

Essential Energy

Revised Cost Allocation Method

June 2017

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Inquiries about this publication should be addressed to:

Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Tel: (03) 9290 1444  
Fax: (03) 9290 1457

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)  
AER Reference: 56853

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# Shortened forms

|  |  |
| --- | --- |
| Table text heading |  |
| AER | Australian Energy Regulator |
| CAM | Cost Allocation Method |
| Distributor, DNSP | Distribution Network Service Provider |
| NEL | National Electricity Law |
| NEM | National Electricity Market |
| Rules, NER | National Electricity Market Rules |
| guidelines | Distribution Cost Allocation Guidelines |

# Introduction

## Summary

On 2 June 2017 Essential Energy submitted a revised Cost Allocation Method (CAM) — see Appendix A to this paper.[[1]](#footnote-1) Essential Energy is a state owned corporation of the New South Wales (NSW) Government, providing electricity distribution services in NSW. A CAM is used to separately account for the costs of providing electricity distribution services, including from other services the distributor might provide. Essential Energy proposed its revised CAM take effect from 1 July 2017.

We have determined Essential Energy's proposed CAM:

* accords with the requirements of the National Electricity Law (NEL) and National Electricity Rules (the rules)
* gives effect to and is consistent with our Distribution Cost Allocation Guidelines (distribution guidelines)

Accordingly, we have approved Essential Energy's proposed CAM under clause 6.15.4(c) of the rules.

## Background

We are responsible for regulating revenues of electricity distribution businesses in the National Electricity Market (NEM) in accordance with the NEL and the rules. Chapter 6 of the rules deals with economic regulation of electricity distribution services.

Cost allocation concerns attributing a regulated business' costs, or allocating shared costs, between distribution service categories and non-regulated business sections. The different service categories are defined in the NEL and the rules. The CAM allocates costs between:

* direct control services, comprising:
* standard control services
* alternative control services
* negotiated distribution services
* unclassified, or unregulated, services.

In our distribution determinations we classify distributor services to the above categories based on factors specified by the rules. The prices DNSPs charge for the different categories of distribution services depend on the costs incurred in providing those services. It is therefore important cost allocation between service classifications accurately and fairly represents costs incurred in providing those services. We rely upon historical and forecast costs allocated in accordance with an approved CAM to determine prices charged, or revenues raised, by distributors such as Essential Energy.

Distribution regulatory proposals, or the regulatory arrangements proposed by DNSPs to us for a particular regulatory control period, must comply with an approved CAM. The revised CAM subject to this decision paper will be used by Essential Energy to develop its distribution regulatory proposals. Essential Energy will also use its revised CAM to report to us annually for its distribution regulated business.

Following our approval, Essential Energy's revised CAM will remain relevant to its statutory accounts, reporting and regulatory proposals until we approve a further CAM variation.

# Rule requirements and assessment

## The rule requirements

For DNSPs:

* Clause 6.15.4(a) of the rules requires a DNSP to submit to us for approval a document setting out its proposed CAM.
* Clause 6.15.4(b) requires that a CAM give effect to and be consistent with our distribution guidelines.
* Clause 6.15.4(c) provides for us to approve or refuse to approve a CAM submitted under paragraph (a).
* Clause 6.15.4(f) provides for a DNSP to amend its CAM from time to time, subject to our approval.

## Assessment process

Essential Energy submitted a draft of its proposed CAM on 26 April 2017. We assessed the draft proposed CAM. Resulting from this assessment, Essential Energy was provided with feedback that limited corrections were required to permit approval of the CAM.

The results of our assessment of Essential Energy's revised proposed CAM against the requirements of our guidelines are set out in section 3 of this paper.

## Essential Energy CAM revisions and structure

Essential Energy sought AER approval of the attached amended CAM under clause 6.15.4(f) of the rules. Essential Energy submitted that a major driver of revisions to its CAM is change to its corporate structure following the dissolution of Networks NSW.[[2]](#footnote-2) Essential Energy submitted that a further driver for its CAM revision is to demonstrate its compliance with our Ring Fencing Guideline (RFG), the cost allocation principles and its cost attribution obligations. We accept the organisational changes and compliance obligations are significant and justify a revised CAM for Essential Energy.

In proposing revisions to its CAM, Essential Energy proposed to replace its existing eight shared cost allocators (or drivers) with a single allocator—direct costs. Under this proposal Essential Energy’s shared costs (such as its HR and other corporate costs) would be allocated to service categories in the same proportions as directly attributable costs are attributed to service categories. Essential Energy submitted that simplifying its shared cost allocation arrangements will:[[3]](#footnote-3)

* enable monthly allocation, rather than annually
* realise efficiencies, in the form of reduced staff time, in compiling information for submission to the AER.

Essential Energy submitted analysis indicating that the new cost allocation arrangements would leave standard control costs almost unchanged from the current CAM.[[4]](#footnote-4) However, some alternative control costs would be impacted with costs shifting, for example, from metering to other alternative control services.[[5]](#footnote-5)

We consider Essential Energy’s proposal to adopt direct costs as the sole shared cost allocator is, on balance, reasonable. Essential Energy’s proposed new allocator is simple to understand, straightforward to replicate and sufficiently causal. While for any single shared cost category there may be a more causal allocator than direct costs, the advantages from using a single allocator are significant. Those advantages must be weighed against the potential benefits from applying a range of different allocators. Essential Energy submitted analysis indicating there would be minimal differences in outcomes whether direct cost is used or other, more tailored, allocators.[[6]](#footnote-6)

Because costs are expected to shift between some alternative control services we will require Essential Energy to submit to us back-cast historical information. This means Essential Energy will recalibrate its recorded cost information, over a number of years, to match its new CAM and re-submit this information to us. We require this to ensure we have appropriate time series information available for analysis when we assess Essential Energy’s future distribution regulatory proposals.

# Consistency with our cost allocation guidelines

This section sets out our assessment of Essential Energy's proposed CAM against the requirements of our guidelines.

## Essential Energy's CAM assessment

The format and content of Essential Energy's CAM are regulated by clause 3.2(a) of our distribution guidelines. Table 1 compares Essential Energy's proposed CAM against the requirements of clause 3.2(a).

|  |  |
| --- | --- |
| Clause 3.2(a) of the AER’s Distribution Cost Allocation Guidelines | CAM references |
| (1)-(2) A version history and date of issue for the document | Compliant. See page 3. |
| (3) A statement of the nature, scope and purpose of the document and the way in which it is to be used by the distributor. | Compliant. See page 4. |
| (3) Details of the accountabilities within the distributor for the document in order to set out clearly:  A. the distributor's commitment to implementing the CAM; and  B. responsibilities within the distributor for updating, maintaining and applying the CAM and for internally monitoring and reporting on its application. | Compliant. See page 5. |
| (4) A description of the distributor's corporate and operational structure to enable the AER to understand how the distributor is organised to provide its distribution services. | Compliant. See page 6. |
| (5) A specification of the categories of distribution services that the distributor provides to which costs are to be attributed or allocated and the types of persons to whom those services are provided. | Compliant. See pages 6 to 7. |
| (6) The distributor's detailed principles and policies to be used for attributing costs directly to, or allocating costs between, categories of distribution services that meet the requirements of clause 2.2 of the Guidelines. For the avoidance of doubt, this includes the attribution or allocation of costs relating to any related party transactions. | Compliant. See pages 8 to 12. |
| (7) A description of how the distributor will maintain records of the attribution or allocation of costs to, or between, categories of distribution services to enable any such attribution or allocation to be:  A. demonstrated to the AER, in accordance with clause 5.2 of these Guidelines; and  B. audited or otherwise verified by a third party, including the AER, as required. | Compliant. See page 13. |
| (8) A description of how the distributor will monitor its compliance with the CAM and the Guidelines. | Compliant. See page 13. |
| (9) Details of the proposed date on which the CAM will commence, having regard for clause 4.1(d) of these Guidelines. | Compliant. See page 13. |

1. Essential Energy, *Cost Allocation Method*, May 2017. [↑](#footnote-ref-1)
2. Essential Energy, CAM Amendment Justification, April 2017, pp. 3-4. [↑](#footnote-ref-2)
3. Essential Energy, *CAM Amendment Justification*, April 2017, p. 4. [↑](#footnote-ref-3)
4. Essential Energy, *CAM Amendment Justification*, April 2017, p. 6. [↑](#footnote-ref-4)
5. The allocation of shared costs to Essential Energy’s water distribution business will also increase. [↑](#footnote-ref-5)
6. Essential Energy, *CAM Amendment Justification*, April 2017, pp. 5–6. [↑](#footnote-ref-6)