Final decision

NSW electricity distribution network service providers

cost allocation method

March 2008

Contents

Shortened forms

AER	Australian Energy Regulator
CAM	cost allocation method
DNSP	distribution network service provider
IPART	Independent Pricing and Regulatory Tribunal (NSW)
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 (CAMs) submitted by Country Energy, EnergyAustralia and Integral Energy in accordance with the National Electricity Rules (NER). The AER has concluded that the CAMs are consistent with the cost allocation guidelines set out by the Accounting Separation Code for Electricity Distributors in NSW, prepared by the Independent Pricing and Regulatory Tribunal (IPART) and subject to this are the same CAM that each business used in preparing its last regulatory accounts for submission to the IPART. The assessment of the each CAM was based on the advice of McGrathNicol Corporate Advisory, 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 the cost allocation guidelines and method for NSW DNSPs. The AER is required to approve or refuse to approve a CAM proposed by each NSW DNSP.

Each of the NSW businesses are required to be assessed against the same factors in the rules. The rules applying to the CAMs for each of the NSW businesses are identical, consequently the AER has decided to set out its decision on each of the CAMs in a single decision document.

This document sets out the AER’s decisions on the CAMs proposed by Country Energy, EnergyAustralia and Integral Energy.

2 Process

Country Energy, EnergyAustralia and Integral Energy were each required to submit a proposed CAM to the AER by 1 February 2008. McGrathNicol Corporate Advisory (McGrathNicol) was engaged to assist the AER in assessing the compliance of each CAM with the transitional Chapter 6 rules, and produce a report on each CAM for the consideration of the AER. As the McGrathNicol reports address confidential material provided by the DNSPs the AER has not published the McGrathNicol reports. The AER also wrote to the IPART to request its assistance in assessing the proposed CAMs.

2.1 Country Energy

On 1 February 2008 a document prepared by a third party in December 2007 was received from Country Energy that outlined a proposed approach to cost allocation to be taken by Country Energy. Following receipt of the proposed CAM the AER requested additional information. Subsequently, Country Energy provided the following documents:

- confirmation that Country Energy would apply the CAM set out in the 2007 document
- an earlier report referred to in the 2007 document
- a document containing summary information on Country Energy’s proposed CAM
- a document listing the allocator that would be adopted under the proposed CAM in the cases where more than one potential allocator was listed
- the publicly available version of Country Energy’s CAM to be maintained on its website

The report prepared by McGrathNicol on Country Energy’s proposed CAM was provided to Country Energy for comment. Country Energy provided a response to the McGrathNicol report.

2.2 EnergyAustralia

A document outlining EnergyAustralia’s proposed CAM was received on 4 February 2008. Following receipt of the proposed CAM the AER requested additional information from EnergyAustralia. Subsequently, EnergyAustralia provided the following documents:

- a more detailed document outlining EnergyAustralia’s proposed CAM
- the publicly available version of EnergyAustralia’s proposed CAM to be maintained on its website

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

2.3 Integral Energy

A document outlining Integral Energy's proposed CAM was received on 1 February 2008. Following receipt of the proposed CAM the AER requested additional information from Integral Energy. Subsequently, Integral Energy provided the following documents:

- a more detailed document outlining Integral Energy's proposed CAM
- a report prepared by Deloitte that outlines Integral Energy's approach to allocating corporate overheads and excel spreadsheets containing the models used by Integral Energy to allocate overhead costs
- an excel spreadsheet containing details of cost accounts.
- the publicly available version of Integral Energy's proposed CAM to be maintained on its website

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

3 Rule requirements

3.1 Cost allocation guidelines for NSW

Clause 6.15.5 of the transitional Chapter 6 rules specifies that:

6.15.5 Cost Allocation Guideline (NSW)

The Accounting Separation Code for Electricity Distributors in NSW prepared by the IPART and in force immediately before the start of the regulatory control period 2009-2014 in relation to the NSW Distribution Network Service Providers are deemed to be Cost Allocation Guidelines made by the *AER* for the regulatory control period 2009-2014.

3.2 Cost allocation method for NSW

Clause 6.15.6 of the transitional Chapter 6 rules outlines the CAM to be used by NSW DNSPs and the time period in which it must notify the relevant DNSP of its decision to approve or refuse to approve the its proposed CAM. Clause 6.15.6 states:

6.15.6 Cost Allocation Method (NSW)

(a) Each NSW 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 1 month after the commencement date.

(b) The Cost Allocation Method proposed by a NSW Distribution Network Service Provider must:

(1) give effect to and be consistent with the Cost Allocation Guidelines; and

(2) be prepared using, as far as practicable but subject to subparagraph (1), the same cost allocation method as it last used when preparing its regulatory accounts for submission to the IPART.

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

(1) gives effect to and is consistent with the Cost Allocation Guidelines; and

(2) has been prepared, as far as practicable but subject to subparagraph (1), using the cost allocation method the relevant *Distribution Network Service Provider* last used when preparing its regulatory accounts for submission to the IPART.

(d) The *AER* must notify the relevant *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 relevant *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) A NSW 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 *Distribution Network Service 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 *Distribution Network Service 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 *Distribution Network Service 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) A NSW Distribution Network Service Provider must maintain a current copy of its Cost Allocation Method on its website.

3.3 The Accounting Separation Code for Electricity Distributors in NSW

The Accounting Separation Code for electricity distributors in NSW (the Code) provides the guidelines for accounting separation and financial reporting by NSW DNSPs. The guidelines provide the basis for allocation by electricity distributors of incomes, expenses, assets, liabilities and equity between network monopoly functions and other functions of electricity distributors. Paragraphs 11, 15, 16 and 17 of the Code specify cost allocation guidelines for NSW DNSPs.

Paragraph 11 specifies that electricity distributors are required to identify the incomes, expenditures, assets and liabilities associated with activities that belong to electricity distribution network services. Those expenses associated with cross-functional or shared corporate activities are to be allocated to distribution network services and other functions on a documented defensible basis.

Paragraph 15 specifies that activity based reporting principles should be adopted in the first instance. All financial items that can be allocated directly and reliably to a distributor function should be so allocated. Only those items that cannot be allocated directly and reliably without going to a great deal of effort should be pooled in a suitable common service category, to be allocated with reference to Paragraphs 16 and 17.

Paragraph 16 specifies that for those corporate activities which cannot be directly allocated using activity based reporting methods the preferred indirect allocation methods are specified in Tables B, C and D.2 of the code.

Table B specifies the preferred CAMs where activity based reporting is not used. Table B identifies the indirect cost pools and the cost allocation bases according to which the indirect costs are to be allocated. Within Table B, boxes B.1 – B.4 specify the allocation method for labour on-costs, motor vehicle/mobile plant expenses, and engineering and technical costs.

Table C specifies corporate income allocations and Table D.2 specifies the allocation of corporate assets and liabilities.

Paragraph 16 also specifies that where the methods specified in Tables B, C and D.2 are not used the relevant items are to be allocated to the network monopoly and other business functions on a documented defensible basis.

Paragraph 17 specifies that if there are corporate information technology activities that are not amenable to direct attribution or one-step indirect allocation, they can be indirectly allocated across other corporate activities prior to the allocation of corporate activities.

3.4 IPART - Regulatory Information Requirements for Electricity Distributors in NSW

Section 3.5 of the *Regulatory Information Requirements for Electricity Distributors in NSW* sets out principles of revenue and cost allocation that NSW DNSPs were required to comply with in previous regulatory periods. Section 3.5 provides that in general, revenue and cost items are to be allocated on a causation basis by identifying:

- a directly traceable cause and effect relationship with the provision of the product or service; or

- a verifiable relationship between the item and the output of the individual product or service; or

- a cost has a direct causal relationship associated with a pool of common costs and allocation of that pool can be made using a relevant, reliable and verifiable factor such as relative use

In general, cost items that are directly attributable to a particular business segment should be allocated accordingly. Cost items that are indirectly attributable should be allocated using an appropriate causal based allocator where possible. If a causal based allocator cannot be established without undue cost and effort, the relevant costs may be allocated on a non-causal but defensible basis.

4 AER Considerations

4.1 Country Energy

Country Energy’s proposed CAM allocates costs between the electricity network business segment and other business segments. Costs are directly attributed to specific business segments where possible. When costs are not able to be directly attributed without undue cost and effort the preferred allocators listed in the Accounting Separation Code are used in the first instance. When the allocators listed in the Accounting Separation Code are not used the costs are allocated on a causal, defensible basis.

4.1.1 Consistency with the cost allocation guidelines

Clause 6.15.6(b)(1) of the transitional Chapter 6 rules requires that Country Energy’s proposed CAM give effect to, and be consistent with, the cost allocation guidelines. The relevant guidelines are those set out in The Accounting Separation Code for Electricity Distributors in NSW, prepared by the IPART.

Country Energy’s proposed CAM includes a chart of accounts which lists cost accounts including the department, a description of the department, the business segments it applies to, the account name, the key cost drivers and suggested allocators for the costs. The proposed allocators for indirect costs are causal and defensible. The IPART has advised that, in its view, Country Energy’s proposed CAM is consistent with the cost allocation guidelines. McGrathNicol has advised that, in its view, Country Energy’s proposed CAM is broadly compliant with the cost allocation guidelines. The AER is therefore satisfied that Country Energy’s proposed CAM complies with the cost allocation guidelines in the Accounting Separation Code.

4.1.2 Consistency with previous cost allocation method

Clause 6.15.6(b)(2) of the transitional Chapter 6 rules requires that Country Energy’s proposed CAM be prepared, as far as practicable, using the same CAM it last used in its regulatory accounts for submission to the IPART. The IPART has advised that, in its view, Country Energy’s proposed CAM has been prepared, as far as practicable, using the same CAM it last used in its regulatory accounts for submission to the IPART. McGrathNicol has advised that, in its view, there is nothing to indicate that Country Energy’s proposed CAM is inconsistent with the CAM it last used in preparing its regulatory accounts for submission to the IPART.

Country Energy’s proposed CAM for the 2009–14 regulatory period allocates costs between the following business segments:

- Electricity Network (Regulated)
- Gas Network (Regulated)
- Electricity Retail (Regulated)
- Other Retail (Gas and Unregulated Electricity)
- Water
- Other (Unregulated)

Country Energy has stated that the proposed CAM is the same as the CAM that it last used in the submission of its regulatory accounts to the IPART. Country Energy noted that the IPART required that costs be reported at a higher level of aggregation. The AER is satisfied that Country Energy's proposed CAM has been prepared, as far as practicable, using the CAM it last used in preparing its regulatory accounts for submission to the IPART.

4.2 EnergyAustralia

EnergyAustralia's proposed CAM separates costs simultaneously into order types and cost centres. The order types are capital expenditure and operating expenditure. The cost centres are different business units. The business units comprise Enerserve, Network, Retail, Shared Services and Holding Company. Costs are then allocated to services using two levels of disaggregation. First, costs are allocated between standard control services, alternative control services, unregulated distribution services and non-network services. Second, standard control services costs are allocated between distribution and transmission costs. The AER is satisfied that this form of disaggregation enables an assessment of cost allocation by EnergyAustralia.

4.2.1 Consistency with the cost allocation guidelines

Clause 6.15.6(b)(1) of the transitional Chapter 6 rules requires that EnergyAustralia's proposed CAM give effect to, and be consistent with, the cost allocation guidelines set out in The Accounting Separation Code for Electricity Distributors in NSW, prepared by the IPART. The IPART has advised that, in its view, EnergyAustralia's proposed CAM is consistent with the cost allocation guidelines. McGrathNicol has advised that, in its view, EnergyAustralia's proposed CAM is broadly compliant with the cost allocation guidelines. The AER is therefore satisfied that EnergyAustralia's proposed CAM complies with the cost allocation guidelines in the Accounting Separation Code.

Operating expenditure

EnergyAustralia's proposed CAM directly attributes operating costs, where possible, to a specific division and then within each division to a specific service activity, for example standard control or alternative control. For operating costs which cannot be directly attributed, EnergyAustralia's proposed CAM uses a causal allocator that is either taken from those listed in Table B of the Accounting Separation Code, is a causal allocator or has a defensible basis.

The AER is satisfied that the allocators used to allocate operating costs in EnergyAustralia's proposed CAM comply with the cost allocation guidelines in the Accounting Separation Code.

Capital expenditure

EnergyAustralia's proposed CAM directly attributes capital expenditures on **system assets** directly to either standard control services, alternative control services or unregulated distribution services. EnergyAustralia's proposed CAM wholly and directly attributes capital expenditures on **non-system assets**, where possible, to standard control services or non network services based on whether the assets are used for the provision of the particular type of service, or whether the asset is used by a business unit involved in providing the particular type of service.

EnergyAustralia's proposed CAM allocates the remaining capital expenditure, which cannot be directly attributed, using allocators that are taken from Table B of the Accounting Separation Code or allocators that are causation based and/or defensible. The AER is satisfied that the allocators used to allocate capital expenditure in EnergyAustralia's proposed CAM comply with the cost allocation guidelines in the Accounting Separation Code.

4.2.2 Consistency with previous CAM used

Clause 6.15.6(b)(2) of the transitional Chapter 6 rules requires that EnergyAustralia's proposed CAM be prepared using the same CAM it last used in its regulatory accounts for submission to the IPART. The IPART has advised that, in its view, EnergyAustralia's proposed CAM has been prepared, as far as practicable, using the same CAM it last used in its regulatory accounts for submission to the IPART. McGrathNicol has advised that, in its view, there is nothing to indicate that EnergyAustralia's proposed CAM is inconsistent with the CAM it last used in preparing its regulatory accounts for submission to the IPART. The AER is therefore satisfied that EnergyAustralia's proposed CAM is consistent with the CAM it last used when preparing its 2006–07 regulatory accounts for submission to the IPART.

4.3 Integral Energy

Integral Energy's proposed CAM directly allocates costs to its regulated distribution business where possible. Costs that cannot be directly allocated without undue cost and effort are allocated using a defensible basis.

4.3.1 Consistency with the cost allocation guidelines

Clause 6.15.6(b)(1) of the transitional Chapter 6 rules requires that Integral Energy's proposed CAM give effect to, and be consistent with the cost allocation guidelines. The relevant guidelines are those set out in The Accounting Separation Code for Electricity Distributors in NSW, prepared by the IPART. The IPART has advised that, in its view, Integral Energy's proposed CAM is consistent with the cost allocation guidelines. McGrathNicol has advised that, in its view, Integral Energy's proposed CAM is broadly compliant with the cost allocation guidelines. The AER is therefore satisfied that Integral Energy's proposed CAM complies with the cost allocation guidelines in the Accounting Separation Code.

Corporate overhead costs

Integral Energy's proposed CAM uses a cost to serve model, which allocates corporate overhead costs between the retail and network business segments. Step 1 of this model re-allocates costs completed by each business unit for other business units to the business unit that actually performed the work. For example, costs incurred by the human resources division for work done by the finance division are re-allocated to the finance division in this step. Step 2 of this model then allocates business unit costs to either the retail or network businesses based on the amount of effort that each business unit dedicates to retail and network activities. The cost to serve model is activity based and measures the level of activity in each business unit dedicated to the network and retail businesses respectively.

The AER is satisfied that the cost to serve model is an activity based, causal and defensible method for allocating corporate overhead costs that have identifiable cost drivers.

Corporate overhead costs that do not have a specific driver, such as the costs of the Board are not able to be allocated using the cost to serve model. These corporate overheads are allocated using a corporate sustaining driver. The corporate sustaining driver is based on the split of all corporate overheads allocated that have a driver. This is considered by the AER to be a defensible basis for allocation of the relevant corporate overheads, which comprise approximately ten percent of all corporate overheads. The split between network and retail using the corporate sustaining driver is updated annually to reflect the costs incurred in each year. The method of calculating the split between network and retail, however, remains the same.

Corporate overhead costs are allocated between prescribed, street lighting, metering, other excluded, other network, regulated retail and other retail services based on the direct costs allocated to those services.

Network overhead costs

Network overhead costs are allocated between prescribed, street lighting, metering, other excluded, other network, regulated retail and other retail services based on the direct costs allocated to those services. The AER considers this a causal, defensible basis for allocation.

Once all overhead costs have been allocated, the credit for capitalised overheads is accounted for, with the total credit adjusted against the business unit from which they were initially derived. Network capitalised overheads are adjusted against Network overheads prior to their allocation to line items. This accounts for costs capitalisation within the business.

The IPART and McGrathNicol have advised that, in their view, Integral Energy’s proposed CAM is consistent with the cost allocation guidelines

4.3.2 Consistency with previous CAM used

Clause 6.15.6(b)(2) of the transitional Chapter 6 rules requires that Integral Energy’s proposed CAM be prepared, as far as practicable, using the same CAM it last used in its regulatory accounts for submission to the IPART. The IPART has advised that, in its view, Integral Energy’s proposed CAM has been prepared, as far as practicable, using the same CAM it last used in its regulatory accounts for submission to the IPART. McGrathNicol has advised that, in its view, there is nothing to indicate that Integral Energy’s proposed CAM is inconsistent with the CAM it last used in preparing its regulatory accounts for submission to the IPART. The AER is therefore satisfied that Integral Energy’s proposed CAM is consistent with the CAM it last used when preparing its 2006–07 regulatory accounts for submission to the IPART.

5 Consideration of factors set out in the rules

The transitional Chapter 6 rules set out a number of factors for consideration in assessing the CAMs proposed by Country Energy, EnergyAustralia and Integral Energy. The AER's consideration of the relevant factors is set out in this chapter.

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

(1) gives effect to and is consistent with the Cost Allocation Guidelines; and

(2) has been prepared, as far as practicable but subject to subparagraph (1), using the cost allocation method the relevant Distribution Network Service Provider last used when preparing its regulatory accounts for submission to the IPART.

Based on the information before it, the AER is satisfied that all of the proposed CAMs are consistent with the cost allocation guidelines contained in the Accounting Separation Code for Electricity Distributors in NSW, prepared by the IPART.

The AER is also satisfied that all of the proposed CAMs have been prepared, as far as practicable, using the CAM last used by the DNSP when preparing its regulatory accounts for submission to the IPART.

The AER must therefore approve all of the CAMs in accordance with clause 6.15.6(c) of the transitional Chapter 6 rules.

6 Decision

The AER has decided that CAMs proposed by Country Energy, EnergyAustralia, Integral Energy give effect to, and are consistent with, the cost allocation guidelines contained in The Accounting Separation Code for Electricity Distributors in NSW prepared by the IPART. The AER has also decided that, subject to being consistent with the cost allocation guidelines, the CAMs proposed by Country Energy, EnergyAustralia and Integral Energy have been prepared, as far as practicable, using the CAM that each business last used in preparing its regulatory accounts for submission to the IPART. The AER has therefore decided to approve the CAMs proposed by Country Energy, EnergyAustralia and Integral Energy.

Appendix A: CAM submitted by Country Energy

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

Appendix B: CAM submitted by EnergyAustralia

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

Appendix C: CAM submitted by Integral Energy

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