Attachment 7.4

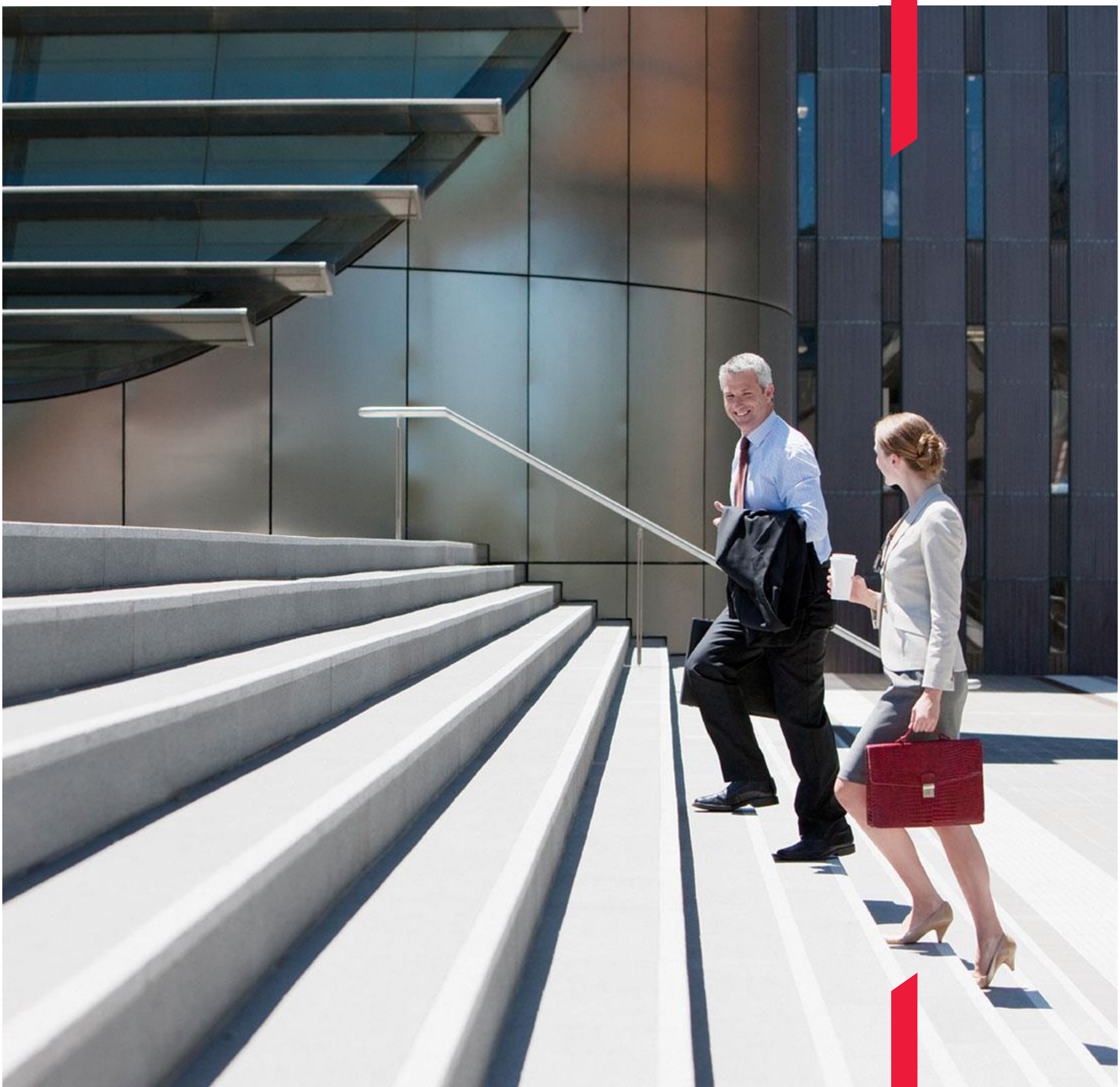
# Expenditure Reclassification Review

January 2020

Dampier Bunbury Pipeline

# Dampier to Bunbury Pipeline
## Regulatory Cost Allocation Review

30 December 2019



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# Introduction

BDO have been engaged by Dampier to Bunbury Pipeline (DBP) to undertake a review of its proposal to classify certain expenditure as operating expenditure (opex) in the next Access Arrangement for 5 years (AA5) commencing in 2021. This report documents the scope, agreed approach and our findings.

# Scope and Scope Limitations

The assignment is a consulting engagement as outlined in the 'Framework for Assurance Engagements', issued by the Auditing and Assurances Standards Board, Section 10. Consulting engagements employ an assurance practitioner's technical skills, education, observations, experiences and knowledge of the consulting process. The consulting process is an analytical process that typically involves some combination of activities relating to: objective-setting, fact-finding, definition of problems or opportunities, evaluation of alternatives, development of recommendations including actions, communication of results, and sometimes implementation and follow-up.

The nature and scope of work has been determined by agreement between BDO and DBP. This consulting engagement does not meet the definition of an assurance engagement, as such; we are not proposing an audit in accordance with generally accepted auditing standards.

Except as otherwise noted in this report, we have not performed any testing on the information provided to confirm its completeness and accuracy.

Our report is prepared solely for the use of DBP and its regulatory proposal to the Economic Regulation Authority (ERA). No responsibility to any third party shall be accepted, as our report has not been prepared, and is not intended, for any other purpose.

This report is based on the latest information made available to us as at the date of this report and we accept no responsibility to update it for events that take place after the date of its issue.

The following items have been excluded from the scope of this review:

1. Except as otherwise noted, we will not perform any testing on the information provided to confirm its completeness and accuracy.
2. In performing our procedures, we will rely upon certain representations made by DBP and their representatives. We will not perform procedures to verify the accuracy or completeness of such representations.

# Approach

To address the objectives of this assignment, the following procedures were determined, agreed and undertaken:


## Phase 1: Business Understanding

In this phase, BDO engaged with DBP project managers and key business representatives to understand the nature of the activities undertaken in the programs under review, as referred to in Table 1 below.

We also reviewed business cases for the Asset Management, Pipeline and Mainline Valve Inspections and Station Inspections programs with total forecast expenditure of $9.272m, representing almost 90% of the expenditure under review.

**Table 1:**

| Program | Activities | AA5 forecast $m Dec 2020 |
|---|---|---|
| **Asset Management** | Minor engineering changes and Engineering and Operational Projects subsequent/support costs (e.g. asset drawings, engineering software) | 2.887 |
| **Decommissioning** | Develop, plan and execute decommissioning strategy for non-operational assets/facilities which may include onsite decommissioning, mothballing, electrical and mechanical isolation or dismantling | 0.516 |
| **OHS** | Health and safety improvement projects such as electronic notice board upgrades, incident management system upgrades, contractor management systems, mental health and wellbeing, safety culture and other initiatives as identified during the year | 0.464 |
| **Process Safety** | Process safety improvement initiatives such as process safety metric tracking and reporting tools, safety culture initiatives and resulting business system updates | 0.258 |
| **Pipeline and Mainline Valve Inspections** | Intelligent pigging of the DBNGP and laterals (completed in AA4, next required AA6), Mandatory calibration and testing of pressure vessels and pressure relief valves at Mainline Valves, Inspection of above/below ground piping interface, Inspection of piping under insulation and within buried pits | 2.266 |
| **Station Inspections** | Mandatory calibration and testing of pressure vessels and pressure relief valves at Compressor Stations and Meter Stations, Inspection and re-preservation of compressor bundles in storage | 4.119 |
| **Total proposed to be reclassified to Operating Expenditure (opex)** | | **10.510** |

### Phase 2: Business Information Analysis

In this phase, we conducted a review of the information obtained as part of phase 1.

Work completed:

- Reviewed and considered the activities associated with each program of work as provided by DBP.
- Reviewed and considered the business cases provided by DBP for the Asset Management, Pipeline and Mainline Valve Inspections and Station Inspections programs.
- Reviewed publicly available information relating to the regulatory accounting treatment of asset inspection cost by other regulated utilities businesses.
- Considered the reasonableness of expensing the costs associated with these programs for regulatory purposes considering accounting standards and regulatory practice in Australia. Further information in relation to guidance drawn from accounting standards and other relevant Australian Accounting Standards Board (AASB) pronouncements, is provided in Appendix 1.

### Phase 3: Report Findings

This report documents a summary of our findings (‘Key Findings’) and a detailed explanation of our findings (provided in Appendix 2).

# Summary of Key Findings

Based on the information provided we consider DBP's proposal to treat all of the expenditure listed in Table 1 of this report, as operating expenditure is reasonable with the relevant key points being as follows:

- With regard to the asset inspection programs referred to as "Pipeline and Mainline Valve Inspections" and "Station Inspections" we have reviewed accounting standard *AASB 116 Property, Plant and Equipment* which provides some guidance in relation to the treatment of inspection costs that in certain cases may be capitalised (e.g. "major" inspections).
- Given the scale and relative cost of these rolling annual inspection programs undertaken by DBP, we believe they are not of a nature or magnitude that would be considered major inspections but are rather integral to the ongoing operation and maintenance of those assets. As such, we believe the expenditure associated with these activities should be therefore, treated as operating expenditure.
- Supporting this conclusion, having reviewed regulatory practice in Australia, from publicly available Regulatory Information Notices (RINs), we have noted that asset inspection costs are widely accounted for as operating and maintenance expenditure by electricity Distribution Network Service Providers (DNSPs) in multiple regulated jurisdictions across Australia.
- Further, we note recently in Western Australia, the Economic Regulation Authority (ERA) has accepted ATCO's proposal for its next access arrangement in 2020-24 (AA5) to account for expenditure associated with gas pipeline, inline inspections as opex. Similarly, the ERA has also approved expenditure by ATCO on leak surveys and pipeline patrols as opex in the next access arrangement.
- We suggest none of the activities within the "Asset Management" or "OHS" programs materially add to the value of existing assets by extending their life or increasing their capacity but rather are an ongoing program of activities that relate to the safe and reliable operation of DBP's assets. We believe this expenditure should be therefore, classified as operating expenditure.
- We believe that the costs associated with the "Process Safety" and "Decommissioning" programs are of an ongoing operational nature and are therefore, also operating expenditure.
- We suggest the forecast expenditure by DBP as part of undertaking all of these activities and programs in the next access arrangement as shown in Table 1 and as described to BDO by DBP, meets the definition of an expense as provided in paragraph 69(b) of the *Framework for the Preparation and Presentation of Financial Statements* ("*the Framework*"). See Appendix 1 for relevant extracts from *the Framework*.
- Further, given the activities and programs are all integral to DBP's ongoing business of earning operating revenues from the use of these assets, we believe the expenditure should be recognised at the time incurred in accordance with paragraph 94 of *the Framework* and the matching principles in paragraph of 95.

# Appendix 1 – Guidance in Accounting Standards and other AASB pronouncements

- The accounting standard considered relevant in reviewing the appropriate treatment of asset inspection costs (e.g. the Pipeline and Mainline Valve Inspections and Station Inspections programs) is *AASB 116 – Property, Plant and Equipment*, where paragraph 14 states:

  *"A condition of continuing to operate an item of property, plant and equipment (e.g. an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised."*

- While there is no specific accounting standard applicable to other programs within the scope of this review, guidance exists in the Australian Accounting Standard Board's *Framework for the Preparation and Presentation of Financial Statements* (*"the Framework"*).
- Amongst other things, *the Framework* provides definitions for the elements of financial statements (e.g. assets, liabilities, income and expenses) and further guidance in relation to the timing of recognition for this expenditure. For example:

  – Paragraph 49 defines an asset as:

    *"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."*

  – Paragraph 69(b) defines an expense as:

    *"Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants."*

  – Paragraph 78 further defines expenses that:

    *"Encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation."*

- *The Framework* also provides further guidance in relation to the timing of recognition for this expenditure. For example:

  – Paragraph 94 states:

    *"Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably."*

  – Paragraph 95 states:

    *"Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events."*

  – Paragraph 97 goes on to state:

    *"An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset."*

# Appendix 2 - Detailed Findings

Detailed below are our findings and observations from the procedures that we performed. Dollar amounts shown in this section are in June 2019 $’s consistent with forecast expenditure in the business cases provided to BDO by DBP.

| Asset Management | |
|---|---|
| **Description of activities:**<br>DBP proposes expenditure of approximately $0.55m per annum, totalling $2.80m over the next 5 year access period, on an Asset Management program comprising activities grouped under two main categories:<br>• Engineering and Operational Projects<br>• Management of Changes<br><br>From the draft business case provided, BDO understands:<br>• Engineering and Operation Projects includes technical drawing updates, software updates and updates to GIS mapping with the main objective being to maintain the safe and reliable operation of the pipeline; and<br>• Management of Changes is focused on addressing defects or unsafe situations and can occur due to safety, operational, quality or financial reasons that require minor changes to the pipeline. | **Findings:**<br>Having assessed the underlying objective and outcomes from these activities, BDO considers it is reasonable for this expenditure to be treated as opex from 2021.<br>The basis of this opinion is the ongoing recurrent and operational nature of these activities and that none are materially extending the useful life or increasing the capacity of DBP’s assets in a measurable way.<br>Rather BDO understands these activities are ensuring the ongoing safe and reliable operation of DBP’s pipeline, which is more related to day-to-day operational and maintenance activities.<br>In accordance with the AASB’s *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |
| **Decommissioning** | |
| **Description of activities:**<br>DBP proposes expenditure of $0.50m over the next 5-year access period in relation to decommissioning non-operational assets/facilities. | **Findings:**<br>Having reviewed the activities proposed under this category of expenditure, BDO considers that it is reasonable for this expenditure to be treated as opex from 2021, on the basis that the activities relate to planning and executing the decommissioning of non-operational assets/facilities and therefore not adding to the value or extended life of those assets.<br>In accordance with the AASB’s *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |

| OHS | |
|---|---|
| **Description of activities:**<br>DBP proposes expenditure of $0.45m over the next 5-year access period in relation to occupational health and safety projects. | **Findings:**<br>Having reviewed the activities proposed under this category of expenditure, BDO considers that it is reasonable for this expenditure to be treated as opex from 2021, on the basis that the activities are not adding value to or extending the life of an asset and that the expenditure is recurrent and operating in nature.<br>In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |
| **Process Safety** | |
| **Description of activities:**<br>DBP proposes expenditure of $0.25m over the next access period in relation to process safety initiatives. | **Findings:**<br>Having reviewed the activities proposed under this category of expenditure (i.e. broadly a program of relatively small business improvement initiatives) BDO considers that it is reasonable for this expenditure to be treated as opex from 2021 on the basis that the activities are of a recurrent operating nature and are not aligned to an asset.<br>In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |
| **Pipeline and Mainline Valve Inspections** | |
| **Description of activities:**<br>DBP proposes expenditure of approximately $0.77m in 2020-21 and $0.36m per annum thereafter, totalling $2.20m over the next 5-year access period, on a rolling program of pipeline and mainline value inspections.<br>This program comprises four core asset inspection categories:<br>• Inspection of piping at above/below ground interface [redacted]<br>• Manual inspection of pressure vessels [redacted]<br>• Manual inspection of pressure relief valves [redacted]<br>• Inspection of piping under insulation and | **Findings:**<br>Having assessed these asset inspection activities, BDO considers these are not major inspections as referred to in *AASB 116 Property, Plant and Equipment* and that it is reasonable for this expenditure to be treated as opex from 2021.<br>In addition, having looked at regulatory practice in Australia, BDO notes that in Western Australia, the Economic Regulation Authority (ERA) has recently approved ATCO's next access arrangement proposal for 2020-24 (AA5) which includes expenditure on gas pipeline, inline inspections classified as opex, along with expenditure on leak surveys and other pipeline inspections also treated as opex.<br>Further, considering publicly available documents pertaining to Western Power's current access arrangement as an electricity DNSP, this indicates that asset inspection costs is |

| | |
|---|---|
| buried in pits [redacted] | accounted for as operating and maintenance expenditure as part of its reported opex.<br><br>BDO also notes that other economic regulators require electricity DNSPs to 'expense' asset inspection costs as part of their reported opex. For example, based on publicly available RIN reporting for 2018, SA Power Networks reported $14.2m expenditure as opex in relation to asset inspection activities, Energex reported $22.3m and Jemena reported $2.2m as opex in the same period.<br><br>In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |
| **Station Inspections** | |
| **Description of activities:**<br>DBP proposes expenditure of between approximately $0.78m and $0.82m per annum totalling $3.99m over the next 5- year access period on a rolling program of station inspections.<br>This program comprises five core inspection categories:<br>• Pressure vessel – compressor stations [redacted]<br>• Pressure vessel – meter stations [redacted]<br>• Pressure release value – compressor stations [redacted]<br>• Pressure release value – meter stations [redacted]<br>• Compressor station bundles [redacted] | **Findings:**<br>Having assessed these asset inspection activities, BDO considers these are not major inspections as contemplated by *AASB 116 Property Plant and Equipment*, and that it is reasonable for this expenditure to be treated as opex from 2021.<br><br>As mentioned for Pipeline and Mainline Valve Inspections above, the proposal by DBP to treat this expenditure as opex is consistent with practice in the regulated gas and electricity industry.<br><br>In accordance with the AASB's *Framework for the Preparation and Presentation of Financial Statements*, BDO considers this expenditure meets the definition of an expense and that it should be recognised as operating expenditure at the time incurred. |

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