AUSTRALIAN ENERGY REGULATOR

Explanatory statement

Electricity distribution network service providers

Proposed cost allocation guidelines

April 2008

1 Introduction

The Australian and state and territory governments have agreed in the Australian Energy Market Agreement (AEMA) to establish a national framework for, among other things, the economic regulation of electricity distribution networks. The Ministerial Council on Energy (MCE) has prepared legislation and rules to give effect to the national framework, which include amendments to the National Electricity Law (NEL) and the National Electricity Rules (NER). Further information about these amendments is available through the MCE's website at http://www.mce.gov.au/.

This explanatory statement accompanies the proposed cost allocation guidelines (guidelines) and provides the AER's reasons for the proposed guidelines. It has been prepared to satisfy the AER's obligations under clauses 6.16(b)(2) and (3) of the NER.

The AER has also prepared a discussion paper, which forms part of this explanatory statement, which provides additional information and requests written submissions on specific issues.

2 Rule requirements

Clause 6.15.3(a) requires the AER to make, in accordance with the distribution consultation procedures, cost allocation guidelines relating to the preparation by a distribution network service provider (DNSP) of its cost allocation method. Clause 6.15.3(d) enables the guidelines to be amended or replaced by the AER from time to time in accordance with the distribution consultation procedures at clause 6.16.

The guidelines must comply with the cost allocation principles prescribed in clause 6.15.2. Furthermore, clause 6.15.3(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 guidelines. Rather, clause 6.15.3(c) states that:

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

- the format of a *Cost Allocation Method*; and
- the detailed information that is to be included in a *Cost Allocation Method*; and
- the categories of *distribution services* which are to be separately addressed in a *Cost Allocation Method*, 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
- the allocation methods which are acceptable and the supporting information that is to be included in relation to such methodologies in a *Cost Allocation Method*.

Under clause 11.14.3, a DNSP that was providing distribution services at the date of the NER amendment will:

- remain subject to the old regulatory regime for the duration of the transitional regulatory period
- not become subject to the new regulatory regime until the end of the transitional regulatory period.

However, clause 11.14.6 provides that a DNSP subject to the old regulatory regime is still required to apply clause 6.15 of chapter 6 for the purposes of the next distribution determination, which requires it to:

- submit a cost allocation method to the AER for approval
- apply and comply with the cost allocation method that is approved by the AER.

Chapter 6 will not apply to the AER’s first electricity distribution determinations for NSW and the ACT for the period commencing 1 July 2009, as these determinations will be made in accordance with separate transitional arrangements under the NER.

In addition, clause 11.17.4 requires the AER to produce separate cost allocation guidelines for Victorian DNSPs. These Victorian guidelines:

- must be formulated with regard to the ESCV’s cost allocation guidelines

- must be designed to ensure, to the maximum practicable extent, consistency between cost allocation as required by the ESCV's distribution pricing determination and cost allocation in later regulatory control periods.

3 Purpose and objectives of the proposed guidelines

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

- contribute to the national electricity objective
- be consistent with the cost allocation principles in the NER
- prevent cost shifting or incorrect allocation of costs between standard control, alternative control, negotiated distribution and other services
- promote transparency in the cost information provided by a DNSP
- 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 DNSP's compliance with its cost allocation method, will be addressed in the AER's future regulatory information instrument concerning these matters.

4 The nature and reasons for the proposed guidelines

Cost allocation concerns the attribution of a regulated business's direct costs to standard control, alternative control, negotiated distribution 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. Clause 6.18 sets out the distribution pricing rules.

Effective cost allocation has an important role to play in promoting the national electricity objective which is stated in section 7 of the National Electricity Law as follows:

> The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to–
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.

Effective cost allocation requirements support the national electricity objective by:

- promoting the appropriate allocation of costs between direct control, negotiated distribution 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 standard, alternative control, negotiated distribution 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 national electricity 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
- publish the final guidelines.

5.1 Invitation for written submissions

Interested parties are invited to make written submissions to the AER by 14 May 2008, having regard to the issues outlined in the attached discussion paper on the proposed guidelines. The processes for consultation are also outlined therein.

7

Discussion paper

Electricity distribution network service providers

Proposed cost allocation guidelines

April 2008

Request for submissions

Interested parties are invited to make written submissions to the Australian Energy Regulator (AER) on the issues discussed in this paper by the close of business 14 May 2008. Submissions can be sent electronically to AERInquiry@aer.gov.au.

Alternatively, written submissions can be sent to:

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457

The AER prefers that all submissions be in an electronic format and publicly available, to facilitate an informed, transparent and robust consultation process. Accordingly, submissions will be treated as public documents and posted on the AER's website, www.aer.gov.au except and unless prior arrangements are made with the AER to treat the submission, or portions of it, as confidential.

Any enquiries about this discussion paper, or about lodging submissions, should be directed to the AER's Network Regulation South Branch on (03) 9290 1444 or at the above email address.

Contents

Glossary

AEMA	Australian Energy Market Agreement
AER	Australian Energy Regulator
Capex	Capital expenditure
DNSP	Distribution Network Service Provider
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NER	National Electricity Rules
Opex	operating and maintenance expenditure
SCO	Standing Committee of Officials of the Ministerial Council on Energy
ESCV	Essential Services Commission of Victoria

1 Introduction

The Australian Energy Regulator (AER) is responsible for the economic regulation of distribution network service providers (DNSPs) in the National Electricity Market, in accordance with the National Electricity Rules (NER).

On 30 November 2007, the AER released an issues paper on the following guidelines, schemes and models that are required to be published under Chapter 6:

- post tax revenue model (PTRM)
- roll forward model (RFM)
- cost allocation guidelines
- efficiency benefit sharing scheme (EBSS).

The AER also released a separate issues paper on the development of a service target performance incentive scheme (STPIS).

This discussion paper is intended to elicit comments from interested parties on how the development of the cost allocation guidelines (guidelines) can best support the transition to a nationally consistent framework for economic regulation of electricity distribution networks.

The AER received a number of submissions on its issues paper, 10 of which commented on the guidelines. These submissions are addressed in Section 10 of this paper and are available on the AER's website.

In considering the development of these guidelines, the AER has considered the requirements of the NER and has had regard to the approach taken to the guidelines it developed for the regulation of electricity transmission networks, taking into account differences in the nature of transmission and distribution networks. The AER is mindful of these differences and the need to tailor guidelines for the purposes of distribution regulation where appropriate to do so, and has adopted this approach in the proposed guidelines for distribution networks.

1.1 Consultation process

The NER requires the AER to publish its cost allocation guidelines by 30 June 2008. The distribution consultation procedures in Part G of chapter 6 require the AER to publish proposed cost allocation guidelines, an explanatory statement and an invitation for submissions. Stakeholders must be allowed at least 30 business days to make submissions to the AER. Within 80 business days of publishing the proposed cost allocation guidelines the AER must publish its final decision and guidelines.

1.2 Basis for consultation

The Australian and state and territory governments have agreed under the Australian Energy Market Agreement (AEMA) to establish a national framework for, among other things, the economic regulation of electricity distribution networks. The Ministerial Council on Energy (MCE) has prepared legislation and rules to give effect to the national framework, which include amendments to the National Electricity Law (NEL) and NER.

The amendments came into effect from 1 January 2008 making the AER responsible for economic regulation of electricity distribution networks within the national electricity market (NEM). This responsibility includes regulating the prices and revenues of electricity DNSPs after the current determinations of state and territory regulators have finished their terms.

This paper is intended to elicit comments from stakeholders regarding the proposed guidelines and issues in moving to a national framework, based on the provisions in the NER.

This paper is structured as follows:

- Section 2 discusses the relevant requirements of the NER
- Section 3 outlines the purpose and objectives of the proposed guidelines
- Section 4 discusses cost allocation in the context of the AER’s wider regulatory framework
- Section 5 identifies features of, and differences between, regulated businesses that are relevant to the AER’s development of the guidelines
- Section 6 discusses alternative broad approaches for regulating cost allocation, which are relevant to the development of the guidelines
- Section 7 proposes the key elements of cost allocation arrangements that have been included in the proposed guidelines
- Section 8 deals with the transitional issues relating to cost allocation arrangements faced by Victorian DNSPs
- Section 9 presents the AER’s response to submissions made on the AER’s issues paper released in November 2007
- Section 10 provides a consolidated list of issues raised in this discussion paper on which specific comments have been sought from stakeholders.

2 Rule requirements

2.1.1 General requirements

Clause 6.15.3(a) of the NER requires the AER to make, in accordance with the distribution consultation procedures, guidelines relating to the preparation by a DNSP of its cost allocation method. Clause 6.15.3(d) enables the cost allocation guidelines to be amended or replaced by the AER from time to time in accordance with the distribution consultation procedures at clause 6.16.

The guidelines must comply with the cost allocation principles prescribed in clause 6.15.2. Clause 6.15.3(b)(1) requires that the guidelines give effect to and be consistent with the cost allocation principles. The NER does not, however, set out the required contents of the guidelines. Rather, clause 6.15.3(c) states that:

Without limiting the generality of paragraph (b), the cost allocation guidelines may specify:

(1) the format of a cost allocation method;

(2) the detailed information that is to be included in a cost allocation method

(3) the categories of distribution services which are to be separately addressed in a cost allocation method, 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

(4) the allocation methods which are acceptable and the supporting information that is to be included in relation to such methods in a cost allocation method.

For procedural efficiency, it is proposed that the guidelines clearly specify:

- the required contents of a regulated business' cost allocation method – this is discussed further in section 7.2
- the basis on which the AER will assess a regulated business' proposed cost allocation method for approval – this is discussed further in section 7.3
- the basis on which the AER will consider proposed changes to a regulated business' proposed cost allocation method over time – this is discussed further in section 7.4
- how the AER expects the cost allocation method to be applied over time.

This will ensure clarity, consistency and transparency regarding:

- 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 method.

Clause 6.15.4(a) requires each DNSP to develop a proposed cost allocation method for submission to the AER in accordance with the requirements of the guidelines. The cost allocation method 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 to meet the requirements of the NER.

In addition to the requirements noted above, the NER includes:

- a requirement for the AER to prepare cost allocation guidelines 6 months after the commencement of the NER

- conditions for the AER's consideration, approval and amendment of the DNSPs' cost allocation methods.

Diagram 1 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 guidelines; and the cost allocation method.

Diagram 1: Cost allocation arrangements

Cost allocation principles

Responsibility: The cost allocation principles are prescribed in the NER.

Cost allocation guidelines

Responsibility: The AER to develop cost allocation guidelines which must give effect to and be consistent with the cost allocation principles outlined in the NER.

Cost allocation method

Responsibility: Regulated businesses to develop their own cost allocation method, in accordance with the guidelines and the NER, and submit to the AER for approval.

2.1.2 Special provisions applying to New South Wales and the Australian Capital Territory

Chapter 6 of the NER will not apply to the AER's first electricity distribution determinations for NSW and the ACT for the period commencing 1 July 2009, as these determinations will be made in accordance with separate transitional arrangements under the NER. The AER has released separate consultation papers in relation to these determinations which are available on the AER's website. The guidelines that will apply to the forthcoming NSW and ACT determinations are separate from those discussed in this paper and have been established in accordance with the requirements of the transitional provisions.

NSW and ACT DNSPs will not have to submit a cost allocation method in accordance with general chapter 6 as they will already have submitted a cost allocation method under transitional chapter 6. The cost allocation methods developed under transitional chapter 6 will then apply for future periods, subject to the amendment provisions contained in clauses 6.15.4(f) and 6.15.4(g) of the NER.

2.1.3 Special provisions applying to Victoria

Clause 11.17.4 of the NER requires the AER to produce separate cost allocation guidelines for Victorian DNSPs. These guidelines:

- must be formulated having regard to the ESCV's cost allocation guidelines
- must be designed to ensure, to the maximum practicable extent, consistency between cost allocation as required by the ESCV's distribution pricing determination and cost allocation in later regulatory control periods.

2.2 Cost allocation principles

To address the requirements of clause 6.15.3(b)(1), the guidelines should be designed to give effect to the cost allocation principles in clause 6.15.2(1)-(7), which are reproduced at Appendix A of this discussion paper. In particular, this clause provides that a DNSP must apply a cost allocation method 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 a particular service must not be reallocated to another service during the course of a regulatory control period.

The guidelines aim 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, to give effect to the national electricity objective it is also proposed that the guidelines promote transparency in the information provided by the regulated business, so that the AER can adequately understand the business that it is regulating.

3 Purpose and objectives of the proposed guidelines

The proposed guidelines outline the required contents of a regulated business' cost allocation method and the basis on which the AER will assess that method for approval.

The objectives of the proposed guidelines are to:

- contribute to the national electricity objective
- be consistent with the cost allocation principles in the NER
- prevent cost shifting or incorrect allocation of costs between standard control, alternative control, negotiated distribution and other services
- promote transparency in the cost information provided by a DNSP
- 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 other regulatory instruments or guidelines. The exception to this general rule is that arrangements relating to the nature and conduct of regulatory audits, including audits of a DNSP's compliance with its cost allocation method, will be addressed in future regulatory information instruments covering these matters.

Cost allocation concerns the direct attribution of a regulated business' standard control, alternative control, negotiated distribution, and other services costs; 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 future regulatory information instruments.

Effective cost allocation has an important role to play in promoting the national electricity objective which is stated in section 7 of the National Electricity Law as follows:

> The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to–
>
> (c) price, quality, safety, reliability and security of supply of electricity; and
>
> (d) the reliability, safety and security of the national electricity system.

Effective cost allocation requirements support the national electricity objective by:

- promoting the appropriate allocation of costs between standard control, alternative control, negotiated distribution 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 cost shifting from unregulated sections of a business to regulated sections of a business;
- making the treatment of direct and shared costs transparent and so as to 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.

3.1 Working assumptions

The following working assumptions have been used in preparing this discussion paper and the proposed cost allocation guidelines:

- the 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 other regulatory information instruments
- the guidelines will only deal with cost attributions and allocations down to the services level, not individual prices for different categories of services. Clause 6.18 of the NER (distribution pricing rules) sets out the framework for the allocation of costs for pricing purposes
- 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 accounts requirements take precedence over statutory accounts requirements for regulatory purposes.

Q1.	*Are the working assumptions used to prepare this discussion paper and the proposed guidelines appropriate?*

4 Cost allocation in the context of the regulatory framework

4.1 Related distribution guidelines

While this discussion paper and the proposed guidelines have been prepared separately to the other guidelines, there is recognition that any new cost allocation arrangements will need to be appropriately coordinated with related elements of the regulatory framework in the NER.

In particular, the guidelines are an important:

- input into future regulatory information instruments to be developed under the NER and NEL
- consideration in the AER's assessment of a regulated business' revenue proposal.

4.2 Uses of regulatory expenditure information

A DNSP will use forecast capital and operating expenditure as the basis for:

- preparing its revenue proposal for its regulated services, as required by clauses 6.5.6 and 6.5.7
- setting prices for a negotiated distribution service, as required by clause 6.7.1.

Actual expenditure information presented in a DNSP's regulatory accounts could be used for a variety of purposes, including to:

- compare a DNSP's actual expenditure against the forecast applied in the AER's regulatory determination
- assess trends in a DNSP's expenditure over time
- publish financial information during the course of the regulatory period
- apply incentive mechanisms based on a DNSP's expenditure levels
- provide base level historical information for the AER to assess a regulated business' expenditure requirements in later regulatory periods.

The AER's future regulatory information instruments may require DNSPs to prepare certified annual statements. The AER will use these statements, and any additional information provided by a DNSP, to monitor, report on, and enforce compliance with the DNSP's cost allocation method.

The future distribution ring-fencing guidelines may require that DNSPs maintain separate accounts for the provision of ring-fenced services, which are defined as standard control services, alternative control services, negotiated distribution and other services. The guidelines will also require DNSPs to allocate shared costs between ring-fenced services and other services in accordance with a method that complies with any guidelines that the AER prepares. The cost allocation guidelines are therefore an important and necessary instrument for preventing subsidisation of contestable activities.

4.3 Relationship between statutory and regulatory accounts

It is a typical regulatory accounting requirement that:

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

4.4 Importance of delineating services

Given that cost allocation concerns the attribution and allocation of costs between standard control, alternative control, negotiated distribution 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
- the AER to compare the costs allocated by the regulated business over time.

5 Differences between regulated businesses

There are significant differences between DNSPs that affect the complexity of cost allocation arrangements; for example:

- Ownership arrangements - some businesses are publicly owned while others are privately owned, which means that businesses may be under different influences and pressures in allocating costs.

- 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 closer scrutiny of costing arrangements.

- 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 distribution and related services that the regulated business provides - some businesses only provide regulated services whereas others provide a mix of regulated and unregulated services.

- 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 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.

Q2. Is it possible to derive a single set of allocators applicable to all network service providers?

Q3. If yes, would it be appropriate to do so?

6 Alternative approaches to regulating cost allocation

There are 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' cost allocation method
- changes to the cost allocation method over time
- the conduct of the regulatory audit as it relates to cost allocation
- 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 to deal with each of these matters, including whether it will:

- mandate cost allocation requirements to be applied uniformly across all regulated businesses
- set requirements to be applied by the regulated business unless appropriate justification is provided for variations (to ensure that high-level principles set by the AER continue to be promoted)
- allow the business to propose cost allocation arrangements, having regard to the cost allocation principles set out in the guidelines, with changes to the existing position to be approved by the AER
- 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 methods.

7 Key elements of proposed cost allocation arrangements

7.1 Selection of cost allocators for shared costs

The cost allocation principles in clause 6.15.2 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. A distinction is drawn here between:

- the selection of a cost allocator, such as floor space in a building, employee headcount or regulatory asset value, which 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 the numeric value or percentage of the allocator may be expected to vary between years or regulatory periods, depending on circumstances within the business.
The benefit of the AER choosing the allocators is that a single set of allocators could be applied consistently in all regulated businesses. However, this approach would not readily:

- recognise the differences between regulated businesses, as discussed in section 0. 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 could result in different allocators applying to different regulated businesses (albeit that they should all promote the cost allocation principles). This in turn could limit to some degree the direct comparability of cost information, although adjustments could be made to address this.

The AER considers that the provision of relevant, reliable and consistent information within an individual regulated business over time is preferable to obtaining information that is strictly comparable between different regulated businesses at any point in time. This is not intended to understate the value of comparing costs across 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.

Another option would be to consult with regulated businesses 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. However, an industry standard would still need to incorporate sufficient flexibility to accommodate the unique characteristics and circumstances of individual businesses. The AER would be pleased to work with businesses in the development of such an industry standard.

The second key issue relates to the timing for the approval of the allocators. If the business is allowed to choose its allocators, they could either be approved by the AER before they are applied, or the business could be free to apply them first and then describe and justify the choice of 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 building block proposal. 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 assessing whether the allocators have been correctly applied, rather than assessing whether the allocators applied by the business are appropriate

- removes the matter of cost allocators from further debate during the distribution determination process, when there are many other critical 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 the AER's view that:

- the regulated business, rather than the AER, selects the specific allocators for shared costs, subject to the cost allocation principles under the NER and the cost allocation guidelines

- the regulated business is required to include its allocators in its proposed cost allocation method, 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

- it would assess and approve the allocators as part of its broader consideration of the cost allocation method, as discussed in section 7.3

- the business is 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 7.7.

There is also 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 avoided cost.

However, the use of avoided cost may be problematic as it has the potential to allow cost shifting from unregulated parts of a business to the regulated part of a business. As with transmission, the AER's view is that DNSPs must not use the avoided cost approach without the AER's prior approval. However, the AER wishes to explore this issue further and invites comment on whether the avoided cost method should be allowed under the guidelines and, if so, should it be restricted to immaterial costs?

Q4. Should the regulated business or the AER select the allocators for shared costs?

Q5. Is there merit in the regulated businesses working together to produce a future industry standard for the attribution and allocation of costs?

Q6. Should cost allocation be allowed using the avoided cost method and, if so, under what circumstances should it be allowed?

7.2 Contents of cost allocation method

Clause 6.15.2(1) of the NER provides that:

> the detailed principles and policies used by a 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.

As contemplated in clause 6.15.3(c) (2), it is proposed that the cost allocation guidelines mandate the contents of the cost allocation method in order to address this requirement. This is considered necessary to promote procedural efficiency in the preparation, assessment and approval of the documents and clarity, consistency and transparency of outcomes.

It is proposed that a regulated business' cost allocation method 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 is to be used

- roles and responsibilities for updating, maintaining and applying the method; which 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. This is considered to be critical to effective cost allocation

- the business' detailed principles and policies of cost attribution and allocation – this should detail the regulated business' approach to practically implementing the cost allocation principles under the NER using its cost allocation method. It is proposed that the detailed principles and policies must address directly attributable and shared costs

- the business' 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 to enable any such attribution or allocation to be demonstrated to the AER and audited, and otherwise verified as required

- the business' compliance monitoring – this should describe how the business will monitor its compliance with the cost allocation method and the cost allocation guidelines

- commencement date – this should detail the proposed date on which the cost allocation method will commence

7.3 Assessment and approval of cost allocation method

The proposed guidelines include details of the basis on which the AER will assess and approve a cost allocation method, consistent with the relevant provisions of the NER. This will 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 6.15.4(b) provides that the cost allocation method must give effect to, and be consistent with, the cost allocation guidelines. As clause 6.15.3(b)(1) requires the guidelines to be consistent with, and give effect to, the cost allocation principles, the cost allocation method must by implication also promote the principles

- clauses 6.15.4(c) and 6.15.4(d) provide that the AER must refuse or approve a proposed cost allocation method within 6 months of receiving it, failing which it will be deemed to have been approved

- clause 6.15.4(e) allows the AER to amend a cost allocation method submitted to it, after consulting with the business, in the course of its approval.

The proposed cost allocation guidelines specify that the AER will assess a regulated business' cost allocation method 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 method:

- contains the information required by the cost allocation guidelines
- effectively promotes the cost allocation principles under clause 6.15.2.

It is proposed that any decision by the AER to reject or amend a proposed cost allocation method must include an explanation of the reasons for its decision. The timing of the submission and approval of cost allocation methods is discussed in section 7.8.

7.4 Amending an approved cost allocation method

The NER provides that the DNSP:

- may apply to the AER to amend its cost allocation method from time to time (clause 6.15.4(f))
- must amend its cost allocation method if required to do so by the AER (clause 6.15.4(g)).

As noted previously, 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, the proposed guidelines include details of:

- the circumstances under which an amendment can be made
- the basis on which the AER will assess and decide to amend a cost allocation method
- the actions required of a regulated business in the event that such an amendment is approved.

The proposed guidelines provide that:

- a regulated business should only be able to apply to amend its cost allocation method if it can demonstrate in its application that:
  - there has been a material change in its circumstances
  - the amendment is necessary for the business to effectively promote the cost allocation principles
  - the resultant amended cost allocation method would give effect to, and be consistent with, the cost allocation guidelines
  - the amendment will not jeopardise the comparability of the resultant financial information with that previously provided to the AER

    - the impact of the proposed change can be quantified and demonstrated to the AER.

- a regulated business can only make a proposal to amend its cost allocation method prior to the start of the regulatory year in which the amendment will take effect

- an amended cost allocation method 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 (part of the regulatory information instrument) and the preceding regulatory financial forecasts on a basis consistent with the amended cost allocation method. While this would increase the regulatory compliance burden for industry, it would be necessary to:

    - ensure that the effects of changes are disclosed and reconciled over time

    - compare financial information for a business on an on-going basis.

- the AER may, in consultation with the regulated business, review the regulated business' cost allocation method as part of each revenue determination to ensure that it continues to give effect to, and is consistent with, the guidelines. If the AER does not explicitly approve a regulated business' amended cost allocation method within 6 months the amended cost allocation method will be deemed to be approved.

7.5 Application of a cost allocation method

Clause 6.15.1 of the NER provides that:

> A Distribution Network Service Provider must comply with the *Cost Allocation Method* that has been approved in respect of that provider from time to time by the AER under this rule 6.15.

The proposed cost allocation guidelines do not seek to include an exhaustive list of the circumstances in which a regulated business is required to apply its cost allocation method. Rather, the guidelines state that the method 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 6.5.6

- forecast capital expenditure is submitted to the AER in accordance with clause 6.5.7

- prices for a negotiated distribution service are determined in accordance with clause 6.7.1

- a certified annual statement is submitted to the AER in accordance with a regulatory information instrument

- actual or estimated capital expenditure is used for the purposes of increasing the value of its regulatory asset base under schedule s6.2.1(f).

7.6 Accounting principles and policies

Clause 6.15.2(4) of the NER provides that:

> 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.

Part of the requirement of clause 6.15.2(4) will be addressed in the cost allocation method itself (if the content proposed in section 7.2 is adopted) through the description and justification of the allocators, though the requirement to disclose the numeric quantity of the chosen allocator will not. 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 method.

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 method
- 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.

7.7 Regulatory audit

The AER's regulatory information instrument will require an audit to be performed before, and be provided to the AER to accompany the submission of, the DNSP's revenue proposal.

It is considered that audit arrangements need to be sufficiently flexible to accommodate the differences in the nature of regulated businesses discussed in section 5. Ensuring that the audit arrangements have regard to the individual characteristics of a regulated business can be best achieved if the scope and terms of the audit are agreed on an individual basis between the AER and the regulated business.

The AER's regulatory information instrument will deal with the auditing of DNSPs historic and forecast financial information. It is considered that these instruments, rather than the guidelines, are most appropriate to address arrangements relating to the nature and conduct of regulatory audits. 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.

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 to 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 to relevant regulatory requirements.

  Because it is proposed that the AER approve a regulated business' cost allocation method 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 method).
- *against what instruments compliance is being assessed* – in the future, the regulated business will continue to prepare financial information for submission to the AER in accordance with the AER's regulatory information instrument. However, in preparing this financial information, the business will also need to comply with the requirements of:
  - the cost allocation guidelines
  - its approved cost allocation method.

  It is therefore proposed that the AER's regulatory information instrument 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 proposed cost allocation guidelines to require any audit of financial information under the AER's regulatory information instrument to include an assessment of whether a sample of allocations of shared costs accords with the regulated business' approved cost allocation method.

Q7. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assesses whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?

7.8 Timing and transition issues

Clause 6.15.3(e) of the NER provides that the AER must make cost allocation guidelines within 6 months after the commencement of the NER, in accordance with the distribution consultation procedures in clause 6.16 – these procedures include timeframes for consulting on, and finalising, the guidelines.

Subject to the transitional provisions of the NER, DNSPs are required under clause 6.15.4(a) to submit to the AER for its approval a document setting out their proposed cost allocation method:

- within 12 months after the commencement of the NER
- in the case of an entity that is not a Distribution Network Service Provider more than 6 months after the commencement of the NER, within 6 months of being required to do so by the AER.

As noted above, clauses 6.15.4(c) and 6.15.4(d) deal with the process for assessing and approving proposed cost allocation methods and clause 6.15.1 provides that a DNSP must comply with the cost allocation method that has been approved in respect of that provider.

NSW and ACT DNSPs do not have to submit a cost allocation method in accordance with the guidelines as they will already have submitted a cost allocation method under transitional chapter 6 of the NER. The cost allocation methods developed by the NSW and ACT DNSPs under transitional chapter 6 will then apply for future periods, subject to amendments allowed by clauses 6.15.4(f) and 6.15.4(g) of the NER – see section 2.1.2 of this discussion paper.

Under clause 11.17.5(a), Victorian DNSPs must submit their proposed cost allocation method together with their building block proposal after the commencement of chapter 6. The building block proposal is part of a regulatory proposal (clause 6.8.2 (c)(2)) which must be submitted (in accordance with clause 6.8.2 (b) of the NER):

(1) at least 13 months before the expiry of a distribution determination that applies to the service provider, or
(2) if no distribution determination applies to the service provider, within 3 months after being required to do so by the AER.

The NER envisages that a regulated business' cost allocation method 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 method to take effect immediately, or
- at the start of a new regulatory period.

It is possible that different approaches will be appropriate for different businesses, having regard to 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 methods
- the assessed need to start collecting information at a set date and 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 method 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 and how the business’ actual and forecast costs can be compared over time.

8 Issues relating to the drafting of guidelines for Victorian DNSPs

Underlying the AER's approach to regulation is the requirement to contribute to the achievement of the national electricity objective:

> The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to–
>
> (e) price, quality, safety, reliability and security of supply of electricity; and
>
> (f) the reliability, safety and security of the national electricity system.

In determining the framework for the Victorian cost allocation guidelines, the AER has also taken into account the following matters:

- the benefits of regulatory consistency across jurisdictions, taking into account specific NER requirements
- the benefits of consistency between transmission and distribution regulation, taking account of different network characteristics between the sectors
- transparency and simplicity of regulation
- minimisation of the burden and cost of regulation where appropriate, having regard to the benefits of a consistent national framework of regulation.

Having regard to these matters, the policy framework underpinning the AER's proposed cost allocation guidelines is essentially the same as that which currently applies in Victoria, with the exception of one issue - the use of avoided cost as a basis to allocate cost.

8.1 Victorian transitional provisions

Clause 11.17.4 of the NER requires the AER to produce cost allocation guidelines specifically applicable to Victorian DNSPs. Clause 11.17.4 of the NER stipulates that guidelines of specific application to Victoria:

(a) must be formulated with regard to the ESC cost allocation guidelines

(b) must be designed to ensure, to the maximum practicable extent, consistency between cost allocation as required by the ESC distribution pricing determination and cost allocation in later regulatory control periods.

8.2 The use of avoided cost as a basis for cost allocation

The rationale which underscores ring-fencing is reflected in the AER's support of a fully distributed cost allocation method. Separation of regulated and contestable services provided by regulated businesses ensures that there is a clear demarcation between these services. The potential for manipulation or distortion of the regulatory process is checked by these measures. The regulatory requirement ensuring regulated businesses fully distribute their shared costs and do not subsidise unregulated parts of the business with regulated parts is not a new requirement for regulated entities. The Victorian Electricity Industry Guideline No.3 developed and administered by the Essential Services Commission of Victoria (ESCV), which deals with ring-fencing, also requires a DNSP to prepare separate accounts for its distribution business.

The Victorian approach to the use of avoided cost can be found in clause 3.6.7 of Electricity Industry Guideline No. 3, which states that:

"If an item is Immaterial and a Causal Relationship cannot be established without undue cost and effort, the Licensee shall provide the Commission with a separate list of these items indicating a description and amount. The Licensee may effect an allocation of these items on a Non-Causal Basis, provided it is accompanied by a supporting note documenting for each such item:

- a defensible basis of allocation which shall not be avoidable cost".

The AER shares the concerns implied by the ESCV's approach to the use of avoided cost but also acknowledges that there may be instances where the use of avoided cost could be warranted.

There are potential difficulties with the concept under a full allocation approach as avoided cost attributes costs to one cost centre irrespective of whether the cost is shared. This provides the potential for some services to cross-subsidise other services which is inconsistent with the cost allocation principles in the NER.

The avoided cost method may be used in a variety of business scenarios. However, the AER must assess the application of avoided cost through the prism of regulating distribution businesses and more particularly in relation to the allocation of costs between regulated and other services.

Also, the AER must ensure that any proposed cost allocation method, such as avoided cost, is consistent with the ring-fencing objectives and cost allocation principles. The intention of these principles is to prevent regulated services from subsidising unregulated services, and to promote transparency in the cost information provided by a DNSP.

The AER therefore considers it prudent to require DNSPs to demonstrate that adequate safeguards are in place to prevent cost shifting from regulated sections of the business to unregulated sections of the business.

8.3 AER's decision and rationale on avoided cost

The AER's view is that Victorian DNSPs must not use the avoided cost approach without the AER's prior approval.

In adopting this approach, the AER has considered and to a large extent adopted the ESC's principles of cost allocation. The AER believes that similar outcomes to the current Victorian arrangements can be achieved by not completely prohibiting the use of avoided cost but by reviewing its use on a case-by-case basis. To safeguard against the potential risk of cost shifting from unregulated sections of a business to regulated sections of a business, businesses wishing to use avoided cost must approach the AER and make their case in the first instance. The AER can then permit or refuse approval of the use of avoided cost having regard to the potential outcomes of its use.

This approval would be limited to uses such as the granting of administrative relief to Victorian DNSPs for the allocation of immaterial costs.

In coming to this decision, the AER notes that:

(a) It has had regard to the ESCV's Electricity Industry Guidelines No.3 by comparing their overall effect and intent with the AER's proposed cost allocation guidelines and also by specifically considering and taking into account the use of the avoided cost approach for Victorian DNSPs. A clause by clause comparison of the Victorian Electricity Industry Guideline No.3 and the AER proposed cost allocation guidelines can be found at Appendix B.

(b) Consistency (to the maximum practicable extent) has been maintained between cost allocation as required by the ESC distribution pricing determination and cost allocation in later regulatory control periods, as any immaterial usage of the avoided cost approach would not affect that consistency.

9 Response to submissions

This chapter details the AER's response to submissions made by stakeholders to the preliminary issues paper released in November 2007.

9.1 Accommodation of previous regulatory arrangements

Several stakeholders emphasised that the cost allocation guidelines should grant DNSPs sufficient flexibility in composing their cost allocation methods to adopt approaches similar to those they used in past regulatory arrangements.

In determining the framework for the proposed cost allocation guidelines, the AER has taken into account the following matters:

- the benefits of regulatory consistency across jurisdictions, taking into account specific NER requirements
- the benefits of consistency between transmission and distribution regulation, taking account of different network characteristics between the sectors
- transparency and simplicity of regulation
- minimisation of the burden and cost of regulation where appropriate, having regard to the benefits of a consistent national framework of regulation.
- any feedback from the preliminary issues paper.

From the AER's perspective, the principles of cost allocation detailed in the NER are similar to the jurisdictional principles on cost allocation.

There are a number of issues to address in maintaining a consistent approach to cost allocation between electricity transmission and electricity distribution (and between different jurisdictions) whilst at the same time allowing DNSPs as much flexibility as possible to accommodate their particular circumstances. The NER and the AER's proposed cost allocation guidelines have attempted to balance any potential differences by allowing DNSPs to:

- choose their own cost allocator
- compose their own cost allocation methods that are business specific.

whilst maintaining the overall approach required by the NER and NEL.

9.2 Possible "doubling up" of cost allocation methods

A number of submissions have raised concerns that the rules will require DNSPs to apply two sets of cost allocation methods in the transitional regulatory period.

The AER's responsibility to regulate DNSPs is governed by the NER and the NEL. The NER specifies that, for the purposes of the next distribution determination, DNSPs will be subject to the new regulatory regime which will include the AER's cost allocation guidelines.

With regard to the old regulatory regime's cost allocation methods, the NER states:

- the cost allocation methods that applied for the old regulatory regime only apply for the duration of the transitional regulatory period

- the old regulatory regime cost allocation methods will not apply to the next regulatory determination.

Therefore, DNSPs will only be subject to one cost allocation regime at any particular time.

9.3 Rule requirements and the collection and disclosure of information

A number of submissions raised concerns that the requirements for the collection of information might be excessive.

The AER notes the concerns raised in relation to the level of reporting requirements proposed by the guidelines and the potential to place an additional burden on regulated businesses. The main concerns relate to the content and level of detail to be provided in a DNSP's cost allocation method. This is a new requirement under the NER whereby a business must prepare and submit to the AER for approval a document outlining its approach to meeting or complying with the cost allocation principles contained in the NER. As a new requirement, it is understandable that there are concerns regarding the level of detail. However, DNSPs should note that clause 6.15.2(1) of the NER provides that the AER needs sufficient information to enable it to replicate reported outcomes.

10 Summary of issues for comment

Comments are sought from interested parties on the scope of the AER's considerations outlined in this discussion paper and the specific issues 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 discussion paper.

Q1. Are the working assumptions used to prepare this discussion paper and the proposed guidelines appropriate?

Q2. Is it possible to derive a single set of allocators applicable to all network service providers?

Q3. If yes, would it be appropriate to do so?

Q4. Should the regulated business or the AER select the allocators for shared costs?

Q5. Is there merit in the regulated businesses working together to produce a future industry standard for the attribution and allocation of costs?

Q6. Should cost allocation be allowed using the avoided cost method and, if so, under what circumstances should it be allowed?

Q7. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assesses whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?

Appendix A: Cost allocation principles- clause 6.15.2 of the NER

The following principles constitute the *Cost Allocation Principles*:

(1) the detailed principles and policies used by a Distribution Network Service Provider to allocate costs as 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.

Appendix B: A comparison of ESCV Electricity Industry Guideline No.3 and AER Cost Allocation Guidelines

ESCV Electricity Industry Guideline No. 3	Corresponding AER Cost Allocation Guidelines	AER's comments
Clause 3.6.1 The allocation of Statutory Accounts between Distribution Business and non-distribution business activities and across Distribution Business Segments shall be based on the principle that: items which are Directly Attributable to the Distribution Business and Distribution Business Segment are assigned accordingly; and items not Directly Attributable, shall be allocated to the Distribution Business and across Distribution Business Segments using an appropriate allocator, as indicated in following paragraphs. **Clause 3.6.2** An item may be Directly Attributable to the Distribution Business but not Directly Attributable to a Distribution Business Segment. In this circumstance the allocation across Distribution Business Segments will be	**Clause 2.2.3 (a)** In accordance with the requirements of clause 6.15.2(3)(i), only costs that are directly attributable to the provision of a particular category of distribution services may be directly attributed to that category of services. **Clause 2.2.3 (b)** A cost may be directly attributable to a DNSP but not directly attributable to a particular category of distribution services provided by the DNSP. In this circumstance, the allocation of costs between or within	The AER considers that these clauses are virtually identical in nature and has adopted the NER framework for Victorian DNSPs for national consistency.

made using an appropriate allocator as indicated in the following paragraphs.	categories of distribution services may only be made in accordance with clause 2.2.4	
<u>Clause 3.6.3</u> Items that are not Directly Attributed, are to be allocated on a Causation Basis.	**<u>Clause 2.2.4 (a)</u>** In accordance with the requirements of clause 6.15.2(3)(ii), *shared costs* incurred in providing several categories of *distribution services* must be allocated between or within those categories using an appropriate *causal* allocator, except to the extent that: the shared costs are immaterial; or a causal relationship cannot be established without undue cost and effort.	These clauses give guidance on indirect cost attribution. Although virtually identical in nature, the AER's guidelines and NER allow very minor allowances for immaterial costs or where a causal relationship cannot be established without undue cost.
<u>Clause 3.6.4</u> If an item is not Directly Attributable and a Causal Relationship cannot be established without undue cost and effort, the Licensee shall provide the Commission with a separate list of these items indicating a description and amount. The Licensee may effect an allocation of these items on a Non-Causal Basis, provided it is accompanied by a supporting note documenting for each such item:	**<u>Clause 2.2.4</u>** (a) If a *shared cost* is *immaterial* or a *causal relationship* cannot be established without undue cost and effort then the *DNSP* may allocate the *shared cost* to, or within, a particular category of *distribution services* using a *non-causal* allocator provided that: (1) The non-causal allocator accords with an AER approved *Cost Allocation Method*;	These clauses deal with the substantiation of shared costs by the distribution business to the regulator. They are virtually identical in nature with the exception of the AER's view on avoided costs. The AER's position on avoided cost is discussed in part 8 of this issues paper.

a defensible basis of allocation which shall not be avoidable cost; the reason for choosing that basis; and an explanation why no Causal Relationship could be established. Allocation based on avoidable cost is not permitted.	(2) The aggregate of all shared costs subject to non-causal bases of allocation is not material; and (3) The non-causal basis of allocation is approved in writing by the AER. (d) The bases of non-causal allocation will be subject to review by the AER. The AER expects only to accept a non-causal basis of allocation if the DNSP can demonstrate that there is likely to be a strong positive correlation between the non-causal basis of allocation and the actual cause of the resource or service consumption or utilisation that those shared costs represent. A DNSP is not permitted to allocate shared costs using an avoided cost approach unless approved by the AER.	
<u>Clause 3.6.5</u> A Licensee shall produce for each item that has not been Directly Attributed to the Distribution Business and/or Distribution Business Segment a supporting work paper	**<u>Clause 2.2.1 (b)(2)</u>** For shared costs: A. the nature of each cost item; B. the categories of *distribution services*	These clauses deal with the substantiation of shared costs by the distribution business to the regulator. The basis and documents required are almost identical.

that includes: the amounts that have been allocated to the Distribution Business and/or Distribution Business Segment and amounts that have not been so allocated; a description of the method of allocation and reasons for choosing that method; and the numeric quantity of each allocator.	between or within which each cost item is to be allocated; C. the nature of the allocator, or allocators, to be used for allocating each cost item; D. the reasons for selecting the allocator, or allocators, for each cost item and an explanation of why it is the most appropriate available allocator, or set of allocators, for the cost item; E. whether the numeric quantity or percentage of the allocator, or allocators, to be applied for each cost item will: (i) Remain unchanged over the *regulatory control period*; or (ii) Change from time to time throughout the *regulatory control period*. F. if clause 2.2.1(b)(2)E(i)applies: (i) Details of the numeric quantity or percentage of the allocator, or allocators; and (ii) An explanation of how the numeric quantity or percentage has been calculated, including where the data for determining this numeric quantity or percentage have been sourced. G. if clause 2.2.1(b)(2)E(ii)applies, an	

	explanation of how the DNSP intends to calculate the numeric quantity or percentage throughout the regulatory control period, including where the data for determining the changing numeric quantities or percentages are to be sourced; and H. how and where records will be maintained to enable the allocation to be audited or otherwise verified by a third party, including the AER.	
<u>Clause 3.6.7</u> If an item is Immaterial and a Causal Relationship cannot be established without undue cost and effort, the Licensee shall provide the Commission with a separate list of these items indicating a description and amount. The Licensee may effect an allocation of these items on a Non-Causal Basis, provided it is accompanied by a supporting note documenting for each such item: a defensible basis of allocation which shall not be avoidable cost; the reason for choosing that basis; and an explanation why no Causal Relationship	**<u>Clause 2.2.4 (c)</u>** If a *shared cost* is *immaterial* or a *causal relationship* cannot be established without undue cost and effort then the *DNSP* may allocate the *shared cost* to, or within, a particular category of *distribution services* using a *non-causal* allocator provided that: (1) The non-causal allocator accords with an AER approved Cost Allocation Method; (2) … (3) The non-causal basis of allocation is approved in writing by the AER; and (4) The DNSP provides a supporting work paper to the AER documenting for each	These clauses deal with the substantiation of shared costs by the distribution business to the regulator. The basis and documents required are almost identical.

could be established.	such shared cost: A. The basis of allocation; B. The reason chosen for that basis; C. A demonstration that the shared cost is immaterial or an explanation of why no causal relationship could be established; and D. A numeric quantity or percentage of the non-causal allocator applied to each category of distribution service and in total.	
Clause 3.6.8 Non Causal Bases of allocation shall only be applied to the extent that the aggregate of all items subject to all Non Causal Bases of allocation, is not Material to the Regulatory Accounting Statements.	**Clause 2.2.4 (c)** If a *shared cost* is *immaterial* or a *causal relationship* cannot be established without undue cost and effort then the *DNSP* may allocate the *shared cost* to, or within, a particular category of *distribution services* using a *non-causal* allocator provided that: (2) The aggregate of all shared costs subject to non-causal bases of allocation is not material.	These clauses deal with the aggregate of shared costs. They are virtually identical in nature but the definition of materiality is defined in the NER for the AER's guidelines.

Clause 3.9 An item is Material if its omission, misstatement or non-disclosure has the potential to prejudice the understanding of the financial position and nature of the Distribution Business, gained by an assessment of the Regulatory Accounting Statements.	**Glossary** An item is material if its omission, misstatement or non-disclosure has the potential to prejudice the understanding of the financial position of the DNSP, gained by an assessment of financial information relating to the DNSP.	
Clause 3.6.9 Bases of allocation will be subject to the review of the Commission. The Commission expects to only accept a Non Causal Basis if a Licensee can demonstrate that there is likely to be a strong positive correlation between the Non Causal Basis and the actual cause of resource or service consumption or utilisation that those costs represent	**Clause 2.2.4 (d)** The bases of *non-causal* allocation will be subject to review by the *AER*. The *AER* expects only to accept a *non-causal basis* of allocation if the *DNSP* can demonstrate that there is likely to be a strong positive correlation between the *non-causal basis* of allocation and the actual cause of the resource or service consumption or utilisation that those shared costs represent.	These clauses deal with the review process by the regulator. They are virtually identical in nature.

Appendix C: Response to individual stakeholder submissions

Integral Energy	
Broadly speaking, Integral Energy stated that it is desirable to develop a consistent national approach to DNSP regulation but such an approach will require time to develop and the methodologies adopted by the AER will need to provide appropriate flexibility to accommodate distribution-specific issues. Integral Energy recommended that the AER transition towards a single set of guidelines for DNSPs over time using the jurisdictional guidelines as a base.	Please refer to section 10.1 of this discussion paper. It is the intention of the AER to proposed guidelines that are consistent in all jurisdictions while at the same time reflecting the requirements of the NER and NEL.
Ergon Energy	
Ergon Energy noted that the timeframes for developing and approving the AER's cost allocation guidelines and the DNSP's cost allocation method may introduce a degree of uncertainty to the preparation of Ergon Energy's Regulatory Proposal. As a consequence (of the rules), the regulatory proposal will be prepared on the basis of expenditure that is allocated in accordance with the CAM, although Ergon Energy may be required to submit its regulatory Proposal prior to the AER approving the CAM.	The AER will work closely with Ergon Energy prior to its revenue determination to resolve this issue.

Energy Networks Association (ENA)	
ENA was disappointed at the policy outcome in the rules that potentially sees distributors subject to two cost allocation reporting arrangements that are likely to be largely duplicative in intent though inconsistent in form. The AER has an opportunity to ameliorate the practical impact of this poor outcome through the appropriate exercise of its discretion around cost allocation guidelines issues. ENA requested that the AER should at the first round of reviews err towards acceptance of distributor proposed methodologies that are based on existing jurisdictional arrangements, and pursue harmonisation following the assumption in each jurisdiction of full regulatory monitoring and enforcement functions.	Please refer to section 10.2 of this discussion paper. Please refer to section 10.1 of this discussion paper.
Aurora Energy	
Aurora believed that jurisdictional cost allocations have been specifically developed for each distributor and any newly proposed methodology may result in DNSPs having to undertake additional administrative burden to satisfy multiple masters. It would be preferable for the AER to work through any such issues as part of the handover of regulatory powers.	Please refer to section 10.1 of this discussion paper.

Energex	
Energex requested that the CAM should support business growth, organisational change and provide sufficient flexibility to accommodate the introduction or discontinuation of services. Energex requested that when approved changes are made to a cost allocation method, discretion should be exercised in relation to requests for the restatement of historical results due to the associated compliance costs. Energex sought clarification in regard to the level of detail to be specified in the cost allocation method and the level of service segmentation that allocations should be made to. The level of service segmentation required will impact significantly on the actual operational administration costs associated with the cost allocation method.	Please refer to section 10.1 of this discussion paper. The AER intends to fully consult stakeholders on future information as part of the process to develop regulatory information instruments. Please refer to section 10.1 of this discussion paper.
Alinta and United Energy Distribution (UED)	
Alinta and the UED noted that 'dual' cost allocation regimes for DNSPs may apply up until the next distribution determination Alinta and the EUD commented that the requirements for the collection of information should not be excessive.	Please refer to section 10.2 of this discussion paper. Please refer to section 10.3 of this discussion paper.

Both parties requested that the AER: ▪ be as economical as possible with its information requirements; ▪ state them all upfront in the guidelines; and ▪ state in the guidelines the specific circumstances under which the AER might require further clarification of information submitted, rather than relying on its general powers to make subsidiary requests. The parties stated that the use of avoided cost should not be discouraged or marginalised by the AER guidelines	Please refer to section 10.3 of this discussion paper. In addition, the AER intends to fully consult stakeholders on future information as part of the process to develop regulatory information instruments. The AER's preliminary view on use of avoided cost is discussed in section 7 and section 8 of this discussion paper.
Major Energy Users Inc.	
The MEU agreed with the approach proposed by the AER but expects that the AER will consult with the jurisdictional regulators to identify the methods used by them in developing cost allocation principles.	The AER will apply the requirements of the NER and the NEL in the development of the cost allocation guidelines. The AER will also follow the distribution consultation procedures in the NER to consult with all interested parties and notes that jurisdictional regulators tend to follow the same high level cost allocation procedures as the AER. The final cost allocation guidelines for DNSPs will be fully reflective of the NER and the NEL and will be in accordance with best regulatory practice.

Essential Services Commission of South Australia (ESCOSA)	
Issues surrounding the use of regulated assets in the provision of regulated and unregulated services and the allocation of costs between these services will require careful consideration by the AER.	The AER will apply the requirements of the NER and the NEL in the development of the cost allocation guidelines. The AER will also follow the distribution consultation procedures in the NER to consult with all interested parties and notes that jurisdictional regulators tend to follow the same high level cost allocation procedures as the AER. The final cost allocation guidelines for DNSPs will be fully reflective of the NER and the NEL and will be in accordance with best regulatory practice.
ActewAGL	
No further comments are provided but ActewAGL is involved in ongoing consultation with the AER.	