Advisory
Level 3
100 Melville Street
Hobart Tas 7000

GPO Box 1231M
Hobart Tas 7001
Australia

ABN: 51 194 660 183
Telephone: +61 3 6230 4000
Facsimile: +61 3 6230 4050
DX: 135 Hobart
www.kpmg.com.au

Amy Marie-Parker
Leader Financial Analysis & Reporting
TasNetworks
1-7 Maria Street
Lenah Valley
TAS 7008

Our ref TN15-AER LetterDRAFTv2 091215 11 50am_Grace markup

23 December 2015

Dear Amy

Independent advice on the backcasting of the Economic Benchmarking and Category Analysis information for TasNetworks

1. Background

In July 2014, the transmission network service business that was formerly delivered by the Transend Networks Pty Ltd corporate entity and the distribution network service business that was formerly delivered by the Aurora Energy Pty Ltd corporate entity, were both transferred to a new corporate entity, Tasmanian Networks Pty Ltd (TasNetworks). Consequently, in accordance with the requirements of Clauses 6.15.4 and 6A.19.4 of the National Electricity Rules (NER), TasNetworks prepared a new "Transmission Cost Allocation Methodology and Distribution Cost Allocation Method" (new CAM) for the network services provided by the new entity. This was submitted to the Australian Energy Regulator (AER) and approved in June 2015

In June 2015, the AER wrote to TasNetworks requesting it to restate (backcast) information set out in certain:

- Category Analysis (CA) RIN templates; and
- Economic Benchmarking (EB) RIN templates

(collectively RINs) relating to transmission and distribution services provided in the years:

- 2006 to 2014 for the Category Analysis RIN; and
- 2009 to 2014 for the Economic Benchmarking RIN.[1]

In its email of 11 June 2015, the AER stated:

[1] AER, Emails to TasNetworks, 25 June 2015 and 11 June 2015.

"... the change in CAM will result in a break in the historical data series we collected from TasNetworks, for revenues and expenditures previously reported from 2006-14 for Economic Benchmarking and 2009-14 for Category Analysis. Therefore we require the historic CA/EB RIN data to be backcast in accordance with the new CAM. . . ."

We understand from TasNetworks that the requirement to revise the CAM in June 2015 arose from a need to describe the new corporate structures and ownership arrangements of the transmission and distribution networks, and this change in legal ownership did not result in any significant changes in:

- the costs attributable to the services delivered by two networks;
- the causal relationships between services and costs; or
- the method and methodology used to attribute costs to service categories.

Accordingly, TasNetworks is of the view that backcasting the RIN templates required by the AER will not result in any material impact on:

- Costs allocated to each of the transmission and distribution networks or among service categories.
- The comparability of historic costs prepared under the original CAMs and the new CAM.

2. Purpose

The sole purpose of this letter is to provide independent advice to TasNetworks on a number of matters set out below, concerning the impact of the new CAM on the comparability of information reported in TasNetworks' historic RIN templates. We understand that TasNetworks may provide a copy of this letter to the AER to assist TasNetworks to manage its regulatory obligations to the AER.

3. Scope

Our analysis, set out in this letter considers the following matters on which TasNetworks has sought advice from KPMG.

1. Does the new CAM, in combination with the corporate structure of TasNetworks, result in an allocation of costs to transmission and distribution services differently to the cost allocation methodology and cost allocation method approved by the AER that operated previously? ***(Refer section 4 below)***
2. What is an appropriate framework and threshold for an assessment of materiality as it relates to changes to RIN data as a result of the new CAM? ***(Refer section 5 below)***
3. What is the impact on costs disclosed in the RINs, of backcasting RIN information for the 2013/14 financial year under the new CAM? ***(Refer section 6 below)***

The remainder of this letter summarises our findings on each of these questions and the procedures and reasoning we undertook to arrive at those findings.

4. Conceptual comparison of the previous CAMs to the new CAM

4.1 Context

The new CAM relates to the separate provision of transmission and distribution services within the new entity, TasNetworks. The two CAMs which it superseded related to the separate provision of transmission and distribution services within the Aurora Energy and Transend legal entities, respectively.

We have undertaken a conceptual comparison of the three CAMs, namely:

- Aurora Energy Cost Allocation Method Version 6.3 dated May 2011
- Transend Cost Allocation Methodology Issue 1.0 dated April 2008
- TasNetworks Transmission Cost Allocation Methodology and Distribution Cost Allocation Method dated June 2015.

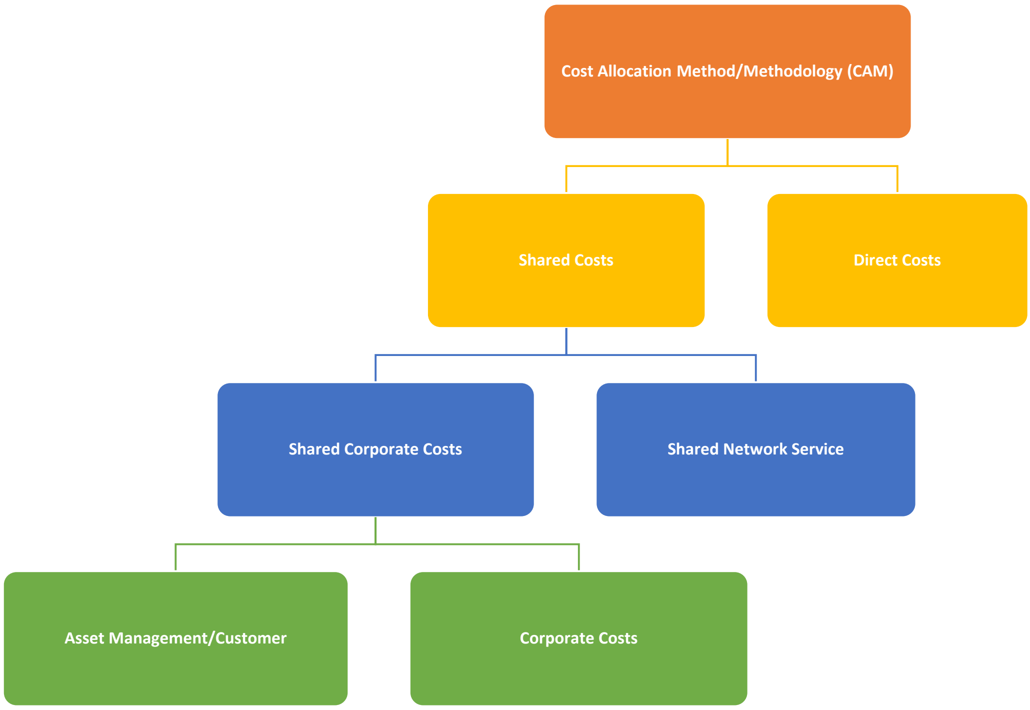
4.2 Conceptual analysis

Under the new entity, TasNetworks, the quantum of future costs subject to allocation and hence the costs reported under the new CAM will most likely be impacted by future efficiency improvements. However the **causal relationships** which govern the scope and nature of costs attributed and allocated to the different network services are independent of and hence do not change as a consequence of, the legal entity in which the business activities of each network are conducted.

Accordingly, because both the previous and new CAMs describe the same causal relationships, the application of the new CAM to historic costs should not be expected to have any significant impact on the allocation of those costs.

4.3 Detailed analysis

Having resolved the above conceptual analysis, we undertook further detailed analysis of all cost components that are subject to the new or old CAMs to identify items where the basis of allocation cost driver has been revised under the new CAM. This started with consideration of the total pool of costs to be allocated by the CAM. This was then split into Direct Costs (i.e. directly attributable costs) and Shared Costs. The Shared Costs are further split into Shared Network Service costs and Shared Corporate Costs. The Shared Corporate Costs are further split into Asset Management/Customer Costs and Corporate Costs. These various levels of costs are presented below:



The detailed analysis revealed that:

- The CAM change would have nil impact on attribution of direct costs which continue to be captured via chart of account dimensions within the general ledger under both the old and new CAM. Therefore no further analysis of this category was performed.
- The CAM change would have nil impact on allocation of shared network service costs. This is because shared network services costs are allocated using a causal factor, direct labour hours, which has not changed under the new CAM. Therefore no further analysis of this category was performed.
- There was no change to the capitalisation policy as a result of the new CAM therefore there would be no impact on the asset management/customer cost pool. Therefore no further analysis of this category was performed.
- The final cost pool is Corporate Costs. We identified that certain shared Corporate Costs have a different basis of allocation cost driver under the new CAM. Further analysis was required to quantify the impact of this change. This further analysis is reported below in section 6. In terms of quantification and context, in 2013/14, total Corporate Costs for both the transmission and distribution businesses was $23m which is only 19% of total overheads ($120m). It is clear from this analysis that the impact of the change in CAM is quarantined to a small portion of costs within the businesses in 2013/14. The same

conclusion is applicable to other regulatory years the AER has requested be backcast, on the basis that the business models have not changed significantly over that period.

4.4 Summary

In terms of answering the question does the new CAM result in an allocation of costs which is different to that operated previously, the analysis shows that the impact is quarantined to some corporate costs which are a small portion of total overheads. As a result we have concluded that the impact of the change is unlikely to be material. The following section addresses the matter of materiality.

5. Consideration and resolution of materiality.

It was important for TasNetworks to resolve an appropriate framework and threshold for an assessment of materiality as it relates to changes to RIN data as a result of the new CAM. This would provide input and parameters within which to undertake the backcasting exercise.

5.1 Background

We note that the AER's Cost Allocation Guidelines require that any amendment to a CAM "*will not jeopardise the comparability of the resultant financial information with earlier information provided by that NSP to the AER.*[2]"

- The Cost Allocation Guidelines do not provide a reference point for what quantum of change could "*jeopardise the comparability of the resultant financial information*". However, it was deemed appropriate to consider the concept of materiality when making this assessment.

5.2 Detailed analysis

Materiality is a concept which is addressed in the AER's Cost Allocation Guidelines, the RINs, the Australian Accounting Standards Board and the Auditing and Assurance Standards Board. Each of these sources were interrogated in order to establish a level of materiality that would meet the purpose of this exercise.

5.2.1 AER Cost Allocation Guidelines

The electricity distribution network service providers (DNSP) cost allocation guidelines June 2008 states that:

> *"an item is material if its omission, misstatement or non-disclosure has the potential to prejudice the understanding of the financial position of the DNSP, gained by an assessment of financial information relating to the DNSP"*[3]

[2] For example, Electricity distribution network service providers (DNSP) cost allocation guidelines June 2008, p15

[3] Electricity distribution network service providers (DNSP) cost allocation guidelines June 2008, Glossary

The electricity transmission network service providers (TNSP) cost allocation guidelines September 2007states that:

> *"an item is material if its omission, misstatement or non-disclosure has the potential to prejudice the understanding of the financial position of the TNSP, gained by an assessment of financial information relating to the TNSP"*[4]

The AER cost allocation guidance is consistent with the definition of materiality in the accounting and auditing standards as noted below in paragraphs 5.2.3 and 5.2.4. However, there is no guidance provided on the benchmark upon which to base the materiality or the other determining factors.

5.2.2 Regulatory Information Notice

In early 2016, TasNetworks is required to submit the distribution Regulatory Proposal for the next regulatory period (commencing 1 July 2017) to the AER. As part of this process TasNetworks has been requested to complete the Distribution Reset RIN. The Reset RIN templates and Reset RIN guidelines provide the following definition which is consistent with that providing in the EB and CA RINs:

> *"information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively to influence the economic decisions of users (including the AER) taken on the basis of the information provided in accordance with the Notice"*[5]

5.2.3 Australian Accounting Standards Board

The Australian Accounting Standards Board (AASB) provide some guidance on materiality in AASB 1031 Materiality. Specifically in relation to quantitative thresholds:

> *"Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items shall, of necessity, be drawn at arbitrary levels. Materiality is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial statements, and their information needs. Materiality judgements can only be properly made by those who have the facts. In this context, the following quantitative thresholds may be used as guidance in considering the materiality of the amount of items included in the comparisons referred to in paragraph 13 of this Standard:*
>
> *(a) an amount which is equal to or greater than 10 per cent of the appropriate base amount may be presumed to be material unless there is evidence or convincing argument to the contrary; and*

[4] Electricity transmission network service providers (DNSP) cost allocation guidelines September 2007, Glossary
[5] Distribution reset RIN, Schedule 1

> *(b) an amount which is equal to or less than 5 per cent of the appropriate base amount may be presumed not to be material unless there is evidence, or convincing argument, to the contrary."*[6]

More recently the AASB have released AASB 2015-3 Amendments to Australian Accounting Standards arising from the Withdrawal of ASB 1031 Materiality. This standard applies to all reporting periods beginning after 1 July 2015 and as such has not been considered as part of this analysis.

5.2.4 Auditing and Assurance Standards Board

The concept of materiality is further explored from an audit perspective by the Auditing and Assurance Standards Board. Auditing Standard ASA 320 'Materiality in planning and performing an audit' provides some additional insight into the concept of materiality. Paragraph 2 explores the concept of materiality as:

> *"Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial report"* [7]

The standard goes on to say:

> *"The auditor's determination of materiality is a matter of professional judgement, and is affected by the auditor's perception of the financial information needs of users of the financial report. "*[8]

5.3 Summary

In the context of the new CAM and the request from the AER to undertake and report on a backcasting exercise, the users of the RIN data are the AER and the public more broadly. TasNetworks takes the view that as regulators and the public, there is a lower appetite for variations to RIN disclosures. Taking into account the users and the guidance noted above, KPMG recommends a conservative materiality threshold of 5% be set.

To select a benchmark against which to apply the threshold of 5% we considered the following factors:

- The EB and CA templates prescribed by the AER for the purpose of backcasting mainly consist of opex related templates, together with one revenue, one provisions and one repex templates.

---

[6] AASB 1031 Materiality, paragraph 15

[7] ASA 320 Materiality in Planning and Performing and Audit, paragraph 2

[8] ASA 320 Materiality in Planning and Performing and Audit, paragraph 4

- Based on analysis performed in Section 4.3 above, revenue, provisions and repex templates were scoped out and only opex templates with overhead components were determined as potentially subject to backcasting.
- Opex, in particular regulated opex, is one of the key elements of the regulatory revenue building block.

As such, opex was considered the relevant base amount which serves a more conservative base compared to total.

To illustrate the materiality calculation, regulatory year 2013/14 was calculated and is presented below:

Materiality for backcasting 2013/14 RIN:

	Transmission 2013/14 $ Thousands	Distribution 2013/14 $ Thousands
Base amount – regulated opex	45,598	74,151
Percentage applied	5%	5%
Materiality	2,280	3,780

6. Recalculation of CA and EB data for 2013/14.

Having established a position in relation to materiality with reference to the RIN disclosures, the next step was to assess the impact on costs disclosed in the RINs as a result of the change in the CAM. To obtain an assessment of this we completed a backcast of the 2013/14 RIN financial disclosures as a guide to the impact. 2013/14 was selected on the basis of being the most recently completed RIN period. The changes in cost allocation resulting from the new CAM are limited and restricted to a small proportion of costs for each of the historic years (see paragraph 4.3). Because of this, the 2013/14 backcast comparison can be considered as representative of all the historic years requested by the AER to be backcast.

6.1 Approach to the recalculation

To quantify the impact of the CAM change, using historic financial information for the regulatory year 2013/14, the following procedures were performed:

- For corporate cost items with a different basis of allocation cost driver under the new CAM, sourcing relevant data from previous EB or CA submission. This data included the total amount of the cost allocation across the various services segments.
- Re-allocation of the corporate cost, using the new basis of allocation cost driver under the new CAM.

- Calculating the variance in allocation to each service segment between the old CAM and the new CAM and assessing if it is material based on materiality level determined at Section 5.

6.2 Results of the recalculation

Following the recalculation, the conceptual analysis (as detailed in section 4) was corroborated by the recalculation undertaken for 2013/14. In summary, we present below the single largest account type variance and the total variance for transmission and distribution:

Materiality analysis

	Variance $ Thousands
TRANSMISSION (old Transend)	
Financial analysis and reporting (single largest variance at the account type level)	(396)
Total of all documented variances	(532)
Materiality	2,280
DISTRIBUTION (old Aurora)	
Treasury operations – debt management (single largest variance at the account type level)	(446)
Total of all documented variances	(620)
Materiality	3,708

The recalculation of the RIN data from 2013/14 proved that for that year, any variance arising from the new CAM is not material individually or in aggregate. The application of one materiality amount to individual variances and the variances in aggregate is consistent with the expected methodology that would be applied by independent auditors of RINs.

In terms of sensitivity of the calculations performed, the variances would have to be understated by almost five times (transmission) and six times (distribution) in order that they be considered material.

In terms of sensitivity of the calculations performed, the variances would have to be understated by almost five times (transmission) and six times (distribution) in order that they be considered material.

Section 4 demonstrates that the impact of applying the new CAM to historical years would not differ significantly between years. Accordingly the finding for 2013/14 that the variances resulting from applying the new CAM are not material, can be applied to the historical years that the AER has asked to be backcast.

Important notice

Inherent Limitations

This letter has been prepared as outlined in the Scope Section. The services provided in connection with this engagement comprise an advisory engagement which is not subject to

Australian Auditing Standards or Australian Standards on Review or Assurance Engagements, and consequently no opinions or conclusions intended to convey assurance have been expressed.

No warranty of completeness, accuracy or reliability is given in relation to the statements and representations made by, and the information and documentation provided by, TasNetworks management and personnel consulted as part of the process.

KPMG have indicated within this report the sources of the information provided. We have not sought to independently verify those sources unless otherwise noted within the report.

KPMG is under no obligation in any circumstance to update this report, in either oral or written form, for events occurring after the report has been issued in final form.

The findings in this report have been formed on the above basis.

Third Party Reliance

This report is solely for the purpose set out in the Purpose Section and for TasNetworks' and the AER's information, and is not to be used for any other purpose or distributed to any other party without KPMG's prior written consent.

This report has been prepared at the request of TasNetworks in accordance with the terms of KPMG's contract dated 28 July 2015. Other than our responsibility to TasNetworks, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way for the use of this report for any purpose other than that for which it has been prepared.

Yours sincerely

Keith Lockey
Director

Yours sincerely

Paul Green
Partner