

Cost Allocation Guideline - *Electricity Infrastructure Investment Act*

Draft

August 2023

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Glossary

Term	Definition
Australian Energy Regulator	has the meaning set out in the National Electricity Law.
Avoided cost	is a cost that a Network Operator would avoid incurring by virtue of taking an alternative course of action.
Business days	a day, in New South Wales, excluding a Saturday, Sunday, public holiday and bank holiday.
Directly attributable or directly attributed	an item is directly attributable or directly attributed to an object such as a business segment of a Network Operator, if it is wholly and exclusively associated with that segment.
Direct costs	are those costs that can be directly attributed to the provision of a particular category of regulated and unregulated services.
EII Act, the Act	Electricity Infrastructure Investment Act 2020 (NSW).
EII Regulation	Electricity Infrastructure Investment Regulation 2021 (NSW) made under the EII Act.
EII revenue determination guidelines	Revenue determination guideline for NSW contestable projects, and Transmission Efficiency Test and revenue determination final guideline for non-contestable projects.
Immaterial	means not material.
Material or materiality	an item is material if its omission, misstatement, or non-disclosure has the potential to prejudice the understanding of the financial position of the Network Operator, gained by an assessment of financial information relating to the Network Operator.
National Electricity Law	means the National Electricity Law set out in schedule to the National Electricity (South Australia) Act 1996.
National Electricity Rules	means the rules, as defined in the National Electricity Law.
Network Operator	means a person who owns, controls, or operates, or proposes to own, control or operate, network infrastructure under the EII Act.
Non-causal or non-causation based method of allocation	Method of allocation other than a causal or causation-based method of allocation.
EII regulated activities	Activities of a Network Operator, for which the Network Operator is paid under a revenue determination made under the EII framework (the EII Act and EII Regulation).
Other regulated activities or services	Activities of a Network Operator, for which the Network Operator is paid under a revenue determination made under the NER. These are prescribed transmission or direct control services.
Other activities or services	Activities or services of a Network Operator, where the revenues earned by a Network Operator do not fall under a revenue determination under the EII framework or the NER.
Shared costs	are those costs that cannot be directly attributed to the provision of a particular category of regulated and unregulated services but which are allocated between different categories of regulated and unregulated services.

Invitation to make submissions

We invite interested parties to make written submissions in response to this draft Guideline, and the other draft supporting guidelines for the Electricity Infrastructure Investment Act released by the AER, by close of business 23 August 2023.

Please contact us if you would like to meet with AER staff during this consultation period. Submissions should be sent electronically to REZ@aer.gov.au with the title 'Submission – Draft Guidelines EII Act' We ask that all submissions sent in an electronic format are in Microsoft Word or another text-readable document form.

Alternatively, submissions may be sent to:

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Enquiries about this paper, or about lodging submissions, should be directed to REZ@aer.gov.au.

Confidentiality

The AER prefers that all submissions be publicly available to facilitate informed and transparent consultation. Submissions will be treated as public documents unless otherwise requested.

Parties wishing to submit confidential information are requested to:

- clearly identify the information that is the subject of the confidentiality claim, and
- provide a non-confidential version of the submission in a form suitable for publication.

All non-confidential submissions will be placed on the [AER's website](#). For further information regarding the AER's use and disclosure of information provided to it, please see the [ACCC/AER Information Policy](#) available on our website.

Public forum

The AER will host an online public forum to allow stakeholders the opportunity to ask questions about our draft Guidelines before submissions close.

The public forum will be held from 10 am to 11 am (AEST) on 14 August 2023. To register your interest in the public forum, please email REZ@aer.gov.au by close of business on 11 August 2023.

Next steps

We will consider submissions received and feedback from the public forum before we publish the final guideline in **early September 2023**.

1 Nature and authority

1.1 Introduction

The Australian Energy Regulator (AER) exists to ensure energy consumers are better off, now and in the future. We are the economic regulator for electricity and gas networks in every state and territory in Australia except Western Australia. We regulate electricity networks under the National Electricity Law (NEL) and National Electricity Rules (NER). We are also a Regulator in NSW under the *Electricity Infrastructure Investment Act 2020 (NSW)* (EII Act).

In making a revenue determination under the EII Act, we require the Network Operator to provide us with information we consider necessary to enable us to make a revenue determination.¹ This includes the accurate identification and allocation of the cost of delivering different types of activities or services. Effective cost allocation requirements prevent cross-subsidisation between activities or services, ensuring consumers only pay the efficient costs of the services they consume.

This guideline sets out the arrangements to manage the attribution of direct costs and the allocation of shared costs by Network Operators between and within the different regulated activities it delivers under the EII Act, Other regulated activities or services it delivers under the NER and Other activities or services it delivers.

1.2 Authority

In our role as a Regulator under the EII Act, we must issue guidelines in relation to the exercise of our functions.² A key function of our role is to make revenue determinations for Network Operators authorised by the Consumer Trustee, or authorised or directed by the Minister, to undertake network infrastructure projects in NSW (under Part 5 of the EII Act).³

1.3 Role of this guideline

The role of this guideline is to detail the process for:

1. a Network Operator preparing and submitting its proposed or amended cost allocation methodology to us for approval,
2. us approving or rejecting a Network Operator's proposed or amended cost allocation methodology,
3. amending and reviewing a Network Operator's approved cost allocation methodology from time to time, and
4. a Network Operator applying its cost allocation methodology.

¹ EII Act, s. 38(7) and EII Regulation, cl. 48(1) & (2)

² EII Act, s. 64(4)(a) and EII Regulation, cl. 47(1)(a)

³ EII Act, s. 38.

1.4 Rationale for this guideline

A cost allocation methodology identifies and separates the costs of delivering each activity or service type undertaken by a Network Operator. This ensures the costs of delivering regulated activities or services can be accurately reflected in a revenue determination.

The EII Act regulates activities on an individual project basis rather than a whole-of-network basis as under the NER, and each project is subject to its own revenue determination. Costs associated with each project must therefore be separately identified. The costs of infrastructure projects under the EII Act must also be separated from costs of delivering regulated services under the NER. This guideline describes how a Network Operator must amend an existing cost allocation methodology to separately account for EII regulated activities, or how a new Network Operator may prepare a cost allocation methodology for activities delivered under the EII Act.

1.5 Relationship between this guideline, the EII revenue determination guidelines and cost allocation methodology

Both the EII contestable and non-contestable guidelines (EII revenue determination guidelines) make references to how a Network Operator may amend or develop a cost allocation methodology and submit it to us for approval. To the extent possible this guideline is consistent with the EII revenue determination guidelines. Where there is any deviation, this guideline takes precedence.

We will monitor, report on, and enforce compliance with the Network Operator's cost allocation methodology in accordance with this guideline and the requirements of Appendix A (EII Chapter 6A) of the EII non-contestable guideline.

1.6 Interaction with the National Electricity Rules

EII Chapter 6A explains the EII cost allocation guideline requirements and cost allocation methodology.⁴ For EII non-contestable revenue determinations, we are required, as far as is reasonably practicable, to make EII guidelines consistent with Chapter 6A of the NER.⁵ Therefore, the cost allocation sections of EII Chapter 6A are modified sections from Chapter 6A of the NER and therefore are largely consistent with Chapter 6A of the NER.

Although EII Chapter 6A applies to EII non-contestable revenue determinations, the EII cost allocation guideline may also be applied to EII contestable revenue determinations.

The EII Act and *Electricity Infrastructure Investment Regulation 2021 (NSW)* (EII Regulation) refer to 'activities' delivered by Network Operators. The NER refers to 'services' delivered by service providers, who can also be Network Operators under the EII Act. Activity types refer to activities delivered under different revenue determinations made under the EII Act (with each revenue determination defining a unique activity type). Service types refer to the service categories (distribution or transmission) used under the NER.

⁴ EII Ch 6A cl. 6A.19.3.

⁵ EII Regulation, cl. 47A(3)(b)

This guideline is intended to apply alongside the NER cost allocation guidelines. We expect a network operator who also delivers services under the NER framework to comply with both guidelines.

1.7 Processes for revision

We may amend this guideline from time to time. Should we amend this guideline, we will publish the proposed amendment on our website for a period of at least 20 business days and consider any submissions received within that period.⁶ We may not consult on any amendments we consider to be minor or administrative.⁷ Where changes to Chapter 6A of the NER will have a material impact on EII Chapter 6A, we will consult on any proposed changes to this guideline.

⁶ EII Regulation, cl. 47C(1).

⁷ EII Regulation, cl. 47C(2)(b).

2 Cost allocation principles

2.1 Developing principles and policies

This guideline must give effect to and be consistent with the EII Cost Allocation Principles,⁸ and a Network Operator's proposed Cost Allocation Methodology must give effect to and be consistent with this guideline.⁹ Clause 6A.19.2 of EII Chapter 6A set out the EII Cost Allocation Principles. Each of the principles are discussed in detail below.

2.1.1 Detailed principles and policies

1. A Network Operator's detailed principles and policies for attributing costs directly to, or allocating costs between or within:
 - a) each EII regulated activity,
 - b) Other regulated activities or services, and
 - c) Other activities or services

must be sufficiently detailed to enable us to replicate the reported outcomes through the application of those principles and policies.¹⁰
2. To enable us to replicate the Network Operator's reported outcomes, a Network Operator must include information on the following matters:
 - a) For directly attributable costs:
 - i) the nature of each cost item,
 - ii) the activity or service type between or within which the cost item is to be directly attributed,
 - iii) the characteristics of the cost item that associate it uniquely with or within each activity or service type to make it a directly attributable cost, and
 - iv) how and where records will be maintained to enable the basis of attribution to be audited or otherwise verified by a third party, including us.
 - b) For shared costs:
 - i) the nature of each cost item,
 - ii) the activity or service type between or within which each cost item is to be allocated,
 - iii) the nature of the allocator, or allocators, to be used for allocating each cost item,
 - iv) 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,
 - v) whether the numeric quantity or percentage of the allocator, or allocators, to be applied for each cost item will:

⁸ EII Chapter 6A, cl. 6A.19.3(b)

⁹ EII Chapter 6A, cl. 6A.19.4(b).

¹⁰ EII Chapter 6A, cl. 6A.19.2(1).

- A. remain unchanged over the regulatory control period, or
 - B. change from time to time throughout the regulatory control period.
- vi) If clause 2.1.1.2(b)(v)(A) applies:
- A. details of numeric quantity or percentage of the allocator, or allocators, and
 - B. 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
- vii) If clause 2.1.1.2(b)(v)(B) applies, an explanation of how the Network Operator 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
- viii) how and where records will be maintained to enable the allocation to be audited or otherwise verified by a third party, including by us.

2.1.2 Substance over legal form

1. A Network Operator shall attribute costs directly to, or allocate costs between or within, activity or service types based on the substance of the underlying transaction or event.
2. Where the substance and legal form differ, the substance rather than the legal form of a transaction or event shall be used as the basis of cost attribution or allocation.¹¹
3. In determining the substance of a transaction or event, all of its aspects and implications shall be considered, including the expectations of, and motivations for, the transaction or event.
4. For the purposes of determining the substance of a transaction or event, a group or series of transactions or events that achieves, or is designed to achieve, an overall commercial effect shall be viewed in aggregate.

2.1.3 Attribution of direct costs

1. Only costs that are directly attributable to or within the provision of a particular activity or service type may be directly attributed to that activity or service type.¹²
2. A cost may be directly attributable to a Network Operator but not directly attributable to a particular activity or service type provided by the Network Operator. In this circumstance, the allocation of costs between or within activities or service types may only be made in accordance with clause 2.1.4.

2.1.4 Allocation of shared costs

1. Shared costs incurred in providing several activities or services must be allocated between or within those categories using an appropriate causal allocator, except to the extent that:¹³
 - a) the shared costs are immaterial, or
 - b) a causal relationship cannot be established without undue cost and effort.

¹¹ EII Chapter 6A, cl. 6A.19.2(2).

¹² EII Chapter 6A, cl. 6A.19(2)(i).

¹³ EII Chapter 6A, cl. 6A.19(2)(ii).

2. For the avoidance of doubt, a Network Operator must allocate its shared costs:
 - a) between or within the different EII regulated activities it delivers,
 - b) between or within different types of Other regulated activities or services that it provides under the NER, and
 - c) between or within different types of Other activities or services it provides.
3. If a shared cost is immaterial or a causal relationship cannot be established without undue cost and effort, then the Network Operator may allocate the shared cost to, or within, the activity or service type using a non-causal allocator provided that:
 - a) the non-causal allocator accords with an AER approved cost allocation methodology,
 - b) the aggregate of all shared costs subject to non-causal bases of allocation is not material,
 - c) the non-causal basis of allocation is approved in writing by us, and
 - d) the Network Operator provides a supporting work paper to us documenting for each 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 a non-causal relationship could be established, and
 - D. a numeric quantity or percentage of the non-causal allocator applied to each activity or service type and in total.
4. The bases of non-causal allocation will be subject to review by us. We expect only to accept a non-causal basis of allocation if the Network Operator 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.
5. A Network Operator is not permitted to allocate shared costs using an avoided cost approach unless approved by us.

2.1.5 Not allocate cost more than once

1. A Network Operator must not allocate the same cost more than once.
2. For the avoidance of doubt, clause 2.1.5.1 means that:
 - a) the same cost may not be treated as both a direct cost and a shared cost,
 - b) a direct cost may only be attributed once to a single EII regulated activity, Other regulated activity or service, or Other activity or service,
 - c) a shared cost may only be allocated once to a single EII regulated activity, Other regulated activity or service, or Other activity or service, and
 - d) a Network Operator may only recover the same cost once through the charges that it levies for its regulated and unregulated activities or services.

2.1.6 Consistency with legal and functional separation guideline

The detailed principles, policies, and approach that a Network Operator uses to attribute costs directly to, or to allocate costs between or within, activity or service types must be consistent with our EII legal and functional separation guideline.¹⁴

¹⁴ The draft EII legal and functional separation guideline will be released for public consultation at the same time as this draft guideline.

3 Preparing and submitting cost allocation methodology

3.1 Contents of cost allocation methodology

1. Each Network Operator must submit for approval a document setting out its proposed cost allocation methodology¹⁵ that includes:¹⁶
 - a) a version history and date of issue for the document,
 - b) a statement of the nature, scope and purpose of the document and the way in which it is to be used by the Network Operator,
 - c) details of the accountabilities within the Network Operator for the document to clearly set out:
 - i) the Network Operator's commitment to implementing the cost allocation methodology; and
 - ii) responsibilities within the Network Operator for updating, maintaining, and applying the cost allocation methodology and for internally monitoring and reporting on its application.
 - d) a description of the Network Operator's corporate and operational structure to enable the AER to understand how the Network Operator is organised to provide the different types of activities and services it delivers,
 - e) a specification of the EII regulated activities, Other regulated activities or services, and Other activities or services that the Network Operator provides to which costs are to be attributed or allocated, and the types of persons to whom those services are provided,
 - f) the Network Operator's detailed principles and policies to be used for attributing costs directly to, or allocating costs between or within EII regulated activities, Other regulated activities or services, and Other activities or services that meet the requirements of clause 2.1 of this guideline. For the avoidance of doubt, this includes the attribution or allocation of costs relating to any related party transactions,
 - g) a description of how the Network Operator will maintain records of the attribution or allocation of costs between or within EII regulated activities, Other regulated activities or services, and Other activities or services to enable any such attribution or allocation to be:
 - i) demonstrated to us, in accordance with clause 5.2 of this guideline and
 - ii) audited or otherwise verified by a third party, including us, as required.
 - h) a description of how the Network Operator will monitor its compliance with the cost allocation methodology and this guideline,
 - i) details of the proposed date on which the cost allocation methodology will commence, having regard for clause 4.1(5) of this guideline, and

¹⁵ EII Chapter 6A, cl. 6A.19.4(a).

¹⁶ EII Chapter 6A, cl. 6A.19.3(c)(2).

- j) A statement signed and dated by not less than two directors of a Network Operator, which states whether in the directors' opinion, the information contained in the cost allocation methodology is accurate and which confirms the Network Operator's intention to comply with the cost allocation methodology as approved by us.
- 2. A Network Operator must submit its proposed cost allocation methodology to us in electronic form. Before doing so, a Network Operator must ensure that its submission can be transmitted in an electronic format that is compatible with our information systems.

3.2 Aligning cost allocation methodologies between the EII and the NER

- 1. A Network Operator or an affiliated entity may also be a network service provider under the NER and have a pre-existing cost allocation methodology. In this case, it will need to amend its existing cost allocation methodology.

An amended cost allocation methodology must meet the requirements of this guideline subject to the following:

- a) The updated cost allocation methodology should also comply with NER cost allocation guidelines, and
- b) Any amendments to an existing NER cost allocation methodology would be subject to clause 4.2 of the NER cost allocation guidelines.
- 2. The Network Operator must provide, in its cost allocation methodology, a statement confirming that any marginal increases in direct costs as a result of including EII regulated activities, will match the marginal increases in shared costs.

3.3 Timing for submission of cost allocation methodology

- 1. For an initial determination, each Network Operator must make its best endeavours to submit its proposed cost allocation methodology to us for approval at least 60 business days before the Network Operator's revenue proposal is due to be submitted.¹⁷ For subsequent determinations the Network Operator must meet the 60-business day deadline.¹⁸

¹⁷ AER, [*Transmission Efficiency Test and revenue determination final guideline non-contestable network infrastructure projects*](#), April 2023, p. 12

¹⁸ EII Chapter 6A, cl. 6A.19.4(a)(3).

4 Approving proposed cost allocation methodology

4.1 AER's assessment of proposed cost allocation methodology

1. We may approve or refuse to approve a Network Operator's proposed cost allocation methodology.¹⁹
2. We will notify the Network Operator of our decision to approve or refuse to approve the Network Operator's proposed cost allocation methodology within 30 business days of its submission. If we fail to notify the Network Operator of our decision within 30 business days, we are taken to have approved the Network Operator's cost allocation methodology.²⁰
3. In approving a cost allocation methodology, we may, after consulting with the relevant Network Operator, amend the proposed cost allocation methodology.²¹
4. We may make our approval of a Network Operator's cost allocation methodology conditional on:
 - a) the cost allocation methodology either taking effect immediately upon approval or at some future date determined by us, and
 - b) a defined basis for the relevant Network Operator transitioning between its existing cost allocation arrangements and those set out in the approved cost allocation methodology so that the Network Operator's actual and forecast costs can be compared over time.

4.2 Amending approved cost allocation methodology

1. A Network Operator may amend its approved cost allocation methodology from time to time in accordance with clause 6A.19.4(f) of EII Chapter 6A.
2. A Network Operator's proposed amendment to its cost allocation methodology must be submitted to us for approval and provide detailed reasons for the proposed amendment. We have up to 60 business days from the date the Network Operator submits the proposed amendment to approve the amendments.²² Any proposed amendments are also subject to changes that we notify the Network Operator of, being changes that we consider are reasonably necessary or desirable.²³
3. In deciding whether to approve a Network Operator's request to amend its cost allocation methodology, matters we may have regard to include whether:
 - a) there has been a material change in the Network Operator's circumstances,
 - b) the amendment is necessary for the business to effectively promote the cost allocation principles,
 - c) the resultant amended cost allocation methodology would give effect to, and be consistent with, this guideline,

¹⁹ EII Chapter 6A, cl. 6A.19.4(c).

²⁰ EII Chapter 6A, cl. 6A.19.4(d).

²¹ EII Chapter 6A.19.4(e)

²² EII Chapter 6A.19.4(f)(1)

²³ EII Chapter 6A.19.4(f)(2)

- d) the amendment will jeopardise the comparability of the resultant financial information with earlier information provided by that Network Operator to us, and
 - e) the Network Operator can quantify and demonstrate to us the impact of the proposed amendment.
4. We may make our approval to amend a Network Operator's cost allocation methodology conditional on the relevant Network Operator restating its historic or forecast financial information on a basis consistent with the amended cost allocation methodology.
5. A Network Operator must amend its approved cost allocation methodology if we require it to do so, to account for any change to this guideline. In these circumstances, the amendments only come into effect on the date we approve the amendments, or 90 business days after the submission of the amendment, whichever is earlier.²⁴ Any proposed amendments are also subject to changes that we notify the Network Operator of, being changes that we consider are reasonably necessary or desirable.²⁵

²⁴ EII Chapter 6A, cl. 6A.19.4(g)(1).

²⁵ EII Chapter 6A, cl. 6A.19.4(g)(2)

5 Application of cost allocation methodology

5.1 Obligation to apply cost allocation methodology

1. Under the NER and the EII Act, a Network Operator must comply with the cost allocation methodology we have approved in respect of that Network Operator.²⁶
2. A Network Operator is to allocate expenditure in accordance with its cost allocation methodology when preparing a revenue proposal.

5.2 Demonstrating application of cost allocation methodology

1. If requested, a Network Operator must provide documentation supporting the financial information that has been prepared in applying the cost allocation methodology.
2. The supporting documentation must:
 - a) demonstrate how the Network Operator has applied the detailed principles and policies in its approved cost allocation methodology,
 - b) provide details of the numeric quantity or percentage of the allocator, or allocators, applied to each cost item, and
 - c) 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.
3. The Network Operator must commission an audit of the application of its cost allocation methodology when required to do so by us.²⁷

5.3 Publication of cost allocation methodology

1. A Network Operator must maintain a current copy of its approved cost allocation methodology on its website.²⁸

²⁶ EII Chapter 6A, cl. 6A.19.1.

²⁷ AER, [Revenue determination guideline for NSW contestable network projects](#), August 2022, p. 26

²⁸ EII Chapter 6A, cl. 6A.19.4(h).