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CORPORATE ADVISORY

**Review of Cost  
Allocation Methodology  
*Transend***

**Australian Competition and  
Consumer Commission**

20 May 2008

**CONFIDENTIAL**

**The contacts at McGrathNicol Corporate Advisory in connection with this report are:**

**Michael Dunnett**

Ph: (02) 6222 1415

Fax: (02) 6222 1499

[mdunnett@mcgrathnicol.com](mailto:mdunnett@mcgrathnicol.com)

**Aidan Hardy**

Ph: (02) 6222 1440

Fax: (02) 6222 1499

[ahardy@mcgrathnicol.com](mailto:ahardy@mcgrathnicol.com)

## Disclaimer

This report has been prepared in accordance with the Terms of Reference, dated 25 February 2008, for the Australian Competition and Consumer Commission. A copy of the Terms of Reference is attached at Appendix 1 to this report.

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The conclusions contained in this report are based solely on the information provided to us. Except where specifically stated, we have not sought to establish the reliability of the sources of information presented to us by reference to independent evidence. Furthermore, we reserve the right to amend any conclusions, if necessary, should any further information become available.

Neither the firm nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person or organisation other than the Australian Competition and Consumer Commission in respect of the information set out in this report, including any errors, omissions or negligence however caused.

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## 1 Executive summary

### 1.1 Introduction

The Australian Energy Regulator (AER) engaged McGrathNicol to assist in a review of the proposed Cost Allocation Methodology (CAM or Methodology) of selected Transmission Network Service Providers (TNSP).

Our review was conducted in the overall context of how well Transend's proposed Methodology addresses and complies with the AER's Cost Allocation Guidelines. Particular reference was also made to:

- + The AER's ability to replicate Transend's reported outcomes; and
- + Transend's compliance with the Transmission Ring-Fencing Guidelines (TRFG) in attributing costs directly to, or within, categories of transmission services.

In undertaking this review, the following activities have been performed:

- + Exceptions based review identifying how well Transend's proposed CAM complies with the AER's Cost Allocation Guidelines and subsequently the National Electricity Rules' (the NER) Cost Allocation Principles;
- + Assessment of the AER's ability to replicate Transend's reported outcomes; and
- + Review of the consistency of Transend's proposed CAM with the TRFG.

### 1.2 Key findings

The key findings from our review of Transend's proposed CAM are provided below.

#### **Review of compliance with the AER's Cost Allocation Guidelines**

Based on the information provided, Transend's proposed CAM appears to be compliant with the AER's Cost Allocation Guidelines.

#### **Review of compliance with the NER's Cost Allocation Principles**

Based on the information provided, Transend's proposed CAM appears to be compliant with the NER's Cost Allocation Principles.

#### **Assessment of the AER's ability to replicate Transend's reported outcomes**

Based on our review and discussions with the AER, Transend's proposed CAM appears sufficient to enable the AER to replicate its reported outcome.

#### **Review of consistency with the Transmission Ring-Fencing Guidelines**

Based on our review of Transend's CAM, nothing has come to our attention that indicates that Transend's proposed CAM is inconsistent with the TRFG.

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## 2 Introduction

### 2.1 Background

- + The AER is an independent Government statutory authority.
- + The AER enforces the National Electricity Law (the NEL) and National Electricity Rules and is responsible for the economic regulation of TNSPs in the National Electricity Market (the NEM).
- + In September 2007, the AER published a set of guidelines that provide direction for TNSPs in managing the attribution of direct costs and the allocation of shared costs between, and within, different categories of transmission services.
- + Based on the guidelines, TNSPs are required to develop detailed principles and policies for the attribution of these costs which constitute its respective CAM.
- + The AER is responsible for approving each TNSP's CAM based on the criteria outlined in the NEL and the AER's Cost Allocation Guidelines.
- + In accordance with chapter 6A.19.1 of the NEL, a TNSP must comply with the Methodology that has been approved in respect of that provider.
- + As part of the AER's approval process, McGrathNicol has been engaged to assist in reviewing Transend's proposed CAM.

### 2.2 Scope

This report will provide the AER with a review of the following:

- + The extent to which Transend's proposed CAM meets and complies with the AER's Cost Allocation Guidelines;
- + The AER's ability to replicate Transend's reported outcome based on its proposed CAM; and
- + The detailed principles and policies Transend has proposed to ensure consistency with the TRFG.

### 2.3 Capacity and experience

McGrathNicol was created on 1 July 2004 following our departure from KPMG. We are one of the largest national advisory firms in Australia with over 260 professional consultants.

Our Canberra office specialises in advising Government clients. We are on 26 different government panels and are leading advisors to numerous Government departments.

Both senior consultants selected for this engagement are Chartered Accountants and have significant experience in working with government and reviewing costing models and methodologies.

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## 3 Regulatory framework and guidelines

### 3.1 National Electricity Market

The NEM is an open access wholesale electricity market created to maintain a competitive environment and provide electricity customers with greater access to suppliers of their choice.

The participation in, and operations of the NEM, are governed by the NER.

### 3.2 National Electricity Rules

The NER have the force of law under the NEL, and prescribe the procedures and processes for market operations, power system security, network connection and access, and pricing for network services in the NEM.

In accordance with the NER, all TNSPs must submit their respective CAM to the AER for approval.

Chapter 6A.19.2 of the NER identifies the Cost Allocation Principles that a TNSP must adhere to when preparing its CAM.

The NER's Cost Allocation Principles represent the basic framework and requirements upon which a TNSP's CAM should be developed.

These principles are incorporated at clause 2.2 of the AER's Cost Allocation Guidelines.

### 3.3 Cost Allocation Methodology

A TNSP's CAM describes the detailed principles and policies for attributing costs to, or allocating costs between or within, categories of transmission services that it provides.

Under chapter 6A.19.4 (b) of the NER, a TNSP's proposed CAM must give effect to, and be consistent with the Cost Allocation Guidelines.

### 3.4 AER's Cost Allocation Guidelines

In accordance with chapter 6A.19.3 of the NER, the AER developed a set of guidelines to assist TNSPs in the following:

- + Preparation of CAMs, including the attribution and allocation of costs;
- + Formatting and the submission of CAMs to the AER for approval; and
- + Application of approved CAMs.

The AER's Cost Allocation Guidelines give effect to and are consistent with the NER's Cost Allocation Principles and may be amended from time to time in accordance with the NER.

## 4 Methodology used to address scope

### 4.1 Overall methodology

In addressing the scope of this engagement, we have conducted our review based on the AER's Cost Allocation Guidelines, the NER's Cost Allocation Principles and the TRFG. Whilst we have undertaken a thorough analysis of Transend's proposed CAM, we have presented our report on an *exceptions* basis.

Based on this approach, we have excluded detailed commentary in respect of those findings which appear to be compliant or consistent with the AER's Cost Allocation Guidelines, the NER's Cost Allocation Principles and the TRFG.

Accordingly, we have only identified issues of non-compliance or inconsistency which we believe are pertinent to the AER's decision making.

### 4.2 Methodology used to assess compliance with the AER's Cost Allocation Guidelines

We have reviewed the compliance of Transend's proposed CAM based on the AER's Cost Allocation Guidelines and the NER's Cost Allocation Principles.

#### AER's Cost Allocation Guidelines

In order to determine the degree of compliance with the AER's Cost Allocation Guidelines, we have reviewed the following format and content requirements (as detailed in clause 3.2 of the AER's Cost Allocation Guidelines):

- 3.2 (1) A version history and date of issue for the document;
- 3.2 (2) A statement or description of the nature, scope and purpose of the document and the way it is to be used;
- 3.2 (3) Details of Transend's commitment to implement its proposed CAM and those responsible within its organisation for updating, maintaining, monitoring and reporting on its application;
- 3.2 (4) A description of Transend's corporate and operational structure to enable an understanding of its organisational structure and provision of services;

- 3.2 (5) A specification of the categories of transmission services Transend provides and to whom these services are provided;
- 3.2 (6) The existence of detailed principles and policies used for attributing direct costs and allocating costs between different categories of transmission services, with specific reference to the requirements of clause 2.2 of the AER's Cost Allocation Guidelines;
- 3.2 (7) Details of how Transend maintains records of cost attributions and allocations such that it is in accordance with clause 5.2 of the AER's Cost Allocation Guidelines and could be audited or verified by a third party;
- 3.2 (8) A description of how Transend proposes to monitor its compliance with its CAM and the AER's Cost Allocation Guidelines;
- 3.2 (9) Details of the proposed date on which Transend's CAM will take effect, having regard for clause 4.1 (d) of the AER's Cost Allocation Guidelines; and
- 3.2 (10) A statement signed and dated by at least two Transend directors, indicating in their opinion that the CAM is accurate and confirming Transend's intention to comply with and implement the CAM as approved by the AER.

Where Transend's proposed CAM addressed each of the above requirements, the CAM was deemed compliant in respect of that criterion.

#### NER's Cost Allocation Principles

Under clause 3.2 (6) of the AER's Cost Allocation Guidelines (see above), TNSPs are required to comply with clause 2.2 of the AER's Cost Allocation Guidelines. Clause 2.2 refers to the NER's Cost Allocation Principles which TNSPs are required to adhere to when preparing their proposed CAM.

In order to determine Transend's degree of overall compliance with the AER's Cost Allocation Guidelines, we have subsequently reviewed the extent to which Transend's proposed CAM satisfies the NER's Cost Allocation Principles. The NER's Cost Allocation Principles, detailed in Chapter 6A.19.2 of the NER, are as follows:

- (1) A TNSP's CAM must be described in sufficient detail to enable the AER to replicate the 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) Costs directly attributable to business segments must be assigned accordingly, i.e. costs should be allocated to the relevant transmission services in which resources are consumed;
- (4) Costs not directly attributable to a specific category of transmission service must be assigned based on an appropriate allocator, and the reasons for using that methodology must be clearly described;
- (5) The same cost must not be allocated more than once;
- (6) A TNSP's CAM must be consistent with the TRFG;
- (7) Costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services; and
- (8) Costs which have been allocated to negotiated transmissions services may be reallocated to prescribed transmission services to the extent they satisfy all other principles.

Where Transend's proposed CAM addressed each of the above requirements, the CAM was deemed compliant in respect of that criterion.

#### **4.3 Methodology used to assess the AER's ability to replicate Transend's reported outcomes**

In order to determine the AER's ability to replicate the reported outcome, we have reviewed the level of detail included in Transend's proposed CAM.

Where sufficient information exists to provide the AER with the necessary comfort that costs will be allocated appropriately between categories of transmission services, Transend's proposed CAM was deemed to have satisfied this requirement.

#### **4.4 Methodology used to assess the consistency with the Transmission Ring Fencing Guidelines**

In order to determine the consistency of Transend's proposed CAM with the TRFG we have reviewed the principles and policies used to allocate costs across services.

Particular reference has been made in relation to the requirement that TNSPs allocate their costs to reflect the use of assets that are shared between contestable and regulated activities in a fair and reasonable manner to avoid cross-subsidisation.

Where Transend's proposed CAM demonstrates the allocation of costs between transmission services in a fair and reasonable manner to avoid cross-subsidisation, it was deemed to comply with the TRFG.

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## 5 Review of Transend's proposed CAM

### 5.1 Overview

Transend initially provided a high level CAM for the purpose of this review (proposed CAM). Whilst Transend's proposed CAM addressed the majority of the AER's Cost Allocation Guide requirements, additional information was requested to provide the necessary comfort that Transend's CAM was fully compliant.

Following receipt of the additional information and consultation with the AER, it was agreed that this level of information was satisfactory and that our review would be based on the quantum and level of detail provided.



## 5.2 Review of compliance with the AER's Cost Allocation Guidelines

Based on the information provided, we have compiled a table which seeks to identify whether Transend's proposed CAM complies with the AER's Cost Allocation Guidelines.

Our assessment of the compliance of Transend's proposed CAM with the AER's Cost Allocation Guidelines is set out below:

Requirement	Cost Allocation Guidelines Reference	Complies with Guidelines	Findings
A version history and date of issue for the document	3.2 (1)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Version history has been provided.</li> <li>+ Date of issue has been provided.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
A statement or description of the nature, scope and purpose of the document and the way it is to be used	3.2 (2)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Nature, purpose and objectives of the proposed CAM have been provided.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
Details of Transend's commitment to implement its proposed CAM and those responsible within its organisation for updating, maintaining, monitoring and reporting on its application	3.2 (3)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Commitment to implementation has been provided.</li> <li>+ Corporate areas responsible for implementing, applying, maintaining, monitoring and updating the CAM have been identified.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
A description of Transend's corporate and operational structure to enable an understanding of its organisational structure and provision of services	3.2 (4)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Operational structure has been identified, including the governance and responsibility structures in respect of the maintenance and implementation of Transend's CAM.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
A specification of the categories of transmission services it provides and to whom these services are provided	3.2 (5)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Service offerings have been identified.</li> <li>+ Customer target groups have been identified.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
The existence of detailed principles and policies used for attributing direct costs, allocating costs between different categories of transmission services, with specific reference to the requirements of clause 2.2 of the AER's Cost Allocation Guidelines	3.2 (6)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ See section 5.3 of this report.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>

Requirement	Cost Allocation Guidelines Reference	Complies with Guidelines	Findings
Details of how Transend maintains records of cost attributions and allocations such that it is in accordance with clause 5.2 of the AER's Cost Allocation Guidelines and could be audited or verified by a third party	3.2 (7)	✓	<ul style="list-style-type: none"> <li>+ Audit processes, both internal and external, have been identified.</li> <li>+ Whilst Transend has not mentioned in detail how it proposes to maintain records of cost attribution and allocation, it has indicated that when preparing reports for submission to the AER, it will prepare all supporting documentation required in accordance with the Information Guidelines, Submission Guidelines and other relevant guidelines published by the AER.</li> <li>+ Transend will maintain all source documents and records (general ledger information, trial balance, transactions listings etc) for a minimum period of seven years in accordance with the Australian Corporations Act.</li> <li>+ Nothing has come to our attention that indicates any non-compliance with the AER's Cost Allocation Guidelines.</li> </ul>
A description of how Transend proposes to monitor its compliance with its CAM and the AER's Cost Allocation Guidelines	3.2 (8)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Monitoring, reconciliation and audit processes have been identified.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
Details of the proposed date on which the CAM takes effect, having regard for clause 4.1 (d) of the AER's Cost Allocation Guidelines	3.2 (9)	✓	<ul style="list-style-type: none"> <li>+ Date of operation has been identified.</li> <li>+ We note that Transend's proposed CAM is current at the date of publication and applies, subject to approval by the AER, not only for the forthcoming regulatory control period, but also for Transend's submission of its regulatory financial statement for the year ended 30 June 2008.</li> <li>+ In addition, Transend's submission of its previous regulatory financial statements is consistent with its currently proposed CAM.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>
A statement signed and dated by at least two directors, indicating in their opinion that the CAM is accurate and confirming their intention to comply and implement the CAM as approved by the AER	3.2 (10)	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Directors' statement has been provided and has been signed by two of Transend's directors.</li> <li>+ Appears to comply with the AER's Cost Allocation Guidelines.</li> </ul>

### 5.3 Review of compliance with the NER's Cost Allocation Principles

Based on the information provided, we have compiled a table which seeks to identify whether Transend's proposed CAM complies with the NER's Cost Allocation Principles.

Our assessment of the compliance of Transend's proposed CAM with the NER's Cost Allocation Principles is set out below:

Principle	Rules Reference	Cost Allocation Guidelines Reference	Consistent with Principles	Findings
Transend's proposed CAM must be described in sufficient detail to enable the AER to replicate the reported outcomes through application of those principles and policies	6A.19.2 (1)	2.2.1	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ See section 5.4 of this report.</li> <li>+ Appears to contain sufficient information to enable the AER to replicate its reported outcome.</li> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ Appears to comply with the NER's Cost Allocation Principles.</li> </ul>
The allocation of costs must be determined according to the substance of a transaction or event rather its legal form	6A.19.2 (2)	2.2.2	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Allocation of costs appears to have been determined according to their substance or event rather than legal form.</li> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ Appears to comply with the NER's Cost Allocation Principles.</li> </ul>
Costs directly attributable to business segments be assigned accordingly i.e. costs should be allocated to the relevant transmission services in which resources are consumed	6A.19.2 (3)	2.2.3	✓	<b>No findings identified</b> <ul style="list-style-type: none"> <li>+ Where possible, costs shall be directly attributed to, or allocated between or within, categories of transmission services based on the substance of the underlying transaction or event.</li> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ Appears to comply with the NER's Cost Allocation Principles.</li> </ul>

Principle	Rules Reference	Cost Allocation Guidelines Reference	Consistent with Principles	Findings
Costs not directly attributable to a specific category of transmission service be assigned based on an appropriate allocator, and the reasons for using that methodology must be clearly described	6A.19.2 (4)	2.2.4	✓	<p><b>Costs allocated indirectly to categories of transmission services</b></p> <ul style="list-style-type: none"> <li>+ Costs which are indirectly attributable to one or more categories of transmission services are allocated proportionately based on the inputs to each costs' allocation base.</li> <li>+ Details of Transend's shared costs are disclosed in the supporting schedules to the company's regulatory financial statements. This information includes: <ul style="list-style-type: none"> <li>- The nature of each cost item;</li> <li>- Categories of transmission services to which the cost has been allocated; and</li> <li>- Nature and details relevant to each allocator.</li> </ul> </li> <li>+ Transend allocates almost the entirety of its overhead and business costs to its various transmission services on the basis of direct labour hours.</li> <li>+ In the ordinary course of business, it may be inappropriate to use direct labour costs as the principal allocator for overhead and business costs. However, Transend have identified the following rationale for allocating overhead and business costs on a direct labour basis: <ul style="list-style-type: none"> <li>- Represents the most appropriate and equitable driver given the nature of costs;</li> <li>- Reflects the historical basis used to allocated overhead and business costs;</li> <li>- Represents the most practical and transparent driver to allocate costs;</li> <li>- Is reflective of similar allocation results when compared to alternative costs drivers e.g. floor space etc; and</li> <li>- Is consistent with the NER's requirement to allocate costs on a causal basis.</li> </ul> </li> <li>+ Insurance and asset related costs appear to be allocated on a causal basis.</li> <li>+ Based on the above, this approach appears appropriate and consistent with the NER's Cost Allocation Principles.</li> </ul>
The same cost must not be allocated more than once	6A.19.2 (5)	2.2.5	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ From the information provided, costs do not appear to be allocated more than once.</li> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ Appears to comply with the NER's Cost Allocation Principles.</li> </ul>
Must be consistent with the Transmission Ring Fencing Guidelines	6A.19.2 (6)	2.2.6	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ See section 5.5 of this report.</li> <li>+ In the additional information provided, Transend has stated that it is committed to allocating costs consistent with the TRFG.</li> <li>+ Appears to comply with the NER's Cost Allocation Principles.</li> </ul>

Principle	Rules Reference	Cost Allocation Guidelines Reference	Consistent with Principles	Findings
Costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services	6A.19.2 (7)	2.2.7	✓	<ul style="list-style-type: none"> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ However, from the information provided, Transend appear to have reallocated asset-related costs of \$136,000 from prescribed transmission services to non-prescribed transmission services (which include negotiated transmission services).</li> <li>+ Following discussions with the AER, we have been advised that the quantum of these costs is immaterial.</li> <li>+ Accordingly, based on the above, nothing has come to our attention that indicates any non-compliance with the NER's Cost Allocation Principles.</li> </ul>
Costs which have been allocated to negotiated transmissions services may be reallocated to prescribed transmission services to the extent they satisfy all other principles	6A.19.2 (8)	2.2.7	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ Transend has expressly stated that its proposed CAM has been prepared in accordance with the requirements of the AER's Cost Allocation Guidelines and the NER.</li> <li>+ From the information provided, there is nothing to suggest that Transend's proposed CAM is inconsistent with the NER's Cost Allocation Principles.</li> </ul>

## 5.4 Assessment of the AER's ability to replicate Transend's reported outcomes

Transend's proposed CAM provides a high level summary of how it proposes to allocate direct and indirect costs.

Transend's proposed CAM includes the following information:

- + A detailed cost allocation methodology which provides an snapshot of how costs are reported within Transend's chart of accounts and general ledger (i.e. using its Cost Allocation Matrix);
- + Basis for the allocation of direct costs;
- + Basis for the allocation of indirect costs;
- + Changes to the bases of allocation of costs and how this process is managed;
- + Details on the historical consistency of Transend's approach; and
- + The underlying principles of its proposed Methodology.

The above information appears to provide a reasonable basis for the segregation of direct and indirect costs between Transend's transmission services.

Notwithstanding the points identified within this review, based on the information provided and discussions with the AER, Transend's proposed CAM appears sufficient to enable the AER to replicate its reported outcome.

## 5.5 Review of consistency with the Transmission Ring Fencing Guidelines

Transend has provided additional information in respect of its compliance and consistency with the TRFG.

Transend's CAM has been developed explicitly to be able to meet the TRFG. One of the key principles contained within Transend's proposed CAM is that:

*"Costs shall be directly attributed to, or allocated between or within, categories of transmission services based on the substance of the underlying transaction or event".*

In addition, Transend has indicated that it obtains sign-off on the regulatory accounts each year (by the Tasmanian Auditor General) and a separate audit of historical costs (by Ernst & Young) is conducted as part of the revenue proposal submission process.

Accordingly, based on the above and our review of the information provided, nothing has come to our attention that indicates that Transend's proposed CAM is inconsistent with the TRFG.

## Consultancy Terms of Reference

### Outcomes

1. The consultant is to review and assess the proposed CAMs of the following TNSPs: Transend, TransGrid, EnergyAustralia, Powerlink, SPAusNet, ElectraNet, Directlink, Murraylink and Vencorp (including any preliminary submissions) in the overall context of how well they meet and comply with the AER's Cost Allocation Guidelines. Particular reference should also be made to:
  - the AER's need to be able to replicate the reported outcomes; and
  - the detailed principles, policies and approach that the TNSPs use to attribute costs directly to, or to allocate costs between or within, categories of transmission services to ensure they are consistent with the Transmission Ring-Fencing Guidelines.
2. The output of the consultancy will be a draft report<sup>1</sup> followed by a final report to the AER addressing clause 13. The reports will deal with how well each of the 10 point assessment criteria in clause 16 is met. Particular emphasis should be placed on how well TNSPs address and meet clause 16(4), (6) and (7).
3. The consultant will need to give immediate priority to the Transgrid and Transend CAMs for the reasons outlined in clause 18.
4. If necessary, the draft report should also identify any deficiencies and recommend amendments to bring these CAMs to an acceptable standard.
5. Authorship will clearly be attributed to the consultant. The report may be released for public discussion.

### Background

6. The Australian Energy Regulator (AER) is responsible for regulating the revenues of Transmission Network Service Providers (TNSPs) in the National Electricity Market in accordance with the National Electricity Law (NEL) and the National Electricity Rules (NER).
7. The Cost Allocation Guidelines set out general guidance and protocols underlying the Cost Allocation Methodology (CAM) which TNSPs are required to provide to the AER by no later than 28 March 2008.

<sup>1</sup> In the case where a TNSP submit a preliminary Cost Allocation Methodology for assessment (refer to clause 17), the AER will be expecting a draft report on these preliminary methodologies in addition to the requirements under clause 1-4 and 17-22.

8. Under these guidelines, each TNSP is responsible for developing the detailed principles and policies for attributing costs to, or allocating costs between or within, the categories of transmission services that it provides. These detailed principles and policies<sup>2</sup> must be included in the proposed CAM that the TNSP submits to the AER for approval.
9. 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. It is not concerned with the allocation of costs for the purposes of price determination.
10. Effective cost allocation has an important role to play in promoting the National Electricity objective 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.
11. Effective cost allocation requirements support the National Electricity objective by:
  - promoting the appropriate allocation of costs between prescribed, negotiated and other services in order 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; and
  - promoting consistency and comparability in the provision and reporting of financial information over time in relation to the various services.
12. A TNSP's CAM therefore, is a vital part of ensuring that the objectives noted above are realised as it documents the way a business will put the cost allocation principles into effect.
13. As part of the AER's assessment, the regulator is seeking an appropriately qualified consultant to review these CAMs. The consultant's reviews will assist the AER to assess the proposed CAMs relative to the requirements of the Cost Allocation Guidelines and the principles in the NER (6A.19).
14. It would be desirable that the consultant have:

<sup>2</sup> Please refer to the AER's Cost Allocation Guidelines clause 2.2 for further information.



- an in depth understanding of the regulatory environment governing the electricity market, particularly the National Electricity Rules and National Electricity Law;
  - direct and relevant experience in the reviewing and assessing the application of cost allocation; and
  - experience in, liaising and working with, regulated businesses and preparing reports that will be made available in the public domain.
15. Should the consultant be engaged by the AER to fulfil this review, the consultant will need to warrant that, at the date of entering into the contract, no conflict of interest exists or is likely to arise in the performance of its obligations under the contract. If, during the term of the contract, a conflict, or risk of conflict, of interest arises, the contractor undertakes to notify the AER immediately in writing of that conflict or risk.

#### Format and contents of Cost Allocation Methodology

16. Under the Cost Allocation Guidelines, a TNSP's proposed CAM must include the following information:
- (1) a version history and date of issue for the document;
  - (2) a statement of the nature, scope and purpose of the document and the way in which it is to be used by the TNSP;
  - (3) details of the accountabilities within the TNSP for the document in order to set out clearly:
    - A. the TNSP's commitment to implementing the CAM; and
    - B. responsibilities within the TNSP for updating, maintaining and applying the CAM and for internally monitoring and reporting on its application.
  - (4) a description of the TNSP's corporate and operational structure in order to enable the AER to understand how the TNSP is organised to provide its transmission services;
  - (5) Details of the categories of transmission services (prescribed, negotiated and other) that TNSPs allocate costs to and the types of customers (i.e. generators and distributors) to whom those services are provided for;
  - (6) the TNSP's detailed principles and policies to be used for attributing costs directly to, or allocating costs between, categories of transmission services, which are:
    - according to the substance of a transaction or event rather than its legal form
    - that can be directly attributed or, in the case of shared costs, using an appropriate causal allocator, or where no such allocator exists or costs are not material, using a "well-accepted" non-causal allocator and

- so that the same cost is not allocated more than once. Costs allocated to a particular service must not be reallocated to another service during the course of a regulatory control period.
- (7) a description of how the TNSP will maintain records of the attribution or allocation of costs to, or between, categories of transmission services in order to enable any such attribution or allocation to be:
    - A. demonstrated to the AER, in accordance with clause 5.2 of the Cost Allocation Guidelines; and
    - B. audited or otherwise verified by a third party, including the AER, as required.
  - (8) a description of how the TNSP will monitor its compliance with the CAM and the Cost Allocation Guidelines;
  - (9) details of the proposed date on which the CAM will commence, having regard for clause 4.1(d) of the Cost Allocation Guidelines; and
  - (10) a statement signed and dated by not less than two directors of a TNSP, which states whether in the directors' opinion, the information contained in the CAM is accurate and which confirms the TNSP's intention to comply with the AER's CAM as approved by AER.

#### Timing

17. The successful consultant will be required to sign the AER's standard contract.
18. It is expected that TransGrid and Transend (that will be undertaking revenue resets) will submit their preliminary draft CAM for early feedback before the due date of 28 March 2008. Consequently, it is expected that these TNSPs will lodge their proposed CAM by the due date along with other TNSPs.
19. The draft and final report for Transend and TransGrid should be completed 3 weeks after the consultant receives the preliminary and final CAMs from the AER. The deadline for all other reports is outlined in clause 20.
20. This clause report does not apply to Transgrid and Transend. The draft report should be completed 2 months after the lodgement date to fit in with the National Electricity Rules requirements and Consultation Procedures. Consequently, the final report will be due 2 months after the draft report.

#### Consultation process

21. During the course of the reviews, the consultant may be expected to liaise with the TNSPs. These consultations may include but not limited to the following:



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- meeting with the TNSPs at their state offices; and
  - possible written requests for additional information
22. The consultant will also be required to liaise extensively with AER staff and provide the regular updates on progress and any significant issues that have been identified.

**Key source materials**

23. In undertaking the review, the consultant's source materials may include the following documents:
- The AER's Cost Allocation, Information, Ring-Fencing and Submission Guidelines.
  - The National Electricity Rules.