

Sydney Water submission to IPART's Cost Allocation Guide

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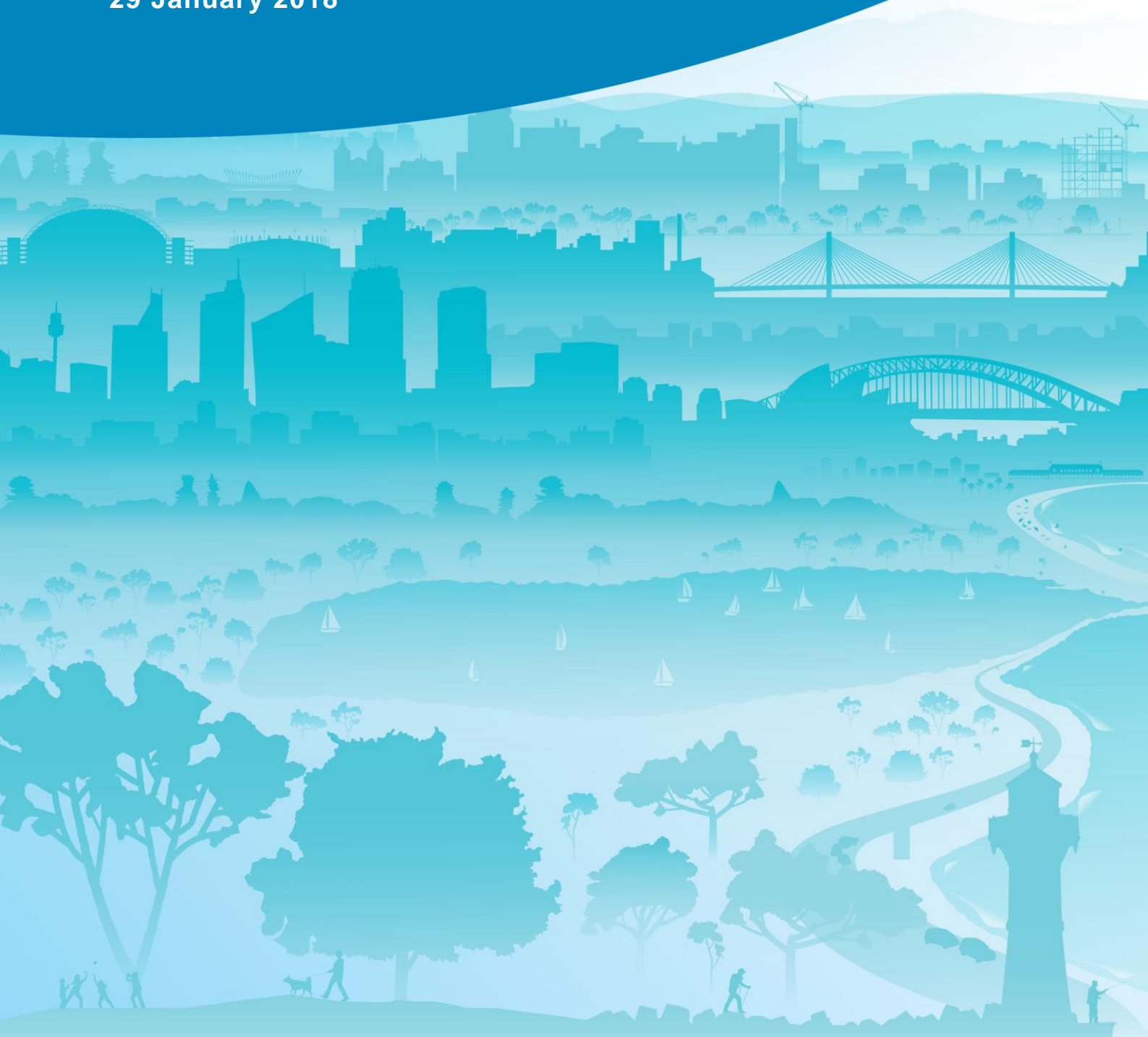


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1 Executive summary

Sydney Water Corporation (Sydney Water) welcomes the opportunity to respond to *Independent Pricing and Regulatory Tribunal's (IPART's) Water Industry Competition Act 2006 Cost Allocation Guide Draft December 2017* (the Draft Guide). This submission outlines Sydney Water's views in relation to the draft Cost Allocation Guide.

Sydney Water has consistently taken a constructive approach when dealing with access-related issues. Our track record demonstrates our willingness to engage with competitors to provide access to our infrastructure and to work positively in dealing with any issues raised.

An important aspect of an effective third party access regime for water industry infrastructure is transparency on the cost method and allocation principles used for declared services. Sydney Water agrees that preparing a Cost Allocation Manual (CAM) in relation to declared infrastructure services will greatly help inform potential access seekers and support efficient commercial decisions. Therefore we welcome the direction and detailed guidance provided in the draft Guide.

While Sydney Water is in agreement with the majority of the draft Guide, we have a number of suggested amendments and clarifications which will better ensure that the CAM is a robust, clear and accessible document and will support timely access to the declared services. We have two main comments:

1. The Cost Allocation Guide needs to be clear that the purpose of the CAM is to present the detailed principles and policies used to allocate costs between different categories of declared services and will not contain any cost data. Our submission identifies some areas where the draft Guide could lead to an expectation that the CAM will contain cost data.
2. Consistent with its purpose under the WIC Act, the scope of the CAM should be confined to explaining the allocation of costs to and within declared services. Sydney Water questions the purpose of requiring the CAM to also include description on the allocation of costs for non-declared services. This information is not necessary and would not support commercial negotiations for third party access seekers for the declared services.

Sydney Water agrees with and supports IPART's objective of the CAM *to facilitate the commencement of negotiations between the service provider and access seekers on the terms of access.*¹ In this regard, it is noted that the negotiating process for access will provide a targeted opportunity for further information to be shared with the access seeker in an efficient and timely manner. The Cost Allocation Guide should complement and support the overall framework for access seekers as set out in the Water Industry Competition Act 2006 (WIC Act).

This will help ensure that the CAM is consistent with the promotion of competition, is transparent and facilitates third party access negotiations in a timely and reasonable way.

We look forward to working constructively with IPART on these issues and the development of the Cost Allocation Manual for declared services.

¹ Draft Guide, section 1.3.

2 Sydney Water's comments

In general, Sydney Water agrees with the proposed requirements for the CAM as proposed in the Draft Guide and supports IPART's objective for the CAM. We support the cost allocation principles set out in section 3 plus the additional requirements on the rationale as set out in section 2.3 of the Draft Guide.²

Sydney Water is supportive of competition emerging under the WIC Act and considers that the transparency and understanding provided by the CAM will provide a basis for the commencement of negotiations. While the Water Industry Competition Act 2006 (the WIC Act) provides for a third party access regime, there has been no use of these provisions since its enactment. Entry and competition in the water sector has been limited with competition only for the market to service individual developers in new developments.

This section presents suggested clarifications to the Draft Guide to ensure it is fit for purpose, supports competition and is proportionate.

2.1 Scope of the Cost Allocation Manual

The declared services for Sydney Water at the commencement of the WIC Act were, and remain, Sydney Water's North Head, Bondi and Malabar sewerage reticulation networks. These networks are physically separate and drain to geographically distinct areas. Specifically, for these networks, the Coverage Declarations capture both the transportation of wastewater; and interconnection services. It does not capture sewage treatment plants for the systems, and the third party users would need to organise alternative treatment services located near the three reticulation networks, as well as their own transportation services between the point of interconnection with Sydney Water's network and the alternative treatment location.

Sydney Water questions the Draft Guide³ potentially expressing a requirement for the CAM to also include explanation on the allocation of costs for non-declared services. We believe that this proposed scope of the CAM is not required under the WIC Act and that service providers should not be required to provide the following information:

- Identification of which direct costs are attributed to non-declared services
- The method for allocating indirect costs across non-declared services

Such information has no value for third party access seekers for the declared services and will not assist or advance commercial negotiations. Further, this information is not required for the CAM to

² For example, Sydney Water agrees with the additional requirements for the CAM to describe how the methodology relates to the development of efficient entry and competition in services upstream or downstream of the declared services; each of the WIC Act pricing principles (section 41) listed in Box 2.1, and any relevant prevailing pricing determinations (e.g., retail price determinations and wholesale price determinations).

³ See section 3.1.1 of the Draft Guide and 3.1 of Table A.1

meet the requirements of the WIC Act which states that service providers must develop a cost allocation manual which sets out the basis on which the service provider establishes and maintains separate cost accounts for each of its declared services. With respect to indirect costs, the CAM therefore only needs to explain the method and rationale for:

- allocating costs between declared services and non-declared services, and
- allocating indirect costs amongst the declared services.

A requirement to explain how indirect costs are allocated among various non-declared services goes beyond the minimum requirements of the CAM, but actually serves no purpose in promoting competition or transparency under the WIC Act. Therefore, we question the rationale for the proposal in the draft Guide to require the CAM to explain and justify how costs are allocated between:

- regulated and unregulated services; and
- all service divisions.

The Cost Allocation Guide should complement and support the framework for access seekers as set out in the WIC Act. We suggest that the Draft Guide is clarified to state that the scope of the CAM is to explain the allocation of costs to and within declared services, and not to explain the attribution and allocation of costs among or within non-declared services.

This additional information might be useful for other IPART reviews and processes as recognised in the Draft Guide. However, Sydney Water considers that the declared services CAM is not the appropriate instrument for IPART to collect this information.

2.2 Capital costs

Section 4.3 of the Draft Guide discusses the method for allocating the RAB across cost objects assigned to services and recognises that there are several options to do this.

Sydney Water agrees with the Draft Guide that the service provider should be provided with the option to propose the appropriate method for making these allocations, consistent with the objectives of the WIC Act and its own circumstances. IPART can then consider and evaluate that method under the CAM approval process.

It would not be appropriate for the Cost Allocation Guide to mandate one particular method for use in allocating existing assets.

2.3 Forecast costs

Section 2.3 of the Draft Guide states that if used for the purpose of setting access prices, the cost allocation methodology would be expected to be applied to a service provider's *forecast* costs.

Sydney Water agrees that the method would apply to the service provider's forecast costs and that the forecast costs should be allocated consistent with any prevailing price determination.

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.

2.4 Fixed and variable costs

Section 3.2 of the Draft Guide states that the service provider should clearly distinguish between fixed and direct variable costs. Sydney Water 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).

2.5 Interconnection Services

Sydney Water supports the inclusion of information on interconnection services into the declared services subject to the information being practical and useful to the access seeker.⁴ To achieve this, Sydney Water considers that the CAM would need to provide:

- a definition of typical “interconnection services”
- a description of the general framework which Sydney Water will apply to determine the proposed costs for such interconnection services.

We are happy to work further with IPART on this issue when we submit the CAM for approval.

2.6 Detail required on cost objects and allocators

Sydney Water is keen to ensure that the CAM is effective in supporting entry and competition. We note that the extent of the information required as proposed in the Draft Guide is detailed. We encourage IPART to consider whether this level of detail could detract from the accessibility and flexibility of the CAM, which could be contrary to the purposes of the CAM under the WIC Act.

In Section 4, 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.
- That underlying cost data is not required to be provided in the CAM.

⁴ Draft Guide, section 2.1.

Sydney Water is also concerned about the proposed requirement to provide numeric quantity data for allocators⁵, i.e. we should provide the method, not actual allocations.

Causal allocators seek to reflect underlying practical and operational cause and effect relationships between services and shared costs. Because these relationships can be expected to change as technologies and operations change, including for reasons of improving efficiency, it is reasonable to expect that allocators will change.

It is also important to appreciate that the choice of allocator will also depend on the quality of the data and information systems. As information systems change and data collection improves, it may become possible over time to better identify or measure allocators that more closely describe causal relationship.

For these reasons, allocators should not be regarded as static or permanent. Therefore, Sydney Water is concerned with the proposed requirement to provide numerical data or a percentage of the allocators applied. This could make the CAM less able to efficiently adapt to changes or system improvements.

We also note that Section 3.3.2 of the Draft Guide (p.12) states that *Information for the chosen allocator should be available at reasonable cost*. Sydney Water considers that this statement should be removed or clarified in the final Guide. It is not necessary for Sydney to be required to provide detailed information (which may be commercial sensitive) to stakeholders under the CAM. This is not required for the CAM to satisfy the objectives.

2.7 Ability to replicate outcomes

Section 4 of the Draft Guide states that information should be provided in sufficient detail to enable a third party, including IPART, to replicate reported outcomes. The draft Guide then defines it to mean “*That is, if all the input information was provided (ie, cost items, cost objects and cost allocators), the third party should be able to reproduce the service provider’s results, by applying the cost allocation methodology as described.*”

Sydney Water considers that the interpretation to be able to replicate reported outcomes, is in principle mistaken and will provide a false perception of the depth of information that must be provided in the CAM. The cost allocation model will not include all the input information as it will not contain data on a service provider’s costs.⁶

Replicating reported outcomes would only be possible if third parties have access to the same input cost data used by Sydney Water to develop access prices – cost items, cost objects and cost allocators are insufficient by themselves. Under the WIC Act, as recognised in the Draft Guide, the CAM is a principle based document and service providers are not required to provide cost data in

⁵ Draft Guide, sections 4.4.2 and 3.3.3

⁶ Some which is highly sensitive and confidential, for example, services provided under out-sourcing contracts

the CAM (which would in any event change yearly). Therefore, the CAM by itself would be insufficient to replicate reported prices.

Sydney Water therefore suggest that the draft Guide should clarify that a CAM is intended to provide a clear understanding of all allocation principles and methods that will be used by the service provider to develop proposed access prices, with sufficient detail that if IPART or other third parties used the same input data, applied the described method they would be able to replicate the same outcomes. Sydney Water advises that this statement is clarified in the final Guide to prevent any misperceptions that the CAM will contain actual cost data.

Generally, there are instances in the draft Guide where IPART applies the term “cost item” to infer actual costs when the correct meaning of this term is a type of cost. For example, section 4 of the Draft Guide states “*Accordingly, a provider should clearly identify the specific operating costs (direct and indirect cost items) allocated to each of the declared services.*” Sydney Water considers that this could be expressed more clearly as follows: “*Accordingly, a provider should clearly identify the **types of** specific operating costs (direct and indirect cost items) allocated to each of the declared services.*” This would further help remove any expectation that the CAM will include actual cost data.

2.8 Checklist and further guidance

Sydney Water agrees that it would be useful for the Guide to include a checklist of requirements and appreciate the draft checklist provided in appendix A. However it seems 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. IPART may also need to review the draft checklist in light of the comments and suggestions we have made in the submission.