

## 1 Introduction

This Issues Paper is the beginning of our targeted consultation on specific parts of our asset disposals policy. We are seeking comment from stakeholders on:

- ▼ the definition of the term “sales value” in our policy
- ▼ the treatment of sales costs – ie, transaction costs incurred in selling or otherwise disposing of assets, and
- ▼ the treatment of remediation costs – ie, the costs incurred in remediating land for sale.

Sydney Water raised these issues in relation to our asset disposals policy, which was first published in our Final Report on our 2016 Determination of Sydney Water’s prices for its monopoly services for the 2016-20 period.<sup>1</sup> We have included our current asset disposals policy in Appendix B of this Paper.

Our approach to asset disposals involves removing the **regulatory value** of an asset from the regulatory asset base (RAB) when the asset is sold or written down. This is the value of the asset as it entered the RAB (if known), adjusted for the effects of depreciation and indexation.

However, for assets purchased before IPART established a RAB for each water business, we are unable to determine the exact regulatory value of assets in the RAB. The RAB for each water business was established using a line-in-the-sand approach, applying a discounted cash-flow method. Therefore, we do not have any data on the efficient value of pre line-in-the-sand assets when they entered the RAB.

To address this, our current asset disposals policy has established a formula for significant pre line-in-the-sand assets and for where the regulatory value of the asset as it entered the RAB is unknown. We will estimate the regulatory value of pre line-in-the-sand assets by multiplying their “sales value” by the ratio of the utility’s RAB at the line-in-the-sand ( $RAB_{LIS}$ ) to the depreciated replacement cost ( $DRC_{LIS}$ ) of its assets at the time of the line-in-the-sand establishment of the RAB. That is:

$$\text{Regulatory value of an asset} = (RAB_{LIS}/DRC_{LIS}) \times \text{sales value of the asset}$$

However, as outlined below, Sydney Water has since raised questions relating to how “sales value” should be defined in the above equation, specifically whether it should be **net of sales costs** and (where relevant) **remediation costs**.

IPART’s response is to seek stakeholder views through this Issues Paper on the definition of “sales value” and the treatment of sales and remediation costs, for the purpose of estimating the regulatory value of assets that regulated utilities sell or otherwise dispose of.

IPART’s policy is to only allow prudent and efficient costs to be included in the RAB and revenue requirement. Therefore, any costs added to the revenue requirement or deducted from the RAB must be prudent and efficient.

This is important because customers should only pay for the efficient costs of services. At the same time, we need to ensure that the right incentives are in place for utilities to dispose of assets that are not needed to provide regulated services.

<sup>1</sup> IPART, Sydney Water pricing review – Final Report, June 2016, pp 283-287.

Closely linked to the issue of defining the term “sales value” is the definition of “receipts from sale” for **non-significant assets** (defined in Appendix B). In our asset disposals policy, we remove the “receipts from sale” from the RAB for all non-significant asset disposals. Given that the purpose of this consultation is to clarify our asset disposals policy, we would also like to clarify whether we should be using consistent terminology - ie, “sales value” for both non-significant and pre line-in-the-sand significant asset disposals. Otherwise, we would need to provide separate definitions for “sales value” and “receipts from sale”.

Our preliminary view is that we should:

- ▼ use the gross “sales value” definition when determining the value of a sold asset to deduct from the RAB
- ▼ incorporate efficient sales costs into the operating expenditure allowance, and
- ▼ assess the prudence and efficiency of remediation costs to determine whether these costs should be included in the operating expenditure allowance.

This definition and approach would apply to significant and non-significant assets, subject to any concerns about the implementation costs or feasibility of this for non-significant assets.

## 2 Review process

We plan to release our decision in December 2017, in advance of our metropolitan pricing reviews in 2018-19 and 2019-20. Our indicative timetable for this review is outlined in Table 1 below.

**Table 1 Timetable for the review of IPART’s asset disposals policy**

Milestone	Timeframe
Release Issues paper	25 September 2017
Submissions due on the Issues Paper	6 November 2017
Release policy paper	December 2017

**Submissions are due by Monday, 6 November 2017. Submissions can be lodged on our website at the asset disposals [review page](#) (see link at bottom of page).<sup>2</sup>**

## 3 Sydney Water asked for clarification of our policy

Sydney Water recently informed us that it was unclear whether the term “sales value” in our asset disposals policy was net of sales costs. Sydney Water proposed that the term “sales value” should be net of sales and remediation costs,<sup>3</sup> otherwise there could be a financial disincentive for it to sell surplus land.<sup>4</sup> This net value, multiplied by the ratio of the utility’s RAB to DRC at the time the initial RAB was established, would then be removed from the RAB when significant pre line-in-the-sand assets are sold.

<sup>2</sup> [www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro-Pricing/Asset-disposals-policy-2017](http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro-Pricing/Asset-disposals-policy-2017)

<sup>3</sup> Remediation costs can be particularly relevant for some land sales.

<sup>4</sup> IPART and Sydney Water officer level meeting, 13 April 2017.

## Identifying the regulatory value of assets in the RAB



Our current asset disposals policy is outlined at Appendix B.

The objective of our asset disposals policy is to determine the value that should be removed from a regulated business's RAB when it disposes of an asset.

For all asset disposals, pre or post line-in-the-sand, we distinguish between **significant** and **non-significant** assets. For significant assets, we use different methods to remove them from the RAB depending on whether they were acquired pre or post line-in-the-sand. For non-significant assets, we apply the same method regardless of when they were acquired – ie, we remove the “receipts from sale” from the RAB for practical simplicity.

Our asset disposals policy centres on the following principle:

**From first principles**, we consider the asset's identifiable regulatory value should be removed from the RAB. This is the value of the asset as it entered the RAB (if known), adjusted for the effect of depreciation and indexation.<sup>5</sup>

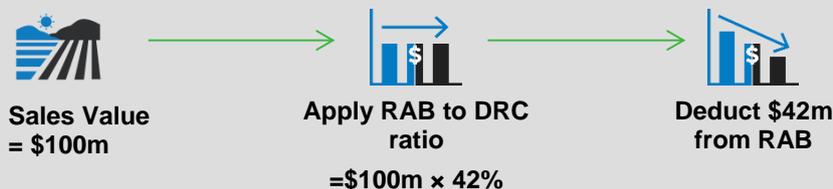
We are able to calculate the regulatory value of assets acquired after the establishment of each utility's line-in-the-sand RAB. Therefore, for the sale of these post line-in-the-sand assets, we remove the original regulatory value included in the RAB (ie, prudent and efficient capital expenditure on the asset), adjusted for inflation and depreciation. The line-in-the-sand RABs for most of the water utilities we regulate were established in 2000.

However, we do not know the exact regulatory value of assets that were purchased before we set a line-in-the-sand RAB. For such assets that are significant, we use the asset's “sales value”, multiplied by the utility's RAB to DRC ratio at the time of line-in-the-sand, as a proxy for their regulatory value. That is, the estimate of a significant, pre line-in-the-sand asset's regulatory value can be expressed as:

$$\text{Regulatory value of an asset} = (\text{RAB}_{\text{LIS}}/\text{DRC}_{\text{LIS}}) \times \text{sales value of the asset}$$

We show in Box 1 how this would work in practice for a RAB to DRC ratio of 42%, using the gross “sales value”. Appendix A contains four worked examples outlining some of the different possible ways we could treat asset disposals.

### Box 1 Sale of a pre line-in-the sand significant asset



<sup>5</sup> IPART, Review of prices for Sydney Water Corporation - From 1 July 2016 to 30 June 2020 , Final Report, June 2016, p 283.

## Our past treatment of asset disposals

Prior to our 2015-16 review of metropolitan water prices (Sydney Water, Hunter Water and WaterNSW) we did not have an asset disposals policy. Asset disposals were handled differently in each review. Removing the “receipts from sale” or an adjusted book value from the RAB were amongst the approaches that had previously been applied.

## 4 What issues are we consulting on?

In response to Sydney Water’s questions, we are consulting on specific aspects of our current asset disposals policy. Key questions include:

- ▼ Should we allow utilities to recover sales and/or remediation costs associated with asset disposals through regulated prices?
- ▼ If so, should this be through:
  - ▽ leaving these costs in the RAB, or
  - ▽ including these costs in the utility’s operating expenditure allowance?
- ▼ What are the implications for the definition of “sales value” for significant pre-line-the-sand assets and non-significant assets?
- ▼ Should we change the terminology for non-significant assets from “receipts from sale” to “sales value”?
- ▼ If we allow regulated businesses to recover sales and/or remediation costs from prices to customers through either leaving them in the RAB or including them in operating expenditure allowances, how can we ensure they are prudent and efficient?

### Clarifying our definitions and terminology

#### The treatment of sales costs

For the purposes of this paper, sales costs are the costs incurred by a regulated utility when it sells an asset (eg, the legal and other transaction costs associated with a land sale).

A key question for this review is should we allow utilities to recover efficient sales costs through their regulated prices and, if so, how?

This question relates to the appropriate definitions of “sales value” (for significant assets) and “receipts from sale” (for non-significant assets) in our assets disposal policy – ie, whether these definitions should be gross or net of sales costs.

If they are net of sales costs, then sales costs are effectively left in the RAB – for the utility to earn a return on and of these costs through its regulated prices. This approach could be applied for significant pre line-in-the-sand assets and non-significant assets, where “sales value” (or “receipts from sale”) is used to calculate a proxy for regulatory value (in the RAB).

However, “sales value” is not used for significant post-line-in-the-sand assets. For these assets, we should be able to identify the regulatory value. Hence, the regulatory value (not the “sales value”) is deducted from the RAB. To include sales costs in the RAB for

significant post line-in-the-sand assets, we would have to deduct the regulatory value net of sales costs or add sales costs to the RAB.

Our preliminary view is that when a significant post line-in-the-sand asset is disposed of we would calculate and remove the exact regulatory value of the asset from the RAB. For non-significant assets (pre or post line-in-the-sand) we would deduct the gross “sales value” from the RAB. For significant pre line-in-the-sand assets we would remove a proportion of the gross “sales value” from the RAB, as indicated by the equation:  $RAB/DRC \times \text{gross “sales value”}$ . However, for all asset sales, we propose applying a prudence and efficiency test to see if sales costs should be added to the utility’s operating expenditure allowance.

### **The treatment of remediation and improvement costs associated with asset sales**

In the context of this paper, remediation costs can be defined as those costs associated with reversing or stopping environmental damage to land before it is sold.

We propose using a prudence and efficiency test to review these costs, to determine their appropriate regulatory treatment.

Our preliminary view is that, where we think remediation costs should be recovered through regulated prices, these costs should be incorporated into the utility’s operating expenditure allowance, rather than incorporating these costs into the RAB.

In deciding whether to provide an operating expenditure allowance for remediation costs, we propose assessing the prudence and efficiency of these costs. Relevant factors may include whether the need to remediate is mandated (ie, required by regulation) or discretionary, whether the land is pre or post line-in-the-sand, and incentives (or otherwise) for the efficient remediation and sale of assets.

We seek views and information on:

- ▼ What is the appropriate regulatory treatment of remediation costs? Does this vary in different circumstances and across different asset classes, eg, pre or post line-in-the-sand?
- ▼ What, if any, requirements do regulated businesses have to remediate land before it is sold?
- ▼ What drives or determines decisions of regulated businesses to remediate or improve land before it is sold?

### **Issues relating to practical implementation**

Further consideration and clarification on implementation of aspects our asset disposals policy may be necessary. Key questions include:

- ▼ Should we subject sales and/or remediation costs that are proposed to be included in the RAB or the operating expenditure allowance to the same prudence and efficiency test that we apply to other building block costs?
- ▼ What are the implications of the answer to the above question for the implementation of our asset disposals policy, including how information is provided to IPART?

Other, related considerations are outlined below.

### Net sales value:

If some form of adjustment to the “sales value” of an asset is necessary, this should be done simply, transparently and accurately. If we adopt the net sales value approach:

- ▼ Should the regulated business be allowed to remove sales and remediation costs from gross sales value and supply us with the **net sales value**?
  - ▽ This may be administratively efficient, however it would not allow us to review the prudence and efficiency of these costs (which would remain in the RAB under the ‘net sales value’ definition).
- ▼ Should we require the regulated business to separately provide us with the sales and remediation cost data that is netted off the sales value, to allow us to assess the prudence and efficiency of these costs?

### Gross “sales value”:

The “gross sales value” approach allows for separate regulatory treatment of sales and remediation costs, and consistent treatment of sales and remediation costs across both pre and post line-in-the-sand assets.

This can enhance transparency, and may help to ensure that only prudent and efficient sales and remediation costs are included in a utility’s notional revenue requirement, and recovered through regulated prices to customers.

### IPART’s assessment of sales and remediation costs:

We may need to amend our annual information return (AIR) to collect data on remediation and sales costs associated with asset disposals.

Depending on the materiality of sales and remediation costs:

- ▼ IPART (and its expenditure consultants) may need to have regard to and develop methodologies for assessing the prudence and efficiency of these costs
- ▼ this may increase the complexity of our expenditure reviews.

## 5 Questions for comment



We would like your feedback on the following questions, and our preliminary position outlined in Section 6. **Our preliminary position is to use a gross “sales value” definition, incorporate efficient sales costs into an operating expenditure allowance, and assess remediation costs using a prudence and efficiency test, to determine if they should be included in the operating expenditure allowance.** We would also apply the same definition/approach to significant and non-significant assets, subject to any concerns about the implementation costs or feasibility of this for non-significant assets. This is shown below.

<b>Question 1</b>	<b>Should our policy refer to gross or net “sales value”?</b>
<b>Context</b>	<p>Sydney Water asked for clarification on whether “sales value” was exclusive or inclusive of sales costs.</p> <p>We are now consulting on whether we should require businesses to report gross or net “sales value”.</p> <p>What types of costs are included in sales costs?</p>
<b>Question 2</b>	<b>How should we account for sales costs in our policy?</b>
<b>Context</b>	<p>Depending on whether we use a gross or net “sales value”, our possibilities for dealing with sales costs include:</p> <ul style="list-style-type: none"> <li>▼ If “sales value” is defined as net of sales costs, we could allow businesses to remove sales costs before submitting “sales value” data to us, ie there is an allowance for sales costs in the RAB, but no IPART review of sales costs.</li> <li>▼ If “sales value” is defined as gross “sales value”, we can ignore sales costs and not factor them into our calculations, ie there is no allowance for sales costs.</li> <li>▼ If “sales value” is defined as net of sales costs, we could remove sales costs based on data provided by the regulated business, ie there is an allowance for sales costs in the RAB, but IPART reviews and deducts prudent and efficient sales costs from “sales value”.</li> <li>▼ If “sales value” is defined as gross “sales value”, we could include efficient sales costs in the business’s operating expenditure allowance – ie, the gross “sales value”, including sales costs, is removed from the RAB, but IPART reviews sales costs and includes efficient costs in the operating expenditure allowance.</li> </ul>
<b>Question 3</b>	<b>Should we make the “sales value” definition and terminology consistent between significant and non-significant asset disposals?</b>
<b>Context</b>	<p>While our policy distinguishes between significant and non-significant asset disposals, the term “sales value” is only used for significant assets, and only if those assets were purchased pre line-in-the-sand. For all non-significant assets, we remove the full “receipts from sale”.</p> <p>If we apply the same definition to significant and non-significant assets (for example, gross “sales value”), we should also make the terminology consistent.</p>

<b>Question 4</b>	<b>Are organisations required to remediate land before sale, or in other circumstances?</b>
<b>Context</b>	<p>For the purpose of this review of our asset disposals policy, remediation costs can be defined as those costs associated with reversing or stopping environmental damage on land before it is sold.</p> <p>We are seeking information on whether remediation is required under legislation or regulation? That is, whether it is discretionary or mandatory, and under which circumstances?</p> <p>Should expenditure on remediation of land be treated as operating expenditure or capital expenditure? How has it been treated to date? Should this be different when an asset is being prepared for sale?</p> <p>What activities are included in remediation?</p>
<b>Question 5</b>	<p><b>Should we adjust the “sales value” for remediation costs?</b></p> <p><b>What is the appropriate regulatory treatment of remediation costs?</b></p>
<b>Context</b>	<p>The proportion of the “sales value” deducted from the RAB could be net of remediation costs. All other things being equal, this would decrease the amount that is removed from the RAB.</p> <p>Alternatively, the proportion of the “sales value” deducted from the RAB could include remediation costs (remediation costs not net of the “sales value”), and the efficient value of these costs could be added to the utility’s operating expenditure allowance.</p> <p>Or, there could be no adjustment for remediation costs, on the basis that the decision to remediate and sell should be one the business makes taking into account the costs and benefits of remediation (and sale).</p>
<b>Question 6</b>	<b>How is the decision to remediate/improve land before sale approached in your organisation?</b>
<b>Context</b>	<p>Do stakeholders have a standard procedure for deciding whether to remediate?</p> <p>Does the decision to remediate land affect your decision to sell?</p>

<b>Question 7</b>	<b>Are there any other costs we should be aware of in refining our asset disposals policy?</b>
<b>Context</b>	<p>We did not explicitly consider remediation costs when we set our asset disposals policy.</p> <p>Are there any other costs we should take into account as we seek to refine our policy?</p>
<b>Question 8</b>	<b>How should we implement your recommendations?</b>
<b>Context</b>	<p>Based on your feedback to questions one to seven, how should we implement what you are recommending as part of our asset disposals policy?</p> <p>Are there any implementation issues that haven't been mentioned and need to be addressed?</p>

## 6 Preliminary Analysis



Below we discuss the decisions we seek to make with regard to our asset disposals policy and the implications of different options.

### Decision 1: Definition of “sales value” used to calculate regulatory value in RAB

Possible outcomes for this decision:

- ▼ Net “sales value” = Gross “sales value” – sales costs
  - ▽ **Implication:** This means that the sales costs will remain in the RAB after the asset has been removed and the business will recover its sales costs over time through the return on and of the RAB (return on only for land because land does not depreciate).
- ▼ Gross “sales value” = “receipts from sale” not taking into account sales costs
  - ▽ **Implication:** For significant pre line-in-the-sand assets, the RAB is reduced by the sales value of the asset multiplied by its RAB/DRC value at the time of the line-in-the-sand. This would result in a greater reduction to the RAB than the “net sales value” approach, as there would be no allowance for sales costs left in the RAB.

### Decision 2: returning efficient sales and remediation costs to the regulated business

Possible outcomes for this decision:

- ▼ Under the net “sales value” approach:
  - ▽ **Implication:** as above, the implications are that the sales and remediation costs (assuming they are capex and have been included in the net “sales value”) will remain in the RAB after the asset has been removed and the business will recover

its sales costs over time through the return on and of the RAB (return on only for land because it does not depreciate).

- ▼ Under the gross “sales value” approach:
  - ▽ **Implication:** sales and/or remediation costs would not be recovered through the RAB. For the utility to recover these costs, they would need to be added to its operating expenditure allowance.

## Our preliminary position

---

Our preliminary position is to:

- ▼ use a gross “sales value” definition for determining the value of the asset to deduct from the RAB when it is sold
- ▼ incorporate efficient sales costs into the operating expenditure allowance, and
- ▼ assess remediation costs using a prudence and efficiency test to determine if they should be included in the operating expenditure allowance.

The gross “sales value” definition would apply to significant and non-significant assets.

We outline this position in Table 2.

We seek comments on our preliminary positions, in addition to responses to the questions outlined in this paper.

**Table 2 Our preliminary position**

Issues to decide	Preliminary position	Analysis
<b>Definition of “sales value”</b>	<b>Gross “sales value”:</b> “sales value” is 100% of the money received from the sale of the asset (unadjusted).	<ul style="list-style-type: none"> <li>▼ Using gross “sales value” in our equation (multiplied by the ratio of RAB to DRC) is the best proxy for the current value of a pre line-in-the-sand asset in the RAB.</li> <li>▼ We want to maintain the current market value unadjusted to reflect that assets enter the RAB at market value and are inflated over time. This allows us to uphold our principle of removing an amount as close to the regulatory value of the asset as possible.</li> <li>▼ This provides greater transparency because any sales costs can be either excluded or included in operating expenditure separately.</li> <li>▼ This also avoids any complications from making adjustments directly to the “sales value”.</li> <li>▼ Separately adding sales costs to the operating expenditure allowance, rather than including in the RAB, enables a consistent treatment of sales costs between significant pre-line-in-the-sand assets where we need to use “sales value” as a proxy for regulatory value, and significant post line-in-the-sand assets where we know the regulatory value and therefore “sales value” is not used.</li> </ul>
<b>Sales costs</b>	<b>Incorporate prudent and efficient sales costs into the operating expenditure allowance</b>	<ul style="list-style-type: none"> <li>▼ We recognise that there are efficient costs associated with selling an asset.</li> <li>▼ These costs should be returned to the business through operating cost allowances in target revenue used to calculate maximum prices.</li> </ul>
<b>Remediation costs</b>	<b>IPART will assess remediation costs for prudence and efficiency to determine if they should be included in the operating expenditure allowance</b>	<ul style="list-style-type: none"> <li>▼ This policy only applies to remediation undertaken for the purposes of selling an asset. It does not apply to improvement or maintenance works undertaken at other times.</li> <li>▼ Requires the use of a prudence and efficiency test to determine if any operating expenditure allowance is required.</li> </ul>

## A Worked Examples

We outline four examples of how our asset disposal policy could treat **pre line-in-the-sand significant asset disposals** (including sales and remediation costs).

- ▼ **Scenario 1** uses net “sales value” for the RAB reduction - ie, gross “sales value” less the costs of selling and remediation.
- ▼ **Scenario 2** uses a “sales value” less the costs of selling for the RAB reduction, and adds the cost of remediation to the operating expenditure allowance.
- ▼ **Scenario 3** uses gross “sales value” for the RAB reduction, and adds the cost of sales to the operating expenditure allowance.
- ▼ **Scenario 4** uses gross “sales value” for the RAB reduction, and adds the costs of sales and remediation to the operating expenditure allowance.

In each scenario, we assume a utility sells a parcel of land for a gross “sales value” of \$100 m. The utility’s RAB/DRC ratio is 42% (value removed from RAB). We also assume that remediation is undertaken by the regulated business in all scenarios. Therefore, the “sales value” reflects the impact remediating the land has on the market value of the land.

**Scenario 1 – using net “sales value” (gross sales value less costs of selling and remediation)**

<p><b><u>“Sales value”</u></b></p> <p>Gross sales value = \$100m</p> <p>Sales Costs = \$5m Remediation costs = \$10m</p> <p>Net sales value = \$85m</p>	<p><b><u>RAB reduction</u></b></p> <p>Net sales value = \$85m</p> <p>RAB reduction <math>\\$85m \times 42\% = \\$35.7m</math></p> <p>RAB less \$35.7m</p>
<p><b><u>Financial impact on customers</u></b></p> <p>Prices fall based on the return on and of \$35.7m</p>	<p><b><u>Financial impact on the utility</u></b></p> <p>The utility keeps gross sales value less cost of sales and remediation= \$85m</p> <p>The utility forgoes return on and of assets on \$35.7m</p>

The utility provides IPART with a net “sales value” (net of sales and remediation costs) of \$85m. That is, the utility removes sales (\$5m) and remediation (\$10m) costs before submitting the ‘net sales’ value to us. The RAB reduction is 42% of \$85m, which equals \$35.7m.

The utility receives the gross “sales value” less sales and remediation costs (\$85m) up front, but foregoes the return on and of \$35.7m. Prices to customers decrease by the return on and of \$35.7m. \$15m of costs remain in the RAB, for the utility to recover its sales and remediation costs.

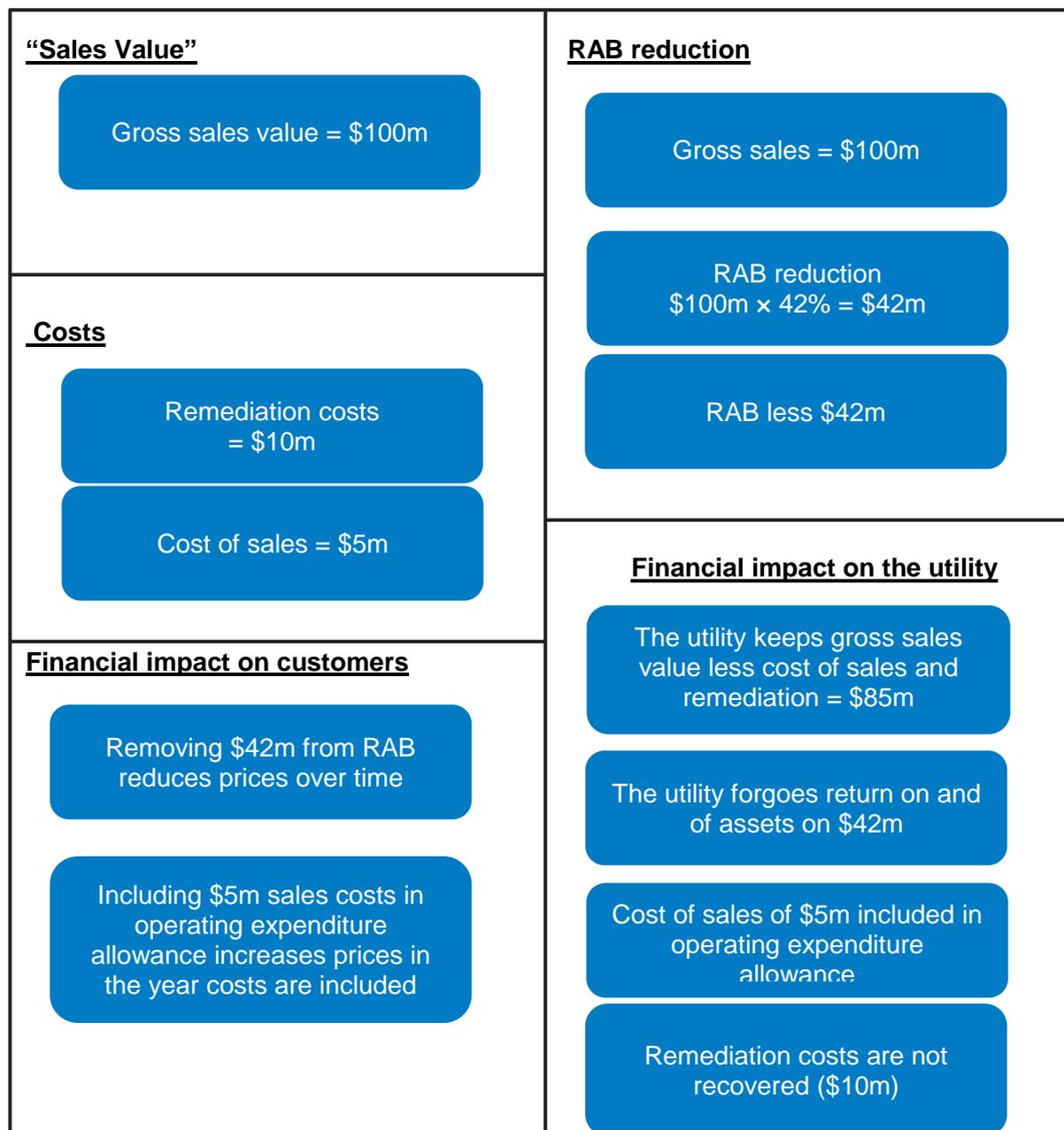
**Scenario 2 – “Sales value” net of sales costs, with separate opex allowance for remediation costs**

<p><b><u>“Sales value”</u></b></p> <p>Gross sales value = \$100m</p>	<p><b><u>RAB reduction</u></b></p> <p>Gross sales value less cost of sales = \$95m</p>
<p><b><u>Costs</u></b></p> <p>Cost of sales = \$5m</p> <p>Remediation costs = \$10m Included in operating expenditure</p>	<p>RAB reduction \$95m × 42% = \$39.9m</p> <p>RAB less \$39.9m</p>
<p><b><u>Financial impact on customers</u></b></p> <p>Removing \$39.9m from RAB reduces prices</p> <p>Remediation costs of \$10m included as operating expenditure increases prices in year costs included</p>	<p><b><u>Financial impact on the utility</u></b></p> <p>The utility keeps gross sales value less cost of sales and remediation = \$85m</p> <p>The utility forgoes return on and of assets on \$39.9m</p> <p>Remediation costs of \$10m included in operating expenditure allowance</p>

In Scenario 2, the utility provides IPART with a net “sales value” (net of sales costs) and the sales cost data. IPART would deduct the sales costs and use the net “sales value” to calculate the RAB reduction. The RAB reduction is 42% of \$95m, which equals \$39.9m.

The utility also provides IPART with any associated remediation cost data. If approved by IPART, remediation costs would be included in the utility’s operating expenditure allowance. The utility receives the gross “sales value” less sales and remediation costs (\$85m) up front, but foregoes the return on and of \$39.9m. Prices to customers decrease by the return on and of \$39.9m, offset by the \$10m remediation costs included in the operating expenditure allowance in the first year.

**Scenario 3 – Gross “sales value”, with opex allowance for sales costs**



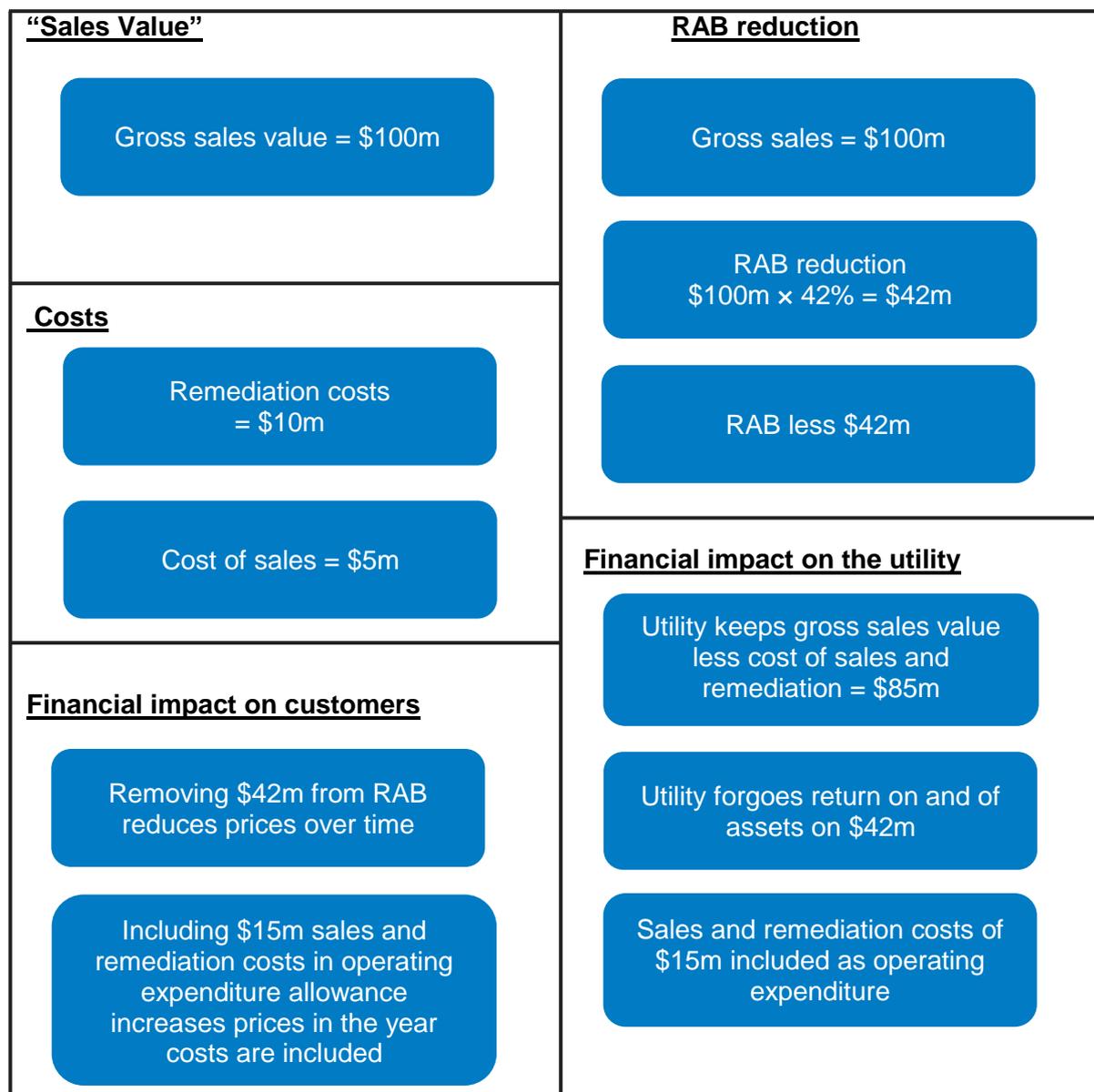
In Scenario 3, the utility provides IPART with a gross “sales value” and the costs it incurred in selling the asset. The utility also reports any remediation costs it incurred as part of the asset sale. Under this scenario, IPART reviews remediation costs on a case-by-case basis and only includes prudent and efficient costs in the operating expenditure allowance.

In this case, IPART assesses the remediation costs are not prudent and efficient and therefore it does not include them in the operating expenditure allowance. The RAB reduction is 42% of \$100m (the gross “sales value”), which equals \$42m; and the efficient sales cost is included in the operating expenditure allowance.

The utility receives the “gross sales value” and the \$5m sales costs back in the same year through its operating expenditure allowance, but foregoes the return on and of \$42m. Prices

to customers decrease by the return on and of \$42m, but this is offset by the increase in the operating expenditure allowance in the first year due to the inclusion of sales costs (\$5m).

**Scenario 4 – Gross “sales value”, with opex allowances for sales and remediation costs**



In Scenario 4, the utility provides IPART with a gross “sales value” and the costs it incurred in selling the asset. The utility also reports any remediation costs it incurred as part of the asset sale. Under scenario 4, IPART includes both efficient sales costs and efficient remediation costs (\$10m) in the utility’s operating expenditure allowance. The RAB adjustment is 42% of \$100m (the gross sales value), which equals \$42m.

The utility receives the “gross sales value” (\$100m) and the \$5m sales costs and \$10m remediation costs back in the same year through its operating expenditure allowance, but foregoes the return on and of \$42m. Prices to customers decrease by the return on and of \$42m, which is offset by the inclusion of sales costs (\$5m) and remediation costs (\$10m) in the first year operating expenditure allowance.

## B Asset disposals policy

### Regulatory treatment of asset disposals

The purpose of this section is to outline our policy framework for asset disposals. The primary issues we considered in relation to asset disposals are:

- ▼ how and when to remove an asset from the RAB, given that it is no longer used to provide regulated services to customers, and
- ▼ whether the business should be provided an allowance in the revenue requirement to pay any capital gains tax resulting from the sale of an asset subject to capital gains tax.

From first principles, we consider the asset's identifiable **regulatory value** should be removed from the RAB. This is the value of the asset as it entered the RAB (if known), adjusted for the effect of depreciation and indexation. We also consider that the business should pay any tax obligations from the regulatory profit it retains.

This approach means the business bears the risk of any profits or losses arising from the sale of an asset, and customers are not affected. We consider this appropriate because, although the asset was purchased by the business to provide regulated services to customers, the benefit customers received came from consuming the service, not owning the asset. Therefore, the impact of any profit or loss should lie entirely with the business (or shareholder).

However, data on the value of individual assets in the RAB and their original cost may be limited. This means that, in many cases, when an asset is sold we will be required to estimate its regulatory value.

We use different methods for estimating the regulatory value of assets when the original cost is unknown, depending on when the asset being disposed entered the RAB (ie, whether it is a pre or post line-in-the-sand<sup>6</sup> asset). We also distinguish between significant and non-significant assets.

#### *Significant asset write-offs*

**Definition:** Assets that are not sold and where the book value of the disposed asset or class of assets accounts for more than 0.5% of the opening value of the RAB in the year in which the asset is disposed.

**Treatment:** These disposals will be dealt with separately, as and when the need arises.

#### *Significant asset sales*

**Definition:** (a) Assets that incur capital gains tax (ie, this includes all land sales), or (b) those where the "receipts from sale" from the asset or class of assets account for more than 0.5% of the opening value of the RAB in the year in which the asset is sold.

<sup>6</sup> The year of Sydney Water's regulatory line-in-the-sand is 2000.

**Treatment pre line-in-the-sand:** Where the regulatory value of the asset as it entered the RAB is unknown, we will estimate its regulatory value based on:

- ▼ the ratio of the RAB to the depreciated replacement cost (DRC) at the time the RAB was established *multiplied by*
- ▼ the sale value of the asset.

We consider the RAB to DRC ratio multiplied by the gross “sales value” (“sales value”) is a good proxy for an asset’s regulatory value because it represents the average value at which all assets were entered into the RAB at the line-in-the-sand (the DRC reflected each business’s actual cost of the individual assets).

The RAB to DRC ratio is also used to determine the regulatory profit from which the business would pay any tax obligation.<sup>7</sup> Our treatment of pre-line-in-the sand assets will allow the businesses to retain a significant proportion of the proceeds from the sale of their assets, removing potential disincentives to sell assets surplus to requirements. It will also mean that customers will not continue to provide the business with a return on or of assets that have been sold, which will be reflected in lower prices.

Given the difficulty of unravelling what assets were operational (and therefore included in the RAB) and what were non-operational at the time the line-in-the-sand was drawn (and the initial RABs established); we consider that we should apply the RAB to DRC ratio to the “sales value” of all pre line-in-the-sand assets.

We first set Sydney Water’s RAB in 2000, the “line-in-the-sand”.<sup>8</sup> To set the RAB at the 2000 line-in-the-sand, we calculated the economic value of Sydney Water’s assets. This was based on the operating profit that Sydney Water was expected to achieve, and our estimate of the appropriate rate of return (the WACC).<sup>9</sup> In subsequent price determinations, we have rolled this RAB forward by adding all prudent and efficient capital expenditure, indexing for inflation, and deducting depreciation and asset disposals.

As the RAB at this point estimated the value of the business as a whole, it is not possible to identify which specific assets contributed to that RAB and in what proportion. However, if a business can make a convincing case that an asset was clearly non-operational at the line-in-the-sand, then, on an exception basis, we would not adjust the RAB for that asset sale.

Table 3 sets out the RAB to DRC ratio for each metropolitan water business. These are the ratios that would be used to determine the regulatory value of assets acquired pre line-in-the-sand to be removed from the RAB.

<sup>7</sup> The regulatory profit would be calculated as ‘sale value of asset x (1-RAB/DRC)’.

<sup>8</sup> IPART, *Sydney Water Corporation - Prices of water supply, sewerage and drainage services - Medium-term price path from 1 October 2000 – Determination and Final Report*, September 2000, pp 20-22.

<sup>9</sup> It did not represent the accounting value of its physical assets. As the calculation used revenue from prices at the time, this ensured that there would be no price shocks to customers resulting from a return on capital calculation using a RAB based on physical asset values multiplied by WACC. See IPART, *Sydney Water Corporation - Prices of water supply, sewerage and drainage services - Medium-term price path from 1 October 2000 – Determination and Final Report*, September 2000, pp 20-22.

**Table 3 RAB to DRC ratio for each metropolitan water business as at line-in-the-sand (2000)**

	RAB at line-in-the-sand (\$billion)	DRC value at line-in-the-sand (\$billion)	RAB to DRC ratio
Sydney Water	5.3	12.5	0.42
Hunter Water	0.8	1.9	0.42
Gosford Council	0.2	0.5	0.42
Wyong Council	0.2	0.4	0.43
WaterNSW (formerly SCA)	0.6	1.7	0.39

**Note:** The RAB to DRC ratio has been calculated using unrounded numbers. In 2000, the book value was the DRC for each of the businesses, except for WaterNSW where we have used an estimated DRC. This is because the 2000 book value for SCA was based on an optimised deprival value rather than a DRC.

**Source:** IPART, *Sydney Water Corporation, Prices of water supply, sewerage and drainage services, Medium-term price path from 1 October 2000*, p 20; Sydney Water Annual Report 2000, p 39; IPART, *Hunter Water Corporation, Prices of water supply, sewerage and drainage services, Medium-term price path from 1 July 2000*, June 2000, p 11; Hunter Water Corporation, Annual Report 1999-2000, p 53; IPART, *Gosford City Council, Prices of water supply, sewerage and drainage services, Medium-term price path from 1 July 2000*, June 2000, p 10; IPART, *Wyong Shire Council, Prices of water supply, sewerage and drainage services, Medium-term price path from 1 July 2000*, June 2000, p 11; IPART, *Sydney Catchment Authority, Prices of water supply services, Medium-term price path from 1 October 2000*, p 17.

**Treatment post line-in-the-sand:** If an asset was acquired after the line-in-the-sand was drawn, then in principle it should be possible to estimate the value of the asset in the RAB (taking into account the effects of depreciation and indexation).

In practice, the available information will differ depending on the type of asset sold and when it was purchased. For example, the purchase cost of a parcel of land may be readily available. On the other hand, the cost of purchasing an old building, converting it to the required standard and maintaining it, may not be available.

We treat these disposals on a case-by-case basis, adopting the underlying principle that we will use our best estimate of the regulatory value of the asset. Some of the options that may be available to us include:

- ▼ tracking actual capex (actual purchase costs and improvements), where possible and practical to do so, and calculating the appropriate depreciation and indexation
- ▼ using an indexed tax value, or
- ▼ using an indexed book value, which may be appropriate for example for plant and equipment, where the book value is generally the depreciated historical cost.

#### *Non-significant asset disposals (sales and write-offs)*

**Definition:** Assets that do not incur capital gains tax (ie, this excludes all land assets) and where the book value of the disposed asset or class of assets accounts for 0.5% or less of the opening value of the RAB in the year in which the asset is disposed.

**Treatment:** Businesses regularly dispose of assets that have not reached the end of their book lives, for example computer equipment, vehicles or water meters. Some of these assets have market value and are sold, while others are simply written off and discarded. These 'normal' disposals are usually very small and have very little impact on the RAB.

We will treat these disposals differently, depending on whether they are sales or write-offs.

For **asset sales**, we will remove the “receipts from sales” from the RAB. We consider that this approach is simple to administer, particularly for disposals that represent a relatively small proportion of the utility’s RAB (ie, less than 0.5%).

For **asset write-offs**, we will not deduct any value from the RAB, except as deemed necessary on a case-by-case basis. This reflects that our decisions on efficient and prudent capital expenditure will take into account the expected asset lives of classes of assets. Where an expenditure review has been undertaken, further adjusting the RAB by using the accounting treatment of asset write-offs risks double counting RAB deductions.