Final decision

Electricity Transmission Network Service Providers

Cost Allocation Methodologies

August 2008

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Contents

Shortened forms

AER	Australian Energy Regulator
CAM	Cost allocation methodology
Capex	Capital expenditure
NEL	National Electricity Law
NEM	National Electricity Market
NER	National Electricity Rules
Opex	Operating and maintenance expenditure
TNSP	Transmission Network Service Provider

1 Introduction

1.1 Summary

The Australian Energy Regulator (AER) has assessed the proposed cost allocation methodologies (CAMs), of the nine Transmission Network Service Providers (TNSPs) in the National Electricity Market (NEM). These TNSPs are:

- Directlink
- ElectraNet
- EnergyAustralia
- Murraylink
- Powerlink
- SP AusNet
- Transend
- TransGrid
- VENCorp

Transend and TransGrid's proposed CAMs have already been assessed and approved by the AER in April 2008. Letters of approval, Final Decisions and McGrathNicol Corporate Advisory (McGrathNicol) final reports on the CAMs have been released. These reports and letters can be viewed on the AER's website: www.aer.gov.au . This report focuses on the CAMs of the seven remaining TNSPs.

The AER engaged McGrathNicol Corporate Advisory to provide expert independent advice on the compliance of the proposed CAMs with the requirements of the NER and the AER's Cost Allocation Guidelines (the Guidelines). McGrathNicol concluded that in all cases the CAMs appeared to be broadly compliant with the Guidelines.

The AER has assessed the remaining proposed CAMs, taking account of McGrathNicol's independent advice, and has determined that they:

- are in accordance with the National Electricity Rules (NER); and
- give effect to and are consistent with the Guidelines.

Accordingly, the AER has approved the CAMs proposed by Directlink, ElectraNet, EnergyAustralia, Murraylink, Powerlink, SP AusNet and VENCorp under clause 6A.19.4(c) of the NER.

1.2 Background

The AER is responsible for regulating the revenues of TNSPs in the National Electricity Market (NEM) in accordance with the NER and National Electricity Law (NEL). Chapter 6A of the NER deals with the economic regulation of electricity transmission services.

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. The Guidelines only deal with cost attribution down to the level of services, not individual prices for different categories of services. Cost allocation for pricing purposes is dealt with separately through the Pricing Methodology Guidelines released by the AER on 29 October 2007.

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

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

Effective cost allocation requirements support the national electricity objective by:

- Promoting the appropriate allocation of costs between prescribed, negotiated and other services 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.
- Promoting consistency and comparability in the provision and reporting of financial information over time in relation to the various services.

The CAMs set out arrangements to manage the attribution of direct costs and the allocation of shared costs between different categories of transmission services. Each TNSP is responsible for developing the detailed principles and policies for attributing costs to, or allocating costs between, the categories of transmission services that it provides. These detailed principles and policies must be included in the proposed CAM that it submits to the AER for approval.

The NER requires that the CAM proposed by each TNSP must give effect to and be consistent with the Guidelines.

2 Process and NER requirements

2.1 Rule requirements

In the development of the Guidelines and the assessment of the proposed CAMs, the AER has followed the requirements of the NER. The overall content of a TNSP's CAM is governed by the Guidelines and clause 6A.19.3(c) of the NER which provides:

> Without limiting the generality of paragraph (b), the Cost Allocation Guidelines may specify:
>
> (1) the format of a Cost Allocation Methodology;
>
> (2) the detailed information that is to be included in a Cost Allocation Methodology;
>
> (3) the categories of transmission services which are to be separately addressed in a Cost Allocation Methodology, such categories being determined by reference to the nature of those services, the persons to whom those services are provided or such other factors as the AER considers appropriate; and
>
> (4) the allocation methodologies which are acceptable and the supporting information that is to be included in relation to such methodologies in a Cost Allocation Methodology.

The approval process for the CAM is specified by clause 6A.19.4(a) to (e) of the NER which provides:

> (a) Each Transmission Network Service Provider must submit to the AER for its approval a document setting out its proposed Cost Allocation Methodology:
>
> (1) by no later than 28 March 2008; or
>
> (2) in the case of an entity that is not a Transmission Network Service Provider as at 28 September 2007, within 6 months of being required to do so by the AER.
>
> (b) The Cost Allocation Methodology proposed by a Transmission Network Service Provider must give effect to and be consistent with the Cost Allocation Guidelines.
>
> (c) The AER may approve or refuse to approve a Cost Allocation Methodology submitted under paragraph (a).
>
> (d) The AER must notify the relevant Transmission Network Service Provider of its decision to approve or refuse to approve the Cost Allocation Methodology submitted to it under paragraph (a) within 6 months of its submission, failing which the AER will be taken to have approved it.
>
> (e) As part of giving any approval referred to in paragraph (c), the AER may, after consulting with the relevant Transmission

Network Service Provider, amend the Cost Allocation Methodology submitted to it, in which case the Cost Allocation Methodology as so amended will be taken to be approved by the AER.

2.2 Review of proposed TNSP CAMs

McGrathNicol was engaged to assist the AER in assessing the compliance of the proposed CAMs, and to produce reports on each of the CAMs for the AER's consideration.

In performing its review, McGrathNicol assessed:

- the compliance of the proposed CAMs with the Guidelines and the NER;
- the AER's ability to replicate the reported outcomes of the TNSPs (formulated in accordance with their CAMs); and
- the consistency of the proposed CAM's with the AER's Transmission Ring Fencing Guidelines.

McGrathNicol's reports on the TNSP CAMs are attached at Appendix B.

3 AER considerations

Details of each of the proposed CAMs, how they allocate costs, and any other AER considerations are provided below. Copies of the CAMs are attached at Appendix A.

3.1 Cost allocation methodologies

3.1.1 Directlink

Directlink's CAM governs the allocation of direct and shared costs to its transmission network. All direct costs are allocated to prescribed transmission services. As Directlink joint venture is 100 percent owned by the APA group, which manages a number of regulated gas and electricity assets, the CAM also covers the allocation of shared corporate overhead costs to Directlink from the APA group.

The corporate overhead costs are allocated according to the percentage of revenue the asset contributes to total revenue. Corporate overhead costs include costs associated with the following: Directors; CEO; CFO; GM Operations; Commercial; Human Resources; Legal; Secretariat; Internal Audit; Information Technology and state office support costs.

Directlink allocates corporate costs in this manner because:

- Shared costs are unavoidably incurred as part of Directlink's revenue generation;
- There is a causal relationship between revenue and shared costs; and
- This cost allocation approach has been previously accepted as an appropriate approach by the AER for the APA Group's gas infrastructure division.

3.1.2 ElectraNet

ElectraNet's CAM states that where possible ElectraNet will directly allocate costs to the different transmission services that it provides. ElectraNet assigns each of its assets to a category of transmission services. Costs that can be attributed to an asset are then directly allocated to the category of transmission services that asset is assigned to.

ElectraNet's shared costs are identified as Asset Related Expenditure and Business Unit Chargeable Costs.

Indirect Asset Related Expenditure is allocated according to the usage of assets in each of the transmission service categories. Examples of causal allocators used to allocate indirect asset related expenditure include:

- Rating capacity or agreed maximum demand as a percentage of total capacity or demand of all transmission service categories; and
- Number of units of plant installed.

ElectraNet uses a transfer pricing methodology (TPM) to allocate costs across business units. The resulting costs for each business unit are used to determine a burdened labour rate. The TPM typically uses the following allocators:

- Headcount; and
- Forecast working hours.

3.1.3 EnergyAustralia

EnergyAustralia's CAM is applied by EnergyAustralia in the derivation of its regulatory accounts for transmission and distribution, and is based upon its distribution CAM. During the next regulatory control period (2009-14) EnergyAustralia's electricity distribution and transmission networks will be economically regulated by the AER on the basis of the transitional Rules as a distribution network.

EnergyAustralia's CAM has two levels of disaggregation. Firstly, costs are disaggregated between standard control services, alternative control services, unregulated distribution services and non network services. Costs are further disaggregated between standard control services distribution and standard control services transmission.

At the first level of disaggregation EnergyAustralia allocates costs directly when possible. If costs are shared between the different services then EnergyAustralia allocates costs across services using allocation methods previously approved by IPART.

At the second level of disaggregation EnergyAustralia also directly allocates costs where possible. When this is not possible then EnergyAustralia allocates costs between transmission and distribution direct control services according to the relative asset values. Whole-business shared costs are then allocated according to the proportion of costs already allocated according to the asset values.

EnergyAustralia's CAM was, for logistical reasons, only signed by one director - EnergyAustralia's managing director. As the managing director's signature carries significant weighting the AER considered it appropriate to grant EnergyAustralia a waiver on the requirement that the CAM be signed by two directors.

3.1.4 Murraylink

Murraylink's CAM governs the allocation of direct and shared costs to its transmission network. All direct costs are allocated to prescribed transmission services. As Murraylink joint venture is 100 percent owned by the APA group, which manages a number of regulated gas and electricity assets, the CAM also covers the allocation of shared corporate overhead costs to Murraylink from the APA group.

The corporate overhead costs are allocated according to the percentage of revenue Murraylink contributes to total revenue. Corporate overhead costs include costs associated with the following: Directors; CEO; CFO; GM Operations; Commercial; Human Resources; Legal; Secretariat; Internal Audit; Information Technology and state office support costs.

Murraylink allocates corporate costs in this manner because:

- Shared costs are unavoidably incurred as part of Murraylink's revenue generation;
- There is a causal relationship between revenue and shared costs; and
- This cost allocation approach has been previously accepted as an appropriate approach by the AER for the APA Group's gas infrastructure division.

This is consistent with the approach used for Directlink, noted above.

3.1.5 Powerlink

Powerlink assigns each asset and activity to a category of transmission services. Where a cost is directly associated with an asset the relevant category of transmission services for that asset is automatically applied to that activity. Shared costs are allocated as follows:

- Business support costs are allocated based on direct labour; and
- Procurement costs (transmission services) are allocated using a standard procurement oncost rate determined by forecast procurement costs or forecast external purchases. After this:
  1. the procurement oncost rates are directly charged to particular business activities; then
  2. the business activity costs are subsequently allocated to the relevant category of transmission service.

3.1.6 SP AusNet

SP AusNet allocates costs directly to projects, assets and services where possible and appropriate. SP AusNet employs an activity based costing method to allocate the remaining costs that have not been directly attributed.

SP AusNet's proposed CAM uses the following shared cost allocation methods:

- Non-labour costs (eg. Insurance and audit fees) are allocated based on asset values or inventory transactions;
- Non-project costed labour (generally of a corporate or overhead nature) is allocated based on an ABC (activity based costing) survey conducted across SP AusNet responsibility centres; and
- Management service charges from SPI Management Services Pty Ltd (SPIMS) are allocated to the three SP network businesses based on an ABC survey conducted by all SPIMS staff. Subsequently, service charges are allocated to business segments and service categories proportionate to the direct expenditure for each service.

3.1.7 VENCorp

Where practicable VENCorp allocates costs directly to the business segment in which they were incurred. Costs that cannot be directly allocated are allocated to the corporate segment. Corporate costs are fully allocated based on the following methods:

- For corporate costs associated with computing, depreciation, insurance and occupancy - costs are allocated according to the number of Full Time Equivalents (FTEs) per segment as a percentage of the total organisational FTEs:

- All remaining corporate costs are allocated according to the number of hours worked per segment as a percentage of total organisations hours.

3.2 Consistency with the Guidelines

McGrathNicol did not identify any issues with any of the proposed CAMs. Based on the information provided, McGrathNicol concluded that:

- All the proposed CAMs appear to be compliant with the AER's Cost Allocation Guidelines.

- All the proposed CAMs appear to be compliant with the Cost Allocation Principles in clause 6A.19.2 of the NER.

- All the proposed CAMs appear to be sufficiently detailed so as to enable the AER to replicate the reported outcomes of the TNSPs.

- All the proposed CAMs appear to be consistent with the AER's Transmission Ring-Fencing Guidelines.

A copy of McGrathNicol's final reports on the CAMs is attached at Appendix B.

4 Decision

The AER considers that the CAMs proposed by Directlink, ElectraNet, EnergyAustralia, Murraylink, Powerlink, SP AusNet and VENCorp give effect to and are consistent with the Guidelines. The AER therefore approves the CAMs proposed by these TNSPs under clause 6A.19.4(c) of the NER.

Appendix A: TNSP Cost Allocation Methodologies

The public CAMs submitted by the TNSPs are attached as separate documents. Electronic copies of these are available at www.aer.gov.au.

Appendix B: McGrathNicol's final reports on the TNSP CAMs

McGrathNicol's final reports on the TNSP CAMs are attached as separate documents. Electronic copies of these are available at www.aer.gov.au.