APPENDIX 13
ACCOUNTING TREATMENT

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19 February 2016

Dear Brendan

Accounting Advisory Services for the Melbourne Metro Rail Authority

We appreciate the opportunity to have assisted the Melbourne Metro Rail Authority (**MMRA**) in the provision of Accounting Advisory Services as part of our engagement to provide commercial and financial advisory services for the Melbourne Metro Rail Project under the terms of your purchase order number 245694, dated 18 September 2014 (as updated as agreed between the parties, including your variation letter dated 3 July 2015), issued under the Open Standing Offer Agreement between the Department of Treasury and Finance and KPMG for the provision of Commercial and Financial Services for Infrastructure and Capital Asset Projects, and Commercial Transactions (collectively, the **Engagement Contract**).

We refer you to the letter of advice issued to you on 15 February 2016. Following that letter, you have requested that changes you have made to the underlying assumptions in your model be reflected in a new letter of advice. We provide you with this letter, dated 19 February 2016, and note that none of the accounting principles changed from the letter provided to you on 15 February 2016. Only the Appendices have been updated with changes to the assumptions you have requested us to incorporate. As of 19 February 2016, we have completed our services under the Engagement Contract. This deliverable is in final form and supersedes all draft versions as well as the letter of advice dated 15 February 2016.

1. Scope

The purpose of this advice is to provide accounting advisory services to the MMRA to support the request for funding (**Business Case**).

The table below sets out the work packages and procurement models that are proposed for the project.

<table>
<tr><th colspan="2">Work package</th><th>Procurement model</th></tr>
<tr><td rowspan="3">Early Works</td><td>Utilities relocation / protection and site preparation</td><td>Managing Contractor</td></tr>
<tr><td>Tram works</td><td>Franchisee delivery (Yarra Trams) via existing Projects Agreement</td></tr>
<tr><td>Construction power</td><td>Direct agreements with utilities providers</td></tr>
<tr><td colspan="2">Tunnels and Stations</td><td>Availability based Public Private Partnership</td></tr>
<tr><td colspan="2">Rail Systems</td><td>Competitive Alliance</td></tr>
<tr><td colspan="2">Rail Infrastructure</td><td>Competitive Alliance</td></tr>
<tr><td colspan="2">Wider Network Enhancements</td><td>Case by case determination</td></tr>
</table>

The agreed scope of this advice is as follows (the **subject matter**):

1.1. Outline the accounting considerations in connection with recognition of the Public Private Partnership (**PPP**) that is proposed for the tunnels and stations component of the project (the most significant work package). Payments under the PPP arrangement will be fixed upon financial close and paid over the period of the concession. This will include the accounting principles in respect of the following matters:

- Recognition of the project cost and related obligations during the construction and operational phases of the project;
- Measurement of related costs and obligations under existing and proposed accounting methods;
- Accounting for lifecycle payments; and
- Accounting for capital contributions.

1.2. Outline the accounting principles to be applied in determining whether costs incurred (project and other) are to be capitalised as property, plant and equipment or expensed as incurred (these principles are applicable to all work packages and procurement models).

1.3. Outline the accounting principles to be applied in connection with recognising separate components of property, plant and equipment, residual values and depreciation (these principles are applicable to all work packages and procurement models).

The scope excluded the following areas:

- Review of agreements – the advice will be based on principles to be considered based on the assumptions and circumstances provided in sections 3&4 of this letter of advice (provided by you) as the agreements related to the PPP have not been drafted at the date of this letter;

- Quantification of amounts associated with the project (including fair value assessments) – we based the values included in our advice on information from management's estimates and/or models and the assumptions you have requested we use as outlined in Section 3;

- The accounting principles to be considered in determining the legal entity in which project costs and related obligations should be recorded;

- Lease arrangements between the State, the PPP project vehicle (**Project Co**) and other parties, including application of fair value principles; and

- Principles for recognition and measurement of securitisation structures.

2. Advice

2.1. Accounting considerations in connection with the PPP model for tunnels and stations

The current availability PPP procurement model in Victoria has the following features:

- The State engages a third party (Project Co) that is responsible for design, construction and maintenance of an infrastructure asset (in this case, the new tunnels and stations part of the project) and for the provision of certain services during the operating term.

- The State compensates Project Co through Quarterly Service Payments (**QSP**s) that commence after the design and construction phase – typically the State is not required to make any payments until commercial acceptance (subject to the provision of any capital contributions – as discussed below). Under the "Victorian Model" (described below), recognition of the leased asset takes place when the risks and rewards incidental to ownership are transferred on commercial acceptance.

- QSPs are paid over the service concession period and are made up of principal and interest payments, lifecycle costs and other operating costs (the types of costs can be identified separately). The "principal" component is equivalent to the cost of construction (and any other costs) incurred during the construction phase. It represents, in accounting terms, the amount that exists on commercial acceptance and that needs to be repaid over the service concession term.

Summary of accounting models in connection with PPPs

This advice in connection with the PPPs is provided from the perspective of two specific accounting models:

- The traditional Victorian PPP accounting model (**Victorian Model**), an approach under accounting principles contained within the *Department of Treasury and Finance: Accounting & Reporting Guidance for Social Infrastructure Public Private Partnership Projects* guidance (**DTF guidance**). These principles were developed over a period of time, in the absence of any specific accounting pronouncements (for Australian public sector entities) in connection with PPPs; and

- The approach proposed by the Australian Accounting Standards Board as included in an exposure draft, Exposure Draft: *ED 261: Service Concession Arrangements: Grantor* (**ED 261** or **ED 261 model**).

  In May 2015, the Australian Accounting Standards Board issued ED 261, aimed at clarifying the accounting treatment requirements for parties such as the State in PPP style arrangements. ED 261 is based on the *International Public Sector Accounting Standard (IPSAS) 32 Service Concession Arrangements: Grantor*.

  At a conceptual level, ED 261 requires arrangements in which cash is transferred to Project Co to be recognised under a *financial liability* model. Broadly, it also requires recognition of the obligation and related asset during the construction phase (which is earlier than the Victorian Model).

  At the date of this report, the ED 261 model has yet to be finalised as an Accounting Standard. The Australian Accounting Standards Board will evaluate responses from stakeholders in relation to the exposure draft, which may or may not result in changes to the requirements and guidance currently contained therein. Once an Accounting Standard is issued by the AASB, the Victorian Model will in all likelihood be replaced by that Accounting Standard.

The accounting considerations under these two models are summarised in the table below, highlighting similarities and differences of significance under these two models:

Accounting matter	Victorian Model	ED 261 Model
Timing of recognition (refer Section 2.1.1 below)	The arrangement is recognised at commercial acceptance (post construction). The accounting treatment follows finance lease principles under AASB 117 – *Leases* (**AASB 117**)	The arrangement is recognised progressively after financial close, as construction activities are undertaken. This is the most significant difference that ED 261 (in its current form) includes and will result in earlier recognition of assets and liabilities when compared to existing accounting practice.

Accounting matter	Victorian Model	ED 261 Model
Initial recognition of the asset (refer Section 2.1.2 below)	Under finance lease principles, the asset is recorded at the lower of: • fair value; or • the present value of future minimum lease payments. Both the asset and liability are typically recorded at equal value on commencement of the lease. The assumption is made that the "fair value" of the asset equates to the construction and other costs incurred by Project Co during the construction phase that are expected to be recovered through payment of capital QSPs. (Refer Appendix 1, Schedule 1.1)	The asset is recorded at fair value (which is assumed to be equivalent to construction and directly attributable costs for purposes of this advice) and progressively recognised over the construction term.
Initial recognition of the liability (refer Section 2.1.2 below)	Under leasing principles, similar to the leased asset recognition, the liability is recorded at the lower of: • the present value of future minimum lease payments (discounted at the rate implicit in the lease); and • the asset's fair value. Under the Victorian Model, it is assumed that the present value of future minimum lease payments (capital) will not be lower than the fair value of the asset.	The ED 261 model requires recognition of the liability at the fair value equivalent to the fair value of the service concession asset. In practice, this amount will be calculated in a similar manner to the Victorian Model and would equate to the present value of future capital payments, discounted using the appropriate discount rate.

Accounting matter	Victorian Model	ED 261 Model
	This results in both the leased asset and liability recognised at fair value (with construction and construction phase costs incurred by the Project Co used as a proxy for the fair value to be recognised). Using the capital QSPs and the fair value on the date of recognition, the "rate implicit in the lease" is calculated as the rate that discounts the capital QSPs to the fair value of the asset (and liability) at commercial acceptance. (Refer Appendix 1, Schedule 1.1)	
Subsequent measurement of the asset (refer Section 2.1.3 below)	After the initial recognition of the assets, their subsequent measurement will be subject to the same principles under both models. The subsequent measurement would include: • Recognising the assets at their fair values at every reporting date; • Depreciating the assets over their useful economic lives; and • Testing and accounting for impairment (as appropriate).	
Subsequent measurement of the liability (refer Section 2.1.4 below)	The lease obligation is reduced by allocating minimum lease payments between the finance charge element and the reduction of the outstanding liability, using a constant periodic rate of interest on the remaining balance of the liability.	The subsequent measurement of the liability will follow similar principles to those under the Victorian Model. (Note: fair value as an alternative measurement basis for financial liabilities is not discussed in this letter of advice.)

Accounting matter	Victorian Model	ED 261 Model
	Under this model, the "rate implicit in the lease" as calculated above, is used to allocate QSP capital payments between principal and interest components. (Refer Appendix 1, Schedule 1.2)	
Treatment of lifecycle payments (refer Section 2.1.5 below)	Lifecycle payments are made by the State as part of QSPs to the Project Co. Under the Victorian Model, the traditional approach is to expense these charges as incurred on the basis that they typically represent maintenance type costs (and incidental replacement costs). However, to the extent that a replaced item represents a significant component to the overall project (and will require regular replacement during the concession period) the costs related to that component are capitalised and amortised over a shorter period (similar to the ED 261 approach).	ED 261 provides an example, in which lifecycle costs are capitalised as a separate component of the concession asset. This is, however, dependent upon sufficient certainty over timing and amount of the cost incurred by Project Co.
Treatment of facilities management and other service costs (refer Section 2.1.6 below)	Expensed as incurred over the service concession period.	
Capital contributions (refer Section 2.1.7 below)	These contributions are typically recorded as "prepayments" until commercial acceptance.	Capital contributions are also recorded as "prepayments" until they are offset against construction obligations arising from construction activities performed by the Project Co.

Accounting matter	Victorian Model	ED 261 Model
	However, treatment of capital contributions may vary depending on the nature of the arrangement and what the capital contributions relate to. (Refer Appendix 1, Schedule 1.1)	

Set out below is our advice on the accounting treatment in relation to the subject matter. The advice outlined below must be read in conjunction with sections 3 to 7 below.

2.1.1. Timing of recognition

Recognition as a lease under the Victorian Model:

In the absence of any specific accounting pronouncements, the Victorian Model, aligned with the DTF guidance, directs the accounting for the capital portion of QSPs to be treated as a finance lease obligation. This treatment was adopted on the basis of the following principles:

- Whilst the project agreement does not take the legal form of a lease, under AASB Interpretation 4: *Determining whether an Arrangement contains a Lease* (**Interpretation 4**), the legal form of a lease is not required for lease accounting principles to apply.

- Under Interpretation 4, a lease exists when the arrangement conveys the right to use an asset to another party. This will be the case where the arrangement 1) is dependent on the use of a specific asset and 2) conveys the right to use that asset to the 'lessor'. Both of these conditions will likely be met in availability based PPP arrangements (the type of PPP arrangement described under Section 2.1 of this report).

- Payments are made over the life of the service concession period with due regard to the construction cost of the service concession asset (and construction phase costs) and an appropriate return.

- Considering the service concession asset usually reverts to the State at the end of the service concession period for no cost and that QSPs are sized to return the construction and construction phase costs (plus an appropriate return) to Project Co (a third party), the lease will usually be classified as a finance lease.

- The lease payments are determined by allocating the QSPs between "finance lease" payments and other payments. Only the finance lease payments (or capital payments) are used to determine the value of the leased asset and leased liability upon initial recognition.

Timing of recognition under the Victorian Model:

Having determined that finance lease principles apply, the date on which the concession asset (leased asset) and the lease obligation are recognised is the "commencement of the lease" – which is the date on which the lessor is entitled to exercise its rights to use the asset.

Under the Victorian Model, this date is usually determined to be the date of commercial acceptance. The DTF guidance takes the view that risks and rewards are transferred only at commercial acceptance and that recognition of both the asset and liability is appropriate only after construction has been completed and the State formally "accepts" the assets.

Timing of recognition under the ED 261 model:

ED 261 requires the financial assets and liability to be recognised during the construction period. In an example accompanying ED 261, it is clear that an asset is recognised during the construction period (which was assumed to be at the same value as construction and related costs incurred to that date) with an equivalent financial liability.

In contrast to the Victorian Model, under the ED 261 model the assets (and liabilities) would be recognised progressively as the construction takes place. The financial liability under ED 261 is recognised at the same value and at the same time as the construction costs are incurred.

2.1.2. Initial recognition of the asset and liability

Initial recognition under the Victorian Model:

Considering that finance lease principles apply under the Victorian Model, the leased asset and leased liability will both be recognised at the same time and the same value.

The value at which the asset (and liability) is to be initially recognised is determined as the lower of 1) the 'future minimum lease payments' discounted at the 'rate implicit in the lease' and 2) the asset's fair value.

These concepts are discussed below as they pertain to the Victorian Model:

- *Future minimum lease payments*: These values are "principal and interest" payments and are sourced from the financial model that supports the PPP. They represent the payments (including a return) to Project Co for the construction and other costs incurred during the construction period.

- *Rate implicit in the lease:* This rate is the rate that, when applied to the future minimum lease payments, will return a value that is equivalent to the fair value of the asset at inception of the lease. The approach followed under the Victorian Model is to calculate this return at commercial acceptance, based on the value of construction and related costs incurred by the Project Co during the construction phase (and that are expected to be repaid by the capital portion of QSPs). Whilst this approach is common, we note that the calculation is required at <u>the inception</u> of the lease as opposed to the <u>commencement</u> of the lease. The inception of the lease could be earlier than the commencement of the lease and if there is a time-lag between these two dates, care should be exercised that the earlier date is used to calculate the rate implicit in the lease. The value of the asset and the value of the liability would very likely be different on the date of recognition, if the rate implicit in the lease were calculated at inception as opposed to commencement of the lease. This advice, however, assumes that the rate implicit in the lease is calculated at commercial acceptance, in line with the existing Victorian Model.

There is an assumption in the Victorian Model that the fair value of the asset at commencement of the lease will approximate the total cost incurred by the Project Co in relation to the construction and construction period costs (the total which are to be paid for over the life of the concession through capital QSPs) at commercial acceptance.

In line with the DTF guidance, we have assumed that the fair value of the leased asset is lower than or equal to the present value of the minimum lease payments (i.e. the leased asset and leased obligation are both recorded at construction and construction period costs incurred by the Project Co as a proxy for fair value).

Initial recognition under the ED 261model:

ED 261 requires the recognition of a service concession asset and a related liability as either a ‘financial liability’ (when a series of cash payments are required under the service concession arrangement, which is also referred to as an availability based PPP) or, alternatively, a ‘right to the operator liability’ (where the operator generates revenue from the use of the asset during the service concession period, which is also referred to as a demand risk or economic PPP, such as a toll road).

The QSPs represent contractual cash flows (once determined and contracts have been executed) required to be made from the State to Project Co and should be accounted for as a ‘financial liability’ if the ED 261 model were to be adopted.

The asset is initially recorded at fair value (for purposes of this advice, the assumption is made that the construction and related costs incurred are equal to the asset’s fair value) and an equal financial liability is recognised simultaneously.

Whilst the principle of recognising the asset and liability at similar values and at the same time, are not significantly different, the timing of recognising the asset and liability is earlier than under the Victorian Model (as discussed in 2.1.1 above).

2.1.3. Subsequent measurement of the asset

For both the Victorian Model and the ED 261 model, after initial recognition of the assets, they will be subject to the following subsequent measurement provisions included in Australian Accounting Standard AASB 116 *Property, Plant and Equipment* (**AASB 116**):

- Items of Property, Plant and Equipment are carried at fair value in line with the policy dictated by DTF.

- Depreciation: Each item of property, plant and equipment that is significant in relation to the total, needs to be depreciated separately. The depreciation charge is usually recognised in the profit and loss and recorded over the useful economic lives of the various assets, to reduce their carrying amounts to an appropriate residual value. Useful lives and residual values need to be reviewed on an annual basis. The assets will only be depreciated when they are ready for use, that is, after commercial acceptance.

- Impairment: The carrying amounts of items of property, plant and equipment could also be impacted by impairment charges. Impairment testing and other considerations are not discussed further in this paper, but these are governed by Australian Accounting Standard AASB 136 Impairment of Assets.

2.1.4. Subsequent measurement of the liability

Under both the accounting models, the capital QSPs are allocated between principal and interest payments:

- Interest accrues on the liability and is recorded as an expense in the income statement over the life of the concession. It is settled through the interest portion of the capital QSPs.

- The principal portion of the capital QSP reduces the outstanding obligation to zero over the life of the service concession arrangement.

This method is similar to an 'amortised cost' basis of accounting for financial liabilities as well as the method applicable to finance leases.

Schedule 1.2 included in Appendix 1 is an amortisation schedule that indicates the principal payments and interest over the life of the concession (calculated quarterly, but reported on an annual basis), calculated on the basis of a finance lease under the Victorian Model.

ED 261 Financial liability: Discount rate

ED 261 indicates that the rate to be used in accounting for interest should be the cost of capital of the operator (i.e. Project Co). If this is not determinable, the interest rate used should be the rate implicit in the arrangement, the State's incremental borrowing rate, or "another rate appropriate to the terms and conditions of the arrangement".

Judgement will be required to determine the rate of interest to be used. We have assumed, for illustration in this letter of advice, that the rate of interest would be determined as the rate that would return a present value, when used to discount future capital payments, equal to the construction phase costs when they are incurred.

2.1.5. Treatment of lifecycle payments

Project Co is required to maintain the concession assets to a particular standard, not only during the concession period, but also to meet certain "handback" requirements at the end of the concession term. Lifecycle payments are made as part of QSPs (outside of the capital payments) to ensure particular assets are maintained / replaced at regular intervals.

Lifecycle payments under the Victorian model:

The accounting treatment under the DTF guidance is typically to expense lifecycle costs as incurred, as a proxy for maintenance costs (and on the basis that they are paid only for incidental replacement of assets).

This accounting treatment is often adopted as a result of the State making contractual payments to Project Co, without the contractual requirements for Project Co to spend the funds on specific assets or for specific purposes or even to provide information to the State on when and how these funds are spent.[1] This lack of information has previously caused public sector entities to expense these costs as incurred, instead of recognising any particular asset or component.

Prior to ED 261, lifecycle payments were not specifically addressed, but the principles outlined in ED 261 (as included below) could equally apply under the Victorian Model.

Lifecycle payments under ED 261:

ED 261 specifically includes lifecycle costs in an example. The AASB requested specific comment from stakeholders as to whether the existing exposure draft contains sufficient guidance in respect of lifecycle costs.

The accounting treatment proposed in ED 261 is outlined below:

- The assets to which the lifecycle payments are applied are identified as separate items of property, plant and equipment (this is also referred to as components).

[1] Project Co effectively takes risk on the timing and quantum of lifecycle costs required to meet the contractual requirements and is not contractually obliged to spend the lifecycle component of the QSP on a particular part of the asset, or to spend these amounts when received. Although PPP contracts typically include a range of asset management and other reporting requirements, these are not typically directly linked to the expenditure of the lifecycle component of the QSP.

- These components are depreciated over a much shorter period as compared to the service concession period. They are depreciated over the period between the date on which these are taken into use and ending when they are replaced through lifecycle payments made.

- The lifecycle payments are recognised as new items of property, plant and equipment with similar (and shorter) useful economic lives.

However, ED 261 indicates that the assumption was made that "there is sufficient certainty regarding the timing and amount of the [item being the subject of lifecycle costs] for it to be recognised as a separate component…" and "If this was not the case (e.g. where the operator might [incur lifecycle costs] in future, or might incur additional maintenance over the period of the service concession arrangement), it might not be appropriate to recognise a component."

In the absence of further guidance, it appears as if ED 261 favours the capitalisation of lifecycle payments, but recognises that if the payments are made to Project Co without certainty in relation to timing and the amount relating to an activity or replacement, then capitalisation as a separate component will not be appropriate.

The appropriate treatment by the State will need to be determined once the contractual arrangements with Project Co have been finalised (traditional PPPs have not usually provided for sufficient information to link specific activities or assets to lifecycle payments made).

2.1.6. Treatment of service costs

Project Co is responsible for providing services during the concession period and is entitled to be paid for these services.

Whilst these payments are contractually agreed upon and are included in the QSPs, the obligation to make these payments arise over the life of the concession period (as the services are provided and the asset made available for use in the public service).

These services are "executory contracts" from the State's perspective and are expensed when incurred. The recognition and measurement of the service concession assets and liabilities are unaffected by facilities management and other operating costs.

This treatment does not differ between the accounting models.

Schedule 1.3 included in Appendix 1 includes a breakdown of QSPs between finance lease liability repayments and facilities management and other operational charges.

2.1.7. Treatment of capital contributions

A capital contribution (representing an amount that the State pays during the construction phase or upon completion of the asset) usually reduces the amount of QSPs to be paid over the concession period. As these payments are made to the Project Co in advance of the concession asset being recognised on the balance sheet, these payments are typically recorded as "Prepayments" and when the asset is recognised, transferred to the asset as part of its fair value.

Should the State use existing cash resources to make the contribution, this would result in a reduction in net cash balances.

If the payment were to be sourced from new debt (independent of the PPP), the debt will be treated from an accounting perspective as follows:

- Upon initial recognition – fair value of the debt, reduced by directly attributable transaction costs; and

- Upon subsequent measurement – amortised cost, using the effective interest rate method.

This treatment does not differ under the two accounting models.

2.2 Accounting principles to apply in determining whether to capitalise or expense costs incurred

The Project has a number of work packages applying different procurement models and each one of these will likely require an assessment of whether the costs incurred are to be capitalised as part of the Project or expensed as incurred.

We have set out under 2.1 above the accounting considerations in connection with the assets to be recognised under the PPP procurement model.

This section provides the principles under Australian Accounting Standard AASB 116 *Property, Plant and Equipment* (**AASB 116**) to be adhered to when evaluating whether costs are to be capitalised or expensed.

<u>Overriding principle in recognising items of property, plant and equipment</u>

An asset can only be recognised when:

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

- its cost can be measured reliably.

The accounting standard does not prescribe the unit of measurement to be applied in evaluating whether capitalisation is appropriate, but as explained later, different components of Property, Plant and Equipment need to be depreciated separately.

Key to the determination of capitalisation is the phrase “cost”. The cost of an item of Property, Plant and Equipment that can be capitalised comprises:

- its purchase price (excluding refundable taxes, such as GST);
- the initial estimate of costs of dismantling and removing the item and restoring the site on which it is located (if there is a requirement to do so); and
- costs directly attributable to bringing the asset to the location and condition necessary for it to operate as intended by management.

The last bullet is a key consideration in the infrastructure environment. This category includes direct labour, site preparation costs, delivery and handling costs, installation and assembly costs, costs of testing operational functionality and professional fees.

Considering that the MMRA will engage with a number of counterparties to complete the project, there is a high likelihood that a number of different costs will be incurred and recharged to the State. It is crucial that the nature of the costs be assessed to determine whether they are necessary for bringing the asset to the location and condition necessary for it to be operated in the way intended by management.

As far as the PPP arrangement is concerned, the asset will be recognised at fair value under the Victorian Model. The fair value is assumed to be construction and construction period related costs.

2.3 Accounting principles in connection with componentisation of Property, Plant and Equipment, residual values and depreciation

A very common issue faced in large scale projects is the allocation of costs incurred into components to comply with the requirements of Australian Accounting Standards.

Components are smaller identifiable parts of classes of Property, Plant and Equipment that are depreciated separately and usually over different useful lives. It is therefore common to identify, record and depreciate separate components, regardless of whether these were separately acquired. Items of a different nature, useful life or depreciation method will require separation in order to allocate the depreciation materially accurately over the appropriate useful lives of different components.

As an example – an asset is delivered by a contractor and includes electrical equipment, fixtures, surface works, etc. Management would need to identify which parts of the larger asset are significant and would be subject to different depreciation periods and replacement requirements. Also refer to the discussion under lifecycle payments under 2.1.5.

Another area that significantly impacts depreciation is residual value determination. Assets are depreciated over their useful economic lives up to their residual values, which are required to be reviewed on an annual basis.

3. Assumptions for Business Case: Capital and Service component calculations

Redacted commercial-in-confidence

4. Facts, circumstances and assumptions

Our advice as outlined above has been formed on the basis of the following facts, circumstances and assumptions as provided to us:

Background

- The procurement models are outlined in the Scope section of the advice.
- The procurement model to be applied in the delivery of the tunnels and stations for the new Melbourne Metro Rail Project will be via an availability PPP, with an operating period of 25 years.

Assumptions

Assumptions relating to the Victorian Model:

- For the Victorian Model we have assumed that the 'commencement of the lease' and the 'inception of the lease' occurs on the same date, being commercial acceptance on 30 September 2023.
- For the Victorian Model, we have assumed that the fair value of the asset at initial recognition is equal to its construction costs and construction period costs that would be incurred by Project Co. In the guidance issued by DTF, the Project Co could take the following costs into account when determining the amount to be charged to the State. Therefore, implicitly these costs form part of the fair value of the PPP asset.
    - Design and construction costs
    - Upfront bidding fees
    - Underwriting fees / Establishment fees
    - Special Purpose Vehicle (SPV) costs during construction
    - Capitalised interest
    - Letter of credit during construction phase
- Following completion of the asset the State will be required to pay QSPs comprising:
    - capital components;
    - lifecycle components; and
    - other services components.

- The QSPs payable by the State can accurately be apportioned into capital (principal and interest), lifecycle and service components.

- The State will have no obligation to commence paying the QSP until commercial acceptance is achieved.

- The State does not control Project Co, and Project Co does not act as an agent of the State.

Assumptions relating to ED 261:

- The assets that will be procured through the PPP strategy meet the definition of a service concession asset as defined in ED 261 (i.e. used to provide public services in a service concession arrangement).

- The tunnels and stations are "whole of life" assets as defined in ED 261 (i.e. assets that will be used for their entire useful lives) and are controlled by the State.

- For the ED 261 model we have assumed that the effective interest rate is determined as the rate that returns the future cash flows over the concession period to a present value equivalent to the construction cost of the asset when those costs are incurred.

5. Relevant literature

Our advice as outlined above has been formed with reference to:

- Framework for the Preparation and Presentation of Financial Statements (**Framework**)

- AASB Exposure Draft ED 261 *Service Concession Arrangements: Grantor* (**ED 261**)

- AASB 13 *Fair Value Measurement* (**AASB 13**)

- AASB 116 *Property, Plant and Equipment* (**AASB 116**)

- AASB 117 *Leases* (**AASB 117**)

- AASB 132 *Financial Instruments: Presentation* (**AASB 132**)

- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets (***AASB 137***)*

- AASB 139 *Financial Instruments: Recognition and Measurement* (**AASB 139**)

- Australian Accounting Standards Board Interpretation 4 – *Determining whether an Arrangement contains a Lease* (**Interpretation 4**)

6. Analysis

The analysis that supports our advice as outlined in Section 2 is included below. Relevant Australian Accounting Standard paragraphs are quoted in this section to support the comments and advice in Section 2.

6.1 Accounting considerations in connection with recognition of the PPP model for tunnels and stations

6.1.1 Accounting under the Victorian Model

In the absence of a particular Accounting Standard for PPP arrangements for grantors, Interpretation 4 was used as a basis for determining that availability PPPs are to be accounted for as leases.

Interpretation 4 requires arrangements that are in substance leases, but that do not have the legal form of leases, to be identified and accounted for in accordance with the leasing standard AASB 17.

a) Treatment of the capital component of QSP

Interpretation 4 states the following:

"*4 Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:*

(a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and

(b) the arrangement conveys a right to use the asset."

These two requirements are elaborated in paragraphs 8 and 9 and are quoted below.

"8 An asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

9 An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output."

Availability PPPs provide the State with the public service asset, and it controls the services provided with the asset through the project agreement with the Project Co. The "output" from the service concession asset is the public service.

It is reasonable to conclude, that in the absence of any specific guidance for the State that the PPP arrangements are deemed to be analogous to leases.

AASB 17 requires lease arrangements to be classified as finance leases or operating leases:

"10 Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications."

Considering the 'leased asset' is constructed and operated for and on behalf of the State, it is transferred to the State at the end of the lease term and the capital portion of QSPs legally repay construction costs (including a return), classification of the arrangement as a finance lease is appropriate.

Based on the analysis above, under the Victorian Model, the capital portion of the QSPs are accounted for under finance lease principles.

b) Initial recognition

In measuring the finance lease liability, QSPs are allocated between capital payments and the operating and facilities management payments. The present value of the future capital payments are calculated in line with AASB 117 paragraphs 20 and 25:

"20 At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset."

The rate implicit in the lease is defined as: *"… the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor."*

Two concepts are highlighted above, both of which addresses timing, and are defined in paragraph 4 of AASB 117:

*"The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:*

(a) a lease is classified as either an operating or a finance lease; and

(b) in the case of a finance lease, the amounts to be recognised at the commencement of the lease term are determined.

*The **commencement of the lease** term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is the date of initial recognition of the lease (ie the recognition of the assets, liabilities, income or expenses resulting from the lease, as appropriate)."*

Although the leased assets and leased liabilities are recorded at commencement of the lease, the determination of the values to be recognised at that date is performed at the inception of the lease. It is also at the inception of the lease that the rate implicit in the lease needs to be calculated.

We have assumed for purposes of this advice, under the Victorian model, that the 'inception of the lease' coincides with the "commence of the lease", both dates being at commercial acceptance of the asset. We further assume that the rate implicit in the lease (concession arrangement) is calculated as the rate that, when used to discount the capital portion of the QSPs, is equal to the construction and related costs.

c) Subsequent measurement

The 'lease payments' are split between capital and interest payments. This is recorded in paragraph 25 of AASB 117 as follows:

"25 Minimum lease payments shall be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge shall be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Contingent rents shall be charged as expenses in the periods in which they are incurred."

d) Cost of the service concession asset

"20 At the commencement of the lease term, lessees shall recognise finance leases as assets… in their statements of financial position at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments…each determined at the inception of the lease."

Under finance lease principles, the leased assets and lease liabilities are usually recorded at the equal amounts.

As discussed above, under the Victorian Model, the concession asset will usually be recorded at commercial acceptance at the fair value of the asset (the construction and related costs are normally used as a proxy of fair value at that date).

e) Lifecycle payments

Under the Victorian Model, lifecycle costs are treated as maintenance costs that extend the useful economic lives of existing service concession assets and are expensed as incurred. This treatment is in line with AASB116, paragraph 12:

"12 Under the recognition principle…an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts..."

However, paragraph 13 indicates circumstances in which capitalisation is required:

"13 Parts of some items of property, plant and equipment may require replacement at regular intervals… Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met..."

The recognition criteria in paragraph 7 is as follows:

"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."

It is common under PPP arrangements that lifecycle payments are made to the Project Co in accordance with the project agreement, without being linked to a specific asset or a timeframe in which the asset needs to be replaced. This draws into question whether the lifecycle payments meet the recognition criteria above and form the basis why they are mostly expensed.

f) Facilities Management and other operational charges

The portion of the QSPs that relate to facilities management is not recognised as part of the asset upfront, but are recognised as executory contracts.

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

The Project Co/Operator is responsible for operating the service concession asset during the concession period and is entitled to be paid for this service.

These services are "executory contracts" from the State's perspective and are expensed when incurred (i.e. when the Project Co/Operator performs the facilities management activities).

g) Capital contributions

Capital contributions made by the State prior to commercial acceptance are recorded as "Prepayments" on the basis that the asset to which it relates has not been recognised (commercial acceptance has not occurred at that point).

If the State were to fund the contribution through increasing its debt levels, the accounting treatment for the debt is specified in AASB 139. The treatment would be at amortised cost using the effective interest method. Paragraph 9 of defines these accounting concepts as follows:

"The ***amortised cost*** *of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility."*

*"The **effective interest method** is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity shall estimate cash flows considering all contractual terms of the financial instrument (e.g., prepayment, call and similar options) but shall not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate… transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments)."*

6.1.2 Accounting under the ED 261 Model

The Scope of ED 261 is set out in paragraph 5 of the Exposure Draft:

"5 This [draft] Standard shall be applied to arrangements that involve an operator providing a public service related to a service concession asset on behalf of a grantor."

Appendix A defines these concepts as follows:

"Grantor - *The entity that grants the right to access the service concession asset to the operator.*

Operator - *The entity that has a right of access to the service concession asset to provide public services subject to the grantor's control of the asset.*

Public service - *A service that is provided by government or one of its controlled entities, as part of the usual government function, to the community, either directly (through the public sector) or by financing the provision of services.*

Service concession arrangement - *A contract between a grantor and an operator in which:*

(a) the operator has the right of access to the service concession asset to provide a public service on behalf of the grantor for a specified period of time; and

(b) the operator is compensated for its services over the period of the service concession arrangement"

For the purposes of this advice, it is assumed that ED 261 will apply to the Tunnels and Station PPP, based on the criteria and definitions above.

a) Treatment of the capital component of QSP

Recognition of the liability in connection with the QSPs are recognised when the asset is recognised, in line with the ED 261 paragraphs below.

"13 Where the grantor recognises a service concession asset…the grantor shall also recognise a liability…

14 The liability recognised in accordance with paragraph 13 shall be initially measured at the same amount as the service concession asset, adjusted by the amount of any other consideration (eg the transfer of an existing asset) from the grantor to the operator, or from the operator to the grantor.

15 The nature of the liability recognised is based on the nature of the consideration exchanged between the grantor and the operator. The nature of the consideration given by the grantor to the operator is determined by reference to the terms of the contract.

16 In exchange for the service concession asset, the grantor may compensate the operator for the service concession asset by any combination of:

(a) making payments to the operator (the 'financial liability' model); and

(b) compensating the operator by other means (the 'grant of a right to the operator' model) such as:

(i) granting the operator the right to earn revenue from third-party users of the service concession asset; or

(ii) granting the operator access to another revenue-generating asset for the operator's use (eg a private wing of a hospital where the remainder of the hospital is used by the grantor to treat public patients or a private parking facility adjacent to a public facility).

Financial Liability Model

17 Where the grantor has a contractual obligation to deliver cash or another financial asset to the operator for the construction, development, acquisition or upgrade of a service concession asset, the grantor shall account for the liability recognised in accordance with paragraph 13 as a financial liability."

Based on the analysis above, the QSPs would represent payments to be made to the Project Co and would consequently be accounted for under the financial liability model.

<u>*b) Initial recognition*</u>

The recognition of the service concession asset (and liability) under ED 261 is specified in paragraphs 8 – 10:

"8 The grantor shall recognise an asset provided by the operator and an upgrade to an existing asset of the grantor as a service concession asset if the grantor controls the asset. The grantor controls the asset if, and only if:

(a) the grantor controls or regulates what services the operator must provide with the asset, to whom it must provide them, and at what price; and

(b) the grantor controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the asset at the end of the term of the arrangement.

9 The grantor shall recognise an asset that will be used in a service concession arrangement for its entire useful life (a 'whole-of-life' asset) if the conditions in paragraph 8(a) are met.

10 The grantor shall initially measure the service concession asset recognised in accordance with paragraph 8 (or paragraph 9 for a whole-of-life asset) at its fair value in accordance with AASB 13 Fair Value Measurement…"

A significant change from the Victorian model is a requirement to recognise construction costs progressively, prior to commercial acceptance. This is stipulated in paragraph AG 30:

"AG30 For example, if the service concession arrangement requires the operator to provide the grantor with progress reports during the asset's construction or development, the costs incurred may be measurable, and would therefore meet the recognition principle in AASB 116 for constructed assets or in AASB 138 for developed assets. Also, where the grantor has little ability to avoid accepting an asset constructed or developed to meet the specifications of the contract, the costs shall be recognised as progress is made towards completion of the asset. Thus, the grantor shall recognise a service concession asset and an associated liability."

In practice, the liability would likely arise over a period of time as construction progresses.

For purposes of this advice, the assumption is made that the construction and related costs are equal to fair value.

c) Subsequent measurement

The financial liability model requires QSPs to be allocated to the outstanding liability, interest charges and service charges.

"20 The grantor shall allocate the payments to the operator under the contract and account for them according to their substance as a reduction in the liability recognised in accordance with paragraph 13, a finance charge and charges for services provided by the operator.

21 The finance charge and charges for services provided by the operator in a service concession arrangement determined in accordance with paragraph 20 shall be accounted for in accordance with other relevant Australian Accounting Standards.

22 Where the asset and service components of a service concession arrangement are separately identifiable, the service components of payments from the grantor to the operator shall be allocated accordingly. Where the asset and service components are not separately identifiable, the service component of payments from the grantor to the operator shall be determined using estimation techniques."

ED 261 provides guidance on the determination of the rate to be used under the financial liability model:

"AG46 The finance charge specified in paragraph 20 is determined based on the operator's cost of capital specific to the service concession asset, if this is practicable to determine.

AG47 If the operator's cost of capital specific to the service concession asset is not practicable to determine, the rate implicit in the arrangement specific to the service concession asset, the grantor's incremental borrowing rate, or another rate appropriate to the terms and conditions of the arrangement, is used.

AG48 Where sufficient information is not available, the rate used to determine the finance charge may be estimated by reference to the rate that would be expected on acquiring a similar asset (eg a lease of a similar asset, in a similar location and for a similar term). The estimate of the rate should be reviewed together with:

(a) the present value of the payments;

(b) the assumed fair value of the asset; and

(c) the assumed residual value;

to ensure all figures are reasonable and mutually consistent."

d) Cost of the service concession asset

As noted in b) above, the service concession asset is recorded progressively during the construction period at the value of construction and construction related costs.

e) Lifecycle payments

ED 261 includes lifecycle costs in an example accompanying the exposure draft and also requests specific comment from stakeholders as to whether the existing exposure draft contains sufficient guidance in respect of life cycle costs.

The accounting treatment in the ED 261 is outlined below:

- The assets to which the lifecycle payments are applied, are identified as separate items of property, plant and equipment (this is also referred to as components);
- These components are depreciated over a much shorter period as compared to the service concession period. They are depreciated over the period between when these are taken into use and ending when they are replaced through lifecycle payments made.
- The lifecycle payments are recognised as new items of property, plant and equipment with similar (and shorter) useful economic lives.

However, ED 261 indicates that the assumption was made that “there is sufficient certainty regarding the timing and amount of the [item being the subject of lifecycle costs] for it to be recognised as a separate component…” and “If this was not the case (eg where the operator might [incur lifecycle costs] in future, or might incur additional maintenance over the period of the service concession arrangement), it might not be appropriate to recognise a component.”

f) Facilities Management and other operational charges

This analysis is similar to the analysis under Section 6.1.1 (f) and is not repeated here.

7. Basis of advice

Inherent limitations

This deliverable has been prepared at the request of MMRA as part of our engagement to provide commercial and financial advisory services for the Melbourne Metro Rail Project under the terms of your purchase order number 245694, dated 18 September 2014 (as updated as agreed between the parties, including your variation letter dated 3 July 2015), issued under the Open Standing Offer Agreement between the Department of Treasury and Finance and KPMG for the provision of Commercial and Financial Services for Infrastructure and Capital Asset Projects, and Commercial Transactions and based on the Scope outlined in section 1 above. The ultimate responsibility for the accounting treatment of any matter rests with the preparers of the financial statements.

The services provided in connection with this engagement comprise an advisory engagement, which is not subject to auditing, review or assurance standards issued by the Australian Auditing and Assurance Standards Board and, consequently no opinions or conclusions intended to convey assurance have been expressed. Any reference to 'review' throughout this deliverable has not been used in the context of a review in accordance with auditing, review or assurance standards issued by the Australian Auditing and Assurance Standards Board.

The advice provided in this deliverable is based upon the facts and circumstances provided to us and the assumptions you have advised we should make, as outlined in section 3 and 4 above. MMRA is responsible for ensuring:

- the facts, circumstances or assumptions regarding the subject matter do not differ from those provided to us; and
- complete and accurate information has been provided to us, including details of other contracts or arrangements, whether documented or orally agreed, which impact upon the overall substance of the subject matter.

If MMRA has not fulfilled these responsibilities, our advice may not be valid. We have not sought to independently verify any information provided to us.

The advice in this deliverable is based on interpretations of accounting standards and other relevant professional pronouncements and legislation current at the date of preparing the advice, as outlined in section 5 above. Should the accounting standards, other relevant professional pronouncements or legislation change, the advice may not be valid.

Third party reliance

This deliverable is solely for the purpose set out in the Scope section and for MMRA's information, and may not be used for any other purpose or provided or distributed to, or accessed or relied upon by, any other party without KPMG's express written consent. Other than our responsibility to MMRA, neither KPMG nor any member or employee of KPMG undertakes responsibility arising in any way from reliance placed by a third party on this deliverable. Any reliance placed is that party's sole responsibility.

We understand that this deliverable may be provided to MMRA's external auditor. MMRA's external auditor is not a party to our engagement letter with MMRA and our engagement was neither planned nor conducted in contemplation of the purposes for which MMRA's external auditor may access this deliverable. MMRA's external auditor is responsible for forming their own audit opinion. Accordingly, MMRA's external auditor may not place reliance on this deliverable. KPMG is not liable for any losses, claims, expenses, actions, demands, damages, liabilities, or any other proceedings arising out of any reliance by MMRA's external auditor on this deliverable.

8. Closing

Please contact Etienne Gouws, Director, at +61 3 9838 4221 or me, if you have any questions. We thank you and the relevant MMRA personnel for all the assistance provided in conducting this engagement and we look forward to continuing to provide service to your organisation.

Yours faithfully

Ralph Ferguson
Partner

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