Reporting capital contributions

AER Guidance Note for electricity distributors

November 2024

AUSTRALIAN ENERGY REGULATOR

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1 Reporting capital contributions

The AER has prepared a guidance note to assist electricity distribution businesses (DNSPs) prepare annual information submissions and regulatory proposals that report capital contributions on a consistent basis for all the DNSPs, in line with the regulatory framework. The guidance note is at Attachment A.

The guidance note has been prepared in response to concerns from DNSPs reporting high value capital contributions for projects that span multiple reporting periods.

A guidance note is not binding, but it can help reduce regulatory burden by ensuring a shared understanding of reported data and consistency with the AER's assessment framework. All DNSPs are encouraged to assess their current reporting practice against the guidance and make changes to conform with the guidance where possible.

1.1 Problem statement

Distribution capital expenditures are reported on an as-incurred basis. The AER's expectation is that capital contributions, as a component of distribution capital expenditure, are also reported and forecast on an as-incurred basis.

We use an as-incurred capital expenditure framework as we consider it better reflects the nature of distribution assets. Distribution assets usually have a shorter build timeframe and are typically put into use (commissioned) at a time close to when the expenditure is incurred. We have consistently applied the as-incurred approach for distribution since 2008, when we developed the distribution regulatory models under chapter 6 of the NER.

In response to an information request by the AER, DNSPs have described a range of reporting frameworks for capital contributions:

- As-commissioned – recognised in the regulatory reports at the time the contribution is recognised in the statutory revenues.
- As-incurred – recognised in the regulatory reports at the same time as and in proportion to the capital expenditure incurred on the project.
- Milestone basis – recognised in the regulatory reports consistent with project 'milestones' and at the same time as milestone contribution payments are recognised in statutory revenues.
- As-billed – recognised in the regulatory reports on receipt, prior to the commencement of the project.

Why does this matter?

The timing misalignment between capital expenditures and capital contributions has the potential to overstate the regulatory asset base for projects which span beyond one reporting year.[1] Where capital contributions are reported in a different reporting year to the related

1 Where the capital contributions are recorded on an 'as-billed' basis the asset base may be understated where the contribution is recognised in an earlier reporting period compared to the capital expenditure.

capital expenditure—for example, on completion of the project (as-commissioned)—the capital expenditures being rolled into the regulatory asset base are effectively GROSS capital expenditures, not NET capital expenditures. That can impact the forecast return on capital (and hence the amount consumers pay), and it may also impact performance under the capital expenditure sharing scheme (CESS), offsetting any capital expenditure efficiencies.

We note the impact of the potential misalignment between reporting capital expenditures and capital contributions is also relevant where the contribution is reported prior to the expenditure being incurred (where the reporting is 'as-billed').

When does this matter?

This timing issue may not be a material issue for many DNSPs. That is because capital contributions are not material, and projects for which capital contributions are received are not large, and do not span multiple years.

However, this will be an issue if projects that span two or more reporting periods (or regulatory control periods) have material capital contributions associated with them. We are seeing examples of such connection projects in Victoria and expect that similar projects may occur in other jurisdictions.

In such cases, the timing mismatch between as-incurred capital expenditure and as-commissioned capital contributions will mean the capital expenditures that are included in the asset base are higher than they would be if capital contributions were reported on an as-incurred basis. Higher capital expenditures lead to a higher asset base value and impact the prices customer pay through higher estimates of revenue requirements derived from return on capital and return of capital building blocks. The impact of higher capital expenditures will occur for the life of the assets.

1.2 AER solution

We acknowledge the current reporting requirements do not provide clear guidance on reporting capital contributions, as is evidenced by the range of interpretations currently in play. We also note the requirement to adhere to Statutory reporting standards, unless otherwise required by the Annual Information Order.

However, we consider it important to maintain consistency across DNSPs, and between our annual reporting, asset base roll forward and capital expenditure incentive scheme.

To mitigate this inconsistency we are requesting all material Type 1 capital contributions for projects that are delivered in a period of greater than 12 months be reported on an as-incurred basis under the regulatory reporting framework.

This will ensure all material capital contributions for a project are reported in the same regulatory reporting years as the capital expenditures on the project.

We consider this option will achieve the consistency the AER is looking for, but not impose significant additional costs on the businesses relating to regulatory reporting. The materiality criteria we have defined will limit the number of projects that are captured under this reporting guidance. Reporting of capital contributions where the materiality criteria are not met can continue as per the DNSPs’ current practise.

2 Key issues raised in consultation

2.1 Need for the guidance

No DNSPs disputed the need to address the timing issue, although some noted the issue is not relevant as they already report capital contributions on an as-incurred basis.

Consistency with current distribution determinationsOne DNSP noted its current distribution determination requires an as-commissioned approach to reporting type 1 capital contributions. A mid-period change will introduce complexity relating to the CESS, and an inconsistency with the requirements of the Order.

We propose to address the complexities arising from forecasts and actual expenditures reported on a different basis in consultation with each affected DNSP.

2.2 Materiality threshold

Several DNSPs raised the issue of an appropriate materiality threshold to mitigate the cost of using an as-incurred methodology for all capital contributions. DNSPs suggested a range of materiality thresholds applying to capital contributions from $50,000 to $250,000. Other DNSPs suggested applying the materiality threshold to the project, either in terms of the size of the new connection assets (MWh) or the expected capital expenditure of the project.

We have applied materiality criteria to manage the cost impact of this change in reporting basis. We have applied materiality criteria relating to the timeframe for the project (greater than 12 months); and also the value of the capital contribution. We consider the value of the capital contributions is the key issue (not the value of the project) and have set the materiality criteria at $200,000, within the range of thresholds proposed by the DNSPs. We consider this balances the need to manage the impact of the mismatch timing for capital contributions against the increased regulatory reporting burden applying this change will have on some DNSPs.

2.3 Estimated v actual data

A DNSP noted that data derived using an allocation method may be classified as estimated data, with consequential impact on assurance standards.

Under the annual information order, the definition of actual information includes the following guidance :

> Actual information: …Information presented whose presentation is based on allocation method using judgments or assumptions, can be still reported as actual. The allocation method would be expected to be clearly documented by the Network Service Provider or Service Provider and approved by senior management as either a regulatory statement accounting policy or regulated statement policy, with any judgments or assumptions used in the allocation remaining consistent between reporting years. The judgments or assumptions used are to be determined in accordance with the Order, notice or other purpose governing the preparation of the information.

We consider that where information on capital contributions is reported consistent with the allocation method described in this guidance the information would meet the definition of actual information.

2.4 Definition of large project

Some DNSPs requested the concept of a large project be defined.

We did not define a large project in the draft guidance note, and in the final guidance have removed the reference to 'large projects'. The materiality criteria for type 1 capital contributions relates to the value of the capital contribution, rather than the project.

3 Implementation

The attached guidance note setting out our reporting requirements, should be used to interpret annual reporting obligations for the 2024-25 reporting year and into the future. The guidance note should be provided to auditors to assist with interpretation of annual reporting requirements.

We also consider that, at each DNSP's discretion, prior year annual information submissions may be resubmitted. This will only be necessary if the DNSP's current interpretation of reporting requirements does not align with our newly advised guidance, and the impact of the timing misalignment is material.

We propose to address issues arising in relation to consistency with forecasting methods for the current reporting period, or other implementation issues arising, with each affected DNSP. We note this may require supplementary information being provided to support calculation of CESS rewards or penalties.

3.1 Concepts

Capital contributions relate to money or other contributions received by the DNSP in relation to the delivery of a specific network project - most often a connection project, although they may also be associated with augmentation projects.

Capital contributions can be classified as type 1 or type 2. This discussion guidance relates to type 1 capital contributions, defined as:

> Cash contributions received by a DNSP:
>
> (a) with respect to standard control services, where tax payable on the capital contribution is recovered via the corporate income tax allowance used to derive the annual revenue requirement;
>
> (b) with respect to alternative control services, where tax payable on the capital contribution is recovered via charges for alternative control services;
>
> For clarity, type 1 capital contributions do not include Power and Water Corporation undergrounding capex (equity funded).

Type 2 contributions are usually gifted assets but are defined as 'capital contributions that do not meet the definition of a type 1 contribution'. Type 2 capital contributions are not a concern in terms of a timing mismatch with capital expenditures, as there is no capital expenditure undertaken by the DNSP on the assets prior to the contribution being received by the DNSP.

Attachment A: Reporting capital contributions - AER Guidance Note for electricity distributors

1. This guidance note is issued to aid electricity distributors (DNSPs) to prepare responses to the Annual Information Order, as issued by the AER in April 2024. It relates to reporting capital contributions in the annual reporting submissions prepared for the AER.
2. Distribution capital expenditures are reported on an as-incurred basis. The AER's expectation is that capital contributions, as a component of distribution capital expenditure, are also reported on an as-incurred basis.
3. The Annual Information Order does not explicitly direct capital contributions to be reported on an as-incurred basis. However, some guidance for reporting capital contributions is provided in the instructions for completing the data workbooks:

    Section 1.2.3 - General

    The electricity distributor must report financial information in the data workbooks that:

    (a) is derived from the audited statutory accounts;

    (b) is verifiable by reference to the audited statutory accounts;

    …

    (e) in so far as is reasonably practicable, is prepared in accordance with the general rules and format of the audited statutory accounts, and use the accounting principles and policies applicable to the audited statutory accounts except as otherwise required by this Order; …

    Section 1.4 Customer and government contributions

    1.4.1 The electricity distributor must not carry forward into the asset base capital contributions treated as revenues in audited statutory accounts and included in the value of assets.

    1.4.2 The electricity distributor must report capital contributions in accordance with the method approved in the electricity distributor's current distribution determination.

    Section 1.6 Regulatory accounting principles and policies

    1.6.2 Unless otherwise required by this Order, the electricity distributor must report capital expenditure and associated data (such as asset volumes) in the data workbooks against the reporting period on an as-incurred basis.

4. Capital contributions may be type 1 or type 2 capital contributions, which are defined as follows:

Type 1 capital contributions	Cash contributions received by a DNSP: (a) with respect to standard control services, where tax payable on the capital contribution is recovered via the corporate income tax allowance used to derive the annual revenue requirement; (b) with respect to alternative control services, where tax payable on the capital contribution is recovered via charges for alternative control services; or cash contributions received by a pipeline service provider: (a) with respect to reference services, where tax payable on the capital contribution is recovered via the corporate income tax allowance used to derive the annual revenue requirement; For clarity, type 1 capital contributions do not include Power and Water Corporation undergrounding capex
Type 2 capital contributions	Any form of capital contributions received by a NSP or pipeline service provider (including gifted assets or cash contributions) that do not meet the definition of Type 1 capital contributions or Power and Water Corporation undergrounding capex (equity funded).

5. This guidance only applies to type 1 capital contributions, and its application is limited to type 1 capital contributions that meet the following materiality criteria:

   (a) The project to which the capital contribution relates is expected to take greater than 12 months to complete; and

   (b) The capital contribution is greater than $200,000.

6. In addition to the requirements set out in the Order, we request the following be used to inform the reporting of capital contributions:

   – all Type 1 capital contributions that meet the materiality criteria in paragraph 5 of this Guidance Note are reported on an as-incurred basis.

7. As-incurred basis means that a type 1 capital contribution that meets the materiality criteria will be allocated across the relevant reporting periods consistent with the timing of when the capital expenditures incurred.

8. The following methodology may be used to allocate capital contributions, where expenditures are incurred across 3 years – years t, t+1 and t+2:

   Total Capcon = $\text{Capcon}_t + \text{Capcon}_{t+1} + \text{Capcon}_{t+2}$

Where

Total Capcon is the total type 1 capital contribution for the project

$Capcon_t$ is the proportion of the capital contribution to be reported in the first year of the project, period t, calculated as

Total Capcon * $(\text{project capex})_t$/ (project capex)

$Capcon_{t+1}$ is the proportion of the capital contribution to be reported in period t+1, calculated as

Total Capcon * $(\text{project capex})_{t+1}$/ (project capex)

$Capcon_{t+2}$ is the proportion of the capital contribution to be reported in period t+2, calculated as

Total Capcon * $(\text{project capex})_{t+2}$/ (project capex)

9. If capital contributions that meet the materiality criteria are allocated across reporting periods using an alternative method to that set out in paragraph 8, the alternative method must be documented in the basis of preparation provided to the AER with the distribution businesses annual information submission.

10. Capital contributions that do not meet the materiality criteria in paragraph 5 may be reported on a basis preferred by the distribution business, and the reporting basis should be documented in the basis of preparation submitted with its annual information submission.

11. This guidance applies for the 2024-25 reporting year, and all subsequent reporting years.

12. This guidance should be used to inform expenditure forecasts to ensure consistency between forecast and actual expenditures.

13. This guidance may be used to support a resubmission of annual information for the reporting years prior to 2024-25. Resubmission of prior year data is only likely to be required where capital contributions are a significant proportion of the capital expenditure associated with a project that spans multiple reporting years.

14. This guidance will impact reporting of capital contributions throughout the annual information submissions. The following tables in the Annual Order may be impacted:

- 2.1.1 - STANDARD CONTROL SERVICES CAPEX EXCLUDING DUAL FUNCTION ASSETS
- 2.1.3 - ALTERNATIVE CONTROL SERVICES CAPEX
- 2.1.5 - DUAL FUNCTION ASSETS CAPEX
- 2.3.3 - AUGEX DATA - HV/LV FEEDERS AND DISTRIBUTION SUBSTATIONS | COST METRICS
- 2.3.4 - AUGEX DATA - TOTAL EXPENDITURE
- 2.5.2 - COST METRICS BY CONNECTION CLASSIFICATION
- 2.5.3 - CAPITAL CONTRIBUTIONS (TYPE 1) BY CONNECTION CLASSIFICATION
- 2.5.4 - NEW NON-STANDARD CONTROL SERVICES CONNECTIONS BY CONNECTION CLASSIFICATION

- 3.3.1 - REGULATORY ASSET BASE VALUES
- 3.3.2 - ASSET VALUE ROLL FORWARD
- 8.1.1 - INCOME STATEMENT
- 8.2.1 - CAPEX BY PURPOSE - STANDARD CONTROL SERVICES - INCLUDING TOTAL CAPITAL CONTRIBUTIONS
- 8.2.3 - CAPEX OTHER - INCLUDING TOTAL CAPITAL CONTRIBUTIONS
- 8.2.4 - CAPEX BY ASSET CLASS - STANDARD CONTROL SERVICES
- 8.2.5 - CAPITAL CONTRIBUTIONS BY ASSET CLASS
- 8.2.5 (B) - CAPITAL CONTRIBUTIONS BY TYPE - ALTERNATIVE CONTROL SERVICES
- 8.2.8 - CAPITAL CONTRIBUTIONS BY ASSET CLASS - PWC UNDERGROUNDING CAPEX (equity funded)
- 8.6.1 ASSET BASE ROLL FORWARD - SCS
- 8.6.2 ASSET BASE ROLL FORWARD – ACS

15. If you have questions relating to the application of this Guidance Note please contact the AER at: Director, Networks Data, networksinformation@aer.gov.au.