Final decision

ActewAGL

cost allocation method

March 2008

AUSTRALIAN ENERGY REGULATOR

Contents

Shortened forms

AER	Australian Energy Regulator
APM	alternative pricing methodology (ICRC)
CAM	cost allocation method
DNSP	distribution network service provider
ICRC	Independent Competition and Regulatory Commission (ACT)
MCE	Ministerial Council on Energy
NEM	national electricity market
NER	National Electricity Rules

1 Introduction

1.1 Summary

The Australian Energy Regulator (AER) has approved the cost allocation methods (CAM) submitted by ActewAGL in accordance with the National Electricity Rules (NER). The CAM proposed by ActewAGL has been prepared, as far as practicable, using the CAM it last used in preparing its regulatory accounts for submission to the Independent Competition and Regulatory Commission (ICRC) and subject to this is consistent with the cost allocation principles set out by the AER for the 2009-14 regulatory control period. The assessment of ActewAGL's CAM was based on the advice of McGrathNicol Corporate Advisory (McGrathNicol), who were engaged by the AER for this purpose.

1.2 Background

The AER is responsible for regulating the revenues and/or prices of distribution network service providers (DNSPs) in the national electricity market (NEM) in accordance with the NER, which were notified in the South Australian Gazette on 20 December 2007.

Within the NER, Chapter 6 deals with the classification and economic regulation of distribution services, while Chapter 6A deals with the economic regulation of transmission services. The Ministerial Council on Energy (MCE) has determined that transitional arrangements will apply to the preparation and assessment of the ACT and NSW 2009 distribution determinations. The transitional arrangements for the 2009–14 regulatory control periods for the ACT and NSW are set out in appendix 1 to Chapter 11 of the NER. Clause references in appendix 1 are numbered commencing with a six.

The NER distinguishes between the rules in Chapter 6 and Chapter 11 by referring to the Chapter 6 rules as 'general Chapter 6 rules,' and Chapter 11 rules as 'transitional Chapter 6 rules.' The AER has followed this convention in this document when referring to the two sets of rules.

Part F of the transitional Chapter 6 rules outlines cost allocation principles and method for the ACT DNSP. The AER is required to approve or refuse to approve a CAM proposed by the ACT DNSP.

This decision applies to ActewAGL.

2 Process

ActewAGL was required to submit a proposed CAM to the AER by 1 February 2008. McGrathNicol was engaged to assist the AER in assessing the compliance of the CAM with the transitional Chapter 6 rules, and produce a report for the AER's consideration.

A document outlining ActewAGL's proposed CAM was received by the AER on 1 February 2008. The AER considered that the document contained sufficient information to make an assessment of its compliance with the requirements of the transitional Chapter 6 rules.

The AER requested that the ICRC review the CAM submitted by ActewAGL. The ICRC provided a review of ActewAGL's proposed CAM in response to the AER's request.

The report prepared by McGrathNicol on ActewAGL's proposed CAM was provided to ActewAGL for comment. ActewAGL provided a response to the McGrathNicol report.

3 Rule requirements

3.1 Cost allocation principles for the ACT

Clause 6.15.7 of the transitional Chapter 6 rules outlines the cost allocation principles to be used by the ACT DNSP in the 2009–14 regulatory control period. Clause 6.15.7 states:

> **6.15.7 Cost Allocation Principles (ACT)**
>
> The following principles constitute the Cost Allocation Principles for the ACT Distribution Network Service Provider:
>
> (1) the detailed principles and policies used by the ACT Distribution Network Service Provider to allocate costs between different categories of *distribution 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 *distribution 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 method;
>
> (4) any cost allocation method which is used, the reasons for using that method 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 Distribution Ring-Fencing Guidelines;
>
> (7) costs which have been allocated to a particular service cannot be reallocated to another service during the course of a *regulatory control period*.

3.2 Cost allocation method for the ACT

Clause 6.15.8 of the transitional Chapter 6 rules outlines the CAM to be used by the ACT DNSP. Clause 6.15.8 states:

> **6.15.8 Cost Allocation Method (ACT)**
>
> (a) The ACT Distribution Network Service Provider must submit to the *AER* for its approval a document setting out its proposed Cost Allocation Method for the regulatory control period 2009-2014 within 1month after the commencement date.
>
> (b) The Cost Allocation Method proposed by the ACT Distribution Network Service Provider must:
>
> (1) be prepared using, as far as practicable, the same cost allocation method as it last used when preparing its regulatory accounts for submission to the ICRC; and
>
> (2) subject to subparagraph (1), be consistent with the Cost Allocation Principles.
>
> (c) The *AER* may approve or refuse to approve the Cost Allocation Method submitted under paragraph (a), but must approve it if the *AER* is satisfied that it:
>
> (1) has been prepared, as far as practicable, using the cost allocation method the ACT Distribution Network Service Provider last used when preparing its regulatory accounts for submission to the ICRC; and
>
> (2) subject to subparagraph (1), is consistent with the Cost Allocation Principles.
>
> (d) The *AER* must notify the ACT Distribution Network Service Provider of its decision to approve or refuse to approve the Cost Allocation Method submitted to it under paragraph (a) within 2 months of its submission, failing which the *AER* will be taken to have approved it.
>
> (e) As part of giving any approval referred to in paragraph (c), the *AER* may, after consulting with the ACT Distribution Network Service Provider, amend the Cost Allocation Method submitted to it, in which case the Cost Allocation Method as so amended will be taken to be approved by the *AER*.
>
> (f) The ACT Distribution Network Service Provider may, with the *AER's* approval, amend its Cost Allocation Method from time to time but:
>
> (1) the amendment:
>
> (i) may be approved on condition that the provider agree to incorporate into the amendment specified additional changes to the Cost Allocation Method the *AER* reasonably considers necessary or desirable as a result of the amendment as submitted; and
>
> (ii) if approved on such a condition, does not take effect unless and until the provider notifies the *AER* of its agreement;

(2) if 6 months elapse from the date of the submission of the amendment and the *AER* has not notified the provider within that period of its approval or refusal to approve the amendment, the amendment is, at the end of that period, conclusively presumed to have been unconditionally approved.

(g) The ACT Distribution Network Service Provider must maintain a current copy of its Cost Allocation Method on its website.

3.3 ICRC guidelines

The alternative pricing methodology (APM) set out at Appendix 6 of the ICRC's *Investigation into prices for electricity distribution services in the ACT, March 2004*, contains cost allocation principles for ActewAGL for the current regulatory control period. These principles were applied by ActewAGL when preparing its regulatory accounts. Section 5 of the APM requires that ActewAGL provide a pricing strategy statement, which includes its cost allocation methodology. The pricing strategy statement also requires an explanation of how the cost allocation methodology complies with the pricing principles of the APM listed in Section 4 of the APM.

Point 2 of Section 4 requires that prices should be based on a well-defined and clearly explained methodology.

Point 3 of Section 4 requires that price development should incorporate an analysis of the cost of service provision that includes:

(a) a definition of the classes of service provided and the parameters by which the quantum and standard of service in each class are measured

(b) an examination of the cost elements that arise from the use, operation and expansion of the network

(c) for each class of service and each cost element, identification of the relationship between the quantum and standard of service provided and the level of current and future costs

(d) an allocation of existing and future network costs to service classes

(e) the translation of allocated costs into service prices at the defined service standard, and

(f) estimates of the range of subsidy-free prices for each service class.

4 AER considerations

4.1 Consistency with previous cost allocation method

Clause 6.15.8(b)(1) of the transitional Chapter 6 rules requires that ActewAGL's proposed CAM be prepared using the same cost allocation method as ActewAGL last used when preparing its regulatory accounts for submission to the ICRC. Subject to this requirement, ActewAGL's CAM must accord with the cost allocation principles set out at clause 6.15.7 of the transitional Chapter 6 rules.

The ICRC was contacted during the assessment to provide assistance to the AER in assessing the compliance of ActewAGL's proposed CAM with the transitional Chapter 6 rules. It was the opinion of the ICRC that ActewAGL's proposed CAM was consistent with the cost allocation arrangements that it has approved on previous occasions. McGrathNicol also outlined in its report that, in comparison with ActewAGL's previous regulatory accounts, the proposed CAM did not appear to be inconsistent with the cost allocation method ActewAGL last used when submitting its regulatory accounts to the ICRC. The AER is satisfied that ActewAGL's proposed CAM complies with clause 6.15.8(b)(1) of the transitional Chapter 6 rules.

4.2 Consistency with cost allocation method principles

Clause 6.15.7(1) of the transitional Chapter 6 rules requires that ActewAGL's proposed CAM outlines the detailed principles and policies used by ActewAGL to allocate costs between different categories of distribution services. The different categories of distribution services provided by ActewAGL are standard control services, alternative control services, and unregulated services. ActewAGLs proposed CAM allocates costs between these categories of service. The details on allocation of costs under ActewAGL's proposed CAM are considered below.

4.2.1 Direct distribution services costs

Clause 6.15.7(3)(i) of the transitional Chapter 6 rules requires that only costs directly attributable to the provision of a particular category of service may be allocated to those services. ActewAGL's proposed CAM allocates direct project costs including materials, contract services and other costs to the category of service of the relevant project. Payroll and payroll related costs are all directly attributed to the relevant category of service based on time booked against projects.

4.2.2 Indirect distribution services costs

Clause 6.15.7(3)(ii) of the transitional Chapter 6 rules provides that costs which are not directly attributable to a particular category of service but which are incurred in providing those services may be allocated using an appropriate allocator. The allocator chosen should be causation based and accord with a well accepted cost allocation method. ActewAGL's proposed CAM allocates electricity network overhead costs, including lease costs, consumables, rates, insurance, staff training, stationery, electricity and protective clothing on the basis of hours booked against projects within each distribution service category.

Clause 6.15.7(3) provides that only those direct costs specified by 6.15.7(3)(i) and those indirect costs specified by 6.15.7(3)(ii) may be allocated to a particular category of distribution service. The AER is satisfied that the direct costs and electricity network overhead costs allocated to distribution services in ActewAGL's CAM comply with clause 6.15.7(3).

4.2.3 Corporate services costs

ActewAGL has submitted that the costs of corporate services provided by ActewAGL Distribution, which are shared between electricity distribution services and other services, are allocated directly or using clear causal based allocators where possible. For example, Human Resources costs are largely allocated based on the number of employees in each division. For cost components where direct allocation is not possible, or there is no ideal causal allocator, ActewAGL's proposed CAM uses a weighted average of four business drivers to allocate costs. These business drivers are the service category's share of revenue, profit, value of asset base in total asset base, and percentage of employee numbers. The AER is satisfied that ActewAGL's allocation of corporate service costs complies with clause 6.15.7(3) of the transitional Chapter 6 rules.

4.2.4 Retail services costs

The costs of customer services provided by ActewAGL Retail to the electricity networks business are allocated to electricity distribution services using a causal basis of allocation. The AER is satisfied that this complies with clause 6.15.7(3) of the transitional Chapter 6 rules.

ActewAGL's proposed CAM directly allocates the costs of marketing services provided by ActewAGL Retail to the electricity networks business, as far as possible. The allocation of some marketing costs, such as internet and website development, Yellow Pages advertising and sponsorship are shared among electricity, gas, and water in proportion to customer numbers. The AER is not satisfied that these other marketing costs are incurred in the direct provision of electricity distribution services. Therefore, the AER considers that this aspect of ActewAGLs proposed CAM does not comply with clause 6.15.7(3) of the transitional Chapter 6 rules. However, ActewAGL notes in its proposed CAM that this approach to allocating marketing costs was accepted by the ICRC at the 2004 determination. It was the ICRCs view, in its correspondence with the AER, that this approach to marketing costs is currently allowed by the ICRC and should continue to be allowed for the 2009–14 regulatory control period.

5 Consideration of factors set out in the rules

The transitional Chapter 6 rules set out the factors for consideration in assessing ActewAGL’s proposed CAM. The AER’s consideration of the relevant factors is set out in this chapter.

6.15.8(c)—The AER may approve or refuse to approve the Cost Allocation Method submitted under paragraph (a), but must approve it if the AER is satisfied that it:

(1) has been prepared, as far as practicable, using the cost allocation method the ACT Distribution Network Service Provider last used when preparing its regulatory accounts for submission to the ICRC; and

(2) subject to subparagraph (1), is consistent with the Cost Allocation Principles.

Based on the information before it, and on the advice of the ICRC and McGrathNicol, the AER is satisfied that ActewAGL’s proposed CAM has been prepared using the CAM last used when preparing its regulatory accounts for submission to the ICRC.

The AER does not consider that ActewAGL’s proposed CAM is consistent with the cost allocation principles. Specifically, the AER is not satisfied that ActewAGL’s allocation of shared marketing costs is consistent with clause 6.15.7(3) of the cost allocation principles in the transitional Chapter 6 rules. However, this requirement is subject to the proposed CAM being consistent with the CAM that ActewAGL last used when preparing its regulatory accounts for submission to the ICRC. The AER is satisfied that ActewAGL’s allocation of shared marketing costs under its proposed CAM is consistent with the allocation of shared marketing costs under the CAM that ActewAGL last used in its regulatory accounts for submission to the ICRC.

The AER must therefore approve ActewAGL’s CAM in accordance with clause 6.15.8(c) of the transitional Chapter 6 rules.

6 Decision

The AER considers that ActewAGL's CAM has been prepared, as far as practicable, using the CAM last used when preparing its regulatory accounts for submission to the ICRC. While the AER is not satisfied that ActewAGLs allocation of certain marketing costs is consistent with the cost allocation principles set out in the transitional Chapter 6 rules, this requirement is subject to the proposed CAM being the same CAM that ActewAGL last used in preparing its regulatory accounts for submission to the ICRC. The AER is satisfied that the allocation of relevant marketing costs is consistent with the CAM last used by ActewAGL in preparing its regulatory accounts for submission to the ICRC. The AER has therefore decided to approve ActewAGL's proposed CAM.

Appendix A: CAM submitted by ActewAGL

The public CAM submitted by ActewAGL is attached as a separate document.