



EnergyAustralia's proposed cost allocation method.

22 January 2009

1. National electricity rules requirements

The special provisions applying to New South Wales and the Australia Capital Territory referred to in Clause 11.15 of the National Electricity Rules (the Transitional Rules) apply to the New South Wales Distribution Network Service Providers (DNSPs) for the regulatory control period 2009-2014.

Clause 6.15.6 (a) of the Transitional Rules requires EnergyAustralia to submit to the AER for its approval a document setting out its proposed cost allocation method (CAM) for the regulatory control period 2009-2014.

Clause 6.15.5 states that "(t)he Accounting Separation Code for Electricity Distributors in NSW prepared by the IPART and in force immediately before the start of the regulatory control period 2009-2014 in relation to the NSW Distribution Network Service Providers are deemed to be Cost Allocation Guidelines made by the AER for the regulatory control period 2009-2014"

Clause 6.15.6 (b) requires the CAM proposed by the DNSPs must (a) give effect to and be consistent with the Cost Allocation Guidelines and (b) be prepared using, as far as practicable the same cost allocation method as it last used when preparing its regulatory accounts for submission to the IPART.

Accordingly, this document sets out EnergyAustralia's proposed CAM and reflects the cost allocation method applied in the 2006-07 regulatory accounts submitted to IPART and the AER on 30 October 2007.

In this CAM proposal, the following terms are used and defined as follows:

- **standard control services:** services provided by EnergyAustralia which are classified as standard control services under the Transitional Rules¹.
- **alternative control service:** a service provided by EnergyAustralia which is classified as an alternative control services under the Transitional Rules².
- **unregulated distribution services:** distribution services classified as an unregulated distribution service under the Transitional Rules³.
- **standard control service – distribution (SCS – Distribution):** services provided by EnergyAustralia which are classified as a standard control service under clause 6.2.3B (a) of the Transitional Rules.

¹ Clause 6.2.3B of the Transitional Rules deemed distribution services that were determined by the IPART for the 2004-2009 Determination to be prescribed distribution services to be standard control services. The IPART's Final Determination No 2, 2004 provided that prescribed distribution services include (a) Distribution Use of System Services (b) Private Power Line Inspections and Customer Installation Inspection (c) Monopoly Services (d) Miscellaneous Services and (e) Emergency Recoverable Works.

² The only service currently so classified is the construction and maintenance of public lighting. However certain unregulated services may be classified as alternate control services under 6.2.3B(2)(ii) if the AER makes a determination under clause 6.2.3B(e)

³ Clause 6.2.3B(b)(2) of the Transitional Rules deemed the following services that were determined by the IPART for the 2004-2009 Determination to be excluded distribution services to be unregulated distribution services, unless the AER makes a determination under clause 6.2.3B(e). These services are (a) Customer Funded Connections (b) Customer Specific Services and (c) Type 1 to 4 Metering Services.

- **standard control service – transmission (SCS –Transmission):** services provided by EnergyAustralia which are classified as a standard control service under clause 6.1.6(c) (1) of the Transitional rules.
- **negotiated distribution services:** services provided by EnergyAustralia which are classified as negotiated distribution services under the Transitional Rules.
- **non network service (NNS):** any services provided by EnergyAustralia other than *standard control services, alternative control services, unregulated distribution services* or *negotiated distribution services*⁴.

2. Background

EnergyAustralia is a State Owned Corporation incorporated on 1 March 1996. EnergyAustralia supplies electricity and gas to more than three million customers in Sydney, the Central Coast, Newcastle and the Hunter. EnergyAustralia operates Australia's largest electricity network. This electricity network comprises mainly distribution assets, however, a small portion of this network is high voltage transmission assets that operate in parallel and provide support to the higher voltage transmission network.

Hence, EnergyAustralia is currently regulated separately as a DNSP by IPART and as a TNSP by the ACCC. During the next regulatory control period (2009-2014) EnergyAustralia's electricity distribution and transmission networks will be economically regulated by the Australian Energy Regulator (AER) on the basis of the transitional Rules as a distribution network. Transmission Pricing arrangements will continue to apply to EnergyAustralia's transmission services.

EnergyAustralia is required to prepare annual regulatory accounts under the IPART's 'Regulatory Information Requirements for Electricity Distributors in NSW – May 1997' for the distribution network business and under the ACCC's 'Statement of principles for the regulation of transmission revenues – Information requirement guidelines – 5 June 2002' for the transmission network business. These annual regulatory accounts must be accompanied by a directors' responsibility statement and an independent review report by an external auditor.

The annual regulatory accounts disaggregate EnergyAustralia's statutory financial statements between the different business segments, representing the different services provided by EnergyAustralia. In the disaggregation of EnergyAustralia's statutory financial statements into the different segments, EnergyAustralia is required to apply the cost allocation principles laid down by IPART in its Accounting Separation Code and by the ACCC in its Information Requirement Guidelines.

3. Cost allocation principles

The Accounting Separation Code (the Code), issued by IPART in December 1996, encourages distributors to adopt activity based reporting and states that "activity based reporting principles should be adopted in the first instance and all financial items that can be allocated directly and reliably to a distribution function should be so allocated. Items that cannot be directly and

⁴ Examples of these services include the retailing of electricity and gas, pole and duct rentals, construction services provided by EnergyAustralia as an Accredited Service Provider (ASP) to third parties, provision of energy for public lighting and other services provided by EnergyAustralia outside of its distribution area.

reliably without going to a great deal of effort, and only those items, should be pooled in a suitable common service category, to be allocated with reference to the principles (contained in Tables B, C and D.2 of the Code)".

Tables B, C and D of the Code provide for preferred and alternative allocation methods where activity based reporting is not used for operating expenditure items, corporate income items and balance sheet items.

In summary, the main underlying principles laid down by IPART in relation to cost allocations are⁵:

1. Cost that can be directly attributed to a business segment will be assigned accordingly,
2. Cost that are not directly attributable will be allocated by either
 - a) using an appropriate allocating factor (i.e. on a causation basis) or
 - b) if a causal allocating factor cannot be established without undue cost and effort, then using a non-causal but defensible basis.

It should be noted that EnergyAustralia submits annual regulatory accounts to IPART that are reviewed by an external audit firm for compliance with the IPART requirements. Such reviews are conducted annually in accordance with the IPART's requirements. These reviews, and any independent verification undertaken by IPART, have found EnergyAustralia to be compliant with the Code and IPART's Principles of revenue and cost allocation guideline.

4. Application of cost allocation principles

4.1 EnergyAustralia's financial system

This proposed CAM document details the application of the allocation principles stated by IPART in its Accounting Separation Code with respect to operating and capital expenditure.

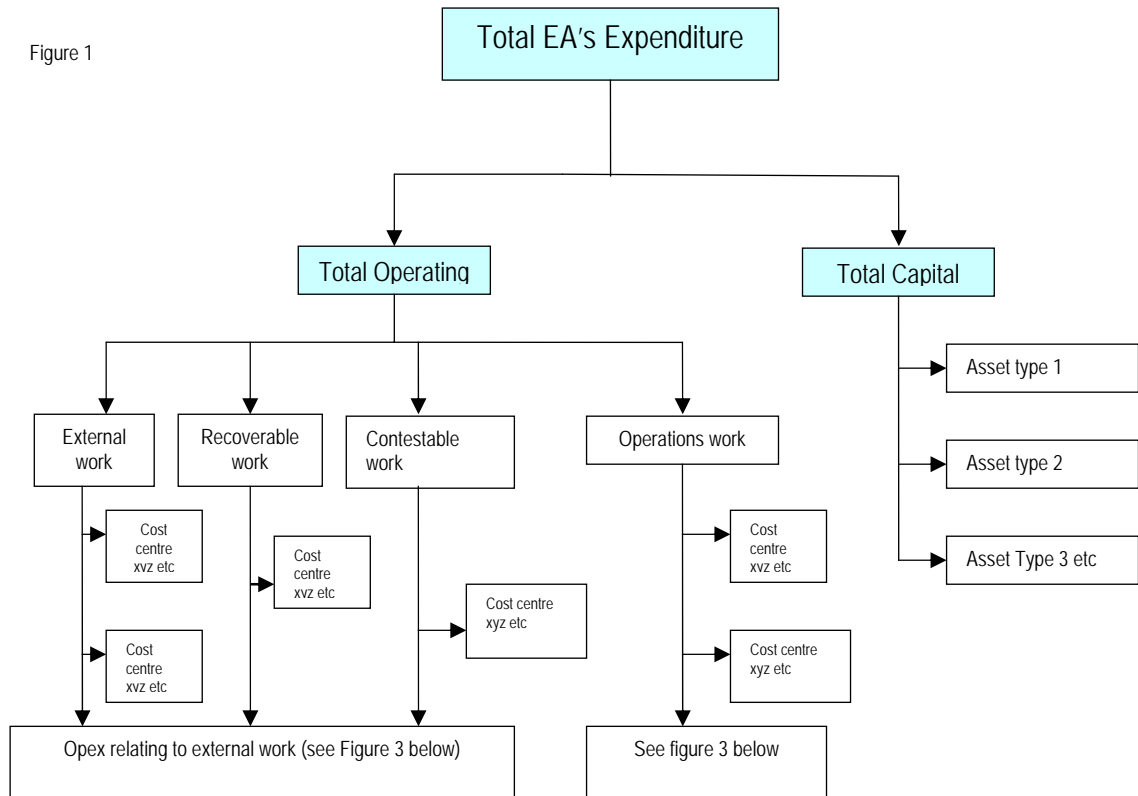
Capital expenditure is the cost of acquiring assets that will provide future service potential or economic benefit to EnergyAustralia and relates generally to the (a) purchase or construction of new assets, (b) augmentation of existing assets or (c) replacement of existing assets.

Operating expenditure describes costs that are incurred in normal day to day business operations of EnergyAustralia and are not capital in nature, i.e. not providing future service potential or economic benefits.

The following diagram depicts the disaggregation of expenditure in EnergyAustralia's financial system.

⁵ Section 3.5 "Principles of revenue and cost allocation" of IPART's Regulatory Information Requirements for Electricity Distributors in NSW – issue No. 1 – May 1997". This guideline was issued by IPART to support the Accounting Separation Code.

Figure 1



EnergyAustralia's financial system uses two cost collection objects known as order types and cost centres to capture expenditure.

Order types are used to capture and disaggregate expenditure between operating and capital. Operating expenditure is further disaggregated between expenditure incurred on external, recoverable, contestable and operations works. Cost centres are business units that perform or engage in specific type/s of work. For example, a cost centre can incur costs of a capital and/or operating nature.

Cost centres are grouped into different divisions that reflect EnergyAustralia's organisational structure. EnergyAustralia is organised into four operating divisions and a holding company. The four divisions are:

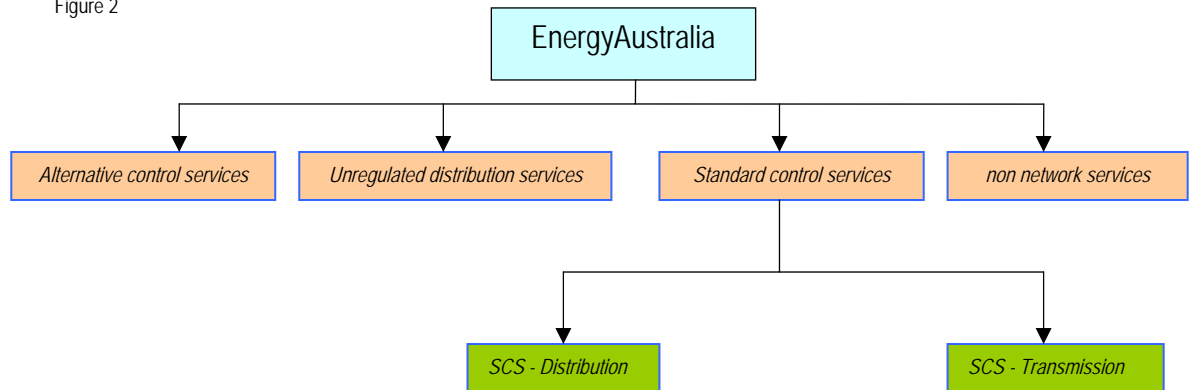
- **Enerserve** – responsible for the maintenance and upgrade of EnergyAustralia's electricity infrastructure. This division also carries out some external work (eg. customer connections) and installs and maintains public lighting.
- **Network** – responsible for the operation of distribution and transmission networks.
- **Retail** – responsible for energy sales, marketing and wholesale activities.
- **Shared Services** – responsible for customer interfaces via the contact centres, billing and IT operational capability.

The holding company is responsible for corporate wide functions such as financial reporting, legal and internal audit.

4.2 Operating Expenditure

The disaggregation of EnergyAustralia's operating expenditure into the different services involves the application of the cost allocation principles at different "disaggregation levels". This is illustrated by the diagram below.

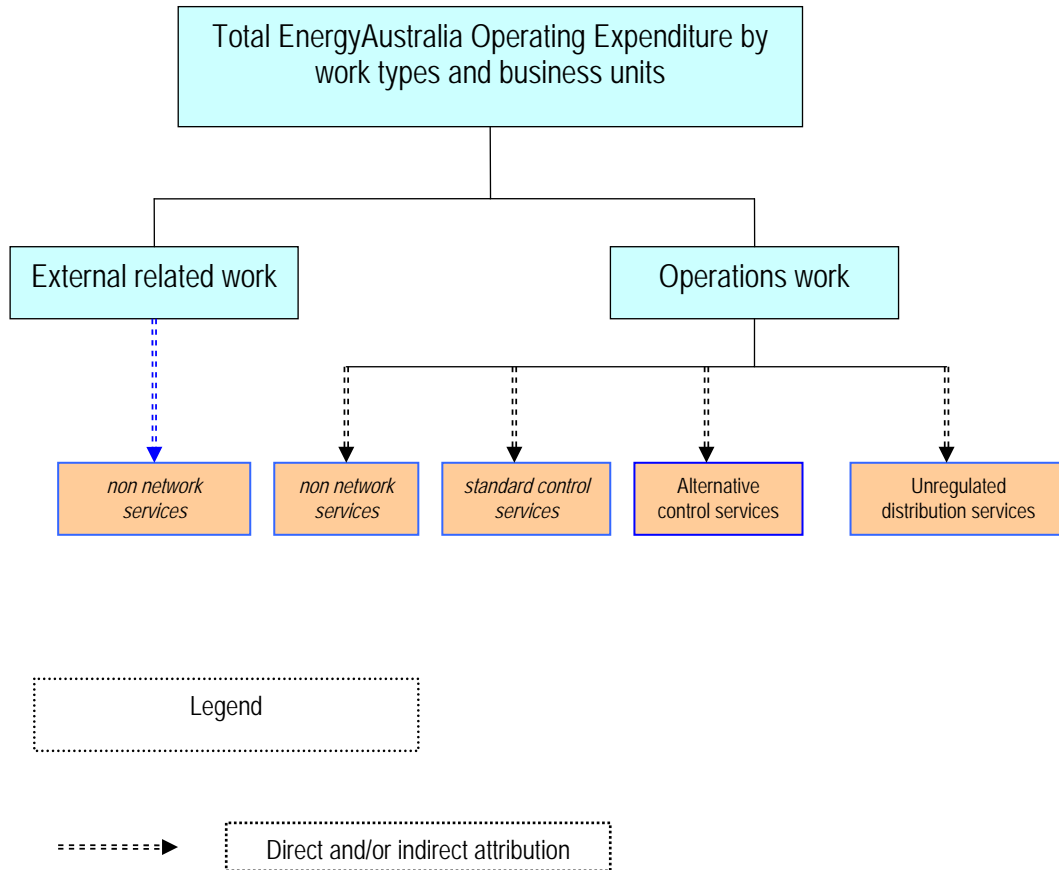
Figure 2



Firstly, the total operating expenditure of EnergyAustralia is dissected into *alternative control services*, *unregulated distribution services*, *standard control services* or *non network services*. This is the first level of disaggregation (level 1). *Standard control services* is then dissected between *standard control services - distribution* and *standard control services - transmission* (level 2).

4.2.1 Determining the disaggregation of Total operating expenditure into Level 1 Services

Figure 3



As outlined above in section 4.1, EnergyAustralia's financial system disaggregates costs according to the type of work and the business units that incurred the cost. Costs incurred with respect to external, contestable, recoverable works are directly attributable to the *non network services*. Cost incurred on operations work (expenditure relating to the normal day to day network operations) are either directly and/or indirectly attributed to *standard control services*, *alternative control services* or *unregulated distribution services*.

Figure 4

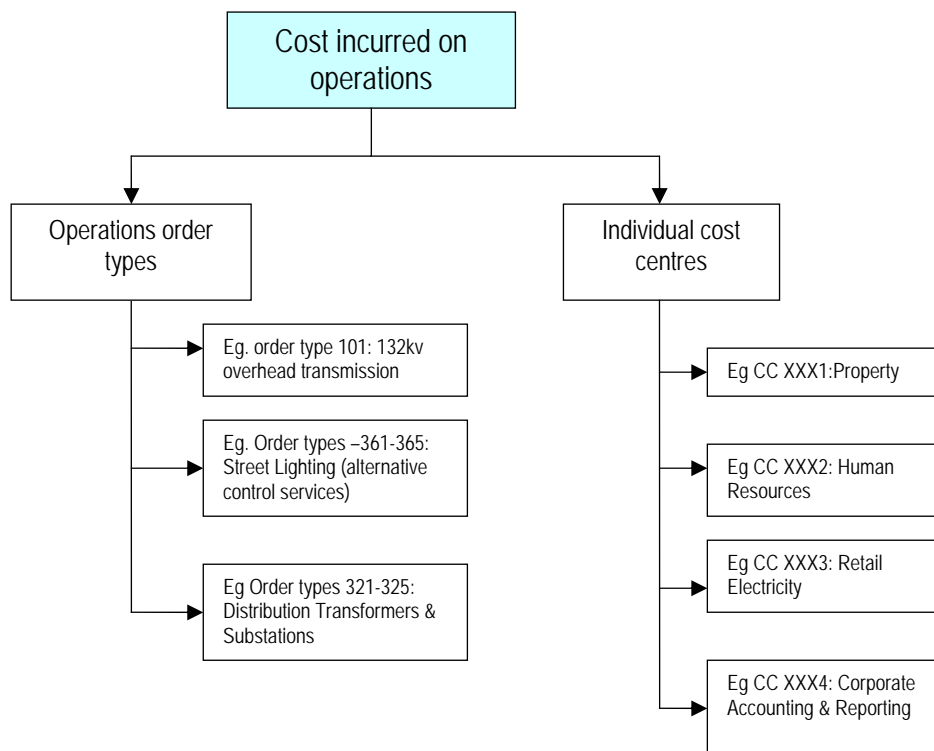


Figure 4 above shows the detailed breakdown of operating expenditure incurred on operations work. Cost relating to operations works is broken down into costs incurred on different work activities and by different individual cost centres. The nature of each work activity and each individual cost centres are reviewed and the cost allocation principles prescribed by IPART as outlined in section 3 above are applied to each individual work activities and cost centre to determine the amount of costs to be attributed to the different services.

For example, costs captured on order type "101: 132 kV overhead transmission" are directly and wholly attributed to *standard control services*; costs captured on order types '361-365: street Lighting' are directly and wholly attributed to *alternative control services*.

Similarly, costs captured on cost centre "XXX3: Retail Electricity" are directly and wholly attributed to *non network services*.

If a cost is shared between the different services, then it is allocated across the services using the preferred/alternative allocation methods as prescribed by IPART in tables B of the Code.

For example, costs incurred by cost centre "XXX1-Property" are allocated across the different services using floor space weighted by premium/non premium rent as the allocator. Floor space weighted by premium/non premium rent is the preferred allocation method prescribed by Table B of the Code for allocating costs relating to property management.

Similarly, costs incurred by cost centre "XXX2: Human Resources" are allocated across the different services using staff numbers, weighted by labour costs, as the allocator. In similar manner to floor space, staff numbers is the preferred allocation method in Table B of the Code.

In relation to cost centre "XXX4 – Corporate Accounting & Reporting", the costs incurred by this cost centre are allocated using "direct operating costs" as the approach prescribed in Table B of the Code. "Direct operating costs" is defined by IPART as "those operating expenses

attributed on an activity basis to natural monopoly network and other functions, including labour oncost, stores, transport.... prior to the indirect allocation of Corporate expenses...".

Based on this guidance contained in the Code, "direct operating costs" is calculated by EnergyAustralia as the relative proportion of costs of the four operating divisions (namely Enerserve, Network, Retail and Shared Services) that have been attributed to the different services. This direct operating costs allocation method is applied to cost centres of the Holding Company where an appropriate allocator, based on a causal relationship, cannot be established without undue cost and effort.⁶

In summary, the detailed disaggregation of expenditure as contained in EnergyAustralia's financial system is reviewed periodically to ensure that the cost allocation principles prescribed by the Code are appropriately applied. This is an internal review that is in addition to the annual reviews required by IPART as part of the preparation and submission of the annual regulatory accounts as discussed above.

4.2.2 Determining the disaggregation of Standard Control Services between Distribution and Transmission – Level 2

Once the total operating cost have been separated between the different services, the *standard control services* costs are then disaggregated between *standard control services - distribution* and *standard control services - transmission* to distinguish between the costs incurred by EnergyAustralia in providing distribution services and transmission services in its role as both a DNSP and a TNSP.

The Glossary of the National Electricity Rules contains the following definitions, which are relevant to distinguishing between transmission and distribution costs⁷:

- A TNSP is "a person who engages in the activity of owning, controlling or operating a transmission system".
- A transmission system is defined as "a network of assets that operates at (a) nominal voltages of 220kV or (b) nominal voltages between 66kV and 220kV that operates in parallel to and provides support to the higher voltage transmission network or (c) nominal voltage between 66kV and 220kV that do not operates in parallel to and provides support to the higher voltage transmission network but is deemed by the AER to be transmission system.
- A DNSP is "a person who engages in the activity of owning, controlling or operating a distribution system".
- A distribution system is "a system that is not a transmission system".

Based on the above definitions, EnergyAustralia's business performs both DNSP and TNSP functions. Consequently, the allocation of the total *standard control services* costs between *SCS –Distribution* and *SCS – Transmission* is performed by identifying the relationship between the nature of the cost captured by each individual order types (as illustrated in figure 4 above) and the asset classes that are classified under the National Electricity Rules (the NER) as either transmission system assets or distribution network assets.

⁶ See also section 3.5 of IPART's "Regulatory Information Requirements for Electricity Distributors in NSW".

⁷ Chapter 10 of the NER.

The allocation of the total *standard control services* costs between *standard control services - distribution* and *standard control services - transmission* are performed using three allocation methods. These methods are:

- (a) direct allocation to the *standard control services - distribution* of costs that specifically relate to this service. For example, costs incurred by the contact centres of Shared Services division in response to emergency calls relating to the distribution network or costs incurred in the maintenance of distribution overhead and underground cables are directly allocated to *standard control services - distribution*.
- (b) allocations based on transmission and distribution assets values. Under this allocation method, costs incurred on the maintenance of both transmission and distribution system assets are allocated between the *standard control services - distribution* and *standard control services - transmission* based on the proportion of distribution and transmission asset values.

For example, as depicted in figure 4 above, costs incurred on order type 101 is for the maintenance of 132 kV overhead transmission. EnergyAustralia's network comprises of 132 kV overhead system network assets that are categories as either transmission system assets or distribution system assets in accordance with the definitions of these in the NER. Hence, costs incurred on the maintenance of 132 kV overhead transmission is allocated to *standard control services - transmission* based on the values of 132 kV overhead assets identified as transmission system assets as a proportion of the total values of 132 kV overhead assets.

- (c) indirect allocation of remaining support/corporate costs based on the proportion of costs that have been allocated between *standard control services - distribution* and *standard control services - transmission* using the methods described in (a) and (b) above.

It should be noted that the above allocation methods were used by IPART and the ACCC when making the current distribution and transmission decisions, and have subsequently been confirmed by the AER as the appropriate methods to be applied by EnergyAustralia in its annual regulatory accounts of the current regulatory period 2004-2009.

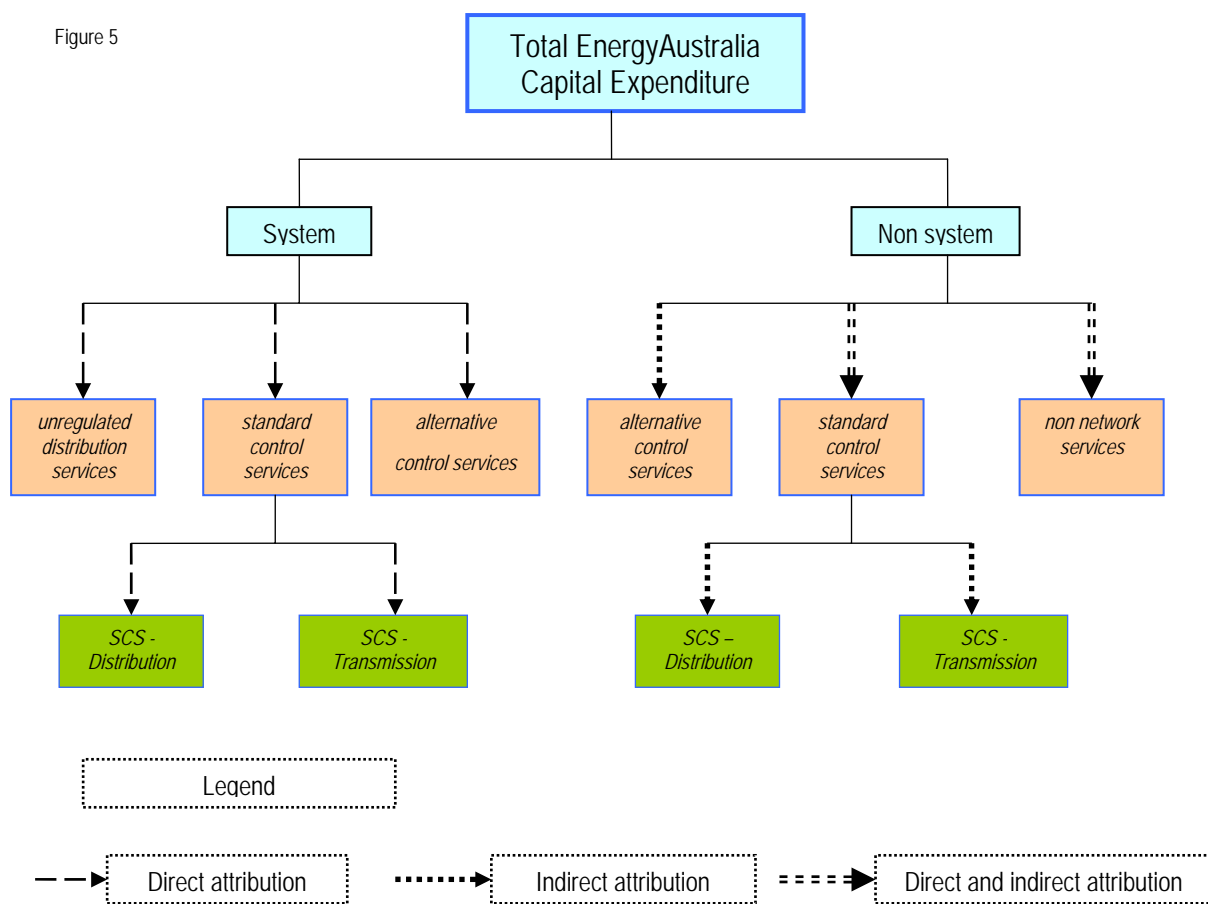
4.3 Capital Expenditure

As noted in section 4.1 and figure 1 above, EnergyAustralia's financial system uses a specific set of order types to disaggregate capital expenditure between different asset types. These asset types can be classified as system assets or non system assets. System assets are those assets that form the distribution, transmission or public lighting system network. An example of a non system asset is administrative and office land and buildings.

This disaggregation is utilised to effect the allocation of capital expenditure between *standard control services*, *alternative control services*, *unregulated distribution services* and *non network services* in the first instance and allocation of the *standard control services* capital expenditure between *standard control services - distribution* and *standard control services - transmission*.

The following diagram illustrates the allocation of capital expenditure between the different services.

Figure 5



Total capital expenditure is allocated as follows:

- capital expenditure on system assets are wholly and directly allocated to either *standard control services*, *alternative control services* or *unregulated distribution services*.
- capital expenditure on non system assets that are used for the provisions of *standard control services* or *non network services* or that are incurred by business units involved in *standard control services* or *non network services* are allocated wholly and directly to *standard control services* or *non network services* respectively.
- remaining capital expenditure incurred by other business units is allocated between *standard control services*, *alternative control services* or *non network services* using an appropriate allocator. For example, capital expenditure on non system land and buildings is allocated across the different services using floor space weighted by premium/non premium rents.⁸

The allocation of capital expenditure of *standard control services* between *standard control services - distribution* and *standard control services - transmission* are as follows:

⁸ Table D.2 of the Code specified floor space as the preferred allocation method for Corporate buildings and site improvements assets. EnergyAustralia has applied this preferred allocation method to the allocation of capital expenditure incurred on corporate (non system) land and buildings.

- a) capital expenditure on system network assets are directly attributed to either *standard control services - distribution* or *standard control services - transmission*.
- b) non system capital expenditure are allocated between *standard control services - distribution* and *standard control services - transmission* based on transmission system assets as a proportion of total system assets. This proportion is 12.4% and is applied for the current 2004-2009 regulatory period.

5. Negotiated Services (Negotiated Distribution Services and Negotiable Components of Direct Control Services)

As required by clause 6.15.6 (b) the CAM has been prepared using the same cost allocation method as was used when preparing regulatory accounts for submission to IPART, i.e. EnergyAustralia's 2006-07 regulatory accounts. At the time of submitting the 2006-07 regulatory accounts, and at the time of submitting this CAM, EnergyAustralia had no identified negotiated distribution services as defined by the Rules. However, EnergyAustralia expects that over the course of the 2009-2014 regulatory period there is a reasonable likelihood (but not a certainty) that negotiated distribution services will arise.

EnergyAustralia has been developing its approach to delineating negotiated transmission services from prescribed transmission services for the purposes of determining "negotiated distribution services" for the next regulatory determination. Once the delineation between services has been agreed between EnergyAustralia and the AER, EnergyAustralia will be in a better position to establish the likelihood and extent of services provided under the negotiated transmission service category.

Similarly, in relation to the Negotiable Component of Direct Control Services, EnergyAustralia is currently preparing its proposal as to whether (any and if so which) components of direct control services should be negotiable components.

Nevertheless, if a negotiated distribution service or a negotiable component of a direct control service is identified, EnergyAustralia intends to price this service in a manner consistent with the cost allocation principles established in the IPART cost allocation regime applied over the current regulatory period being:

1. Cost that can be directly attributed to a business segment will be assigned accordingly,
2. Cost that are not directly attributable will be allocated by either
 - a. using an appropriate allocating factor (i.e. on a causation basis) or
 - b. if a causal allocating factor cannot be established without undue cost and effort, then using a non-causal but defensible basis.

At this stage, EnergyAustralia anticipates that the costs attributed and/or allocated to negotiated distribution services and negotiable components of direct control services will be undertaken at the network level, i.e. costs will be allocated to these negotiated services at the same time that costs are allocated to standard control services, alternative control services and non-network services as seen in sections 4.2 and 4.3 above. While, this is EnergyAustralia's current expectation, the ultimate implementation of the IPART cost allocation regime will of course be dependent upon the facts of the negotiated service identified and the procedural approach that best reflects the costs of providing that service in accordance with the cost allocation principles set out above.

Attachment 1 – EnergyAustralia’s cost allocators

Cost Item	Cost Allocation Method to whole of EA Standard Control Services	Causal Relationship	Standard Control Services Disaggregation Method (Distribution/Transmission)	Cost Item	Cost Allocation Method to whole of EA Standard Control Services	Causal Relationship	Standard Control Services Disaggregation Method (Distribution/Transmission)
External Related Works				Project and Contracts Group – Indirect Costs	Allocated based on split of Project and Contracts Group – Direct Costs	✓	C
External Related Works - Direct	Direct operating costs	N/A	N/A	Security Operations Costs	Weighted % based on nature of property	✓	C
External Related Works - Indirect	Proportion of “revenue earned” Floor space	N/A	N/A		Floor space	✓	
Enerserve Division				Network Division			
Costs Incurred in the Maintenance / Operation of EA's Electricity Network	Direct operating costs	✓	A, B, C	Operating Cost of Distribution Network	Direct operating costs	✓	A, C
Costs Incurred in the Maintenance / Operation of Public Lighting Systems	Direct operating costs	✓	N/A	Customer Service Centres	Estimated proportion of costs incurred for network services	N/A	C
Marketing and Bad Debts Management Costs	Direct operating costs	N/A	N/A	Retail Division			
Fleet Costs	Fleet charges	✓	C	Retail Costs	Direct operating costs	N/A	N/A
Logistics / Warehousing Costs	Logistic charges	✓	C	Shared Services Division			
Projects and Contract Group – Direct Costs	Direct labour costs	✓	C	Commercial and Industrial Customers and EnergyAssist Program	Direct operating costs	N/A	N/A

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Cost Item	Cost Allocation Method to whole of EA Standard Control Services	Causal Relationship	Standard Control Services Disaggregation Method (Distribution/Transmission)	Cost Item	Cost Allocation Method to whole of EA Standard Control Services	Causal Relationship	Standard Control Services Disaggregation Method (Distribution/Transmission)
Energy and Water Ombudsman NSW Fee – Standard Control Services	Direct fee charges related to standard control services	✓	A	Shared projects	Based on overall proportion of costs dedicated to Network and Retail projects	✓	A
Energy and Water Ombudsman NSW Fee – Non Network Services	Direct fee charges related to non network services	N/A	N/A	Debtor Management			
Costs incurred for Energy and Water Ombudsman (complaints)	Direct attribution via “time entry”	N/A	A	Disconnections and Revenue Protection (Electrical Theft)	Direct operating costs	✓	A
Contact Centre Group				Debt Collections (Field Visits, Outbound Calls)	Direct operating costs	N/A	N/A
Emergency Response Costs	Direct operating costs	✓	A	Utilities Services - Metering			
Retail Sales Campaign Costs	Direct operating costs	N/A	N/A	Metering Services for Network Business	Direct operating costs	✓	A
Emergency Responses	Work load (Number of calls multiplied by Average handle time)	✓	A	Collation and Forwarding of Metering Data – communication cost	Number of NMIs and “dial up” frequency	✓	A
Account Overflows and Queries	Work load (Number of calls multiplied by Average handle time)	✓	A	Collation and Forwarding of Metering Data – other cost	Direct labour cost via “time entry” system		
Integrated business solutions				Utility services – small customer billings			
Network Related Projects	Project specific expenditure	✓	A				
Retail related projects	Project specific expenditure	N/A	N/A				

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Management and Resolution of Billing Exceptions - Retail Related	Direct operating costs	N/A	N/A	Data Operations Group			
Management and Resolution of Billing Exceptions - Network related	Direct operating costs	✓	A	Data Maintenance in GIS and MBS System	Direct operating costs	✓	A
Other Billing Exceptions	Estimated proportion of costs incurred for network services	N/A	A	Network Billing	Direct operating costs	✓	A
IT Infrastructure and Applications				Registration of New Retail Customer into IT System	Direct operating costs	N/A	N/A
Support and Operations of Network Related IT systems	Direct operating costs	✓	B	Holding Company			
Support and Operations of Retail Related IT systems	Direct operating costs	N/A	N/A	Network Property	Direct operating costs	✓	C
Operations and Support	Number of users Work load Number and type of interfaces Number of PCs	✓	B	Financial Systems	Direct operating costs	✓	C
Telecommunication Line Rentals	Number of landlines	✓	B	Middle Office	Direct operating costs	N/A	N/A
Facilities Management Costs	Number and nature of servers	✓	B	Human Resources	Staff numbers (weighted by labour cost)	✓	C
				Property Management (Except Land Tax)	Floor space (weighted by rent)	✓	C
				Land Tax	system/non system land values	✓	B

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Office of CIO (IT Strategy & Architecture)	IT CAPEX budget	✓	B	Network Year End Adjustments and Other Direct Costs	Direct operating costs	✓	
Office of CIO (IT Vendor Sourcing & IT Security)	Number of PCs	✓	B	Year End Adjustments Relating to HR Provisions (Superannuation, Workers Comp etc)	Number of employees weighted by labour costs	✓	
Office of CIO (Governance Policies, Standards and Methodologies)	IT CAPEX budget & number of PCs	✓	B	Debt Management Expense	Same allocation for interest expense	✓	
Accounts Payable	Volume by unit price	✓	C	Other Expenses	Direct operating cost %	✓	
Fixed Asset	Volume by unit price	✓	C				
Legal	Volume by unit price	✓	C				
Internal Audit	Nature of audit projects & number of days	✓	C				
Insurance	Nature of insurance policies	✓	C				
Business Planning	Nature of activities & related budgeted costs	✓	C				
Other Cost Centres	Total direct operating cost %	✓	C				
Year End Adjustments							