Final decision

Electricity transmission network service providers

Cost allocation guidelines

September 2007

AUSTRALIAN ENERGY REGULATOR

Inquiries concerning the currency of these guidelines should be addressed to the:

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Shortened forms

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
ETNOF	Electricity Transmission Network Owners Forum
MEU	Major Energy Users Inc.
NEM	National Electricity Market
NER	National Electricity Rules
TNSP	Transmission Network Service Provider

1. Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of Transmission Network Service Providers (TNSPs) in the National Electricity Market (NEM) in accordance with the National Electricity Law (NEL) and the National Electricity Rules (NER).

The cost allocation guidelines (the guidelines) sets out general guidance and protocols underlying a TNSP's cost allocation methodology, which TNSPs are required to provide to the AER by no later than 31 March 2008. The guidelines are a principle-based document requiring principles and policies to be applied and disclosed:

- in a manner which ensures that the AER has the information it requires for the proper performance of its statutory functions

- in a form that is transparent to the AER and can be used to replicate the reported outcomes.

The first proposed cost allocation guidelines (first proposed guidelines) and associated issues paper were released in January 2007 for public consultation. In developing this final decision, consideration has been given to the objectives of the NEL and NER and the submissions received.

The AER received eight submissions from stakeholders, including distribution network service providers and the National Generators Forum. Issues raised in the submissions have been addressed in this final decision but have not resulted in any substantive changes to the guidelines.

2. Rule requirements

Clause 6A.19 of the NER details the proposed new cost allocation arrangements for the transmission sector. The NER includes:

- A requirement for the AER to prepare cost allocation guidelines by 28 September 2007 (clause 6A.19.3(e)).
- A requirement that the cost allocation guidelines give effect to, and be consistent with, a prescribed set of cost allocation principles in clauses 6A.19.2(1)-(8) of the NER.
- A requirement for TNSPs to submit cost allocation methodologies to the AER in accordance with the guidelines.
- Conditions for the AER's consideration, approval and amendment of the TNSPs' cost allocation methodologies.
- Clause 6A.20 of the NER details the process that the AER must follow in developing, amending or reviewing these guidelines.
- Clause 11.6.17(f) of the NER requires the AER to publish the guidelines by 30 September 2007.

3. Purpose and objectives of the guidelines

The role of the guidelines are to detail the basis for:

- a TNSP preparing and submitting its proposed cost allocation methodology to the AER for approval
- the AER approving or rejecting a TNSP’s proposed cost allocation methodology or approving or rejecting a TNSP’s amended cost allocation methodology
- amending and reviewing a TNSP’s approved cost allocation methodology from time to time
- a TNSP applying its cost allocation methodology.

4. The nature and reasons for guidelines

Cost allocation relates to the attribution of a regulated business' direct costs to prescribed, negotiated and other services and the allocation of shared costs between these different services. The guidelines deal with cost attribution and allocation between the above-mentioned services. These guidelines are not used to determine individual prices for different categories of services. Cost allocation for pricing purposes will be dealt with separately through the pricing methodology guidelines to be released by the AER by 31 October 2007.

Effective cost allocation has an important role to play in promoting the NEM objective. The NEM objective is stated in section 7 of the National Electricity Law and reads as follows:

The national electricity market objective is 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.

Effective cost allocation requirements support the NEM 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 to 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 guidelines will give effect to and be consistent with the cost allocation principles outlined in the NER and will support the NEM objective.

5. Issues raised in submissions and the AER's response

Interested parties raised five main issues, stating that the guidelines:

- are inconsistent with the requirements under the NER regarding the collection and disclosure of information
- should allow the use of avoided cost as a basis for cost allocation
- should establish safe harbour provisions
- required directors to sign off on the cost allocation methodology
- required an audit of the cost allocation methodology.

Appendix A contains a discussion and the AER's response to other issues raised in submissions which can be found at the AER's website: www.aer.gov.au.

5.1 Rule requirements and the collection and disclosure of information

Stakeholder responses to the guidelines were critical of the reporting requirements. The issues raised concerning the reporting requirements were that:

- the reporting requirements were inconsistent with the NER
- the level of detail and disclosure required were excessive
- the AER is acting beyond its power.

The Electricity Transmission Network Owners Forum (ETNOF) considered that the guidelines are inconsistent with the NER. Furthermore, it considered that the disclosure requirements proposed in the guidelines extend beyond the cost allocation principles and are inconsistent with the Australian Accounting Standards (AASB) as well as the Corporations Act.

Alinta, Energex and EnergyAustralia also expressed their concerns about the high level of information requirements under the guidelines to report on 'each cost item' and consider that such a requirement may not be intended by the NER.

AER response

The AER notes the concerns raised about the level of reporting requirements proposed by the guidelines and the potential for placing an additional burden on regulated businesses. The main concerns relate to the content and level of detail to be provided in a TNSP's cost allocation methodology. This is a new requirement under the NER whereby a business must prepare and submit to the AER for approval a document outlining its approach to meeting or complying with the cost allocation principles contained in the NER. As a new requirement, it is understandable that there are concerns regarding the level of detail. However, TNSPs should note that clause 6A.19.2(1) of the NER provides that the AER needs sufficient information to enable it to replicate reported outcomes. For example, by following the cost allocation methodology, the AER should be able to reproduce the figures reported in the TNSP's annual reporting templates and its revenue proposal.

AER decision

To give effect to the above response, the guidelines will contain further explanation of the relevant requirements but will remain essentially unchanged.

5.2 The use of avoided cost

The Victorian electricity distributors CitiPower and Powercor stated that an avoided cost approach is fully consistent with the NEM objective, which has economic efficiency as its core principle.

ETNOF stated that there may be merit in using an avoided cost methodology in some instances and should not be restricted to immaterial items.

Further, EnergyAustralia stated that TNSPs should have the freedom to propose cost allocation methodologies that best present their underlying circumstances.

The Major Energy Users Inc. (MEU) was opposed to the use of an avoided cost method for cost allocation purposes. The MEU was concerned that the avoided cost approach may be biased towards the largest business element carrying the bulk of the shared costs, and would inherently allow cross-subsidisation to occur as a result.

AER response

The AER's regulatory role—acting to ensure TNSPs fully distribute their shared costs and do not engage in cross-subsidisation—is by no means a new requirement for transmission businesses. The AER's ring-fencing guidelines require the separation of the accounting and functional aspects of regulated transmission services from other contestable services provided by TNSPs. The rationale which underscores ring-fencing is also reflected in the AER's support of a fully distributed cost allocation methodology. Separation of regulated and contestable services provided by TNSPs ensures that there is a clear demarcation between these services. The potential for manipulation or distortion of the regulatory process is checked by these measures.

The AER acknowledges that the application of avoided cost is an appropriate approach for implementing demand management policies, pricing methodologies or deciding which of two competing options is the most efficient or attractive. However, there are potential difficulties with the concept under a full allocation approach as avoided cost attributes costs to one cost centre irrespective of whether the cost is shared.

The avoided cost method may be used in a variety of business scenarios. However, the AER is not assessing the concept in general terms. The AER must assess the application of avoided cost through the prism of regulating transmission businesses and more particularly of allocating costs between regulated and other services. Furthermore, the AER must ensure that any proposed cost allocation methodology, such as avoided cost, is consistent with the ring-fencing objectives and cost allocation principles. The intention of these principles is to prevent cross-subsidisation between prescribed, negotiated and other services, and to promote transparency in the cost information provided by a TNSP.

Given that costs can only be allocated to one cost centre—regardless of whether other services could be allocated a share of these costs—the use of an avoided cost approach is problematic. . This provides the potential for some services to cross-subsidise other services which is inconsistent with the cost allocation principles in the NER.

In these circumstances, the AER considers it prudent regulatory policy to require assurances from TNSPs that adequate safeguards are in place to prevent cross-subsidisation of costs.

AER decision

To give effect to the above response the guidelines will remain unchanged. The use of avoided cost attribution will be allowed, but only with the AER's approval. TNSP's will be required to provide adequate safeguards regarding the potential cross-subsidisation of costs issue.

5.3 Safe harbour provisions

ETNOF stated that it would be inappropriate for the AER to tightly prescribe what it will and will not accept as a cost allocation methodology and instead allow TNSPs to choose their own sets of cost allocators. Furthermore, ETNOF recommended that the guidelines could establish a 'safe harbour' by developing the detailed principles and policies acceptable for inclusion in a cost allocation methodology necessary to enable meaningful and repeatable attribution of costs to different transmission services.

Energy Australia stated that the AER should seek to include in the guidelines those methodologies that it believes are generally acceptable approaches to cost allocation.

AER response

Whilst the AER agrees that 'safe harbour' provisions can be particularly useful when applied to legislation that carries financial penalties, for instance, the AER does not consider the use of such provisions in the guidelines appropriate. The AER notes that in the submission requesting the use of 'safe harbour' provisions, very little detail on how they would be implemented or benefit regulated businesses was included. Furthermore, the AER notes that interested parties have consistently argued that a 'one size fits all' cost allocation methodology is not appropriate under this legal framework due to the underlying differences in businesses' structure and accounting and information systems. For this reason, the AER essentially allows each business to develop its own cost allocation methodology under the general guidance of the NER and guidelines.

Furthermore, the AER has examined the practices of other energy regulators, at both the jurisdictional level in Australia and internationally, and has not found any instances where ‘safe harbour’ provisions were used in the way proposed in submissions. The AER considers that the guidelines allow substantial latitude for regulated businesses to develop their own cost allocation methodology in a flexible manner. Therefore, the application of safe harbours in the context of these guidelines appears to add little value for individual TNSPs.

AER decision

The AER does not intend to introduce the use of ‘safe harbour’ provisions into the guidelines. TNSP’s will have the ability to propose cost allocation methodologies that reflect the cost allocation principles contained in the NER and conform with the AER’s ring-fencing guidelines.

5.4 Directors’ responsibility statement

ETNOF made a submission that the proposed directors responsibility statement imposed additional obligations beyond those required by the NER. ETNOF also stated that the requirement for a directors responsibility statement on cost allocation methodology may be confused with a responsibility statement by director under the Corporations Act, and is unnecessary as the latter normally would include assertions about the fairness and presentation and basis of preparation of the statement as a whole.

AER response

Directors, as stewards of a company should take reasonable steps to place themselves in a position to guide and monitor the management of the company. The AER considers that it would be reasonable to expect that, inter alia, a director:

- fundamentally understands the business of the company—the director should be familiar with the essential workings of the business
- is obligated to stay informed about the company's activities.

Appropriate allocation of costs is fundamental to prevent cross-subsidisation between the regulated and unregulated parts of the business. As such, the AER seeks reassurance at director level that the methodology has been carried out in compliance with the businesses’ approved cost allocation methodology.

Under clause 6A.19.3(c)(2) of the NER, the AER has the ability to specify in the guidelines what detailed information should be included in the cost allocation methodology.

Accordingly, the AER is of the view that a director’s responsibility statement will enhance the regulatory process, as it will provide the AER and stakeholders with reasonable assurance that the cost allocation principles have been applied.

AER decision

To give effect to the above response the guidelines remain unchanged.

5.5 Audit of cost allocation methodology

Alinta referred to the auditing requirement set out in the guidelines and questioned the AER's ability to impose such an auditing requirement under the NER.

Alinta also states that auditor's primary duty of care should be to the business, not the AER, since the business is responsible for commissioning the auditor, not the regulator.

In contrast to these views, the MEU recommended that the AER should establish an audit process to verify that costs have been allocated appropriately.

AER response

Under clauses 6A.17.1(d) and (e) of the NER, the AER has the power to:

- monitor, report on and enforce compliance with the cost allocation methodology and has wide scope to specify in the guidelines what detailed information should be included in the cost allocation methodology

- may request or undertake verification or independent audit of any information sought by it, or provided to it.

The AER notes the concerns raised in submissions about the duplication of auditing requirements in the guidelines and the information guidelines. The AER will add additional information in the audit requirements to provide the extra clarity sought by the regulated businesses. Essentially, the AER will seek assurance, provided through the routine audit of the statutory accounts, that the TNSP is complying with its approved cost allocation methodology and putting into practice the cost allocation principles of the NER.

AER decision

To give effect to the above response, the AER has decided to make the following amendments to the guidelines:

delete section 5.3(a) replace it with:

> The audit and verification provisions relating to a TNSP's compliance with it cost allocation methodology are found in the AER's information and submission guidelines.

delete section 5.3(c).

Appendix A—Other issues[1]

Submissions were received from:

- Alinta
- Australian Pipeline Group
- CitiPower & Powercor Australia
- Electricity Transmission Network Owners Forum (ETNOF)
- Energy Australia
- Energex
- Major Energy Users Inc
- National Generators Forum

ISSUE	PARTY	RESPONSE
1. High level issues		
1.1 The information and disclosure sought in the cost allocation guidelines is a financial reporting requirement.	ETNOF	Please refer to the final decision paper.
1.2 The cost allocation guidelines seek information to a level of detail and disclosure that is more than, and is inconsistent with, what is required by the NER.	ETNOF, EnergyAustralia, Energex, Australian Pipeline Group, Alinta	Please refer to the final decision paper.
1.3 Normal business practice is not to use a cost allocation process in forecasting future expenditures as suggested by the wording in clause 5.1(b).	ETNOF	Please refer to the final decision paper. Specifically, there will be no audit requirement of forecast capex or opex information.

[1] Submissions containing all issues can be found on the AER's website: www.aer.gov.au.

1.4 Neither the proposed cost allocation guidelines nor the issues paper rule out development of a single cost allocation methodology which can be applied to TNSPs across the board (safe harbour).	ETNOF	Please refer to the final decision paper.
2. Other high level issues		
2.1 Risks for generators arising from a reconfiguration of the transmission network. This may allow the TNSP to seek to recover the costs of a network reconfiguration from an individual generator. An additional clause should be adopted in the guidelines with the added affect that these costs cannot be reallocated to prescribed entry services.	National Generators Forum	The addition of this clause will require a NER change. Furthermore, this issue has been discussed extensively in the AEMC's determination under the Transmission network replacement and reconfiguration, Rule Determination, 1 March 2007.
2.2 Allocation to a TNSP which is part of a larger business structure. The proposed cost allocation guidelines does not appear to contemplate that shared costs may arise which are outside of a TNSP but are attributable to the provision of transmission services.	ETNOF	Please refer to the final decision paper. The cost allocation principles contained in the NER are sufficiently broad to deal with this situation.
2.3 The directors statement required in the cost allocation methodology (clause 3.2(a)(10)) is an extension of the requirements in the NER and may be beyond the AER's powers.	ETNOF	Please refer to the final decision paper.

2.5 The proposed cost allocation guidelines prohibit the use of an avoided cost basis of allocation (clause 2.2.4(e)), which was considered inappropriate in the interest of efficiency.	All submissions	Please refer to the final decision paper.
2.6 The cost allocation guidelines should clarify that determination of broader economic costs necessary for the pricing of negotiated services be addressed in the negotiating frameworks submitted to the AER, rather than the cost allocation methodology.	ETNOF	This issue will be clarified once the pricing methodology guidelines are released.
2.7 Audit application of the cost allocation methodology. Alinta questioned whether the power to audit certified annual financial statements conferred upon the AER for information guidelines extends to cost allocation methodology.	Alinta	Please refer to the final decision paper.
3. Matters of detail		
3.1 Where material costs are subject to allocation, the disclosure requirements of clause 2.2.4 again extend beyond the disclosure of principles and policies.	ETNOF	The AER considers that this section is appropriate as it is dealing with both material and immaterial cost allocation. The AER does not intend to change the current wording.
3.2 The approval criteria for non-causal bases of allocation in clause 2.2.4(c) of the proposed cost allocation guidelines were considered to be unnecessary and several are unworkable.	ETNOF	The AER considers that this section is appropriate as it is potentially dealing with both material and immaterial cost allocation. The AER does not intend to change the current wording.

3.3 The cost allocation guidelines do not provide guidance on the circumstances enabling the AER to initiate changes to a cost allocation methodology.	ETNOF, Alinta	Apart from the changes allowed under clause 6A.19.4(g)—only when the AER changes the cost allocation guidelines—the AER will not initiate changes to the cost allocation methodology.
3.4 The AER should allow changes to the cost allocation methodology that are beyond the scope of the NER if it provides for cost allocation to be fairly presented or improves fairness of the presentation of costs.	ETNOF	Please refer to the final decision paper.
3.5 Clause 4.2(f) of the proposed cost allocation guidelines should be amended so that any requirement to restate financial information applies only where the change in the cost allocation methodology may result in a material restatement of historical costs.	ETNOF	Please refer to the final decision paper.
3.6 Clause 3.2 of the proposed cost allocation guidelines sets out requirements that include matters of substantive detail rather than a description of a methodology.	ETNOF	The AER does not consider any of these clauses to be redundant as: ▪ A TNSP can divide up its services in various ways, and 3.2(5) requires the TNSP to choose categories by reference to the types of person to whom the services are provided. ▪ The AER considers all information—including related party transactions (see clause 3.2(6)) appropriate. ▪ Although related to information provisions, clause 3.2(7) is asking for a description of how records will be maintained.

		▪ ‘Compliance’ includes ensuring that costs are correctly allocated—the financial reports might give an indication of how this is done but the allocation itself will be separate to the presentation of data in the financial reports.
3.7 A second round of consultation on the cost allocation guidelines should be undertaken.	ETNOF	The AER has held a roundtable that facilitated further discussion on this matter.

Appendix B—Cost allocation guidelines