

4 June 2012

Mr Martin Priest
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CONFIDENTIAL

Dear Mr Priest

Review of Electricity Networks' Cost Allocation Methodology

In accordance with our letter of 16 November 2011 and the contract for the provision of services between ActewAGL Distribution and McGrathNicol, we are engaged to undertake a review of ActewAGL Networks Division's ("Networks") Cost Allocation Methodology ("CAM").

As part of our review activities, we have prepared a model that sets out alternative approaches for the allocation of overheads (both corporate and divisional) to projects, which ultimately impacts on the amount of expenditure attributed to capital projects versus operational projects.

We identified that the approach to the allocation of corporate overheads to Networks' divisions (known as the Fixed Price Service Charge ("FPSC")) has the potential to significantly impact the attribution of expenditure to capital and operational projects.

Networks' current method for allocating the FPSC to projects

The corporate overhead costs that form the basis for the FPSC are grouped into eight categories: Business system costs; Human resource costs; Logistics / purchasing costs; Legal fees, Accommodation costs; Finance-related costs, Executive Related costs and Safety costs. Corporate overheads are based on a number of cost drivers as determined by ActewAGL Finance. The FPSC allocated to Networks for the financial year ending 30 June 2012 totals \$22.8 million. It is noted that we have not reviewed the basis for the allocation of the FPSC to Networks.

The FPSC is recovered by Networks through a charge to projects by applying a percentage on-cost to direct labour. The impact of charging the FPSC to projects is that it will result in overheads being split between operating projects (such as maintenance) and capital projects. This ultimately leads to the classification of the FPSC charges as either operating or capital for the purposes of the revenue proposal for the upcoming regulatory period.

The split of the FPSC by expenditure (between capital, operating, regulated, unregulated) is based on the historical labour hours attributed to projects over a period of years (as determined by Networks). The current on-cost percentage applied to recover the FPSC to projects is a flat rate of 15 per cent per annum, and is applied to all Network cost centres (noting that only 12 cost centres currently charge time to projects and therefore recover these costs).

Based on the current flat percentage of 15 per cent per annum, it is projected that for the financial year ending 30 June 2012, the total amount of the FPSC allocated to projects through the direct labour on-cost will be \$5.5 million. Of the \$5.5 million allocated to projects, this will be allocated between operating expenditure projects and capital expenditure projects.

As a result, there is an amount of approximately \$17.3 million that is not allocated to projects. This amount remains in the profit and loss statement as an unallocated operating expense.

P7-120524-AAGLCAM01-lettreFPSC-MD

Alternative method of allocating the FPSC to projects

We have modelled a scenario where the amount of the FPSC allocated to projects is increased to full absorption. That is, where the full amount of corporate overheads (\$22.8 million) is allocated.

One way this could be achieved is by increasing the labour on-cost percentage from 15 per cent per annum to a rate sufficient to ensure the full FPSC is allocated. Alternatively, the FPSC could be allocated directly to projects based on other costs drivers such as direct materials, total project cost or a blended cost driver.

The AER's Cost Allocation Guidelines and Cost Allocation Principles

The AER enforces the National Electricity Law ("the NEL") and National Electricity Rules and is responsible for the economic regulation of Distribution Network Service Providers ("DNSPs") in the National Electricity Market ("the NEM").

In June 2008, the AER published a set of guidelines that provide direction for DNSPs in managing the attribution of direct costs and the allocation of shared costs between, and within, different categories of distribution services. Based on these guidelines, DNSPs are required to develop detailed principles and policies for the attribution of these costs.

The AER is responsible for approving each DNSP's CAM based on the criteria outlined in the NER and the AER's Electricity DNSP Cost Allocation Guidelines. The Cost Allocation Guidelines give effect to the Cost Allocation Principles.

The NER's Cost Allocation Principles represent the basic framework and requirements upon which a DNSP's CAM should be developed. The NER's Cost Allocation Principles, as detailed in Chapter 6.15.2 of the NER, require that:

- (1) A proposed CAM must be described in sufficient detail to enable the AER to replicate the reported outcomes through application of those principles and policies.
- (2) The allocation of costs must be determined according to the substance of a transaction or event rather than its legal form.
- (3) Costs directly attributable to business segments must be assigned accordingly, i.e. costs should be allocated to the relevant distribution services in which resources are consumed.
- (4) Shared costs incurred in providing several categories of distribution services must be allocated between these categories using appropriate causal allocators except to the extent that the shared cost is immaterial and a causal relationship cannot be established with undue costs and effort.
- (5) The same cost must not be allocated more than once.
- (6) The detailed principles, policies and approach used to attribute costs directly to or to allocate costs between categories of distributions services must be consistent with the Distribution Ring Fencing Guidelines.
- (7) Costs which have been attributed or allocated to a particular distribution service must not be reattributed or reallocated to another service during the course of a regulatory control period.

Assessment of whether the full allocation of the FPSC to projects is likely to be in accordance with the AER's Cost Allocation Guidelines and Cost Allocation Principles

Chapter 6.15.2 (4) of the Cost Allocation Principles indicates that shared costs should be allocated. Based on our review of the above principles, we consider that the allocation of a higher proportion of corporate overheads to projects (including up to 100% recovery) does not appear to be inconsistent with

the AER's Cost Allocation Principals. We also note that it is not inconsistent with practices adopted by other DNSPs¹.

The argument for allocating the full amount of the FPSC to projects would be based on the principle that ActewAGL would be able to demonstrate that the corporate activities (the cost of which to Networks is represented by the FPSC) support the operating divisions in the delivery of projects.

Basis of the allocation of the FPSC to projects

The FPSC is allocated by ActewAGL Finance to Networks based on a number of cost drivers (including drivers based on annual revenue, employees and indirect drivers). We consider that it is not necessary for the FPSC to be allocated by Networks to its projects based on the same drivers. Further, such an approach is likely to be inappropriate given the different nature of how the costs that constitute the FPSC arise, and how these are consumed by a project. The cost driver(s) used by Networks should be the best causal allocator, reflecting a project's consumption of the resources.

Currently, ActewAGL allocate the FPSC to projects through an on-cost to direct labour rates. This is on the basis that there is a causal relationship between direct labour and the consumption by Networks of the various categories of corporate overhead costs that constitute the FPSC. We consider that the allocation of the FPSC based on a labour on-cost percentage appears to be reasonable and consistent with the AER's Cost Allocation Guidelines and Cost Allocation Principles.

However, ActewAGL is considering changing the basis of its allocation of the FPSC to projects to a cost driver (cost drivers) representing total direct costs (specifically including direct labour, direct materials and contractor expenses). The reason that ActewAGL is considering this change of cost driver is that they believe that direct costs would be a more appropriate cost driver with a better causal link to the costs being allocated than using a cost driver of direct labour only.

We consider that using a total direct cost driver appears reasonable and consistent with the AER's Cost Allocation Guidelines and Cost Allocation Principles. Further, we consider that if Networks determines that a total cost driver is a better causal driver than direct labour for the allocation of the FPSC, then such an approach should be adopted where the cost of implementation is not unreasonable.

Allocation of divisional overheads

The principles for the allocation of the divisional overheads are consistent with the principles set out above in respect of the allocation of the corporate overheads.

We consider that, provided Networks is able to demonstrate that the divisional overheads support the projects undertaken by Networks, it is reasonable to allocate these overheads up to full absorption.

Unregulated services

In accordance with the current cost allocation methodology, the FPSC is recovered to unregulated projects through the labour rate on-cost. In any revised cost allocation methodology, Networks should consider the allocation of overhead costs to the unregulated business, and consistency with the AER's Cost Allocation Guidelines and Cost Allocation Principles.

Disclaimer

It is noted that the AER will be responsible for the determination of whether a DNSP's CAM is in accordance with the Cost Allocation Guidelines. We are not able to confirm that that a proposed CAM incorporating a full allocation of the FPSC would be approved by the AER. It is a matter for the

¹ Based on our review of the cost allocation methodologies prepared by other Australian electricity Distribution Network Service Providers.

ActewAGL to form its own view in respect of cost allocation and ensure that this methodology is supportable and backed by evidence.

In addition, the cost allocation methodologies we have explored are not necessarily exhaustive, nor necessarily the most optimal ways for ActewAGL to allocate costs. Importantly, we have not assessed whether these approaches are likely to be acceptable to the AER or consistent with the Cost Allocation Guidelines as detailed in the National Electricity Rules.

In all circumstances, no representation, warranty or undertaking (expressed or implied) is made in relation to the proposed cost allocation approaches and no responsibility is taken or accepted by McGrathNicol for the adequacy, completeness or accuracy of the assumptions on which these scenarios are based.

Contact

Should you wish to discuss these cost allocation matters further, please contact either Michael Dunnett on (02) 6222 1415 or Aidan Hardy on (02) 6222 1440.

Yours faithfully

A handwritten signature in blue ink that reads "McGrathNicol Advisory". The signature is written in a cursive, flowing style.

McGrathNicol Advisory
Contact: Shane O'Keeffe