Cost Allocation Method - Independent Report

Power and Water Corporation

20 November 2018

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1. Background

Power and Water Corporation (PWC) is a statutory corporation responsible for electricity, gas and water services across the Northern Territory. From 1 July 2019, PWC's electricity distribution services will be subject to regulation by the Australian Energy Regulator (AER) for the first time under the Northern Territory National Electricity Law and Rules.

In January 2018, the AER approved PWC's proposed Cost Allocation Method for the 2019-24 regulatory period (AER-approved CAM).

On 27 September 2018, the AER published its draft decision on the electricity distribution determination for PWC for the 2019-24 regulatory period. To determine the prices charged or revenues raised by PWC for the purposes of the distribution determination, the AER relies on historical and forecast costs allocated in accordance with the AER-approved CAM.

As part of its response to the AER's draft decision, PWC sought an independent review of its cost allocation processes.

2. Scope of our work

PWC engaged EY to perform an independent review with the following scope:

- Briefly describe the corporate cost allocation process undertaken by PWC;
- Undertake a review of how PWC allocated its corporate costs in 2017-18; and
- Provide an opinion as to whether PWC's allocation of corporate costs in 2017-18 had been undertaken in a manner consistent with the AER-approved CAM.

PWC provided the following documents which we relied on to perform our independent review:

- 2017-18 Corporate Cost Model (Letter to EY – CAM Independent Report – Attachment 1 – 2017-18 Corporate Cost model.XLSM); and
- PWC's AER-approved CAM, which can be found at the following link: https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/cost-allocation-method/power-and-water-corporation-cost-allocation-method-2018.

3. PWC's approach to cost allocation

PWC's cost allocation process is based on two frameworks:

- The Corporate Cost Model, which covers the allocation of corporate overhead costs across PWC's Operational Business Units; and
- The AER-approved CAM, which covers the allocation of costs to and within PWC's regulated electricity distribution business.

The AER-approved CAM refers to two Corporate Business Units: Financial Services and Shared Services. In the Corporate Cost Model these are comprised of the following business units:

- Financial Services: 82 (Financial Services) and 83 (Strategy, Economics and Regulation); and
- Shared Services: 72 (Retail[1]), 81 (Governance and Corporate Services) and 84 (Managing Director).

The General Ledger transactions for the above Corporate Business Units are entered into the Corporate Cost Model and each transaction is manually assigned a cost allocator. This choice of allocator drives the allocation of the costs between the Operational Business Units, which are:

- Power;
- Water;
- Sewerage;
- Gas;
- System Control;
- Minor Centres; and
- Indigenous Essential Services (IES).

As noted in the AER-approved CAM, the corporate overhead costs for the IES business unit are allocated on a marginal cost basis. When applying the cost allocation percentages for each of the Operational Business Units (other than IES), the Corporate Cost Model first reduces the total amount to be allocated by the amount that has been allocated to IES on a marginal cost basis. The IES amounts are manual inputs into the Corporate Cost Model.

The allocation percentages for the remaining Operational Business Units are determined on a similar basis. That is, the percentages applicable to each Operational Business Unit for each of the allocators are calculated excluding IES. This means that the allocation percentages applied in the Corporate Cost Model calculations reflect the relative values of the drivers for the remaining (i.e. non-IES) Operational Business Units.

The overall allocation percentage for each Operational Business Unit is therefore lower for any transactions that are impacted by a marginal allocation for IES.

[1] This business unit manages the customer service function.

4. EY approach to CAM review

EY undertook a review of the consistency of the 2017/18 Corporate Cost Model with the AER-approved CAM, focusing on:

- The consistency of the current (2017-18) Corporate Cost Model with PWC's AER-approved CAM; and
- Whether corporate costs were allocated to PWC's business units in a manner consistent with the current (2017-18) Corporate Cost Model for the 2017-18 financial year.

In completing this review, we:

- Compared the allocators for the Corporate Business Units (i.e. Business Units 72, 81-84 in the Corporate Cost Model) applied in the Corporate Cost Model against those set out in Appendix 1 of the AER-approved CAM;
- Traced the allocation of the corporate overhead trial balance from the summary of allocated corporate overheads for each Operational Business Unit in the Summary_Cost_Centre sheet, through to the source data in the Trial_Balance_Paste sheet of the Corporate Cost Model. This was done to identify the methodology applied, which was then compared to the methodology set out in the AER-approved CAM. This component of the review focused on the following sheets in the Corporate Cost Model:
    - "Mapping" sheet, which takes the raw data from the trial balance and applies the allocators chosen in the "Allocations" sheet and the values for those allocators from the "Allocations_Methods" sheet;
    - "Journal_Prep", which is an intermediate sheet that draws the data from the "Mapping" sheet (note that it does not apply any transformations to the data); and
    - "Summary_Cost_Centre", which draws the data from the "Journal_Prep" sheet and summarises the allocations to each Operational Business Unit by corporate overhead cost centre;
- Undertook a range of checks to confirm that the line items from the trial balance had all been picked up and that the overall allocated amounts reconciled to the trial balance.

We consulted with the PWC Finance team during the course of the review for clarification of Corporate Cost Model functionality and to understand the nature of specific cost centres within the Corporate Business Units.

We also identified the following parameters from the Corporate Cost Model:

- The value of the allocation percentage for Power Networks for each of the allocators used in the 2017-18 Corporate Cost Model; and
- The corporate cost (dollar amounts) allocated to Power Networks for those costs allocated on a non-causal basis.

5. Findings

Based on the scope of our review as set out above, we conclude that:

- The allocators applied in the Corporate Cost Model are consistent with the allocators set out in Appendix 1 of the AER-approved CAM; and
- The allocation methodology applied in the Corporate Cost Model is consistent with the methodology set out in the AER-approved CAM.

We note:

- The costs for the Training Unit (Cost Centre “TUN”) are allocated in the Corporate Cost Model on a combination of “FTE” and “FTE + Contractors”. The cost allocator for training listed in Appendix 1 of the AER-approved CAM is “FTE and Contractors”. This has been interpreted as FTE and Contractors, or one or the other. This is considered to be consistent with the AER-approved CAM given the nature of the costs, some of which are only applicable for internal employees;
- There are some cost allocators in the model that are not consistent with the AER-approved CAM. However, in each case, the value(s) for the transactions and / or cost centres are null or sum to nil for 2017-18 (at the cost centre level). Thus, there are no costs allocated to the Operational Business Units and, thus, no inconsistency with the AER-approved CAM; and
- Appendix 1 of the AER-approved CAM lists “licences” as the allocator for the following IT systems: FMS, GIS, Maximo and RMS. The allocator applied in the Corporate Cost Model is “OPS Driver”, which is a composite allocator derived from licence numbers, hardware and labour. The primary driver for the value of the “OPS Driver” allocator is licence numbers and, hence, “OPS Driver” is considered to be consistent with “Licences” as an allocator.

6. Declaration and limitations

In preparing this report, we confirm that:

- The factual matters stated in the report are, as far as the consultant knows, true;
- The consultant has made all enquiries considered appropriate based on the scope of work requested by PWC; and
- The opinions stated in the report are genuinely held by the consultant.

However our work:

- Was not be performed in accordance with generally accepted auditing, reviewing or other assurance standards in Australia and accordingly does not express any form of assurance;
- Did not involve expressing an opinion on the reasonableness of the allocators used;
- Did not involve validating or commenting on the value of the corporate allocators; and
- Did not involve undertaking a review or audit of the Corporate Cost Model's mathematical accuracy or structural integrity, other than to the extent needed to determine that the allocators and allocation methodology was consistent with the AER-approved CAM.

7. Qualifications of consultants

The review was undertaken by Partner, Cara Graham and Associate Director, Kristel Whitaker from EY's Economics, Regulation and Policy.

Key team member		Profiles
	Cara Graham Partner – Economics, Regulation & Policy Bachelor of Commerce Honours in Commerce ICAA	Cara has over 16 years' experience in the energy industry. She joined EY from electricity distributor Energex where she held a number of senior roles, including being a member of Energex's Full Retail Competition project management team, establishing the team to interface with retailers and the Australian Energy Market Operator (AEMO), and representing Energex on executive-level national workgroups such as AEMO's workgroup responsible for managing changes to market system used within the National Electricity Market. Cara has extensive experience working with network businesses on their regulatory proposals.
	Kristel Whitaker Associate Director – Economics, Regulation & Policy Bachelor of Agricultural Economics (Hons) Masters of Applied Finance	Kristel is an experienced Associate Director in EY's Economics, Regulation and Policy Group, based in Brisbane, and has played a pivotal role within a number of clients in the development of robust regulatory proposals and pricing of regulated activities. Kristel brings an in depth and practical understanding of cost allocation for DNSPs in the NEM, having assisted Ergon Energy, Energy, Ausgrid, CitiPower/Powercor and Western Power on their cost allocation methods.

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