

12 March 2018

1 IPART's Cost allocation guide

Today, the Independent Pricing and Regulatory Tribunal (IPART) released its *Cost allocation guide* (the Guide) under the *Water Industry Competition Act 2006* (WIC Act). In finalising the Guide, we considered submissions from interested parties on our Draft Guide. We may update the Guide from time to time, in which case we will again consult with stakeholders. This information paper explains the purpose of the Guide, and outlines our responses to comments made by stakeholders in relation to our Draft Guide.

2 Access to infrastructure services under the WIC Act

The WIC Act provides for private sector participation and competition in the NSW water and wastewater industry. To facilitate this, infrastructure services can be 'declared' under Part 3 of the WIC Act, meaning that a third party must be granted access to these services subject to certain criteria and the establishment of an access agreement or determination. In addition, service providers can seek to establish voluntary access undertakings, where they proactively put forward the terms, conditions and prices under which access seekers would be provided access.

IPART's role under Part 3 of the WIC Act

IPART has several roles under Part 3 of the WIC Act, including:

- ▼ assessing and making recommendations on applications for coverage declarations for infrastructure services
- ▼ assessing and approving voluntary access undertakings, and
- ▼ arbitrating, or appointing an arbitrator for, certain disputes over access to infrastructure services, and making access determinations to resolve such disputes.

3 Cost allocation manuals required for declared services

Under section 42 of the WIC Act, the provider of a declared service must develop a cost allocation manual, which sets out the basis on which the service provider will establish and maintain separate cost accounts for each of its declared services.

IPART may approve this cost allocation manual or may require it to be amended and resubmitted to us before we reconsider it for approval. Once approved, a service provider may only vary its cost allocation manual with IPART's consent.

The purpose of cost allocation manuals

Cost allocation relates to the attribution and allocation of a service provider's direct and indirect costs to its declared and other services. Cost allocation manuals aim to ensure that costs are transparently and appropriately allocated and apportioned. A cost allocation manual required under Part 3 of the WIC Act must set out the basis on which a service provider intends to establish and maintain separate cost accounts for each of its declared services.¹

¹ WIC Act s 42(2).

We consider a key purpose of a cost allocation manual is to improve transparency and help overcome information asymmetry between the service provider and potential access seekers. This can facilitate the commencement of negotiations between the service provider and access seekers on the terms of access.

We consider that access should be priced in a manner that leads to appropriate incentives for entry in the provision of services potentially open to competition, and that is in the long-term interest of end-users. The cost allocation manual should therefore demonstrate that the costs allocated to a service provider's declared services:

- ▼ reflect efficient, attributable costs, and
- ▼ do not unduly favour the service provider in the supply of potentially competitive services.

Finally, a transparent cost allocation manual would assist an arbitrator (eg, IPART) if it were called upon to arbitrate a dispute between a service provider and an access seeker, and consequently was required to make a determination on the terms of access.

The purpose of IPART's Cost allocation guide

The Guide is intended to assist service providers in preparing their cost allocation manuals for their declared infrastructure services. The Guide outlines our views on:

- ▼ principles that should be used by a service provider in allocating costs and developing its cost allocation manual, and
- ▼ what a service provider's cost allocation manual should include, as a minimum.

4 Current declared services

Three of Sydney Water's sewage reticulation networks (Bondi, Malabar and North Head) were 'declared' from the outset of the WIC Act (both conveyance and interconnection services).²

As per the requirements of the WIC Act, Sydney Water developed a cost allocation method and a manual, which sets out how it will allocate costs and maintain separate accounts for its declared infrastructure.³ Sydney Water is currently in the process of finalising its manual, and incorporating amendments that we have previously requested.⁴ We expect Sydney Water to submit its revised cost allocation manual to us to consider it for approval by mid-2018.

² Sydney Water's sewerage reticulation networks for North Head, Bondi and Malabar were 'declared' infrastructure services under the WIC Act from the outset of its commencement on 8 August 2008.

³ The WIC Act requires that, within 3 months after an infrastructure service becomes the subject of a coverage declaration, the service provider (Sydney Water) must submit a cost allocation manual to IPART in relation to that infrastructure. Sydney Water submitted its cost allocation manual for its declared services to IPART on 7 November 2008.

⁴ IPART did not approve Sydney Water's 2008 cost allocation manual and required that Sydney Water amend the cost allocation manual to include further information about its cost allocation method. Sydney Water elected, in accordance with IPART's suggestion, to delay resubmitting its cost allocation manual, given reconsideration of price structures for retail sewerage services that was being conducted at the time.

5 Responses to stakeholder submissions on Draft Guide

We released a Draft of the Guide for stakeholder comment in December 2017. We received submissions from Hunter Water Corporation (Hunter Water), Sydney Water Corporation (Sydney Water), and the Public Interest Advocacy Centre (PIAC). The submitters were largely supportive of the Guide, but also made a number of comments on specific issues. We address the key issues raised below.

Submission: The scope of the cost allocation manual should be declared services only

Both Sydney Water and Hunter Water submitted that the Draft Guide required the cost allocation manual to extend beyond just the declared services, and that this exceeds the requirements under the WIC Act.⁵

We agree that the scope of the cost allocation manual as suggested by the Draft Guide went beyond what is required under the WIC Act. In accordance with the requirements of the WIC Act, the subject of a service provider's cost allocation manual are its **declared infrastructure services**.

However, we consider that allocating costs to certain non-declared services may be required depending on the cost allocation method adopted. For example, the cost of declared services could be identified as the *residual* cost after deducting the cost of non-declared services from total cost:⁶

$$\text{Cost of Declared Service} = \text{Total Cost} - \text{Cost of Non-Declared Services}$$

In this case, the subject of a service provider's cost allocation manual is still its declared infrastructure services, but they are costed as a residual of some or all of non-declared services. Therefore, the cost allocation manual would need to describe how costs are allocated to the non-declared services.

Allocating costs in this manner may support access pricing approaches such as a 'retail-minus' approach, where the price of accessing a service is generally based on the service provider's retail price minus the avoided or avoidable costs of the potentially contestable services (ie, non-declared) upstream and downstream of the declared services.

A 'retail-minus' avoidable cost approach was favoured by the Australian Competition and Consumer Commission (ACCC) in its determination of the access dispute between Sydney Water and Services Sydney Pty Ltd in 2007.⁷

More recently, IPART determined that water and wastewater wholesale services provided by Sydney Water and Hunter Water for on-selling by a wholesale customer should be priced using the *retail-minus 'reasonably efficient competitor cost' plus net facilitation costs* approach.⁸ In general, we favour a cost allocation method and access price that leads to

⁵ Sydney Water submission on Draft Cost allocation guide, 29 January 2018; and Hunter Water submission on Draft Cost allocation guide, 29 January 2018.

⁶ Note that 'Total Cost' could mean the total cost of a service division, a product line, a delivery system etc.

⁷ Australian Competition & Consumer Commission, *Access dispute between Services Sydney Pty Ltd and Sydney Water Corporation, Arbitration Report*, 19 July 2007.

⁸ IPART, *Prices for wholesale water and sewerage services – Sydney Water Corporation and Hunter Water Corporation*, June 2017.

appropriate incentives for entry in the provision of services potentially open to competition, and that is in the long-term interest of end-users.

We have amended the Guide to reflect our response above.

Submission: Actual cost information should not be required in the cost allocation manual

Both Sydney Water and Hunter Water submitted that the cost allocation manual should not contain actual cost data.⁹ Sydney Water said the Draft Guide in several locations could be interpreted as requiring actual cost information to be included in the manual.¹⁰

We agree that the cost allocation manual should not contain actual cost information, and it was not the intent that our Guide would require that. We have amended the Guide to improve clarity and to ensure that it could not be interpreted as requiring actual cost information to be included in a cost allocation manual.

Submission: Deviations from the Guide should have a demonstrable and material benefit to consumers

PIAC noted that since the Guide is not legally binding, there may be circumstances where a service provider would want to deviate from the Guide. PIAC submitted:

If this should occur, IPART should only accept deviation if the business can clearly demonstrate that doing so would result in a materially preferable outcome for consumers. Further, PIAC recommends that the Guide include explicit principles to this effect to provide additional certainty to businesses and stakeholders.¹¹

We agree that the Guide could benefit from further clarity regarding what we might consider when assessing whether to approve deviations from the Guide. However, we do not agree that a demonstrable and material benefit to consumers (end-users) is the only scenario where it may be appropriate to approve a deviation. For example, there may be pragmatic reasons why a service provider would prefer to deviate from the Guide which could have a neutral or negligible impact on end-users.

Instead, we consider the service provider should demonstrate that any proposed deviations from the Guide would not cause material detriment to end-users. We have amended the Guide to include this requirement.

Submission: Any cause-and-effect relationships between a cost and a driver should be described, even if impractical to quantify and use as allocator

PIAC supported that when allocating costs where a causal relationship could not be established, the basis for allocation should still be transparent and defensible. PIAC submitted further:

PIAC interprets this as primarily covering instances where a causal link intuitively exists but quantifying the precise nature of the relationship is impractical. PIAC recommends that businesses are also required to explicitly state this relationship...¹²

⁹ Sydney Water submission on the Draft Guide, 29 January 2018; and Hunter Water submission on the Draft Guide, 29 January 2018, p 3.

¹⁰ Sydney Water submission on the Draft Guide, 29 January 2018.

¹¹ PIAC submission on the Draft Guide, 30 January 2018.

¹² Ibid.

We agree that where such an intuitive link exists, the nature of this link should be described, even if it is impractical to quantify and is therefore not used as an allocator. We have amended the Guide to this effect.

Submission: A service provider may need discretion to use well-justified methods to forecast costs and revenues outside a determination period

Sydney Water submitted:

When developing proposed access prices for the declared services, it also may be necessary to include forecast of costs for a period longer than the current determination period, especially if the timing of the access request is close to the end of the determination period or if the access seeker is seeking a long term price. In this regard, Sydney Water suggests that the service provider will need some discretion to decide on the appropriate forecasts to use at the time an access request is made, supported by a clear and justified rationale in the CAM for that forecast method.¹³

We agree that the service provider may need to forecast costs, revenues and changes to allocators for periods outside a determination period. Where that is the case, the cost allocation manual should set out principles and outline methods that the service provider would use to forecast key costs, revenues and allocators. We have amended the Guide to reflect this.

Submission: The Guide needs to provide further guidance on the definition of fixed and variable costs

In relation to the requirement in the Guide to clearly distinguish between fixed and variable costs, Sydney Water submitted that it “would appreciate some guidance on the definition of fixed and variable costs as there may be some cost types which have characteristics of both fixed and variable components (e.g., plant capacity or nutrient limits where there are increases in costs when defined thresholds are met).”¹⁴

We agree that whether a cost is fixed or variable depends on the time horizon being considered, as well as the incremental nature of some costs. We have added definitions of fixed and variable costs and have amended the Guide to require the service provider to describe the extent to which a cost is fixed or variable, including the time horizon over which the cost may be fixed, and the drivers that may cause the cost to be varied.

Submission: The Guide needs to provide further clarification on the meaning of the terms ‘cost item’ and ‘cost object’

Sydney Water submitted:

...we suggest that the Guide will benefit from further clarification of the meaning of the terms “cost item” and “cost object” and the relationship between these two terms, given that these are used interchangeably and refer to any activity where the service provider wants to separate record costs.¹⁵

We have amended the Guide to ensure there is no confusion in the terminology used to refer to costs and cost objects.

¹³ Sydney Water submission on the Draft Guide, 29 January 2018, p 5.

¹⁴ Ibid.

¹⁵ Ibid.

Submission: The cost allocation manual should not include numeric information on allocators

Sydney Water raised concern regarding the requirement to provide numerical data or a percentage for allocators. It noted allocators should not be considered static or permanent, because:

- ▼ they reflect underlying cause-and-effect relationships between services and shared costs that may change as technologies and operations change, and
- ▼ the choice of allocator depends on the quality of the data and information systems, and as information systems change and data collection improves, better allocators may be identified.¹⁶

While we agree that many allocators are not static, there may be allocators that would not be expected to change on a regular basis. The Guide only requires numeric or percentage information on allocators that would not be expected to change prior to the next review and update of the cost allocation manual.

As stated in the Guide, we require the service provider to review the cost allocation manual regularly. Service providers subject to a retail price determination are required to review their cost allocation manual at least once every determination period (currently at least once every four years).

Submission: The consolidated list of requirements in the appendix of the Draft Guide is inconsistent with the requirements in body of the Draft Guide

In relation to the consolidated list of requirements in Appendix A of the Draft Guide, Sydney Water noted in its submission that “some of the language in this checklist is inconsistent with the content of the Draft Guide as it implies that more information is required”.¹⁷

We have revised the consolidated list in Appendix A so that it is consistent with the text in the body of the Guide.

¹⁶ Ibid., p 6.

¹⁷ Ibid., p 7.