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M^cGRATHNICOL

CORPORATE ADVISORY

**Review of Cost
Allocation Methodology**

Powerlink

**Australian Competition and
Consumer Commission**

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The contacts at McGrathNicol Corporate Advisory in connection with this report are:

Michael Dunnett

Ph: (02) 6222 1415

Fax: (02) 6222 1499

mdunnett@mcgrathnicol.com

Aidan Hardy

Ph: (02) 6222 1440

Fax: (02) 6222 1499

ahardy@mcgrathnicol.com

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The conclusions contained in this report are based solely on the information provided to us. Except where specifically stated, we have not sought to establish the reliability of the sources of information presented to us by reference to independent evidence. Furthermore, we reserve the right to amend any conclusions, if necessary, should any further information become available.

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1 Executive summary

1.1 Introduction

The Australian Energy Regulator (AER) engaged McGrathNicol to assist in a review of the proposed Cost Allocation Methodology (CAM or Methodology) of selected Transmission Network Service Providers (TNSP).

Our review was conducted in the overall context of how well Powerlink's proposed Methodology addresses and complies with the AER's TNSP Cost Allocation Guidelines. Particular reference was also made to:

- + The AER's ability to replicate Powerlink's reported outcomes; and
- + Powerlink's compliance with the Transmission Ring-Fencing Guidelines (TRFG) in attributing costs directly to, or within, categories of transmission services.

In undertaking this review, the following activities were performed:

- + Exceptions based review identifying how well Powerlink's proposed CAM complies with the AER's Cost Allocation Guidelines and subsequently the National Electricity Rules' (the NER) Cost Allocation Principles;
- + Assessment of the AER's ability to replicate Powerlink's reported outcomes; and
- + Review of the consistency of Powerlink's proposed CAM with the TRFG.

1.2 Key findings

The key findings from our review of Powerlink's proposed CAM are provided below.

Review of compliance with the AER's Cost Allocation Guidelines

Based on the information provided, Powerlink's proposed CAM appears compliant with the AER's Cost Allocation Guidelines.

Review of compliance with the NER's Cost Allocation Principles

Based on the information provided, Powerlink's proposed CAM appears compliant with the NER's Cost Allocation Principles.

Assessment of the AER's ability to replicate Powerlink's reported outcomes

Based on the information provided and discussions with the AER, Powerlink's proposed CAM appears sufficient to enable the AER to replicate its reported outcome.

Review of consistency with the Transmission Ring-Fencing Guidelines

Based on the information provided, Powerlink's proposed CAM appears to be consistent with the TRFG.

2 Introduction

2.1 Background

- + The AER is an independent Government statutory authority.
- + The AER enforces the National Electricity Law (the NEL) and the NER, and is responsible for the economic regulation of TNSPs in the National Electricity Market (the NEM).
- + In September 2007, the AER published a set of guidelines that provide direction for TNSPs in managing the attribution of direct costs and the allocation of shared costs between, and within, different categories of transmission services.
- + Based on these guidelines, TNSPs are required to develop detailed principles and policies for the attribution of these costs which constitute its respective CAM.
- + The AER is responsible for approving each TNSP's CAM based on the criteria outlined in the NER and the AER's Cost Allocation Guidelines.
- + In accordance with chapter 6A.19.1 of the NER, a TNSP must comply with the Methodology that has been approved in respect of that provider.
- + As part of the AER's approval process, McGrathNicol has been engaged to assist in reviewing Powerlink's proposed CAM.

2.2 Scope

This report will provide the AER with a review of the following:

- + The extent to which Powerlink's proposed CAM meets and complies with the AER's Cost Allocation Guidelines;
- + The AER's ability to replicate Powerlink's reported outcome based on its proposed CAM; and
- + The detailed principles and policies Powerlink has proposed to ensure its consistency with the TRFG.

2.3 Capacity and experience

McGrathNicol was created on 1 July 2004 following our departure from KPMG. We are one of the largest national advisory firms in Australia with over 260 professional consultants.

Our Canberra office specialises in advising Government clients. We are on 26 different Government panels and are leading advisors to numerous Government departments.

Both senior consultants selected for this engagement are Chartered Accountants and have significant experience in working with Government and reviewing costing models and methodologies.

3 Regulatory framework and guidelines

3.1 National Electricity Market

The NEM is an open access wholesale electricity market created to maintain a competitive environment and provide electricity customers with greater access to suppliers of their choice.

The participation in, and operations of the NEM, are governed by the NER.

3.2 National Electricity Rules

The NER have the force of law under the NEL, and prescribe the procedures and processes for market operations, power system security, network connection and access, and pricing for network services in the NEM.

In accordance with the NER, all TNSPs must submit their respective CAM to the AER for approval.

Chapter 6A.19.2 of the NER identifies the Cost Allocation Principles that a TNSP must adhere to when preparing its CAM.

The NER's Cost Allocation Principles represent the basic framework and requirements upon which a TNSP's CAM should be developed.

These principles are incorporated at clause 2.2 of the AER's Cost Allocation Guidelines.

3.3 Cost Allocation Methodology

A TNSP's CAM describes the detailed principles and policies for attributing costs to, or allocating costs between or within, categories of transmission services it provides.

Under chapter 6A.19.4 (b) of the NER, a TNSP's proposed CAM must give effect to, and be consistent with, the AER's Cost Allocation Guidelines.

3.4 AER's Cost Allocation Guidelines

In accordance with chapter 6A.19.3 of the NER, the AER developed a set of guidelines to assist TNSPs in the following:

- + Preparation of CAMs, including the attribution and allocation of costs;
- + Formatting and submission of CAMs to the AER for approval; and
- + Application of approved CAMs.

The AER's Cost Allocation Guidelines give effect to, and are consistent with the NER's Cost Allocation Principles and may be amended from time to time in accordance with the NER.

4 Methodology used to address scope

4.1 Overall methodology

In addressing the scope of this engagement, we have conducted our review based on the AER's Cost Allocation Guidelines, the NER's Cost Allocation Principles and the TRFG.

Although, we have undertaken a thorough analysis of Powerlink's proposed CAM, we have presented our report on an *exceptions* basis.

Based on this approach, we have excluded detailed commentary in respect of those findings which appear to be compliant or consistent with the AER's Cost Allocation Guidelines, the NER's Cost Allocation Principles and the TRFG.

Accordingly, we have only identified issues of non-compliance or inconsistency which we believe are pertinent to the AER's decision making.

4.2 Methodology used to assess compliance with the AER's Cost Allocation Guidelines

We have reviewed the compliance of Powerlink's proposed CAM based on the AER's Cost Allocation Guidelines and the NER's Cost Allocation Principles.

AER's Cost Allocation Guidelines

In order to determine the degree of compliance with the AER's Cost Allocation Guidelines, we reviewed the following format and content requirements, (as detailed in clause 3.2 of the AER's Cost Allocation Guidelines):

- 3.2 (1) A version history and date of issue for the document;
- 3.2 (2) A statement or description of the nature, scope and purpose of the document and the way it is to be used;
- 3.2 (3) Details of Powerlink's commitment to implement its proposed CAM and those responsible within its organisation for updating, maintaining, monitoring and reporting on its application;
- 3.2 (4) A description of Powerlink's corporate and operational structure to enable an understanding of its organisational structure and provision of services;

- 3.2 (5) A specification of the categories of transmission services Powerlink provides and to whom these services are provided;
- 3.2 (6) The existence of detailed principles and policies used for attributing direct costs, allocating costs between different categories of transmission services, with specific reference to the requirements of clause 2.2 of the AER's Cost Allocation Guidelines;
- 3.2 (7) Details of how Powerlink maintains records of cost attributions and allocations such that it is in accordance with clause 5.2 of the AER's Cost Allocation Guidelines and could be audited or verified by a third party;
- 3.2 (8) A description of how Powerlink proposes to monitor its compliance with its CAM and the AER's Cost Allocation Guidelines;
- 3.2 (9) Details of the proposed date on which Powerlink's CAM will take effect, having regard to clause 4.1 (d) of the AER's Cost Allocation Guidelines; and
- 3.2 (10) A statement signed and dated by at least two Powerlink directors, indicating in their opinion that the CAM is accurate and confirming their intention to comply with and implement the CAM as approved by the AER.

Where Powerlink's proposed CAM addressed each of the above requirements, its CAM was deemed compliant in respect of that criterion.

NER's Cost Allocation Principles

Under clause 3.2 (6) of the AER's Cost Allocation Guidelines (see above), TNSPs are required to comply with clause 2.2 of the AER's Cost Allocation Guidelines. Clause 2.2 refers to the NER's Cost Allocation Principles, which TNSPs are required to adhere to when preparing their proposed CAM.

In order to determine Powerlink's degree of overall compliance with the AER's Cost Allocation Guidelines, we subsequently reviewed the extent to which Powerlink's proposed CAM satisfies the NER's Cost Allocation Principles. The NER's Cost Allocation Principles, as detailed in chapter 6A.19.2 of the NER, are as follows:

- (1) A TNSP's CAM must be described in sufficient detail to enable the AER to replicate the 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) Costs directly attributable to business segments must be assigned accordingly, i.e. where possible, costs should be allocated to the relevant transmission services in which resources are consumed;
- (4) Costs not directly attributable to a specific category of transmission service must be assigned based on an appropriate allocator. In addition, the reasons for using that approach must be clearly described;
- (5) The same cost must not be allocated more than once;
- (6) A TNSP's CAM must be consistent with the TRFG;
- (7) Costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services; and
- (8) Costs which have been allocated to negotiated transmissions services may be reallocated to prescribed transmission services to the extent they satisfy all other principles.

Where Powerlink's proposed CAM addressed the above requirements, the CAM was deemed compliant in respect of that criterion.

4.3 Methodology used to assess the AER's ability to replicate Powerlink's reported outcomes

In order to determine the AER's ability to replicate the reported outcome, we reviewed the level of detail included in Powerlink's proposed CAM.

Where sufficient information appears to exist which provides the AER with the necessary comfort that costs will be allocated appropriately between categories of transmission services, Powerlink's proposed CAM was deemed to have satisfied this requirement.

4.4 Methodology used to assess the consistency with the Transmission Ring Fencing Guidelines

In order to determine the consistency of Powerlink's proposed CAM with the TRFG, we reviewed the principles and policies used to allocate costs across services.

Powerlink is required to allocate costs in a fair and reasonable manner based on the use of assets shared between contestable and regulated activities. The purpose of the above is to avoid possible cross subsidisation between services.

Where Powerlink's proposed CAM demonstrates the allocation of costs between transmission services in a fair and reasonable manner to avoid cross-subsidisation, it was deemed to comply with the TRFG.

5 Review of Powerlink's proposed CAM

5.1 Overview and assumptions

Powerlink's CAM provides a high level summary of how it proposes to allocate direct and indirect costs.

Powerlink's proposed CAM states the following:

- + That it has been prepared in accordance with the requirements of the NER, the AER's Cost Allocation Guidelines and the TRFG; and
- + That it reflects its existing cost allocation methodology used to allocate and attribute costs.

Based on discussions with the AER, and our subsequent understanding of its information requirements, we based our preliminary review on Powerlink's proposed CAM dated 28 March 2008.

Following feedback from Powerlink in response to our cursory review, this report has been updated based on Powerlink's interim and final CAMs dated 24 June 2008 and 15 August 2008 respectively.

5.2 Review of compliance with the AER's Cost Allocation Guidelines

Based on the information provided, we have compiled a table which seeks to identify whether Powerlink's proposed CAM complies with the AER's Cost Allocation Guidelines.

Our assessment of the compliance of Powerlink's proposed CAM with the AER's Cost Allocation Guidelines is set out below:

Requirement	Cost Allocation Guidelines Reference	Complies with Guidelines	Findings
A version history and date of issue for the document	3.2 (1)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Version history has been provided. + Date of issue has been provided. + Appears to comply with this AER Cost Allocation Guideline.
A statement or description of the nature, scope and purpose of the document and the way it is to be used	3.2 (2)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Nature, purpose and objectives of the proposed CAM have been provided. + Appears to comply with this AER Cost Allocation Guideline.
Details of Powerlink's commitment to implement its proposed CAM and those responsible within its organisation for updating, maintaining, monitoring and reporting on its application	3.2 (3)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Powerlink's directors have confirmed its intention to comply with their proposed CAM. + Corporate areas and individuals responsible for implementing, applying, maintaining, monitoring and updating the CAM have been identified. + Appears to comply with this AER Cost Allocation Guideline.
A description of Powerlink's corporate and operational structure to enable an understanding of its organisational structure and provision of services	3.2 (4)	✓	<ul style="list-style-type: none"> + Powerlink has provided a summary of its corporate and operational structures. + Powerlink has also provided a high level summary of its business management model. + Powerlink has not identified how its corporate and operational structures are segregated / arranged to deliver / provide each category of transmission service. However, we consider that the information provided in respect of Powerlink's corporate and operational structure is sufficient. + Based on our review of the information provided, nothing has come to our attention that suggests that Powerlink's proposed CAM is inconsistent with this AER Cost Allocation Guideline. + The AER may wish to seek a breakdown of how Powerlink's corporate and operational structures are segregated / arranged to deliver / provide each category of transmission service.
A specification of the categories of transmission services it provides and to whom these services are provided	3.2 (5)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Service offerings have been identified. + Customer target groups have been identified. + Appears to comply with this AER Cost Allocation Guideline.

Requirement	Cost Allocation Guidelines Reference	Complies with Guidelines	Findings
The existence of detailed principles and policies used for attributing direct costs, allocating costs between different categories of transmission services, with specific reference to the requirements of clause 2.2 of the AER's Cost Allocation Guidelines	3.2 (6)	✓	<ul style="list-style-type: none"> + See section 5.3 of this report. + Powerlink's proposed CAM provides a high level summary of how it allocates direct and indirect costs. + Powerlink proposed CAM assigns direct costs associated with each asset and activity to its categories of transmission services. + Powerlink has indentified its shared costs (business support and procurement costs) and their respective cost allocators (direct labour and a standard procurement oncost rate). + Based on discussions with the AER and additional information provided by Powerlink to the AER, there appears to be sufficient information in relation to the allocation of direct and indirect costs. + Appears to comply with this Cost Allocation Guideline.
Details of how Powerlink maintains records of cost attributions and allocations such that it is in accordance with clause 5.2 of the AER's Cost Allocation Guidelines and could be audited or verified by a third party	3.2 (7)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Powerlink's proposed CAM states that it maintains documentation and records of the allocation and attribution of costs through its SAP computer system. + Powerlink's SAP system allows costs to be automatically allocated to categories of transmission services and provides an integrated approach to tracking costs and activities from their original source. + In addition, Powerlink states that workpapers and documentation with sufficient detail will be available to demonstrate compliance with its proposed CAM and the AER's Cost Allocation Guidelines. + An annual audit of Powerlink's proposed CAM is conducted as part of its regulatory financial report, which includes an assessment of Powerlink's compliance with its approved CAM. + Appears to comply with this AER Cost Allocation Guideline.
A description of how Powerlink proposes to monitor its compliance with its CAM and the AER's Cost Allocation Guidelines	3.2 (8)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Powerlink's CFO is responsible for monitoring compliance with its approved CAM across the organisation. This includes reporting to the Board annually on its application as part of Powerlink's regulatory reporting process. + Powerlink also undertakes an annual independent audit of its regulatory financial statements to ensure its compliance with its approved CAM and its regulatory reporting requirements. + Based on the information provided, there is nothing to suggest that Powerlink's proposed CAM is non-compliant with this AER Cost Allocation Guideline.
Details of the proposed date on which the CAM takes effect, with regard for clause 4.1 (d) of the AER's Cost Allocation Guidelines	3.2 (9)	✓	<ul style="list-style-type: none"> + Powerlink has indicated that the proposed CAM will apply with immediate effect. + Although this may be inconsistent with the AER's Cost Allocation Guideline given the CAM is yet to be approved, Powerlink has indicated that this Methodology is current at the date of publication. + Powerlink's CAM will remain in force until a new or amended version is approved by the Board and AER. + Based on the information provided, there is nothing to suggest that Powerlink's proposed CAM is non-compliant with this AER Cost Allocation Guideline.
A statement signed and dated by at least two directors, indicating that in their opinion, the CAM is accurate and confirming their intention to comply and implement the CAM as approved by the AER	3.2 (10)	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Directors' statement has been provided and signed by two unidentified Powerlink directors. Details of the two signatories have been supplied by the AER. + Appears to comply with this AER Cost Allocation Guideline.

5.3 Review of compliance with the NER's Cost Allocation Principles

Based on the information provided, we have compiled a table which seeks to identify whether Powerlink's proposed CAM complies with the NER's Cost Allocation Principles.

Our assessment of the compliance of Powerlink's proposed CAM with the NER's Cost Allocation Principles is set out below:

Principle	Rules Reference	Cost Allocation Guidelines Reference	Consistent with Principles	Findings
Powerlink's proposed CAM must be described in sufficient detail to enable the AER to replicate the reported outcomes through application of those principles and policies	6A.19.2 (1)	2.2.1	✓	<ul style="list-style-type: none"> + See section 5.4 of this report. + Powerlink's key cost allocation principles assign direct costs associated with each asset and activity to its respective category of transmission service. + Where direct cost attribution is not possible, Powerlink's proposed CAM indicates that a causal basis of allocation is undertaken for the following shared costs: <ul style="list-style-type: none"> - Business support costs: Allocated based on direct labour; and - Procurement costs (transmission services): Allocated based on a standard procurement oncost rate (determined by forecast procurement costs / forecast external purchases). This rate is applied to the external purchase costs for assets and services related to a particular business activity. These costs are subsequently applied to the relevant category of transmission service. + Allocating business support costs based on direct labour, and allocating procurement costs based on a standard procurement oncost rate, appear appropriate. + There appears to be sufficient information to enable the AER to replicate Powerlink's reported outcomes based on Powerlink's proposed CAM and additional information provided in response to the AER's further information request. + Appears to comply with this NER Cost Allocation Principle.
The allocation of costs must be determined according to the substance of a transaction or event rather than its legal form	6A.19.2 (2)	2.2.2	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Powerlink has expressly stated that its cost allocation basis will be reviewed periodically to ensure that substance is always considered over legal form. + Appears to comply with this NER Cost Allocation Principle.
Costs directly attributable to business segments be assigned accordingly i.e. costs should be allocated to the relevant transmission services in which resources are consumed	6A.19.2 (3)	2.2.3	✓	<ul style="list-style-type: none"> + Powerlink's direct cost allocation approach is based on its business model and costing model principles. + Where possible, Powerlink allocates costs directly to its activities. Where an activity is directly related / associated with an asset, the relevant category of transmission service for that asset is automatically applied to that activity. + Powerlink also indicates that some direct costs include activities provided by internal and external service providers. The methods used to capture these costs include: <ul style="list-style-type: none"> - Fee for services (e.g. standard labour rates); and - Fixed charges. + This approach appears reasonable and appears to comply with this NER Cost Allocation Principle.

Principle	Rules Reference	Cost Allocation Guidelines Reference	Consistent with Principles	Findings
Costs not directly attributable to a specific category of transmission service be assigned based on an appropriate allocator, and the reasons for using that methodology must be clearly described	6A.19.2 (4)	2.2.4	✓	<ul style="list-style-type: none"> + Powerlink's proposed CAM indicates that shared costs must be allocated on a causal basis and that the cost allocation approach will be applied consistently throughout the regulatory period. + Powerlink's proposed CAM indicates that a causal basis of allocation is undertaken for those costs not directly attributable to a particular category of transmission service. These costs are allocated as follows: <ul style="list-style-type: none"> - Business support costs: Allocated based on direct labour; and - Procurement costs (transmission services): Allocated based on a standard procurement oncost rate (determined by forecast procurement costs / forecast external purchases). This rate is applied to the external purchase costs for assets and services related to a particular business activity. These costs are subsequently applied to the relevant category of transmission service. + The allocation of business support costs based on direct labour and the allocation of procurement costs on a standard procurement oncost rate appear appropriate. + Based on the information provided, Powerlink's cost allocation methodology appears appropriate and defensible. + Appears to comply with this NER Cost Allocation Principle.
The same cost must not be allocated more than once	6A.19.2 (5)	2.2.5	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Furthermore, Powerlink has expressly stated that it will not allocate the same cost more than once. + Appears to comply with this NER Cost Allocation Principle.
Must be consistent with the Transmission Ring Fencing Guidelines	6A.19.2 (6)	2.2.6	✓	<p>No findings identified</p> <ul style="list-style-type: none"> + Powerlink's states that its proposed CAM has been prepared in accordance with the NER and the TRFG. + In addition, it lists the TRFG as one of its sources of references with its proposed CAM. + Appears to comply with this NER Cost Allocation Principle.
Costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services	6A.19.2 (7)	2.2.7	✓	<ul style="list-style-type: none"> + Although this principle is not expressly referenced within its proposed CAM, Powerlink's proposed Methodology states that a direct cost will only be attributed to one category of transmission service and that a shared cost will only be allocated once. + Accordingly, based on the information provided, there is nothing to suggest that Powerlink's proposed CAM is inconsistent with this NER Cost Allocation Principles.
Costs which have been allocated to negotiated transmissions services may be reallocated to prescribed transmission services to the extent they satisfy all other principles	6A.19.2 (8)	2.2.7	✓	<ul style="list-style-type: none"> + Although this principle is not expressly reference within its proposed CAM, Powerlink's proposed Methodology states that a direct cost will only be attributed to one category of transmission service and that a shared cost will only be allocated once. + Accordingly, based on the information provided, there is nothing to suggest that Powerlink's proposed CAM is inconsistent with this NER Cost Allocation Principles.

5.4 Assessment of the AER's ability to replicate Powerlink's reported outcomes

Powerlink's proposed CAM provides a high level summary of how it proposes to allocate direct and indirect costs to its categories of transmission services.

Powerlink's proposed CAM includes the following information:

- + A high level summary of its corporate and operational structures;
- + A summary of its costing model principles; and
- + A summary of its cost allocation policies, which includes the following details:
 - Powerlink's proposed Cost Allocation Approach;
 - Powerlink's Direct Costing Approach;
 - Powerlink's Shared Costing Allocation; and
 - Powerlink's Cost Allocation Consistency.

Powerlink's direct cost allocation approach is based on its business model and costing model principles.

Where possible, Powerlink allocates costs directly to its activities. Where an activity is directly related / associated with an asset, the relevant category of transmission service for that asset is automatically applied to that activity. This approach appears appropriate.

Powerlink's shared costing allocation methodology states that shared costs must be allocated on a causal basis. Powerlink's proposed CAM indicates that direct labour is used to allocate business support costs and material oncosts is used to allocate procurement costs.

Although direct labour appears to be an appropriate allocator for business support costs, we have insufficient information to make a conclusion in respect of the appropriateness of the allocation of procurement costs.

Ordinarily, we would not expect materials oncost to be a cost driver given the inherent nature of materials oncost (i.e. it is typically an overhead / shared cost itself).

Accordingly, we are not able to determine whether the shared cost allocators adopted by Powerlink's proposed CAM are appropriate.

In order to understand Powerlink's rationale for the selection of materials oncost as a cost driver for procurement costs, we recommend that the AER request the following information:

- + A definition of procurement costs, and examples therein;
- + A definition of material oncosts and how it is used to allocate procurement costs; and
- + The reason for Powerlink's selection of material oncosts as the causal allocator for procurement costs.

Accordingly, based on the above information, it appears that the level of information provided is insufficient to enable the AER to replicate Powerlink's reported outcome.

5.5 Review of consistency with the Transmission Ring Fencing Guidelines

Powerlink's CAM expressly states that its proposed CAM has been prepared in accordance with the NER's requirements, including the TRFG.

In addition, Powerlink's costing model principle assigns each asset and activity to a category of transmission service. This ensures that any cost associated with that asset or activity is attributed to the relevant transmission service to avoid any cross subsidisation.

This process is further supported by Powerlink's financial management system, SAP. SAP's accounting structure revolves around the separation of operating and capital costs to allow the direct allocation and attribution of cost to Powerlink's transmission services.

Based on the information provided, Powerlink's proposed CAM appears consistent with the TRFG.

Consultancy Terms of Reference

Outcomes

1. The consultant is to review and assess the proposed CAMs of the following TNSPs: Transend, TransGrid, EnergyAustralia, Powerlink, SPAusNet, ElectraNet, Directlink, Murraylink and Vencorp (including any preliminary submissions) in the overall context of how well they meet and comply with the AER's Cost Allocation Guidelines. Particular reference should also be made to:
 - the AER's need to be able to replicate the reported outcomes; and
 - the detailed principles, policies and approach that the TNSPs use to attribute costs directly to, or to allocate costs between or within, categories of transmission services to ensure they are consistent with the Transmission Ring-Fencing Guidelines.
2. The output of the consultancy will be a draft report¹ followed by a final report to the AER addressing clause 13. The reports will deal with how well each of the 10 point assessment criteria in clause 16 is met. Particular emphasis should be placed on how well TNSPs address and meet clause 16(4), (6) and (7).
3. The consultant will need to give immediate priority to the Transgrid and Transend CAMs for the reasons outlined in clause 18.
4. If necessary, the draft report should also identify any deficiencies and recommend amendments to bring these CAMs to an acceptable standard.
5. Authorship will clearly be attributed to the consultant. The report may be released for public discussion.

Background

6. The Australian Energy Regulator (AER) is responsible for regulating the revenues of Transmission Network Service Providers (TNSPs) in the National Electricity Market in accordance with the National Electricity Law (NEL) and the National Electricity Rules (NER).
7. The Cost Allocation Guidelines set out general guidance and protocols underlying the Cost Allocation Methodology (CAM) which TNSPs are required to provide to the AER by no later than 28 March 2008.

¹ In the case where a TNSP submit a preliminary Cost Allocation Methodology for assessment (refer to clause 17), the AER will be expecting a draft report on these preliminary methodologies in addition to the requirements under clause 1-4 and 17-22.

8. Under these guidelines, each TNSP is responsible for developing the detailed principles and policies for attributing costs to, or allocating costs between or within, the categories of transmission services that it provides. These detailed principles and policies² must be included in the proposed CAM that the TNSP submits to the AER for approval.
9. Cost allocation concerns the attribution of a regulated business's direct costs to prescribed, negotiated and other services and the allocation of shared costs between these different services. It is not concerned with the allocation of costs for the purposes of price determination.
10. Effective cost allocation has an important role to play in promoting the National Electricity objective to:
 - Promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.
11. Effective cost allocation requirements support the National Electricity objective by:
 - promoting the appropriate allocation of costs between prescribed, negotiated 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 prescribed, negotiated 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; and
 - promoting consistency and comparability in the provision and reporting of financial information over time in relation to the various services.
12. A TNSP's CAM therefore, is a vital part of ensuring that the objectives noted above are realised as it documents the way a business will put the cost allocation principles into effect.
13. As part of the AER's assessment, the regulator is seeking an appropriately qualified consultant to review these CAMs. The consultant's reviews will assist the AER to assess the proposed CAMs relative to the requirements of the Cost Allocation Guidelines and the principles in the NER (6A.19).
14. It would be desirable that the consultant have:

² Please refer to the AER's Cost Allocation Guidelines clause 2.2 for further information.

- an in depth understanding of the regulatory environment governing the electricity market, particularly the National Electricity Rules and National Electricity Law;
 - direct and relevant experience in the reviewing and assessing the application of cost allocation; and
 - experience in, liaising and working with, regulated businesses and preparing reports that will be made available in the public domain.
15. Should the consultant be engaged by the AER to fulfil this review, the consultant will need to warrant that, at the date of entering into the contract, no conflict of interest exists or is likely to arise in the performance of its obligations under the contract. If, during the term of the contract, a conflict, or risk of conflict, of interest arises, the contractor undertakes to notify the AER immediately in writing of that conflict or risk.

Format and contents of Cost Allocation Methodology

16. Under the Cost Allocation Guidelines, a TNSP's proposed CAM must include the following information:
- (1) a version history and date of issue for the document;
 - (2) a statement of the nature, scope and purpose of the document and the way in which it is to be used by the TNSP;
 - (3) details of the accountabilities within the TNSP for the document in order to set out clearly:
 - A. the TNSP's commitment to implementing the CAM; and
 - B. responsibilities within the TNSP for updating, maintaining and applying the CAM and for internally monitoring and reporting on its application.
 - (4) a description of the TNSP's corporate and operational structure in order to enable the AER to understand how the TNSP is organised to provide its transmission services;
 - (5) Details of the categories of transmission services (prescribed, negotiated and other) that TNSPs allocate costs to and the types of customers (i.e. generators and distributors) to whom those services are provided for;
 - (6) the TNSP's detailed principles and policies to be used for attributing costs directly to, or allocating costs between, categories of transmission services, which are:
 - 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 and

- 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.
- (7) a description of how the TNSP will maintain records of the attribution or allocation of costs to, or between, categories of transmission services in order to enable any such attribution or allocation to be:
 - A. demonstrated to the AER, in accordance with clause 5.2 of the Cost Allocation Guidelines; and
 - B. audited or otherwise verified by a third party, including the AER, as required.
 - (8) a description of how the TNSP will monitor its compliance with the CAM and the Cost Allocation Guidelines;
 - (9) details of the proposed date on which the CAM will commence, having regard for clause 4.1(d) of the Cost Allocation Guidelines; and
 - (10) a statement signed and dated by not less than two directors of a TNSP, which states whether in the directors' opinion, the information contained in the CAM is accurate and which confirms the TNSP's intention to comply with the AER's CAM as approved by AER.

Timing

17. The successful consultant will be required to sign the AER's standard contract.
18. It is expected that TransGrid and Transend (that will be undertaking revenue resets) will submit their preliminary draft CAM for early feedback before the due date of 28 March 2008. Consequently, it is expected that these TNSPs will lodge their proposed CAM by the due date along with other TNSPs.
19. The draft and final report for Transend and TransGrid should be completed 3 weeks after the consultant receives the preliminary and final CAMs from the AER. The deadline for all other reports is outlined in clause 20.
20. This clause report does not apply to Transgrid and Transend. The draft report should be completed 2 months after the lodgement date to fit in with the National Electricity Rules requirements and Consultation Procedures. Consequently, the final report will be due 2 months after the draft report.

Consultation process

21. During the course of the reviews, the consultant may be expected to liaise with the TNSPs. These consultations may include but not limited to the following:

- meeting with the TNSPs at their state offices; and
 - possible written requests for additional information
22. The consultant will also be required to liaise extensively with AER staff and provide the regular updates on progress and any significant issues that have been identified.

Key source materials

23. In undertaking the review, the consultant's source materials may include the following documents:
- The AER's Cost Allocation, Information, Ring-Fencing and Submission Guidelines.
 - The National Electricity Rules.