

# Sydney Water submission to IPART's Issues Paper on Asset disposal policy consultation – September 2017

November 2017

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## Executive summary

Sydney Water Corporation (Sydney Water) welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) *Issues paper on its asset disposal policy – September 2017* (the Issues Paper)<sup>1</sup>.

This is an important issue. We are continuously looking to improve the quality and price of services we offer to our customers and the community. In part, we can achieve this by identifying and selling assets which are no longer needed to provide the same, or a better, quality of service for a likely lower bill. However, the current regulatory policy in some cases creates a disincentive for Sydney Water to sell surplus assets. In these instances, the foregone regulated revenue streams (removing surplus assets from the regulatory asset base (RAB)) to Sydney Water is greater than its net proceeds from the efficient sales of surplus assets.

Having the correct and fair regulatory incentives in place for Sydney Water to continue efficiently removing unneeded assets from its RAB will help us deliver all the benefits of efficient asset disposals to our customers and the community, which include:

- customers receive a decrease in the bills paid for products and services supplied by Sydney Water;
- customers no longer pay for assets that are not integral to the provision of services;
- Sydney Water avoids inefficient costs associated with holding surplus assets;
- communities can benefit from the release of surplus land as community spaces such as parks and community centres; and,
- the State benefits from increased land being made available for housing supply in Sydney.

For perspective, Sydney Water holds over 2,200 (necessary and surplus) land assets of which more than 200 were identified as being surplus in 2016 price submission<sup>2</sup> and available to help add to Sydney's housing stock. As we become more efficient in the future, the stock of 200 is likely to grow. Further, for every \$1 of market value of surplus assets we identify for disposal, we are likely able to reduce the regulatory value of the RAB by \$0.42. Without the correct incentives in place our customers and the community may not receive any of these benefits. We consider that this is not in the best interests of our customers or the community.

As a result, working closely with IPART to ensure a better regulatory outcome is vital and we have sought to address the matters raised in the Issues Paper from a perspective of both good regulatory principles and pragmatism. The pragmatic issues include improved consideration of the recognition and recovery of sales, remediation and capital gains taxation costs (a key issue here which we consider also needs to be addressed in this review) incurred in the efficient sale of surplus land assets.

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

<sup>2</sup> Regulatory Treatment of Land Sales. Sydney Water Submission to IPART, April 2015.

While many of suggested ways forward represent sensible incremental improvements, by themselves they will not always be sufficient to completely overcome the regulatory disincentive, and, as a result, are a second-best solution to the issue.

Sydney Water believes that the best solution which achieves the policy objectives and better meets IPART's underlying principles (ie, that the business should bear the risk of any profits or losses arising from the sale of an asset) involves investigating alternative approaches for determining the regulatory value of surplus assets.

In particular, Sydney Water believes there is considerable merit in utilising Sydney Water's newly developed Cost Allocation Manual (CAM) to more accurately impute values for individual regulatory assets. Such an approach would provide Sydney Water with incentives to make efficient decisions concerning the future of assets within its commercial decision-making framework under a simpler and less intrusive regulatory approach. That is, avoiding the need for prudency and efficiency reviews of activities unrelated to the provision of regulated services while ensuring our customers continue to benefit.

## 1 About this submission

This submission outlines Sydney Water's views in relation to IPART's Issues Paper. The Issues Paper consults on specific parts of its asset disposals policy, including:

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

We have developed a submission that outlines Sydney Water's views in relation to these matters as well as a set of broader issues that, in our view, also require addressing to ensure the key policy objectives achieved.

Sydney Water's position on each of IPART's questions (**noted by bold**) is summarised in Table 1 .

**Table 1: Overview of our response to IPART questions raised in the Issues Paper**

Issues Paper
<p><b>1. Should our policy refer to gross or net "sales value"?</b></p> <p>We agree that, where the regulatory value is proxied via the 'sales value', 'sales value' should be defined as gross of the efficient costs incurred in the disposal of the asset (e.g. sales costs, remediation costs and other efficient costs such as CGT).</p>
<p><b>2. How should we account for sales cost in our policy?</b></p> <p>We agree that, where regulatory value is based on the 'sales value':</p> <ul style="list-style-type: none"> <li>• Efficient sales costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB); and</li> <li>• Efficient sales costs should be subjected to efficiency and prudence tests.</li> </ul> <p>We do not agree that, where regulatory value is not based on sales value, that water utilities should be able to recover the efficient sales costs.</p>
<p><b>3. Should we make the "sales value" definition and terminology consistent between significant and non-significant asset disposals?</b></p> <p>Sydney Water agrees that the terminology should be consistent across significant and non-significant assets to ensure clarity and the appropriate application of the asset disposal policy.</p>
<p><b>4. Are organisations required to remediate land before sale, or in other circumstances?</b></p> <p>There are several legislative requirements that compel Sydney Water to remediate surplus land assets, these include:</p> <ul style="list-style-type: none"> <li>• Contaminated Land Management Act 1997 (CLM Act).</li> <li>• Protection of the Environment Operations Act 1997 (POEO Act).</li> <li>• Environmental Planning and Assessment Act 1979 (EP&amp;A Act).</li> <li>• Sydney Water Act 1994 (SW Act).</li> </ul>
<p><b>5. Should we adjust the "sales value" for remediation costs? What is the appropriate regulatory treatment of remediation costs?</b></p> <p>Sydney Water's position is that where regulatory value is based on 'sales value':</p>

- Efficient remediation costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB); and
- Efficient remediation costs should be subjected to efficiency and prudence tests.

We consider that, were regulatory value is not based on “sales value”, water utilities should not be able to recover the efficient remediation costs.

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

As discussed in our response to question 4, legislation is the first driver of determining the requirement of remediation. Following this, Sydney Water commissions independent external experts from a panel to complete a two-step process in regard to prudent and efficient remediation costs. These include:

1. Preliminary Site Investigation (PSI); and
2. Detailed Site Investigation (DSI).

A PSI formally outlines the likelihood of required remediation works for each surplus land asset. If the PSI indicates that remediation is likely required, then a DSI is undertaken.

A DSI is a detailed independent report of the extent of prudent remediation works required to fulfil legislation, along with an action plan (scope of work) to efficiently undertake the remediation works, and an accompanying detailed efficient costing.

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

Sydney Water believes that IPART’s policy for pre line-in-the-sand assets shares the risks of asset ownership and the profits of the sale with customers. In order to ensure that the asset disposal policy is in line with IPART’s principles, consistent treatment of sales, remediation and other efficient costs (such as CGT) is required. In particular, Sydney Water considers that, where regulatory value is based on ‘sales value’:

- A water utility should be able to recover other efficient asset disposal costs, and in particular, Sydney Water proposes that CGT be shared in the same ratio (58:42) between Sydney Water and customers;
- Other efficient asset disposal costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB); and
- Other efficient costs should be subjected to efficiency and prudence tests.

Sydney Water considers that, where regulatory value is not based on ‘sales value’, a water utility should not be able to recover other efficient costs incurred in the disposal of an asset.

#### **8. How should we implement your recommendations?**

As discussed in response to questions 1 to 7, where regulatory values are based on ‘sales value’, Sydney Water considers that efficient sales costs, remediation costs and other efficient costs, such as CGT costs, should be allowed for in operating expenditure allowances. We consider that this should take effect from the beginning of the proceeding 2020 regulatory period (based on forecasts) and then a true-up should be applied in the subsequent regulatory period.

However, should IPART seek to applied a Cost Allocation Manual (CAM) approach to estimating regulatory values, we consider that no efficient sales, remediation or CGT values should be allowed for in operating expenditure allowances in the 2020 regulatory period. Rather, the recognised regulatory value of the identified portfolio of surplus assets is to be removed from the RAB in 2020.

## **1.1 Approach used to develop this submission**

To develop this submission, we carefully considered the Issues Paper and the implications for Sydney Water and our customers, and analysed the changes that have occurred in the policy,

regulatory and commercial operating environments subsequent to our June 2015 proposal and IPART's 2016 Final Report. In particular, we:

- Analysed material changes that have occurred in the policy, regulatory and commercial operating environments subsequent to our proposal being submitted to IPART in June 2016 — such as the development of Sydney Water's Cost Allocation Manual (CAM) which did not exist at the time of the 2016 price review when there was a lack of information on the actual RAB value of individual assets — and the implications of these changes for us and our customers.
- Considered the Issues Paper including:
  - IPART's asset disposal principles and whether they remain 'fit for purpose'; and,
  - Whether the preliminary positions are consistent with achieving the key policy objectives for asset disposal.
- Developed a 'traffic light' system to clearly highlight which aspects of the proposals in the Issues Paper are consistent with achieving the key policy objectives, and based on this assessment, those aspects to which we have:
  - **Agreed** - where the preliminary positions in the Issues Paper are likely to promote the asset disposal principles and our customers' long-term interests ('*green light*')
  - **Partially agreed** - where the preliminary positions in the Issues Paper *could* promote the asset disposal principles and our customers' long-term interests, however further information or refinements are required ('*amber light*')
  - **Disagreed** – where we do not agree with the preliminary positions in the Issues Paper or where aspects of the asset disposal policy are not consistent with the asset disposal principles and our customers' long-term interests ('*red light*').

## 1.2 Structure of this submission

The following chapters of this submission provide detailed comments on the following areas:

- Section 2 — articulates the key objectives and principles for an asset disposal policy.
- Section 3 — assesses the current policy against key principles.
- Section 4 — assesses the proposed policy against key principles.
- Section 5 — provides a summary of which asset disposal costs should be recovered through regulated prices.
- Section 6 — discusses how efficient asset disposal should costs be recovered.
- Section 7 — provides an overview of the issues associated with the current policy and summarises approaches for addressing these issues.

## 2 Objectives of an asset disposal policy

In evaluating IPART's current asset disposal policy and its proposed (or other) modifications, it is important to first clearly articulate what objectives the policy should seek to achieve and key principles which support these objectives. This section sets out an overview of these objectives and principles.

### 2.1 Providing incentives for good asset portfolio management

A regulatory asset disposal policy should support and provide incentives for good asset portfolio management, ensuring that:

- Assets (including land) are held to the extent that they are required for efficient operation and service provision.
- Sound governance processes are in place to ensure only assets that are surplus to requirements are disposed of.
- Assets that are no longer required to provide services (now or in the future), are efficiently disposed of, maximising the return to customers and shareholders.

In Sydney Water's view, a regulatory asset disposal policy is likely to support and provide incentives for good asset portfolio management where it:

- Promotes efficient asset disposal decisions;
- Establishes an appropriate risk allocation and sharing of benefits with customers;
- Minimises regulatory burden/costs; and,
- Provides stability and certainty through time

Each principle is discussed in more detail below.

We encourage IPART to evaluate its asset disposal policy, including refinements to this policy, against these or similarly articulated principles.

#### 2.1.1 Promotion of efficient asset disposal decisions

If assets – especially parcels of land which are more likely to have alternative uses – are surplus to providing regulated services to customers, transferring them to alternative uses should promote economic efficiency (provided the costs of doing so are not greater than the economic benefits in the alternative use).

A fundamental objective of an asset disposal framework should therefore be to **ensure that the regulated business has an incentive to dispose of surplus assets**. Holding onto surplus assets means that the benefits to customers, Sydney Water and the community from the sale of the assets are foregone. In light of this, Appendix A outlines some conditions that must be met in order to ensure the correct asset disposal incentives are present.

#### 2.1.2 Establish an appropriate risk allocation and sharing of benefits with customers

A fundamental principle underlying IPART's new asset disposal policy is that the **business, rather than customers, should bear the entire risk of any profit or losses arising from the sale of an asset, as the benefit to customers came from consuming the service, not owning the**



**asset.** To ensure an internally consistent regime, and to ensure decisions on disposals of different assets (e.g. depending on their age) are not distorted, this principle should be applied consistently as far as possible to all asset disposals.

Another key principle is that **customers should not pay more than the efficient costs of providing services to them** (i.e. they should not pay for assets which are no longer being used to provide services to them). While customers should receive a fair and reasonable share of the benefits of asset disposals, it is important not to allocate an inefficient proportion of the potential sales proceeds to customers such that it no longer becomes financially worthwhile for the business to undertake the transaction. This would prevent efficient economic outcomes and also preclude a price reduction for customers.

### 2.1.3 Minimise regulatory burden/costs

As a general rule, regulation should seek to minimise administrative and compliance costs incurred by both the regulator and the regulated entity. This principle suggests that **the asset disposal framework should be as clear, simple and transparent as possible**. It should also rely, as far as possible, on providing appropriate incentives, rather than detailed regulatory scrutiny extending into activities not directly associated with the supply of regulated services.

### 2.1.4 Provide stability and certainty

Predictability and easily forecast regulatory outcomes are desirable, as they help to minimise risk and variability of outcomes. To ensure businesses can make sound commercial decisions on transactions with significant financial consequences, it is important that the **policy framework is clear and stable**. Lack of certainty or continually changing approaches to the regulatory treatment of asset disposals, will undermine Sydney Water's ability to plan and execute an orderly asset disposal program.

## 3 IPART's current asset disposals policy

Like other regulated water utilities, Sydney Water has over time acquired a portfolio of assets needed to efficiently provide water, wastewater, and stormwater services. As Sydney Water seeks to improve its efficiency over time, assets (including land) become surplus to operational requirements and are sold.

This section briefly sets out IPART's asset disposal policy — including the principles and objectives — and our assessment of the extent to which it is consistent with IPART's asset disposal principles and our customers' long-term interests.

### 3.1 Principles and objectives of IPART's current policy

IPART's asset disposal policy governs the framework for how and when to remove assets from the Regulatory Asset Base (RAB), and ultimately how Sydney Water and our customers are compensated for the disposal of these assets. Previous policies have treated asset disposals differently in each review, with IPART's 2016 Final Report outlining IPART's current policy around deducting the entire sales value from Sydney Water's RAB and key underpinning principles.<sup>3</sup>

In particular, IPART's first principle<sup>4</sup> is that, the 'regulatory value' of the disposed asset should be removed from the RAB. This ensures:

- Customers are not charged a return on assets or regulatory depreciation for assets that are no longer used to provide the regulated services.
- Customers are protected from key sales risks (ie, the business bears the risk of any profits or losses arising from the sale of an asset).

IPART's Issues Paper also recognises the need to ensure the right incentives are in place for utilities to dispose of surplus assets. A major reason for IPART revising its previous policy was a recognition that deducting the entire sales value from the RAB would provide no incentive to Sydney Water to sell any surplus assets, as the reduction in regulated revenue to Sydney Water would always exceed its net sale proceeds, given Sydney Water would also be liable for Capital Gains Tax (CGT) and selling costs.

### 3.2 Current policy for pre- and post- line-in-the-sand assets

IPART's current policy distinguishes between assets which were part of the original 2000 line-in-the-sand RAB and assets which have been added since.

For post 2000 assets, individual RAB values should generally be able to be determined based on purchase cost, regulatory depreciation etc and this value deducted from the RAB when these assets are disposed of.

However, for pre-line-in-the-sand assets individual RAB values have not existed as the starting RAB was an aggregated one for SWC as a whole. In the absence of other information, IPART's policy is to calculate the RAB for these assets to be set at a proportion (42%) of their 'sales value'

<sup>3</sup> IPART, Sydney Water pricing review – Final Report, June 2016.

<sup>4</sup> IPART, Sydney Water pricing review – Final Report, June 2016, p117

on the basis that this was the ratio of the aggregate line in the sand RAB to depreciated replacement cost (DRC) at the time (2001) the initial RAB was set. IPART contends that using gross “sales value” (multiplied 42%) is the best proxy for the current value of a pre line-in-the-sand asset in the RAB. It states that it wants to maintain the current market value unadjusted to reflect the value assets enter the RAB and are inflated over time, allowing IPART to uphold their principle of removing an amount as close to the regulatory value of the asset as possible.





It is clear from IPART’s stated rationale for its approach to valuing pre line-in-the-sand assets that inclusion of an asset’s sales value in the formula for estimating its regulatory value stems **from the lack of identifiable regulatory values for these assets, rather than being a preferred approach in principle.**

### 3.3 Evaluating IPART’s current policy

As noted above, IPART’s current policy **could in some circumstances reduce Sydney Water’s incentive** to dispose of surplus assets. In particular, as shown in Table 2 (and discussed in more detail below), in considering the application of the proposed policy in practice, Sydney Water has encountered issues which suggest further evolution is required. These include

- Lack of clarity on key definitions affecting the calculations.
- Related to this, the potential for the policy to continue to, in some cases, provide a financial disincentive for Sydney Water to undertake efficient asset disposals.

Table 2: Assessing the current asset disposals framework against the policy objectives

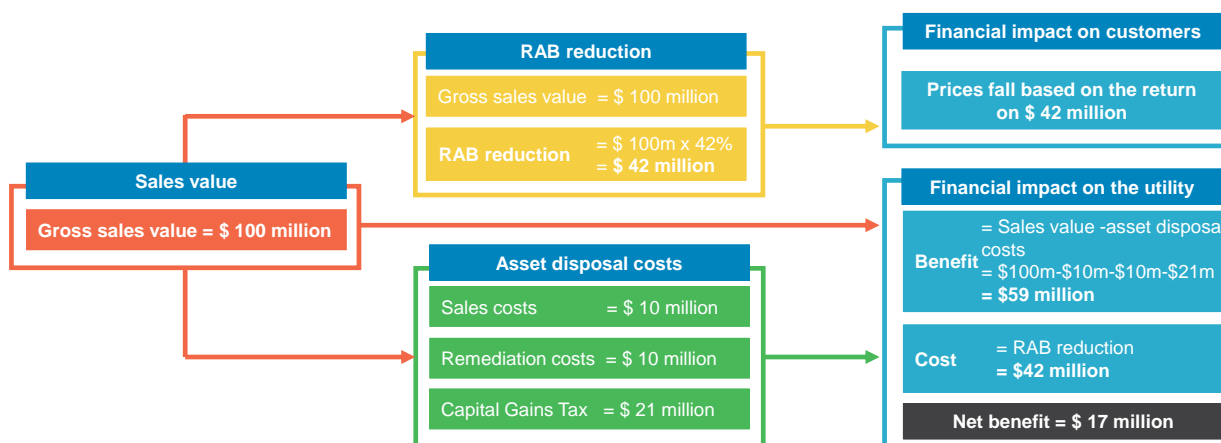
Objective	Our assessment	
Promotion of efficient asset disposal decisions	In some cases it is possible for negative NPV outcomes from selling surplus assets held by Sydney Water in some cases.	
Appropriate risk allocation and sharing of benefits with customers	The current policy does not meet the principles (ie, it does not protect customers from sales risks etc), and can provide disincentives for efficient asset sales which can benefit customers through lower future prices.	
Minimise regulatory burden/costs	At face value, the current policy for determining RAB reductions would seem relatively simple to administer and comply with.	
Provide certainty	Some of the wording in the determination is ambiguous and requires clarification.	

#### 3.3.1 Promotion of efficient asset disposal decisions

As shown in Figure 1 and Figure 2, Sydney Water has found that, in some cases, selling land generates negative NPV cashflow outcomes for Sydney Water. This is because **the net proceeds Sydney Water receives from a sale of an asset can be less than the reduction in 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.** Thus, when Sydney Water sells an asset there are two offsetting financial flows:

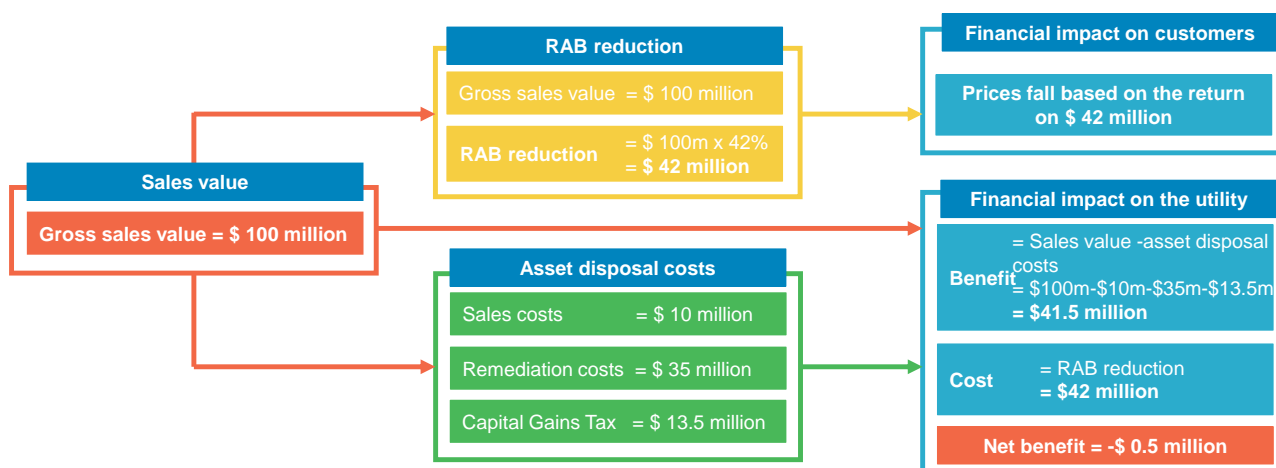
- It receives a 'gross sales value' in the price paid by the buyer of the asset, but its gross proceeds are reduced by costs associated with preparing a land asset for sale (such as remediation costs which can be significant) and associated selling costs, and CGT liability.
- Its future revenues are reduced because its RAB is reduced by 42% of the sales value of the asset (on which it no longer receives a return on and of capital).

Figure 1: Scenario one- Lower remediation costs: "Sales value" is equal to gross sales value, with no allowance for asset disposal costs (IPART's current policy)



Note: this assumes a tax value of \$10 million and that the present value of the return on the RAB reduction is equal to the RAB reduction (i.e. that the return on the RAB is equal to the discount rate)

Figure 2: Scenario two- higher remediation costs: "Sales value" is equal to gross sales value, with no allowance for asset disposal costs (IPART's current policy)



Note: this assumes a tax value of \$10 million and that the present value of the return on the RAB reduction is equal to the RAB reduction (i.e. that the return on the RAB is equal to the discount rate)

### 3.3.2 Appropriate risk allocation and sharing of benefits with customers

In our view the current policy, by linking the imputed RAB value of pre line-in-the-sand assets to current market values, is not consistent with IPART's stated principle: that the

business should bear the risk of any profits or losses arising from the sale of an asset, and customers should not be affected.

Under the current policy for pre line-in-the-sand assets, customers are in effect benefiting from ownership of the asset when it is sold, contrary to IPART's statement that customers should benefit from consuming the service, not from ownership of the asset. In fact, under the current policy, customers share in the benefits from asset ownership but do not bear any of the risks in doing so. This is clearly an asymmetric risk allocation.

### **3.3.3 Minimisation of regulatory burden/costs**

At face value, the current policy would seem relatively simple to administer and comply with. For post 2000 line-in-the-sand assets, there is an existing regulatory value for the asset to remove from the RAB, while for pre line-in-the-sand assets the policy requires multiplying the gross sales value by the 42% ratio specified (as IPART does not consider the other costs incurred by Sydney Water in preparing assets for sale, such as associated selling costs, and CGT liability).

### **3.3.4 Provide certainty**

Linking the imputed RAB value of surplus pre line-in-the-sand assets to current 'sales value' gives rise to definitional issues of how 'sales value' is to be calculated for the purposes of this policy (e.g. net or gross of sales costs and, where relevant, how remediation costs ought to be captured). As noted below, in response to Sydney Water, IPART is in the process of providing In April 2017, greater clarification on how sales and remediation costs should be treated from a regulatory perspective.

## 4 IPART's revised policy: preliminary position

This section briefly sets out IPART's proposed asset disposal policy and our assessment of the extent to which it is consistent with IPART's asset disposal principles and our customers' long-term interests.

### 4.1 Overview of IPART's preliminary position

For assets where the regulatory value is unknown (e.g. currently for pre line-in-the-sand assets), IPART's preliminary position is to base the regulatory value on a proportion of the sales value of the asset. In particular, IPART proposes to:





- Continue to use a gross "sales value" definition for determining the value of an asset to deduct from the RAB (multiplied by the ratio of RAB to DRC at the time of the line-in-the-sand (42%).
- Incorporate efficient sales costs into the operating expenditure allowance, subject to a prudence and efficiency test.
- Assess remediation costs using a prudence and efficiency test to determine if they should be included in the operating expenditure allowance.
- While IPART does not state this explicitly, it appears that it proposes to incorporate sales and remediation costs into the operating expenditure allowance in respect of sales of both pre and post -line-in-the-sand assets.
- As it has not raised the issue of Capital Gains Tax (CGT) in the Issues Paper, the proposed revised policy is that the regulated business would continue to bear all the CGT payable on sale of an asset.

### 4.2 Evaluation of IPART's preliminary position

While IPART's preliminary position outlined in its Issues Paper represents an improvement on the current policy, as shown in Table 4 (and discussed in more detail in the following sections), in our view it still has some significant shortcomings. In particular, IPART's current policy assumes that the RAB to DRC ratio (42%) multiplied by sales value is a good proxy for an asset's regulatory value because it represents the average value at which all assets were entered into the RAB at the line-in-the-sand. However, Sydney Water does not accept this is a reasonable assumption for a number of reasons:

- Many of the assets which were owned by Sydney Water at the line-in-the-sand can be expected to have largely depreciated (in regulatory terms) since that time.
- The market value of land has increased significantly since that time, often at well above inflation.

Table 3: Assessing IPART's proposed revised asset disposal framework against the policy objectives

Objective	Our assessment	
Promotion of efficient asset disposal decisions	It is still possible for negative NPV outcomes from selling surplus assets held by Sydney Water in some cases	
Appropriate risk allocation and sharing of benefits with customers	Linking of the imputed RAB value of pre line-in-the-sand assets to current market values does not meet the principles (ie, it does not protect customers from sales risks), and can provide disincentives for efficient asset sales which would benefit customers in lower future prices	
Minimise regulatory burden/costs	As noted by IPART, the proposed approach may increase the complexity of expenditure reviews, however this will depend on IPART's approach to undertaking prudency and efficiency reviews of activities unrelated to the provision of regulated services	
Provide certainty	The revised policy provides clearer definitions of terms, although it does introduce uncertainty around the process for prudency and efficiency reviews, given the limited information provided on the factors IPART will consider in evaluating prudency and efficiency.	







As discussed in more detail in Section 7, Sydney Water considers that there are now alternative approaches available to better estimate the regulatory value of individual pre line-in-the-sand assets which should be considered.

However, as discussed in more detail below, where IPART retains the use of "sale value", it should recognise that this approach is in effect giving customers a right to a share of any profit or losses on the sale of an asset. This outcome runs counter to its underlying principle that customers are not owners of the assets and so the business should bear the entire risk of any profits or losses arising from the sale of an asset. In addition, this treatment also has direct implications for whether and how asset disposal costs (including CGT payable on capital gains from holding assets) should be recovered.

## 5 Which asset disposal costs should be recovered through regulated prices?

This section provides an overview of our responses to IPART's preliminary view which asset disposal costs should be recovered through regulated prices. In particular, Table 4 provides a summary of our responses to IPART's preliminary view, while the following sections provide more detail around each issue.

Table 4: Overview of our response to IPART's preliminary view on the recovery of efficient asset disposal costs

Preliminary view	Our assessment	
<b>Where regulatory value is not based on sales value (e.g. currently for post line-in-the-sand assets)</b>		
<i>Recovery of efficient sales costs</i>	Where regulatory value is not based on sales value, we do not agree that a water utility should be able to recover the efficient sales costs associated with disposing of an asset.	
<i>Recovery of efficient remediation costs</i>	Where regulatory value is not based on sales value, we do not agree that a water utility should be able to recover the efficient remediation costs associated with disposing of an asset.	
<i>No recovery of other efficient costs</i>	Where regulatory value is not based on sales value, we agree that a water utility should not be able to recover the other efficient costs associated with disposing of an asset.	
<b>Where regulatory value is based on sales value (e.g. currently for pre line-in-the-sand assets)</b>		
<i>Recovery of efficient sales costs</i>	We agree that, where regulatory value is based on sales value, a water utility should be able to recover the efficient asset sales costs.	
<i>Recovery of efficient remediation costs</i>	We agree that, where regulatory value is based on sales value, a water utility should be able to recover the efficient asset remediation costs.	
<i>No recovery of other efficient costs</i>	We consider that, where regulatory value is based on sales value, a water utility should be able to recover other efficient costs incurred in the disposal of an asset, such as CGT.	

IPART's first principle underpinning their policy is that, the 'regulatory value' of the disposed asset must be removed from the RAB. IPART states that this ensures customers are not charged a return 'on' and/or 'of' (for depreciable) assets no longer used to provide regulated services. This principle seeks to ensure the correct incentives are generated for utilities to dispose of surplus assets.

However, the extent to which IPART's proposed asset disposal policy is in line with this principle, depends on whether the asset's regulatory value is already known (as is the case for post line-in-the-sand assets) or imputed from the asset's sales value (as is the case for pre land-in-the-sand assets).



The following sections discuss the recovery of efficient asset disposal costs for post line-in-the-sand assets (Section 5.1) and pre line-in-the-sand assets (Section 5.2).

## 5.1 Recovery of efficient asset disposal costs (post line-in-the-sand assets)

### 5.1.1 IPART's proposed approach

IPART recognises that utilities incur costs in selling an asset, such as:

- **Sales costs** – the costs incurred by a regulated utility when it sells an asset (e.g. the legal and other transaction costs associated with a land sale).
- **Land remediation costs** – the costs associated with reversing or stopping environmental damage to land before it is sold.

Seeking to ensure that the correct incentives are in place for utilities to dispose of surplus assets, and recognising that costs are associated with asset sales, **IPART has proposed utilities could recover prudent and efficient sales and remediation costs** associated with the disposal of post line-in-the-sand assets. **IPART has proposed not to allow water utilities to recover other efficient costs incurred in the disposal of an asset.**

### 5.1.2 Sydney Water's comments

Sydney Water considers that the question of whether, and if so, to what extent, the business should be permitted to recover sales and remediation costs from customers, is **dependent on the approach to impute a RAB value, for deduction from the RAB**. That is, Sydney Water proposes that **where the RAB value to be deducted is separately identifiable and is not linked to current market values, the business should not recover the efficient costs incurred in disposing the asset** (e.g. sales costs, remediation costs and CGT). We consider that this is consistent with IPART's principle that, as owners of the assets, the business should bear the entire risk of profits and losses on the sale of assets.

In our view, this approach would generate the correct incentives for firms around asset disposal, ensuring these activities were prudent and efficient, negating the need for a prudency or efficiency review.

We note that the actual RAB value for post line-in-the-sand assets is available for most individual assets, and so this approach could be applied to the sales of these assets (i.e. the disposal costs would be borne entirely by the business). This approach could also be applied to pre line-in-the-sand assets in due course, if actual values for individual assets are established.

## 5.2 Recovery of efficient asset disposal costs (pre line-in-the-sand assets)

### 5.2.1 IPART's proposed approach

IPART recognises that utilities incur costs in selling an asset, such as:

- **Sales costs** – the costs incurred by a regulated utility when it sells an asset (e.g. the legal and other transaction costs associated with a land sale).

- **Land remediation costs** – the costs associated with reversing or stopping environmental damage to land before it is sold.

Seeking to ensure that the correct incentives are in place for utilities to dispose of surplus assets, and recognising that costs are associated with asset sales, **IPART has proposed utilities could recover prudent and efficient sales and remediation costs** associated with the disposal of pre line-in-the-sand assets. **IPART has proposed not to allow water utilities to recover other efficient costs incurred in the disposal of an asset.**

### 5.2.2 Sydney Water's comments

As noted above, Sydney Water considers that the question of whether, and if so, to what extent, the business should be permitted to recover sales and remediation costs from customers, is **dependent on the approach to impute a RAB value, for deduction from the RAB**. That is, Sydney Water proposes that **where the RAB value is linked to the asset's sales value, the business should recover the efficient costs incurred in disposing the asset (e.g. sales costs, remediation costs and CGT)**. We consider that this is consistent with IPART's principles, as, in this case, customers are owners of the asset and thus, should share in the risk of profits and losses on the sale of assets.

We note that the **regulatory value for pre line-in-the-sand assets is not known for individual assets, and thus the regulatory value of these assets is imputed from the asset's sales value**. Sydney Water considers that **if the current approach of imputing RAB values with reference to sales value is retained** (effectively providing customers with access to a share of the profits or losses on the sale of assets) **customers should contribute to the costs associated with realising those profits or losses**.

In addition, Sydney Water considers that, in order to ensure that the correct incentives are provided to water utilities to dispose of surplus assets, **IPART must ensure that the asset disposal policy accurately and consistently accounts for all costs incurred in the disposal of the relevant asset**. While efficient sales costs and remediation costs are two key components of the costs incurred in selling an asset, **Sydney Water is also subject to other disbursements that must be accounted for, such as CGT**.

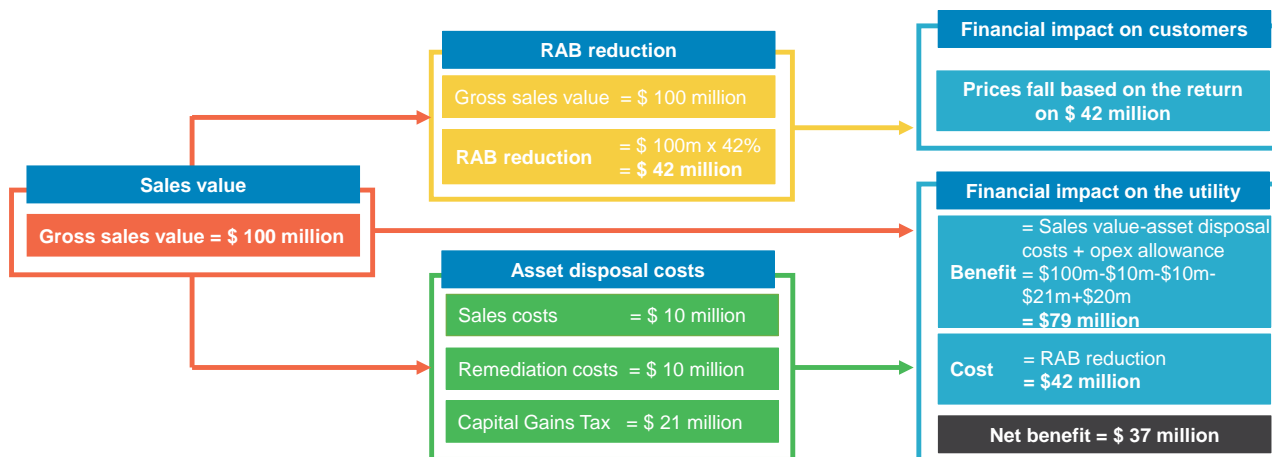
Under IPART's current policy, Sydney Water must pay the full CGT bill from the disposal of assets (despite the fact that customers share in the profits from the sale). This may have a major impact on Sydney Water's financial incentives to sell the asset. In particular, as outlined in our 2016 Pricing Submission, Sydney Water believes that, when applied to land sales, the current asset disposal policy overestimates the land's underlying regulatory value,<sup>5</sup> and as a result, **customers receive a share of capital gains that they have not contributed to and are not required to bear any of the CGT associated with the gain**.

In light of this, **Sydney Water considers that water utilities should be able to recover the efficient costs incurred in the disposal of an asset, including sales costs, remediation costs**

<sup>5</sup> As the regulatory value of an asset is assumed to equal 42% of the sales value (regardless of the asset's underlying characteristics), customers often receive a benefit from the sale of the 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).

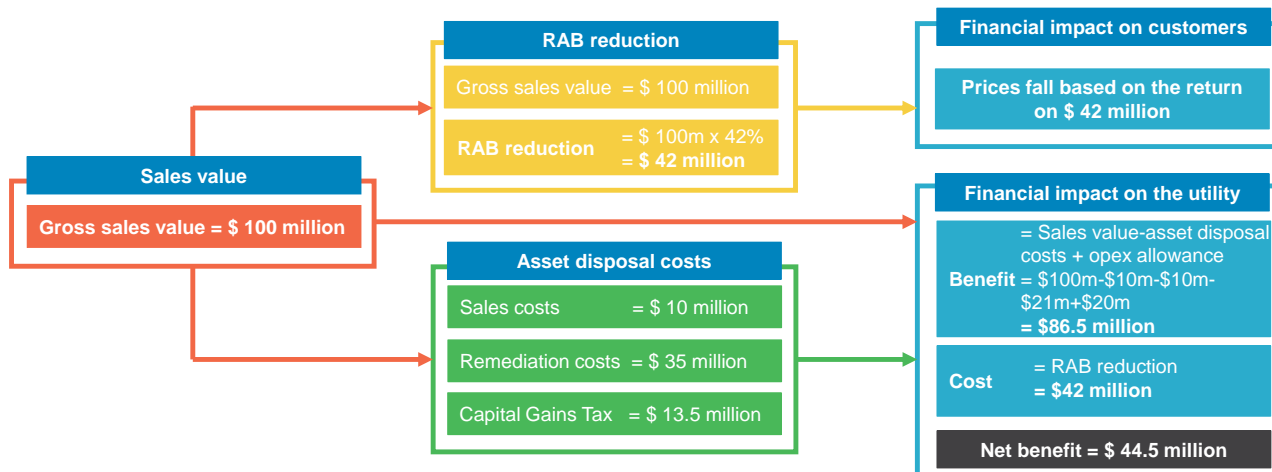
and CGT. As shown in Figure 3 and Figure 4, the recovery of efficient costs associated with the disposal of assets may mitigate the negative NPV outcome that was generated in some cases under the current policy (as per Figure 1 and Figure 2Figure 4).

Figure 3: Scenario three- lower remediation costs: “Sales value” is equal to gross sales value, with operating expenditure allowances for sales and remediation costs



Note: this assumes a tax value of \$10 million and that the present value of the return on the RAB reduction is equal to the RAB reduction (i.e. that the return on the RAB is equal to the discount rate)

Figure 4: Scenario four- higher remediation costs: “Sales value” is equal to gross sales value, with operating expenditure allowances for sales and remediation costs











Note: this assumes a tax value of \$10 million and that the present value of the return on the RAB reduction is equal to the RAB reduction (i.e. that the return on the RAB is equal to the discount rate)

## 6 How should efficient asset disposal costs be recovered?

This section provides an overview of our responses to IPART's preliminary view around the appropriate approach for the recovery of the efficient costs of asset disposal. In particular, Table 5 provides a summary of our responses to IPART's preliminary view, while the following sections provide more detail around each issue.

**Table 5: Overview of our response to IPART's preliminary view around the appropriate approach to recover the efficient costs of asset disposal**

Preliminary view	Our assessment	
<i>Definition of sales value</i>	We agree that where regulatory value is based on sales value, sales value should be defined as gross of the efficient costs incurred in the disposal of the asset (e.g. sales costs, remediation costs and CGT).	
<i>Consistency between significant and non-significant asset disposals?</i>	We agree that there should be consistency in terminology across significant and non-significant asset disposals.	
<b>Recovery of efficient asset sales costs</b>		
<i>Recovery of efficient sales costs via the operating expenditure allowance</i>	We agree that, where regulatory value is based on sales value, efficient sales costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB).	
<i>Assessment of efficient sales costs</i>	We agree that, where regulatory value is based on sales value, sales costs associated with the disposal of an asset, should, in general, be subject to efficiency tests.	
<b>Recovery of efficient asset remediation costs</b>		
<i>Recovery of efficient remediation costs via the operating expenditure allowance</i>	We agree that, where regulatory value is based on sales value, efficient remediation costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB).	
<i>Assessment of efficient remediation costs</i>	We agree that, where regulatory value is based on sales value, remediation costs associated with the disposal of an asset, should, in general, be subject to efficiency tests.	
<b>Recovery of other efficient costs</b>		
<i>No recovery of other efficient costs via the operating expenditure allowance</i>	We consider that, where regulatory value is based on sales value, other efficient costs should be incorporated into the operating expenditure allowance (rather than recovered through the RAB).	
<i>No assessment of other efficient costs</i>	We consider that, where regulatory value is based on sales value, other efficient costs associated with the disposal of an asset, should, in general, be subject to efficient tests.	

As discussed above, Sydney Water considers that in cases **where the RAB value to be deducted is separately identifiable and is not linked to current market values, the business should not recover the efficient costs incurred in disposing the asset** (e.g. sales costs, remediation costs and CGT). As such, this section only considers cases where the assets regulatory value is imputed from its sales value (as is currently the case for pre line-in-the-sand assets).

## 6.1 Definition of sales value

In response to concerns raised by Sydney Water whether the term “sales value” is to be interpreted as net or gross of the associated efficient costs (ie, sales, remediation and other costs), IPART has reviewed the definition of “sales value”. They note:

- If “sales value” is net of sales, remediation and other efficient costs, then these costs are effectively left in the RAB. The utility will recover these costs over time.
- In contrast, if “sales value” is gross of sales, IPART could include efficient asset disposal costs in the business’ operating expenditure allowance – ie, the gross “sales value”, including asset disposal costs, is removed from the RAB, and IPART reviews the costs, including efficient costs in operating expenditure allowances.

### 6.1.1 IPART’s proposed approach

IPART has proposed to use the gross “sales value” definition when determining the value of a sold asset to deduct from the RAB. In particular, when a significant pre-line-in-the-sand asset is sold, a proportion of the gross “sales value” is deducted from the RAB, as indicated by the equation:  $RAB/DRC \times \text{gross “sales value”}$ . It is IPART’s view that the “gross value approach” allows for separate regulatory treatment of sales and remediation costs. Rationalising that enhances transparency, helping to ensure only prudent and efficient sales and remediation costs are included in a utility’s notional revenue requirement, and recovered through regulated prices to customers.

### 6.1.2 Sydney Water’s comments

**Sydney Water agrees that for pre line-in-the-sand assets the ‘sales value’ to be applied when calculating the RAB deduction should be gross** of the efficient costs incurred in asset disposals, such as sales, remediation and CGT. **We note the most efficient cost recovery is via an operating expenditure allowance.** This is because recovery via regulatory operating expenditure allowances aligns the method of cost recovery (in most cases, except where large remediation costs substantially increase sales values, in which case remediation costs may (because of accounting treatments) be capitalised) to the type of costs incurred by the firm i.e. operating costs. Further, remediation and sales costs are in most cases one-off costs, hence operating expenditure allowances align the timing of cost recovery to when costs are incurred.

However, while Sydney Water agrees that this is on balance the best approach to incorporating the recovery of asset disposal costs, we note that there may be practical issues associated with the recovery of costs through operating expenditure. In particular, operating costs are ex-ante estimates which are not afforded an ex-post true-up. As such, proposed operating expenditure is a high-level estimate of expected operating costs, which may poorly and inaccurately capture

specific cost categories at the time (such as remediation costs due to unexpected health hazards etc.). This can be addressed through the use of an ex-post adjustment to true-up the costs at the beginning of the next regulatory period.

## 6.2 Consistency between significant and non-significant asset disposals?

While IPART's asset disposal policy distinguishes between significant and non-significant asset disposals, the term "sales value" is only used for significant assets, and only if those assets were purchased pre line-in-the-sand. For all non-significant assets, IPART removes the full "receipts from sale".

### 6.2.1 IPART's proposed approach

IPART proposes that if they apply the same definition of "sales value" to significant and non-significant assets (i.e. gross "sales value"), then the terminology should also be consistent.

### 6.2.2 Sydney Water's comments

Sydney Water agrees that **the terminology should be consistent across significant and non-significant assets** to ensure clarity and the appropriate application of the asset disposal policy.

## 6.3 Recovery of efficient sales costs

### 6.3.1 IPART's proposed approach

IPART has proposed to allow a water utility to:

- Recover the efficient sales costs incurred in disposing of an asset via the utility's operating expenditure allowance, rather than via the RAB.
- Subject the efficient sales cost to a prudence and efficiency test to ensure that a water utility recovers only the efficient costs associated with service provision and customers only pay for the efficient costs of necessary services.

### 6.3.2 Sydney Water's comments

Sydney Water agrees that, where regulatory value is based on 'sales value':

- **Efficient sales costs should be incorporated into the operating expenditure allowance** (rather than recovered through the RAB); and,
- **Efficient sales costs should be subjected to efficiency and prudence tests.**

## 6.4 Recovery of efficient remediation costs

### 6.4.1 Legislative requirements on Sydney Water to remediate assets

In determining whether to allow water utilities to recover efficient remediation costs, IPART sought further information around what determines whether a water utility undertakes remediation. In general, Sydney Water is compelled to remediate surplus land assets by a range of legislative requirements including:

- Contaminated Land Management Act 1997 (CLM Act).

- Protection of the Environment Operations Act 1997 (POEO Act).
- Environmental Planning and Assessment Act 1979 (EP&A Act).
- Sydney Water Act 1994 (SW Act).

The CLM Act, POEO Act and EP&A Act relate primarily to the maintenance and protection of the environment and public health under a “polluter pays” principle, requiring Sydney Water to remediate to the standard to which final land use is to be applied (ie residential development, commercial or industrial, parklands etc).

In addition, the EP&A Act also canvases the role of planning authorities through the State Environmental Planning Policy 55 - Remediation of Land (SEPP55), which requires planning authorities to consider the potential for contamination to adversely affect the suitability of a site for its proposed use. In general, the main demand and location of Sydney Water’s surplus land assets is for and located in residential zones, or is intended to be rezoned by local councils. This means the standard of remediation is most often high, relative to for example, the standard of remediation required for industrial or commercial zones.

In relation to the SW Act, Section 21(1)(a)(ii) refers to the principle objectives of the Corporation, and specifies (in addition to the protection of the environment and public health, in line with the CLM Act, POEO Act and EP&A Act) that Sydney Water must “*seek to maximise the net worth of the State’s investment in the Corporation.*” In so far as objective (a)(ii) relates to remediation costs, we interpret this objective as requiring Sydney Water to, where efficient, remediate surplus land assets to maximise sales value and the return to the State.

While in theory, Sydney Water’s sale contracts for surplus land generally contain a clause advising the purchaser that the land is taken in its present condition (releasing Sydney Water from any claims and demands relating to the contamination of the site), in practice, Sydney Water could still be held liable and held ultimately responsible for remediation by the NSW Environment Protection Authority (EPA) under the EP&A Act if it was deemed to be the polluter of the site (under a polluter-pays system). In line with the SW ACT, and to minimise such risks arising from the disposal of land, Sydney Water, may in some cases, remediate surplus land to the standard of potential end residential use, even if not yet rezoned as such by local councils.

#### 6.4.2 Undertaking asset remediation

When compelled by legislation to remediate land (particularly in regard to the protection of the environment and public health), Sydney Water commissions independent external experts from a panel to complete a two-step process in regard to prudent and efficient remediation costs. These include:

- **Preliminary Site Investigation (PSI)** – which formally outlines the likelihood of required remediation works for each surplus land asset. If the PSI indicates that remediation is likely required then a detailed site investigation is undertaken.
- **Detailed Site Investigation (DSI)** – a detailed independent report on the extent of prudent remediation works required to fulfil legislation requirements, along with an action plan (scope of work) to efficiently undertake the remediation works and an accompanying detailed efficient costing.

The most common types of remediation include:

- disconnecting or relocating water or sewer pipes;
- boundary fencing;
- driveway/access construction;
- demolition of redundant buildings which typically include asbestos checks and removal to waste management facilities;
- checks for soil contaminants such as lead, arsenic, asbestos, pesticides, etc., and removal (excavation) to waste management facilities followed by replacement/backfilling of soil; and,
- returfing.

### 6.4.3 IPART's proposed approach

IPART has proposed to allow a water utility to:

- Recover the efficient remediation costs incurred in disposing of an asset via the utility's operating expenditure allowance, rather than via the RAB; and
- Subject the efficient remediation cost to a prudence and efficiency test to ensure that a water utility recovers only the efficient costs associated with service provision and customers only pay for the efficient costs of necessary services.

### 6.4.4 Sydney Water's comments

Sydney Water agrees that, where regulatory value is based on 'sales value':

- **Efficient remediation costs should be incorporated into the operating expenditure allowance** (rather than recovered through the RAB); and
- **Efficient remediation costs should be subjected to efficiency and prudence tests.**

## 6.5 Recovery of other efficient costs (e.g. CGT)

### 6.5.1 IPART's proposed approach

IPART's proposed approach is not to allow a water utility to recover other efficient costs incurred in the disposal of an asset (such as CGT).

### 6.5.2 Sydney Water's comments

Sydney Water considers that, in order to ensure that the correct incentives are provided to water utilities to dispose of surplus assets, **IPART must ensure that the asset disposal policy accurately and consistently accounts for all costs incurred in the disposal of the relevant asset.** While efficient sales costs and remediation costs are two key components of the costs incurred in selling an asset, **Sydney Water is also subject to other disbursements that must be accounted for,** such as CGT.

As noted above, IPART's methodology for imputing a RAB value to pre line-in-the-sand assets with reference to their sales value effectively vests some of the risks of asset ownership with customer, and therefore, shares the profit on the sale of those assets between Sydney Water and its customers. Consistency requires that the CGT associated with those profits be shared between



the two classes of beneficiary. In particular, Sydney Water considers that, where regulatory value is based on 'sales value':

- **A water utility should be able to recover other efficient asset disposal costs**, and in particular, Sydney Water proposes that CGT be shared in the same ratio (58:42) between Sydney Water and customers;
- **Other efficient asset disposal costs should be incorporated into the operating expenditure allowance** (rather than recovered through the RAB); and
- **Other efficient costs should be subjected to efficiency and prudence tests.**

## 7 Addressing broader issues in the asset disposal policy

While we believe that clarifications and refinements could improve the current policy, for the reasons outlined in section 3.3 above, these alone will not be sufficient to address the broader problems with the current policy.

In line with good regulatory practice, IPART should consider whether the asset disposal policy remains the best available approach given the material changes that have occurred in the policy, regulatory and commercial operating environments subsequent to this policy being developed. The 2016 policy was developed in circumstances where there was a lack of information on the actual RAB value of individual assets.

We consider this consultation process to be an opportunity to recognise these potential disincentives and to begin a dialogue on the broader set of refinements that are required to the asset disposal policy to ensure that it best achieves the policy objectives. This could involve investigating alternative approaches for determining the regulatory value of pre-line-in-the-sand assets which are sold and deducted from the RAB that better meets IPART's underlying principles (ie, the business should bear the risk of any profits or losses arising from the sale of an asset).

In particular, we believe there is considerable merit in utilising Sydney Water's newly developed Cost Allocation Manual (CAM) for more accurately imputing regulatory values for individual pre line-in-the-sand assets. Using the CAM methodology and the principles outlined in the CAM, Sydney Water is able disaggregate the RAB into individual assets by utilising information contained in its Fixed Asset Register<sup>6</sup>. Under the methodology, each individual asset RAB value (with necessary adjustments for the effect of depreciation and indexation) of disposed assets will be estimated.

Sydney Water therefore suggests that the individual RAB value derived from the CAM methodology could be used as the regulatory value of the asset in the treatment of asset disposals. Consistent with the IPART's current asset disposals policy, this known RAB value of the disposed asset could then be removed directly from RAB when an asset is sold, or in a single transaction at the beginning of each regulatory period for forecast surplus land sales.

This 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.

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<sup>6</sup> The FAR is adjusted for several differences between the methodology of the FAR and RAB eg: CPI indexation and exclusion of gifted assets

## 8 Appendix A: Principles for efficient asset disposal

An asset should be removed from the RAB (or sold) if it is surplus to requirements and it has an economic value in an alternative use which is greater than the costs of moving it to that use. However, the regulated business will only have a financial incentive to sell the asset if the NPV of the net proceeds it receives from the sale (taking into account any sales and remediation costs and CGT) is greater than the NPV of the revenue it foregoes from the reduction in the RAB (even by \$1).

Customers will be better off as long as the NPV of the new revenue requirement (taking into account the reduction in RAB as well as any increase in revenue requirement from bearing some of the asset disposal costs) is less than the old revenue requirement pre-sale of the asset (even by \$1) regardless of how this amount compares to the existing RAB value or current sales value.

It can be easily shown that **under IPART's previous policy** of deducting the entire gross sale value from the RAB (and not compensating the business for sales costs or CGT) will **always breach these conditions** because even though such a transaction would in theory lead to a major benefit to customers, they will not realise this benefit because there will never be an incentive for the business to undertake the sale under those rules.

Similarly, while IPART's new policy (interpreted as deducting 42% of the gross sales value of an asset from the RAB and providing no compensation to the business for CGT) would in theory result in quite significant benefits to customers (but less than the previous policy), in many cases these benefits will not be realised because the business will again often have no incentive to undertake the sale. In particular, while **the revised policy as proposed in the issue paper would further reduce the potential benefits to customers** (by making them pay for the sales costs) **and increase the likelihood that the business will have a financial incentive to undertake the sale**, in some cases – particularly for more marginal transactions – **water utilities will still have no financial incentive to make the sale because it has to bear significant CGT.**

To the extent that the business makes a profit on sales of assets which have appreciated in market value (e.g. land) this can be seen as appropriately returned to the shareholder (ie NSW Govt) who owns the assets rather than to customer (who have simply paid to that point for the costs associated with the original investment to provide services) but have been protected from paying the true opportunity cost of the assets which also reflect foregone returns to the asset owner during the time they were used to provide regulated services. The shareholder (NSW Govt) could of course elect to return some of these profits to water customers through lower prices but arguably this is appropriately a decision for the shareholder rather than the regulator.

