Essential Energy

CAM Amendment Justification

April 2017

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Background

Essential Energy has taken the opportunity to comprehensively review its cost allocation method in preparation for the development of the 2019-24 Regulatory Proposal, and to reflect material changes since the current Cost Allocation Method (CAM) was approved. Essential Energy proposes to make three key amendments to its CAM:

1. Update Essential Energy's corporate and organisational structures to reflect the dissolution of Networks NSW, and rationalisation of regions from five to three.
2. Ensure consistency, and demonstrate compliance with the AER's Ring-Fencing Guideline (RFG). This involves amending the document to clarify that costs are allocated and attributed to distribution services, consistent with the principles set out in the CAM, and use terminology that is consistent with defined terms of the RFG.
3. Drive efficiencies in the shared cost allocation method to allow for the operationalising of the CAM (i.e. allowing for the accurate allocation of shared costs monthly rather than annually). Improvements will be made by:
    a. removing a significant labour impost in reconciling accounts at year-end resulting in accounting operational efficiency; and
    b. ensuring that any major changes to outsourcing arrangements do not unfairly impact the allocation of shared costs between services and thus reduce volatility.

The outcomes of points three and three above involve consolidating the shared cost allocators of the current CAM into a single, Direct Cost, allocator. Other immaterial amendments are made to update or clarify minor issues.

Justification for change

The National Electricity Rules (NER) allow Essential Energy to amend its CAM from time to time, with AER approval[1]. Under the Cost Allocation Guidelines (Guidelines), the AER will approve amendments to the CAM, if Essential Energy can demonstrate that[2]:

1. There has been a material change in its circumstances.
2. The amendment is necessary for Essential Energy to effectively promote the Cost Allocation Principles (Principles).
3. The resultant amended CAM would give effect to, and be consistent with, the Guidelines.
4. The amendment will not jeopardise the comparability of the resultant financial information with earlier information provided by Essential Energy to the AER.
5. Essential Energy can quantify and demonstrate to the AER the impact of the proposed amendment.

Essential Energy considers that the proposed amendments to its CAM meet this criteria, as demonstrated below.

Material change in Essential Energy's circumstances

There have been a number of changes in Essential Energy's circumstances since the current CAM was approved. These changes include changes to Essential Energy's corporate structure, following Networks NSW being dissolved; the need to reflect the application of the CAM in allocating costs to distribution services, to support ring-fencing compliance; and continued focus by management and the executive on business efficiency. These are discussed below.

[1] NER, clause 6.15.4(f)

[2] Guidelines, section 4.2(c)

In 2012, the NSW Government implemented a Network Reform Program (Program) seeking $400 million in savings over four years across the three network businesses. As part of the Program, the networks were combined under an umbrella company called Networks NSW. The NSW Government made the decision to dissolve Networks NSW by 31 December 2015 and as such the CAM no longer accurately reflects Essential ownership or corporate structure.

A further change is that the AER's RFG has introduced a requirement that Essential Energy must allocate or attribute costs to distribution services in a manner that is consistent with the Principles and its CAM. Prior to this requirement, the Principles only applied to the attribution and allocation of costs within distribution services. While Essential Energy is already compliant with this requirement, in that it already attributes and allocates costs to distribution services in accordance with the Principles, its CAM should explicitly state this to demonstrate compliance with RFG cost allocation and attribution obligations.

A key focus for Essential Energy's management is driving operational efficiencies through the deployment of best practice processes with improvements in the cost allocation processes identified as a candidate process for improvement. Under Essential Energy's current CAM, cost allocation percentages are calculated annually using actuals from the previous financial year. At the end of the financial year, the Regulatory team undertakes a process, in consultation with function managers across the business, to review and update the percentages for the Regulatory Accounts. Due to the large number of allocators currently applied within the CAM[3] this process usually takes between 6-8 weeks. As a result, the allocation percentages are only finalised after the close of the Statutory Accounts and requires a significant amount of rework in order to produce the Regulatory Accounts. Essential Energy has identified that a reduction in the number of the shared cost allocators used within its business would enable a more efficient CAM process, resulting in a number of benefits, including:

- A significant reduction in the current effort and rework required at year end to produce the Regulatory Accounts;
- The ability to align the Regulatory Accounts and Statutory Accounts;
- The ability to produce accurate Regulatory reporting on a monthly basis (currently only accurately produced annually);
- The ability to reconcile Enterprise Resource Planning (ERP) system data, Statutory Account data and Regulatory Account data as the data will be derived from a single source of truth;
- Enabling the Category Analysis RIN Overhead and Summary tabs to be populated with actual data rather than estimated data;
- Enabling Essential Energy to more actively engage with the AER's benchmarking process by giving a monthly view of business performance and providing accurate data to internally benchmark against plan/targets (currently accurate data is only available at year end when the Statutory Accounts are completed);
- Greater transparency and ease of understanding of overhead cost allocation for department Managers; and
- Creating efficiency savings that will ultimately flow through to customers.

Promotion of the Principles

Essential Energy conducted rigorous analysis to ensure that the consolidation of the eight shared cost allocators under the current CAM into a single allocator based on Direct Cost, would continue to promote the Principles set out in clause 6.15.2 of the NER (also set out in Appendix 1 to this document). As discussed in section 1.2.1, a more efficient CAM process creates a number of benefits for Essential Energy and its customers, which will enable it to more effectively promote the Principles.

In revising its approach to shared cost allocation, Essential Energy reviewed the eight shared cost allocators and identified a number of changes, which are discussed below and summarised in Table 1. Appendix 2 summarises shared costs by the allocator used to allocate those costs.

[3] Whilst eight allocators are documented in the CAM some of these represent many more allocators in the practical application of the CAM. For example, managerial estimates are required for around 10 different functional areas and each requires its own estimates and results in a separate set of allocation percentages across services.

- **Immaterial costs** – three of Essential Energy's existing allocators (Customer Complaints, Fleet Usage, and Meter Reads) are applied to immaterial costs, which Essential Energy defines as those costs that are less than 1% of total shared costs. Appendix 3 demonstrates how Essential Energy calculates materiality of shared costs. On this basis, Essential Energy proposes to use a non-causal allocator in the place of these three allocators, which complies with the requirement that Essential Energy use a causal allocator, unless the costs are immaterial.
- **Labour-related** – four of Essential Energy's existing allocators are labour-related, that is Direct Labour, FTE Effort on Projects, FTEs and Managerial Estimates Based on FTE Work Effort. Essential Energy considers that the commonality between these allocators means they can be appropriately rationalised into one labour-related allocator.
- **Direct Revenue** – Essential Energy proposed to cease using Revenue as an allocator because direct costs better reflect the drivers of the costs.

Table 1: Review of allocators

Allocator	Conclusion
Customer Complaints	Immaterial costs
Direct Labour	Single labour-related allocator
Fleet Usage	Immaterial costs
FTE Effort on Projects	Replace with Direct Labour
FTEs	Replace with Direct Labour
Managerial Estimates (based on FTE work effort)	Replace with Direct Labour
Meter Reads	Immaterial costs
Revenue	Replace with Direct Cost

Essential Energy's review of allocators resulted in a mix of Direct Cost and Direct Labour allocators for further analysis. To determine whether there was a mix of allocators that better reflected the drivers of its shared costs Essential Energy assessed four similar options:

- Direct Cost
- Direct Labour
- Average of Direct Cost and Direct Labour (average by service of the percentage result from the two above options)
- Mix of both Direct Cost and Direct Labour (department by department allocation of either the direct labour or direct cost allocator).

The differences in percentage allocations for each option, using 2016-17 Q3 forecast data[4], are set out the in the following table and indicate that there only minor differences between each option. The below table sets out the percentage difference for each allocator mix, by service category.

Table 2: Shared cost allocator scenario analysis

SHARED COSTS	Standard Control	Alternative Control - Ancillary Services	Alternative Control - Public Lighting	Alternative Control - Metering	Unregulated	Water	TOTAL
Scenario 1 - Direct Spend	0.1%	1.1%	0.5%	-1.9%	0.0%	0.2%	0.0%
Scenario 2 - Direct Labour	-0.6%	1.7%	0.8%	-2.6%	0.3%	0.4%	0.0%
Scenario 3 - Average Direct Spend + Direct Labour	-0.2%	1.4%	0.7%	-2.3%	0.2%	0.3%	0.0%
Scenario 4 - Mix of Direct Spend and Direct Labour	-0.2%	1.3%	0.6%	-2.2%	0.1%	0.3%	0.0%

[4] Q3 forecast data includes seven months of actual data (July 2016 – January 2017) and five months of forecast data (February 2017 – June 2017)

Essential Energy also qualitatively assessed the differences between each option. It considered Direct Costs to be a better allocator than Direct Labour because it would not be influenced by changes in delivery strategies (internal sourcing vs external sourcing) and therefore would result in less volatility in allocators resulting from those decisions. For example, when a significant portion of a direct cost function is outsourced, but support functions are provided by Essential Energy to support its use of outsourcing, using a Direct Labour allocator would result in that activity (and therefore the associated service) being allocated insufficient shared costs. That is, the level of support costs allocated would not reflect the true level of support provided. For example, many of Essential Energy's corporate functions critically support the development and management of outsourcing arrangements and associated agreements, meaning that the costs of functions such as legal, procurement and finance are driven by the cost of outsourcing arrangements.

Consistency with the Guidelines

As noted in section 1.2.2, Essential Energy's amended CAM promotes the Principles set out in the NER and expanded in the Guidelines. The Compliance Matrix submitted alongside the amended CAM demonstrates this by setting out each NER and Guideline obligation, and referring to the relevant sections of Essential Energy's proposed CAM.

Comparable with earlier financial information

The CAM amendments proposed by Essential Energy will not jeopardise the comparability of the resulting financial information with that provided previously to the AER. As noted in section 6 of the revised CAM, Essential Energy maintains documentation to support preparation of the Regulatory Accounts, including application of the CAM percentage allocators. If required by the AER, Essential Energy could substitute the proposed cost allocator for the current cost allocators in future Regulatory Accounts, enabling the AER to make historical comparisons on a consistent basis.

Quantification of changes

Essential Energy has undertaken modelling to identify the impact of changing from the current cost allocators to a Direct Costs allocator. The results of this modelling are set out in Table 4 and indicate that the change would only have a minor impact on the percentage allocations between service categories.

Table 4: Comparison of current and proposed CAM

SHARED COSTS	Standard Control	Alternative Control - Ancillary Services	Alternative Control - Public Lighting	Alternative Control - Metering	Unregulated	Water	TOTAL
Base Case	271,948,815	6,488,348	2,049,443	14,440,683	2,219,168	7,229,809	304,376,266
Direct Costs	272,365,669	9,686,998	3,682,196	8,517,758	2,220,169	7,903,510	304,376,301
Base Case	89.3%	2.1%	0.7%	4.7%	0.7%	2.4%	100.0%
Direct Costs	89.5%	3.2%	1.2%	2.8%	0.7%	2.6%	100.0%
CHANGE							
Direct Costs	0.1%	1.1%	0.5%	-1.9%	0.0%	0.2%	0.0%

Appendices

Appendix 1 – 6.15.2 Cost Allocation Principles

The following principles constitute the Cost Allocation Principles:

(1) the detailed principles and policies used by a Distribution Network Service Provider to allocate costs between different categories of distribution services must be described in sufficient detail to enable the AER to replicate 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) only the following costs may be allocated to a particular category of distribution services:

(i) costs which are directly attributable to the provision of those services;

(ii) costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should:

(A) except to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be causation based; and

(B) to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well accepted cost allocation method;

(4) any cost allocation method which is used, the reasons for using that method and the numeric quantity (if any) of the chosen allocator must be clearly described;

(5) the same cost must not be allocated more than once;

(6) the principles, policies and approach used to allocate costs must be consistent with the Distribution Ring-Fencing Guidelines;

(7) costs which have been allocated to a particular service cannot be reallocated to another service during the course of a regulatory control period.

Appendix 2 – Application of allocators to shared costs

Allocator	Function	Shared cost
Customer complaints	**People & Services**	Customer Operations
Direct Labour	**Chief Engineer**	Electrical Safety & Authorisations
		Network Data & Performance
		Portfolio Management Office
		Project Development
		Secondary Systems
	Finance and Compliance	Commercial & Decision Support
		Financial Control
		General Counsel
		Governance, Risk & Compliance
		PMO & Corporate Planning
	Health, Safety & Environment	HSE Assurance & Improvements
		HSE Management Systems & Reporting
		Safety & Environmental Services
	Network operations	Network Connections
		Regional Operations
	People & Services	Human Resources Operations
		Internal Audit
		Procurement & Logistics
		Property
Fleet usage	**People & Services**	Fleet
FTE effort on projects	**Chief Engineer**	Maintenance
		Metering services
	Information, Communication & Technology	Business & Support Systems
		Governance, Strategy & sourcing
		Infrastructure systems
		Network Systems
		Service Management
	Network operations	Operational Performance
FTEs	**Finance and Compliance**	Payroll
	Health, Safety & Environment	Health & Injury Management
		HSE Assurance & Improvements
		HSE Management Systems & Reporting
		Safety & Environmental Services
	People & Services	Human Resources Operations
		Learning & Development
		Workplace Relations
Managerial estimates based on FTE time	**Finance and Compliance**	Finance Transactions & Services
		Financial analysis
		Governance, Risk & Compliance
		Network Regulation
		Risk management
	People & Services	Corporate Affairs
Meter reads	**Network operations**	Meter reading
Revenue	**Finance and Compliance**	Network Regulation
	Network operations	Regional Manager Far West

Appendix 3 – Application of materiality thresholds

Total Support CAM_Method	Scenario BaseCase	Excl. Directly Attributable	% Shared Costs
100% Alternative Control - Anc	42,733	N/A	
100% Alternative Control - PL	483,095	N/A	
100% Non-Regulated Other	253,331	N/A	
100% Standard Control	66,227,634	N/A	
Accounts Payable Count	698,662	698,662	0.3%
Billing 1	3,161,531	3,161,531	**1.3%**
Business Services	1,306,945	1,306,945	0.5%
CMS Stats No1	1,852,166	1,852,166	0.7%
Commercial Projects	136,853	136,853	0.1%
Corporate Affairs 1	768,571	768,571	0.3%
Corporate Affairs 2	1,378,972	1,378,972	0.5%
Corporate Affairs 3	1,242,857	1,242,857	0.5%
Direct Labour	87,645,853	87,645,853	**34.8%**
Direct Labour SC / AC	65,924,017	65,924,017	**26.1%**
Employees	15,379,971	15,379,971	**6.1%**
Employees Field	6,207,197	6,207,197	**2.5%**
Fleet Usage	-344,672	- 344,672	-0.1%
FTE Project Time SC / AC	4,343,357	4,343,357	**1.7%**
FTE Project Time SC / AC / URG	12,754,428	12,754,428	**5.1%**
Inactive	0	-	0.0%
IT Usage	34,102,520	34,102,520	**13.5%**
Meter Reading	1,107,167	1,107,167	0.4%
Metering Services 1	323,153	323,153	0.1%
Metering Services 2	139,132	139,132	0.1%
Metering Services 3	844,056	844,056	0.3%
Metering Services 4	996,289	996,289	0.4%
Metering Services 5	697,624	697,624	0.3%
Metering Services 6	923,029	923,029	0.4%
Network Reg / Non Reg Revenue	5,357,336	5,357,336	**2.1%**
Regulated Network Revenue	872,262	872,262	0.3%
Regulatory Affairs 1	2,333,266	2,333,266	0.9%
Risk Management Services	1,194,108	1,194,108	0.5%
Sundry Network & Water Debtors	777,627	777,627	0.3%
Water	3,760,868		
Grand Total	**322,891,937**	**252,124,276**	**100%**

Note 1: To allocate directly attributable department costs in the operational CAM process Essential Energy includes a 100% allocator for each service. These have been excluded in columns three and four above to give a true reflection of actual shared costs.

Note 2: Material costs (those greater than 1% of total shared costs) are in bold text.