

Attachment 11.1

Essential Energy

Cost Allocation Method

April 2017



Table of Contents

Version History	3
1. Introduction	4
2. Background	4
2.1 Regulatory Requirements	4
2.2 Purpose of the CAM	4
3. Responsibility	5
4. Essential Energy's Organisational Structure	6
4.1 Recent changes to Essential Energy's business	6
4.2 Organisational Structure	6
4.3 Essential Energy Service Provision	6
4.3.1 Distribution Services provided by Essential Energy	7
4.3.2 Other services provided by Essential Energy	7
5. Cost Allocation Principles and Policies	8
5.1 Cost allocation principles	8
5.2 Overview of approach	8
5.3 Operating and capital expenditure	8
5.4 Directly attributable costs	9
5.4.1 Projects	9
5.4.2 Function areas (departments)	9
5.4.3 Cost attribution to service categories	9
5.5 Shared costs	10
5.5.1 Percentage allocation based on Direct Costs	11
5.5.2 Allocation of immaterial costs	11
5.5.3 Calculation of allocators	11
6. Record maintenance	12
7. Effective Date	12
8. Appendix 1 – Shared cost summary	13

Version History

Version number	Date	Details of changes
1	November 2003	N/A – first version under AER Guidelines.
2	February 2008	Updated to reflect change in business structure Submitted for 2009 Determination Process
3	April 2014	Updated to reflect Guidelines and review by KPMG and AER staff New Business Structure following amalgamation of Networks NSW Changes to reflect AER Framework and Approach paper on service classification, particularly to incorporate allocations to Alternate Control Services
4	April 2017	Updated to reflect changes to organisational structure, rationalisation of shared cost allocators and structural improvements to the document

In accordance with clause 3.2(a)(1) and (2) of the Cost Allocation Guidelines, this table identifies the version number, history and date of issue for Essential Energy's Cost Allocation Method.

1. Introduction

Essential Energy is a state owned corporation of the New South Wales (NSW) Government, with responsibility for building, operating and maintaining Australia's largest electricity network – delivering essential network services to more than 840,000 homes and businesses across 95 per cent of NSW, part of southern Queensland and northern Victoria. Essential Energy also provides water and sewerage services to 20,000 customers in Far West NSW.

Essential Energy is one of the largest employers in regional NSW, with around 3,000 employees based across 100 depots and regional offices.

2. Background

2.1 Regulatory Requirements

Under clause 6.15.4 of the National Electricity Rules (NER), Essential Energy must submit a document setting out its proposed Cost Allocation Method (CAM) to the Australian Energy Regulator (AER) for its approval. The proposed CAM must give effect to, and be consistent with, the AER's Cost Allocation Guideline (CAG),¹ issued in June 2008.

Section 4.3 of the CAG sets out that the AER, in consultation with Essential Energy, will review its CAM, as part of each distribution determination. This document constitutes Essential Energy's CAM for the 2019-2024 regulatory control period.

2.2 Purpose of the CAM

This CAM establishes a method for attributing direct costs and allocating indirect costs between various categories of Essential Energy's distribution services, that is, between direct control services (standard control services and alternative control services), negotiated services and unregulated distribution services.

Essential Energy also uses the methods and principles set out in this CAM to attribute and allocate costs to non-distribution services, to ensure costs are attributed and allocated at the highest level in a manner that is consistent with those allocated within the distribution business. This ensures that only costs associated with Essential Energy's distribution services are then attributed to, or allocated between categories of distribution services.

Essential Energy confirms that this CAM applies to the allocation of all costs relevant to its role as a Distribution Network Service Provider (DNSP) and has been prepared in accordance with the requirements of the NER and the CAG. This CAM will be used for:

- Forecasting operating and capital expenditure, including to support Essential Energy's 2019-2024 Regulatory Proposal;
- Determining the proposed prices for negotiated distribution services;
- Preparing annual statements submitted to the AER as part of a regulatory information notice; and
- Actual or estimated capital expenditure for the purposes of allocating costs to standard control services when determining the value of any additions or reductions to the Essential Energy Regulated Asset Base, as part of its Regulatory Proposal, in accordance with NER Schedule 6.2.1(f).

¹ <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/cost-allocation-guideline-distribution-2008/final-decision>

3. Responsibility

The Chief Financial Officer has overall responsibility for the governance and sign-off of the CAM and ensuring compliance with it.

The Finance team is responsible for the financial information management system and ensures that it gives effect to this CAM. Finance does this by:

- Ensuring that projects and functional areas are appropriately set up to capture costs;
- Reflecting the values of the shared cost allocators in the financial information management system; and
- Ensuring the financial information management system allocates the shared cost pool between service categories using the shared cost pool and allocation functionality.

The following table sets out the actions and responsibilities with regards to maintaining the CAM, as required in clause 3.2(a)(3) of the CAG.

Table 1: Responsibilities

Department	Position	Responsibility
Various	Business Managers	Provide expert departmental advice and information on functions of their business area
Finance	Manager Financial Planning & Analysis	Ensure correct allocation of directly attributable costs to services Calculate shared cost allocator percentages monthly to be applied to the shared cost pool Update Finance system with calculated shared cost percentages
Finance	Financial Controller	Apply and monitor allocation of shared costs in the financial information management system.
Network Regulation	Network Pricing Manager	Maintain CAM
Finance	Chief Financial Officer	Ensure compliance with the cost allocation method

4. Essential Energy's Organisational Structure

4.1 Recent changes to Essential Energy's business

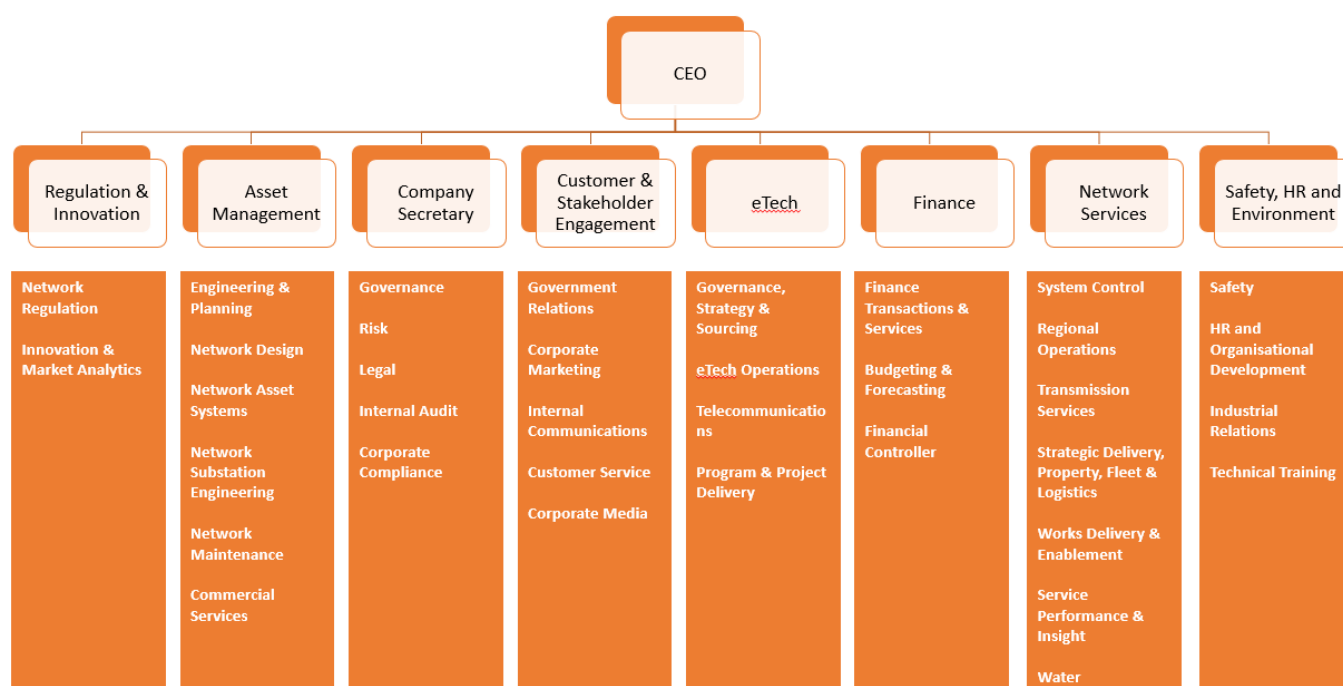
Networks NSW was dissolved on 31 December 2015. Since 1 January 2016, Essential Energy has operated as a stand-alone business with its own Board and under the responsibility of its own Chief Executive Officer.

Essential Energy's business structure was consolidated from five to three regions to more cost effectively deliver cost effective essential services to its network customers, increase its focus on safety and productivity, and ensure consistency in regional operations across the network.

4.2 Organisational Structure

Essential Energy is owned by the New South Wales Government. Figure 1 sets out Essential Energy's organisational structure and the core functions that sit under each business division.

Figure 1: Essential Energy's Organisational Structure and core business functions



4.3 Essential Energy Service Provision

Under clause 3.2(a)(5) of the CAG, Essential Energy is required to specify the classes of distribution services that will have costs allocated to them and the persons to whom the services will be provided. Section 6.2 of the NER classifies distribution services as:

- Direct control services, which are separated into:
 - Standard control
 - Alternative control
- Negotiated distribution services.

Services which are distribution services, but not direct control services or negotiated distribution services, are not classified by the AER, and are referred to as unclassified distribution services.

4.3.1 Distribution Services provided by Essential Energy

Essential Energy provides the following distribution services:

- **standard control services** – provision of core network (or common distribution) services, some connection services that are not available contestably, and type 7 metering services for the supply of electricity to customers via the distribution network. These services include, planning, construction, maintenance and operation of the distribution network and are provided to all of Essential Energy's customers who are connected to the network and for whom electricity tariffs apply.
- **alternative control services** – services supplied to a specific customer. These services include, legacy type 5 and 6 metering services (e.g. maintenance, reading and data services), ancillary services related to electricity supply that are typically provided to customers on request (e.g. disconnection of a meter) and public lighting services provided to local councils. Alternative control services can be provided to all residential and business customers and a number of other parties, including retailers, developers, builders and governments.
- **unregulated distribution services** – these distribution services include distribution asset rental services such as allowing the use of distribution assets to hang assets associated with the National Broadband Network.

Essential Energy does not provide negotiated distribution services.

4.3.2 Other services provided by Essential Energy

Services which are not distribution services are not regulated by the AER, and are referred to as unregulated services.

Essential Energy provides water services which are not subject to regulation by the AER under the name Essential Water. Essential Water, which is part of Essential Energy's Network Services division, provides water supply services to 20,000 customers in Far West NSW, including Broken Hill, Menindee, Sunset Strip and Silverton. Essential Energy also provides sewerage services to Broken Hill.

5. Cost Allocation Principles and Policies

5.1 Cost allocation principles

Clause 3.2(a)(6) of the CAG requires Essential Energy to include in its CAM the detailed policies and principles it will use for attributing costs to, or allocating costs between, categories of distribution services. Essential Energy confirms that this CAM gives effect to the Cost Allocation Principles specified in clause 6.15.2 of the NER and section 2.2 of the CAG. Essential Energy further confirms that this is true for both directly attributable and shared costs. Essential Energy's principles are:

- Costs are directly attributed to, or allocated between, categories of distribution services, based on the substance of the underlying transaction or event, rather than its legal form.
- The same costs are not allocated more than once.
- Costs will not be reallocated between service lines during a regulatory control period.
- Direct costs can only be attributed once to a single category of distribution services and shared costs are only allocated once between categories of distribution services.
- Shared costs are collated into a pool and allocated across standard control services, alternative control services, unclassified distribution services and unregulated business activities.
- Detailed principles, policies and the approach used to attribute costs directly to categories of distribution services are consistent with the Ring-Fencing Guideline. That is, that only costs associated with distribution services are attributed or allocated to distribution services and using the principles set out in this CAM.²

5.2 Overview of approach

Essential Energy uses PeopleSoft to collect and report all financial information and Works and Assets Management System (WASP) to store job estimates. Each cost by functional area and project type is categorised as a direct cost or shared cost, based on the nature of the cost. The Finance team monitors the allocation of shared costs to services and the costs that are included in the shared cost pool to ensure that only costs identified as shared costs in this CAM are included in the shared cost pool.

Expenditure is allocated as follows:

1. Field services labour is charged directly to specific projects, such as system capex and emergency response, via timesheets. Materials, fleet & stores costs, and contractor costs for these projects are also directly charged to projects.
2. Labour on-costs, such as workers compensation, provision of leave and payroll tax, are added to labour costs and are also considered direct costs of that labour.
3. Shared costs (those costs not directly attributable) are allocated to services on the basis of the cost allocators described in this CAM.

5.3 Operating and capital expenditure

Essential Energy's chart of accounts and systems have been established so that both operating expenditure (opex) and capital expenditure (capex) can be separately accounted for and reported in accordance with regulatory reporting requirements.

This CAM does not distinguish between opex and capex in the treatment of costs. However, each cost is identified and classified in accordance with Essential Energy's Capitalisation Policy. The allocation of costs to business segments occurs independently of whether they are opex or capex in nature.

² <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-2016/final-decision>

5.4 Directly attributable costs

Directly attributable costs are identified on the basis that a project or function area relates solely to one service category, such as a standard control service, and no portion of that cost or expense relates to another service category. This identification occurs in the financial information management system in one of two ways - through projects or function areas.

5.4.1 Projects

Costs such as labour, contractors and materials may be charged directly to a project that is designated as relating to a particular service category. For example, *Project Type 11445 – Underground Asset Inspection* relates to standard control services and *Project Type 70055 – Quality of Supply* relates to the Water Division (i.e. unregulated services).

Projects are the lowest level of aggregating costs in PeopleSoft and each project is set up with a project type that identifies it as being opex or capex, in accordance with Essential Energy's Capitalisation Policy. The project type also classifies the project by service category, in accordance with this CAM.

Project types also identify costs as being either direct or shared. On this basis, direct costs are attributed directly to service categories while shared costs are included in the shared cost pool. The financial information management system contains controls that ensure a project cost can only be attributed or allocated to a service category once.

5.4.2 Function areas (departments)

While costs relating to function areas are not charged directly to a project, they can relate solely to a single service category. Where this is the case they are directly attributed to it when the CAM processes are executed by Finance. Examples of this include Street Lighting Management, which is costed directly to alternative control services and National Broadband Network, which is costed directly to unclassified distribution services. Where the costs of a particular function area cannot be directly attributed to a service category, they are included in the shared cost pool.

As with project costs, controls within the financial information management system ensure that function area costs can only be attributed once to a service category.

5.4.3 Cost attribution to service categories

Table 2 sets out the nature of directly attributable costs, the service categories they are attributed to and the characteristics that associate it with that category, as required under clause 2.2.1(b) of the CAG.

Table 2: Directly attributable costs – cost allocation policies and framework

Function	Nature	Service category	Characteristics of attribution
Asset performance and risk	Network engineering – earthing, maintenance, mains and substations	Standard control service	Network-related function
Commercial services – NBN	Rental of regulated assets (i.e. poles) to National Broadband Network for purpose of supporting telecommunications infrastructure	Unregulated distribution service	Was not classified for 2014-19 regulatory control period however AER proposed to classify as unclassified distribution service for 2019-24
Commercial services - ASP	Accredited Service Provider relationship including authorisation	Alternative control service	ASPs carry out contestable work in Essential Energy's distribution area
Engineering and planning	Forecasting and demand, distribution planning, sub-transmission planning, power quality and reliability, and	Standard control service	Network-related function

Function	Nature	Service category	Characteristics of attribution
	network investment, SCADA, DSA, Protection & Load Control		
Network design	Land and routes, mains and substation design	Standard control service	Network-related function
Network design – contestable	Contestable design and certification	Alternative control service	Services provided to third parties under Ancillary Service charges
Inventory & Logistics	Sale of stock to ASPs	Unregulated distribution service	Sales to Accredited Service Providers is not covered under the determination, however it is considered a distribution service by Essential Energy as it ensures the safe and reliable operation of its network by ASPs
Vegetation management	Veg delivery & performance, compliance & stakeholder management, Veg operations	Standard control service	Function is responsible for management of vegetation near networks
Programs – delivery & performance	Program management, technical support	Standard control service	Program management of network-related works
System control	Contestable network	Alternative control service	Services provided to third parties under Ancillary Service charges
	Customer installations	Standard control service	Inspections of customer installations
Water ³	Water management, sewerage, reservoirs & services, water treatment	Unregulated service	Water services are regulated by IPART

5.5 Shared costs

Shared costs are those which contribute to more than one service category. As discussed in section 5.4, Essential Energy puts all project and function costs that cannot be directly attributed to a service category into a shared cost pool, which needs to be allocated between service categories. Shared costs include:

- Regulation
- CEO office
- Human Resources (HR) and Industrial Relations (IR)
- Finance, including internal audit
- Operational Health and Safety.

Essential Energy uses one allocator, Direct Costs, to allocate its shared costs. This allocator is used because it best reflects the way that shared costs are driven across the business and its services.

³ Although the Water business is considered to be unregulated by the AER, it is State regulated and this CAM is also used to derive their allocation of shared costs

5.5.1 Percentage allocation based on Direct Costs

Essential Energy calculates a Direct Cost percentage allocator, based on the percentage of total costs directly attributed to each service category. For its material shared costs, Essential Energy considers that Direct Cost is a causal allocator because the total direct costs to deliver a project or function drives the level of support, reflected through shared costs, required to assist with that delivery.

5.5.2 Allocation of immaterial costs

Clause 2.2.4(c) provides that, where a shared cost is immaterial or a causal relationship cannot be established without undue cost and effort, it can be allocated using a non-causal allocator. As noted in section 5.6.1, Essential Energy has identified some immaterial cost categories, such as non-direct meter reading costs. These costs will also be allocated to service categories using the Direct Cost allocator. Essential Energy considers 'immaterial' costs to be those that are less than one per cent of the total direct costs for that cost category.

5.5.3 Calculation of allocators

The Finance team calculates the Direct Cost allocator at the end of each month, and uploads the percentages into the financial information management system. This ensures that the percentages reflect the most recent financial information and ensure the shared cost pool is allocated using the most accurate percentages possible. It should be noted that, although the percentages may change each month, the allocation method itself will not change.

The detailed information required under clause 2.2.1(2) of the CAG is set out in Appendix 1.

6. Record maintenance

Essential Energy confirms that it maintains financial source documentation and records consistent with accounting standards and statutory requirements to adequately demonstrate compliance with the CAM and for the purposes of clause 3.2(a)(7) of the CAG.

Essential Energy will maintain records of cost allocation, as follows:

- The CAM will be applied to both Essential Energy's audited annual statutory financial statements and the annual RIN to assign costs to their relevant services.
- Essential Energy will prepare and maintain appropriate documentation to support the preparation of the RIN for submission to the AER. These records and working files will be provided to external auditors for the purpose of providing an audit opinion on the annual RIN.
- As part of the audit of the RIN, Essential Energy's Chief Executive Officer (CEO), Chief Financial Officer and other senior executives sign a Management Representation Letter, attesting to auditors that the RIN has been prepared in accordance with the CAM.
- In addition, the CEO signs a Statutory Declaration attesting that the RIN, to the best of their knowledge, is true and accurate in all material respects.
- Essential Energy will establish, maintain and keep records demonstrating that it has attributed and allocated costs to distribution services in a manner consistent with requirements of the AER Ring-Fencing Guideline.
- Essential Energy's records management policy requires financial records to be maintained for seven years. In addition, records of expenditure and costs allocation are maintained in the financial information management system at Essential's Energy's offices for at least seven years.

7. Effective Date

The CAM, once approved by the AER, will take effect on 1 July 2019 and be published on Essential Energy's website. In addition, the CAM will be applied for the purposes of developing expenditure forecasts for the 2019-2024 Regulatory Proposal.

8. Appendix 1 – Shared cost summary

Function	Nature	Service category	Reason for allocation
Corporate	Corporate labour overheads, CEO Office, Company Secretary and General Counsel, Deputy CEO, customer contact	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Total direct costs to deliver projects by service category reflect the corporate overhead costs required to support delivery
Customer and stakeholder engagement	Market liaison, new connections	<ul style="list-style-type: none"> Standard Alternative 	Total direct costs to deliver projects by service category reflect the costs relating to customer and stakeholder engagement
Customer and stakeholder engagement	Customer service management	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Total direct costs to deliver projects by service category reflect the costs relating to customer and stakeholder engagement
eTech	eTech management and operations, program and project delivery	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Total direct costs to deliver projects by service category reflect the eTech costs required to support delivery
Finance	Commercial analysis, payroll remuneration and benefit, accounts payable/receivable, treasury	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Total direct costs to deliver projects by service category reflect the Finance costs required to support delivery
Safety, HR and environment	Health and safety, HR services, recruitment, IR, technical training	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Total direct costs to deliver projects by service category reflect the Safety, HR and environment costs required to support delivery
Asset management	Management, telecommunications	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Asset management costs are driven by the total direct costs for the projects in each service category
Asset management	Network data maintenance, network asset systems, Electrical Safety Office governance and reporting	<ul style="list-style-type: none"> Standard Alternative 	Asset management costs are driven by the total direct costs for the projects in each service category
Commercial services	Street lighting	<ul style="list-style-type: none"> Alternative Unregulated 	Total direct costs to deliver projects by service category reflect the costs to deliver street lighting services between service categories
Secondary systems	Generation	<ul style="list-style-type: none"> Standard Unregulated 	Total direct costs to deliver projects by service category reflect the

Function	Nature	Service category	Reason for allocation
			secondary system costs required to support delivery
Network service management	Network operations management	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Network management costs are driven by the total direct costs for the projects in each service category
Network Services Regional areas: <ul style="list-style-type: none"> North Coast Northern Southern 	Field time allocated to non-directly attributable projects (support projects such as training, meetings, etc), regional services management and support costs, work scheduling	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Total direct costs to deliver projects within a service category reflect the shared costs required to support delivery
Operational performance	Business administration, operational reporting, program coordination	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Total direct costs to deliver projects by service category reflect the operational performance costs required to support delivery
Property, fleet, logistics and procurement	Procurement, ICT sourcing, PMO & governance, fleet, inventory	<ul style="list-style-type: none"> Standard Alternative Water Unregulated 	Total direct costs to deliver projects by service category reflect the property, fleet and procurement costs required to support delivery
Inventory and logistics	Regional warehouses and stores	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Total direct costs to deliver projects by service category reflect the inventory and logistics costs required to support delivery
Programs Management – Network Services	Distribution capital and maintenance program management and support	<ul style="list-style-type: none"> Standard Alternative 	Capital and maintenance program management and support costs are driven by the total direct costs in each service category
Meter reading	Meter reading and management	<ul style="list-style-type: none"> Alternative Water 	Cost is immaterial
Major projects	Substation refurbishment, secondary systems, project management	<ul style="list-style-type: none"> Standard Unregulated 	Substation refurbishment and other costs are driven by the total direct costs for the projects in each service category
Transmission ⁴ services	Technical operations, engineering workshop, underground mains	<ul style="list-style-type: none"> Standard Unregulated 	Transmission services costs are driven by the total direct costs for the projects in each service category
Engineering	Technical enquiries	<ul style="list-style-type: none"> Standard Alternative Unregulated 	Total direct costs to deliver projects by service category reflect the technical enquiries costs required to support delivery

⁴ Transmission here is the internal name given to describe how Essential Energy manages sub-transmission lines, as part of the distribution network, rather than suggesting Essential Energy provides 'transmission services' as described in the NER

Function	Nature	Service category	Reason for allocation
Network interruptions and enquiries	Network contact centre	<ul style="list-style-type: none"> • Standard • Alternative • Water • Unregulated 	Total direct costs to deliver projects by service category reflect the contact centre costs required to support delivery
System control	Planned workgroup, operational technology, network operations	<ul style="list-style-type: none"> • Standard • Alternative 	Total direct costs to deliver projects by service category reflect the system control costs required to support delivery