Western Distributor Business Case Accounting Treatment Guidance

Cabinet in Confidence

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pwc

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1 Introduction

This paper has been prepared to outline the accounting considerations and budget implications of the preferred delivery model for the Western Distributor project ("the Project") as identified in the Western Distributor Business Case ("the Business Case"). The Business Case recommends that the Western Distributor works are procured through an availability Public Private Partnership ("PPP") model.

This paper does not consider the accounting implications of the Monash Freeway Upgrade and Webb Dock Access Improvement Works both of which have been proposed to be procured under the traditional Design and Construction contract method.

The delivery model identified by the Business Case proposes that the State sets up a State owned Entity ("SOE") which will enter into an agreement with the private sector operator ("PPP consortium") to deliver and operate the Project assets using an availability PPP.

We have not concluded on whether this proposed model will be a viable option based on any accounting and net debt objectives the State may have. The purpose of this paper is to outline the key considerations to assist the State in analysing and assessing the Business Case. This paper sets out the accounting and budgetary considerations of the proposed model as follows:

- Accounting framework – identifies the accounting guidance which is applicable to availability PPPs.
- Proposed availability PPP – outlines the proposed model and the accounting treatment under this model.
- Budget impact and net debt considerations – outlines the potential impact that the proposed model may have on the State's credit rating, including whether the SOE would be considered self-supporting.
- Appendices – provides additional accounting guidance applicable to the proposed model.

In reviewing this paper, it should be noted that details of the proposed Project scope can be found in the Business Case.

2 Accounting framework

2.1 Overview

This section describes the key accounting guidance from the Australian Accounting Standards Board ("AASB") that is applicable for availability PPPs. This includes:

- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* ("AASB 108"). This guidance assists in determining the appropriate accounting guidance in absence of specific guidance
- AASB 117 – *Leases* ("AASB 117"). This is the accounting guidance that is currently applied by the State to account for availability PPPs
- Exposure Draft 261 – *Service Concession Arrangements: Grantor* ("ED 261"). This is the proposed guidance for service concession arrangements from the grantor's perspective. When ED 261 becomes applicable as an accounting standard, the State will have to apply this guidance to its service concession arrangements.

Other relevant accounting guidance has been included in Appendix C and includes the following:

- AASB 10 – *Consolidated Financial Statements* ("AASB 10"). This guidance outlines the factors the State must consider in assessing whether it controls the SOE and whether it will need to consolidate the SOE's assets and liabilities into its balance sheet.
- AASB 118 – *Revenue* ("AASB 118"). This is the current guidance which will need to be applied to account for tolls. AASB 15 – *Revenue from Contracts with Customers* ("AASB 15") will also be considered as it will be operative for periods beginning on or after 1 January 2017.
- AASB 132 – *Financial Instruments: Presentation* ("AASB 132") and AASB 139 – *Financial Instruments: Recognition and Measurement* ("AASB 139"). This guidance is applicable to accounting for financial liabilities and equity instruments recognised as part of the proposed model.
- AASB 124 – *Related Party Disclosures* ("AASB 124"). As the State and SOE are related parties, transactions between them will need to be disclosed in accordance with this guidance.
- AASB 13 – *Fair Value* ("AASB 13"). This guidance will be used by the State to determine the fair value of the service concession assets upon initial recognition.
- AASB 1004 – *Contributions* ("AASB 1004"). This guidance is applicable for any contributions by the Commonwealth to the State.

2.2 Current accounting for service concession arrangements

A service concession arrangement is a contract between a grantor and an operator in which 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 the operator is compensated for its services over this period. In this case, the grantor is the public sector entity that grants the right to access the service concession asset to the operator. The operator is the entity that has a right of access to the service concession asset.

Currently there is no authoritative guidance that addresses grantor accounting for service concession arrangements issued by the International Accounting Standards Board ("IASB") or the AASB. Hence in accordance with AASB 108 in the absence of an Australian Accounting Standard that specifically applies to a transaction, an accounting policy should be developed using a hierarchy of sources as established by paragraphs 11 and 12 of AASB 108. Applying the requirements of AASB 108, the leasing principle of "risk and rewards" under AASB 117 is adopted by the State to account for service concession arrangements.

The "risk and rewards" approach involves assessing the risks and rewards of each party to determine whether the grantor or operator recognises the asset. The asset will be recognised on balance sheet by the entity that is exposed to the majority of the risks and rewards embodied in the asset.

The risks and rewards approach, when applied to availability PPPs, results in the State accounting for those arrangements as finance leases under AASB 117, with the State being the lessee. The State recognises a finance lease asset and lease liability on its balance sheet from the date the asset is available for use. These entries reflect:

- the State's financial obligations to the operator
- the ability for the State to control the use of the asset
- the ability for the State to receive substantially all of the asset's benefits.

However, when applied to economic PPPs, adopting the risk and rewards approach has often resulted in the State only recognising an asset at the end of the concession term. This financial reporting outcome arises because the State typically has no financial obligations to the operator. The operator bears the risk of recovering the investment through charging the users for using the asset.

Under the current guidance of AASB 117 the Project assets must be recognised by the State entity which bears the majority of the identified risks and rewards irrespective of assets ownership.

2.3 Future accounting for service concession arrangements

ED 261 was released by the AASB in May 2015 providing guidance for grantors to account for service concession arrangements.

The proposed grantor guidance adopts a "control or regulated" approach to account for service concession arrangements which mirrors the operator's accounting under Interpretation 12 Service Concession Arrangements. Under this approach the State will recognise an asset provided by the operator or recognise an upgrade to an existing asset of the State, as a service concession asset if the State controls the asset. The State controls the asset if:

a The State 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 State controls through ownership, beneficial entitlement or otherwise – any significant residual interest in the asset at the end of the term of the arrangement.

Service concession assets will be initially recognised at fair value. Where the State recognises a service concession asset a liability should also be recognised.

In a "financial liability model" (ie an availability PPP), the liability recognised by the State should be a financial liability.

In a “grant of a right to the operator model” (ie an economic PPP), the State should account for the liability recognised as the unearned portion of the revenue arising from the exchange of assets between the State and the operator. The State should recognise revenue and accordingly reduce the liability over the concession term.

ED 261 proposes the new standard to be applied to annual reporting periods beginning on or after 1 January 2017, with early adoption permitted. The AASB is currently contemplating whether to extend this application date following the comment letter period for ED 261.

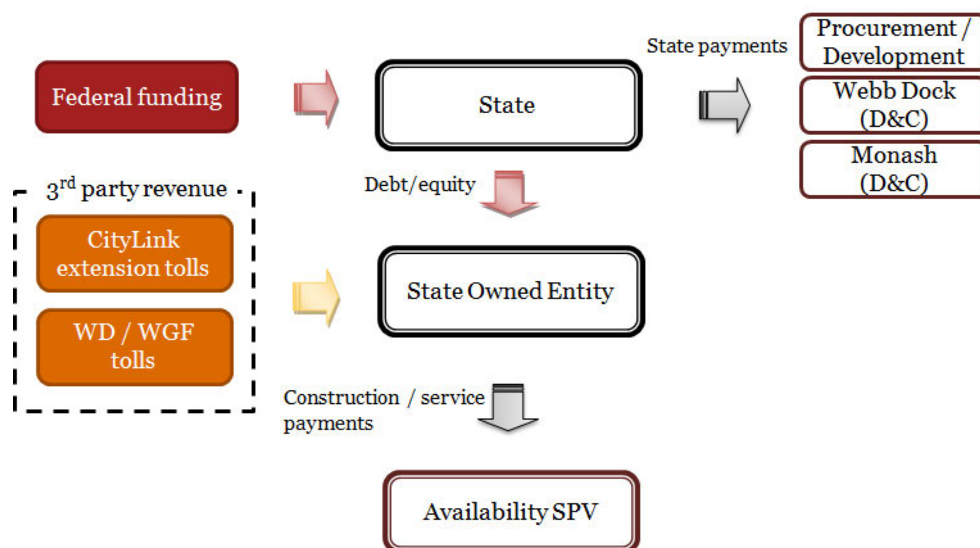
Under the future guidance, the determination of the specific State entity that should recognise the Project assets will be defined by which entity is deemed to control the assets.

Further commentary on the future accounting guidance for service concession arrangements is outlined in Appendix B.

3 Proposed availability PPP

3.1 Overview

The diagram below illustrates the structure of the proposed availability PPP model.



Under this model:

- The State will establish a 100% State owned special purpose vehicle, SOE, to take responsibility for toll revenue collection and the payments to the PPP consortium (this is referred to as the "Availability SPV" in the diagram above).
- The SOE enters into an agreement with the PPP consortium established by the private sector operator to deliver the Western Distributor Project via an availability PPP.
- The SOE will have the rights to design, construct, finance, maintain and operate the assets over the life of the concession.
- The SOE is expected to be funded using debt and equity funding from the State. It has been assumed that the State will either use existing cash or incur external borrowings to provide debt and equity funding to the SOE.
- For the purposes of the Business Case it has been assumed that the State will receive a capital contribution from the Federal government ("Commonwealth support") to assist in funding.

During the construction phase:

- The PPP consortium will obtain private finance to fund the Project.
- The State funding will consist of:
  - A loan issued to the SOE during the construction phase. This loan will be used to fund any remaining construction period costs including management and delivery costs.

- Injection of equity to the SOE, funded using Commonwealth support, which is assumed to be provided to the State in the form of a grant.

- The construction costs incurred by the PPP consortium will be funded by a combination of private finance and construction payments made by the SOE.

During the operation phase:

- At commencement of the operation phase, the State will grant a commercial "on-call" debt facility, which will be drawn upon to fund the difference between the SOE's net operating revenue and the cost of the PPP availability payments. The facility will be sized to an amount equal to the nominal value of the forecast availability payments. The loan will then be repaid from the CityLink concession extension toll revenues.
- The SOE pays capital availability payments during the operation phase to the PPP consortium. The funds received by the PPP consortium will be used to repay the private finance.
- Toll revenue would be collected by the SOE during the concession period. Toll revenue in relation to the CityLink extension will be received from 2035. Toll revenue will be used to repay debt and equity financing of the State.

3.2 Assumptions

- The State has the power over the SOE to direct the SOE's relevant activities (ie enter into the availability PPP with private sector operator to deliver and operate the Project assets for the benefit of the State); the State is exposed to the SOE's significant variable returns (ie toll revenue) and has ability to use its power over the SOE to affect the amount of the SOE's returns for the State's benefit.
- The SOE will have its own governing body that has the power over the daily operation of SOE.
- The arrangements are structured such that the SOE is a self-supporting entity (able to support its own capital raising).

3.3 Accounting considerations

Considerations under the current accounting framework

Which specific State entity should recognise the Project assets and liabilities?

In determining the specific State entity that should recognise the Project assets, it is necessary to ascertain which entity has been assigned the majority of these risks and rewards.

In order for SOE to recognise the Project assets and liabilities, they must have the following:

- responsibility for the performance of the State's obligations under the Project
- obtain benefits incidental to ownership (ie entitlement to toll revenues)
- residual interest in the Project assets at the end of the Project term
- responsible for making availability payments and capital contributions to the PPP consortium
- bear risks incidental to ownership (ie defaults, credit risk, etc.)

These factors will need to be considered in determining whether the SOE should recognise the Project assets and liabilities. If these factors are not present, the accounting treatment would have to be reconsidered. We have assumed for the

purpose of this paper that the SOE holds a majority of the risks and rewards of the Project assets based on the proposed Project structure.

SOE

How should the cash flows from the State be recorded by SOE?

- The State will fund the SOE through using a mix of debt and equity. The debt and equity will represent financial instruments as they result in a financial asset for the State and either a financial liability or equity for the SOE. The undrawn portion of the "on-call" debt facility will be disclosed by the SOE. This amount will not be recorded as a financial liability until it is drawn down.
- The loans entered into with the State will be recorded as financial liabilities (ie loan payables) by the SOE. The loans will be recorded during the construction phase and operations phase when the funds are received/drawn down from the State.
- The "on-call" debt facility will be disclosed when the contract is entered into between the SOE and the State and the debt can be drawn down as needed. This is expected to occur during the operations phase. As the debt is drawn down it will be recorded as a financial liability.
- The "on-call" debt facility could have an embedded derivative if the interest rate on the facility is fixed. The derivative would have nil value on initial recognition. Subsequent to initial recognition, the derivative would be measured at fair value with any gains or losses recognised through the profit or loss.
- All debt (including the "on-call" facility) is assumed to be made available on a commercial arms-length basis.
- In the event that it is determined that the loan between the State and SOE is at off-market rates, it will need to be measured at fair value; the SOE would measure the loan using market rates. The adjustment would be reflected by using the effective interest rate method.
- The SOE will record equity reflecting the equity investment from the State. This will be recorded during the construction phase when the funds are received from the State.

How should SOE account for the availability PPP?

- Applying AASB 108 requirements and the State's current accounting policy, the SOE would account for this availability PPP as a lease arrangement under AASB 117.
- The arrangement with PPP consortium represents an in-substance finance lease arrangement between the SOE and the PPP consortium, with the SOE being the lessee. Finance lease classification means that the substantial risks and rewards of ownership lie with the lessee. It is assumed that the SOE will take the entire economic benefits of ownership while also having the residual interest in the Project assets at the end of the Project term. If the risks and rewards incidental to ownership rest with the SOE, this arrangement is a finance lease.
- The SOE will recognise a finance lease asset and lease liability at the lease commencement date. The lease commencement date is defined in AASB 117 as the "date from which the lessee is entitled to exercise its right to use the leased asset". The date of construction completion for the Project components should be used as the lease commencement date under the arrangement. The lease asset and liability should be recognised at the lease commencement date.
- In accordance with AASB 117, the finance lease asset should be recorded at the lower of the present value of the minimum lease payments and the fair value of the leased asset. It is most appropriate to value the Project assets at the fair

value in accordance with AASB 13. As the Project assets are highly specialised, the depreciated replacement cost approach would be the most appropriate method to estimate the fair value of the Project assets. The fair value of the Project assets are the costs implicit in the operator's model as this represents the current replacement cost of these assets. Any initial direct costs incurred by the SOE in relation to the lease are added to the amount recognised as the lease asset.

- A corresponding finance lease liability is recognised at lease commencement at the same value as the lease asset (excluding the initial direct costs). Any construction payments made by the SOE to the PPP consortium during the construction phase will be recorded as prepaid asset when the payment is made. These constructions payments are funded from the State funding. The prepaid asset will be allocated against the finance lease liability upon lease commencement.
- The SOE will recognise interest expense in relation to the loan payables to the State and the finance lease liability to the PPP consortium.

How should the SOE recognise revenue from tolls?

As the toll revenue will be retained by the SOE, the SOE will recognise toll revenue during the concession period once the road is operating and tolls are effective. Revenue will be recognised as customers utilise the toll roads.

State

This section describes the accounting implications for the State in the context of the State as a stand-alone entity; excluding the results of its subsidiaries and the State on a consolidated basis; including the results of its subsidiaries.

How is the SOE accounted for by the State?

- Based on the assumption outlined in Section 3.2 above, the State is deemed to control the SOE. The SOE's assets and liabilities will be consolidated on to the State's consolidated balance sheet. Accordingly the State's consolidated balance sheet will include the prepaid asset (when the State funding is paid to the PPP consortium) before lease commencement, and the finance lease asset and lease liability recognised for the Project at lease commencement.
- The State (as a stand-alone entity) will have financial assets recorded in relation to the loan receivables from the SOE; upon consolidation these financial assets will be eliminated against the loan payables recognised by the SOE.
- The State (as a stand-alone entity) will disclose a financial commitment for the undrawn "on-call" facility; this will be disclosed when a contract is entered into between the SOE and the State and the debt can be drawn down as needed. This is expected to occur during the operations phase. As the debt is drawn down it will be recorded as a financial asset by the State. The commitment disclosure will be removed upon consolidation.
- As the SOE and the State will be related parties, the transactions between them that eliminate on consolidation will need to be disclosed by the State; this includes the loans to the SOE.
- The State (as a stand-alone entity) will have an investment in subsidiary for its equity investment in the SOE; this amount will be eliminated against the equity recorded in the SOE upon consolidation.
- The State will have a financial liability recognised for any external borrowings entered into. This financial liability will not be eliminated on consolidation. The State will incur interest expense on this financial liability.

- Toll revenue will be recognised during the concession term in the consolidated financial statements of the State. Toll revenue is recognised as customers utilise the toll roads.

How should Commonwealth support be recorded by the State?

- Commonwealth support in the form of a grant will be recorded as a contribution by the State. This will be recorded as income by the State when it is received assuming there are no other conditions that need to be met.

Considerations under the grantor accounting framework

In this section we have outlined differences to the current grantor accounting framework for the SOE and the State.

Which specific State entity should recognise the Project assets and liabilities?

Under the future guidance, the SOE will recognise the Project assets and liabilities if it controls the assets. In order for the SOE to control the project assets they must control or regulate the services provided by the PPP consortium, the price of the services provided, and who the services are provided to.

In order for SOE to recognise the Project assets and liabilities, they must have the following:

- obtain benefits incidental to ownership (ie toll revenues, public benefit)
- bear risks incidental to ownership (ie defaults, credit risk, etc.)
- residual interest in the Project assets at the end of the Project term
- responsible for making availability payments and capital contributions to the PPP consortium
- ability to set prices for toll services.

These factors will need to be considered in determining whether the SOE should recognise the Project assets and liabilities. If these factors are not present, the accounting treatment would have to be reconsidered. Note this paper assumes that the proposed structure would achieve the points stated above and therefore that the Project assets and liabilities will be recognised by the SOE.

The State should also consider whether the SOE is an agent acting on their behalf to manage the service concession arrangement and therefore whether the SOE controls the Project assets. Principal versus agent considerations are outlined in AASB 15 paragraphs B34 – B38.

"*An entity is a principal if the entity controls a promised good or service before the entity transfers the good or service to a customer.*" (AASB 15 paragraph B35).

"*An entity is an agent if the entity's performance obligation is to arrange for the provision of goods or services by another party. When an entity that is an agent satisfies a performance obligation, the entity recognises revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the other party to provide its goods or services.*" (AASB 15 paragraph B36).

Indicators of an agency relationship are as follows:

1. another party is primarily responsible for fulfilling the contract
2. the entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return

3 the entity does not have discretion in establishing prices for the other party's goods or services and, therefore, the benefit that the entity can receive from those goods or services is limited

4 the entity's consideration is in the form of a commission

5 the entity is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services.

This paper assumes that the SOE is not acting as an agent and therefore that the Project assets and liabilities would be recognised by the SOE.

SOE

When does the SOE recognise the Project assets?

- Under the "control or regulated" approach proposed by the ED 261, the SOE will recognise service concession assets if the SOE controls the asset.
- The SOE controls the services the operator must provide with the assets and to whom it must provide them; the SOE also controls any significant residual interest in the assets at the end of the concession term. Note that the PPP consortium does not charge users of the roads; it is the SOE that receives toll revenue. Therefore the SOE is deemed to control the Project assets.
- It is assumed in the event of default the SOE will still be required to make a payment equivalent to the fair value of work performed less the costs associated with replacing the PPP consortium. As such the SOE would recognise the Project assets progressively during the construction phase such that the full Project asset is recognised at the beginning of the operations phase. Therefore, the SOE will recognise the Project assets as service concession assets as they are constructed.

How should the SOE measure the Project assets?

- The SOE would initially measure the service concession asset at its fair value in accordance with AASB 13. Under AASB 13 paragraph 9, fair value is the price that would be received to sell the service concession asset in an orderly transaction between market participants at the measurement date.
- Fair value is expected to be similar to the calculation under the finance lease guidance, however initial direct costs that are transaction costs would be excluded from the total asset value. Project assets will be recognised as they are constructed; that this is different to the existing finance lease approach where the asset is recognised upon lease commencement.

How should the SOE account for their obligation to the PPP consortium?

- Under the proposed model, there would be a contractual obligation for the SOE to deliver cash to the PPP consortium during the operation phase. Therefore, the definition of financial liability under AASB 132 would be met. The recognition of this financial liability is discussed in Appendix C.
- As the service concession assets are recognised, a liability should be recognised by the SOE. The liability should be measured initially at the same amount as the service concession assets.

State

How does the State account for the availability PPP?

- Based on the assumption outlined in Section 3.2 above, the State is deemed to control the SOE. Accordingly the State's consolidated balance sheet will include the service concession assets and the financial liability during construction.
- The service concession assets and financial liability will reflect what is recorded in the SOE.
- There are no other expected impacts of the future grantor accounting standard. All other accounting consequences are expected to remain consistent with the current accounting framework.

Example 1.0 Illustrative example under existing framework

Under the current accounting framework, the accounting consequences of the proposed structure may be considered to be as follows:

Table 1.1: Entity: SOE level (Public Non-financial Company)

Description of accounting impact	Construction Phase	Operation Phase
Loan payables (ie financial liability) to the State Any loan entered into between the State and SOE will be recorded as a loan payable by SOE. The SOE will record the loan payable when it receives the cash. Under the proposed model the State will issue two debt instruments to the SOE; a loan during the construction phase and an "on-call" debt facility at the beginning of the operation phase. The "on-call" debt facility will be recorded as a financial liability as it is drawn down. The undrawn portion of the "on-call" debt facility will be disclosed but not recorded by the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Cash Cr Loan Payables	Dr Cash Cr Loan Payables
Equity for the State Any equity investment between the State and the SOE will be recorded as an equity contribution. SOE will record the equity contribution when cash is received. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Cash Cr Equity Contribution	
Prepaid asset to PPP consortium Any contributions made in the construction phase to the PPP consortium will be recognised as a prepayment of the finance lease.	Dr Prepayment of lease Cr Cash	
Finance lease asset and liability A finance lease asset and lease liability will be recognised on the date the asset is available for use, which is expected to be day one of the operation phase. Under the State's existing accounting policy, no road asset or financial liability is recognised until the road asset is ready for use. Disclosure of the lease liability commitments will be included in the financial statements as a note to the accounts from the inception of the lease.		Dr Leased Asset Cr Lease Liability
Allocation of prepaid lease payments against lease liability on day one of the operation period.		Dr Lease Liability Cr Prepayment

Description of accounting impact	Construction Phase	Operation Phase
Revenue from tolls Recognition of revenue from tolls during the operations phase.		Dr Cash/Deferred revenue Cr Revenue
Interest expense Interest expense incurred in relation to the loan from the State and the finance lease liability will be recognised using the effective interest rate method. The interest expense on the loans from the State will eliminate upon consolidation in the State's consolidated financial statements.	Dr Interest Expense Cr Interest Payable* *For the State loan drawn down during construction	Dr Interest Expense Cr Interest Payable/Lease liability
Availability payments throughout the operations phase Availability payments will be made to the PPP consortium throughout the concession term. This will reduce the finance lease liability.		Dr Lease liability Cr Cash/Payables

Note the following accounting impacts have not been reflected in the journal entries above;

- revaluation of PPE
- depreciation of PPE
- operating expenses
- transaction costs
- repayments of loans to State
- dividends to the State
- gains/losses on derivative financial instruments.

Table 1.2 – Entity: State level (General Government Sector)

Description of accounting impact	Construction Phase	Operation Phase
Loan receivable (ie financial asset) from the SOE Any loan entered into between the State and SOE will be recorded as a loan receivable from the SOE. The State will record the receivable when it provides the cash to SOE. Under the proposed model the State will issue two debt instruments to	Dr Loans receivable Cr Cash	Dr Loans receivable Cr Cash

Description of accounting impact	Construction Phase	Operation Phase
the SOE; a loan during the construction phase and an "on-call" debt facility at the beginning of the operation phase. The "on-call" debt facility will be recorded as a financial asset as it is drawn down. The undrawn portion of the "on-call" debt facility will disclosed as a financial commitment. This will eliminate upon consolidation in the State's consolidated financial statements.		
Commonwealth grant The Commonwealth support will be recognised as grant income when it is received.	Dr Cash Cr Grant income	
Equity for the State Any equity investment between the State and the SOE will be recorded as an investment in subsidiary by the State. The State will record the investment when cash is paid to the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Investment in subsidiary Cr Cash	
Interest income Interest income will be recognised in relation to the loan receivable from the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Interest Receivable Cr Interest Income *For the State loan drawn down by SOE during construction	Dr Cash/Interest Receivable Cr Interest income

Note the following accounting impacts have not been reflected in the journal entries above;

- repayments of loans granted to SOE
- dividends received from SOE
- external borrowings
- gains/losses on derivative financial instruments.

Example 2.0 Illustrative example under future accounting framework

Under the future accounting framework, the accounting consequences of the proposed structure may be considered to be as follows:

Table 2.1 – Entity: SOE level (Public Non-financial Company)

Description of accounting impact	Construction Phase	Operation Phase
Loan payables (ie financial liability) to the State Any loan entered into between the State and SOE will be recorded as a loan payable by SOE. The SOE will record the loan payable when it receives the cash. Under the proposed model the State will issue two debt instruments to the SOE; a loan during the construction phase and an "on-call" debt facility at the beginning of the operation phase. The "on-call" debt facility will be recorded as a financial liability as it is drawn down. The undrawn portion of the "on-call" debt facility will be disclosed but not recorded by the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Cash Cr Loan Payables	Dr Cash Cr Loan Payables
Equity for the State Any equity investment between the State and the SOE will be recorded as an equity contribution. SOE will record the equity contribution when cash is received. This will eliminate upon consolidation in the State's financial statements.	Dr Cash Cr Equity Contribution	
Service concession asset (road) Journal to recognise the service concession asset and financial liability during construction phase	Dr Service concession asset (road) Cr Financial Liability	
Revenue from tolls Recognition of revenue from tolls during the operations phase.		Dr Cash/Deferred revenue Cr Revenue

Description of accounting impact	Construction Phase	Operation Phase
Interest expense Interest expense incurred in relation to the loan from the State and the financial liability to the PPP consortium will be recognised using the effective interest rate method. The interest expense on the loans from the State will eliminate upon consolidation in the State's consolidated financial statements.	Dr Interest Expense Cr Interest Payable* *For the State loan drawn down during construction	Dr Interest Expense Cr Interest Payable/Financial liability
Availability payments throughout the operations phase Availability payments will be made to the PPP consortium throughout the concession term. This will reduce the financial liability.		Dr Financial liability Cr Cash/Payables

Note the following accounting impacts have not been reflected in the journal entries above;

- revaluation of PPE
- depreciation of PPE
- operating expenses
- transaction costs
- repayment of loans to State
- dividends to the State
- gains/losses on derivative financial instruments.

Table 2.2 – Entity: State level (General Government Sector)

Description of accounting impact	Construction Phase	Operation Phase
Commonwealth grant The Commonwealth support will be recognised as grant income when it is received.	Dr Cash Cr Grant income	
Loan receivable (ie financial asset) from the SOE Any loan entered into between the State and SOE will be recorded as a loan receivable from the SOE. The State will record the receivable when it provides the cash to SOE. Under the proposed model the State will issue two debt instruments to the SOE; a loan during the construction phase and an "on-call" debt facility at the	Dr Loans receivable Cr Cash *Loan receivable (ie financial asset) from the SOE*	Dr Loans receivable Cr Cash *Loan receivable (ie financial asset) from the SOE*

Description of accounting impact	Construction Phase	Operation Phase
beginning of the operation phase. The "on-call" debt facility will be recorded as a financial asset as it is drawn down. The undrawn portion of the "on-call" debt facility will be disclosed as a financial commitment. This will eliminate upon consolidation in the State's consolidated financial statements.		
Equity for the State Any equity investment between the State and the SOE will be recorded as an investment in subsidiary by the State. The State will record the investment when cash is paid to the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Investment in subsidiary Cr Cash	
Interest income Interest income will be recognised in relation to the loan receivable from the SOE. This will eliminate upon consolidation in the State's consolidated financial statements.	Dr Interest Receivable Cr Interest Income *For the State loan drawn down by SOE during construction	Dr Cash Cr Interest income/Loan receivable

Note the following accounting impacts have not been reflected in the journal entries above;

- repayments of loans granted to SOE
- dividends from the SOE
- external borrowings
- gains/losses on derivative financial instruments.

4 Budget impact and net debt considerations

4.1 Overview

We understand that one of the State's objectives for the Project is:

"Achieving value for money outcomes for the State and road users, whilst leveraging funding alternative sources that help limit the impact of the Project on the State balance sheet."

We understand that a key reason the State wants to minimise the impact on the balance sheet is so as to minimise any negative impact on State's credit rating as a result of the Project. Accordingly, we have been requested by the State to consider how the Western Distributor structure proposed in the Business Case would impact the credit rating.

This section considers how the proposed structure will impact the credit rating, specifically;

- Background to how credit ratings are determined and how credit ratings are impacted by the accounting treatment
- Key factors credit rating agencies may potentially consider when determining the net debt to operating revenue ratio
- Other factors credit rating agencies may consider in its assessment of credit rating.

4.2 The link between accounting treatment and credit rating

How is credit rating assessed?

The ability to repay future financial obligations is a key focus of the credit rating agencies, namely Standard & Poor's ("S&P's") and Moody's Investor Services ("Moody's").

The credit rating agencies base credit ratings on qualitative and quantitative analysis of a range of financial, economic, fiscal stability and institutional factors. While each agency may weigh the various factors differently, they each have a framework that establishes a quantifiable score set specifically for each Government which is then used to monitor the current and forecast financial results. To demonstrate, we have outlined the key criteria used in S&P's analysis for assessing the credit rating of non-U.S. local and regional governments[1];

[1] Standard & Poor's Credit Rating Portal Ratings Direct Methodology For Rating Non-U.S. Local And Regional Governments June 2014, Table 18

1)	Institutional framework	Defines the environment it operates in including the wider political, institutional, administrative, and budgetary systems of the country in which it is located. Measures how the predictability, reliability and supportiveness of public finance systems and legislative frameworks are likely to affect to ability to service debt in the long term.
2)	Economy	Measures how economic factors are likely to affect revenue generation capability and spending needs and ultimately the ability to service debt in the medium to long term. Key ratio: GDP per capita
3)	Financial management	Measures how the quality of financial management and its political context are likely to affect ability to service debt over time.
4)	Budgetary flexibility	Measures how much revenues could be increased or expenditures reduced in the case of need to maintain debt servicing ability. Key ratio: modifiable revenues as % of adjusted operating revenues
5)	Budgetary performance	Measures the level and volatility of expected cash flows (from operations and investment activities) that are available to service debt. Key ratio: Balance after capital accounts as % of total adjusted revenues
6)	Liquidity	Measures how internal sources of liquidity, such as cash reserves and cash flow generation, and external sources, namely bank lines and market access are likely to affect debt servicing capability. Key ratio: free cash, liquid assets, and committed undrawn bank lines as % of next 12 months' debt
7)	Debt burden	Measures how expectations for the level, structure and sustainability of debt are likely to affect debt servicing capability. A public sector payment stream (availability payment) is likely to be added to Debt Burden where risk transfer is minimal. Toll arrangements are unlikely to be added to Debt Burden but are considered as contingencies due to potential political, economic or stated guarantees to support private partner performance. These contingencies are considered in 8). Key ratio: tax-supported debt as % of consolidated operating revenues.
8)	Contingent liabilities	The size and quality of contingent liabilities can have a material impact on the creditworthiness of a government.

Whilst we are not in the position to conclude on the credit rating impact given the combination of considerations undertaken by the credit rating agencies, we do note that the net debt to operating revenue ratio is based on publicly reported information. The ratio has a more pronounced impact on the credit rating as it is the measure that is typically more subject to change year on year.

How is net debt calculated by credit rating agencies?

Net debt is a term that is used for Government Finance Statistics ("GFS") reporting purposes, and is defined in the ABS GFS manual or the related document Australian System of Government Finance Statistics as follows:[2]

"Net debt, previously published in the now discontinued publication Public Sector Financial Assets and Liabilities, Australia (catalogue. no. 5513.0) is included in the balance sheet presentation for information. It is equal to (deposits held plus proceeds from advances plus borrowing) minus (cash and deposits plus investments plus advances outstanding)".

Government activities covered by the GFS system include not only the functions of government departments and authorities that are financed primarily from taxation but also the operations of government-owned corporations and authorities[3]. Therefore, the definition of net debt above would include the debt of government-owned corporations including those that are self-supporting.

Accordingly, the State reports its net debt position based on the underlying accounting treatment, that is, whether transactions are classified on balance sheet as financial assets or financial liabilities in accordance with Australian Accounting Standards.

In the credit rating agencies assessment of debt burden further adjustment is made to the State's reported net debt. For example S&P's equivalent to net debt is "tax supported" debt which includes the following items[4];

- Direct debt of the local or regional government;
- Guaranteed debt of government related entities or other entities that are not self-supporting
- Non-guaranteed debt of government related entities that are not self-supporting
- Debt of non-cash government related entities, when the long-term rating on the government related entities is the same as the long-term rating on the local or regional government, based on our opinion of an "almost certain" likelihood that the local regional government will provide support
- Debt of PPPs and securitizations, when the risk transfer to the private sector is not material enough to treat the public sector entity's financial commitment as a contingent liability.

Based on S&P's definition, tax-supported debt excludes guaranteed and unguaranteed debt of government related entities that are self-supporting. This is a point of difference to the State's net debt (based on accounting), that is, if there is a financial liability in an entity that is classified as self-supporting this would be excluded from S&P's net debt calculations.

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[2] Australian Bureau of Statistics (ABS) publications Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005 (ABS Catalogue No. 5514.0) and Amendments to Australian System of Government Finance Statistics, 2005 (ABS Catalogue No. 5514.0) published on the ABS website.

[3] Australian Bureau of Statistics (ABS) publications Australian System of Government Finance Statistics: Concepts, Sources and Methods, 2005 (ABS Catalogue No. 5514.0) and Amendments to Australian System of Government Finance Statistics, 2005 (ABS Catalogue No. 5514.0) published on the ABS website.

[4] Standard & Poor's Credit Rating Portal Ratings Direct Methodology For Rating Non-U.S. Local And Regional Governments June 2014, paragraph 176

Moody's also uses net debt in its credit rating assessment; this is referred to by Moody's as "net direct and indirect debt". Moody's determines net direct and indirect debt as follows[5]:

"…debt guaranteed by the regional and local government ("RLG"), debt obligations issued by majority-owned enterprises that may or may not be guaranteed by the RLG and debt-like instruments or commitments such as capital leases, public-private partnerships ("PPP") and securitization transactions for which the RLG is or may become responsible."

However, debts of government-owned entities that are deemed self-supporting, generating sufficient funds to support their operations including interest payments, can be deducted from the RLG's measure of net direct and indirect debt."

Therefore, similar to S&P, Moody's net direct and indirect debt excludes the debt of government-owned entities which are deemed to be self-supporting.

What is self-supporting?

Self-supporting debt is defined by S&P as the debt of a government related entity that does not need financial support from its local or regional government and is unlikely to require support in the future. Financial support includes any direct or indirect contribution aiming at balancing operating accounts, financing investments, or repaying debt[6].

In its definition of self-supporting debt, S&P notes that when a government related entity receives sizable revenues from its local or regional government for a service, S&P evaluates the exchange as if it were remuneration at market rates for a service that could be provided in comparable terms by a private contractor[7]. Therefore if it is determined that the revenues are at market rates and the services could be provided in comparable terms by a private contractor, these revenues would not be considered support from the local or regional government.

Moody's defines self-supporting as a government-owned entity that generates sufficient funds to support their operations[8]. This support could be in the way of interest payments. This definition appears to be consistent with S&P's definition.

Self-supporting entities generally have investment-grade stand-alone credit profile (SACP) or estimated creditworthiness if the SACP is not formally established[9].

Could a State-owned tolling company be classified as self-supporting?

There are examples of utility entities that are considered self-supporting; however, we are not aware of any precedent to date in Australia where a tolling government related entity is considered self-supporting. However in the credit rating

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5 Moody's Investment Service Rating Methodology Regional and Local Governments, January 18 2013. This methodology applies to regional and local governments outside the US.

6 Standard & Poor's Credit Rating Portal Ratings Direct Methodology For Rating Non-U.S. Local And Regional Governments June 2014, paragraph 178

7 Standard & Poor's Credit Rating Portal Ratings Direct Methodology For Rating Non-U.S. Local And Regional Governments June 2014, paragraph 178

8 Moody's Investment Service Rating Methodology Regional and Local Governments, January 18 2013. This methodology applies to regional and local governments outside the US.

9 Standard & Poor's Credit Rating Portal Ratings Direct Methodology For Rating Non-U.S. Local And Regional Governments June 2014, paragraph 178

assessment for British Columbia, Canada, S&P concluded that the Transportation Investment Corporation is considered to be self-supporting.[10] The Transportation Investment Corporation holds a toll road called the Port Mann/Highway 1. There is a current expansion project being undertaken to widen the highway, add special purpose ramps, and add a new bridge.

Could the SOE be classified as self-supporting?

We strongly encourage the State to engage in discussions with the credit rating agencies about whether the SOE would be considered self-supporting under the proposed model. Typically historical performance of an entity is required to demonstrate that the entity is not budget dependent; ie is self-supporting. If the SOE is considered as a "self-supporting" entity then its debt will be excluded from the State's net debt calculation.

4.3 Determining net debt impact of proposed structure

What are the accounting impacts of the transaction?

Section 3.3 of this report outlines the accounting consequences of the proposed transaction by entity. A high level summary of the initial balance sheet accounting consequences is presented in table 2.1 below.

Table 2.1: Summary initial balance sheet impact over the construction phase under current accounting framework for the proposed structure

GGS	PNFC
Financial asset – represents loans from the State to SOE during construction	Cash – represents the cash received from the State. Cash will reduce as the payments are made.
Financial Liability – represents a reduction is cash/increase in borrowings	Financial Liability – Represents loan received from the State
	Lease Liability – represents availability payment obligations to the concessionaire over the concession period. The liability will reduce as cash payments are made and will offset the reduction in cash.

Is the SOE considered to be self – supporting?

The proposed structure outlined in Section 3.1 of this report includes a SOE, which is a 100% State owned special purpose vehicle. The classification of this entity is expected to be a Public Non-Financing Company ("PNFC"). Given the classification as an PNFC, a credit rating agency would assess whether a PNFC entity is self-supporting when calculating 'adjusted' net debt (or the equivalent term used by credit rating agencies, for example tax-supported debt).

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[10] Standard & Poor's Rating Services, Ratings Direct, Supplementary Analysis; British Columbia (Province of), 3 June 2015, page 4

Self-supporting classification is ultimately determined by the credit rating agencies and it is important to note that the self-supporting assessment is a case-by-case assessment, where the credit rating agencies will take into consideration both quantitative and qualitative factors reflecting the individuality of the arrangement.

Whilst we are not in the position to conclude that the SOE is a self-supporting entity, and effectively not dependent on the budget, we consider there to be certain factors that support SOE being a self-supporting entity. These factors are discussed below with reference to the financial analysis undertaken for the Project (contained in Attachment O: Financial Analysis to the Business Case).

Satisfying the factors below does not necessarily guarantee that the SOE will be considered self-supporting by the credit rating agencies. We strongly encourage the State to engage in discussions with the credit rating agencies about the credit rating impact of the proposed structure.

Reliability of cash flow forecasts for the SOE

- Robust cash flow forecasts support SOE's ability to fully service its debt through the toll revenue to be collected. The work on the forecasts include, well-tested assumptions, robust traffic volume forecasts, and discount rates used in the cash flow model. The cash flow forecasts currently show head room that supports repayment of debt as well as a significant dividend stream over time.
- A point of difference for this SOE is that majority of the forecasted revenue is based on proven traffic volumes, [redacted] The majority of forecasted cash inflows are from the CityLink extension (ie existing toll road) and the West Gate Freeway (ie the existing road with proven traffic volumes). There is independent expert evidence to support the forecasted usage of the roads (for example data supporting that the roads are currently at capacity; the ability for the users to choose alternative route is limited; and the proposed tolls charged to the heavy commercial vehicles on the West Gate Freeway are not expected to significantly impact the usage of the road etc.).
- It is acknowledged that the significant cash flows are not expected to be collected by SOE until 2035; this has been considered in the structuring of the debt repayment profile to the State to be based on high cash flow coverage.

Positive operating cash flow

- It is forecasted that the SOE is cash flow positive from the first day of operations. The positive cash flow is driven by the tolls collected on the Western Distributor and West Gate Freeway upgrade.
- The lease liability reflects the capital component of the availability payments. These will be funded by the loan provided by the State during the construction phase.
- There will be several loans between the State and the SOE. These loans will be drawn down during both the construction phase and the operations phase. The loans will be paid back throughout the concession term, with most of the repayments occurring after 2035 when the CityLink toll revenues are received.

Transactions with the State and SOE are at market terms.

- The inter-entity loan and "on-call" debt facility between the State and the SOE are on an arm's length basis with market terms, rates and covenants. The SOE would be able to go to the market and get an equivalent loan/facility. There are no financial guarantees between the State and SOE.

If SOE is considered self-supporting what is the impact on net debt?

If the credit rating agencies were to conclude SOE meets the definition of a self-supporting entity, any financial assets or financial liabilities of SOE would be excluded from the net debt calculation and SOE revenue would be excluded from operating revenue. We expect that the proposed transaction would not have a significant impact on net debt and the metric net debt to operating revenue however there could be a slight increase in revenue from 2035 due to dividends and interest received by the State from SOE.

4.4 Broader credit rating considerations

The State's credit rating is assessed on a variety of qualitative and quantitative factors, including the debt burden of its general government sector and related government entities. We anticipate the credit rating agencies would consider the following factors in their assessment. We note this is not an exhaustive list of factors that might be considered by the credit rating agencies.

- *Liquidity* makes up part of the assessment for both S&Ps and Moody's overall credit rating assessment. The repayment of the State's financial receivable from SOE is reliant on toll revenue from the CityLink concession extension from 2035. The time frame of repayment is expected be analysed by the credit rating agencies in their liquidity assessment.
- *Limited precedent* of a toll road being classified as a self-supporting entity may be a concern. This potentially could be mitigated through transparent discussions with the credit rating agencies on the intended economics of the transaction.

Example 3.0 Illustrative example for net debt to operating revenue ratio implications

Under the current and future accounting framework, the net debt to operating revenue ratio implications of the proposed structure may be considered to be as follows:

Table 3.1 – Net debt to operating revenue impact for Whole of Government if self-supporting classicisation is achieved for the SOE

Entity	Net debt impact	Operating revenue impact	Net debt to operating revenue ratio implications	Timing of net debt to operating revenue ratio impact
State (GGS)	• Increase in loan receivables (financial asset) • Decrease in cash and/or increase in external borrowings (financial liability)	• Interest income on loan to SOE • Dividend income from the SOE	Minimal impact on net debt as the decrease in cash and/or external borrowings would be offset by the loan receivable from the SOE. There would be a slight increase in operating revenues due to interest and dividend income being received from the SOE. Note this assumes that interest and dividend income is included in the credit rating agencies definition of operating income.	Timing of impact is dependent on the recognition of interest and dividend income.

Entity	Net debt impact	Operating revenue impact	Net debt to operating revenue ratio implications	Timing of net debt to operating revenue ratio impact
SOE	• No finance lease liability (current accounting) or financial liability (future accounting) would be included in the Whole of Government assessment because the debt of the SOE would be excluded if it is classified as self-supporting. • No loan payable would be included in the Whole of Government assessment because the debt of the SOE would be excluded if it is classified as self-supporting.	• No toll revenues would be recorded because the operating revenue of the SOE would be excluded if it is self-supporting.	The SOE's net debt and operating revenue would have no impact on the Whole of Government's net debt to operating revenue ratio if it is considered self-supporting.	Not applicable.

Table 3.2 – Net debt to operating revenue impact for Whole of Government if self-supporting classicisation is NOT achieved for the SOE

Entity	Net debt impact	Operating revenue impact	Net debt to operating revenue ratio implications	Timing of net debt to operating revenue ratio impact
State (GGS)	• Increase in loan receivables (financial asset) • Decrease in cash and/or increase in external borrowings (financial liability)	• Increase in interest income from interest on loan to SOE • Increase in dividend income dividends received from the SOE	Minimal impact on net debt as the decrease in cash and/or external borrowings would be offset by the loan receivable from the SOE. There would be a slight increase in operating revenues due to interest and dividend income being received from the SOE. Note this assumes that interest and dividend income is included in the credit rating agencies definition of operating income.	Timing of impact is dependent on the recognition of interest and dividend income.
SOE	• Increase in cash from State that has not yet been transferred to the PPP consortium • Increase in finance lease liability (current accounting) or financial liability (future accounting) to the PPP consortium • Increase in loan payable to the State (financial liability).	• Toll revenue	The finance lease liability (current accounting) or financial liability (future accounting) would increase net debt and therefore have a negative impact on the net debt to operating revenue ratio. This impact would be reduced by any cash in the SOE that has not yet been transferred to the PPP consortium. The loan payable to the State would increase net debt and therefore have a negative impact on the net debt to operating revenue ratio. Operating income would increase for toll revenues.	*Current accounting* Net debt will be impacted at the lease commencement date (Day 1 of the operation phase) when the finance lease liability is recorded. Timing of impact on operating revenues is dependent on the recognition of toll revenue. *Future accounting* Net debt will be impacted when construction commences on the Project assets. Timing of impact on operating revenues is dependent on the recognition of toll revenue.

Appendices

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Appendix A AASB pronouncements

In considering the matters above, we have made reference to the following official pronouncements:

- AASB 10 – *Consolidated Financial Statements* (“AASB 10”) Compiled July 2015.
- AASB 13 – *Fair Value* (“AASB 13”) Compiled August 2015.
- AASB 15 – *Revenue from Contracts with Customers* (“AASB 15”) Compiled December 2014.
- AASB 117 – *Leases* (“AASB 117”) Compiled August 2015.
- AASB 118 – *Revenue* (“AASB 118”) Compiled December 2013.
- AASB 124 – *Related Party Disclosures* (“AASB 124”) Compiled July 2015.
- AASB 132 – *Financial Instruments: Presentation* (“AASB 132”) Compiled August 2015.
- AASB 139 – *Financial Instruments: Recognition and Measurement* (“AASB 139”) Compiled August 2015.
- AASB 1004 – *Contributions* (“AASB 1004”) Compiled January 2015.
- Exposure Draft 261 – *Service Concession Arrangements: Grantor* (“ED 261”) released May 2015.

Appendix B Further accounting guidance for service concession arrangements

1. What is the accounting framework that currently applies for service concession arrangements?

The authoritative guidance for the accounting of service concession arrangements is provided in Interpretation 12, but it only specifies the accounting for the operator. It is well documented that there has been no definitive guidance for Grantor accounting issued by either the IASB or the AASB. The topic is being considered by the AASB, following the release of a standard by the International Public Sector Accounting Standards Board ('IPSASB'). An exposure draft of a proposed standard, ED 261, was released in May 2015 with responses due in July 2015. The AASB is currently deliberating on the responses to ED 261 and a standard is expected to be released by October 2016. It is proposed that an entity would apply this draft standard to annual reporting periods beginning on or after 1 January 2017, with early adoption permitted. In the absence of any authoritative guidance in Australia each Australian state government has, over the past decade, determined the most appropriate accounting policy to be applied by governments in relation to transactions of this nature.

Grantors for PPP transactions typically account for the obligations of the grantor as a finance lease. This view was endorsed as a preferred model by a Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) paper issued in 2004/05 and was broadly drawn from principles established in Financial Reporting Standard FRS 5 *Reporting the Substance of Transactions* – Application Note F "Private Finance Initiative and Similar Contracts" (FRS 5) issued by the UK accounting standard setter in 1998.

This approach is more broadly described as a "risk and rewards" approach. The approach involves assessing the risks and rewards of each party to determine whether the grantor or operator will recognise the asset. The asset will be recognised by the entity that is exposed to the majority of the risks and rewards embodied in the asset. Potential risks and rewards incidental to ownership that may be considered in the assessment includes, demands risks, responsibility for performance related penalties, availability to the asset, residual risk and obsolescence. The approach does not involve splitting the asset between the grantor and the operator. Current accounting standards for non-financial assets do not contemplate 'unbundling" components of non-financial assets in this way. In considering aspects of accounting for PPP transactions in December 2007, the AASB made this clear. AASB Agenda Paper 12.11, states that the recognition of the asset cannot be split based on the proportionate share of risk and rewards, an asset must be recognised in full.

Most PPP transactions will be classified as either an Availability or User Pay model. Using the risks and rewards approach mentioned above, there is established and broadly accepted accounting for PPP transactions in each classification across each jurisdiction in Australia. The application of a risk and rewards approach results in the following treatment:

- Availability PPP's are recorded on balance sheet as a finance lease asset and liability, with measurement based on the lower of the minimum lease payments and the fair value of the asset, and recognised on the balance sheet at the lease commencement date (once construction is complete).
- User-pay PPP's do not require the grantor to make any payments to the operator. Applying a risks and rewards model will typically result in a conclusion that the operator has the majority of the risks and rewards of the asset. This is because of the operator's exposure to demand risk. For this type of arrangement there is another aspect to consider. Often, the asset which is the subject of the arrangement is intended to be transferred to the grantor at the end of the concession. There is some diversity in practice around the recognition of this "residual interest" in the asset. The two policies currently adopted are to recognise the residual interest gradually over the concession term or to recognise the asset at the end of the concession term.

The risks and rewards approach was acknowledged by the AASB in 2007 to represent one of three acceptable approaches to accounting for a grantor's participation in PPP arrangements.

Returning to first principles: What other accounting models could be applied?

As noted above, in 2007, the AASB considered a range of alternative accounting treatments for grantors of PPP transactions. This report was prepared specifically in response to the introduction of Interpretation 12, and whether the introduction of that interpretation should have an impact on the selected policy of the grantor. The report considered four alternative policies:

Alternative approach	Description
Substantially all/majority of risks and rewards	Assessment of which entity has majority of the risks and rewards to determine whether the grantor or operator would recognise the asset. Asset is recognised in full. This approach draws from the lease accounting literature.
Control	The entity that is expected to receive the future economic benefits of the asset and controls the use of the asset would recognise the asset. This approach draws from the literature dealing with property, plant and equipment, AASB 116 *Property, Plant and Equipment*.
Timing of control or regulation	The entity that controls or regulates the use of the asset would recognise it. This approach draws from Interpretation 12, applying the mirror of the accounting for the operator to the grantor by analogy. The criteria includes that the grantor would be regarded as controlling the asset where it controls services, availability of service and the price.

Alternative approach	Description
Rights and obligations	The asset is viewed to have a number of future economic benefits that can be shared amongst the parties; accordingly a partial asset could be recognised by the grantor. This approach was rejected by the AASB as it was not founded on the accounting principles embodied in the Australian accounting literature for non-financial assets.

More recently, an accounting standard has been developed by the IPSASB to apply to grantors involved in PPP arrangements. The IPSASB approach is consistent with the control or regulation approach noted above. The proposed grantor guidance under ED 261 adopts a "control or regulated" approach to account for service concession arrangements which mirrors the operator's accounting under *Interpretation 12 Service Concession Arrangements*. Under this approach the State will recognise an asset provided by the operator and an upgrade to an existing asset of the State as a service concession asset if the State controls the asset.

The same accounting treatment for the Western Distributor proposal would be achieved under both the control model and the IPSASB's control or regulation model.

One question to consider now is whether the release of the IPSASB standard and the AASB's current deliberations on ED 261 mean that the risks and rewards approach can no longer be regarded as an appropriate basis for determining the accounting for the State's participation in the Western Distributor.

When the accounting treatment for a particular transaction is not prescribed by an Australian accounting standard, preparers of financial statements must follow the requirements of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop a relevant and reliable policy for the transaction. Paragraphs 11 and 12 of that standard specify that the policy should be developed giving priority to the requirements in Australian Accounting Standards dealing with similar and related issues and the concepts set out in the *Framework for the Preparation and Presentation of Financial Statements*. Preparers **may** also consider the most recent pronouncements of other standard setting bodies to the extent that these do not conflict with the Australian Accounting Standards and the Framework.

These paragraphs make clear that the IPSASB standard and ED 261 should not be given greater weight than existing Australian Accounting Standards in developing the accounting policy to apply to hybrid PPPs. Instead, it remains appropriate for the State's policy to be founded on the control approach or the risks and rewards approach, subject to the expectation set out in paragraph 10 of AASB 108 that the resultant information is relevant and reliable.

How does the control based model compare with the risks and rewards approach?

Set out below is a broad overview of the different accounting outcomes that would arise on application of the current State accounting policy compared to the alternative control based approach for a hybrid PPP.

	Current State policy	Alternative control approach *
Measurement of asset	Initially, asset value is limited to the present value of the minimum lease payments. This is represented by the fixed obligation for the grantor to make payments (essentially the availability component of the arrangement).	Asset value is recorded in full based on the fair value of the asset under construction.
Components of liability	Liabilities are only recognised to the extent there is a direct obligation. Where no payments are required by the grantor, that component is not recorded as a liability. Therefore liability recognition will only exist for the lease component and an assessment will be required of any contingent elements to assess recognition under AASB 139.	Similar to the current state policy, a liability is recognised for the availability component and any contingent payment obligation. The user pays component of the arrangement means that the State does not have a liability for the entire financing of the asset. The difference between the value of the asset it controls and the liability represents a gain that is enjoyed by the State through having a third party finance part of the construction of the asset.
Timing of recognition	Under lease accounting, there is explicit lease recognition at the lease commencement date which is determined to be once construction is completed and the asset put into operation.	The allocation of construction risks and the contractual obligations of the parties during the construction term would need to be assessed to determine whether recognition of the asset/liability during construction would be required.

Conclusion on the merits of adopting the control based model

It would be possible for the State to adopt the control model summarised above to account for the Western Distributor arrangement.

It is likely that a standard on grantor accounting for service concession arrangements will be released by the AASB before the Western Distributor Project has commenced. Early adoption of the proposed AASB standards is expected to the permitted; the State should consider whether early adoption of the standard is appropriate. This will eliminate the need for the State to transition to the emerging guidance after the Project is underway.

Assessment of other available accounting literature

The IPSASB is a public sector accounting standard setting body which released IPSAS 32, a standard that addresses accounting for concession arrangements from the grantor perspective. The AASB does not require these standards to be mandatorily adopted however they may be considered. It is intended to mirror Interpretation 12 and the scope; principals for recognition of an asset and terminology are consistent with the applicable guidance in Interpretation 12. As discussed above Interpretation 12 applies to service concession arrangements from the operator's perspective and as such we have considered Interpretation 12 by analogy to support the analysis of the accounting from the grantor's perspective.

Interpretation 12 paragraph 5 defines service concession arrangements that fall within the scope of the Interpretation. This arrangement is deemed to fall within the scope of Interpretation 12 for the operator because

1. the State controls or regulates the services that the Consortium must provide with the infrastructure as the road must be operated as a public road (ie all public can chose to drive on the road should they choose),

2. the State controls or regulates to whom the service must be provided and at what price the service is provided,

3. the State controls, through ownership, the residual interest in the road at the end of the arrangement, and

4. the Consortium will construct the infrastructure for the purpose of this service arrangement.

Through analysis of Interpretation 12 Note 1, as the PPP consortium has a contractual right to receive cash from the State, the Consortium will recognise a financial receivable. It is the State and not the PPP consortium that will recognise the service concession asset on their balance sheet. Accordingly, the mirror to this accounting for the grantor if Interpretation 12 applied is that the State should record a financial liability and the service concession asset on their balance sheet.

Appendix C Other accounting guidance

Consolidation

Entities that are controlled by the State will have their assets and liabilities consolidated on the State's balance sheet. When determining if the State controls an entity, the principles to be followed are outlined in AASB 10. AASB 10 focuses on the concept of control as the determining factor in whether an entity should be included within consolidated financial statements.

AASB 10 requires all of the following for one entity (an investor, in this case the State) to control another (an investee, the SOE):

- Power over the investee
- Exposure or rights to variable returns
- The ability to use the power over the investee to affect the amount of the investee's returns.

For public sector entities, the guidance for control under AASB 10 has focused on the power that an investor has to effect decisions.

Whether the State has the power to affect an entity's (ie the SOE's) returns will depend on whether the State's has the ability to direct the entity's operations for the benefit of the State. The State's power over the investee's relevant activities that affect returns means that the State has the ability to impact the variability of the entity's returns.

Toll revenue from the State

Current Accounting

AASB 118 is the current guidance which would need to be applied to account for toll revenues collected by the SOE. AASB 118 applies to revenue arising from the sale of goods, the rendering of services and interest, royalties and dividends.

Under the proposed model the SOE would recognise toll revenue when customers utilise the toll roads. In accordance with AASB 118 paragraph 20, "when the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion."

The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

1. the amount of revenue can be measured reliably
2. it is probable that the economic benefits associated with the transaction will flow to the SOE
3. the stage of completion of the transaction at the end of the reporting period can be measured reliably
4. the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

In accordance with AASB 118, the SOE would measure revenues at the fair value of the consideration received or receivable. Note that fair value under AASB 118 assumes that the transaction occurs between market participants in an orderly transaction.

Future Guidance

AASB 15 will be operative for periods beginning on or after 1 January 2017 and will be applicable to the toll revenues. Based on a high level assessment, we expect that the new guidance would have no significant impact on the accounting for toll revenues collected by the SOE. On transition to AASB 15, the State will need to undertake a robust assessment of the requirements of AASB 15 and confirm that there are no impacts.

Financial liabilities

AASB 132 provides guidance on the presentation of financial instruments and AASB 139 provides guidance on recognition and measurement of financial instruments.

AASB 132 paragraph 11 defines a financial liability as a:

"(a) a contractual obligation:

i) to deliver cash or another financial asset to another entity; or

ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity.

(b) a contract that will or may be settled in the entity's own equity instruments and is:

i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments."

Recognition of the liability

An entity should only recognise a financial liability when it becomes party to the contractual provisions of the instrument. This occurs when the contract is entered into and one of the parties' fulfills their obligation under the contract. In the case of a loan, this occurs when cash is paid to the party issuing the financial liability.

The recognition of the finance lease liability under the current guidance for service concession arrangements, AASB 117, has been discussed in Section 2.3.

Under the future guidance for service concession arrangements, the grantor recognises a financial liability when they have an obligation to make payments to the operator. In accordance with AASB 139 paragraph 14 a liability should be recognised when an entity becomes party to the contractual provisions of the arrangement.

Measurement of the liability

Financial liabilities must be measured at fair value on initial recognition in accordance with AASB 139 paragraph 43. After initial recognition the liability should be measured at amortised cost using the effective interest method during both the construction and operating term of the arrangement. The effective interest method is a method of calculating the amortised cost of the financial liability and of allocating the interest over the relevant period. The effective interest rate is the rate that exactly discounts the estimated future cash flows through the financial instrument's expected life, and is calculated by considering all the contractual terms, including all construction related fees and amounts paid or received between the PPP consortium and the SOE.

Derivative instruments

AASB 139 paragraph 9 defines a derivative as a financial instrument that has all of the three characteristics:

1. its value changes in response to the change in specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable

2. it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

3. it is settled at a future date.

The first criterion is that the value of the financial instrument changes in response to a change in variable. This criterion would be met if the interest rate on an "on-call" facility that is expected to be drawn down over a prolonged period of time is fixed.

Based on the terms of the "on-call" debt facility between the SOE and the State, a derivative could exist. Criteria (b) and (c) would be met under the proposed arrangement. Criterial (a) would be met if the interest rate of the "on-call" debt facility is fixed.

If there is a derivative financial instrument, it would have a nil value on initial recognition. Subsequent to initial recognition, a derivative must be measured at fair value with any change in value recorded in the profit or loss.

Related party considerations

The loan between the State and SOE would be considered a related party transaction and therefore the State would need to disclose the following in their stand-alone financial statements in accordance with AASB 124, paragraph 27:

1. significance of the transaction in terms of size;

2. whether it is carried out on non-market terms;

3. whether it is outside normal day-to-day business operations;

4. whether it is disclosed to regulatory or supervisory authorities;

5. whether it is reported to senior management; and

6. whether is it subject to shareholder approval.

Fair value of the service concession asset

ED 261 makes reference to AASB 13 to determine the fair value of the service concession assets upon initial recognition.

In measuring fair value of public sector assets, such as toll roads, under AASB 13 it is likely that current replacement cost or the discounted cash flow for tolling will be used.

Contributions from the Commonwealth

As outlined in the Business Case, it has been assumed that the Commonwealth support will be in the form of a grant. Grants are accounted for under AASB 1004. A grant is considered a non-reciprocal transfer and is therefore deemed a contribution. The grant should be recognised as income by the transferee when the transferee gets control over the grant, irrespective of whether restrictions or conditions are imposed it use.

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