Attachment 7.10

Response to Draft Decision: Advice Regarding Opex versus Capex Classification

A report by Deloitte

2016/17 to 2020/21 Access Arrangement Information Response to Draft Decision

Australian Gas Networks

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Deloitte Touche Tohmatsu
ABN 74 490 121 060

11 Waymouth Street
Adelaide SA 5000
GPO Box 1969
Adelaide SA 5001 Australia

Tel: +61 8 8407 7000
Fax: +61 8 8407 7001
www.deloitte.com.au

Ashley Muldrew
Regulatory Economist
Australian Gas Networks Limited
Level 6
400 King William St
ADELAIDE SA 5000

5 January 2016
Our Ref: PJW/SD

Dear Ashley

Re: Advice regarding Opex versus Capex classification for project SA09 Valve Corrosion Protection

In accordance with our engagement letter dated 13 November 2015, we have set out our advice below regarding the appropriate classification of the business case SA09 Valve Corrosion Protection as Capital Expenditure (capex) or Operating Expenditure (opex), in accordance with Australian Accounting Standards. Our report to you is set out as follows:

1. Advice regarding the classification of the business case;
2. Relevant accounting pronouncements;
3. Key considerations when determining classification between capex and opex;
4. Discussion of the relevant background for the business case and the application of the key considerations to determine the appropriate classification

This letter of advice should be read in conjunction with our Engagement Letter.

We bring to your attention that we have not considered whether the classification between capex and opex in accordance with Australian Accounting Standards is consistent with the classification that would be determined under the regulatory framework of the National Gas Rules.

Advice

Based on our understanding of the business case and the application of relevant accounting pronouncements, we recommend that the business case SA09 Valve Corrosion Protection be classified as Capex.

The relevant accounting pronouncements and background used to draw our conclusions are set out in the sections below.

Relevant accounting pronouncements

The following pronouncements have been considered and referred to in reaching our conclusion in this letter of advice:

- AASB *Framework for the Preparation and Presentation of Financial Statements*; and
- AASB 116 *Property, Plant and Equipment*.

Key considerations when determining classification

In order to determine whether the business case should be classified as Opex or Capex, it is necessary to determine whether the expenditure incurred on the project has given rise to an asset or an expense. Per AASB 116 para. 7:

The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the item will flow to the entity; and

(b) the cost of the item can be measured reliably

Per AASB *Framework* para 53, the *future economic benefit* embodied in an asset relates to the potential of that asset to contribute to the flow of cash and cash equivalents to an entity. This may be directly through an operational asset, or indirectly through the ability of the asset to reduce future cash outflows.

For the purpose of this accounting advice, we have assumed that the cost of each item can be measured reliably, through the use of invoices (for materials and contractors) and the use of timesheets to allocate internal labour to the appropriate cost element of each project.

AASB 116 also provides guidance in regard to subsequent costs incurred in relation to an existing item of Property, Plant and Equipment (PPE) at para. 12-14. This guidance is particularly relevant to this advice as the business case which forms the basis of the advice relates to additions or modifications to existing assets, rather than new assets.

Determining whether expenditure gives rise to a future economic benefit is a highly judgemental task, which is dependent on a number of factors. In coming to a conclusion on the appropriate classification of the business cases, we have assessed each project against the following key considerations:

Consideration	Effect on conclusion
Will the project described in the business case directly result in increased cash flows?	Increased cash flows provide evidence of a future economic benefit. This would be a strong evidence of capex.
Will the project result in a change to the useful life of an asset?	If the useful life of an asset were extended due to the works performed, it would suggest that there is a future economic benefit as cash flows will be obtained from the use of the asset for a longer period. This would be suggestive of capex.
Will the project lead to lower operating costs through efficiencies or new operating methods?	Decreased future operating costs represent an indirect future economic benefit, and as such are evidence of capex.
Will the project significantly alter an asset?	Significant changes to an asset (e.g. addition of new components or sub-systems) may lead to future economic benefits through additional functionality or efficiency. This would be suggestive of capex.
Where the business case relates to repairs to an asset(s), is the repair routine and recurring, or an infrequently recurring major repair?	AASB 116 para 12 proscribes the recognition of the day-to-day costs of servicing an item, which are "*primarily the costs of labour and consumables, and may include the cost of small parts".* As such, repairs and maintenance are generally considered to be opex. Per AASB 116 para 13, parts of items of PPE which are replaced periodically and infrequently may be recognised in the carrying amount of the item, providing the recognition criteria per para 7 are met. In general, large and infrequent replacements of parts of an item of PPE are considered to be capex.

Consideration	Effect on conclusion
Does the business case relate to a major inspection for an item of PPE which is a condition of continuing to operate the item?	AASB 116 para 14 states that the cost of major inspections of an item which are a condition of continued operation (e.g. aircraft inspections based on hours flown) may be recognised in the carrying amount of the item. This would be suggestive of capex.
Does the project relate to the relocation or redeployment of an asset which is already in operation?	AASB 116 para 20 states that "*costs incurred in using or redeploying an item are not included in the carrying amount of that item*". Therefore, where an item that is already in use is moved, the costs of the relocation must be expensed.
Does any of the expenditure in the business case relate to spare parts, stand-by equipment or servicing equipment for an item which is to be capitalised as PPE?	AASB 116 para 8 allows for spare parts, stand by and servicing equipment to be recognised as PPE where the recognition criteria per para 7 have been met. We note that this criteria is not applicable to the business case which is the subject of this advice, and such has not been included in our discussion below.

Discussion and analysis of business case SA09 Valve Corrosion Protection

Background

- The project entails the grit blasting of critical isolation valves in situ and coating to protect against further corrosion.
- It has been over 20 years since a major coating application has been undertaken, with various amounts of "touch up" painting undertaken over the years during routine inspections.
- Engineering inspections and maintenance feedback has highlighted that:
  - Corrosion pitting has been gradually progressing in all valve pits over time to a point that a remediation program is required before ongoing corrosion becomes critical; and
  - Periodical maintenance, as relied upon to-date, will no longer be effective in stemming the degradation and will not be cost effective.
- New coating standards and materials are now available with special corrosion inhibitors, which protect the pipe and valves in valve chambers for 30 to 40 years when properly applied.
- This program avoids expensive replacement should the valve become inoperable. If the latter occurs, the pipeline must be shut down using hot tap and stopple equipment, a section cut out, and a new valve installed. The cost of replacing the valve can vary between $10,000 and $20,000. The estimated cost to recoat the isolation valves is $3,888 per valve ($2014/15, direct costs only).
- The estimated cost to recoat each valve is split as follows:
  - External contractors (coating and traffic control) of $2,160; and
  - Internal labour (excavations, technicians, supervision) of $1,724.
- Isolation valves fit within the asset category "Mains", with an estimated useful life of 60 years and a remaining useful life of 49 years

We have also made the following assumptions:

- The valves will continue to be used for 30 years (bottom end of estimated life of coating), implying that recoating program will extend the useful life of the isolation valves (although, as noted above, the FAR will not be updated).

Analysis

Consideration	Analysis
Will the project described in the business case directly result in increased cash flows?	No
Will the project result in a change to the useful life of an asset?	The application of the coating will allow for the valves to remain in service beyond the end of their estimated useful life.
Will the project lead to lower operating costs through efficiencies or new operating methods?	Replacing the valves is 2.5 to 5 times more expensive than recoating the valves based on estimates provided in the business case, which suggests a reduction in future costs. However, it is unknown how many valves would ultimately fail and when, and as such there is some uncertainty regarding the extent of the value of future economic benefits.
Will the project significantly alter an asset?	Recoating of valves and associated piping does not appear to be a significant alteration.
Where the business case relates to repairs to an asset(s), is the repair routine and recurring, or an infrequently recurring major repair?	This particular repair is undertaken infrequently, last occurring approximately 20 years ago. We also understand that new materials will produce a coating which will last for 30-40 years, suggesting that the benefits from this project will be long lasting.
Does the business case relate to a major inspection for an item of PPE which is a condition of continuing to operate the item?	No – this project relates to remedial works being carried out on valves.
Does the project relate to the relocation or redeployment of an asset which is already in operation?	No

Conclusion

On balance, we consider the expenditure in relation to SA09 to be Capex in nature, due to the following considerations:

- The work being carried out is a major, infrequent repair rather than routine maintenance.
- The coating being applied is extremely long lasting, with an expected life of 30-40 years, which will extend the useful economic life of the asset beyond the initial estimate.

While the failure rate is uncertain, the continued operation of valves (rather than replacement) suggests that there will be some future economic benefit from the project.

- We consider that each element of the project cost should be capitalised, as all works are related to the recoating of the valves (i.e. there are no inspection or other costs which are not Capex in nature).

We also note that per AASB 116, there are specific requirements for:

- the derecognition of costs of replacement parts of an item (per AASB 116 para 70); and
- accounting for the changes in the expected useful life or residual value of an asset (AASB 116 para 51).

However, per the scope set out in our engagement letter we have not commented on the accounting for the derecognition or changes in the useful life of the assets.

Limitations on our advice and statement of responsibility

The ultimate responsibility for the determination of the appropriate accounting treatment of each business case rests with the management of AGN. We suggest you discuss any decision concerning the appropriate accounting treatment of the business case with your external auditor.

This letter of advice is prepared solely for the use of the AGN. We understand that a copy of this advice will be provided to the Australian Energy Regulator (AER). This letter of advice is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. This letter of advice has been prepared for the purpose of assisting you in your evaluation of the appropriate accounting treatment of the business cases. You should not refer to or use our name or this letter of advice for any other purpose.

Our letter of advice has not addressed any tax, regulatory, or other matters other than the specific accounting treatment described above.

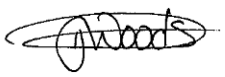
We have drawn our conclusion based solely on the facts and other information provided to us by AGN, as outlined in the background section of this letter of advice and our interpretation of the relevant accounting pronouncements. If the facts, circumstances, assumptions or other information outlined in this letter of advice prove to be different from those described, our conclusion may change. We have not audited, tested or otherwise verified any of the information provided to us by AGN and we have assumed that all such information is accurate, complete and not misleading in any way.

Our advice is based on our interpretation of Australian accounting pronouncements currently on issue. In the event that new or revised Australian Accounting Standards or Interpretations or other applicable pronouncements are issued in the future, our advice should be reconsidered in light of such changes and/or new requirements. We are under no obligation however to update our advice for information provided further to the date of this letter of advice, or for other future events.

The interpretation of Australian accounting pronouncements involves the exercise of professional judgement. In particular, many issues relating to Australian Equivalents to International Financial Reporting Standards presently remain subject to professional interpretation in the absence of relevant authoritative interpretations. Accordingly, the facts, circumstances, assumptions and conclusions described in this letter of advice may be viewed differently by others including the Australian Securities and Investments Commission (ASIC). In addition, due to the evolution of professional interpretation of Australian accounting pronouncements, the facts, circumstances, assumptions and conclusions described in this letter of advice may subsequently be viewed differently by us and/or others including the ASIC. We are under no obligation to update our advice for changes in our interpretation of Australian accounting pronouncements.

Please do not hesitate to contact me if you require any further assistance

Yours sincerely



Penny Woods
Partner
Deloitte Touche Tohmatsu