Final decision

Electricity distribution network service providers

Cost allocation guidelines

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AUSTRALIAN ENERGY REGULATOR

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Shortened forms

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
CAM	Cost Allocation Method
DNSP	Distribution Network Service Provider
ESC	Essential Services Commission of Victoria
NEL	National Electricity Law
NEM	National Electricity Market
NER	National Electricity Rules
RII	Regulatory Information Instrument
RIN	Regulatory Information Notice
RIO	Regulatory Information Order
TNSP	Transmission Network Service Provider

1 Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of Distribution Network Service Providers (DNSPs) in the National Electricity Market (NEM) in accordance with the National Electricity Law (NEL) and the National Electricity Rules (NER).

Under the NER, the AER is required to develop and publish certain models, guidelines and schemes. The cost allocation guidelines set out arrangements to manage the attribution of direct costs and the allocation of shared costs by DNSPs between different categories of distribution services. The categories of distribution services are: standard control services, alternative control services, negotiated distribution services and non-regulated services.

On 1 April 2008, the AER released and invited submissions on the following proposed 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)
- service target performance incentive scheme (STPIS).

In addition, the AER held a public forum in Melbourne on 23 April to explain its proposed guidelines, schemes and models and to receive comments from stakeholders.

The AER subsequently received 16 written submissions on its proposed guidelines package which are available on the AER's website, www.aer.gov.au.

This final decision sets out the AER's consideration of comments raised in these submissions in relation to the proposed cost allocation guidelines. Stakeholders that provided submissions in relation to the proposed cost allocation guidelines are listed in Appendix A of this final decision.

In developing this final decision, consideration has been given to the objectives of the NEL and NER and the submissions received. The AER received 10 submissions from stakeholders in relation to the proposed cost allocation guidelines. Issues raised in the submissions have been addressed in this final decision but have not resulted in any substantive changes in the final guidelines.

2 Rule requirements

Clause 6.15.3(a) of the NER requires the AER to make, in accordance with the distribution consultation procedures, cost allocation guidelines relating to the preparation by a 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:
>
> (1) the format of a Cost Allocation Method; and
>
> (2) the detailed information that is to be included in a Cost Allocation Method; and
>
> (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; and
>
> (4) 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 ESC’s cost allocation guidelines

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

3 Purpose and objectives of the guidelines

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

- contribute to the national electricity objective
- give effect to and 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 non-regulated 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 assurance matters, including reviews 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 guidelines

Cost allocation concerns the attribution of a regulated business's direct costs to standard control, alternative control, negotiated distribution and non-regulated services and the allocation of shared costs between these different services. The guidelines only deal with cost attribution down to services, not individual prices for different categories of services. Clause 6.18 of the NER 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 NEL 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 non-regulated services in order to properly reflect the consumption or utilisation of a resource or service by a business, or part of a business
- preventing cost-shifting between standard, alternative control, negotiated distribution and non-regulated 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
- ensuring 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 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 Issues raised in submissions and the AER response

Stakeholders raised a number of issues in relation to the proposed cost allocation guidelines released on 1 April 2008. The main issues raised by stakeholders were that:

- the proposed guidelines required a level of detail which is excessive and unclear regarding the collection and disclosure of information
- the proposed guidelines should give further consideration to the use of avoided cost as a basis for cost allocation
- the proposed guidelines should be more transparent regarding the assurance requirements relating to DNSPs' compliance with the cost allocation method.

These issues are considered in detail below. Appendix A contains a summary of other issues raised in submissions and the AER's consideration of those issues.

5.1 Rule requirements and the collection and disclosure of information

Stakeholder responses to the guidelines were critical of the reporting requirements. Responses stated that the level of detail and disclosure required were excessive and unclear.

Stakeholders also expressed concerns about the requirements under the guidelines to report on 'each cost item' and considered that such a requirement may not be intended by the NER.

Also, stakeholders submitted that working papers required to support non-causal allocation would lead to high compliance costs.

AER response

The AER notes the concerns raised about the reporting requirements in the proposed guidelines. The main concerns relate to the content and level of detail to be provided in a DNSP's cost allocation method.

While DNSPs have not in all cases previously been required to submit a cost allocation method to their jurisdictional regulators, they have been required to allocate their costs between the different categories of distribution services. Furthermore, the AER considers that the preparation of a cost allocation method will for the most part only involve documenting existing processes, particularly as the high level cost allocation principles applied in the jurisdictions are similar to those outlined in the NER.

As a new requirement, it is understandable that there are some concerns regarding the level of detail required in a DNSP's cost allocation method. However, clause 6.15.2(1) of the NER provides that the AER needs sufficient information to enable it to replicate reported outcomes. In addition, any working papers required under the cost allocation guidelines will only need to be provided if requested. Clause 3.2 of the guidelines deals with the format and content of cost allocation methods. Additionally, examples of approved cost allocation methods with the level of detail required can be found on the AER's website at: www.aer.gov.au.

AER decision

The guidelines will remain unchanged as the level of guidance and detail required in preparing a cost allocation method is considered appropriate.

5.2 The use of avoided cost

Submissions provided by United Energy, Alinta AE, ETSA and Aurora all stated that the requirements on the use of avoided cost should be made less stringent.

AER response

The nature of the AER's regulatory role in relation to cost allocation—acting to ensure DNSPs fully distribute their shared costs and do not subsidise some categories of distribution services with other categories of distribution services—is by no means new for DNSPs. Separation of costs associated with regulated and contestable services provided by DNSPs ensures that there is a clear demarcation of the resources used to provide these services. The potential for manipulation or distortion of the regulatory process is checked by these measures.

The AER acknowledges that the application of avoided cost is an appropriate approach in some circumstances. However, there are potential difficulties with the concept under a full allocation approach as avoided cost attributes a cost to one cost centre irrespective of whether the cost is shared.

The avoided cost method may be used in a variety of business scenarios in a firm's broader decision-making processes, such as in relation to price setting. However, the AER is not assessing the concept in general terms. The AER must assess the application of avoided cost having specific regard to the regulation of DNSPs and particularly to the appropriate allocation of costs between regulated and non-regulated services. Furthermore, the AER must ensure that any proposed cost allocation method, such as avoided cost, is consistent with the ring-fencing provisions and cost allocation principles. The intention of these principles is to prevent one category of distribution services funding another category, and to promote transparency in the cost information provided by a DNSP.

In summary, costs can only be allocated to one cost centre under the avoided cost approach regardless of whether non-regulated services could be allocated a share of these costs. The use of avoided cost is therefore problematic as it provides the potential for some services to subsidise non-regulated services, which is inconsistent with the cost allocation principles in the NER. In these circumstances, the AER considers it prudent regulatory policy to require assurances from DNSPs that adequate safeguards are in place to prevent one category of distribution services subsidising another category of distribution services.

AER decision

The guidelines will remain unchanged. The use of avoided cost attribution will be allowed, but only with the AER's approval and only for immaterial expenditure.

5.3 Assurance requirements and regulatory information instruments

Stakeholders considered that the assurance requirements regarding cost information that is to be requested through future regulatory information instruments should instead be specified now in the cost allocation guidelines.

AER response

The guidelines are primarily a document to assist DNSPs prepare a cost allocation method. Therefore, in relation to any future assurance requirements, the AER has adopted the same approach as for transmission, whereby these assurance requirements will be placed in the same regulatory information instruments that specify reporting arrangements (whether annually or for building block proposals). This provides a single point of reference for DNSPs to understand all of their obligations regarding the reporting of information and the level of assurance/verification required. The AER considers that incorporating assurance requirements in these information instruments is a better approach given their close relationship with the data being provided.

Further, the AER appreciates DNSPs' need for certainty, given the imminent commencement of revenue determination processes in particular and expects that any assurance requirements will be consistent with those incorporated in the recent NSW/ACT regulatory information notices. Full consultation will be undertaken with DNSPs, as per the relevant NEL requirements, during the preparation of future regulatory information instruments and sufficient time will be provided to allow businesses to comply with any assurance requirements.

AER decision

The guidelines will remain unchanged. Full consultation in regard to the use of future regulatory information instruments will be undertaken in the development of those instruments.

Appendix A: Other issues raised by stakeholders

ISSUE	STAKEHOLDER	RESPONSE
Collection and disclosure of information		
The preparation of working papers to justify non-causal allocation will impose high compliance costs.	ENERGEX	Refer to section 5.1.
The role of the 'working papers' that are to be provided in support of the CAM remains unclear. In particular: ▪ The information that is to be provided in the working papers relative to the CAM and their interaction with the CAM. ▪ Whether the working papers will be treated as 'confidential' between the submitting DNSP and the AER.	Ergon	Refer to section 5.1. Claims of confidentiality of information contained in the working papers will be decided on a case by case basis.
Clause 5.2(b) of the guideline appears to contain overlapping information requirements which should be simplified. If subsections (2) and (3) are required, the subsection (1) should not be required.	Alinta AE, United Energy	The AER does not consider that there are overlapping information requirements in clause 5.2(b) of the guidelines. For comments on information requirements for working papers refer to final decision.

Avoided cost		
ENERGEX does not support a restriction on the use of the avoided cost method to immaterial costs only. In ENERGEX's view, such a restriction is inconsistent with Clause 6.18 of the NER.	ENERGEX	Refer to section 5.2.
A broader exploration of the use of avoided cost should be permitted within the guidelines	Alinta AE, United Energy	Refer to section 5.2.
Assurance requirements and regulatory information instruments		
The distribution information requirements will primarily be a function of the nature of regulatory information instruments yet to be developed by the AER. The role to be played by such instruments in the AER's cost allocation approval process is not identified in the cost allocation guidelines.	ENERGEX	Refer to section 5.3.
ENERGEX seeks confirmation that prior capex will not have to be restated to reflect the proposed CAM for use in the RFM	ENERGEX	DNSPs will be fully consulted on any information requests prior to the submission of their revenue proposals.
It is not clear whether the AER envisages any departures from Australian Accounting Standards in the preparation of regulatory accounts, including regulatory accounting requirements potentially exceeding statutory accounting requirements. For example, in relation to the level of reporting detail, the application of materiality thresholds and capitalisation policies.	ENERGEX	DNSPs will be fully consulted if approaches that differ to Australian Accounting Standards are to be adopted. Sufficient time will be provided to comply with any new requirements.

Ergon believes that all substantive provisions related to the preparation and application of a DNSP's CAM should be contained in the guidelines. Ergon is concerned that, as currently drafted, the guidelines rely heavily on the use of the regulatory information instruments to provide the level of detail the DNSPs will require to effectively develop and apply their CAMs.	Ergon	Refer to section 5.3.
Ergon does not believe that the National Electricity Law or National Electricity Rules envisage the use of regulatory instruments for matters of general application to all DNSPs.	Ergon	Regulatory information orders may apply generally to DNSPs. Also, refer to final decision.
The scope of the regulatory audit should be clarified in the guidelines. Also, audit requirements will need to be known with sufficient time and certainty to ensure that a complying audit can be performed prior to, and accompany, Ergon's regulatory proposal.	Ergon	Refer to section 5.3.
With respect to the Victorian cost allocation guideline, the businesses are unclear as to whether it is intended to apply to every line item on the profit and loss statement, balance sheet and cash flow statement or only to those items that are required by the AER to implement the NER.	Citipower & Powercor	The cost allocation methods only deal with the costs of service provision. Future regulatory information instruments will deal with the specific reporting requirements regarding financial statements. Full consultation will be undertaken at the appropriate time. Also, refer to final decision

Other issues raised		
The significantly wider range of services provided by DNSPs compared to TNSPs results in considerably greater complexity when allocating costs appropriately across all services.	ENERGEX	The cost allocation methods govern the allocation of costs between four types of services – standard control, alternative control, negotiated and unregulated services. The requirements are the same for TNSPs.
The CAMs require the establishment of distribution service classifications well before the are required for the purpose of revenue proposals for some DNSPs.	Aurora	The CAM should only contain the principles and policies for allocating costs to the four categories of distribution services mentioned above. The cost allocation methods do not require the classification of costs *within* the service levels.
The final classification of services will not be known until the distribution determination is issued and as a consequence, a DNSP will be unable to develop its CAM on the basis of the four possible service categories identified.	Ergon	Refer to comment directly above.
Aurora requests that it be exempt from the requirements of the NER with respect to the provision of its cost allocation method and instead be allowed to provide its cost allocation method at a date more consistent with the provision of its regulatory proposal	Aurora	Refer to comment directly above. Also, given the level of service allocation required the AER considers Aurora will be able to meet the required timeframe.

In light of the assumption that the guidelines will only deal with cost attributions and allocations at the services level, why does clause 5.1 of the proposed cost allocation guidelines provide that a DNSP is to apply its CAM in preparing prices for a negotiated distribution service.	ENERGEX	This requirement is explicitly stated in Clause 6.7.1 of the NER and repeated in the cost allocation guidelines.
Materiality should be defined in quantitative terms.	ENERGEX	The AER considers that the definition of materiality provided in the guidelines is appropriate.
Clause 2.2.4(d) should be removed from the guidelines as clause 2.2.4(c) covers its requirements.	ENERGEX	The AER will retain clause 2.2.4(d). The AER will only accept a non-causal basis of allocation if it can be demonstrated that there is likely to be a strong positive correlation between the non-causal basis of allocation and the actual cause of the cost.
The current situation where DNSPs decide what is contestable work and what is to be undertaken internally is not transparent, nor is the calculation process for works that DNSPs choose to carry out themselves for the developer.	SPA consulting	The classification of contestable and non-contestable work is beyond the purpose and scope of the cost allocation guidelines.

It is important for guidelines and models set out by the AER to serve as high-level 'safe-harbour' provisions for DNSPs.	ENA	The AER does not consider the inclusion of 'safe harbour' provisions in the cost allocation guidelines to be appropriate. The AER notes that interested parties have consistently argued that a 'one size fits all' cost allocation method is not appropriate under this legal framework due to the underlying differences in businesses' structures and accounting and information systems. For this reason, the AER essentially allows each business to develop its own cost allocation method under the guidance and requirements of the NER and guidelines.
The AER should err towards acceptance of DNSP proposed methods that are based on existing jurisdictional arrangements.	ENA	The cost allocation guidelines accommodate previous reporting arrangements by allowing DNSPs to: ▪ choose their own cost allocator; and ▪ prepare their own cost allocation methods.

In regard to clause 2.2.4(c) of the proposed cost allocation guidelines - the guidelines as currently worded require costs that are considered to be material in nature to be allocated using a causal allocator. This requirement appears inconsistent with the rules. In addition, it requires use of a causal allocator even if it can be shown that a causal relationship cannot be established without undue cost and effort in circumstances where the use of a causal allocator is unlikely to improve the underlying reporting of the substance of the cost. The requirement that shared costs must be allocated using causal allocators unless it can be shown that either the cost is immaterial or that a causal relationship cannot be established without undue cost and effort is sufficient in circumstances where the bases of non-causal allocation are subject to review by the AER.	ETSA	The AER agrees. The cost allocation guidelines have been altered in light of ETSA's comment.