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Independent Auditor's Review Report to the directors of Powercor Australia Ltd

We have reviewed the accompanying "financial information" included in table 2 and table 4 of the PAL RRP BUS 9.07 – Reclassification of repairs – Dec2020 – Public report relating to the Revised Regulatory Proposal 2021-2026 (the "Proposal") for:

- the 12 months ended 31 December 2015;
- the 12 months ended 31 December 2016;
- the 12 months ended 31 December 2017;
- the 12 months ended 31 December 2018; and
- the 12 months ended 31 December 2019;

together, the "Tables" of Powercor Australia Ltd ("Powercor" or the "Company"). The Tables have been prepared by management in accordance with the Basis of Preparation.

Management's Responsibility for the Tables

Management is responsible for the preparation and fair presentation of the Tables in accordance with the Basis of Preparation. Management has determined that the Tables are appropriate to meet the needs of the directors and the reporting requirements of the Australian Energy Regulator ("AER"). Management's responsibility also includes such internal control as they determine is necessary to enable the preparation and fair presentation of the Tables that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the Tables based on our review. We have conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2405 *Review of Historical Financial Information Other than a Financial Report*. ASRE 2405 requires us to conclude whether anything has come to our attention that causes us to believe that the Tables are not presented fairly, in all material respects, in accordance with the Basis of Preparation. This Standard also requires us to comply with relevant ethical requirements.

A review in accordance with ASRE 2405 is a limited assurance engagement. The auditor performs procedures, primarily consisting of making enquiries of management and others within the entity, as appropriate, and applying analytical procedures and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Australian Auditing Standards. Accordingly, we do not express an audit opinion on the Tables.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the "financial information" of Powercor included within the Tables does not present fairly, in all material respects, in accordance with the Basis of Preparation.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our conclusion, we draw attention to "Management's Responsibility for the Tables" paragraph above which states that the Tables have been prepared in accordance with the Basis of Preparation.

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The Tables have been prepared to assist Powercor to meet the reporting requirements of the AER. As a result, the Tables may not be suitable for another purpose. Our report is intended solely for the Directors of Powercor and the AER and should not be used by other parties.

We understand that the AER may publish a copy of our report on their website. We accept no responsibility to any person or entity, apart from Powercor, that is provided with, or obtains a copy of our report, without our written agreement. No other person or entity is entitled to rely, in any manner, or for any purpose, on this report. We do not accept or assume responsibility to anyone other than Powercor for our work, for this report, or for any reliance which may be placed on this report by any party other than Powercor.

DELOITTE TOUCHE TOHMATSU

DELOITTE TOUCHE TOHMATSU

[redacted]

Chartered Accountants
Melbourne, 18 December 2020

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Independent Limited Assurance Report to the directors of Powercor Australia Ltd

Conclusion

We have undertaken a limited assurance engagement relating to the accompanying "non-financial information" included in Table 3 of the PAL RRP BUS 9.07 – Reclassification of repairs – Dec2020 – Public report relating to the Revised Regulatory Proposal 2021-2026 (the "Proposal") for:

- the 12 months ended 31 December 2015;
- the 12 months ended 31 December 2016;
- the 12 months ended 31 December 2017;
- the 12 months ended 31 December 2018; and
- the 12 months ended 31 December 2019;

together, "Table 3" of Powercor Australia Ltd ("Powercor" or the "Company"). The non-financial information included in Table 3 have been prepared by management in accordance with the Basis of Preparation.

Based on the procedures performed and the evidence obtained, nothing has come to our attention that causes us to believe that the "non-financial information" of Powercor included within Table 3 is not prepared, in all material respects, in accordance with the Basis of Preparation.

Basis for Conclusion

We conducted our limited assurance engagement in accordance with Australian Standard on Assurance Engagements ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information ("ASAE 3000"), issued by the Australian Auditing and Assurance Standards Board.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our conclusion.

Management's Responsibilities

Management is responsible for:

- Ensuring that the non-financial information included in Table 3 are prepared in accordance with the Basis of Preparation.
- Determining that the non-financial information included in Table 3 is appropriate to meet the needs of the directors and the reporting requirements of the Australian Energy Regulator ("AER").
- Designing, establishing and maintaining an effective system of internal controls to ensure that the non-financial information included in Table 3 is prepared in accordance with the Basis of Preparation.

Our Independence and Quality Control

We have complied with the independence and other relevant ethical requirements relating to assurance engagements, and applied Auditing Standard ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements in undertaking this assurance engagement.

Assurance Practitioner's Responsibilities

Our responsibility is to express a limited assurance conclusion on the non-financial information included in Table 3 based on the procedures we have performed and the evidence we have obtained. ASAE 3000 requires that we plan and perform our procedures to obtain limited assurance about whether, anything has come to our attention that causes us to believe that the non-financial information included in Table 3 is not prepared, in all material respects, in accordance with the Basis of Preparation

A limited assurance engagement in accordance with ASAE 3000 involves identifying areas where a material misstatement of the non-financial information included in Table 3 is likely to arise, addressing the areas identified and considering the process used to prepare the non-financial information included in Table 3. A limited assurance engagement is substantially less in scope than a reasonable assurance engagement in relation to both the risk assessment procedures, including an understanding of internal control, and the procedures performed in response to the assessed risks.

The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed. Accordingly, we do not express a reasonable assurance opinion about whether Table 3 have been prepared, in all material respects, in accordance with the Basis of Preparation.

Our procedures included:

- Inquiring of the relevant staff to determine the reliability of the processes, procedures used and the systems applied to provide, prepare and maintain the information;

- Inspecting the processes, procedures and systems to test that they were correctly used and applied by the relevant staff to prepare, provide and maintain the information;

- Inquiring of relevant staff and inspecting whether there are any changes in the processes, procedures or systems during the reporting periods, that may have compromised the reliability of the information prepared and provided;

- Agreeing the information presented in Table 3 with the underlying source information produced by the processes, procedures and systems;

- Inspecting the basis of preparation documents and inquiring of relevant staff whether Table 3 and related source data have been produced in accordance with the description provided in the basis of preparation documents;

- Evaluating the designation of the information as "Actual" or "Estimated" as reported in the basis of preparation documents; and

- Inquiring of the relevant staff through analytical review, including comparison of the template to historical reported information, whether the processes, procedures or systems provide information which corresponds to information previously provided, provide any missing information or unusual trends that suggest errors in information entry or manipulation.

Inherent Limitations

Because of the inherent limitations of an assurance engagement, together with the inherent limitations of any system of internal control there is an unavoidable risk that it is possible that fraud, error, or non-compliance with laws and regulations, where there has been concealment through collusion, forgery and other illegal acts may occur and not be detected, even though the engagement is properly planned and performed in accordance with Standards on Assurance Engagements.

Restricted use

This report is made solely to the Directors of Powercor in accordance with our engagement letter dated 1 December 2020, for the purpose of assisting you to meet your reporting obligations to the AER. We disclaim any assumption of responsibility for any reliance on this report to any person other than the Directors of Powercor or for any purpose other than that for which it was prepared.

However, we understand that a copy of the report has been requested by the AER for the purpose of assessing Powercor's compliance with the Basis of Preparation. We agree that a copy of the report may be provided to the AER for their information in connection with this purpose but only on the basis that we accept no duty, liability or responsibility to the AER in relation to the report. We accept no duty, responsibility or liability to any party, other than you, in connection with the report or this engagement.

We disclaim any assumption of responsibility for any reliance on this report to any person other than the Directors or for any purpose other than that for which it was prepared.

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Chartered Accountants
Melbourne, 18 December 2020

Reclassification of repairs

PAL RRP BUS 9.07 - Reclassification of repairs - Dec2020
Public

Revised regulatory proposal 2021–2026

Contents

1 Overview

Our original proposal reclassified 'minor repairs' from capital expenditure to operating expenditure. The draft determination did not accept the proposed reclassification of minor repairs due to lack of clarity of the costs being reclassified, lack of unitised data to demonstrate unit costs and lack of historical data.

Our revised proposal is to continue to seek to expense repair works where the works result from either asset faults or identified asset defects. Expensing these costs better reflects the nature of the work in that:

- the costs incurred are to repair a network asset, rather than refurbish or replace a network asset. The repair works do not extend the life of the asset and it is therefore more appropriate to expense such works
- the costs on average constitute up to 90 per cent labour costs and only 10 per cent materials, which is indicative of repair and maintenance work, rather than network asset replacement work. Repairs are typically made up of labour costs such as dispatch, ensuring the safety of the site, traffic management, excavation where necessary, investigating reasons for fault/defect, and only minor materials costs.

Repairs are more akin to maintenance, which is immediately expensed, rather than refurbishment or replacement of assets that are depreciated over a longer period. This is consistent with our approved cost allocation methodology.

For our revised proposal, we have conducted a more granular examination of each job completed over the past five years to better identify jobs that are more appropriately classified as repairs rather than asset replacements. Adopting a more granular approach has resulted in a 23 per cent reduction in our proposed reclassification compared to our original proposal.

To support our revised proposal, and in response to the draft determination, we have provided:

- clearer definitions of the costs being reclassified
- further clarification as to why these works should be expensed rather than capitalised
- historical unitised data to demonstrate volume of works and unit rates.

2 Background

2.1 Our original proposal

Our original proposal sought to reclassify 'minor repairs' from capital to operating expenditure. Typically, minor repairs include labour-intensive work that arise from an asset failure or identified defects that could result in an imminent asset failure (if not repaired).

Expensing minor repair costs better reflects the nature of the work—the costs are incurred to maintain the age of the asset and the work does not result in the creation of a new asset. These costs are more akin to maintenance and repair which is immediately expensed, rather than refurbishment or replacement of assets that are depreciated over a longer period.

We proposed to adjust our base year operating expenditure for the total cost of minor repairs estimated in 2019 and remove any forecast minor repairs from our replacement capital expenditure forecast. These changes are net present value (**NPV**) neutral, which means customers are no worse-off in the long term.

2.2 Draft determination

The AER did not accept our proposed reclassification of minor repairs based on the advice of its consultant EMCa. EMCa found:

- our minor repairs definition was circular without a clear definition of minor repairs
- the annual minor repairs expenditure claimed to be incurred in 2019 was not consistent with either the historical information in the recast regulatory information notices (RIN) or aggregated unitised project cost information
- the historical information in the recast RIN showed substantial year to year variance in works proposed as minor repairs and some annual line item costs may be estimated rather than actuals
- using the 2019 unitised project costs (totalling $1.6 million), 15 projects were above $10,000 and have an average unit cost of $34,282. EMCa did not support this as a 'minor' repair.

3 Revised proposal

3.1 Summary of our revised proposal

Our revised proposal is to expense *repairs* resulting from either asset faults or identified asset defects. Treating these costs as operating expenditure better reflects the nature of the work:

- the costs incurred are to *repair* a *network* asset, rather than refurbish or replace a network asset. The repair works typically do not extend the life of the asset, or create a new network asset, and it is therefore appropriate to expense those works. While costs may include replacements of some parts (e.g. a cable termination), this is usually only a part of a network asset (e.g. an underground cable) without which the asset cannot work, but the replacement of the part does not prolong the life of the network asset[1]
- the costs are on average made up of around 90 per cent labour costs and 10 per cent materials, which is indicative of repair and maintenance work, rather than a network asset replacement. Repairs are typically made up of labour costs such as dispatch, ensuring the safety of the site, traffic management, excavation where necessary, investigating reasons for fault/defect, and only minor materials costs. Labour costs are also higher for repair works because of the disaggregated nature of the work and inability to synergise costs in the same manner as with planned project work. Material costs are lower as they do not include permanent network asset replacement. As such, repairs differ in the scope of works and cost breakdowns from 'project' work, or planned replacement works, which are capitalised.

Repairs are more akin to asset maintenance, which is immediately expensed, rather than refurbishment or replacement of assets that are depreciated over a longer period. This is in line with our approved cost allocation methodology that stipules costs that are not capitalised for regulatory purposes include:

- assets that don’t provide future economic benefit for longer than 12 months
- indirect (corporate) overheads
- minor repairs resulting from asset failure and identified defects that could result in an imminent asset failure (if not repaired)
- asset inspection costs
- pole treatment costs
- components of a solution that are cloud based, and paid for on a ‘pay as you go’ basis
- training
- lease costs.

3.1.1 Definition of the works and scope of works

The draft determination found our definition of repair works circular and unclear. In its report to the AER, EMCa states:[2]

> *If a ‘repair’ resulting from an asset failure was that the asset was replaced, then this would be replacement capital expenditure, not opex. If the repair resulted from a component failure that may (if not repaired) lead to failure of the asset (and assuming that the asset was repaired and not replaced), then this could potentially form the basis for an auditable*

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1 Network assets are typically defined as per the regulatory information notice (RIN) template '2.2 Repex.'

2 EMCa, Powercor, Review of Aspects of Proposed Expenditure, Regulatory Submission for period 2021/22 to 2025/26, p. 216

definition of an opex minor repair. However, this is not how Powercor has defined what it proposes as minor repairs in its Cost Allocation Methodology.

To clarify, we are only proposing to reclassify repair expenditure that includes a scope of works where a network asset is repaired—whether as a result of a fault or a defect—not permanently replaced. These repair works would not lead to an extension of the life of the asset, or a new permanent asset being installed. There may be some parts of the asset replaced during the repair, such as a cable termination, or there may be a temporary asset installed as part of the fault repair, however we are not proposing to reclassify any works where the works include a permanent refurbishment or permanent replacement of a network asset.

To provide further confidence of the type of works involved in these repairs, we have provided a more detailed scope of works in the table below. As the descriptions show, only a very small part of the works is related to installation of a supporting part of a network asset.

Table 1 Description of repair works proposed to be reclassified as operating expenditure

Repair category	Description of tasks and works
Faults	
Conductor faults	• Locate site of conductor fault • De-energise line at fault location (if working under shutdown) • Ensure access to asset, including traffic management where necessary • Assess conductor for damage, and if intervention is required • If intervention required and possible, repair section of damaged conductor • Clean, grease and remake cable • Test and confirm cable ready for energisation • Make site safe • Re-energise line • Dispose of waste materials
Underground cable faults	• Locate site of cable fault • De-energise line and underground cable at fault location (if working under shutdown) • Excavate site to gain access, including potential soil test and traffic management • Assess cable for damage, and if intervention is required • If intervention required and possible, repair section of damaged conductor • Test and confirm cable ready for energisation • Reinstate excavation site • Make site safe • Re-energise line • Dispose of waste materials
All other faults (Includes faults of all other assets, including pole and pole top, distribution transformers and switchgear, service lines and all other faults	• Confirm site of fault • De-energise line at pole/pole top fault location (if working under shutdown) • Ensure access to site/asset, including traffic management where necessary • Assess site for damage, and if intervention is required • If intervention required and possible, repair section of damaged asset • Make site safe • Re-energise line • Dispose of waste materials

Repair category	Description of tasks and works
Defects	
Cable termination/joint works	• De-energise line and underground cable section • Disconnect and remove connection (may require civil works to join new cable section) • Install new cable termination, perform electrical commissioning tests on cable section then reconnect to overhead line • Re-energise line and underground cable section • Dispose of removed termination and cable sections (if required)
SWER Iso earth repairs	• De-energise line and underground cable section • Disconnect and remove the earth connection between SWER isolating substations and the ground • Install new connection, perform electrical commissioning tests on cable section then reconnect to overhead line • Re-energise line and underground cable section • Dispose of removed connection and cable sections (if required)
Zone substation switchyard lighting refurbishment	• De-energise and isolate lighting circuit • Remove existing light or lighting structure • Install new light or lighting structure (may require new concrete foundation if inadequate or new LV wiring if in poor condition) • Performance electrical testing on lighting circuit and recommission • Re-energise circuit • Dispose of removed components

Source: Powercor

3.1.2 Our historical repairs data

The draft determination found our annual minor repairs expenditure in 2019 to not be consistent with our historical information in the recast regulatory information notices (RIN) or our aggregated unitised project cost information. The draft determination also claimed our historical information in the recast RIN showed substantial year on year variance in works proposed as minor repairs and that some annual line item costs may be estimated rather than actuals.

To clarify, our 2019 minor repairs costs in our original proposal were estimates of 2019 calendar year costs. As such, the value differed from the later submitted recast RIN data, which included 2019 actuals (and we had subsequently provided 2019 actuals in information request (**IR**) 35).

For our revised proposal, we have conducted a more granular examination of each job we have completed over the past five years. This has enabled us to better identify jobs that capture repairs rather than asset replacement. This included examining types of work involved in each work order and the cost of labour and materials in those orders. Through this assessment, we have updated the historical expenditure per type, as per the table below. All the updated data is actual historical data. There are no estimates.

Table 2 Historical repairs expenditure, $000, nominal

	2015	2016	2017	2018	2019
Conductor faults	388.3	466.8	405.9	496.2	479.3
Underground cable faults	444.6	316.9	418.5	448.1	387.8
Pole and pole top faults	166.6	377.4	435.9	537.8	546.4
Transformer and switchgear faults	144.2	128.3	225.7	305.8	332.5
Service faults	431.8	986.0	779.7	113.6	131.6
Other faults	132.8	180.4	201.9	226.6	530.3
Cable termination/joint replacements	2.9	162.8	97.1	61.6	2.2
SWER Iso earth repairs	545.5	168.1	165.4	1.4	599.5
Zone substation switchyard lighting refurbishment	6.7	98.7	31.3		
Total	**2,263**	**2,885**	**2,761**	**2,191**	**3,010**

Source: Powercor

In the time given for IR035, we were unable to provide a full breakdown of the historical jobs and unit costs to be reclassified. Since then, we have implemented an improved methodology to examine thousands of expenditure orders over the past five years, to establish:

- the scope of works included in each completed job
- the breakdown of expenditure between labour and materials
- and the appropriateness of treating that work as minor repairs.

Table 3 and table 4 also summarise the number of jobs and unit costs of the identified repairs works over the five years.

Table 3 Volume of repairs per repair type

	2015	2016	2017	2018	2019
Conductor faults	134	190	159	208	161
Underground cable faults	70	87	91	105	100
Pole and pole top faults	50	160	175	196	191
Transformer and switchgear faults	50	72	114	143	147
Service faults	263	625	465	50	55
Other faults	57	83	82	90	165
Cable termination/joint replacements	1	4	1	3	2
SWER Iso earth repairs	80	52	39	0	146
Zone substation switchyard lighting refurbishment	1	2	2	0	0

Source: Powercor

Table 4 Unit cost of repairs per repair type, $000, nominal

	2015	2016	2017	2018	2019
Conductor faults	2.9	2.5	2.6	2.4	3.0
Underground cable faults	6.4	3.6	4.6	4.3	3.9
Pole and pole top faults	3.3	2.4	2.5	2.7	2.9
Transformer and switchgear faults	2.9	1.8	2.0	2.1	2.3
Service faults	1.6	1.6	1.7	2.3	2.4
Other faults	2.3	2.2	2.5	2.5	3.2
Cable termination/joint replacements	2.9	40.7	97.1	20.5	1.1
SWER Iso earth repairs	6.8	3.2	4.2		4.1
Zone substation switchyard lighting refurbishment	6.7	49.3	15.7		

Source: Powercor

3.1.3 Unit rates

Our analysis shows the average unit rate for a repair job is around $2,500 for fault jobs and around $9,200 for repairs related to defects, with only 12 repairs that cost more than $10,000 on average (or 0.2% of all jobs identified). This demonstrates these repairs are minor in nature.

However, while most repairs are minor, there can still be repairs that are more costly, but as they do not extend the life of the network asset, they should be expensed (rather than capitalised). Jobs can become more expensive if they involve:

- soil tests (usually around $5,000 per test)
- a larger number of field workers on site due to the complexity of the job.

Equally, there may be larger works taking place at a site where there are multiple non-network assets that may require repair. For example, zone substation lighting replacements will take place at once, and involve a number of technicians at a site, which results in larger unit rate.

As such, we do not consider it appropriate to use a unit rate threshold to determine what repairs should be expensed. Rather, the description of the works, whether the works extend the life of the asset and the extent to which the costs are labour rather than materials should be the determining factors.

3.2 Revised proposal forecasts

The table below summarises our forecast operating expenditure base adjustment. The adjustment is based on the 2015-2019 historical average, as provided in PAL RRP MOD 10.06.

Table 5: Revised proposal costs, $million 2021

	2021/22	2022/23	2023/24	2024/25	2025/26
Proposed costs	2.48	3.11	2.93	2.28	3.13

Source: Powercor

3.2.1 Adjustment for replacement expenditure

We have removed the value of the expenditure being reclassified from our replacement expenditure proposal.