset value declines each year, based on its definitive life span, where, under the accounting standards, the goodwill value does not change as it holds an indefinite life span.

Table D– Comparison of a goodwill where APTPPL has applied amortisation and Australian accounting standards

Year	1	2	3	4	5	6	7	8	9	10	11	12
APTPPL $30.1 mil	$30.10	$27.59	$25.08	$22.58	$20.07	$17.56	$15.05	$12.54	$10.04	$7.53	$5.02	$2.51
Amortisation charge	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*	*-$2.51*
Written down value of goodwill	**$27.59**	**$25.08**	**$22.58**	**$20.07**	**$17.56**	**$15.05**	**$12.54**	**$10.04**	**$7.53**	**$5.02**	**$2.51**	**$0.00**
Goodwill $30.1 mil under accounting standards	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1	$30.1
Amortisation charge	-	-	-	-	-	-	-	-	-	-	-	-
Written down value	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**	**$30.1**

As a result of having no charge being applied to goodwill, as per Australian accounting standards, the carrying amount of the goodwill will be included into perpetuity, thus always impacting the rate of the reference tariff going forward.

Whilst we understand that APTPPL have determined to amortise goodwill over the life of the original contract, i.e. until 2020, from our interpretation of the gas rules there is no specific requirement bestowed upon them to adopt this approach. When considering any prospective rule changes as a result of this review, the area of amortisation of goodwill will need to be considered carefully.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Under Australian accounting standards, the only time the carrying value of the goodwill may be remeasured is if the goodwill is ever considered "impaired". AASB 136 *Impairment of Assets* requires goodwill to be tested for impairment annually.

Impairment testing can be described as management testing whether the carrying amount of the goodwill exceeds the recoverable amount expected to be generated from this goodwill as an asset. The recoverable amount of goodwill is determined by reference to the present value of the future anticipated net cash flows associated with each individual cash generating unit ("CGU") (A CGU is defined at AASB136 paragraph 6 and is considered to be the smallest identifiable group of assets that generate cash inflows that are largely independent of cash inflows from other assets or groups of assets.). The RBP would therefore be one of the CGU's required to prepare individual cash flows. In this instance, the incremental cash flows of the RBP CGU should be, as a minimum, a proxy for the savings anticipated as a result of this acquisition. If this recoverable amount, calculated annually, is greater than the goodwill amount of [redacted] million associated with the RBP CGU, then the goodwill value does not change.

If, however, the analysis of the recoverable amount results in an amount lower than the goodwill on the balance sheet, then an impairment loss must be recognised, in accordance with AASB 136. The difference between the goodwill and the recoverable amount would be charged to the profit and loss, consequently reducing the goodwill value to the recoverable amount.

We would then assume that, as per Rule 77 (2)(e) *redundant assets identified during the course of the earlier access arrangement period; if any impairment was determined* the portion of the goodwill to be allocated to the capital base would be the revised goodwill amount (i.e. the recoverable amount).

Consideration of the cost associated with the goodwill as "operating expenditure"

From discussion we have had with AER staff, one factor that was requested to be considered, was around whether the cost associated with the goodwill could be determined as "operating expenditure".

As per Scope 1 of this paper, in accordance with the Australian Accounting standards, the nature of the expenditure is clearly capital– this cannot be refuted. Under the National Gas Rules, we feel it also cannot be refuted, as when interpreting relevant definitions the cost associated with the goodwill is directly linked to pipeline assets. For example, it must be confirming capital expenditure only if it is in direct relation to pipeline assets. Pipeline assets are defined in Rule 69 as capital assets that constitute the pipeline, **or** are otherwise used by the service provider to provide services. The goodwill asset (payment for termination of PMA) was, and is, used by APTPPL to reduce the cost of services, by bringing the services in-house.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Scope 3.0 Provide advice in relation to the context in which any adjustments can be made to the Pipeline Management Agreement contract buyout and assess whether the associated costs are efficient.

This regulatory valuation was reviewed in the KMPG report, via an independent valuation (KPMG have indicated at numerous instances in their report that they have adopted a conservative approach in their valuation logic). We reviewed the logic of the KPMG valuation and agreed with the overall approach adopted (without review over the veracity of the base financial data utilised in the valuation model).

We have some minor points that could be considered in the valuation technique applied by KPMG, however, we do not believe that this would significantly impact the end result where KPMG concluded that the goodwill valuation of $30.1 million was supported by their independent valuation (Our sensitivities on the valuation indicated that even if our proposed questions were agreed with by KPMG the overall conclusion of the report would not change).

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Scope 4.0 Identification of any other key areas of inquiry for the AER in relation to the Pipeline Management Agreement contract buyout capex proposed in the earlier access arrangement proposal.

From our review of the external consultants report *APTPPL- Access arrangement submission, October* 2011 and other key documentation impacting this circumstance, we suggest the following additional lines of inquiry that AER could present to APTPPL in assisting with their decision on whether the goodwill component acquired for the RBP is an appropriate capital expense to be included in the opening capital asset base for the access arrangement period.

- For AER to be certain that the costs incurred in respect of the goodwill will benefit the end users, we suggest that a request is made from APPTL for an analysis to be conducted over what the tariff cost would be under the old circumstances, being under the PMA and under the new circumstances, being the inclusion of the goodwill in the capital asset base.
- As the determination of the National Gas Rule 79 is entirely driven on results of forecasted financial data that is provided by APTPPL, we suggest that AER consider one of the following:
  - to obtain comfort over the forecast figures utilised by APTPPL, we suggest that requests are made to obtain representations from APTPPL's management over the integrity and or reasonableness of the data, as these forecast costs would have been considered any in impairment testing conducted annually in the preparation and audit of the statutory financial statements; and
  - to engage a consultant to conduct a detailed review over the underlying assumptions and methodology applied to the forecasted figures utilised in the valuation of the goodwill allocation to the RBP, the forecast tariff calculations under the old and new arrangements for Rule 79 (2)(a) and the estimated incremental revenue costs for Rule 79 (2)(b).
- Investigate whether there any other examples of capital expenditure costs that are determined as "conforming capital expenditure:" where they have related directly to a cost savings for the service provider, rather than the capital spend resulting in incremental services and incremental revenue being generated.

Additional points to note:

In addition to the lines of inquiry stated above, from our research, we have identified areas where we feel need to be addressed as a result of this case:

(1) Proposed Amendments to the National Gas Rules, including to:
- explicitly state that intangible assets, such as goodwill, directly attributable to the pipeline can or cannot be included in the regulatory opening capital base and provide justification as to this determination. If goodwill is to be included, determine some rules around how to amortise this amount over a contract period, notwithstanding the fact that current accounting standards do not require goodwill to be amortised;
- explicitly state that conforming capital expenditure must result in a lower cost of a tariff to the end user (at present it only refers to lowest cost for providing services; however it is our interpretation that the lowest cost is to flow through to the end user); and
- consider whether in Rule 79(4)(b) the word "decremental" should be included as well under an or/ scenario when considering operating expenditure reductions as in the case in this example.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Scope 5.0 Review if the AER's preliminary views in relation to the Pipeline Management Agreement contract buyout in the access arrangement proposal and provide advice about any matters AER should consider for its draft decision.

We are yet to be provided with AER's preliminary views in relation to the PMA, hence have not addressed this term of reference.

Appendix 1– Review of capital expenditure for the Roma to Brisbane Pipeline access arrangement

Key reference documents utilised

KPMG report “Regulatory accounting treatment of Pipeline Management Agreement termination payment”, October 2011.

APT Petroleum Pipelines Access Arrangement Submission– October 2011.

National Gas Rules version 12, specifically Part 9– Price and Revenue Regulation.

Australian Pipeline Ltd Board Paper– Acquisition of Alinta’s pipeline operation agreements for APG’s assets and associated assets, 26 February 2007.

Applicable Australian Accounting Standards, particularly AASB 3 Business Combinations, AASB 138 Intangible Assets and AASB 136 Impairment of Assets.

Australian Accounting Standards Board’s Framework for the Preparation and Presentation of Financial Statements, released in July 2004.