

Jemena Gas Networks (NSW) Ltd

2015-20 Access Arrangement

Response to the AER's draft decision and revised proposal

Appendix 4.10 - Capitalised overheads

Public

27 February 2015



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1. OVERVIEW

1. This appendix deals with the recovery of Jemena Gas Networks (NSW) Ltd (**JGN's**) forecast capitalised overheads in response to the Australian Energy Regulator's (**AER's**) draft decision of November 2014 on JGN's initial revised Access Arrangement (**AA**) dated 30 June 2014 (**initial proposal**).
2. In its draft decision, the AER considered that JGN's forecast capitalised overheads of \$144.4 million (\$2015, escalated costs) included in its initial proposal were not prudent and efficient and reduced them to \$109.0 million (\$2015, escalated costs) in its alternative capex forecast.¹ In making its decision, the AER expressed concern with how JGN reports and forecasts some of its overhead costs.
3. We want to clearly demonstrate to the AER our process for capitalising overheads. We are hopeful that this will resolve any confusion about what categories of costs are reflected in overhead costs and which costs are direct costs, or included in opex. We note the constructive engagement with the AER on this issue since the draft decision (refer to the supporting information included as appendix 1.7).
4. It is very important that JGN be provided the opportunity to recover its overhead costs necessary for delivering its capital and maintenance programs and hence JGN's reference services. Therefore, this appendix aims to provide transparency in how JGN defines and reports overheads, and how its forecast capitalised overheads reflect the lowest sustainable cost.
5. JGN notes that the NSW energy market conditions are characterised by rising wholesale gas prices, falling electricity prices, competition from alternative non-traditional energy sources, gas appliance substitution, challenging government policy settings and improving energy efficiency. These conditions place JGN squarely in a competitive market environment with other fuels that can power NSW homes and businesses and drive JGN to seek out the lowest sustainable total cost solutions (including its forecast capitalised overheads) in delivering the safe and reliable level of service our customers expect for their money.
6. In light of the draft decision, we have prepared this appendix to explain:
 - how we classify costs for business-as-usual statutory purposes
 - how we reported and forecast overheads in the initial proposal
 - our understanding of the AER's concerns with the draft decision and our response to those concerns, and
 - our revised approach to forecasting overheads in our revised proposal.

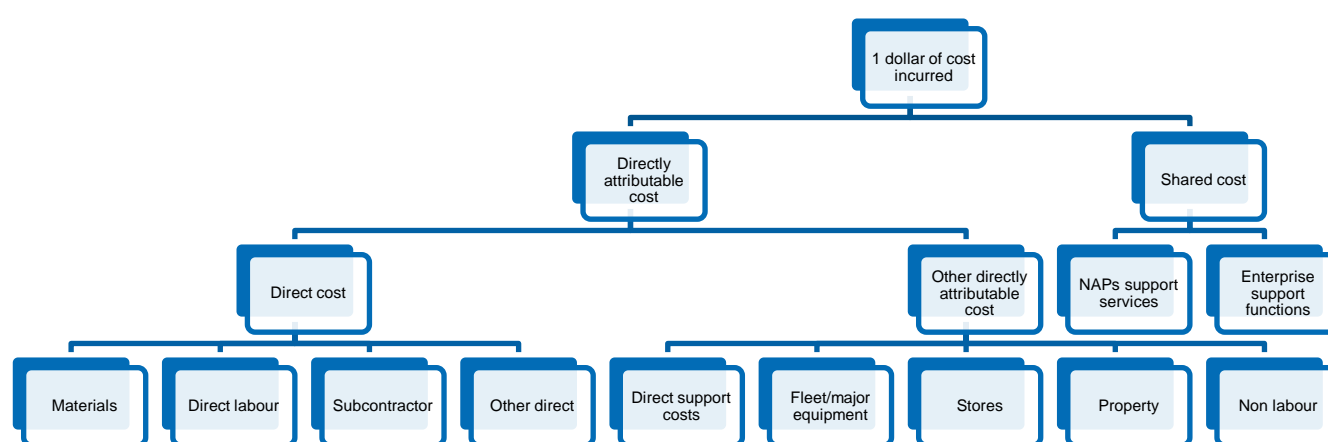
¹ The AER allowed \$109.0M explicitly. The AER also inferred that the historical unit rates that it adopted included \$15.2M of direct overheads.

2. COST CLASSIFICATION AT JEMENA GAS NETWORKS

2.1 WE HAVE THREE BROAD COST CATEGORIES

7. At JGN, a dollar of cost incurred will fall into one of the cost categories set out in Figure 2–1. This categorisation is used for statutory purposes, and is quite different to how we prepare costs for regulatory purposes.

Figure 2–1: Cost flows at JGN



8. Within JGN's business, costs are classified as either directly attributable costs or shared costs. Further information on each category is set out in section 6.7.1 of Jemena's cost allocation methodology (**CAM**), provided as **Attachment A**. We note that the CAM was submitted with our AA RIN response on 30 June 2014.

2.2 CAPITALISATION OF OVERHEAD COSTS

9. In accordance with section 6.7.3 of the Jemena CAM, JGN only capitalises costs as an asset when it is probable that future economic benefits associated with the item will flow to JGN and the costs of the item can be measured reliably. In addition, capitalisation of costs must comply with relevant accounting standards, including AASB 116 – property, plant and equipment, and our actual capitalised costs are audited annually for compliance with these standards and our parent company's capitalisation policy.

3. OUR INITIAL PROPOSAL

10. Parts of the AA RIN required us to report costs differently to the approach set out in section 2. We needed to report using an activity-based costing approach. In other words, the cost categories describe the activity for which the cost is being incurred. Examples are “operating and maintenance” or “capacity development” or “marketing”.
11. We also reported ‘overheads’ for regulatory purposes. We reported three categories of overheads for regulatory purposes, being:
 - network overheads
 - direct overheads
 - corporate overheads.
12. Importantly, in JGN’s AA RIN response, we did not include direct capitalised overheads in the overheads template (template 14) as part of total overheads. However, we did include total capitalised overheads in the forecast capex in the capex templates of JGN’s AA RIN response.
13. This was due to the methodology used to forecast direct overheads in the capex forecast as outlined in section 3.2.2.
14. This led to forecast capitalised overheads disclosed in the AA RIN template 14 of \$93.1 million (\$2015, escalated costs) being lower than JGN’s forecast of total capitalised overheads across its capex driver categories of \$144.4 million (\$2015, escalated). This may have caused confusion.

3.1 NETWORK OVERHEADS

3.1.1 DEFINITION

15. The AA RIN defines network overheads as:

...the cost of providing network, control and management services that cannot be directly identified with specific operational activity (such as routine maintenance, vegetation management, etc.).

For distribution NSPs [network service providers], network overhead includes the following:

- *management (not directly related to any of the functions listed below)*
- *network planning (i.e. system planning)*
- *network control personnel*
- *quality and standards functions including standards and manuals, asset strategy (other than network planning), compliance, quality of supply, availability, and network records (e.g. geographical information systems (GIS))*
- *project governance and related functions including supervision, procurement, works management, logistics and stores; and*

3 — OUR INITIAL PROPOSAL

- *other, including training, Occupational Health and Safety functions, training, network billing and customer service.*

16. Our reported network overhead costs included:

- Management O&M
- Network planning
- Network control and operational switching
- Project governance and related functions
- Quality and standard functions
- Other
- IT.

17. Stores were reported as part of direct overheads.

3.1.2 FORECASTING APPROACH

18. We forecast network overheads using the base, step and trend method, with the base being the amount of network overheads estimated to be capitalised in 2013-14. This is set out in the JGN opex model (refer to view 2).²

3.2 DIRECT OVERHEADS

3.2.1 DEFINITION

19. Direct overheads are the stores, property and non-labour costs identified in Figure 2–1:

- *property*—represents an allocation of JGN's property, rental and outgoing costs against capital and maintenance projects. These property costs only relate to JGN's operation-based sites such as logistics facilities and control rooms and do not include corporate offices. JGN interprets that property costs fit within the AA RIN network overhead definition of "cost of providing network, control and management services that cannot be directly identified with specific operational activity". Furthermore, 'logistics' is identified in the AA RIN network overhead definition as a project governance and related function.
- *stores*—represents JGN's labour, property and material costs in operating its warehouses. 'Stores' is identified in the AA RIN network overhead definition as a project governance and related function.
- *non labour*—represents the residual costs (excluding labour, fleet, major equipment and property) within operation cost centres. Typical residual costs include (among others) office administration, telecommunications, travel and accommodation costs.

20. Clearly, by their nature, direct overheads are integral in delivering JGN's capital and maintenance programs and hence JGN's reference services.

² For example, see: JGN, 2015-20 access arrangement information, appendix 7.1, 30 June 2014, Calc/Opex Summary (view 2), row 86.

3.2.2 FORECASTING APPROACH

21. For our initial proposal, we forecast direct overheads as a fixed percentage of the forecast direct capital program costs for each year of the next AA period. They were allocated to the capex program construction rates used to generate each forecast for each capex category.

3.3 CORPORATE OVERHEADS

3.3.1 DEFINITION

22. Corporate overheads are defined by the AA RIN as:

...the cost of providing corporate support and management services by the corporate office that cannot be directly identified with specific operational activity.

Corporate overhead costs typically include those for executive management, legal and secretariat, human resources, finance, and other' corporate head office activities or departments.

23. We complied with the AA RIN. As a result, corporate costs included:

- offices of the CEO
- finance
- insurance
- human resources
- legal and secretariat
- regulatory
- other corporate head office costs.

3.3.2 FORECASTING APPROACH

24. We forecast corporate overheads using the base, step and trend method, with the base being the amount of corporate overheads estimated to be capitalised in 2013-14. This is also set out in the JGN opex model (refer to 'view 2' in the opex model).³

³ See: JGN, 2015-20 access arrangement information, appendix 7.1, 30 June 2014, Calc/Opex Summary (view 2).

4. AER'S DRAFT DECISION

25. The AER noted that JGN did not set out the forecast method for its overhead expenditure in its revised AA but instead indicated that its treatment of overhead allocation and capitalisation is detailed in its AA RIN response.⁴ The RIN response set out that JGN's approach consists of a category build-up of network and corporate overheads which totals \$93.1 million (\$2015, escalated costs). However, the AER determined that JGN did not allocate this amount across its capex driver categories and that it included an additional \$51.3 million across its capex driver categories so that overheads totalled \$144.4 million (\$2015, escalated).
26. This led the AER to be concerned with potential double counting, and therefore the AER requested that JGN explain the difference between the amounts in the overhead build up and the amount in the capex summary. JGN stated that this reflected direct overheads.⁵
27. In addition, the AER was not satisfied that total planning costs are a direct cost incurred in relation to facilities renewal and upgrade. Therefore, it considers total planning costs to be an overhead cost. JGN does not agree with this view and believes that such costs are direct capital in nature.

4.1 SUMMARY OF AER'S DRAFT DECISION

28. In its draft decision⁶, the AER included \$109.0 million (\$2015, escalated costs) of total overheads expenditure in its alternative capex forecast.⁷ The AER considered that JGN's proposed amount of \$144.4 million (\$2015, escalated costs) is not prudent and efficient. To address this, the AER applied its forecast opex rate of change in place of JGN's forecast opex rate of change. The AER also used the average of the 2012-13 and 2013-14 direct overheads in place of JGN's method of rolling forward the direct overhead share of total capex in FY13.
29. Table 4–1 shows the comparison of JGN's forecast capitalised overheads included in its initial proposal with the AER's draft decision.

Table 4–1: Comparison of JGN's forecast capitalised overheads with AER's draft decision \$millions, \$2015

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
JGN's revised AA 30 June 2014 (A)						
Direct overheads	10.2	10.5	10.8	10.3	9.4	51.2
Network overheads	17.0	17.2	17.4	17.5	17.6	86.6
Corporate overheads	1.3	1.3	1.3	1.3	1.3	6.5
Total capitalised overheads	28.5	29.0	29.5	29.0	28.3	144.4
AER's draft decision (B)						
Network overheads	3.9	3.8	3.9	3.7	3.4	18.7

⁴ JGN, 2015-20 Access Arrangement Information – Public, 30 June 2014, Appendix 06.07 Forecast capital expenditure report – PUBLIC, p. 51.

⁵ AER, Draft decision Jemena Gas Networks (NSW) Ltd, Access arrangement 2015–20, Attachment 6: Capital expenditure, November 2014, p 6-44.

⁶ AER, Draft decision Jemena Gas Networks (NSW) Ltd Access Arrangement 2015–20, Overview November 2014, p 65.

⁷ The AER allowed \$109.0M explicitly. The AER also inferred that the historical unit rates that it adopted for market expansion included \$15.2M of direct overheads

	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Corporate overheads	16.7	16.8	16.8	16.8	16.8	84.0
Total capex overheads	1.3	1.3	1.3	1.3	1.3	6.3
Total capitalised overheads	21.8	21.8	22.0	21.8	21.5	109.0
Difference (A)-(B)						
Direct overheads	6.4	6.7	6.9	6.6	6.0	32.5
Network overheads	0.3	0.4	0.6	0.6	0.7	2.6
Corporate overheads	0.0	0.0	0.0	0.0	0.1	0.2
Total capitalised overheads	6.7	7.2	7.5	7.2	6.8	35.4

30. The AER's draft decision to disallow \$35.4 million of overhead costs across the three overhead cost categories comprises:
- 1) rate of change – reduction of \$3.5 million resulting from a mix of disallowed material cost escalators and escalation weights (broadly labour/non-labour cost split).
 - 2) methodology change to direct overheads – reduction of \$16.7 million. Broadly, JGN submitted a capital program based on a 'cost plus' methodology where direct overheads were built into the unit rate calculation and as a result scale with the capital program resulting in approximately \$9-10 million p.a. The AER stated that JGN had not adequately justified the basis of its forecast for direct overheads (as a percentage of forecast direct capital costs). Instead, the AER considers that five years of historical data are required in order to assess the trend but in the absence of that data, the AER adopted a base amount equal to the average of actual direct overheads expenditure for 2012-13 and 2013-14, or \$6.75M, as a "placeholder", in applying its preferred base, step, trend approach.
 - 3) concern of double counting – reduction of \$15.2 million. The AER inferred that the unit rates it adopted for market expansion capex included \$15.2 million of direct overheads.
31. This appendix deals with the AER's concern with the methodology change and double counting.

5. JGN'S REVISED PROPOSAL APPROACH

32. JGN's proposed method for determining its network and corporate overheads is consistent with its initial proposal and the AER's draft decision; that is the base, step and trend approach.
33. For its direct overhead costs, consistent with the AER's draft decision, JGN has recalculated its unit rates to remove direct overheads and instead adopted the base, step and trend approach to forecast its direct overheads. For example, please refer to appendix 4.2 which provides the market expansion unit rate model.⁸
34. For absolute clarity, capitalised overhead costs do not include total planning costs (**TPC**) (now called FEED and related costs), network planning costs, or network control and operational switching costs (system planning).⁹

5.1 WHAT IS JGN'S METHOD

35. JGN's proposed method for determining its total overheads is set out in Table 5–1 below, comparing its revised proposal and the AER's draft decision.

Table 5–1: Comparison of methods to determine JGN's total overhead costs

Overhead category	JGN revised AA 30 June 2014	AER draft decision November 2014	JGN revised AA 27 February 2015
Direct overheads	Recovered through capital rates	Base, step, trend	Base, step, trend
Network overheads	Base, step, trend	Base, step, trend	Base, step, trend
Corporate overheads	Base, step, trend	Base, step, trend	Base, step, trend

36. The AER accepted JGN's proposed base, step and trend approach for determining JGN's total network and corporate overheads in its initial proposal. Therefore, JGN does not propose to change its approach with regard to network and corporate overheads.
37. In its draft decision the AER stated a preference for a base, step and trend approach for JGN's total direct overheads rather than JGN's initial proposed cost plus methodology where costs were included in the construction unit rate calculation. The AER adopted the average of JGN's 2012-13 and 2013-14 costs as the base amount in substituting its forecast direct overheads. In its revised proposal JGN has changed its methodology to the base, step and trend approach but has adopted actual direct overheads for 2013-14 as the base year amount.
38. JGN's revised unit rates exclude direct overheads as set out in appendix 4.2

⁸ Like in our initial proposal, have continued to remove Capital Program Management (CPM) costs from the market expansion unit rates. Also, like in our initial proposal, we have forecast these costs using a base, step and trend method, and included these amounts in our capitalised network overheads forecast (refer X15:Y39 within "Output\TCE" of the appendix 4.2). CPM is the labour cost of employees who are directly associated with the delivery of the capital program, but are unable to time-write to specific projects.

⁹ See JGN, *Response to the AER's draft decision*, sections 4.6.2.2 and 4.14.2.1 for JGN's detailed response on these costs.

5.2 JGN'S BASE, STEP AND TREND APPROACH

39. JGN has employed the base, step and trend approach¹⁰ for forecasting overheads in the 2015-20 AA period. JGN has, for each overhead category:
- 1) established the efficient base year based on JGN's current and historical costs; JGN has adopted 2013-14 actual costs as its base year across all three overhead categories.
 - 2) trended its adjusted base year opex forward, escalating the forecast for real rate of change
 - 3) added forecast costs arising from foreseeable incremental step changes in expenditure. Note that there are no step changes adopted in any of our overhead forecasts.
40. JGN has employed the same base, step and trend approach to its direct, network and corporate overheads in its revised proposal.
41. In determining JGN's base year for direct overheads the AER adopted the average of JGN's 2012-13 and 2013-14 costs as the base year in substituting its forecast direct overheads because of its concerns with JGN's proposed method of forecasting those costs as a percentage of forecast direct capital costs. Instead, the AER considers that five years of historical data are required in order to assess the trend. In the absence of that data, the AER applied its opex rate of change to a base amount equal to the average of actual direct overheads expenditure for 2012-13 and 2013-14 as a placeholder.
42. In its revised proposal JGN has changed its method to the AER's preferred base, step and trend approach and adopted 2013-14 as the base year. JGN has adopted 2013-14 as the base year given that 2012-13 was the first year in which costs were collected under the new costing arrangements implemented from April 2012. JGN considers that it is likely that there was some misallocation of costs early in that year as operational staff transitioned to the new cost collection approach. Therefore, 2013-14 is likely to be a more representative year and reflect the best estimate of a sustainable base level of direct overheads. JGN notes that the amount for the first six months of 2014-15, when annualised, is broadly in line with the actual amount for 2013-14 (\$7.16 million versus \$7.29 million), well above the amount for 2012-13.

5.3 WHAT ARE JGN'S REVISED OVERHEADS?

43. Table 5–2 shows JGN's revised forecast capitalised overheads included in its revised proposal.

Table 5–2: JGN's revised forecast capitalised overheads \$millions, \$2015

	2013-14 (actual)	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	Total
Direct overheads	7.2	7.0	7.1	7.2	7.3	7.3	7.4	36.3
Network overheads	16.0	15.7	15.8	16.0	16.2	16.3	16.5	80.7
Corporate overheads	1.9	1.9	1.9	1.9	2.0	2.0	2.0	9.8
Total capitalised overheads	25.1	24.6	24.8	25.1	25.4	25.6	25.9	126.8

¹⁰ As set out in JGN, *JGN access arrangement information*, 30 June 2014, appendix 7.2

5 — JGN'S REVISED PROPOSAL APPROACH

5.3.1 NO DOUBLE-COUNT

44. Our initial proposal included \$51.2 million (\$2015) of direct overheads in the direct capital program costs (refer Table 4–1).
45. We have removed direct overheads from the forecast direct capital costs as explained in the capex chapter (chapter 4 of the revised proposal) and noted above. We have removed \$55.1 million (\$2015), which is consistent with the amount that was included in the initial proposal (noting that our revised proposal reflects, for example, higher connection volume forecasts). This \$55.1 million comprises direct overheads removed from:
 - market expansion unit rates and market expansion projects, of \$23.0 million
 - refer cells X15:Y39 within “Output|TCE” of appendix 4.2
 - non market expansion capex, of \$32.1 million
 - refer cells T324:T333 within “Input|Escalators” of appendix 4.1
46. As noted, our *revised* overheads forecasting methods for all categories (direct, network and corporate) adopt the base, step and trend method. The base year is 2013-14.
47. For direct overheads, applying this new method (the AER preferred method), we have added back \$36.3M (\$2015)—refer Table 5–2.
48. At an aggregate capitalised overheads level, there is alignment to JGN's AA RIN. We note that our AA RIN is drawn from exactly the same systems which are used to prepare our audited statutory accounts.
49. Note that, to avoid confusion, this reconciliation is undertaken in \$2014 dollars, recognising that our 2013-14 AA RIN and statutory accounts are prepared on that basis. In other words, \$24.7 million (\$2014) is equivalent to \$25.1 million (\$2015) reported in Table 5–2

Figure 5–1: Reconciliation of base year capitalised overheads to AA RIN capitalised overheads

	2013-14 (actual)
Revised proposal (\$2014)	\$24.72
AA RIN (Nov 14) (\$2014)	\$24.72
Reconciliation check	✓

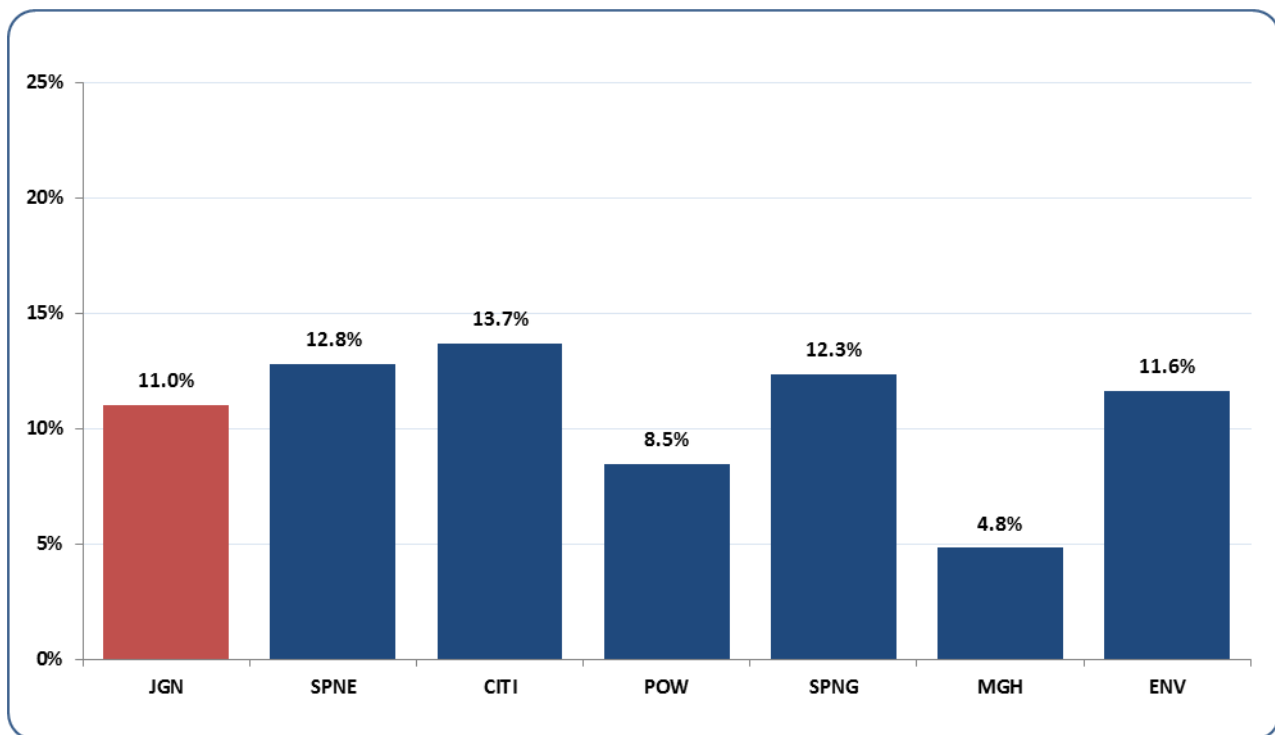
Table 14.3

Capex/opex overhead apportionment (actual/forecast)	2013-14
	Actual
	Nominal
Opex overheads	92,050
Capex overheads	24,721
Total overheads	116,770
Source(s) of data:	

5.4 COMPLIANCE WITH THE RULES

50. JGN's capitalised overheads are integral in delivering JGN's capital programs and hence JGN's reference services.
51. In revising its forecast capitalised overhead costs, JGN has adopted the AER's preferred base, step and trend approach across all three overhead categories to ensure that they are arrived at on a reasonable basis and represent the best forecast possible in the circumstances.¹¹
52. We have also benchmarked our forecast capitalised overhead rate with that of other network business. JGN is proposing capitalised overheads of ~\$126M and this is equivalent to approximately 11 per cent of the gross capex program of \$1,144.3M.
53. Table 5–2 shows that JGN's proposed capitalised overheads percentage is broadly comparable to the AER's allowed capitalised overheads percentage for Victorian electricity and gas distributors.

Figure 5–2: Capitalised overheads as a percentage of gross capex



Source: JGN estimates, EDPR 2010 final decisions for Citpower, Powercor, SPAusNet electricity; Victorian GAAR 2012 final decisions for Multinet, Envestra, SPAusNet gas.

54. We note that we benchmark well at a multi-lateral total factor productivity and capex partial productivity level, indicating our total capex (including capitalised overheads) is efficient.¹²

¹¹ Rule 74(2).

¹² JGN, JGN 2015-20 access arrangement information, 30 June 2014, appendix 4.3

55. In accordance with rule 79, JGN's revised forecast capitalised overheads are such as would be incurred by a prudent service provider acting efficiently, in accordance with good industry practice, to achieve the lowest sustainable cost of providing reference services.

Attachment A

Cost Allocation Methodology [c-i-c]

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