AUSTRALIAN ENERGY REGULATOR

First Proposed

Electricity Transmission Network Service Providers

Cost Allocation Guidelines

EXPLANATORY STATEMENT AND ISSUES PAPER

January 2007

1 Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of transmission network service providers (TNSPs) in the National Electricity Market (NEM) in accordance with the National Electricity Rules (NER).

This Explanatory Statement accompanies the First Proposed Cost Allocation Guidelines (proposed guidelines) and provides the AER's reasons for the proposed guidelines. It has been prepared to satisfy the AER's obligations under clauses 11.6.17(c), and 6A.20(b)(2) and (3) of the NER.

The AER has also prepared an Issues Paper, which forms part of this Explanatory Statement, which provides additional information and requests written submissions on specific issues.

2 Rule requirements

Clause 6A.19.3 of the NER requires the AER to publish the Cost Allocation Guidelines (the guidelines) by 28 September 2007. The guidelines must comply with the principles prescribed in the NER at clause 6A.19.2.

Under clause 11.6.17 the AER must publish proposed guidelines on or before 31 January 2007 that will apply to SP AusNet, VENCorp and ElectraNet for any transmission determination made in 2008. These guidelines will form the basis for consultation to develop the guidelines that will apply to all other TNSPs in future regulatory periods.

3 Purpose and objectives of the proposed guidelines

The proposed guidelines outline the required contents of a regulated business's Cost Allocation Methodology and the basis on which the AER will assess that methodology for approval. The objectives of the proposed guidelines are to:

- contribute to the NEM objective
- be consistent with the cost allocation principles in the NER
- prevent cross-subsidisation between prescribed, negotiated and other services
- promote transparency in the cost information provided by a TNSP and
- assist in the setting of efficient capital and operating expenditure allowances.

The guidelines will be a stand alone document. All substantive cost allocation provisions will, as far as possible, be included in the guidelines rather than some other regulatory instrument or guideline. The exception to this general rule is that arrangements relating to the nature and conduct of regulatory audits, including audits of a TNSP's compliance with its Cost Allocation Methodology, will be addressed in the AER's Submission Guidelines and Information Guidelines.

4 The nature and reasons for the proposed guidelines

Cost allocation concerns the attribution of a regulated business's direct costs to prescribed, negotiated and other services and the allocation of shared costs between these different services. The proposed guidelines will only deal with cost attribution down to services, not individual prices for different categories of services. Cost allocation for pricing purposes will be dealt with separately, through the Pricing Principles Guidelines to be released by the AER by 31 October 2007.

Effective cost allocation has an important role to play in promoting the NEM objective. The NEM objective is stated in section 7 of the National Electricity Law and reads as follows:

> The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

Effective cost allocation requirements support the NEM objective by:

- Promoting the appropriate allocation of costs between prescribed, negotiated and other services in order to reflect the consumption or utilisation of a resource or service by a business, or part of a business.
- Preventing cross-subsidisation between prescribed, negotiated and other services and the prices paid by end customers for any of these services being inappropriately inflated or discounted.
- Making the treatment of direct and shared costs transparent and so ensure that only efficient costs relevant to the provision of a service are passed through to customers.
- Promoting consistency and comparability in the provision and reporting of financial information over time in relation to the various services.

The proposed guidelines will give effect to and be consistent with the cost allocation principles outlined in the NER, and will support the NEM objective.

5 Consultation process

The AER anticipates that it will engage in the following consultation process:

- publish the proposed guidelines, this Explanatory Statement and additional material inviting written submissions

- consider any written submissions received during consultation
- if necessary, publish a further consultation draft and invite submissions and
- publish the final guidelines.

6 Invitation for written submissions

Interested parties are invited to make written submissions to the AER, having regard to the issues outlined in the attached discussion paper on the proposed guidelines. The processes for consultation are also outlined therein.

Attachment 1

Australian Energy Regulator

First Proposed Transmission Network Service Provider Cost Allocation Guidelines

Issues Paper

January 2007

Contents

Summary

Clause 6A.19 of the final National Electricity Rules (NER) for the electricity transmission sector includes:

- A requirement for the Australian Energy Regulator (AER) to prepare Cost Allocation Guidelines by 28 September 2007.
- A requirement that the Cost Allocation Guidelines give effect to, and be consistent with, a prescribed set of Cost Allocation Principles.
- A requirement for TNSPs to submit Cost Allocation Methodologies to the AER in accordance with the AER's Cost Allocation Guidelines under defined timeframes.
- Conditions for the AER's consideration, approval and amendment of the TNSPs' Cost Allocation Methodologies.

Purpose of this Issues Paper

The purpose of this Issues Paper is to consider key issues relevant to the AER's development of new Cost Allocation Guidelines for the electricity transmission sector. On the basis of the preliminary positions drawn in this Issues Paper, the AER has prepared proposed Cost Allocation Guidelines for the electricity transmission sector.

Interested parties are invited to comment on these proposals, including as they are reflected into the proposed Cost Allocation Guidelines.

Changes to existing cost allocation requirements

The AER's existing cost allocation requirements for the electricity transmission sector are contained in its Information Requirements Guidelines. The NER requires regulated businesses to prepare a Cost Allocation Methodology, which gives effect to and is consistent with the Cost Allocation Guidelines and the Cost Allocation Principles in the NER. The existing high-level principles for cost allocation, set out in clause 3.3 of the Information Requirements Guidelines, are consistent with the Cost Allocation Principles in the NER.

Therefore, the main change to the existing cost allocation arrangements, apart from the need for these requirements to be set out in terms of their own separate guideline, relates to the formal approval of a business' Methodology. Under the exiting arrangements the AER does not formally approve a business' Cost Allocation Methodology. The NER, however, requires that the AER formally approves a business' Methodology before it is applied with any changes to the methodology also needing to be approved by the AER. Therefore the impact of the changes arising from the new Cost Allocation Guidelines, for regulated businesses, is not likely to be significant.

Relationship between the National Electricity Rules, Guidelines and Methodology

It is proposed that, for procedural efficiency, the Cost Allocation Guidelines clearly specify:

- the required contents of a regulated business's Cost Allocation Methodology
- the basis on which the AER will assess a regulated business's proposed Cost Allocation Methodology for approval
- the basis on which the AER will consider proposed changes to a regulated business's proposed Cost Allocation Methodology over time in order that it be a 'living document' and
- how the AER expects the Cost Allocation Methodology to be applied over time.

Each regulated business's Cost Allocation Methodology should set out how, in a practical sense, it will allocate its costs to give effect to, and be consistent with the requirements of, the Cost Allocation Guidelines, in order to meet the requirements of the NER.

Selection of cost allocators for shared costs

It is proposed that the Cost Allocation Guidelines provide for:

- The regulated business, rather than the AER, selecting the specific allocators for shared costs, subject to the Cost Allocation Principles under the NER and the Cost Allocation Guidelines.
- The regulated business being required to include its allocators in its proposed Cost Allocation Methodology, together with the reasons why the chosen allocators best promote the Cost Allocation Principles and any other objectives that the AER may specify in the Cost Allocation Guidelines.
- The AER assessing and approving the allocators as part of its broader consideration of the Cost Allocation Methodology.

Assessment and approval of Cost Allocation Methodology

It is proposed that the Cost Allocation Guidelines specify that the AER will assess a regulated business's Cost Allocation Methodology on the basis of whether it:

- contains the information required by the Cost Allocation Guidelines and
- effectively promotes the Cost Allocation Principles under clause 6A.19.2 of the NER.

It is also proposed that any decision by the AER to reject or amend a proposed Cost Allocation Methodology must include an explanation of the reasons for its decision.

Amending a Cost Allocation Methodology

It is proposed that the Cost Allocation Guidelines state the matters the AER will have particular regard to in deciding whether to approve a request by a regulated business to amend its Cost Allocation Methodology. These matters include whether a regulated business can demonstrate that:

- There has been a material change in its circumstances.
- The resultant amended Cost Allocation Methodology would give effect to, and be consistent with, these Guidelines.
- The amendment will not jeopardise the comparability of the resultant financial information with that previously provided to the AER by the regulated business.

The AER will only approve an amended Cost Allocation Methodology to take effect from the start of a new regulatory year.

Application of a Cost Allocation Methodology

It is proposed that the Cost Allocation Guidelines not seek to include an exhaustive list of the circumstances in which a regulated business is required to apply its Cost Allocation Methodology. Rather, the Guidelines should state that the methodology should be applied, without limitation, for the purposes required by the NER, being when:

- Forecast operating expenditure is submitted to the AER in accordance with clause 6A.6.6 of the NER.
- Forecast capital expenditure is submitted to the AER in accordance with clause 6A.6.7 of the NER.
- Prices for a negotiated transmission service are determined in accordance with clause 6A.9.1 of the NER.
- A certified annual statement is submitted to the AER in accordance with clause 6A.17.1(a) of the NER.
- Actual or estimated capital expenditure is used for the purposes of increasing the value of its regulatory asset base under clause S6A.2.1(f)(4) of the NER.

1 Introduction

1.1 Nature and purpose of cost allocation

Cost allocation concerns the attribution of a regulated business's direct costs to prescribed, negotiated and other services and the allocation of shared costs between these different services. The Cost Allocation Guidelines will only deal with cost attributions down to services, not individual prices for different categories of services. Cost allocation for pricing purposes will be dealt with separately, through the Pricing Principles Guidelines to be released by the AER by 31 October 2007.

Effective cost allocation has an important role to play in promoting the NEM Objective. The NEM Objective is stated in section 7 of the NEL and reads as follows:

> The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

Effective cost allocation requirements support the NEM objective by:

- Promoting the appropriate allocation of costs between prescribed, negotiated and other services in order to reflect the consumption or utilisation of a resource or service by a business, or part of a business[1].

- Preventing cross-subsidisation between prescribed, negotiated and other services and the prices paid by end customers for any of these services being inappropriately inflated or discounted.

- Making the treatment of direct and shared costs transparent and so ensure that only efficient costs relevant to the provision of a service are passed through to customers.

- Promoting consistency and comparability in the provision and reporting of financial information over time in relation to the various services.

1.2 National Electricity Rules

Clause 6A.19 of the NER details the proposed new cost allocation arrangements for the transmission sector.

The NER includes:

- A requirement for the AER to prepare Cost Allocation Guidelines by 28 September 2007.

[1] For example, section 7.4 of the AER's Information Requirements Guidelines provides that "When a cost is attributed to a business segment, it should reflect the consumption or utilisation of a resource or service; and when a business segment consumes or utilises a resource or service, it should attribute a corresponding cost".

- A requirement that the Cost Allocation Guidelines give effect to, and be consistent with, a prescribed set of Cost Allocation Principles in clause 6A.19.2(1)-(8) of the NER.

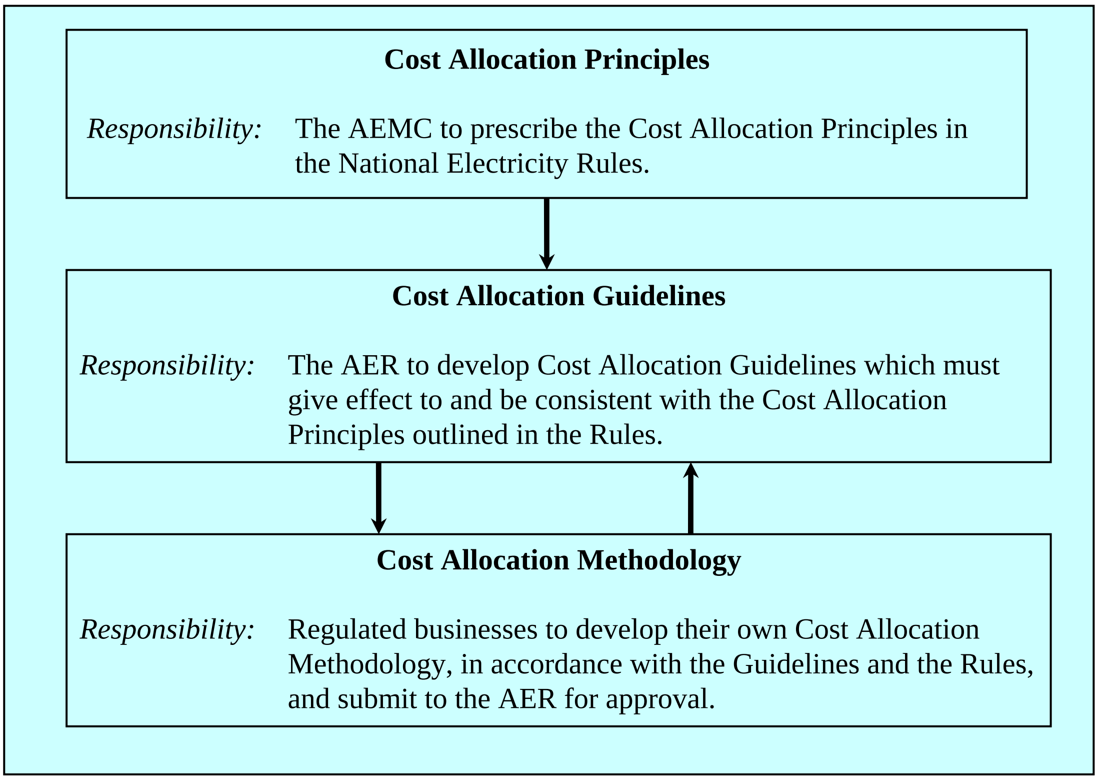
- A requirement for TNSPs to submit Cost Allocation Methodologies to the AER in accordance with the AER's Cost Allocation Guidelines under defined timeframes.

- Conditions for the AER's consideration, approval and amendment of the TNSPs' Cost Allocation Methodologies.

Clause 6A.20 of the NER details the process that the AER must follow in developing, amending or reviewing its Guidelines, including the Cost Allocation Guidelines.

Diagram 1 below illustrates the interrelationship between the elements of the cost allocation arrangements, and the respective responsibilities of the different parties, as specified in the NER including: the Cost Allocation Principles; the Cost Allocation Guidelines; and the Cost Allocation Methodology.

Diagram 1: Cost allocation arrangements



1.3 Cost Allocation Principles

In order to address the requirements of clause 6A.19.3(b)(1) of the NER, the new Cost Allocation Guidelines should be designed to give effect to the “Cost Allocation Principles” in clause 6A.19.2(1)-(8) of the NER, which are copied at Attachment A of this Issues Paper. In particular, this clause provides that a TNSP must apply a cost allocation methodology that only allocates costs to a service:

- According to the substance of a transaction or event rather than its legal form.
- That can be directly attributed or, in the case of shared costs, using an appropriate causal allocator, or where no such allocator exists or costs are not material, using a “well-accepted” non-causal allocator.
- So that the same cost is not allocated more than once. Costs allocated to prescribed transmission services must not be reallocated to negotiated transmission services. However, costs may be reallocated from negotiated to prescribed transmission services in accordance with a set methodology complying with these guidelines.

Promoting these principles is the primary purpose of the Cost Allocation Guidelines to ensure that only efficient costs are allocated to different services and that the prices paid by end customers for these services are not inappropriately inflated or discounted.

However, in order to give effect to the NEM Objective detailed in section 1.1, it is also proposed that the new Cost Allocation Guidelines:

- Promote transparency in:
    - the information provided by the regulated business, so that the AER can adequately understand the business that it is regulating and
    - the decisions made by the AER.

1.4 Changes to the existing cost allocation requirements

The AER's existing cost allocation requirements for the electricity transmission sector are contained in its Information Requirements Guidelines. These Guidelines set out high level cost allocation principles to be applied by a TNSP when disaggregating its base accounts for the purposes of developing regulatory financial statements. At present, the AER does not formally approve a regulated business's Cost Allocation Methodology.

In accordance with the requirements of the new National Electricity Rules, the AER is developing new, stand alone Cost Allocation Guidelines, which give effect to the Cost Allocation Principles in the NER. The AER's nominated approach to cost allocation, is not substantially different from the existing arrangements.

The existing high-level principles for cost allocation set out in clause 3.3 of the Information Requirements Guidelines are consistent with the "Cost Allocation Principles" in the NER, requiring that:

- Costs that are directly attributable to the business segments should be directly attributed.
- Cost that not directly attributable will be allocated to business segments using an appropriate causal allocator.
- Where an appropriate causal allocator can not be established, without undue cost and effort, a defensible non-causal allocator should be used.

The existing arrangements also provide regulated businesses with the flexibility to determine their own Cost Allocation Methodology, including the determination of appropriate allocators for shared costs, subject to applying the above high-level principles. This approach recognises the differences between businesses and allows businesses to propose a Methodology that best suits how their costs are incurred.

Therefore, the main change to the existing arrangements relates to the formal approval of a business' Methodology. As noted above, the NER requires that the AER formally approves a business' Methodology before it is applied, with any changes to any approved methodology also needing to be approved by the AER. Therefore, the impact of the changes arising from the new Cost Allocation Guidelines, for regulated businesses, is not likely to be significant.

1.5 Consistency between the transmission and distribution cost allocation guidelines

As the national energy regulator, the AER will seek to maximise consistency between the development of electricity transmission and distribution Cost Allocation Guidelines where practical and efficient.

However, given the regulatory arrangements under the NER that will in the future apply to the two sectors are at different stages of development, the AER has decided to prepare Cost Allocation Guidelines for electricity transmission and distribution in separate processes. The AER will develop electricity distribution Cost Allocation Guidelines based on the timeframes outlined in the AER's *Electricity Distribution Regulatory Guidelines, Statement of Approach, September 2006 (Statement of Approach)*. As noted in the *Statement of Approach* the AER will consult on a distribution Cost Allocation Issues Paper in the first quarter of 2007.

The AER has decided on timeframes for consultation and publication of its issues papers to give distribution businesses in New South Wales and the Australian Capital Territory sufficient time to consider regulatory guidelines prior to making their reset application. The AER will ensure that its preparation of the guidelines for distribution remains within the legislative and Rule making framework.

Despite the separate processes for developing electricity distribution and transmission Cost Allocation Guidelines, the AER expects there will be considerable overlap between these guidelines and will seek to ensure that common issues in transmission and distribution are, to the extent possible, dealt with in a similar time-frame. The AER believes that consistency between these guidelines can be achieved even if they are developed through separate processes.

1.6 Working assumptions

The following working assumptions have been used in preparing this Issues Paper:

- The Cost Allocation Guidelines introduced for the transmission and distribution sectors should be consistent where possible.

- The Cost Allocation Guidelines will be stand-alone documents. All substantive cost allocation provisions used in the regulatory framework will, as far as possible, be included in Cost Allocation Guidelines, rather than in Information Guidelines, Submission Guidelines, Ring-Fencing Guidelines or other regulatory instruments.

- The Cost Allocation Guidelines will only deal with cost attributions and allocations down to services, not individual prices for different categories of services. Cost allocation for pricing purposes will be dealt with separately, such as through Pricing Principles Statements.

- All revenues, costs, assets and liabilities of regulated business will have their origin in statutory accounts, although a single set of regulatory accounts could potentially draw from the statutory accounts of multiple entities.

- Regulatory requirements take precedence over statutory requirements for regulatory purposes.

Q1. Are the working assumptions used to prepare this Issues Paper appropriate?

1.7 Purpose of this Issues Paper

The purpose of this Issues Paper is to consider key issues relevant to the AER's development of new Cost Allocation Guidelines for the electricity transmission sector. Clause 6A.19 of the NER for the electricity transmission sector requires the AER to prepare Cost Allocation Guidelines by 28 September 2007.

1.8 Structure of this Issues Paper

The remainder of this document is structured as follows:

- section 2 discusses cost allocation in the context of the AER's wider regulatory framework
- section 3 identifies features of, and differences between, regulated businesses that are relevant to the AER's development of new Cost Allocation Guidelines
- section 4 discusses alternative broad approaches for regulating cost allocation, which are relevant to the development of new Cost Allocation Guidelines
- section 5 proposes the key elements of cost allocation arrangements that have been reflected into the proposed Cost Allocation Guidelines and
- section 6 lists the questions on which interested parties' specific comments have been sought throughout the rest of this Issues Paper.

1.9 Previous consultations in developing the proposed framework

The preparation of this Issues Paper and proposed framework discussed herein has benefited from separate consultations with officers of each of the following organisations during May and June 2006:

- *Jurisdictional Regulators*—the Essential Services Commission of Victoria (ESC), the Independent Pricing and Regulatory Tribunal of NSW (IPART), the Queensland Competition Authority (QCA), the ACT Independent Competition and Regulatory Commission (ICRC), the Essential Services Commission of South Australia (ESCOSA) and the Office of the Tasmanian Energy Regulator OTTER).
- *Distribution Network Services Providers* (DNSPs)—Citipower (Victoria), Powercor (Victoria), AGL (Victoria), United Energy (Victoria), SP AusNet (Victoria), ETSA Utilities (South Australia), EnergyAustralia (NSW), Integral

Energy (NSW), Country Energy (NSW), Energex (Queensland), Ergon Energy (Queensland) and Aurora Energy (Tasmania).

- *Transmission Network Services Providers* (TNSPs)—SP AusNet, Transgrid, EnergyAustralia, ElectraNet, Powerlink Queensland and Transend.

These consultations followed discussions between the AER and the Energy Networks Association about cost allocation issues. It should be noted that these consultations also covered the development of a cost allocation approach for the distribution sector. As noted above, the AER will, to the maximum extent possible, aim to achieve consistency of approach between the transmission and distribution sectors.

On 19 November 2006 the AER received a written submission from the Electricity Transmission Network Owners Forum (ETNOF) on an earlier draft of the proposed Cost Allocation Guidelines. These comments will be considered as part of the wider consultation process in 2007, which this paper is intended to commence.

2 Cost allocation in the context of the regulatory framework

2.1 Related transmission guidelines

The Australian Energy Market Commission's (AEMC) final determination in relation to Chapter 6 of the NER requires seven new guidelines, including the Cost Allocation Guidelines, to be published by 28 September 2007. The other guidelines to be prepared by that date are the Submission Guidelines, Information Guidelines, and arrangements for the Efficiency Benefits Sharing Scheme and the Service Target Performance Incentive Scheme. The AER must also prepare a Post-Tax Revenue Model and an Asset Base Roll Forward Model under the NER by that date. The NER requires the AER to also develop Ring-Fencing Guidelines, however, the date for preparing these Guidelines is not specified in the NER.

While this Issues Paper and the proposed Cost Allocation Guidelines have been prepared separately to the other guidelines, there is full recognition that any new cost allocation arrangements will need to be appropriately coordinated with related elements of the AER's future regulatory framework.

In particular, Cost Allocation Guidelines are an important:

- input into Information Guidelines and Ring Fencing Guidelines to be developed under the NER and
- consideration in assessing a regulated business's revenue proposal in accordance with Submission Guidelines to be developed under the NER.

2.2 Uses of regulatory expenditure information

During the consultations referred to in section 1.9, regulated businesses emphasised the importance of understanding how the regulator will use requested information that is the subject of the cost allocation requirements. In this regard, it is expected that:

- A TNSP will use forecast capital and operating expenditure as the basis for:
  - preparing its revenue proposal for its prescribed services, as is required by clauses 6A.6.6 and 6A.6.7 of the NER and
  - setting prices for a negotiated transmission service, as is required by clause 6A.9.1 of the NER.
- Actual expenditure information presented in a TNSP's regulatory accounts could be used for a variety of purposes, including to:
  - compare a TNSP's actual expenditure against the forecast applied in its regulatory determination

- assess trends in a TNSP's expenditure over time
- publish financial information during the course of the regulatory period
- apply incentive mechanisms that are based on a TNSP's expenditure levels and
- provide base level historical information for a regulator to assess a regulated business's expenditure requirements in later regulatory periods.

Clause 6A.17.1(a) of the NER requires TNSPs to prepare certified annual statements in accordance with the new Information Guidelines. Clause 6A.17.1(d)(2) allows the AER to use these statements, and any additional information provided by a TNSP, to monitor, report on and enforce compliance with the TNSP's Cost Allocation Methodology.

Actual or estimated capital expenditure could be used for the purposes of increasing the value of a TNSP's regulatory asset base, as is contemplated under clause S6A.2.1(f)(4) of the NER.

The AER's Transmission Ring-Fencing Guidelines (issued 15 August 2002) require that TNSPs maintain separate accounts for the provision of ring-fenced services, which are defined as prescribed services. The guidelines also require TNSPs to allocate shared costs between ring-fenced services and other services in accordance with a methodology that complies with any guidelines that the AER prepares. Cost Allocation Guidelines are therefore important and necessary to the overall regulatory framework in preventing subsidisation of contestable activities.

2.3 Relationship between statutory and regulatory accounts

It is a typical regulatory accounting requirement, including of the AER's existing Information Requirements Guideline for TNSPs, that:

- regulatory requirements take precedence over statutory requirements for regulatory purposes and
- a single set of regulatory accounts could potentially draw from the statutory accounts of multiple entities given that a regulated business is not defined by legal entity structures but rather by the activities and services it provides.

This has given rise to regulators requiring costs to be allocated within and between legal entities to determine what is appropriately attributable to different services provided by a regulated business.

2.4 Importance of delineating services

Given that cost allocation concerns the attribution and allocation of costs between prescribed, negotiated and other services, it is essential that the AER and regulated businesses share a clear understanding of the nature, and regulatory classification, of each category of service being provided to customers. Without such an understanding, it will not be possible for:

- a business to demonstrate to the AER's satisfaction that its costs are being allocated appropriately between the different categories of services or

- the AER to compare the costs allocated by the regulated business over time.

A lack of clarity about service definitions has the potential to be particularly problematic in the distribution sector where, despite "prescribed distribution services" and "excluded distribution services" being defined under the NER, jurisdictional regulators currently apply different tests for classifying services. This means that some services are classified as "prescribed" in some jurisdictions and "excluded" in others, and *vice versa*. While this issue is not as significant in the transmission sector, the experience in distribution underlies the importance of maintaining a clear and effective approach to service definition and cost allocation. The issue is also relevant in ensuring appropriate consistency between sectors in relation to cost allocation requirements.

3 Differences between regulated businesses

There are significant differences between regulated electricity transmission businesses that affect the need for, and complexity of, cost allocation arrangements, including in relation to:

- Their ownership arrangements—some businesses are publicly owned and others are, in whole or part, privately owned, which means that businesses may be under different influences and pressures in allocating costs.

- Their corporate structures—some businesses have simple corporate structures whereas others are part of more complex arrangements with multiple entities within a conglomerate structure.

- The range of industry sectors in which a business operates—some businesses only operate in the electricity industry whereas others also operate in other industries, such as gas. This has the potential to significantly increase the complexity of their cost allocation arrangements and therefore the need for close scrutiny of costing arrangements by regulators.

- The number of separate regulated businesses within the group—some businesses only operate in a single regulated sector, such as transmission or distribution, whereas others may operate in both sectors, either individually or as part of a group.

- The range of the prescribed and other services that the regulated business provides—some businesses only provide prescribed services whereas others provide a mix of prescribed, negotiated and other services. As noted in section 2.4, the complexity of this matter is increased in the distribution sector given that there is currently not a consistent regulatory categorisation of the same categories of services between jurisdictions.

- The businesses' operating models—some businesses undertake almost all of their activities internally, making very limited or no use of related or third party contracts, whereas others rely to a much greater extent on these contracts for the provision of their services.

- Their approach to developing and reporting their costs for regulatory purposes—some businesses (in certain cases as a result of specific regulatory requirements) develop and report their costs on a fixed basis, such as on a labour and materials basis or on a labour only basis.

Each of the regulated businesses and jurisdictional regulators consulted in preparing this document highlighted the need for the AER to incorporate sufficient flexibility into the future cost allocation arrangements to accommodate differences between businesses. Furthermore, they were of the common view that:

- Having an in-depth understanding of each business is critical to the development of appropriate cost allocation arrangements.

- There is no single set of cost allocators that it would be appropriate to apply to all network service providers.

- The businesses are (and will always be) better informed about the nature of their own operations than the regulator and they are therefore better placed to determine the appropriate causal (or where necessary non-causal) allocators of their shared costs. It is, however, clearly the regulator's responsibility to determine whether these allocations are appropriate.

The regulated businesses also emphasised that it is an involved (and costly) process to establish the systems, processes and resources to give practical effect to their regulatory accounting obligations, including their cost allocation requirements. They consistently emphasised that the AER should have regard for this in developing its new cost allocation arrangements and that if any significant changes are to be required to their current requirements then appropriate time, and transition arrangements, be allowed to enable them to implement their new obligations.

These concerns have informed the approach taken as set out in section 5.9 of this document. In addition, the need for flexibility is seen as particularly relevant given the desirability of establishing as much consistency of approach to cost allocation as is possible between the different regulated sectors.

Q2.	*Would it be appropriate to apply a single set of allocators to all network service providers?*

4 Alternative approaches to regulating cost allocation

The consultations referred to in section 1.9 identified a range of alternative approaches to regulating cost allocation arrangements for regulated businesses.

The differences between the alternative approaches principally revolve around the way in which the Cost Allocation Guidelines would treat:

- the selection of the cost allocators for shared costs
- the information to be included in the regulated business's Cost Allocation Methodology
- changes to the Cost Allocation Methodology over time
- the conduct of the regulatory audit as it relates to cost allocation and
- the cost allocation information to be given to support financial information provided to the regulator, whether it be in regulatory accounts or a revenue proposal.

There are a range of options available to the AER about the way in which it will deal with each of these matters, including whether it will:

- Mandate cost allocation requirements to be applied uniformly, without variation, by the regulated businesses.
- Set requirements to be applied by the regulated business unless it provides an appropriate justification for changing them that would ensure that high-level principles set by the AER continue to be promoted.
- Allow the business to propose cost allocation arrangements for approval by the AER before they are applied, having regard for high-level principles set by the AER, with any changes to the approved position also needing to be approved by the AER applying the same principles.
- Allow the business to develop and apply its own approach without prior approval by the AER, subject to subsequently demonstrating that the resultant outcomes promote high-level principles set by the AER.

The following section examines the potential application of these approaches in the AER's Cost Allocation Guidelines and regulated businesses' Cost Allocation Methodology.

5 Key elements of proposed cost allocation arrangements

The purpose of this section is to propose the key features of new Cost Allocation Guidelines. The positions proposed in this section have been reflected in the First Proposed Cost Allocation Guidelines for the electricity transmission sector.

5.1 Relationship between National Electricity Rules, Guidelines and Methodology

Diagram 1 below illustrates the interrelationship between the elements of the cost allocation arrangements as specified in the NER including: the Cost Allocation Principles; the Cost Allocation Guidelines; and the Cost Allocation Methodology.

Diagram 1: Cost allocation arrangements

Cost Allocation Principles

Responsibility: The AEMC to prescribe the Cost Allocation Principles in the NER.

The Cost Allocation Principles are under clause 6A.19.2(1)-(8) of the NER.

Cost Allocation Guidelines

Responsibility: The AER to develop Cost Allocation Guidelines and be responsible for approving regulated businesses' Cost Allocation Methodologies.

Clause 6.A.19.3(b)(1) of the NER states that the Cost Allocation Guidelines must give effect to and be consistent with the Cost Allocation Principles.

Cost Allocation Methodology

Responsibility: Regulated Businesses to develop their own Cost Allocation Methodology and submit to the AER for approval.

A business's Cost Allocation Methodology should set out how, in a practical sense, it will allocate its costs to give effect to the Cost Allocation Principles under the NER consistent with the requirements of the Cost Allocation Guidelines.

The nature and purposes of National Electricity Rules made by the AEMC, the Cost Allocation Guidelines made by the AER and the Cost Allocation Methodology made by the regulated business need to be clearly understood.

Section 34(3)(e) of the National Electricity Law gives the AEMC power to make National Electricity Rules to confer a function on the AER to make or issue guidelines in accordance with the NER.

Clause 6A.19.3(a) of the NER requires the AER to make, in accordance with the transmission consultation procedures, Cost Allocation Guidelines relating to the preparation by a TNSP of its Cost Allocation Methodology.

As discussed in section 1.3, clause 6A.19.2 of the NER sets out the Cost Allocation Principles and clause 6A.19.3(b)(1) requires that the guidelines “must give effect to and be consistent with the Cost Allocation Principles”.

The NER does not, however, set out the required contents of the Cost Allocation Guidelines. Rather, clause 6A.19.3(c) states that:

Without limiting the generality of paragraph (b), the Cost Allocation Guidelines may specify:

(1) the format of a Cost Allocation Methodology;

(2) the detailed information that is to be included in a Cost Allocation Methodology;

(3) the categories of transmission services which are to be separately addressed in a Cost Allocation Methodology, such categories being determined by reference to the nature of those services, the persons to whom those services are provided or such other factors as the AER considers appropriate; and

(4) the allocation methodologies which are acceptable and the supporting information that is to be included in relation to such methodologies in a Cost Allocation Methodology.

Given that the AER will ultimately be regulating nine electricity TNSPs (and thirteen electricity DNSPs once it takes responsibility for regulating the distribution sector) it is proposed that, for procedural efficiency, the Cost Allocation Guidelines clearly specify:

- The required contents of a regulated business’s Cost Allocation Methodology – this is discussed further in section 5.3 below.
- The basis on which the AER will assess a regulated business’s proposed Cost Allocation Methodology for approval – this is discussed further in section 5.4 below.
- The basis on which the AER will consider proposed changes to a regulated business’s proposed Cost Allocation Methodology over time in order that it be a ‘living document’ – this is discussed further in section 5.5 below.
- How the AER expects the Cost Allocation Methodology to be applied over time.

This will ensure that there is clarity, consistency and transparency about:

- What all businesses need to provide to the AER.

- The basis on which the AER will consider, assess and approve the regulated businesses' submissions.

- How regulated businesses apply their Cost Allocation Methodology.

Clause 6A.19.4(a) of the NER requires each TNSP to develop a proposed Cost Allocation Methodology for submission to the AER in accordance with the requirements of the Cost Allocation Guidelines. The Cost Allocation Methodology should set out how, in a practical sense, a regulated business will allocate its costs to give effect to, and be consistent with the requirements of, the Cost Allocation Guidelines, in order to meet the requirements of the NER.

It is noted that clause 6A.19.3(d) of the NER enables the Cost Allocation Guidelines to be amended or replaced by the AER from time to time in accordance with the transmission consultation procedures at clause 6A.20.

5.2 Selection of cost allocators for shared costs

The Cost Allocation Principles in clause 6A.19.2 of the NER provide that, wherever possible, costs be directly attributed to the provision of a service. It is therefore only in the case of shared costs that a choice of allocator needs to be made in order to allocate costs between services.

Two key issues need to be considered in deciding how cost allocators for shared costs should be determined.

Firstly, a shared cost allocator could either be selected by the regulated business or the AER itself. It is noted that a distinction is drawn here between:

- the selection of a cost allocator, such as floor space in a building, headcount or regulatory asset value - this is the focus of this discussion and

- the numeric value or percentage that is applied for the purposes of allocating costs between services.

Once selected, the cost allocator remains constant over time whereas it is expected that the numeric value or percentage of the allocator would change between years or regulatory periods, depending on what occurs within the business.

The benefit of the AER making the decision about the allocators is that a single set of allocators could be applied consistently by all regulated businesses. However, this approach would not readily:

- Recognise the differences in the nature of regulated businesses discussed in section 3. This is evident, for example, when considering a head-count allocator for both a business that mainly out-sources its operations (and thus has few employees) and a business that does not (and so has a larger workforce).

- Reflect the underlying substance of transactions or events in allocating costs, which can only be done effectively if it is informed by a detailed knowledge of those transactions or events and indeed, the regulated business itself.

These two limitations can be overcome if the regulated business chooses the allocator, although this would mean that different allocators would apply to different regulated businesses (albeit that they should all promote the Cost Allocation Principles). This in turn would limit the direct comparability of cost information, although adjustments could be made in order to address this.

This second approach was broadly supported during the consultations referred to in section 1.9. This reflected a view that the AER should pursue the provision of relevant, reliable and consistent information *within* an individual regulated business over time ahead of obtaining information that is strictly comparable *between* different regulated businesses at any point in time. This was not intended to understate the value (or need) of the regulator being able to compare the costs of providing transmission and distribution services across the regulated businesses but rather to recognise the unique nature of each business and ensure that costs are allocated to reflect the underlying substance of transactions as a primary goal.

An option was also identified during the course of the consultations for the regulated businesses to work together to develop an "industry standard" for the attribution and allocation of costs. This would have the benefit of being informed by the businesses' understanding of their collective operations but would still need to incorporate sufficient flexibility to accommodate the unique characteristics and circumstances of individual businesses. In order for this concept to proceed it would need to be accepted and advanced by the regulated businesses themselves, although the AER would be pleased to cooperate in and facilitate the development of such a standard.

The second key issue relates to the timing for the approval of the allocators. If the business is allowed to choose its allocators then they could either be approved by the AER before they are applied, or alternatively the business could be free to apply them first and only describe and justify the choice and application of the allocators at a later time. There are several benefits to requiring up-front regulatory approval of shared cost allocators, including that it:

- Promotes certainty and transparency about the basis on which costs will be allocated prior to a business preparing and submitting its revenue proposal to the AER. The approved allocators should be applied both in their revenue proposal and in the subsequent preparation of their annual regulatory accounts during the regulatory period. This would therefore promote consistency in the information presented by the business over time.

- Allows the scope of the cost allocation component of the regulatory audit to be confined to just assessing whether the allocators have been appropriately applied, rather than assessing whether they are in fact appropriate. This is consistent with the view emphasised by several regulators consulted in preparing this document that the AER should be careful to avoid "contracting out regulatory judgement" to consultants and auditors.

- An up-front approval removes the matter of cost allocators from further debate during the revenue determination process, when there are many other more critical (and time consuming) matters being dealt with between the AER and the regulated business. It therefore 'locks away' a matter that is capable of being dealt with in advance of the determination.

It is therefore proposed that the Cost Allocation Guidelines provide for:

- The regulated business, rather than the AER, selecting the specific allocators for shared costs, subject to the Cost Allocation Principles under the NER and the Cost Allocation Guidelines.
- The regulated business being required to include its allocators in its proposed Cost Allocation Methodology, together with the reasons why the chosen allocators best promote the Cost Allocation Principles and any other objectives that the AER may specify in the Cost Allocation Guidelines.
- The AER assessing and approving the allocators as part of its broader consideration of the Cost Allocation Methodology, as discussed in section 5.4 below.
- The business being required to demonstrate and explain its application of the approved cost allocators in supporting notes to its revenue proposal and regulatory accounts as discussed in section 5.7 below.

Finally, there is the question of permissible approaches to the allocation of costs. There are a variety of cost allocation methods available to businesses to attribute their costs. Essentially, there should be an attribution of all costs, including shared costs, and this is commonly achieved by using the fully distributed cost method. Other possible methods include activity based costing, marginal cost, and incremental and avoidable cost. However, the use of avoidable cost may be problematic where it can be a matter of considerable judgement as to the quantum of costs a business would save by no longer performing a particular activity. The AER therefore invites comment on whether the avoidable cost method should be allowed under the guidelines and, if so, should it be restricted to immaterial costs?

Q3. Should the regulated business or the AER select the allocators for shared costs?

Q4. Is there merit in the regulated businesses working together to produce an "industry standard" for the attribution and allocation of costs?

Q5. Should cost allocation be allowed using the avoidable cost method and, if so, should it only be allowed for immaterial costs?

5.3 Contents of Cost Allocation Methodology

Clause 6A.19.2(1) of the NER provides that:

> the detailed principles and policies used by a Transmission Network Service Provider to allocate costs between different categories of transmission services must be described in sufficient detail to enable the AER to replicate reported outcomes through the application of those principles and policies.

As discussed in section 5.1 and contemplated in clause 6A.19.3(c)(2) of the NER, it is proposed that the Cost Allocation Guidelines mandate the contents of the Cost Allocation Methodology in order to address this requirement. This is considered necessary in order to promote procedural efficiency in the preparation, assessment and approval of the documents and clarity, consistency and transparency of outcomes.

It is proposed that the regulated businesses' Cost Allocation Methodologies be required to contain the following information:

- A version history and date of issue for the document.
- The nature, scope and purpose of the document – as the document will have a practical application within each regulated business, it should detail explicitly why it has been prepared and the way in which it should be used.
- Roles and responsibilities for updating, maintaining and applying the Methodology – this will ensure that there is a clear accountability within each business for the document.
- Corporate and operational structure – this will enable the AER to understand how the regulated business is structured to provide its regulated services.
- The nature and definition of service categories – this will enable the AER to understand the nature of the services that the regulated business provides. As noted in section 2.4, this is considered to be critical to effective cost allocation.
- The business's detailed principles and policies of cost attribution and allocation – this should detail the regulated business's approach to practically implementing the Cost Allocation Principles under the NER using its cost allocation methodology. It is proposed that the detailed principles and policies must address directly attributable and shared costs.
- The business's approach to records management – this should describe how the business will maintain records of the attribution or allocation of costs to, or between, categories of services in order to enable any such attribution or allocation to be demonstrate to the AER and audited and otherwise verified as required.
- The business's compliance monitoring – this should describe how the business will monitor its compliance with the Cost Allocation Methodology and the Cost Allocation Guidelines.
- Commencement date – this should detail the proposed date on which the Cost Allocation Methodology will commence.
- Attestation of the accuracy of information – at least two directors of the business should attest to the accuracy of the information contained in the Cost Allocation Methodology and confirm the business's intention to comply with the Cost Allocation Methodology as approved by the AER.

5.4 Assessment and approval of Cost Allocation Methodology

As discussed in section 5.1, it is proposed that the Cost Allocation Guidelines include details of the basis on which the AER will assess and approve a Cost Allocation Methodology, consistent with the relevant provisions of the NER. This is considered necessary in order to promote certainty and transparency in the way in which the AER discharges its regulatory responsibilities.

The NER does not provide specific guidance on the approval process, although:

- Clause 6A.19.4(b) provides that the Cost Allocation Methodology must give effect to, and be consistent with, the Cost Allocation Guidelines. As clause 6A.19.3(b)(1) requires the Guidelines to be consistent with, and give effect to, the Cost Allocation Principles, the Methodology must by implication also promote the Principles.
- Clauses 6A.19.4(c) and 6A.19.4(d) provide that the AER must refuse or approve a proposed Cost Allocation Methodology within six months of receiving it, failing which it will be deemed to have been approved.
- Clause 6A.19.4(e) allows the AER to amend a Cost Allocation Methodology submitted to it, after consulting with the business, in the course of its approval.

It is proposed that the Cost Allocation Guidelines specify that the AER will assess a regulated business's Cost Allocation Methodology on the basis of whether it gives effect to, and is consistent with, the Cost Allocation Guidelines/Principles. In this way, the AER will need to ensure that the Cost Allocation Methodology:

- Contains the information required by the Cost Allocation Guidelines.
- Effectively promotes the Cost Allocation Principles under clause 6A.19.2 of the Rules.

It is proposed that any decision by the AER to reject or amend a proposed Cost Allocation Methodology must include an explanation of the reasons for its decision.

The timing of the submission and approval of Cost Allocation Methodologies is discussed in section 5.9 below.

5.5 Amending an approved Cost Allocation Methodology

The NER provides that the TNSP:

- May apply to the AER to amend its Cost Allocation Methodology from time to time (clause 6A.19.4(f)).
- Must amend its Cost Allocation Methodology if required to do so by the AER (clause 6A.19.4(g)).

As noted previously, in order to promote certainty and transparency in the way in which the AER discharges its regulatory responsibilities, as well as consistency in the nature of the information that the AER receives from regulated businesses, it is proposed that the Cost Allocation Guidelines include provisions relating to:

- The basis on which the AER will assess and decide upon an application to amend a Cost Allocation Methodology.
- The action required of a regulated business in the event that such an amendment is approved.

It is proposed that the Cost Allocation Guidelines provide that:

- A regulated business should only be able to amend its Cost Allocation Methodology if it can demonstrate in its application that:
  - there has been a material change in its circumstances
  - the amendment is necessary for the business effectively to promote the Cost Allocation Principles
  - the resultant amended Cost Allocation Methodology would give effect to, and be consistent with, these Guidelines
  - the amendment will not jeopardise the comparability of the resultant financial information with that being provided to the AER by the regulated business and
  - the impact of the proposed change can be quantified and demonstrated to the AER.[2]
- An amended Cost Allocation Methodology can only take effect from the start of a new regulatory year.
- The AER may make the approval of the amendment conditional on the regulated business restating the previous year's Regulatory Reporting Statements and the preceding Regulatory Financial Forecasts on a basis consistent with the amended Cost Allocation Methodology.[3] While this would increase the regulatory compliance burden for industry, without it the AER could not effectively:
  - ensure that the effects of changes are disclosed and reconciled over time and
  - compare financial information for a business on an on-going basis.
- The AER, in consultation with the regulated business, review the regulated business's Cost Allocation Methodology as part of each revenue cap determination for the relevant business in order to ensure that it continues to give effect to, and is consistent with, the Cost Allocation Guidelines.

[2] These requirements draw from similar requirements in clause 5.8 of the QCA's "Electricity Distribution – Regulatory Reporting Guidelines", November 2005.

[3] This requirement draws from similar requirements in clause 4.4 of the QCA's "Electricity Distribution – Regulatory Reporting Guidelines", November 2005.

- If the AER does not explicitly approve a regulated business's amended Cost Allocation Methodology within six months the amended Cost Allocation Methodology will be deemed to be approved.

5.6 Application of a Cost Allocation Methodology

Clause 6A.19.1 of the NER provides that:

> A Transmission Network Service Provider must comply with the Cost Allocation Methodology that has been approved in respect of that provider from time to time by the AER under this rule 6A.19.

It is proposed that the Cost Allocation Guidelines not seek to include an exhaustive list of the circumstances in which a regulated business is required to apply its Cost Allocation Methodology. Rather, the Guidelines should state that the methodology should be applied, without limitation, for the purposes required by the NER, being when:

- Forecast operating expenditure is submitted to the AER in accordance with clause 6A.6.6 of the NER.
- Forecast capital expenditure is submitted to the AER in accordance with clause 6A.6.7 of the NER.
- Prices for a negotiated transmission service are determined in accordance with clause 6A.9.1 of the NER.
- A certified annual statement is submitted to the AER in accordance with clause 6A.17.1(a) of the NER.
- Actual or estimated capital expenditure is used for the purposes of increasing the value of its regulatory asset base under clause S6A.2.1(f)(4) of the NER.

5.7 Cost Allocation information to be provided with other financial information

Clause 6A.17.1(d)(2) of the NER provides that a TNSP's certified annual financial statements and additional information provided by a TNSP to the AER may be used by the AER:

> to monitor, report on and enforce compliance with the provider's Cost Allocation Methodology.

In addition, clause 6A.19.2(4) of the NER provides that:

> any cost allocation methodology which is used, the reasons for using that methodology and the numeric quantity (if any) of the chosen allocator must be clearly described.

Part of the requirement of clause 6A.19.2(4) will be addressed in the Cost Allocation Methodology itself (if the content proposed in section 5.3 is adopted) through the description and justification of the allocators, although the requirement to disclose the numeric quantity of the chosen allocator will not. In order to address this requirement, and to promote transparency in the information provided to the AER by the regulated business, it is proposed that the Cost Allocation Guidelines include a requirement to provide supporting work papers with financial information that has been developed using the Cost Allocation Methodology. It is noted that there is a requirement of this kind in section 3.3 of the AER's current Information Requirements Guidelines.

It is proposed that the supporting work papers must:

- Demonstrate how the regulated business has applied the detailed principles and policies in its approved Cost Allocation Methodology.

- Provide details of the numeric quantity or percentage of the allocator, or allocators, applied to each cost item.

- Provide an explanation of how the numeric quantity or percentage of each allocator has been calculated for each cost item, including where the data for determining the numeric quantity or percentage have been sourced.

It is noted that this is complemented by a broader information gathering power under clause 6A.17.1(c) of the NER, which allows the AER to:

> require a Transmission Network Service Provider to provide, by a date and in the form and manner specified by the AER, any additional information the AER reasonably requires for a purpose set out in paragraph (d).

5.8 Regulatory audit

There are two broad provisions in the National Electricity Rules in relation to the conduct of regulatory audits:

- Clause 6A.10.2(b)(2) provides that the Submission Guidelines must specify "the requirements for any information contained in or accompanying the Revenue Proposal to be audited or otherwise verified". It is anticipated that this would include the audit of the allocation of costs used for the purposes of developing capital and operating expenditure forecasts.

- Clause 6A.17.1(e) provides that "The AER may request or undertake verification and/or independent audit of any information sought by it, or provided to it, under this clause 6A.17", that is, in relation to the provision of the TNSP's annual certified financial statements.

It is considered that audit arrangements need to be sufficiently flexible to accommodate the differences in the nature of regulated businesses discussed in section 3.

Ensuring that the audit arrangements have regard for the individual characteristics of a regulated business, and are therefore 'fit for purpose', can be best achieved if the scope and terms of the audit are agreed on an individual basis between the AER and a regulated business.

The AER's existing Information Requirements Guidelines deal with the auditing of TNSP's historic and forecast financial information. It is considered that the future Information Guidelines and Submission Guidelines, rather than the Cost Allocation Guidelines, are the most appropriate instruments through which arrangements relating to the nature and conduct of regulatory audits should be addressed. This is because regulatory audits are generally broader in scope than just cost allocation. They typically concern whether regulatory accounts fairly represent the financial performance and results of the business given relevant regulatory requirements (such as Guidelines).

The Information Guidelines and Submission Guidelines, rather than the Cost Allocation Guidelines, will therefore address arrangements relating to the nature and conduct of regulatory audits.

There are, however, several cost allocation issues that are directly relevant to the scope of the audit, including:

- *What is being audited* – in general terms, a regulatory audit could assess whether:
  - the nature of the cost allocators applied by a regulated business are the most suitable and appropriate that could be used, having regard for relevant regulatory requirements and / or
  - the regulated business has made appropriate attributions (in the case of direct costs) and allocations (in the case of shared costs) in preparing its financial information, having regard for relevant regulatory requirements.

  Because it is proposed that the AER approve a regulated business's Cost Allocation Methodology prospectively, it is proposed that the scope of the regulatory audit (as it relates to cost allocation) only assess whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable. This will include assessing whether the numeric value or percentage that is applied for the purposes of allocating costs between services is appropriate (i.e. has been determined in accordance with the methodology).

- *Against what instruments compliance is being assessed* – in the future, the regulated business will need to continue to prepare financial information for submission to the AER in accordance with Information Guidelines and Submission Guidelines. However, in preparing this financial information, the business will also need to comply with the requirements of:
  - the Cost Allocation Guidelines and
  - its approved Cost Allocation Methodology.

  It is therefore proposed that the Information Guidelines and Submission Guidelines ensure that the scope of the audit is sufficiently broad to accommodate these other instruments.

- *How the auditor needs to audit shared costs* – The AER has included a provision in the Cost Allocation Guidelines to require any audit of financial information under the Information Guidelines and Submission Guidelines to include an assessment of whether a sample of allocations of shared costs accords with the regulated business's approved Cost Allocation Methodology.

Q6. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assess whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?

5.9 Timing and transition issues

Transitional guidelines for revenue resets commencing in 2007

A separate transitional consultation process has been undertaken with SP AusNet, VENCorp and ElectraNet. These businesses have revenue resets that commence in the first half of 2007 and require relevant guidelines to be ready prior to submitting their Revenue Proposals and proposed Negotiating Frameworks to the AER in Feb-March and June 2007. This, however, is before the guidelines are finalised by the AER under the Chapter 6A NER in September 2007. Accordingly, a separate set of transitional guidelines has been issued to these businesses for use in their next resets in 2007-08 following a separate consultation process in December 2006 and January 2007 with these businesses. These transitional guidelines are essentially the same and have been released at the same time as the proposed guidelines, which will be the subject of the further process set out in this paper.

Timing and other matters

Clause 6A.19.3(e) of the NER provides that the AER must make Cost Allocation Guidelines by 28 September 2007, in accordance with the transmission consultation procedures in clause 6A.20 – these procedures include timeframes for consulting on, and finalising, the guidelines.

Each TNSP is then required under clause 6A.19.4(a) to:

> submit to the AER for its approval a document setting out its proposed Cost Allocation Methodology:
>
> (1) by 28 March 2008; or
>
> (2) in the case of an entity that is not a Transmission Network Service Provider as at 28 September 2007, within 6 months of being required to do so by the AER.

As already noted above, clauses 6A.19.4(c) and 6A.19.4(d) of the NER deal with the process for assessing and approving proposed Cost Allocation Guidelines and clause 6A.19.1 provides that "A Transmission Network Service Provider must comply with the Cost Allocation Methodology that has been approved in respect of that provider from time to time by the AER".

The NER therefore envisage that a regulated business's Cost Allocation Methodology will take effect from the date that it is approved by the AER. This could potentially be a different date for different businesses and could be:

- a date during an existing regulatory period if the AER considered it appropriate for the Cost Allocation Methodology to take effect immediately or

- a future date if the AER considered that the Methodology should not apply until the start of a new regulatory period.

It is possible that different approaches will be appropriate for different businesses, having regard for matters such as:

- The need to maintain consistency and comparability of information reporting within a regulatory period.
- The nature and significance of the differences between current and future cost allocation methodologies.
- The assessed need to start collecting information on a set basis for future use.
- The time remaining in the current regulatory period.

It is therefore proposed that the Cost Allocation Guidelines include provisions to:

- Allow the AER to require that a Cost Allocation Methodology either take effect immediately upon approval or at some future date determined by the AER.
- Require the regulated business to detail how it will transition between its current and new cost allocation arrangements if it considers that the Cost Allocation Methodology should not take effect immediately and, even if it does take effect immediately, how the business's actual and forecast costs can be compared over time.

6. List of questions for comment

Comments are sought from interested parties on the scope of the AER's considerations in, and on the specific questions identified throughout, this Issues Paper, and listed below. In addition, interested parties are invited to comment on the proposed Cost Allocation Guidelines, which have been developed on the basis of the approach proposed in this Issues Paper.

Q1. Are the working assumptions used to prepare this Issues Paper appropriate?

Q2. Would it be appropriate to apply a single set of allocators to all network service providers?

Q3. Should the regulated business or the AER select the allocators for shared costs?

Q4. Is there merit in the regulated businesses working together to produce an "industry standard" for the attribution and allocation of costs?

Q5. Should cost allocation be allowed using the avoidable cost method and, if so, should it only be allowed for immaterial costs?

Q6. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assess whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?

Any submissions or comments made must be received by close of business 1 May 2007 and should be addressed to:

First Proposed Guidelines
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

Appendix A Cost Allocation Principles - clause 6A.19.2 of the NER

The following principles constitute the Cost Allocation Principles:

(1) the detailed principles and policies used by a Transmission Network Service Provider to allocate costs as between different categories of transmission services must be described in sufficient detail to enable the AER to replicate reported outcomes through the 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) only the following costs may be allocated to a particular category of transmission services:

  (i) costs which are directly attributable to the provision of those services; and

  (ii) costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should:

    (A) except to the extent the cost is immaterial or a causal-based method of allocation cannot be established without undue cost and effort, be causation-based; and

    (B) to the extent the cost is immaterial or a causal-based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well-accepted cost allocation methodology;

(4) any cost allocation methodology which is used, the reasons for using that methodology and the numeric quantity (if any) of the chosen allocator must be clearly described;

(5) the same cost must not be allocated more than once;

(6) the principles, policies and approach used to allocate costs must be consistent with the Transmission Ring-Fencing Guidelines;

(7) costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services; and

(8) costs which have been allocated to negotiated transmission services may be reallocated to prescribed transmission services to the extent they satisfy the principle referred to in subparagraph (3).