

IPART's required amendments to Sydney Water's Cost Allocation Manual

Sydney Water Corporation submitted (SWC) its Cost Allocation Manual (the Manual) to IPART for approval in November 2008. Outlined below are IPART's comments on this Manual. IPART requests that SWC amend the Manual to address these comments and then re-submit the Manual to IPART for further consideration.

1 General comments

The points below highlight IPART's view that SWC's Manual should provide more information and explanation on its proposed cost allocation methodology. This includes:

- ▼ Further explanation of, and justification for, SWC's means of allocating the Regulatory Asset Base (RAB) across its services.
- ▼ Further and clearer explanation of how SWC's costing systems (eg, its ABC system) work, including the key allocation principles and methodologies underpinning these systems.
- ▼ A more comprehensive list of direct cost items and more information on how/why these items are classified as 'direct'. For example, this could be provided in a table, with supporting/explanatory text.
- ▼ A more comprehensive list of indirect cost items, the means of allocating each of these items to services (cost objects) and the justification or rationale for each means of allocation. This could also be provided in a table, with supporting/explanatory text.

In providing further information/explanation, SWC's Manual should clearly explain how each element and stage of its proposed cost allocation methodology relates to relevant cost allocation principles (including the cost allocation principles listed in IPART's Draft Cost Allocation Guide).

More detailed comments are provided below.

2 Detailed comments

2.1 The Causality Principle in Allocating Costs (section 1.4 of SWC's Manual)

SWC's Manual states that: "the majority of capital costs can be identified at a system level." The Manual should discuss/clarify how this statement reconciles with its discussion on the RAB (including the disconnection between the RAB and individual assets) and the need to develop a methodology to allocate the RAB (and hence capital costs) across systems and services (section 4.2.1 of the Manual). For instance, given the need to allocate the RAB across services, the Manual should clarify the proportion of 'direct' capital costs compared to the proportion of capital costs that need to be allocated across systems and services.

This section of the Manual also states that: "The majority of costs (>80%) are therefore allocated on a directly causal basis." The Manual should:

- ▼ outline what "directly causal basis" means and how SWC determines this
- ▼ clarify whether this is ">80%" of SWC's total wastewater costs (ie, operating costs and capital-related costs) or just ">80%" of wastewater operating costs.

2.2 Definition of Wastewater Services (section 4.1 of SWC's Manual)

Brief explanation of other services

The Manual should provide more information on 'trade waste', 'ancillary' and 'other' services - including a brief explanation of what these services comprise, and where and to whom these services are provided. This additional text does not have to be detailed or lengthy, and could include references (eg, to Sydney Water publications) to where sufficiently detailed information is available.

Means of allocating costs to 'retail' wastewater services?

Much of the Manual explains how SWC allocates costs to 'transport' and 'treatment and disposal' services within each distinct geographic wastewater system. However, the Manual should also clearly explain:

- ▼ How it determines SWC's wastewater 'retail' service cost (ie, how are costs allocated to determine the cost of this service)
- ▼ Why 'retail' service costs are determined at (or allocated to) the aggregate wastewater level rather than the system level (as 'transport' and 'treatment' services are)
- ▼ The rationale or basis for each means of allocation to determine retail costs.

2.3 Capital-related costs (section 4.2.1 in SWC's Manual)

2.3.1 Allocating the Regulatory Asset Base (RAB) to establish the initial asset values for each service at the start of the current retail price determination period

SWC's proposed cost allocation methodology allocates the Regulatory Asset Base (RAB) to its declared services.¹ The Manual states that SWC's cost allocation method allocates values to individual assets in the following manner:

- STPs that serve the three sewerage reticulation networks used to provide the declared Transport Services have been valued in the RAB at their depreciated MEERA value
- Transport assets are valued as a residual so as to equal the RAB for each system.²

However, the Manual does not explain how SWC's aggregate wastewater RAB is determined and then how this wastewater RAB is allocated to each distinct wastewater system (prior to transport assets then being valued as a 'residual' for each system). Also, the Manual does not sufficiently explain the rationale or justification for its proposed allocation methodology. The Manual should therefore clearly explain:

1. how SWC's wastewater RAB is determined – ie, how SWC's RAB is initially allocated across its water, wastewater, stormwater and recycled water divisions
2. how SWC's wastewater RAB is then allocated to:
 - its geographic wastewater systems
 - its declared and non-declared services within these systems
3. the justification or rationale for each means (or stage) of allocation.

As part of 3 above, the Manual should provide more information on the MEERA valuations, including the justification for selecting this method of valuation, key assumptions used in the valuation of each sewage treatment plant (eg, assumed configuration, optimisation and performance of the 'replacement' asset relative to the existing asset) and the rationale for these assumptions.

In explaining SWC's proposed allocation methodology, worked examples should be provided for ease of understanding. In providing justification for SWC's proposed allocation methodology, the Manual should relate SWC's methodology to relevant cost allocation principles (including those outlined in IPART's Draft Cost Allocation

¹ SWC's Manual (p 16 and 17) states that:

"The RAB is rolled forward at the beginning of each subsequent regulatory period to include actual capital expenditure from the previous period as assessed by IPART to have been efficient.

"The RAB is divided into water, wastewater and stormwater components. However, in determining the RAB, IPART does not disaggregate wastewater capital costs into Transport and other Services, or by geographic area. Sydney Water's cost allocation method therefore allocates capital costs to the Services, including to Transport and to Treatment and Disposal Services by STS."

² P 17.

Guide) and references to any supporting documents or sources of information should be provided.

2.3.2 **Attributing/allocating capital expenditure and asset disposals incurred throughout the current retail price determination period**

As mentioned above, the Manual provides some explanation of how the RAB (incorporating historical capital expenditure) is initially allocated across services. However, it is not clear how capital expenditure (including 'work in progress') and asset disposals forecast to occur over the current retail price determination period³ are attributed or allocated to services. For example, it is not totally clear whether they are:

- ▼ incorporated into the RAB prior to the RAB being allocated to services; or
- ▼ allocated/attribution to services after the initial RAB allocation.

This should be clarified, and where necessary the distinction should be clearly made between the allocation of the RAB (incorporating historical capital expenditure) and the allocation/attribution of capital expenditure forecast to occur over the current regulatory period.

Assuming that capital expenditure and asset disposals forecast to occur over the current regulatory period are attributed or allocated to services *after* the initial RAB allocation (as appears to be the case), the Manual should provide more information/explanation in regard to the following:

Capital expenditure to be incurred throughout the determination period

Direct cost items

1. Examples of capital expenditure over the determination period that is classified as 'direct', and the basis for this classification.

Indirect cost items

1. A description of the composition of 'corporate capital expenditure'. The Manual should explain the justification/rationale for grouping 'corporate capital expenditure' items together for the purposes of allocation.
2. Clarification/explanation of how corporate capital expenditure is allocated by SWC to its wastewater division (ie, across SWC's water, wastewater, stormwater and recycled water divisions).⁴

³ 2008/09 to 2011/12.

⁴ The Manual (p 18) states that "Corporate capital expenditure is allocated to water, wastewater and stormwater services based on the percentages applied by IPART." However, this should be explained further (eg, what percentages and how are these determined?).

3. The Manual should provide worked examples, and the justification/rationale for SWC's means of allocating corporate capital expenditure:
 - to its wastewater division (ie, across SWC's water, wastewater, stormwater and recycled water divisions), then
 - across geographic wastewater systems, and then
 - to services (declared and non-declared) within these systems.
4. In addition to 'corporate capital expenditure', the Manual should provide a comprehensive list of any other indirect or shared capital expenditure items that need to be allocated across services. For each such item, the Manual should:
 - describe the composition of the shared or indirect cost item, including the justification/rationale for grouping cost items together for the purposes of allocation
 - explain how the expenditure item is allocated:
 - o to SWC's wastewater division (ie, across SWC's water, wastewater, stormwater and recycled water divisions),
 - o across geographic wastewater systems, and
 - o to services (declared and non-declared) within these systems
 - provide worked examples and the justification/rationale for each stage/means of allocation.
5. As mentioned above, this information could be presented in tables, for ease of explanation and understanding, with supporting text and worked examples.

Asset Disposals

1. As per comments in regard to capital expenditure above, the Manual should distinguish between historic asset disposals (which are subtracted from the RAB prior to its initial allocation across services) and asset disposals forecast to occur over the current regulatory period (which appear to be allocated per the method described on page 18 of the Manual).
2. The Manual (p 18) states that most of SWC's disposals are categorised as corporate assets. It should more clearly explain how corporate asset disposals are allocated by SWC:
 - to its wastewater division (ie, across SWC's water, wastewater, stormwater and recycled water divisions), then
 - across geographic wastewater systems, and then
 - to services (declared and non-declared) within these wastewater systems.

In doing so, the Manual should also explain the rationale or justification for each means of allocation.

3. In addition to corporate asset disposals, the Manual also mentions that 'system-related' asset disposals are relatively minor and are allocated as follows:

- total disposals are divided between water and wastewater using the relative proportion of MEERA asset values
- the wastewater portion is then allocated to the 4 major ocean sewage treatment systems based on their relative capital expenditure for the pricing period.

The Manual should explain:

- how 'system-related' asset disposals are allocated to infrastructure services (eg, transport, treatment, retail, etc) within "the 4 major ocean sewage treatment systems"
- the rationale or justification for SWC's means of allocating 'system-related' asset disposals. In doing so, it should explain why asset disposals are not applied directly to the systems and services to which they relate.

4. SWC's Manual should also explain whether (and if so, how and why):

- asset disposals are allocated to SWC's stormwater and recycled water services, as well as "between water and wastewater"
- there are any shared or common MEERA values (ie, assets) that have to be allocated or apportioned between water, wastewater, stormwater and recycled water (note that this point is relevant to SWC's use of MEERA values throughout its proposed cost allocation methodology).

Developer charges

The Manual should update reference to (and treatment of) developer charges (capital contributions), in light of the Government's decision to abolish these charges for all services but recycled water.

Depreciation

IPART's calculation of SWC's revenue requirement as part of the recent retail price determination included provision for regulatory depreciation, which is a function of the life and value of SWC's assets.

The Manual should explain:

- ▼ how its method of allocating the RAB equates with its IPART determined depreciation allowance; and
- ▼ how SWC's depreciation allowance is allocated across services and the rationale for this means of allocation.

2.3.3 Rolling forward individual RABs or re-establishing initial asset values for each service at the start of future retail price determination periods?

Rather than maintaining separate RABs for each service from one price determination to the next (after the initial allocation of the RAB), IPART understands

that SWC proposes that the initial values for each service be re-established at the start of each retail price determination period using the same methodology for allocating SWC's overall RAB as outlined in section 4.2.1 of the Manual. If this is the case, SWC's Manual should:

- ▼ clearly note and explain this approach; and
- ▼ explain the justification or rationale for it.

2.4 Operating costs (section 4.2.2 in SWC's Manual)

Activity Based Costing System

IPART recognises that SWC's Manual does not need to provide detailed information on the mechanics of SWC's ABC system or how it interacts with SWC's other systems. However, IPART considers that there is scope for the Manual to provide a clearer overview and explanation of how these systems work, including the attribution/allocation methodologies and principles that underpin them. In doing so, the Manual should provide additional information on:

1. The "underlying allocation assumptions" of the ABC system, and how it works to attribute or allocate costs (eg, an explanation of how a few key cost items are traced through to end cost objects could be provided, using a combination of text, tables and/or figures, if necessary). Note that SWC's response to the 'Allocation of Direct and Indirect Costs' section below may address this point.
2. The "major review of the system and underlying allocation assumptions" - eg, when will this review occur and what will it involve?
3. How SWC's costing systems are maintained, reviewed, updated and verified/audited.
4. How costs that are recorded and attributed/allocated by SWC's costing systems (ABC, etc) relate to Sydney Water's forward efficient costs (ie, revenue requirement) as determined by IPART at the prevailing price determination.
5. Where more detailed information on SWC's costing systems can be obtained (if so desired by an access seeker or stakeholder).

Allocation of Direct and Indirect Costs

The Manual provides some general information or examples of how some operating costs are classified and allocated. For example, at various sections on pages 19 to 20 the Manual mentions that:

- "...a system planner's costs will be allocated to a particular system depending on proportion of time spent on that system."

- “Common costs such as IT, HR, and executive costs are allocated to all assets proportionate to their respective direct costs.”
- “Some business units may be linked to multiple products or services, such as corporate costs. These indirect costs are allocated to services using an appropriate driver such as proportion of direct costs, staff numbers or property numbers.”
- “...activity costs are then allocated to defined assets or services on the basis of relevant cost drivers such as maintenance hours, electricity usage kWh and management time.”

However, more comprehensive information is required. For each category of cost (direct and indirect, or as per the three categories on page 19 of the Manual⁵), the Manual should:

1. Provide a comprehensive list and description of cost items. For direct cost items, this should include an explanation as to why/how they are classified as ‘direct’. For indirect cost items or pools, this includes description/explanation of the composition of an indirect cost item and why elements within such an item or pool can be grouped together for the purposes of allocation.
2. Provide an indication of the proportion of total wastewater operating costs covered under each cost category (being ‘direct’, ‘indirect’ or as per the three categories on page 19 of the Manual).
3. Identify and describe the means by which each indirect cost item/pool is allocated across cost objects (services) and the rationale/justification for each means of allocation (with reference to cost allocation principles and cost drivers).

IPART notes that the information requirements outlined in 1 to 3 above could be presented in the Manual in the form of a table, with supporting text and worked examples (provided that this gives sufficient information and explanation).

2.5 Allocation of costs to customer categories and individual customers (sections 4.3 and 4.4 in SWC’s Manual)

The Manual should:

- ▼ More clearly explain SWC’s proposed approach to allocating costs to customer categories and individual customers (eg, by way of worked examples)

⁵ These three categories on page 19 of the Manual are: 1. a directly traceable cause and effect relationship with the provision of service; or 2. a verifiable relationship between the cost and the output of the individual service; or 3. a direct causal relationship associated with a pool of common costs and allocation of that pool using a relevant, reliable and verifiable factor such as share of direct costs.

- ▼ Provide more explanation of its justification/rationale for each means of allocation – including relating the means of cost allocation to cost allocation principles and cost drivers. For example, the Manual currently provides little explanation as to why the cost of transport services is allocated between residential customers and non-residential customers on the basis of dry weather flows generated by each customer group, as opposed to potential alternative allocators (eg, number of equivalent meters).

2.6 References to access pricing methodologies (including section 1.3 and Appendix 1)

When referring to the ‘retail minus’ access pricing method in Appendix 1 and throughout the Manual, SWC should clearly note that it is SWC’s **proposed** methodology and that the Act provides that access prices will be determined through arbitration and negotiation. For example, section 1.3 of the Manual currently states that:

Appendix 1 to this Manual shows the method for calculating access prices for the declared services.

If SWC wishes to maintain this reference to its access pricing methodology, this text should be amended to read:

Appendix 1 to this Manual shows **Sydney Water’s proposed** method for calculating access prices for the declared services.

Section 1.3 also refers to “the access pricing method established by the Australian Competition and Consumer Commission (ACCC).” However, the Manual should clearly state that this access pricing method was determined for an access dispute under the *Trade Practices Act* and not the *Water Industry Competition Act 2006*. An access pricing method has not been established under the *Water Industry Competition Act 2006*. Therefore, in referring to access prices, this section of the Manual should refer to the negotiate/arbitrate provisions of this Act.

2.7 Other requirements

Contact details

On page 3, the Manual states that: “Any enquiries regarding this Manual should be addressed to General Manager, Finance & Regulatory Division.”

1. The Manual should include a contact name(s), postal and email addresses, and telephone and fax numbers.

Sign-off by CEO and CFO

IPART's finalised Cost Allocation Guide⁶ will require a statement signed and dated by the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO), which states that the information contained in the Manual is accurate and which confirms the service provider's intention to comply with the proposed cost allocation methodology.

1. The revised Manual should include sign-off by the CEO and CFO.

2.8 SWC's queries regarding the corporate RAB

In correspondence to the IPART Secretariat dated 29 May 2009, SWC advised that it needed a response from IPART on the following in order to enable it to finalise the Manual:

The rationale for creating an individual RAB for corporate services. For example, why corporate services now has a separate RAB but other services, such as contestable Retail services does not

At the 2008 price determination, SWC requested a more detailed breakdown of asset classes/lives for the depreciation allowance. Given this, and the fact that SWC provided information on Corporate assets, IPART constructed its pricing model to include provision for a Corporate RAB. (SWC did not provide information for IPART to calculate a separate RAB for Retail services.)

Why the opening asset value was set at zero

IPART allocated the RAB for existing services (Water, Wastewater, and Stormwater) according to the information provided by SWC in its submission to IPART (dated 14 September 2007).⁷ No figures were provided for an opening Corporate RAB in the submission, so the opening Corporate RAB was set to zero.

Why the value of all corporate assets disposals was not subtracted from the Corporate RAB. For example, Sydney Water would understand that the value of the sale of Head Office was allocated across the water, wastewater and stormwater RABs and not directly subtracted from the Corporate RAB

Asset disposals were originally provided by SWC in its Annual Information Return. However, revised asset disposals were provided in a letter to IPART dated 19

⁶ In finalising its Cost Allocation Guide (currently in 'Draft' form), IPART intends to amend the Guide to require CEO and CFO sign-off.

⁷ This was done on a weighted basis from the information in Appendix D, pp D3 to D4.

December 2007, which were separated only into 'Non-depreciable' and 'Depreciable' categories and not across the water, wastewater and stormwater services. In its calculations, IPART assumed a 50:50 split of the assets disposed between the water and wastewater services. Information on the exact split of these disposals was not provided to IPART. The Corporate RAB did not exist until this determination and its opening value was set to zero, making it difficult to match asset disposals against it.

SWC should contact IPART if it has any further queries.