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Contents

1	Executive Summary	2
2	Introduction.....	4
2.1	Background.....	4
2.1.1	Purpose of the report.....	4
2.1.2	Overhead costs.....	4
2.2	AA4 and AA5 Overheads Determinations	5
2.2.1	AA4 Determination.....	5
2.2.2	AA5 Determination.....	6
2.3	Relevant obligations under the National Gas Rules	6
3	Overhead Allocation Methodology	8
3.1	Past approach to overhead allocation	8
3.2	Overhead allocation methodology for AA5	8
3.3	Overhead forecast methodology for AA5 and AA6	1
4	Findings and Outcomes	2
4.1	Indirect cost allocation to capitalised overheads for AA5	2
4.1.1	Overhead Forecast Approach.....	2
4.1.2	Review of AA5 Actual+Forecast Overheads Against AA5 Final Determination.....	2
4.2	External benchmarking.....	3
4.2.1	Total capitalised overhead benchmarking costs	3
4.2.2	Benchmarking by individual cost centre code	4
4.3	Review of AA5 projects	5
4.4	ATCO indirect cost allocation to capitalised overheads for AA6	6
4.4.1	Trend analysis	6
4.4.2	External benchmarking.....	7
5	Conclusion.....	8
5.1	Assessment of the AA5 capitalised overheads	8
5.2	Assessment of the AA6 capitalised overheads	8

1 Executive Summary

ATCO Gas Australia (ATCO) is currently preparing a regulatory submission to the Economic Regulation Authority (ERA) for Access Arrangement Six (AA6). ATCO asked CutlerMerz to assess the growth and sustaining capital expenditure forecasts that attract capitalised overhead expenses for this regulatory submission.

This report includes findings from the review of ATCO's allocation methodology and evaluates the reasonableness of forecasted indirect costs for the upcoming AA6 period.

AA4 and AA5 Determination

In the Access Arrangement 4 (AA4) determination, the Economic Regulation Authority (ERA) applied a benchmarked overhead capitalisation rate of 15% of direct capex.

The ERA's assessment methodology of overhead costs changed in Access Arrangement 5 (AA5), marking a departure from the previous AA4 decision. The AA4 decision calculated overheads as a percentage of direct capex at a benchmark rate (15%) of ATCO's peers. In the AA5 decision, the ERA approved a fixed dollar value for overheads that was equivalent to an average of 20% of capex based on the forecast capex in the ERA's determination.

AA5 Actual Overheads

For the AA5 period, ATCO developed a new overhead allocation methodology. The approach involves a top-down and bottom-up calculation. The bottom-up approach sets the total overhead cost pool at the beginning of the period and allocates percentages of opex costs as capital overheads to achieve a target amount. The top-down approach calculates actual capitalised overheads as a percentage of direct capex, taking into account labour cost components. Deviations between the top-down and bottom-up approaches are adjusted to maintain alignment.

ATCO's methodology for calculating actual capitalised overheads in AA5 was consistent with its revised proposal and the ERA's AA5 determination, allowing some deviations but aiming to balance them out. The treatment of time-sheeted labour as direct capex aligns with the AA5 determination as well.

AA5 and AA6 Forecast Overheads

For forecasting overheads in the remainder of AA5 and for AA6, ATCO applies similar approaches to calculating actual capitalised overheads, using current overhead capitalisation rates for AA5 and estimated rates for AA6. The forecast methodology is consistent with the AA5 revised proposal and maintains alignment with the ERA's determinations.

Overall, ATCO's new methodology improves the accounting of overheads to individual projects and cost centres while having only a minor effect on aggregate totals.

Indirect cost allocation to capitalised overheads for AA5

We consider ATCO's capitalised overheads over the AA5 period are reasonable given ATCO is tracking to underspend their capitalised overhead allowance over AA5, the trend of overhead costs is stable across the regulatory period, our review of a sample of projects indicates robust accounting of separate time-sheeted labour and overheads and benchmarking analysis reveals ATCO's capitalised overheads are set at comparable rates to its industry peers.

ATCO's base-step-trend forecasting approach to estimate overhead expenses is likely to be accepted for future periods as we believe capitalised overheads are allocated appropriately.

ATCO's actual and forecasted capitalised overheads for AA5 are in line with the final determination, and the recorded values in ATCO's accounts should be accepted by the ERA when calculating the AA6 opening RAB.

A review of AA5 overhead costs for specific projects indicates that ATCO has good accounting of cost separation between time-sheeted labour and capitalised overheads.

Cost allocation to capitalised overheads for AA6

We consider ATCO's forecast capitalised overheads over the AA6 period are reasonable given the proposed average overhead capitalisation rate of 15% is an efficient rate, as deemed previously by the ERA in regulatory decisions. ATCO has demonstrated a robust framework and accounting process to estimate overheads and benchmarking analysis reveals ATCO's capitalised overheads are set at comparable rates to its industry peers.

In summary, we have found that ATCO's overhead allocation methodology for different regulatory periods is reasonable and aligned with recent regulatory decisions. The company's approach to forecasting overheads and allocating indirect costs is consistent and well-accounted for, reducing the risk of misallocation.

2 Introduction

2.1 Background

ATCO Gas Australia (ATCO) owns, operates and maintains three reticulated gas networks in Western Australia:

- the Mid-West and South-West gas distribution system, which serves Geraldton, Bunbury, Busselton, Harvey, Pinjarra, Brunswick Junction, Capel and the Perth greater metropolitan area including Mandurah;
- Albany; and
- Kalgoorlie.

These combined networks are made up of approximately 14,000 km of pipelines, connecting more than 800,000 end users to natural gas and LPG.

Of the three gas distributions networks, only the Mid-West and South-West gas distribution system is a covered pipeline as defined under the National Gas Law (NGL). Being a covered pipeline, an access arrangement (AA) review is required every five years. ATCO is required to submit a proposal for its next AA, the AA6 period, in September 2023.

The AA review determines the tariffs for the reference services provided by the covered pipeline; therefore ATCO must isolate the costs that relate to the covered pipeline and present them in a format that can be scrutinised by the Economic Regulation Authority (ERA) and independently audited.

The area of focus in this report is the allocation of indirect costs (capitalised overheads) to the capital program for the covered pipeline.

2.1.1 Purpose of the report

The purpose of this report is to review ATCO's indirect cost allocation methodology to estimate overhead costs attributable to capital projects and the implication of this methodology on the AA6 determination.

ATCO is seeking advice on whether the allocation methodology is consistent with the ERA's AA5 determination and whether the allocation methodology is likely to be approved by the ERA for AA6.

This report seeks to:

- Assess a sample of projects from 2020, 2021 and 2022 in AA5 and demonstrate whether they are consistent with ATCO's methodology
- Benchmark each of the costs allocated indirectly against equivalent functions in other gas and electricity distribution businesses
- Assess the reasonableness of the forecast of indirect costs for the AA6 period

2.1.2 Overhead costs

Overhead costs are those costs that are not directly attributable to the output of a gas distribution businesses but are necessary to support their operations. Costs incurred in undertaking projects can be allocated:

- Directly to operating expenditure (Opex) activities
- Directly to capital expenditure (Capex) activities
- Indirectly to Capex as a shared overhead between projects

The focus of this report will be on the apportionment of costs indirectly related to capital projects. These costs are allocated to the internal labour and external (contracted) labour costs of each project. Those indirect costs referred to as overheads which are apportioned to capital projects are capitalised by being added to the regulatory asset base (RAB).

ATCO incurs overhead costs across the following business areas, which are shared and allocated across individual projects as described below:¹

Network construction: Includes indirect costs associated with the establishment and maintenance of pipeline assets including the internal labour cost (and associated fleet running costs, IT and telecommunications costs) of management and administration support. It also includes the costs of training staff, planning teams and inspection teams whose hours cannot be directly attributed to projects and activities but are indirectly driven by network construction.

Customer and corporate services: Includes the portion of services provided by corporate departments such as Finance, Human Resources, Regulatory, Legal and Risk that relate to the capex program but cannot be directly allocated to projects or activities via timesheets or invoices. Most of these costs are internal labour and the associated costs of employees use of fleet, IT and telecommunications.

Asset management: Includes the indirect costs of technical support services, compliance and risk departments, and asset services. Most of these costs are internal labour and associated costs of staff whose hours cannot be allocated directly to projects and activities but arise as a consequence of incurring directly attributable costs.

IT: Includes a portion of total technology costs that are indirectly associated with the construction of network assets. These costs include a portion of software licences, storage and connectivity services and are incurred to establish the capital assets but cannot be directly attributed to individual projects and activities.

2.2 AA4 and AA5 Overheads Determinations

2.2.1 AA4 Determination

In its AA4 determination, the ERA applied a benchmarked overhead capitalisation rate, where capitalised overheads were set at 15% of direct capex. The ERA's AA4 decision was based on overhead capitalisation benchmarks from AER decisions in relation to gas and electricity distribution networks around the time of 2015 (SP AusNet 15%, Envestra 13% and Multinet 5%).² In the AA4 final decision, the ERA considered that regulatory precedent in Australia was to accept historical overhead allocations over time, or on a base year. The ERA determined that ATCO's detailed bottom-up estimation of overheads in the AA4 proposal had not considered its historical overhead allocations in AA3. Furthermore, the ERA determined ATCO had not provided sufficient reasons to explain the material increase in overheads from AA3 period to that proposed for the AA4 period.³

2.2.1.1 Cost Accounting Changes during AA4

In 2018, ATCO instituted a process that required recording hours of internal labour in timesheets. This allowed internal labour costs to be directly allocated to capex and opex projects, with the remaining costs allocated to the overhead cost category. Prior to 2018, time-sheeting was limited to a small proportion of cost centres. This accounting change occurred part way through the AA4 regulatory period, creating a marked difference between the way costs were being allocated and capitalised across the regulatory period.

¹ ATCO, 2020 Overheads review, 25 January 2021, p. 1.

² ERA, Final decision on proposed revisions to the Mid-West and South-West Gas distribution systems access arrangement for 2020 to 2024, November 2019, p. 201.

³ ERA, Final decision on proposed revisions to the Mid-West and South-West Gas distribution systems access arrangement for 2014 to 2019, June 2015, p. 176.

Time-sheeting of labour was intended to bring about more accurate allocation of costs directly to specific capital projects, leaving a smaller proportion allocated to overhead costs. This change led to an increase in direct capex, a reduction in overhead costs being capitalised as a percentage of direct capex and a reduction in actual opex.

The implementation of time-sheeting in 2018 also gave ATCO a better understanding of the cost composition relevant to network capital projects and provided more data to allocate costs to their underlying driver.⁴ ATCO used this information to back-cast the amounts of internal labour that were previously allocated to overheads that should have been part of direct capex.

2.2.2 AA5 Determination

For the AA5 period, the ERA changed its methodology for determining ATCO's allowance for capitalised overheads from using a strict 15% of direct capex in AA4, to accepting ATCO's proposed base-step-trend model for calculating overheads. While calculated as a fixed expenditure amount, the capitalised overheads allowance was equivalent to an average of 20% of forecast direct capex over AA5.⁵

The ERA's AA5 decision approved a capital expenditure allowance of \$60.49 million (\$2019) for overhead costs to be incurred over the AA5 period.

2.3 Relevant obligations under the National Gas Rules

The National Gas Rules (NGR) provide the requirements for forecasts and estimates included as part of an Access Arrangement. NGR Rule 74 is relevant to capital expenditure forecasts such as those overhead costs associated with capital projects:

Rule 74 Forecasts and estimates

- (1) Information in the nature of a forecast or estimate must be supported by a statement of the basis of the forecast or estimate.
- (2) A forecast or estimate:
 - Must be arrived at on a reasonable basis; and
 - Must represent the best forecast or estimate possible in the circumstances.

The criteria for conforming capital are set out in NGR Rule 79:

Rule 79 Forecasts and estimates

- (1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:
 - a) the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;
 - b) the capital expenditure must be justifiable on a ground stated in subrule (2).
- (2) Capital expenditure is justifiable if:
 - a) the overall economic value of the expenditure is positive; or
 - b) the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure; or
 - c) the capital expenditure is necessary:
 - i. to maintain and improve the safety of services; or
 - ii. to maintain the integrity of services; or

⁴ ATCO, 2020 Overheads review, 25 January 2021, p. 4.

⁵ ERA, AA5 Capex model for final decision – Shared with ATCO, Finance input worksheet.

- iii. to comply with a regulatory obligation or requirement; or
 - iv. to maintain the service provider's capacity to meet levels of demand for services existing at the time the capital expenditure is incurred (as distinct from projected demand that is dependent on an expansion of pipeline capacity); or
- d) the capital expenditure is an aggregate amount divisible into 2 parts, one referable to incremental services and the other referable to a purpose referred to in paragraph (c), and the former is justifiable under paragraph (b) and the latter under paragraph (c).

3 Overhead Allocation Methodology

3.1 Past approach to overhead allocation

Prior to 2018 and the introduction of time-sheeting, ATCO assumed a 30% allocation of project costs to capitalised overheads.⁶ Implicitly, this methodology assumed that all projects incurred overheads at the same rate and that the overhead cost pool should be estimated as a variable cost. The approach was accepted by the ERA, but not the rate, which was deemed too high. The AA4 final determination substituted a rate of 15% that was based on benchmarked overhead capitalisation rates for an efficient operator.

The AA5 final determination confirmed the benchmark 15% rate was required to be used for calculating conforming capex for the AA4 period to set the opening RAB for the AA5 period. It was also confirmed that newly introduced categories of timesheeted labour could not be included in direct capex and must remain part of opex in AA4.

Therefore, while ATCO had developed a new methodology for calculating capitalised overheads and direct capex, it could not be used for regulatory purposes during AA4.

3.2 Overhead allocation methodology for AA5

This section describes ATCO's methodology for allocating actual capitalised overhead costs during the AA5 (2020–24) period. This approach will be used for the remainder of the AA5 period as well as the AA6 period.

ATCO's current overhead allocation methodology was applied from 2020 and actual allocations are available up to December 2022 (as of the time of preparing this report), after which only forecasts are available.

As per ATCO's forecasts in the AA5 revised proposal, timesheeted labour is included as direct capex and not as opex.

The overhead allocation methodology involves the calculation of capitalised overheads using a top-down approach that is then reconciled to a bottom-up build-up of overhead costs.

The bottom-up approach sets the total overhead cost pool at the beginning of the period. A cost centre allocation percentage, the percentage of opex costs in the cost centre that are to be capitalised as overheads, is estimated for each opex cost centre such that the aggregate allocation of capitalised overheads from opex (based on forecast opex for the period) will be equal to a target overhead cost pool amount. For ATCO this target is the BST forecast for capitalised overheads from the ERA's final determination.

The starting point for each cost centre allocation percentage is derived from one of the following:

- The percentage of timesheeted direct labour in the cost centre that is recorded to capital projects
 - This is on the basis that non-timesheeted labour and other opex costs in the same cost centre will be split in the same ratios as the timesheeted labour
- An average of the percentage of timesheeted direct labour in the cost centre that is recorded to capital projects in other cost centres
 - This is on the basis that the cost centre supports delivery of work in other cost centres
- Cost centre allocation rates previously recommended by CutlerMerz

⁶ ATCO, 2020 Overheads review, 25 January 2021, p. 2.

- Only used for a small number of cost centres where a data driven allocation rate is not available

At the beginning of each year, ATCO applies the cost centre allocation percentages to the forecast opex in each cost centre to calculate the overhead allocation pool for the coming year. Therefore, the total overhead cost pool will move with changes in actual expenditure over time in each of opex cost centres.

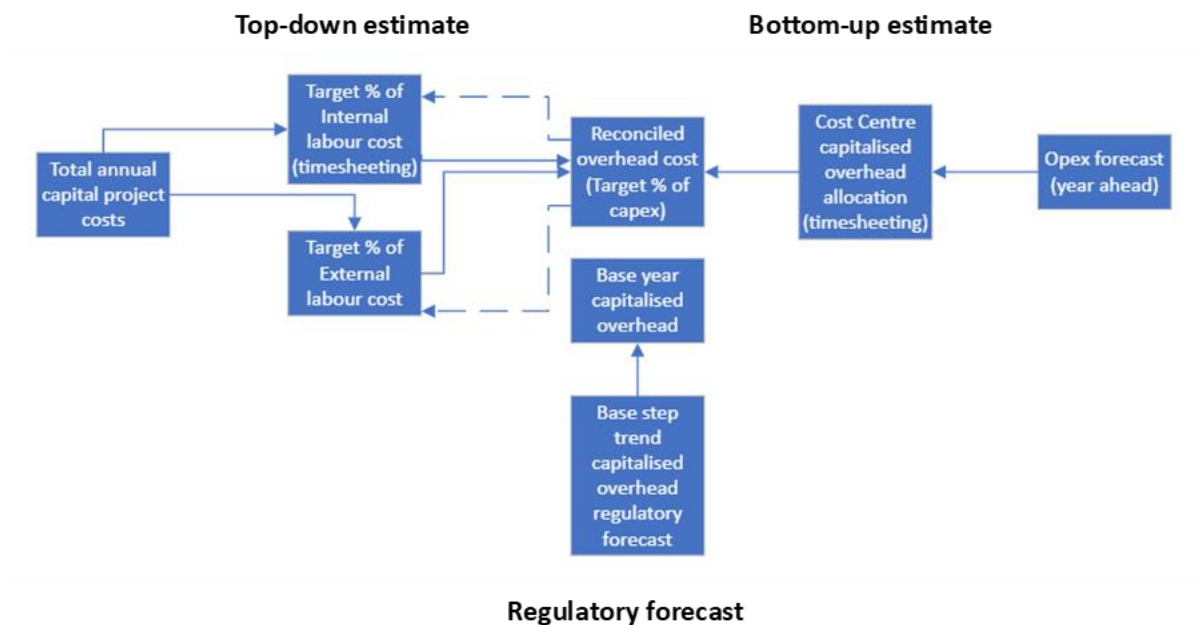
The top-down approach determines the actual capitalised overheads recorded for a given year. This approach calculates capitalised overheads as a percentage of the relevant direct capex, which is similar to the approach used prior to 2020. This is done on the basis of the labour cost components of project direct capex, with capitalised overheads of 16% of external labour and 36% of internal labour costs⁷ added to each capital project. The internal labour costs in this calculation includes timesheeted labour from the cost categories that were previously not timesheeted during AA4, along with field personnel internal labour costs that were always included as direct capex.

The percentage allocation rates are calculated at the start of the period so that the expected overheads to be calculated using this approach will also equal the total capitalised overheads pool. However, actual capitalised overheads in a given year will fluctuate with the cost of internal and external labour recorded against capital projects. If the top-down calculation deviates from the bottom-up total overhead cost pool, the allocation rates can be adjusted to maintain the alignment of the two approaches.

An account is kept for the accrued under allocation of overheads from the top-down approach against the total overhead allocation pool. The calculated overheads using the top-down approach cannot exceed the total overhead cost pool unless there was an under allocation to overheads in previous years.

Figure 3-1 depicts the process ATCO undertakes to calculate capitalised overheads.

Figure 3-1 ATCO overhead estimation process for capital projects



Notes: Solid lines indicate primary processes and dashed lines indicate feedback loops

⁷ An allocation rate of 38% of internal labour was used for 2020, after which the rate was adjusted downwards to 36%

ATCO's approach to calculating actual capitalised overheads is consistent with its revised AA5 proposal and the ERA's AA5 determination. ATCO's revised proposal forecast overheads using a BST approach and was justified on the basis that overheads are largely made up of costs that are fixed in nature and should not fluctuate with changes in the capex program.

ATCO's approach aligns to the AA5 determination by calibrating the bottom-up forecast for capitalised overheads to the BST forecast in the AA5 determination. The approach does allow some deviations to occur, but these are intended to balance out and large deviations will always trigger a realignment through the adjustment of the allocation percentages used for internal and external labour in the top-down calculation.

The ERA did not directly indicate acceptance of the BST approach in its AA5 final determination but did approve a total capex value that included capitalised overheads that were very similar to ATCO's revised proposal values. It is therefore reasonably assumed that a methodology for calculating actual capitalised overheads that is consistent with the approach used in the revised proposal should be acceptable by the ERA.

The treatment of timesheeted labour as direct capex is consistent with the final determination as the forecasts for opex and capex produced by ATCO for the AA5 period were calculated on the basis that timesheeted labour would be part of direct capex during the period. The ERA's issue with timesheeted labour in the determination was limited to the change in cost allocation part-way through the AA4 regulatory period that materially changed the way costs were allocated in that period and introduced the risk of over-recovery of costs from customers.

The change to ATCO's overhead capitalisation calculations in 2020 (after the AA5 determination was made) do not materially change the rate at which capitalised overheads are applied and maintains alignment with the AA5 determination through the top-down overhead allocation pool.

The main effect of the new methodology is to improve the accounting of overheads to individual projects and cost centres, which only has a minor effect on aggregate totals.

3.3 Overhead forecast methodology for AA5 and AA6

ATCO calculates a forecast of capitalised overheads using an approach that is similar to the calculation of actual capitalised overheads.

ATCO calculates long-term forecasts of its capital projects with the same cost categories used for calculating actual capitalised overheads. The current overhead capitalisation rates are applied to the internal labour and contractor cost categories of direct capex to produce a forecast for the capitalised overheads component for the remainder of the AA5 period.

Estimated overhead capitalisation rates that will apply in AA6 are used for the AA6 forecast. These are back-solved from an updated base-step-trend forecast of annual capitalised overheads, consistent with ATCO retaining the methodology used for calculating the BST forecast for the AA5 regulatory proposal.

The adjusted rates used for the AA6 forecast are analogous to reapplying the top-down constraint on the total overheads pool based on the updated BST forecast that would be expected to be included in the final determination for AA6.

ATCO's approach for forecasting future capitalised overheads is consistent with the methodology used for forecasting in the AA5 revised proposal and closely aligns to the calculation of actual overheads.

4 Findings and Outcomes

This section reviews the reasonableness of ATCO's current and future overhead allocation outcomes.

4.1 Indirect cost allocation to capitalised overheads for AA5

4.1.1 Overhead Forecast Approach

In the AA5 decision, the ERA approved ATCO's base-step-trend forecasting approach to estimate overhead expenses. The base-step-trend forecast begins with a single year of actual overhead expenditure estimated via a detailed build-up of overheads derived from summing cost centre allocations, as outlined in section 3.2.

We consider that the regulatory precedent established in AA5 will mean that ATCO's base-step-trend approach will likely be accepted to calculate capitalised overhead costs into the future. As capitalised overhead costs are derived from operating expenditure which is also estimated on the basis of a base-step-trend forecast, the forecast methodology is consistent with underlying expenditure drivers.

The 15% benchmark overhead allocation to capex rate used by the ERA in the AA4 decision is based upon regulatory decisions made by the AER in 2015. We consider this precedent is dated and is unlikely to be used by the ERA to determine an allowance for overheads within the capital expenditure decision, particularly as the strict application of a benchmark rate was not used in the ERA's AA5 decision.

We have assessed ATCO's actual and forecast overheads over 2020–24 and consider that capitalised overhead expenditure is tracking to be compliant with the ERA's AA5 decision. The capitalised overhead trend for AA5 is unlikely to raise concerns of overhead mis-allocation, increasing the likelihood of capitalised overheads being accepted as conforming capex and added to the opening RAB in AA6, in full.

As ATCO is tracking to underspend their overhead allowance over AA5 and the trend of their overhead costs are stable across the regulatory period, we believe capitalised overheads have been allocated appropriately.

4.1.2 Review of AA5 Actual+Forecast Overheads Against AA5 Final Determination

In AA5, the ERA approved an allowance for capitalised overheads of \$60.49 million over 2020–24, as per Table 4-1. ATCO's actual (2020–2021) and forecast (2022–2024) overhead costs over are expected to total \$57.7 million, which is below the ERA's approved allowance.

ATCO's actual overhead costs over AA5 can also be assessed relative to total direct capex over the period. The ERA's approved overhead allowance equated to an average of 20% of approved capex over the AA5 period. The final row Table 4-1 shows that actual overheads as a percentage of actual direct capex is in line with this value.

Table 4-1 ATCO overhead expenditure and ERA AA5 capex allowance, \$2019

	2020 (A)	2021 (A)	2022 (F)	2023 (F)	2024 (F)	Total
Actual qualifying capex (\$millions)	\$45.9	\$53.3	\$59.1	\$60.5	\$62.7	\$281.5
ERA AA5 overhead allowance decision (\$millions)	\$12.01	\$12.02	\$12.11	\$12.20	\$12.15	\$60.49
Actual capitalised overhead allocation (\$millions)	\$9.3	\$10.6	\$11.7	\$13.0	\$13.1	\$57.7
Implied ERA overhead allocation (% of capex)	17%	21%	19%	21%	21%	20%
Actual expenditure overhead allocation (% of capex)	20%	20%	20%	21%	21%	20%

Source: ERA AA5 final decision allowance⁸, ATCO actual expenditure⁹

Notes: (A) denotes actual expenditure, and (F) denotes forecast expenditure.

ATCO’s actual and forecast capitalised overheads for AA5 are in line with the final determination and there is no reason to believe the recorded values will not be accepted by the ERA when calculating the AA6 opening RAB.

4.2 External benchmarking

Benchmarking the allocation of indirect costs between gas and electricity utilities can be challenging as businesses may have different practices to categorise and allocate costs, as well as differences in the setup of their corporate structures.

Notwithstanding the inherent challenges associated with benchmarking analysis, we have assessed the total capitalisation of overheads across gas and electricity distribution network businesses. These businesses share the common characteristics of being regulated and operating network infrastructure within Australia.

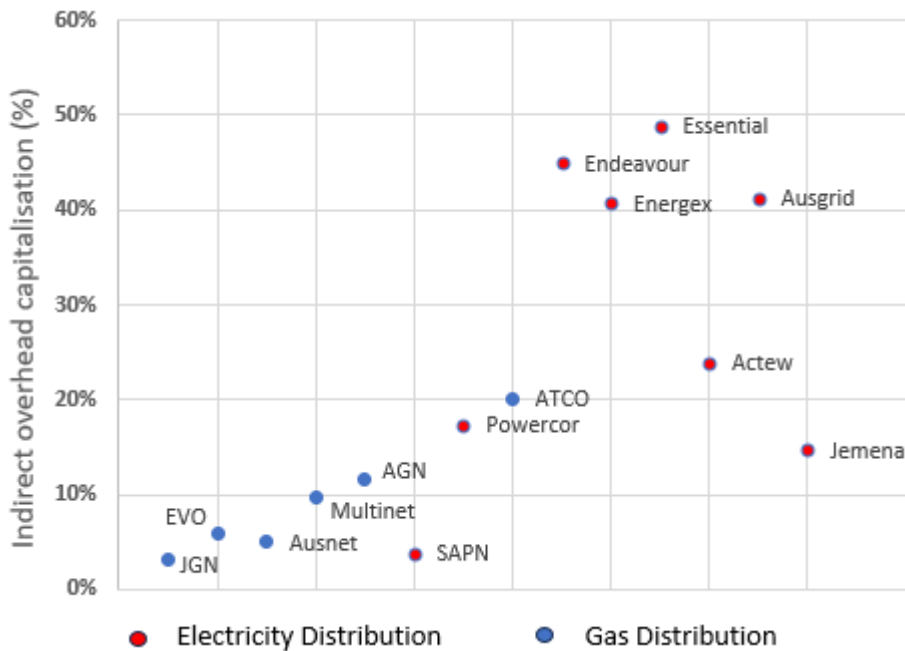
4.2.1 Total capitalised overhead benchmarking costs

The aggregate indirect capitalisation levels presented in Figure 4-1 vary considerably from business to business, however, ATCO’s overhead allocation of 20% in AA5 is high compared to other gas distribution networks but is towards the lower end of the range when compared to electricity network businesses.

⁸ ERA, AA5 Capex model for final decision – Shared with ATCO, Finance input worksheet.

⁹ ATCO, AA5 & AA6 Qualifying Capex Base and Overheads spreadsheet, Qualifying Capex (AA5) worksheet.

Figure 4-1 Total overhead indirect capitalisation for AA5



Source: CutlerMerz, AER Regulatory Information Notices 2021-22

Due to differences in cost allocation methodologies, supply areas, accounting approaches and business structures, we do not believe significant weight should be put on the results of benchmarking. Irrespective of this, when compared to peers across both gas and electricity ATCO benchmarks in the middle of the range.

4.2.2 Benchmarking by individual cost centre code

The considerable variance between the benchmarked allocations of indirect costs at the level of cost centre codes and in aggregate may raise questions about the appropriateness of benchmarking indirect cost allocations. However, Table 4-2 below does indicate that the majority of ATCO’s capitalisation falls within most of the range of benchmarks or is not materially out of range with other networks’ overhead capitalisation levels.

We note that the capitalisation percentages associated with call centre and control room cost centres are materially higher than both our estimated benchmarks and recommended allocations. The activities and tasks performed by these cost centres relate mostly to maintenance activities with little association to capital projects and therefore should not have a large proportion of capitalisation. When queried about the large capitalisation allocations, ATCO explained that the allocations relate, in part, to executive level staff that manage activities associated with these cost centres. As such, the executive staff time is not directly allocated to direct capex or opex but is estimated as a contribution to the capital project and counted as a capitalised overhead.

Table 4-2 ATCO Cost Centre benchmarking

Cost Centre	Approximate Range of Capitalisation % (Benchmarks)	ATCO Capitalisation %	CutlerMerz Recommendation %	Comments
Management	15 – 70	25	30	ATCO capitalisation rate is generally within expected benchmark and aligned with our previous considerations.
Finance	0 – 50	30	15	
Technical Compliance	0 – 55	8	50	
Operations Planning	0 – 60	49	50	
Asset Services	10 – 50	33	70	
IT	0 – 50	13	10	
HSE	0 – 70	42	20	
Regulatory	0 – 50	15	10	
Legal	0 – 30	10	10	
HR	0 – 15	17	15	
Training	0 – 30	42	20	
Customer Engagement	0 – 10	15	0	
Call Centre	0	42	0	Cost centres support co-ordination of capex activities.
Control Room	0 – 20	42	0	
System Monitoring	0 – 20	28	0	

Source: CutlerMerz¹⁰, ATCO¹¹

4.3 Review of AA5 projects

We conducted analysis of the actual overhead costs of specific projects from 2020 to 2022, examining the specific details related to recording of labour through timesheets and its differentiation between being recorded as direct labour versus being allocated as indirect overhead costs. In previous regulatory decisions, the ERA has reduced ATCO’s capital allowance on the basis of time-sheeted labour recovered as part of operating expenditure was also proposed to be capitalised. Table 4-3 lists two projects from growth (augmentation) and network sustaining (replacement) projects that attract overheads. These projects were selected based on being large in value compared to most other projects.

¹⁰ CutlerMerz, ATCO Gas Australia – Indirect Cost Review, October 2017, pp. 17-18.

¹¹ ATCO, BP Capex Overhead Calculations 2022, OH Rate Review Worksheet.

Table 4-3 Overhead costs for growth and network sustaining capital projects

Project name	2020	2021	2022	2023	2024	Total
1520-GCA1-GN-0105 2021 - EOL Replacement PVC - Hamilton Hill	45,833	2,204,774	328,693	-	-	2,579,300
1520-GCA1-GN-0150 2021 - Growth Development Project - Covalent Lithium Mains Extension	-	39,855	81,907	465,712	-	587,474

Source: ATCO¹²

ATCO’s SAP account records include a detailed breakdown of each projects’ costs, including how much labour expense has been directly allocated via timesheeted recording of hours, as well as the overhead amount capitalised. Such separate recording of costs is likely to reduce the incidence of double counting direct labour and capitalised overhead costs and demonstrates a good account of cost separation between time-sheeted labour and capitalised overheads. This provides a reasonable basis to demonstrate in a regulatory context that time-sheeted labour costs have not been double counted by inclusion as capitalised overheads, leading to lower risk of a reduction in the overhead allowance inadvertently due to allocation error.

We consider ATCO’s capitalised overheads over the AA5 period are reasonable given:

- ATCO is tracking to underspend their capitalised overhead allowance over AA5.
- The trend of overhead costs is stable across the regulatory period
- Our review of a sample of projects indicates robust accounting of separate time-sheeted labour and overheads.
- Benchmarking analysis reveals ATCO’s capitalised overheads are set at comparable rates to its industry peers.

4.4 ATCO indirect cost allocation to capitalised overheads for AA6

4.4.1 Trend analysis

ATCO’s expected AA6 forecast of overhead expenses is summarised in Table 4-4 below. Whilst it is an increase in dollar terms of approximately \$9 million compared to the AA5 period, the AA6 forecast is only 15% on average of forecast capex over the 2025–29 period. This appears to be a reasonable forecast estimated with a base-step-trend methodology that results in a historically low and consistent overhead allocation that is close to levels deemed efficient by the ERA. There are no large step changes in the overhead costs.

This forecast represents a marked reduction in the allocation of overhead expenses as a percentage of qualifying capex from AA5 (when the average allocation rate was 20%).

¹² ATCO, Capital Construction File, GCA1 worksheet.

Table 4-4 ATCO forecast overhead expenditure for AA6, \$nominal

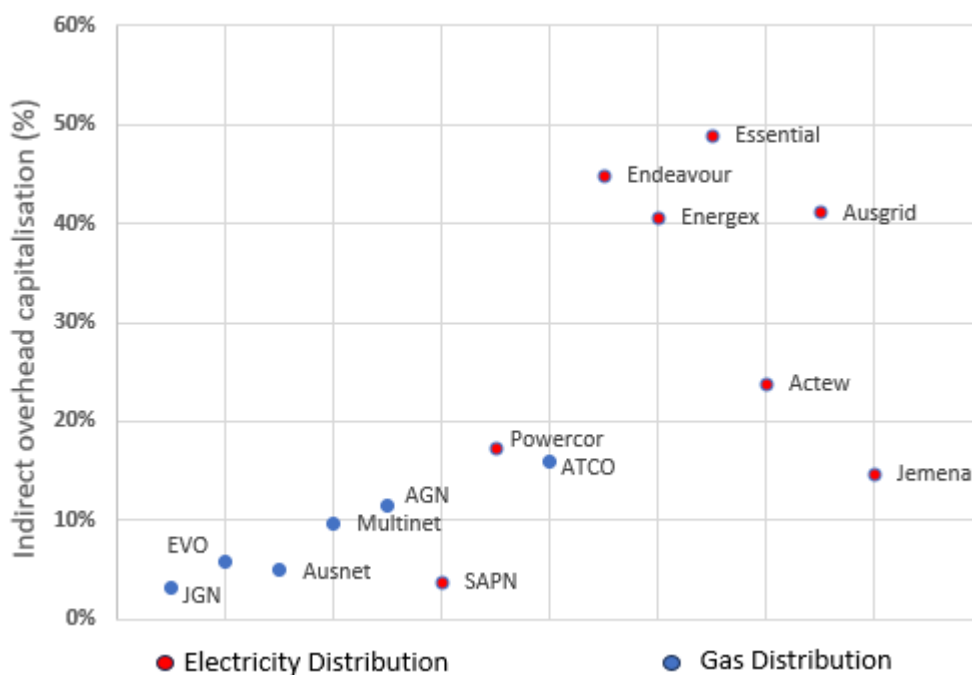
	2025	2026	2027	2028	2029	Total
Actual qualifying capex (\$millions)	\$85.8	\$87.2	\$88.5	\$95.5	\$96.7	\$453.7
ATCO forecast expenditure (\$millions)	\$13.1	\$13.5	\$13.9	\$14.4	\$14.7	\$69.6
ATCO forecast expenditure overhead allocation (% of capex)	15%	15%	16%	15%	15%	15%

Source: ATCO actual expenditure¹³

4.4.2 External benchmarking

As discussed in section 4.2, benchmarking results of overhead allocations between different utilities can vary widely. Nevertheless, ATCO has requested that we compare their allocation methodology against other similar utilities, which is presented below in Figure 4-2 showing ATCO has moved further down toward the lower end of the allocation spectrum. This may be a further indication that ATCO’s allocation methodology for AA6 is not unreasonable.

Figure 4-2 Total indirect overhead capitalisation for AA6



Source: CutlerMerz, AER Regulatory Information Notices 2021-22

We consider ATCO’s forecast capitalised overheads over the AA6 period are reasonable given:

- The proposed average overhead capitalisation rate of 15% is an efficient rate, as deemed previously by the ERA in regulatory decisions.
- ATCO has demonstrated a robust framework and accounting process to estimate overheads.
- Benchmarking analysis reveals ATCO’s capitalised overheads are set at comparable rates to its industry peers.

¹³ ATCO, AA5 & AA6 Qualifying Capex Base and Overheads spreadsheet, Qualifying Capex (AA6) worksheet.

5 Conclusion

We consider that ATCO has estimated overhead costs for the AA5 and AA6 regulatory periods that are reasonable and the product of a robust accounting framework.

5.1 Assessment of the AA5 capitalised overheads

We consider the level of capitalised overheads for AA5 is reasonable and tracking to be under the allowance set by the ERA over 2020–24. The capitalised overheads calculated for AA5 were estimated using a methodology that ATCO has implemented and refined since 2018. The methodology uses a systematic process to record internal labour hours through timesheets to better distinguish direct costs related to a capital project and overhead costs that are collectively shared among all capital projects. We consider that as ATCO continues to look for opportunities to improve their time-sheeting process and, in particular, explore means of recording hours of executive staff for hours used to manage control room and call centre activities, the overhead allocations will continue to become more accurate.

5.2 Assessment of the AA6 capitalised overheads

We consider the forecast of capitalised overheads for AA6 is reasonable and allocated at a rate that the ERA has previously considered efficient. However, the value of capitalised overheads has increased by \$9 million in AA6 from AA5. ATCO should emphasise that the increase in overheads does not reflect any major change in the overhead estimation methodology but rather an increasing trend in areas of capex that attract overheads.

The allocation rate of overheads has declined since AA5, given widespread use of timesheeting labour which has led to more accurate allocation of direct costs and less costs smeared over capital projects as overheads. This approach has led to a more consistent and stable trend of overhead expenses and predictability of expense outcomes. ATCO has a robust overhead estimation framework that ensures that separate accounting of timesheeted labour and overheads creates a low-risk of direct labour costs ever being conflated with overhead expenses.