



HUNTER WATER RESPONSE TO IPART CONSULTATION PAPER

ASSET DISPOSALS

NOVEMBER 2017



Enquiries regarding this submission should be directed to Hunter Water Corporation's Manager, Regulatory Policy.

Telephone: (02) 4979 9612

Email: price.review@hunterwater.com.au

Hunter Water Corporation

Response to IPART's Issues Paper: Review of our WACC method

HW2011-1100

Hunter Water Corporation

36 Honeysuckle Drive, Newcastle

PO Box 5171, Hunter Region Mail Centre, NSW 2310

www.hunterwater.com.au

CONTENTS

1	Introduction	1
2	Hunter Water's asset disposal policy	2
3	Regulatory considerations	4
4	References	6
Appendix A:	Hunter Water's response to IPART's consultation paper questions	A.1

1 INTRODUCTION

Hunter Water welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) *Asset disposals – consultation paper* (the consultation paper) released on 25 September 2017.

Hunter Water considers that the current asset disposals policy is generally sound. This response sets out Hunter Water's position on the specific parts of the asset disposal policy for which IPART is conducting targeted consultation:

- the definition of the term "sales value" in IPART's policy
- the treatment of sales costs – i.e. transaction costs incurred in selling or otherwise disposing of assets, and
- the treatment of remediation costs – i.e. the costs incurred in remediating land for sale.

Hunter Water sets out a position on each of the eight questions detailed in IPART's consultation paper in Appendix A.

2 HUNTER WATER'S ASSET DISPOSAL POLICY

Within its overarching Asset Management Policy, Hunter Water's asset disposal policy aims to ensure that the best value is achieved on property transactions through a transparent process that is underpinned by ethical behaviour and compliance with relevant legislation.

Hunter Water's land holdings are reviewed annually through the property disposal plan process. Once a land holding is deemed surplus to Hunter Water's operational requirements the land can be considered for disposal.

The decision whether to dispose of Hunter Water land holdings or assets is tested against a number of criteria to determine whether the land holding or asset should be retained for operational or other purposes or developed or sold to realise its commercial potential. The assessment considers:

- a) Statutory influences (restrictions or limitations) – are there statutory reasons for retaining ownership of the land holding or asset? This will extend to actual or implied trusts that have been established as a result of Hunter Water's acquisition of the land.
- b) Existing and potential usage – is the land holding or asset used or likely to be used to meet existing or future operational needs?
- c) Conservation value – does the land holding or asset have cultural, natural or heritage value that should be maintained?
- d) Site constraints and opportunities – in addition to conservation value, are there other site constraints such as flood liability, land slip, mine subsidence or other physical impairment?
- e) Maintenance issues – what maintenance obligations does Hunter Water have for the land holding or asset?

Should the proposed disposal be impacted by any of these matters, there would be no decision to proceed unless it can be demonstrated that there is a public and/or economic benefit to the disposal or the contract conditions can be structured to ensure that the issue is addressed.

Where a land holding or asset is capable of being sold on the open market the sale shall be by competitive process involving public auction, tender or expression of interest unless circumstances warrant sale by direct negotiation.

Disposals of land are recorded through the Profit and Loss Statement. A disposal approval report is expected to address the following:

- Background of land including the reason for initial acquisition;
- Heritage and/or environmental issues;
- Future development potential (if any);
- Valuation(s);
- Real estate agency appointed for marketing purposes;
- Recommendation for disposal of land;
- Recommendation for a reserve price and/or negotiable limit (if required);
- Request for Delegated Authority to enter into a Contract of Sale (if required).

Contaminated land

All provisions of the Contaminated Land Management Act 1997 must be complied with prior to the disposal of land. If it is known that Hunter Water's operational (or other) activities have contaminated the land as provided for under the above Act, the relevant Authority must be notified.

Due diligence information

All available information, in addition to the vendor disclosure documents under conveyancing legislation, should be made available to prospective purchasers. For example:

- Identification survey;
- Heritage register entry;
- Environmental report;
- Building plans;
- Essential services certificate;
- Rating information (land & water notices);
- Land Tax information (copy of statutory valuation notice);
- Details of service contractors;
- Existence of Leases/Licences.

Valuations

Hunter Water will obtain at least one valuation from a panel valuer to establish the market value, taking into account the highest and best use of the site and any conditions Hunter Water may place on the sale. The only circumstances in which independent valuations would not be obtained are where it can be clearly demonstrated that a property has no marketable value.

3 REGULATORY CONSIDERATIONS

3.1 Regulatory principles

Hunter Water considers that the main principles to apply in considering the specific issues raised in the consultation paper are that the regulatory treatment should:

- support commercial incentives to efficiently dispose of surplus assets;
- allow an appropriate sharing of risks and benefits for customers, the business and shareholder; and
- be administratively simple and transparent.

3.2 IPART's current approach

Hunter Water supports the main elements of IPART's current asset disposals policy¹ which the consultation paper does not propose to change. The main elements in summary are:

- The disposed asset's identifiable regulatory value should be removed from the Regulatory Asset Base (RAB).
- The asset's regulatory value would be the value of the asset as it entered the RAB (if known), adjusted for the effect of depreciation and indexation.
- In the case of significant² pre line-in-the-sand asset sales where the regulatory value of the asset as it entered the RAB is unknown, the value will be estimated 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.
- In the case of significant post line-in-the-sand asset sales, disposals will be considered on a case by case basis, with the underlying principle being to best estimate the asset's regulatory value. Some relevant estimation options are:
 - tracking actual capex (actual purchase costs and improvements), where possible and practical, 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 book value is generally the depreciated historical cost.
- In the case of non-significant asset disposals, the receipts from sales would be removed from the RAB
- In the case of significant asset write-offs, these will be treated separately as and when the need arises
- In the case of non-significant asset write-offs no value will be deducted from the RAB unless considered necessary on a case by case basis.

¹ Appendix B of IPART's consultation paper.

² IPART defines significant asset sales as those involving assets that (a) incur capital gains tax (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.

3.3 Operating costs versus RAB adjustment

IPART's 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.

Hunter Water welcomes IPART's recognition of the costs incurred in remediating land and transacting asset sales. However, Hunter Water does not consider that the inclusion of such costs in an operating expenditure allowance is a workable or practical way of implementing an asset disposal policy.

Hunter Water would have difficulties accurately forecasting all sales and remediation costs across a four-year determination period (or five years from the time a price submission is lodged). Hunter Water considers the possible disposal of assets and surplus land on an ongoing basis, depending in part on market conditions. Hunter Water does not have a forward plan for asset disposals that extends beyond a year or two. Similarly, the extent of any remediation costs varies from site to site, and is often not quantifiable until initial investigation work is complete.

IPART's current regulatory model does not provide for any ex-post 'true up' of individual operating expenditure line items. In the absence of such a 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.

Hunter Water considers that a RAB adjustment offers a pragmatic approach to treating sales and remediation costs from asset disposals. IPART's expenditure consultants could undertake a review or sampling of asset disposals and apply the prudence and efficiency test to actual transactions. Based on this assessment, IPART could reset Hunter Water's RAB at the start of each price period using the net sales value of asset disposals over the previous price period – consistent with scenario 1 in the consultation paper's Appendix A. This approach avoids the need for a true up of operating costs, allows regulatory scrutiny of each asset disposal, and allows the regulated business to recover prudent and efficient costs through time.

3.4 Valuing pre line-in-the-sand assets

Hunter Water understands that Sydney Water and IPART are discussing a potential new cost allocation approach that could change the way in which regulatory values are determined for Sydney Water's fixed assets. Sydney Water's cost allocation manual sets out a method of imputing regulatory values for pre line-in-the-sand assets using the fixed asset register and various cost allocation rules. This approach offers the scope to determine approximate actual asset values, and could replace IPART's current method of determining pre-2000 regulatory asset values.

Hunter Water does not have any declared water or wastewater service under the access regime established in the *Water Industry Competition Act 2006*, and has not had any reason, to date, to develop an equivalent cost allocation manual. Hunter Water recognises that IPART is interested in exploring the scope for some form of component pricing and reviewing the content of regulatory accounts via the Annual Information Return. This may provide the impetus for Hunter Water to develop a procedure for allocating fixed asset costs, including costs for pre-2000 assets.

Hunter Water can see benefits in applying a cost allocation approach that produces broadly accurate values for pre-2000 assets. 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.

Hunter Water accepts that IPART must set a policy for asset disposals that best balances various objectives using currently available information. Hunter Water 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.

4 REFERENCES

Hunter Water Corporation, 2015, *Submission to IPART on prices to apply from 1 July 2016*, October, Newcastle.

Hunter Water Corporation, 2016, *Asset Management Policy*, June, Newcastle.

**APPENDIX A: HUNTER WATER'S RESPONSE TO IPART'S
CONSULTATION PAPER QUESTIONS**

QUESTIONS FOR COMMENT

1. Should our policy refer to gross or net “sales value”?

Hunter Water considers that sales value should be net of sales costs. This is consistent with Hunter Water's response to IPART's issues paper on prices to apply from 1 July 2016 which stated that:

In terms of calculating the asset sale value for the sale of significant pre-2000 assets, the cost of transacting any sales should be deducted from the sales amount.

The netting out of these costs from sales value would be consistent with both their one-off nature and Hunter Water's accounting treatment. Hunter Water notes that it would be difficult to forecast such costs for inclusion in IPART's operating expenditure allowances. Moreover, not allowing sales costs to be deducted from the sales value of surplus assets also reduces the incentive to dispose of them.

2. How should we account for sales costs in our policy?

For administrative simplicity, Hunter Water proposes that businesses remove sales costs before submitting sales value data to IPART. IPART's expenditure reviews could incorporate a review of a businesses' asset disposal policies to ensure they are efficient and sampling the costs associated with asset disposals. In addition all relevant cost data associated with asset disposals can be provided through IPART's Annual Information Return process and would be available for IPART's prudence and efficiency reviews.

3. Should we make the “sales value” definition and terminology consistent between significant and non-significant asset disposals?

Hunter Water considers that the sales value definition should be consistent between significant and non-significant asset disposals, recognising that such costs may be considered to be immaterial in relation to the disposal of non-significant assets.

4. Are organisations required to remediate land before sale, or in other circumstances?

Within the assets disposal policy outlined in section 2, Hunter Water makes decisions regarding required remediation works for surplus land parcels based on an assessment of the land in question. The key considerations in determining the extent if any of remediation works would include:

- the requirements of the *Contaminated Land Management Act 1997*, and
- Council planning requirements regarding works that may be required before land could be rezoned for an alternative use.

For significant parcels of land, Hunter Water would undertake environmental assessments and land use feasibility studies to determine the extent to which remediation works are required to meet regulatory obligations and optimise sale value.

Hunter Water's sale contracts generally contain a clause advising the purchaser that the land is taken in its present condition and releasing the vendor from any claims and demands relating to contamination of the site to the maximum extent permitted by law.

However, in practice, before any sites considered at likely risk of contamination are marketed a soil study would be conducted as under the *Contaminated Land Management Act 1997*, Hunter Water could still be held liable if it was deemed to be the polluter of the site.

Hunter Water's former Dungog Depot site, which is spread over six residential zoned lots, provides a recent example of Hunter Water's approach to dealing with remediation issues. A site soil study was undertaken which identified varying levels of contaminants (primarily lead) across the site. An appropriate remediation plan was implemented and an independent site auditor appointed to sign off on the works prior to consideration of disposal of all or part of the site. This approach allows stakeholders such as the local council and the Environment Protection Authority to be satisfied that the site has been appropriately remediated. This also makes the site more marketable. From a regulatory point of view, once notified the local Council will reference the site as being contaminated under its Section 149 process until such time as a clearance certificate is produced.

Remediation activities which Hunter Water has undertaken on surplus land have included:

- Soil remediation – excavation and disposal;
- Demolition and disposal of redundant infrastructure; and
- Contamination capping works.

Hunter Water applies the relevant accounting standards relating to asset definition and recognition criteria to determine on a case by case basis whether expenditure on remediation of land is treated as operating expenditure or capitalised for statutory financial reporting purposes.

5. Should we adjust the “sales value” for remediation costs? What is the appropriate regulatory treatment of remediation costs?

Hunter Water considers that the proportion of the sales value deducted from the Regulatory Asset Base should be net of remediation costs. This would mitigate against over-estimating the benefits to water users from land disposals and avoids undermining the incentive for disposing of land that is surplus to operational requirements.

Hunter Water considers that it would be impractical to take account of remediation costs and asset sales costs through the operating expenditure allowance due to the difficulty in forecasting such costs over a price path. Remediation costs in particular are largely unknown until the relevant site assessment processes have been undertaken. The timing of land disposals is also difficult to forecast given inherent property market volatility. Accordingly, Hunter Water believes that it would not be sensible to require businesses to submit forecasts of sales and remediation costs that are highly likely to be inaccurate.

Hunter Water notes that allowing for remediation and sales costs through the RAB adjustment process would be more consistent with current practice whereby Hunter Water's RAB is generally adjusted following asset disposals rather than via forecasts.

It would be fairer to customers to only recognise actual costs that have been validated as prudent and efficient and avoid exposing them to potentially unnecessary price increases.

6. How is the decision to remediate/improve land before sale approached in your organisation?

As outlined in the above response to question four, Hunter Water's remediation decisions are made on a case by case basis to meet regulatory requirements and achieve surplus land disposal objectives.

Remediation and sales decisions are often linked, as demonstrated by the Dungog Depot example and decisions regarding the use of former waste water treatment sites.

A recent example involved the sale of a former Hunter Water reservoir site in East Maitland where Hunter Water decided to re-align some pipes ahead of sale but not remove the reservoir due to uncertainty regarding whether the associated cost could be recouped from the sale. These judgments are very much dependent on site specific characteristics and market circumstances.

7. Are there any other costs we should be aware of in refining our asset disposals policy?

Apart from the standard sales transaction and remediation costs, Hunter Water is unaware of any other costs that IPART needs to consider in refining its policy.

8. How should we implement your recommendations?

Hunter Water's proposed recommendations are consistent with the consultation paper's scenario one and could be implemented accordingly. It is envisaged that due to the difficulty in accurately estimating future asset sales that they would generally be considered through subsequent IPART pricing submissions.
