

IPART's asset disposals policy – for water businesses

This policy explains how we intend to treat asset disposals in our water pricing reviews.

It is largely based on our 2016 asset disposals policy, but has been updated following consultation with stakeholders in 2017-18 (as discussed in the accompanying report).

For other businesses we regulate, we will consider applying the principles in this policy when dealing with asset disposals on a case-by-case basis.

The objectives of our asset disposals policy

Our asset disposals policy is aimed at providing support and incentives for good asset management practices, ensuring that:

- ▼ assets that are no longer required to provide regulated services to customers are efficiently sold or otherwise disposed of, so that customers do not continue to have to pay for such assets and they are allocated to their highest value use, and
- ▼ only assets that are surplus to requirements are disposed of (ie, there is no undue incentive to dispose of assets that are required to provide regulated services to customers).

In addition to promoting the efficient disposal of regulated assets, our policy should also:

- ▼ appropriately allocate any risks, costs and/or benefits of asset disposals between the utility and its customers
- ▼ minimise regulatory burden, and
- ▼ provide certainty and stability to the utility and its customers over time.

The key principle of our asset disposals policy

We consider the asset's identifiable **regulatory value** should be removed from the business's Regulatory Asset Base (RAB), when the asset is sold or disposed of. This is the value of the asset as it entered the RAB (if known), adjusted for the effects 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' asset). We also distinguish between significant and non-significant assets to minimise regulatory cost.

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 accounts for more than 0.5% of the opening value of the RAB in the year in which the asset is sold.

Treatment of significant pre line-in-the-sand assets

For a pre line-in-the-sand asset, we will estimate its regulatory value as:

- ▼ 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.

Where 'the sale value of the asset' in this formula is net of prudent and efficient costs incurred in selling the asset (such as sale costs and any remediation costs specifically tied to the sale of the asset).

It is generally not possible to identify the regulatory value of pre line-in-the-sand assets (see Box A.1). However, we consider the sale value multiplied by the RAB to DRC ratio is a good proxy for an asset's regulatory value, because:

- ▼ the RAB to DRC ratio reflects 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), and
- ▼ the sale value multiplied by the RAB to DRC ratio acts as a proxy for the present value of an asset in the RAB (on average), adjusted for indexation and depreciation, under our regulatory model.

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 and of assets that have been sold, which will be reflected in lower prices.

The 'line-in-the-sand' establishment of initial RABs

For many of the utilities we regulate, we set their initial RAB (ie, at the 'line-in-the-sand') using a discounted cash flow valuation method. For example, we first set Sydney Water's RAB in 2000. To set the RAB at the 2000 line-in-the-sand, we estimated the economic value of Sydney Water's assets. We calculated this by discounting the operating profit that Sydney Water was expected to achieve, using the Weighted Average Cost of Capital (WACC). That is, the initial RAB did not represent the aggregation of the accounting value of its physical assets.

As the RAB at this point estimated the value of the business as a whole, it is not possible to identify which specific (**pre line-in-the-sand**) assets contributed to that RAB and in what proportion.

In subsequent price determinations (**post line-in-the-sand**), we have rolled the RAB forward by adding prudent and efficient capital expenditure, indexing for inflation, and deducting depreciation and asset disposals.

Consideration of non-operational assets at the line-in-the-sand

Given the difficulty of unravelling which assets were operational (and therefore included in the RAB) and which were non-operational at the time the line-in-the-sand was drawn (and the initial RABs established), we consider that we should remove the regulatory value of all pre line-in-the-sand assets from the RAB when they are sold (by applying the RAB to DRC ratio to the sales values of these assets).

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.

Examples of RAB to DRC ratios at the line-in-the-sand

Table A.1 sets out the RAB to DRC ratio for each metropolitan water business and WaterNSW (including specific components of WaterNSW). These are the ratios that (when combined with sales values) would be used to determine the regulatory value of pre line-in-the-sand assets for these businesses at point of disposal, which would be the value to be removed from the RAB.

Table 1 RAB to DRC ratio for each metropolitan water business and WaterNSW, as at each line-in-the-sand

Metro businesses	RAB at line-in-the-sand (\$billion)	DRC value at line-in-the-sand (\$billion)	RAB to DRC ratio
Sydney Water (2000)	5.3	12.5	0.42
Hunter Water (2000)	0.8	1.9	0.42
Gosford Council (2000)	0.2	0.5	0.42
Wyong Council (2000)	0.2	0.4	0.43
WaterNSW	RAB at line-in-the-sand (\$million)	DRC value at line-in-the-sand (\$million)	RAB to DRC ratio
WaterNSW (2000)	647.0	1,653.0	0.39
North Coast Valley (2004)	3.5	31.4	0.11
Hunter Valley (2004)	16.2	360.0	0.04
South Coast Valley (2004)	1.6	30.1	0.05
Fish River Valley (2005)	46.5	225.0	0.21

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.

Consideration of alternative methods for estimating the regulatory value of significant pre line-in-the-sand assets

We will consider alternative methods for estimating regulatory values, on a case-by-case basis, in response to a specific request or proposal by a regulated business. For example, this may involve allocating the RAB across a business's assets in proportion to the MEERA or DRC values of the assets.

Treatment of significant post line-in-the-sand assets

If an asset was acquired after the line-in-the-sand was drawn (or if the value of each asset can be identified at the time the RAB was established), 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.

Exceptions to this may occur if there is a legislative requirement for us to treat asset disposals differently. For example, we regulate WaterNSW's prices for its services in the Murray Darling Basin (MDB) under the ACCC's Water Charge (Infrastructure) Rules (WCIR). We will therefore treat WaterNSW's MDB asset disposals as per the requirements of the WCIR. Currently, this means deducting from the RAB the *"actual (or, in the case of the last year of the preceding period, forecast) revenue received by the operator from disposal of assets used to provide infrastructure services in the preceding period."*¹

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 sales value from the RAB, net of efficient sales costs. 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%).

However, on a case-by-case basis, we will consider removing only the identified regulatory value of non-significant assets from the RAB, if this is proposed by the business during a price review and it provides sufficient information to support this proposal and identify the regulatory value (as per our approach for significant post line-in-the-sand assets).

For **asset write-offs**, we will not deduct any value from the RAB, except as deemed necessary on a case-by-case basis. This is because 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.

¹ Water Charge (Infrastructure) Rules 2010, Schedule 2.

Other considerations

Below we consider other considerations associated with the regulatory treatment of asset disposals.

Capital gains tax

We consider that the business should pay any tax obligations from the regulatory profit it retains because capital gains tax is a cost associated with profit only. 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 to be 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).

Blended assets

Blended assets are assets that were acquired before the line-in-the-sand, but where significant capital expenditure has been incurred on the asset after the line-in-the-sand.

We will treat each component of the blended asset separately, in line with this policy. That is, the pre line-in-the-sand component consistent with our policy for pre line-in-the-sand assets, and the post line-in-the-sand component consistent with our policy for post line-in-the-sand assets.

We will consider how to determine the pre and post line-in-the-sand components and regulatory values of blended assets on a case-by-case basis. If a regulated business sells a blended asset, we will ask for its proposal, with proportionate supporting information, on the respective pre and post line-in-the-sand regulatory values. This includes how to allocate a portion of the sale value to the pre line-in-the-sand component of the blended asset.

Compulsory acquisitions

There may be instances where government compulsorily acquires an asset (eg, to build a road, rail line or for other reasons).

If this occurs, we will apply the central principle of our policy. That is, when an asset is sold or otherwise disposed of its regulatory value should be removed from the RAB, and the business should bear the risk of any profits or losses arising from the sale of the asset.