

## Allocating corporate capital expenditures to the Greater Sydney Determination

### 1.1.1 Updating our approach to cost allocation

Our approach for allocating costs across the IPART determinations was set out in our Cost Allocation Manual (CAM) which was attached to our Greater Sydney pricing proposal. The CAM was prepared in line with the IPART Cost Allocation Guide.

In the 2016-20 Greater Sydney determination, Greater Sydney received a 67% allocation of corporate capex allowance based on the proportional value of the Greater Sydney RAB, with the balance (33%) allocated to the Rural Valley Determination.

As outlined in our CAM, from 2020, corporate capital projects were proposed to be allocated to each IPART determination based on the proportional value of direct salaries. Under this approach, the Greater Sydney Determination would receive a 37 % allocation of corporate capital projects, while WAMC and Rural Valleys would receive a 28% and 36% allocation of corporate capex, respectively. WaterNSW's original proposal reduced the share of Greater Sydney corporate capex from 67% in the 2016 Greater Sydney determination to 37%.

WaterNSW's is subject to four IPART pricing determinations: Greater Sydney Determination, Rural Valleys (RV) Determination, WAMC Determination and the Murray River to Broken Hill Pipeline Determination. WaterNSW is in a unique position in that its shared corporate capex must be recovered through multiple IPART determinations.

A core element for managing these separate regulatory processes is the adoption of a clear, concise and effective approach to the allocation of shared corporate capex, which is applied consistently across the multiple determinations.

However, WaterNSW notes that the regulatory cycles for each of its determinations are not aligned. Furthermore, the pricing issues concerning WaterNSW's customers will differ across multiple determinations, depending on the customer base, determination specific issues, the context and any bill impact considerations.

Shared corporate capex is assessed by IPART across multiple IPART price reviews. This can cause a number of challenges and sequencing issues for IPART. For example, managing multiple efficiency reviews on the same corporate expenditure plan, maintaining consistent decisions across multiple determinations and implementing pricing outcomes which are acceptable to all customers.

WaterNSW argues that it is not desirable for IPART to consider the allocation of corporate capex in isolation of the impacts to the WAMC and RV determinations.

Upon review, and after considering the flow on implications to the WAMC and Rural Valley determinations, WaterNSW has decided to amend its approach to allocating shared corporate capex to its determinations.

WaterNSW is proposing to allocate shared corporate capex using total expenditures ('totex') (excluding lumpy, one-off capital expenditure)<sup>1</sup> as an allocator, instead of direct salaries. The

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<sup>1</sup> As per the WaterNSW CAM and the calculation for totex to allocate opex overhead across the IPART determinations. WaterNSW totex calculation excludes certain lumpy, one-off project expenditure to ensure overheads are allocated to core, steady state projects.

effect of the revised proposal on WaterNSW’s determinations is shown in the table below:

**Table 1– Impact of updating our approach to cost allocation (\$millions, \$2019-20)**

Segment	Greater Sydney Allocation**	WAMC Allocation*	Rural Valley Allocation
% allocation (Salaries)	37% (\$36.47)	36% (\$24.71)	28% (\$32.81)
% allocation (Totex)	63% (\$59.01)	13% (\$12.27)	24% (\$22.71)
% Variance	+26% (\$22.54)	-23% (-\$12.44)	-4% (-\$10.10)
Marginal Revenue Impact (\$, %) – Salaries	\$1.23 (0.6%)	\$3.99 (15.0%)	<ul style="list-style-type: none"> <li>• Immaterial marginal impact at determination level.</li> <li>• Totex represents a more reliable and stable driver to allocate corporate capex within the Rural Valley Pricing Regions as discussed below in table 2.</li> </ul>
Marginal Revenue Impact (% , %) - Totex	\$1.88 (0.9%)	\$2.01 (7.5%)	
Revenue Impact of change in allocation (\$m, %)	<b>\$0.64 (0.3%)</b>	<b>-\$1.98 (-7.4%)</b>	



\*the marginal bill impact for WAMC has been calculated by measuring the variance (%,\$) from WNSW share of the user revenue requirement as a result of the allocation. The additional revenue for WAMC has been calculated by assuming a 6 year asset live for corporate assets and a WACC of 3.2%. The existing revenue requirement for WNSW share of WAMC services has been calculated by multiplying the FY20 total revenue requirement for water management and planning charges of \$56m in table 7.1 (page 75) of the WAMC Final Report by 44%. The 44% split has been sourced from IPART’s March 2018 advice to the Minister on the allocation of the WAMC revenue requirement between WNSW, DPIE and NRAR.

\*\* We have assumed a WACC of 3.2% for both our pricing proposal inputs and the scenarios. This is to align with the February 2020 WACC market updates and the 2020 Draft Determination for Hunter Water Prices and to present a more accurate assessment of the marginal impacts of WaterNSW’s proposal.



The effect of the revised proposal is to allocate a greater share of corporate capex from WAMC into Greater Sydney (i.e. increase from 37% to 63% for Greater Sydney and a reduction from 36% to 13% for WAMC), while maintaining an allocation rate for Greater Sydney which is comparable to the rate applied by IPART in its 2016-2020 Greater Sydney determination (i.e. 67% in the 2016-2020 determination compared to 63% in the proposal). This proposed change to totex results in greater consistency with our overhead allocation methodology and an allocation to Greater Sydney that is better aligned with the allocations from the 2016 Determination.

WaterNSW’s revised proposal reflects a more holistic approach to allocating shared corporate capex across each of the determinations. WaterNSW has considered a number of factors including the materiality of the impact of the change, consistency, administrative simplicity, pricing stability, and causality as shown in Table 2 below:

**Table 2 – Considerations for moving to a ‘totex’ allocator for corporate capex**

Matters	Considerations
<b>Consistency</b> 	<ul style="list-style-type: none"> <li>• Using totex values to allocate corporate capex to each of the determinations is consistent with the allocation method for indirect and corporate opex. It also represents a more streamlined approach to allocating all indirect and corporate cost (opex and capex) to each of the determinations.</li> </ul>
<b>Administrative simplicity and stability</b> 	<ul style="list-style-type: none"> <li>• Using totex values for both corporate capex and opex provides a practical, simple and equitable allocator for shared corporate assets. It also reduces the need to apply separate allocation processes for both corporate capex and opex.</li> <li>• As WaterNSW is required to allocate shared corporate costs across multiple rural valleys (for both WAMC and RV RABs), WaterNSW has considered the administrative cost of collecting</li> </ul>

	<p>the allocation values for each pricing region or subcategory against the benefits, such as whether the proposed allocator is reliable, accurate and stable.</p> <ul style="list-style-type: none"> <li>• WaterNSW considers that there would be a number of distortionary impacts in using direct salary and wages data to allocate WaterNSW corporate capex across the WAMC and RV subcategories or pricing regions.</li> <li>• Direct salary and wages data for each WAMC and Rural Valley subcategory is not a reliable and stable driver to allocate corporate capex across the WAMC and RV RABs.</li> <li>• For instance, although WaterNSW’s timesheets for direct salaries are accurate and stable at the IPART determination level, these timesheets are less accurate and/or highly unstable at the rural valley or pricing subcategories.</li> <li>• This is because a high proportion of RV salary costs are captured under several ‘all valley’ project codes in WaterNSW’s timesheet system. ‘All valley’ costs are specific to the RV determination. However, they are not specific to a Rural Valley or a WAMC subcategory or pricing region.</li> <li>• ‘all valley’ costs include shared asset services such as the costs incurred by WaterNSW to implement ISO standards, asset standards, audits and dam safety surveillance programs across multiple Rural Valley and WAMC pricing regions.</li> <li>• The use of ‘all valley’ projects for time sheet reporting purposes reflects the operating structure of WaterNSW’s maintenance and operations teams who are responsible for servicing assets across multiple locations and valleys.</li> <li>• Given the nature of these costs and the structure of WaterNSW’ maintenance and operations teams, direct salaries would not represent a reliable and stable driver to allocate shared corporate capex across each Rural Valley or each WAMC subcategory or pricing region.</li> <li>• Totex is seen as a more reliable and stable driver to allocate corporate capex across the WAMC and RV RABs given its accuracy. We also note that WaterNSW’s totex calculation excludes certain lumpy, one-off project expenditure.</li> <li>• The use of totex as an allocator also has the added benefit of avoiding the distortionary impacts of using an unstable allocator as discussed above.</li> <li>• Totex values by subcategory are readily available and easy to calculate, reducing administrative costs and burden to WaterNSW.</li> </ul>
<p><b>Pricing Implications</b></p>	<p>WaterNSW has considered the materiality of the change of approach for both Greater Sydney and the WAMC customers.</p>

	<p>Based on the pricing implications, WaterNSW considers totex values to represent an equitable allocator for shared corporate assets across the IPART determinations.</p> <p>As presented in Table 1, we note that there will be significant price shock to WAMC customers in maintaining the current methodology where corporate capex is allocated to the determinations by salaries.</p> <p>The bill impact for WAMC customers are further compounded due to the following regulatory decisions:</p> <ul style="list-style-type: none"> <li>• The WAMC 2016 determination did not provide sufficient capex allowance for ICT systems and corporate assets to support the transfer of WAMC functions into WaterNSW, including the startup/establishment costs required to support an additional 220+ FTEs, thereby placing additional pressure on WaterNSW's ability to reduce costs and minimise bill impacts for WAMC customers.</li> <li>• in 2012, IPART wrote off the value of the WAMC FY12 starting RAB. Given its low regulatory value, and minimal capex allowance for ICT systems and corporate assets, WAMC charges are particularly sensitive to any proposal to allocate shared corporate capex to the WAMC RAB.</li> </ul> <p>In contrast, using totex values to allocate corporate capex to the determinations can reduce the bill impacts for WAMC customers by approximately 7%. The impact of the change in allocation is relatively minor for Greater Sydney customers (e.g. Sydney Water) at 0.3% as shown in Table 1.</p> <p>WaterNSW observes that its revised Greater Sydney allocation (%) is comparable with the Greater Sydney allocation (%) applied by IPART for its 2016 Greater Sydney determination (i.e. 67% in the 2016-2020 determination compared to 63% in the proposal).</p>
<p><b>Causality</b></p> 	<p>WaterNSW considers totex as an allocator to represent a reasonable proxy for the corporate asset base and is therefore consistent with the IPART causality principle.</p> <p>WaterNSW considers that its amended proposal reflects a more effective approach to allocating corporate capex across the multiple IPART determinations.</p>