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CORPORATE ADVISORY

**Review of Cost  
Allocation Methodology**

***VENCorp***

**Australian Competition and  
Consumer Commission**

27 August 2008

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## Disclaimer

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

This document is a confidential report provided to the ACCC and is based on confidential and commercially sensitive information. Accordingly, it should not be used for any other purpose or provided to any third party in full, part or summary, except as required by law, without our prior written consent.

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 ACCC 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 VENCORP'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 VENCORP's reported outcomes; and
- + VENCORP'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 VENCORP'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 VENCORP's reported outcomes; and
- + Review of the consistency of VENCORP's proposed CAM with the TRFG.

### 1.2 Key findings

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

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

Based on the information provided, VENCORP'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, there is nothing to indicate that VENCORP's proposed CAM does not comply with the NER's Cost Allocation Principles.

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

Accordingly, based on the information provided, there is nothing to indicate that the AER would be unable to replicate VENCORP's reported outcome.

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

Based on our review, and given that VENCORP provides prescribed transmission services only, there is no information which indicates that VENCORP's proposed CAM appears 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 the NER, 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 these 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 NER and the AER's Cost Allocation Guidelines.
- + In accordance with chapter 6A.19.1 of the NER, 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 VENCORP's proposed CAM.

### 2.2 Scope

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

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

Although, we have undertaken a thorough analysis of VENCORP'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 VENCORP'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 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 VENCORP'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 VENCORP'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 VENCORP 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 VENCORP 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 VENCORP 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 VENCORP's CAM will take effect, having regard to clause 4.1 (d) of the AER's Cost Allocation Guidelines; and
- 3.2 (10) A statement signed and dated by at least two VENCORP directors, indicating in their opinion that the CAM is accurate and confirming their intention to comply with and implement the CAM as approved by the AER.

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

#### 3.3 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 VENCORP's degree of overall compliance with the AER's Cost Allocation Guidelines, we subsequently reviewed the extent to which VENCORP's proposed CAM satisfies the NER's Cost Allocation Principles. The NER's Cost Allocation Principles, as 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. where possible, 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. In addition, the reasons for using that approach 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 VENCORP's proposed CAM addressed 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 VENCORP's reported outcomes**

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

Where sufficient information appeared to exist which provided the AER with the necessary comfort that costs will be allocated appropriately between categories of transmission services, VENCORP'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 VENCORP's proposed CAM with the TRFG, we reviewed the principles and policies used to allocate costs across services.

VENCORP is required to allocate costs in a fair and reasonable manner based on the use of assets shared between contestable and regulated activities. The purpose of the above is to avoid the possible cross subsidisation between services.

Where VENCORP's proposed CAM demonstrated 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 VENCORP'S PROPOSED CAM

### 5.1 Overview and assumptions

VENCORP has provided a high level CAM for the purpose of this review (proposed CAM).

VENCORP is a statutory authority established by the Gas Industry (Further Amendment) Act 1997.

The Electricity Industry Act 1996 (Vic) (EI. Act), prescribes VENCORP'S function, which includes, but is not limited to, the planning and augmentation of the electricity transmission system. As a result, VENCORP does not own any electricity transmission assets. Accordingly, to the extent that it incurs costs in performing its functions and those costs can be classified as prescribed services, they will be allocated according to its proposed CAM.

VENCORP'S proposed CAM states the following:

*“VENCORP differs from other TNSPs in the manner that it recovers electricity related costs. By virtue of the derogations contained in Chapter 9 of the NER, VENCORP is permitted to recover all “statutory electricity transmission-related costs” which relevantly is defined as “VENCORP'S aggregate actual costs in operating and planning the Victorian Transmission Network. VENCORP'S transmission related costs include prescribed services which are recovered through Transmission Use of System (TUOS) charges”.*

As part of its operational structure, VENCORP does not own any electricity transmission assets. Accordingly, it cannot charge for entry and exit charges.

VENCORP'S proposed CAM states that it is consistent with the approach taken to prepare its current statutory financial statements.

Based on discussion with the AER and our understanding of its information requirements, we have conducted our preliminary review based on VENCORP'S proposed CAM dated March 2008.

Following feedback from VENCORP in response to our cursory review, this report has been updated based on VENCORP'S revised proposed CAM dated July 2008 and signed on 18 August 2008 by its directors.



## 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 VENCORP's proposed CAM complies with the AER's Cost Allocation Guidelines.

Our assessment of the compliance of VENCORP'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)	✓	<p><b>No findings identified</b></p> <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 Guideline.</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)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ Nature, scope and purpose of the proposed CAM have been provided.</li> <li>+ Appears to comply with this AER Cost Allocation Guideline.</li> </ul>
Details of VENCORP'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)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP's Manager, Finance &amp; Risk is responsible for applying, maintaining and updating VENCORP's approved CAM.</li> <li>+ VENCORP's directors have confirmed that its proposed CAM is accurate and that it intends to comply with the CAM as approved by the AER.</li> <li>+ Appears to comply with this AER Cost Allocation Guideline.</li> </ul>
A description of VENCORP's corporate and operational structure to enable an understanding of its organisational structure and provision of services	3.2 (4)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ Organisational objectives have been identified.</li> <li>+ Organisational structure has been provided.</li> <li>+ VENCORP has provided an illustration of its financial/cost structure, which details how it functions, allocate and recover costs.</li> <li>+ Appears to comply with the AER's Cost Allocation Guideline.</li> </ul>
A specification of the categories of transmission services it provides and to whom these services are provided	3.2 (5)	✓	<ul style="list-style-type: none"> <li>+ VENCORP's proposed CAM indicates that it provides prescribed transmission services, and in accordance with the NER, is also able to provide negotiated and non-regulated transmission services. VENCORP's proposed CAM notes that, to date, it has not provided any non-regulated services.</li> <li>+ From the information provided, VENCORP procures bulk shared prescribed transmission services and provides them to transmission network users, as defined in the NER, by contracting with an asset owning TNSP for the service. The asset owning TNSP provides connection services directly to connected participants.</li> <li>+ No information has been provided in relation to the operating and financial relationship between VENCORP and the asset owning TNSPs who provide its connection services.</li> <li>+ Based on the information provided, there is nothing to suggest that VENCORP proposed CAM is inconsistent with this AER Cost Allocation Guideline.</li> </ul>

Requirement	Cost Allocation Guidelines Reference	Complies with Guidelines	Findings
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)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ See section 5.3 of this report.</li> <li>+ Where possible, VENCORP allocates costs directly to the relevant business segments.</li> <li>+ Where it is not possible to allocate costs directly to business segment, these costs are allocated to its corporate segment and fully apportioned to other business segments using the following cost allocators: <ul style="list-style-type: none"> <li>- Full time equivalent as a percentage of total organisation full time equivalents; and</li> <li>- Number of hours worked as a percentage of total organisation hours.</li> </ul> </li> <li>+ Based on the above, nothing has come to our attention that indicates VENCORP's proposed CAM is inconsistent with this AER Cost Allocation Guidelines.</li> </ul>
Details of how VENCORP 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)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP states that its finance systems' structure and processes are consistent with the AER's Cost Allocation Guidelines.</li> <li>+ Furthermore, the supporting work papers adhere to clause 5.2 of the AER's Cost Allocation Guidelines.</li> <li>+ Based on the above, nothing has come to our attention that indicates VENCORP's proposed CAM is inconsistent with this AER Cost Allocation Guidelines.</li> </ul>
A description of how VENCORP proposes to monitor its compliance with its CAM and the AER's Cost Allocation Guidelines	3.2 (8)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ Monitoring, reconciliation and audit processes have been identified.</li> <li>+ Appears to comply with this AER Cost Allocation Guideline.</li> </ul>
Details of the proposed date on which the CAM takes effect, with regard for clause 4.1 (d) of the AER's Cost Allocation Guidelines	3.2 (9)	✓	<ul style="list-style-type: none"> <li>+ The date on which VENCORP's proposed CAM becomes effective is not specifically identified.</li> <li>+ However, VENCORP states that it will become effective upon approval by the AER.</li> <li>+ Based on the above, nothing has come to our attention that indicates VENCORP's proposed CAM is inconsistent with this AER Cost Allocation Guidelines.</li> </ul>
A statement signed and dated by at least two directors, indicating that in their opinion, the CAM is accurate and confirming their intention to comply and implement the CAM as approved by the AER	3.2 (10)	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP has provided a directors' statement signed and dated by two of its directors.</li> <li>+ Appears to comply with this AER Cost Allocation Guideline.</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 VENCORP's proposed CAM complies with the NER's Cost Allocation Principles.

Our assessment of the compliance of VENCORP'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
VENCORP'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	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP has expressly stated that the purpose of its Methodology is to enable the AER to replicate the outcomes reported by the TNSP.</li> <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>+ Based on the above, nothing has come to our attention that indicates VENCORP's proposed CAM is inconsistent with this AER Cost Allocation Guidelines.</li> </ul>
The allocation of costs must be determined according to the substance of a transaction or event rather than its legal form	6A.19.2 (2)	2.2.2	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP's proposed CAM expressly states that its proposed CAM allocates costs according to substance or event rather than form.</li> <li>+ In addition, VENCORP states that it is required to submit a CAM in accordance with Part G and chapter 6A.19.4 of the NER.</li> <li>+ Accordingly, VENCORP's proposed CAM appears to comply with this NER Cost Allocation Principle.</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	✓	<p><b>No findings identified</b></p> <ul style="list-style-type: none"> <li>+ VENCORP's proposed CAM indicates that where applicable, costs are directly attributed to the business segment in which the costs were incurred.</li> <li>+ VENCORP has provided a listing of costs which may be directly attributed to its business segments. These costs include, but are not limited to; Network charges, Labour, Insurance, Vehicles, Rent, Administrative and IT.</li> <li>+ Appears to comply with this NER Cost Allocation Principle.</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	✓	<ul style="list-style-type: none"> <li>+ Costs which are not directly attributable to a business segment will be allocated to VENCORP's corporate segment.</li> <li>+ Corporate costs are fully apportioned based on the following allocation methods: <ul style="list-style-type: none"> <li>- Full Time Equivalents (FTEs) per segment as a percentage of total organisational FTEs: For corporate costs associated with computing, depreciation, insurance and occupancy costs.</li> <li>- Number of hours worked per segment as a percentage of total organisations hours: For all remaining corporate costs:</li> </ul> </li> <li>+ The rationale for allocating indirect costs associated with computing, depreciation, insurance and occupancy, on the proportion of FTE is based on the assumption that these costs do not fluctuate with the number of hours worked. This appears to be appropriate.</li> <li>+ VENCORP's rationale for allocating the remaining indirect costs based on a percentage of number of hours worked per segment is because for these costs, the number of hours worked is directly proportional to the amount of service delivery costs. Accordingly, this appears to be appropriate.</li> <li>+ Appears to comply with this NER Cost Allocation Principle.</li> </ul>
The same cost must not be allocated more than once	6A.19.2 (5)	2.2.5	✓	<ul style="list-style-type: none"> <li>+ VENCORP states that it is required to submit a CAM in accordance with Part G and chapter 6A.19.4 of the NER Cost Allocation Principles.</li> <li>+ VENCORP does not expressly state in its proposed CAM that it will not allocate costs more than once. However, VENCORP does state that it will not allocate costs to more than one category of transmission service or re-allocate costs between categories of transmission services.</li> <li>+ Based on our review of the information provided, nothing has come to our attention which indicates that VENCORP allocates the same costs more than once.</li> </ul>
Must be consistent with the Transmission Ring Fencing Guidelines	6A.19.2 (6)	2.2.6	✓	<ul style="list-style-type: none"> <li>+ VENCORP's proposed CAM expressly stated that in applying its CAM, it will comply and be consistent with the TRFG.</li> <li>+ In addition, VENCORP states that it is required to submit a CAM in accordance with Part G and chapter 6A.19.4 of the NER Cost Allocation Principles.</li> <li>+ We note that VENCORP indicates that this principle will apply unless otherwise permitted or prohibited by the AER, the Electricity Industry Act 2000 (VIC), NEL the NER and any derogation thereto.</li> <li>+ Based on our review of the information provided, nothing has come to our attention which indicates that VENCORP proposed CAM is inconsistent with the TRFG.</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>+ VENCORP's proposed CAM expressly states that VENCORP will not allocate costs to more than one category of transmission service or re-allocate costs between categories of transmission services, when applying its Cost Allocation Methodology.</li> <li>+ We note that VENCORP indicates that this principle will apply unless otherwise permitted or prohibited by the AER, the Electricity Industry Act 2000 (VIC), NEL the NER and any derogation thereto.</li> <li>+ Based on our review of the information provided, nothing has come to our attention which indicates that VENCORP's proposed CAM is inconsistent with this NER Cost Allocation Principle.</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	✓	<ul style="list-style-type: none"> <li>+ VENCORP's proposed CAM expressly states that VENCORP will not allocate costs to more than one category of transmission service or re-allocate costs between categories of transmission services, when applying its Cost Allocation Methodology.</li> <li>+ We note that VENCORP indicates that this principle will apply unless otherwise permitted or prohibited by the AER, the Electricity Industry Act 2000 (VIC), NEL the NER and any derogation thereto.</li> <li>+ Based on our review of the information provided, nothing has come to our attention which indicates that VENCORP's proposed CAM is inconsistent with this NER Cost Allocation Principle.</li> </ul>

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

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

VENCORP's proposed CAM includes the following information:

- + Background to VENCORP's operations and its Corporate structure;
- + An outline of its functions and services;
- + Detailed description of cost types and categories;
- + The underlying principles of its proposed Methodology;
- + A summary of the process used to allocate direct costs;
- + A summary of the process used to allocate shared costs; and
- + Details of additional costing systems used to collect data and monitor costs (Time Control System).

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

Accordingly, based on the information provided, there is nothing to indicate that the AER would be unable to replicate VENCORP's reported outcome.

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

VENCORP's proposed CAM expressly states that its CAM complies with, and is consistent with the TRFG. The allocation of direct and shared costs appears appropriate to enable the allocation of costs to the respective service in which they are incurred.

Furthermore, VENCORP's transmission related costs include, but are not limited to, prescribed transmission services. VENCORP is also able to provide negotiated and non-regulated services. Based on the above and the current services provided by VENCORP, the requirement to demonstrate the allocation of costs between transmission services to avoid cross-subsidisation may not appear applicable.

Accordingly, based on our review of the information provided, nothing has come to our attention that indicates that VENCORP'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.