IPART

Independent Pricing and Regulatory Tribunal
New South Wales

Asset Disposals

Policy Paper
(for application to water businesses)

Final Report
Policies

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The Independent Pricing and Regulatory Tribunal (IPART)

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1 Executive Summary

This paper explains how we intend to treat asset disposals in our water pricing reviews. We discuss changes made to our 2016 asset disposals policy[1], following stakeholder consultation and feedback received in response to our September 2017 Issues Paper.[2]

This policy paper directly applies to water utilities we regulate. For other businesses we regulate we will consider applying the principles in this paper when dealing with asset disposals on a case-by-case basis.

1.1 The objectives of our asset disposals policy

Our asset disposals policy should provide support and incentives for good asset management practices, ensuring that:

- Businesses sell or dispose of assets that they no longer require to provide regulated services to customers, so that customers do not continue to have to pay for such assets and they are allocated to their highest value use.
  - Unless it is sold, disposed of or we change the value of the asset in the Regulatory Asset Base (RAB), the value remains in the Regulatory Asset Base.[3] For assets in the RAB, businesses receive allowances for a return on assets and regulatory depreciation (a return of assets) and these costs are incorporated into the prices customers pay.
- Businesses sell or dispose of only assets that are surplus to requirements (ie, there is no undue incentive to dispose of assets that the business needs 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.

1 Our 2016 asset disposals policy is set out in the Final Report accompanying our 2016 Determination of Sydney Water's prices. IPART, *Review of prices for Sydney Water Corporation from 1 July 2016 to 30 June 2020*, Final Report, June 2016, pp 283-287, Appendix H.

2 IPART, *Asset disposals policy consulation – Issues Paper*, September 2017.

3 Note: We only include assets in the RAB that we deem to be prudent and efficient at the time of the expenditure. We can revalue assets if they become under-utilised, for example by 'stranding' the asset.

1.2 In 2016 we established our asset disposals policy

As part of our 2015-16 reviews of prices for Sydney Water, Hunter Water and WaterNSW we established an asset disposals policy. Our 2016 asset disposals policy is outlined in Box 1.2 below.

The primary issues we considered in relation to asset disposals were:

- 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 through regulated prices to pay any capital gains tax resulting from the sale of an asset subject to capital gains tax.

The principle of removing regulatory value

We consider that we should remove the asset's identifiable **regulatory value** from the RAB. 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. This is appropriate because, although the business purchased the asset 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).

Distinguishing between pre and post line-in-the-sand assets in identifying regulatory value

However, in some cases, we hold only limited data on the value of individual assets in the RAB and their original cost. This means that, in these cases, when the business disposes of an asset we will need to estimate its regulatory value (or use a proxy for its regulatory value). This is particularly the case for **pre 'line-in-the-sand' assets** – ie, assets that the business purchased or acquired to provide its regulated services before we established the initial RAB (at the time we made the 'line-in-the-sand' asset valuation). This is because for several water businesses we established the initial RABs using a discounted cash flow (DCF) valuation method. This means that we assigned a regulatory value to these business's assets as a whole, without assigning values to each individual asset, making it impossible to know or calculate an exact regulatory value for these pre line-in-the-sand assets (see Box 1.1 below).

Box 1.1 The 'line-in-the-sand' establishment of initial RABs

For many of the water utilities we regulate, we set their initial RAB (ie, at the 'line-in-the-sand) using a DCF 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. This was calculated 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.

In many cases, we should be able to identify the regulatory value for **post line-in-the-sand** assets, by tracking their values as they enter the RAB and adjusting them for the effects of depreciation and indexation over time. However, there may be some cases where information is lacking, depending on the type of asset sold and when it was purchased.[4]

Under our 2016 policy, we treat **significant post line-in-the-sand asset 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. We noted that some of the options that may be available to us for estimating the regulatory value of significant post line-in-the sand assets 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.

For **significant pre-line-in-the-sand asset disposals**, where the regulatory value of the asset as it entered the RAB is unknown, our 2016 policy stated that 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.

We considered this to be the best available proxy for an asset's regulatory value, as:

- the RAB to DRC ratio reflects the average value at which all assets were entered into the RAB at the line-in-the-sand, 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.

4 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 readily available.

The RAB to DRC ratios for each metropolitan water business as at the line-in-the-sand, as listed in our 2016 policy, are listed in Table 1.1 below.

Table 1.1 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 (2000, 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.

Distinguishing between significant and non-significant assets

We distinguished between **significant** and **non-significant assets**, for pragmatic reasons. We did this so that the reporting requirements for non-significant asset disposals were not too onerous for the regulated business and IPART, given the relatively small value and large number of assets being sold/written-off.

Our 2016 asset disposals policy defined **significant assets** as an asset or class of assets with a value of more than 0.5% of the RAB or assets that would attract Capital Gains Tax (CGT).[5] It defined **non-significant assets** as an asset or class of assets with a value of 0.5% or less of the RAB and which would not attract CGT (see Box 1.2).

Businesses regularly dispose of non-significant assets - for example, computer equipment, vehicles or meters. Some of these assets have residual market value and businesses may choose to sell them. These disposals are usually very small and have very little impact on the RAB.

For non-significant asset disposals, we decided to remove the receipt of sales from the RAB because it is simple and does not have a material impact on the RAB. We considered this approach would be simple to administer, particularly for disposals that represent a relatively small proportion of the utility's RAB (ie, 0.5% or less).

We considered this approach would create a minimal disincentive to selling non-significant assets, because this usually includes a large number of very minor assets (eg, PCs or cars).

5 Asset class that would attract CGT, assuming the asset was acquired after 1985.

Box 1.2 2016 Asset Disposals Policy

Significant asset write-downs (including 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: 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 for pre line-in-the-sand assets: where the regulatory value of the asset as it entered the RAB is unknown, we will estimate its regulatory value as

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

Treatment for post line-in-the-sand assets: best estimate available of the regulatory value of the asset. Options include:

- tracking actual capex (actual purchase costs and improvements), where possible and practical to do so, adjusting for 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:

- For asset sales, we will remove the receipt 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.

Source: IPART, *Review of prices for Sydney Water Corporation from 1 July 2016 to 30 June 2020*, Final Report, Appendix H, June 2016.

1.3 In 2017 we consulted on our asset disposals policy

In September 2017, we released an Issues Paper on our assets disposals policy, seeking comment from stakeholders on:

- the definition of the term "sale value" in our policy
- the treatment of sale 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.

This was in response to Sydney Water asking whether the term "sale value" in our policy was **gross** sale value or sale value **net** of sale and remediation costs. Sydney Water proposed that sale value should be net of sale and remediation costs; otherwise there may be a financial disincentive for it to sell surplus land in some instances.

According to Sydney Water, if sale costs, remediation costs and/or capital gains tax are sufficiently high, the net proceeds Sydney Water receives from the sale of an asset can be less than the amount recovered from its future regulated revenues arising from reducing the RAB by an amount related to the current market value of the asset, particularly in the case of land.[6]

Our preliminary view in our September 2017 Issues Paper was that we should:

- use the gross "sale value" definition when determining the value of a sold asset to deduct from the RAB
- incorporate efficient sale 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.

We also considered that this definition and approach should apply to significant and non-significant assets, subject to any concerns about the implementation costs or feasibility of this for non-significant assets.

We received five submissions in response to our Issues Paper. We have considered these submissions in making decisions to further refine our asset disposals policy in order to provide greater clarity to regulated businesses and their customers and to ensure our asset disposals policy meets its objectives.

A summary of stakeholder submissions and our responses to these is outlined in Chapter 2.

6 IPART and Sydney Water officer level meeting, 13 April 2017.

1.4 We have updated our assets disposal policy

Our updated asset disposals policy is listed in **Appendix A**. Key elements of this are outlined below.

We have maintained the distinction between significant and non-significant assets

To minimise regulatory and administrative costs, we have maintained our distinction between significant and non-significant asset disposals.

For non-significant assets, we consider sale value net of prudent and efficient sale costs should be removed from the RAB

For non-significant assets, we consider sale value net of prudent and efficient sale costs is generally the best available proxy for regulatory value.

However, on a case-by-case basis, as an alternative to our default approach of removing the net sale value, we will consider removing only the identified regulatory value of non-significant assets from the RAB, in line with our approach for significant post line-in-the-sand assets (see below). This would only occur if the business proposed this approach and provided sufficient information to identify the regulatory value.

Where we remove the identified regulatory value, rather than the sale value, from the RAB we would not provide a separate allowance to the business for costs related to the sale of the asset, for reasons outlined below.

For significant post line-in-the-sand assets, we consider the asset's regulatory value should be removed from the RAB, with no allowance for costs incurred in selling the asset

The central principle of our policy is that when an asset is sold or otherwise disposed of, we will remove its regulatory value from the RAB, and the business should bear the risk of any profits or losses arising from the sale of the asset.

Consistent with this, we consider the business should bear any costs and tax obligations that are related to the sale (and not the delivery of its regulated services to customers) from the profit it retains.

Therefore, for significant assets where the regulatory value is known, we will simply remove this value from the RAB when the asset is sold.

For significant pre line-in-the-sand assets where sale value multiplied by the RAB/DRC ratio is used to estimate regulatory value, we consider sale value net of prudent and efficient sale and remediation costs should be removed from the RAB

Our formula for estimating the regulatory value of pre line-in-the-sand assets uses sale value multiplied by the RAB to DRC ratio to impute the regulatory value of disposed assets.

When referencing sale value, we consider that sale value net of the prudent and efficient costs incurred in selling the asset will generate the best proxy for regulatory value. This is because certain activities undertaken specifically to facilitate the sale of an asset, such as

remediation and other sales-related activities, may increase the sale price of the asset and overstate its regulatory value. We therefore consider that we should correct for this as best we can by deducting prudent and efficient sale and remediation costs from the sale value before applying the RAB to DRC ratio.

In a price review, businesses should provide us with their forecast or actual gross sales values for significant pre line-in-the-sand assets, but separately identify their estimates of prudent and efficient sales costs and remediation costs (if any) tied to the sale. At the forecast or actual point of sale, we would then deduct from the RAB the asset's sale value (net of prudent and efficient sale costs) multiplied by the RAB to DRC ratio.

Under our approach, profit (which is the difference between sale value and regulatory value) is retained by the business. Therefore, customers should not contribute to the business's capital gains tax obligations.

We are open to applying alternative methods to estimate the regulatory value of significant pre line-in-the-sand assets

While we have maintained our formula as the standard or default approach, we will consider alternative methods for estimating regulatory values, such as that proposed by Sydney Water in its submission, on a case-by-case basis in response to a specific request or proposal by a regulated business.

We note that any such alternative method would need to be developed to the extent that it could be applied consistently across the whole of the regulated business.

We have updated our policy to include some valley-specific RAB/DRC ratios for WaterNSW

WaterNSW provided RAB to DRC ratios for its coastal valleys and the Fish River Scheme, which we have accepted.

We have also updated our policy to refer to requirements of the Water Charge (Infrastructure) Rules (WCIR), for WaterNSW's MDB valleys

The ACCC's WCIR currently govern our regulation of WaterNSW's prices in the Murray Darling Basin (MDB), and the WCIR currently require the removal of sale revenue from the RAB when an asset is sold.

We have updated our policy to reflect this requirement, specific for WaterNSW's MDB valleys.

Our policy now refers to 'blended assets'

This recognises that some assets may be comprised of pre and post line-in-the-sand capital expenditure (for example, through augmenting existing assets).

1.5 The structure of this report

The rest of this report is structured as follows:

- Chapter 2 outlines stakeholder submissions in response to our Issues Paper and our responses to these submissions, including implications for our asset disposals policy
- Appendix A outlines our updated (2018) asset disposals policy.

2 Our responses to stakeholder submissions

In response to our Issues Paper, stakeholders provided views on the definition of **sale value** and the treatment of **sale costs** and **remediation costs**.

They also raised several other issues related to our asset disposals policy, including:

- potential alternative methods for estimating the regulatory value of pre line-in-the-sand assets (where regulatory value is not known)
- the treatment of capital gains tax
- the distinction between significant and non-significant assets
- using valley-specific RAB to DRC ratios for WaterNSW, and the treatment of WaterNSW's valleys that are subject to the ACCC's *Water Charge (Infrastructure) Rules 2010*
- the treatment of blended assets, and
- the treatment of compulsory acquisitions by Government under our assets disposals policy.

This chapter outlines stakeholder submissions in response to our Issues Paper and our responses to these submissions. All submissions received by IPART are available on our website.

2.1 The treatment of sale and remediation costs

For the purposes of this paper, sale costs are the costs incurred by a regulated utility specifically to sell an asset (eg, the legal, advertising and other transaction costs associated with optimising the sale value of the asset).

Remediation costs are usually the costs associated with reversing or stopping environmental damage to land before it is sold. In this context, remediation costs are the costs of remediation activities specifically tied to the sale or disposal of an asset (as opposed to remediation costs that may be required when the asset is engaged in delivering regulated services).

2.1.1 Stakeholder views

The Public Interest Advocacy Centre (PIAC)

PIAC supports our preliminary position outlined in the September 2017 Issues Paper. PIAC notes:

> While it may be appropriate for businesses to recover the efficient costs from the sale of assets, PIAC does not consider it appropriate for this to be recovered through the RAB. PIAC also

supports IPART retaining discretion in the amount of remediation costs that a business may recover through its regulated revenue.[7]

Sydney Water

According to Sydney Water, the question of whether, and if so, to what extent, the regulated business should be permitted to recover sales and remediation costs from customers, is dependent on the approach to impute an asset value, for deduction from the RAB.

Sydney Water considers that if the approach of imputing asset values with reference to **sale value** is retained, the regulated business should be able to recover from its customers the efficient costs incurred in disposing of the asset - including sale costs, remediation costs and a share of capital gains tax (CGT).

This is because Sydney Water states that, by referencing the asset's sale value, this approach effectively provides customers with access to a share of the profits or losses on the sale of the asset, through the amount deducted from the RAB. Therefore, according to Sydney Water, customers should contribute to the costs associated with those profits or losses.

Sydney Water is also of the view that, where regulatory value is based on 'sale value':

- "sale value" should be defined as **gross** of the efficient costs incurred in the disposal of the asset (eg, sale costs, remediation costs and other efficient costs such as CGT)
- efficient sale costs, remediation costs and other costs incurred in the disposal of an asset (such as CGT) should be separately incorporated into the regulated business's operating expenditure allowance, subject to prudence and efficiency tests (rather than recovered through the RAB using a "net sale value" definition)
- such costs should be forecast at the time of a price review, but subject to true-up at the subsequent price review/determination (in recognition of the difficulty of accurately forecasting such costs)
- the "sale value" terminology and definition should be consistent between significant and non-significant asset disposals.

Notably, Sydney Water considers that where the disposed asset's value to be deducted from the RAB is separately identifiable and is not linked to current market values, the regulated business should **not** recover from its customers the efficient costs incurred in disposing of the asset (eg, sale costs, remediation costs and CGT). Sydney Water notes that this is consistent with IPART's principle that, as owner of the assets, the business should bear the entire risk of profits and losses on the sale of assets.[8]

Hunter Water

Hunter Water considers that "sale value" should be **net** of prudent and efficient sale and remediation costs (which would mean these costs remain in the RAB, to be funded by customers). This is because of the difficulty in accurately forecasting these costs at a price review (to include in a business's forecast operating expenditure allowance for the

7 PIAC submission to IPART, November 2017.
8 Sydney Water submisison to IPART, November 2017.

upcoming regulatory period), combined with IPART's current regulatory approach of not providing for any ex-post 'true up' of individual operating expenditure items.

Specifically, Hunter Water notes:

- It would have difficulty accurately forecasting all sales and remediation costs across a four-year determination period. It does not have a forward plan for asset disposals that extends beyond a year or two, and the extent of remediation costs varies from site to site, and is often not quantifiable until initial investigation work is complete.
- In the absence of an ex-post 'true-up' mechanism, there are risks for both the business and customers in preparing an ex-ante budget of likely sales and remediation costs for a four-year period.
- A RAB adjustment offers a pragmatic approach to treating sales and remediation costs from asset disposals. At a price review, IPART could assess the prudence and efficiency of a sample of asset disposals and adjust Hunter Water's RAB using the net sales value of asset disposals over the previous price period. This would avoid the need for a true-up of operating costs, allow regulatory scrutiny of each asset disposal, and allow the regulated business to recover prudent and efficient costs through time.[9]

Hunter Water considers that the sale value definition should be consistent between significant and non-significant asset disposals, recognising that sale and other costs of disposal may be considered to be immaterial for non-significant assets.[10]

WaterNSW

WaterNSW supports using sale value **net** of sale and remediation costs in the formula to determine the amount to be deducted from the RAB when significant pre line-in-the sand assets are sold. It argues this provides the best incentive for the business, as it provides it with the best return for selling assets.

WaterNSW also notes that including sale and remediation costs in the business's regulated operating expenditure allowance (under the gross sale value approach) may result in price shocks for customers, "particularly having regard to the granular approach to WaterNSW's RAB and operating expenditure for individual rural valleys."

Like Sydney Water and Hunter Water, WaterNSW queries the ability of the regulated business to accurately forecast sale and remediation costs within its pricing proposal. It notes that this leaves the business with an incentive to include an allowance for such costs in its pricing proposal, which may not be realised, impacting customer bills and business budgeting accuracy.

WaterNSW notes that, irrespective of whether an asset is sold, remediation costs may be required to meet environmental and health and safety standards, and that such costs are likely to be included in the RAB.

WaterNSW does not see any negative implications with including sales and remediation costs within the RAB, particularly as this smooths the impact to customers over time, avoiding bill shock.[11]

9 Hunter Water submission to IPART, November 2017, p 5.
10 Hunter Water submission to IPART, November 2017, p A.3.

2.1.2 IPART's response

When referencing sale value, we consider that sale value net of the prudent and efficient costs incurred in selling the asset will generate the best proxy for regulatory value.

This is because certain activities undertaken specifically to facilitate the sale of an asset, such as remediation and other sale-related activities, may increase the sale price of the asset and overstate its regulatory value. We therefore consider that we should correct for this as best we can by deducting prudent and efficient sale and remediation costs from the sale value before applying the RAB to DRC ratio, to estimate the regulatory value of significant pre line-in-the-sand assets. Similarly, we consider that sale value net of prudent and efficient sale costs is generally the best, most readily available proxy for the regulatory value of non-significant assets.

When we refer to sale and remediation costs in this context, we are referring to costs that are tied specifically to the sale of the asset, rather than remediation costs for an asset that is engaged in the delivery of the business's regulated services.[12]

For significant pre line-in-the-sand assets[13], at a price review businesses should provide us with their forecast or actual gross sales values, but separately identify their estimates of prudent and efficient costs incurred in selling the assets (including sales costs and any remediation costs). We will then deduct from the RAB a value equal to the asset's sale value net of our assessment of prudent and efficient sale and remediation costs multiplied by the RAB to DRC ratio. We would then conduct ex-post assessments when rolling forward the RAB at a subsequent price review (see Box 2.1 below).

Our approach is consistent with the key principle in our asset disposals policy that the regulatory value of an asset, or the best estimate or proxy of this value, should be deducted from the RAB when an asset is sold or disposed of, and that the business should bear the risk of any profits or losses arising from the sale of an asset.

11 Water NSW submission to IPART, November 2017, pp 6 to 7.

12 If remediation costs were not tied to the sale of an asset, but instead were required to deliver regulated services, then they should be added to a business's RAB and the relevant asset's regulatory value.

13 Except WaterNSW's assets in the MDB, which are subject to the ACCC's Water Charge (Infrastructure) Rules (WCIR) – see section 2.5 of this report.

Box 2.1 Example – Significant pre line-in-the-sand asset

A regulated business plans to sell a significant pre line-in-the-sand asset in the next regulatory period. Assume the following:

- a forecast gross sale value is $100
- the regulated business has a RAB to DRC ratio of 0.42 (at the line-in-the-sand)
- forecast prudent and efficient sale costs are $2, and
- forecast prudent and efficient remediation costs associated with the sale are $8.

Multiplying the RAB to DRC ratio by the forecast sale value net of our assessment of prudent and efficient sale and remediation costs, we calculate a proxy regulatory value of $37.80. We would remove this value from the RAB at the time the regulated business expects to sell the asset.

At the next price review, we would conduct an ex-post review when rolling forward the RAB, to check that the business sold the asset, the sale value and the date of the sale (compared to forecast). We would also compare actual sale and remediation costs to forecasts, and adjust the RAB for any differences between forecasts at the time of the last price review and actual, prudent costs.

2.2 Alternative methods for estimating regulatory value

Several stakeholders referred to alternative methods for estimating the regulatory value of pre-line-in-the-sand assets, which relate to allocating RAB values to specific assets.

2.2.1 Stakeholder views

Sydney Water

Sydney Water expressed concern with using sale value multiplied by the RAB to DRC ratio as a proxy for the regulatory value of pre line-in-the-sand assets for several reasons:

- many of the assets that it owned at the time of the line-in-the-sand valuation have largely depreciated (in regulatory terms) since that time
- the market value of land has increased significantly since that time, often at a rate well above inflation.

Sydney Water considers that IPART should investigate alternative approaches for determining the regulatory value of pre line-in-the-sand assets that better meet IPART's underlying principle (ie, that the regulated business should bear the risk of any profits or losses arising from the sale of an asset).

In particular, Sydney Water believes there is considerable merit in using its newly developed Cost Allocation Manual (CAM)[14] and information in its Fixed Asset Register (FAR) to estimate the RAB value of each disposed asset. For example, the initial

14 Sydney Water has developed a cost allocation methodology in order to meet the requirement for a CAM for its wastewater services declared under the *Water Industry Competition Act 2006*. Sydney Water's cost allocation methodology does not currently extend beyond these declared wastewater services.

(line-in-the-sand) RAB could be allocated to pre line-in-the-sand assets in proportion to the asset values in the FAR, adjusted for inflation, depreciation and disposals.

According to Sydney Water, such an approach:

> …may remove financial disincentives to sell surplus assets and better meet IPART's underlying principles – including utilising an identifiable regulatory value and protecting customers from key sales risks – while ensuring customers benefit from lower future prices. It may also be simpler to apply and obviate the need for resolving detailed definitional issues around sales value, relevant deductions and grappling with issues of operating cost forecasting.[15]

Hunter Water

Hunter Water can see benefits in applying a cost allocation approach (as proposed by Sydney Water) that produces broadly accurate regulatory values for pre-2000 assets. It states that this approach "directly addresses the underlying asset valuation problem, rather than relying on a 'work around' method that uses current sales values as a part proxy for earlier RAB values."[16]

However, Hunter Water notes that it has not yet developed a cost allocation manual (like Sydney Water's), and that IPART must develop an asset disposal policy that best balances various objectives, while using currently available information. It anticipates that IPART would re-visit its asset disposal policy in the future, if each metropolitan water utility developed and implemented a cost allocation manual that was approved by IPART.[17]

WaterNSW

WaterNSW identified an alternative approach for estimating the regulatory value of assets, which is similar to Sydney Water's proposal:

- For post line-in-the-sand assets, the value could be determined using the cost of the asset as it entered the RAB, then apportioned to the current RAB adjusted to today's valuation.
- For pre line-in-the-sand assets, values could be determined by using MEERA or DORC values of each asset to allocate the RAB across assets as at the time of the line-in-the-sand, adjusted for today's valuation.

However, WaterNSW notes that its book value asset register contains approximately 78,000 individual assets, and it would be costly for it to develop a dataset for the alternative approach. WaterNSW states that without a "mandatory regulatory requirement", it cannot justify this level of expenditure. Therefore, for practical reasons, WaterNSW would not support or adopt the alternative approach in the near term.[18]

15 Sydney Water submission to IPART, November 2017, p 25.
16 Hunter Water submission to IPART, November 2017, p 5.
17 Hunter Water submission to IPART, November 2017, p 5.
18 Water NSW submission to IPART, November 2017, p 8.

2.2.2 IPART's response

We see potential merit in Sydney Water's proposed alternative approach, as well as the approach identified by WaterNSW. Both approaches are similar. They would be a means of more directly estimating the regulatory value of assets.

In the case of Sydney Water, the alternative approach would also bring together and ensure consistency between our treatment of asset disposals and its Cost Allocation Manual.

We would require more information and need to do more analysis on the specific allocation methodologies before being able to apply them. We also note that Hunter Water and WaterNSW's submissions show that not all regulated businesses would readily be able to implement such approaches in the foreseeable future.

Therefore, as a default, we will retain in our policy our method for estimating the regulatory value of significant pre line-in-the-sand assets. However, we will consider alternative methods for estimating regulatory values, such as those proposed by Sydney Water, on a case-by-case basis in response to a specific request or proposal by a regulated business.

2.3 Capital Gains Tax (CGT)

This section discusses Sydney Water's proposal to share CGT with customers when regulatory value is based on sales value, and our response to this proposal.

2.3.1 Stakeholder views - Sydney Water

As outlined above when discussing sale and remediation costs, Sydney Water considers that if the current approach of imputing asset values with reference to **sale value** is retained, the regulated business should be able to recover from its customers the efficient costs incurred in disposing of the asset – including a share of **CGT** (in addition to sale costs, remediation costs, and any other efficient costs incurred in the disposal of the asset).

According to Sydney Water, this is because, by referencing the asset's sale value, this approach effectively provides customers with access to a share of the profits or losses on the sale of the asset, through the amount deducted from the RAB. Therefore, it states that customers should contribute to the costs associated with realising those profits or losses.

In particular, Sydney Water considers that where regulatory value is based on 'sale value', CGT should be shared in the same ratio between Sydney Water's customers and Sydney Water as the RAB to DRC ratio (42:58) is used to share the sale value.

If this does not occur, Sydney Water contends that it would be required to pay the full CGT bill from the disposal of assets, despite the fact that customers share in the profits from sale.

According to Sydney Water, this may have a major impact on its financial incentives to sell the asset – particularly in relation to land sales.[19]

Sydney Water considers that where the regulatory value is **not** based on sale value, the business should **not** be able to recover the efficient costs of disposing of an asset from its customers. That is, in these circumstances, it should not be able to recovery a share of CGT (or sales or remediation costs) from its customers through regulated prices.

2.3.2 IPART's response

CGT is paid on the difference between the cost of an eligible asset and its sale value or, in other words (for the purpose of this paper), the difference between an asset's regulatory value and its sale value.

We use a formula to estimate the regulatory value of significant pre line-in-the-sand assets (sale value multiplied by the RAB to DRC ratio). When a business sells an asset, it receives the sale value and we subtract the regulatory value from its RAB, which means that it retains the profit (being the difference between the sale value it receives and the regulatory value we deduct from its RAB).

As customers do not share in the profit from the sale of an asset, we consider they should not be required to pay any CGT.

2.4 Distinction between significant and non-significant assets

Our 2016 asset disposals policy defines a **significant** asset as an asset or class of assets with a value greater than 0.5% of the RAB or an asset that would attract CGT. This means that assets that do not align with this definition are **non-significant** assets. When a business disposes of a non-significant asset, our policy states that we will simply remove the sale value from the RAB as a proxy for the regulatory value.

We distinguish between significant and non-significant assets in our asset disposals policy to avoid spending an excessive amount of time identifying and removing the value of non-significant asset disposals, which make up a small proportion of the RAB.

2.4.1 Stakeholder views - Sydney Desalination Plant (SDP)

SDP proposed that we remove our distinction between significant and non-significant assets and treat them consistently under our asset disposals policy (ie, only distinguish between assets included in a regulated business's original RAB and those acquired after). SDP notes that the definition and treatment of non-significant assets under our 2016 asset disposals policy is less commercially advantageous than our treatment of significant assets.

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19 Sydney Water considers the current formula for significant pre line-in-the-sand assets (RAB/DRC x sale value) overestimates the land's underlying regulatory value. According to Sydney Water, "As the regulatory value of an asset is assumed to equal 42% of the sale value (regardless of the asset's underlying characteristics), customers often receive a benefit from the sale of land (in the form of an overestimate of the regulatory value, and thus a larger reduction in the value of the RAB and subsequent prices)." (Sydney Water submission, November 2017, p 17).

SDP argues that allowing regulated businesses to keep any profit from the sale of an asset provides the right incentive for these businesses to sell assets no longer used to provide regulated services. However, our treatment of assets defined as non-significant does not allow regulated businesses to keep the profit from their sale, as the full sale value is deducted from the RAB, thus creating a disincentive to sell surplus assets. Further, businesses are unable to recover the cost of selling these assets (through the regulatory profit), creating a stronger disincentive to sell non-significant assets.

Instead, SDP propose that where an asset of any value is identifiable in the RAB, we should remove that value from the RAB at the point in time that it is sold.

SDP also proposes that there the RAB value of the asset being disposed of cannot be determined, then the utility should be allowed to deduct from the RAB a best estimate of the asset value, using one of the options identified in IPART's asset disposal policy for post line-in-the-sand significant assets. This includes tracking actual capital expenditure, adjusted for depreciation and indexation; an indexed tax value; or an indexed book value.[20]

2.4.2 IPART's response

As our default or standard position, we have decided to maintain our policy to distinguish between significant and non-significant asset disposals, and simply remove the sale value (as a proxy for the regulatory value) when a business disposes of a non-significant asset. However, we now clarify that this is sale value net of efficient sale costs.

We consider it is appropriate to use sale value because of the large number of minor assets of regulated businesses (eg, PCs or cars), and hence the potentially high administrative cost of implementing an alternative approach. Further, given the relatively low value of these assets in RABs, we consider that any disincentive our policy creates to dispose of assets is minimal.

We consider it is appropriate to use sale value net of efficient sale costs, because it is a better proxy for regulatory value than gross sale value.

However, on a case-by-case basis, we will consider removing only the identified regulatory value of non-significant assets from the RAB, in line with SDP's proposal, 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).

2.5 RAB to DRC ratios for WaterNSW and treatment of its MDB valleys

WaterNSW raised two issues specific to its business: valley-specific RAB to DRC ratios, and the treatment of asset disposals under the ACCC's Water Charge (Infrastructure) Rules (WCIR).

20 Sydney Desalination Plant (SDP) submission to IPART, November 2017, p 2.

2.5.1 Stakeholder views - WaterNSW

RAB to DRC ratios for the Coastal Valleys and Fish River Scheme

WaterNSW pointed out that our Issues Paper only contained the RAB to DRC ratio for its Greater Sydney operations (the former Sydney Catchment Authority). Its submission set out the RAB to DRC ratio for Greater Sydney and each of its rural valleys subject to regulation under the *Independent Pricing and Regulatory Tribunal Act 1992* (the IPART Act). These ratios are listed in Table 2.1 below.

The ratios for the Coastal valleys (North Coast, Hunter and South Coast) and the Fish River Scheme were derived from NSW Department of Commerce MEERA valuations of State Water Corporation's assets[21] , depreciating them to 2004, the year of establishment of the rural valley's RAB.[22]

Table 2.1 WaterNSW RAB to DRC ratios

Valley	RAB to DRC ratio
Greater Sydney	0.39
North Coast	0.11
Hunter	0.04
South Coast	0.05
Fish River	0.21

Note: Greater Sydney previously calculated by IPART.

Source: Water NSW submission to IPART, November 2017, p 5.

Treatment of asset disposals under the Water Charge (Infrastructure) Rules

WaterNSW also noted that the balance of its rural valleys, which are in the Murray Darling Basin (MDB), are subject to the ACCC's WCIR, and that the WCIR require the regulator to deduct from the RAB the "*actual revenue received by the operator from disposal of assets used to provide infrastructure services*."[23]

WaterNSW is not clear whether "actual revenue" in this context is net or gross of sale and remediation costs, and it seeks clarity on this.

It also points out that the ACCC's 2016 review of the rules recommended that infrastructure operators whose charges are determined by Basin State regulators (such as IPART) would not be bound by Part 6 of the rules. However, it also notes that changes to the rules in line with the ACCC's final advice is not certain.[24]

21 NSW Department of Commerce, State Water Corporation, 2006 MEERA Valuations of 18 Major Dams, Report No. DC06130, July 2006.

22 WaterNSW submission to IPART, November 2017, pp 5 to 6.

23 IPART regulates WaterNSW's prices in the MDB under accreditation from the ACCC, and subject to the WCIR. IPART regulates WaterNSW's prices in its non-MDB valleys under the IPART Act.

24 WaterNSW submission to IPART, November 2017, pp 5 to 6.

2.5.2 IPART's response

RAB to DRC ratios for the Coastal Valleys and Fish River Scheme

WaterNSW's methodology to calculate the RAB/DRC ratios for the Coastal Valleys and Fish River Scheme in Table 2.1 is consistent with the methodology we used to calculate the original RAB to DRC ratios (Table 1.1 in Chapter 1). We will therefore apply the ratios in Table 2.1 as part of our asset disposals policy.

Treatment of asset disposals under the Water Charge (Infrastructure) Rules

We will treat asset disposals subject to the WCIR 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*."[25]

We consider this to be sale revenue net of prudent and efficient costs incurred in selling the asset (such as prudent and efficient sale costs and any remediation costs for the sale).

2.6 Blended assets

WaterNSW queried how we would treat the sale or disposal of 'blended assets' – ie, assets that were acquired before the line-in-the-sand valuation, but where significant capital expenditure has been incurred on the asset after the line-in-the-sand valuation.

2.6.1 Stakeholder views - WaterNSW

In relation to blended assets, WaterNSW noted that when assessing the regulatory value to be deducted from the RAB, IPART would have to apportion some of the proceeds from sale to apply to the formula (sale value multiplied by the DRC/RAB ratio) to estimate the regulatory value for pre line-in-the-sand assets (while the regulatory value for expenditure incurred post line-in-the-sand should be separately identifiable).

It stated that in some cases it may be apparent how to apportion the sale value (eg, km of pipeline), but in other cases it may not. In these circumstances, it proposes that IPART considers its approach on a case-by-case basis.

2.6.2 IPART's response

We will treat the components of the blended asset separately, in line with our asset disposals 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

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

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.

2.7 Compulsory acquisitions by government

SDP identified the issue of potential compulsory acquisitions of assets by various level of government.

2.7.1 Stakeholder views - SDP

SDP noted there are cases where governments compulsorily acquire a utility's assets (eg, to build a road, rail line or for other reasons), and that the value paid may be above or below the asset's RAB value.

SDP states that whilst it is impossible to establish a rule for every type of compulsory acquisition, IPART's asset disposal policy should reflect a principle that ensures the utility that is subject to compulsory acquisition is in no worse financial position (in NPV terms) as a result of the acquisition.

According to SDP, in determining what constitutes a "no worse financial position", the utility should be able to recover its selling costs, asset remediation costs, future regulatory return on the asset and any associated tax liabilities. SDP also states that the utility should not profit from any windfall gains – eg, in the event the compulsory acquisition financial compensation exceeds the RAB value of the asset.

2.7.2 IPART's response

A compulsory acquisition of a regulatory asset by government is likely to be a rare event. This is particularly likely to be the case for the businesses we regulate, where their regulated assets are often used to provide essential services.

We will treat compulsory acquisitions the same as any other asset disposal – ie, this policy would apply and the regulatory value of an asset (or the best available estimate or proxy of the asset's regulatory value) would be removed from the RAB at point of sale or disposal of the asset.

A IPART's asset disposals policy

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

A.1 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.

A.2 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.

A.3 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.

A.4 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.

A.4.1 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.

A.1 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 sale 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 sale 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 A.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.

A.4.2 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.*"[26]

A.5 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 sale value from the RAB, net of efficient sale 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 prudent and efficient 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.

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

A.6 Other considerations

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

A.6.1 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).

A.6.2 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.

A.6.3 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.

Glossary

CAM	Cost Allocation Manual
CGT	Capital Gains Tax
DCF	Discounted Cash Flow
DORC	Depreciated Optimised Replacement Cost
DRC	Depreciated Replacement Cost
MEERA value	Modern Engineering Equivalent Asset
Pre line-in-the-sand	Before IPART originally established the RAB for the regulated business
Post line-in-the-sand	After IPART originally established the RAB for the regulated business
RAB	Regulatory Asset Base
RAB to DRC ratio	The ratio of the original RAB set by IPART to the DRC of its assets from the same time period
Regulated business	A business that provides services IPART is required to set prices for under the IPART Act 1992
Remediation costs	Costs usually associated with reversing or stopping environmental damage to land before it is sold. In this context, remediation costs are the costs of remediation activities specifically tied to the sale or disposal of an asset (as opposed to remediation that may be required to be incurred when the asset is engaged in delivering regulated services)
Sale costs	Costs incurred by the regulated utility to sell an asset (eg, the legal, promotion and other transaction costs associated with optimising the sale value of an asset)