Response to the Independent Pricing and Regulatory Tribunal Issues Paper

Asset Disposal Policy Consultation 2017

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1. Executive summary

WaterNSW welcomes the opportunity to contribute to IPART's Asset Disposals Policy Consultation 2017 and provides this submission in response to the Issues Paper[1].

A considered IPART Asset Disposals Policy is important in ensuring regulated utilities are able to make optimum asset disposal decisions which appropriately allocate costs and benefits between the utility, customers and shareholders.

Assets held by regulated utilities which are likely to be appropriate for disposal will often be:

- long held (in many cases pre-dating the "line-in-the-sand" date) due to historical decisions on what was considered required from an operational or "future proofing" perspective;
- of significant value (in many cases due to changing surrounding land use and density);
- scrap or surplus following an asset replacement or upgrade; and/or
- requiring either voluntary or regulated remediation to enable a sale to occur at all, or to occur at the highest achievable sale price.

A regulated utility working through a decision of whether or not to dispose of a particular asset is likely to face complex considerations with respect to:

- long-term customer needs and business requirements;
- urban and rural liveability and community need issues;
- environmental considerations;
- commercial considerations; and
- Government/shareholder directives in relation to asset recycling to facilitate infrastructure investment.

Without a considered and consistent IPART Asset Disposal Policy, regulated utilities may either not make optimum decisions or may delay decisions pending further clarity. This would be sub-optimal for the State as a whole and, in many cases, the communities within which the assets are located.

Having regard to the importance of a considered IPART Asset Disposals Policy for regulated utilities and, in particular for WaterNSW, this submission canvasses the issues relevant to WaterNSW's consideration of the policy. In summary, our views are as follows:

- WaterNSW is seeking certainty, to the greatest extent possible, on the asset disposal policy that will apply to its regulated assets;
- we support Scenario 1 as outlined on page 13 of the Issues Paper, as this correctly aligns incentives between the regulated utility and the asset sales process, avoids price shocks for customers and avoids issues associated with forecasting sales and remediation costs;
- regulatory and non-regulatory remediation costs should be included in the RAB to DRC ratio for pre line-in-the-sand assets;
- the asset disposal methodology for some assets which comprise both pre and post line-in-the-sand components may need to be dealt with on a case by case basis to determine which proportion of the sales price applies to which method; and
- any adoption of an alternative approach to an asset disposal methodology for pre line-in-the-sand assets needs to consider the practical implications for each regulated utility in adopting the approach.

[1] IPART, 25 September 2017

2. WaterNSW's business and applicable asset disposal policies

WaterNSW currently operates three regulated asset base (RAB) based businesses, soon to be four:

- Greater Sydney (former Sydney Catchment Authority)
- Rural Valleys (former State Water)
- Water Administration Ministerial Council (WAMC) delegated functions (under the IPART WAMC determination and shared with DPI Water), and
- Broken Hill Pipeline (yet to be constructed).

The Greater Sydney and Rural Valley businesses are those for which assets disposals are currently most relevant[2].

A method of calculating the amount to deduct from the RAB for pre line-in-the-sand assets is required due to:

- many regulated utilities having "line-in-the-sand" RABs, that is, regulated asset bases whose value does not reflect the cost value of the assets but a lower amount decided by Government policy at the time of corporatisation/independent regulation of the utility;

- the need to deduct an amount relevant to disposed assets from the RAB, so that the utility no longer earns a return on assets it no longer owns; and

- as the RAB is much less than the written down or sales value of assets, the whole value of those assets cannot be deducted from the RAB as the RAB would then be artificially depleted.

Therefore, a methodology to apportion the asset value to a value to be deducted from the RAB is required. The methodology selected by IPART is to multiply the sales value by the ratio of the utility's RAB at the time of the line-in-the-sand to the depreciated replacement cost (DRC) of the assets at the time of the line-in-the-sand establishment of the RAB.

The Issues Paper noted only the RAB to DRC ratio for Greater Sydney (0.39). The following table sets out the RAB to DRC ratio for Greater Sydney and each of WaterNSW's rural valleys subject to IPART jurisdiction, which each have a separate RAB.

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

The ratios for the Coastal valleys and the Fish River Scheme have been derived from a NSW Department of Commerce 2006 MEERA Valuation of State Water Corporation's assets[3], depreciated to 2004, the year of establishment of the rural valley's RAB. The ratio for Greater Sydney were determined by IPART in its determination of Sydney Catchment Authority prices from 1 October 2000.

[2] The RAB under the IPART WAMC Determination is small and comprises of shorter-lived assets. The RAB for the Broken Hill Pipeline will only come into being once an IPART determination is made for the pipeline (yet to be constructed). It is unlikely that any of those assets will become surplus in the near term.

[3] NSW Department of Commerce, *State Water Corporation, 2006 MEERA Valuations of 18 Major Dams*, Report No. DC06130, July 2006.

It is important for WaterNSW to have certainty on the RAB to DRC ratio to be applied to each of its rural valleys to make informed asset disposal decisions. If the RAB to DRC ratio approach is to be continued, WaterNSW seeks confirmation from IPART of the RAB to DRC ratios as set out in the table above.

The balance of WaterNSW's rural valleys are subject to the *ACCC Water Charge (Infrastructure) Rules 2010*. The rules require the regulator to deduct from the RAB the "*actual revenue received by the operator from disposal of assets used to provide infrastructure services*".[4] It is not clear whether "actual revenue" in this context is to be interpreted as net or gross of sales and remediation costs. WaterNSW seeks clarity on this question.

The ACCC in its "*Review of the Water Charge Rules, Final Advice, September 2016*", recommended that infrastructure operators whose charges are determined by Basin State regulators (in this case IPART) would not be bound by Part 6 of the rules. However, changes to the rules in line with the ACCC's final advice is not certain.

3. Issues under the RAB to DRC ratio

This section addresses specific issues with the RAB to DRC ratio methodology.

3.1 Net or Gross sales value?

WaterNSW supports Scenario 1 at page 13 of the Issues paper.

Not reflecting sales and remediation costs in regulated operating expenditure correctly aligns incentives.

The regulated utility is seeking to earn the highest return from the sale of the asset. As such, it will need to use its commercial judgement as to balancing the investment in sales and remediation costs with the best sales price that may arise. The regulated utility takes both the risks and reaps the rewards of its expenditure on sale and remediation for the benefit of its shareholders and customers.

After sale, the regulated utility loses the amount from the RAB which is reflected by the proportionate value of the asset no longer being utilised to produce the services supplied by the RAB assets. The regulated utility has no further interest in the asset on behalf of itself and its shareholders. The deduction determined by reference to the net sales value reflects the best obtainable price for the asset considering the investment in sales and remediation costs. This maintains the balance of incentives with the regulated utility.

If sales and remediation costs are incorporated into operating expenditure (scenario 4 at page 17 of the Issues Paper), with the regulator second guessing the "prudency and efficiency" of those costs, a mismatch between actual and forecast sales and remediation cost could distort the sales price and the ability for the regulated utility to obtain the best profit outcome under the market conditions that arise at the time of sale. This results in a poor substitute for incentive based regulation which is readily available through the use of net sales value.

Moreover, if gross sales value is used, customers bear the sales and remediation costs upfront and immediately bear the impact of those costs in customer charges which 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.

[4] Rule 29(2)(a) and Schedule 2

We also query the ability of the regulated utility to forecast sales and remediation costs within its pricing proposal. Commercial sales opportunities may arise organically and may need to be acted upon expeditiously within a pricing period. As such, a business may not be able to forecast required sales and remediation costs into its pricing proposal. It is not clear from the Issues Paper what would occur in these circumstances.

This situation leaves the regulated utility with an incentive to include an allowance for such costs within its pricing proposal which may not be realised, impacting customer bills and business budgeting accuracy. WaterNSW submits that this is a sub-optimum outcome for customers.

WaterNSW does not see any negative implications with customers bearing the costs of sales and remediation costs within the RAB. This smooths the impact to customers over time, avoiding bill shock. A longer term approach to repayment of the costs should not be seen as disadvantageous in the context of RAB's with significant line-in-the-sand write-downs, with customers already favourably advantaged by the written down RAB.

3.2 Remediation costs

WaterNSW notes the questions in the issues paper on remediation costs. We do not think that it is relevant whether the remediation is a regulated requirement or is voluntary by the regulated utility. If remediation is a regulated requirement, then the investment must occur regardless of the sale or may have to occur in order to affect the sale. If remediation is voluntary, the business has made a commercial decision that the investment in remediation will produce the best sales price for both its shareholder and the customer.

This is the alignment of incentives. WaterNSW does not agree that a regulatory review of "prudency and efficiency" should be a substitute for incentive based regulation.

Remediation costs may include decommissioning of the relevant structure, whether or not this is a regulatory requirement.

WaterNSW notes that remediation costs may occur over time and may be capitalised into the RAB. This is likely to arise in the case of mandatory environmental remediation which is required occur irrespective of whether a sale is prospective. If remediation occurs in one regulatory period and a subsequent sale occurs in a following determination period, the RAB is uplifted by the amount of the remediation cost (e.g. $10m). In WaterNSW's view, this is a natural consequence of long-lived assets requiring ongoing maintenance and remediation which require the regulated utility to provide continued investment to meet modern day environmental and health and safety standards. It is not unreasonable for customers to pay for these imposts (which they otherwise would have been required to incur incurred irrespective of any forthcoming sale). The next section on blended assets describes our view on how the subsequent disposal of the assets should be addressed.

3.3 Blended assets

WaterNSW queries the treatment of 'blended assets' which 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.

For example:

- a project to raise a dam wall on a pre-line-in-the-sand dam; and/or
- a pipeline asset, where pipeline replacements have undertaken in segments of the pipeline since the line-in-the-sand.

When assessing the regulatory value to be deducted from the RAB, the regulator will have to apportion some of the receipts of the sale using the sales value multiplied by the DRC/RAB ratio,

while for expenditure incurred on the asset after the line-in-the-sand, the expenditure could be determined by the regulatory value which has entered the RAB. In some cases it may be apparent how to apportion the sales value (e.g. per kilometer of pipeline) but in other cases it may not (e.g. the dam wall example). In these circumstances, WaterNSW proposes that these instances are approached on a case by case basis at the time of the next determination as it would be unlikely that WaterNSW would be disposing of a significant number of assets during a regulatory period.

4. Alternative approach

Section 2 above sets out the RAB to DRC ratio, which is the approach canvassed in the Issues Paper, to determine the amount to be deducted from the RAB for pre line-in-the-sand assets.

The issue paper notes that this is required in the absence of "*any data on the efficient value of pre line-in-the-sand assets when they entered the RAB*"[5]. WaterNSW is aware of an alternative approach which may be used to determine the regulatory value of assets - using the value of each asset in the RAB to determine each asset's proportion of the total cost value, which is then multiplied by the RAB. In this way, a more accurate reflection of that particular asset's weighting in the RAB is determined.

To determine the value of each asset as a proportion of the RAB, the following would be required:

- For POST line-in-the-sand assets, the value of each asset is 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, the value is determined using the MEERA approach (DORC) (then apportioned to the written down RAB as at the time of the line-in-the-sand, adjusted to today's valuation).

The alternative approach sees a definitive amount deducted from the RAB. However, it is not clear whether this approach would see sales and remediation costs deducted from the sales price or treated as operating expenditure (then subject to review by IPART).

WaterNSW's book value asset register contains approximately 78,000 individual assets. Therefore, for WaterNSW to develop a data set for the alternative approach, it would be costly to produce the required data sets. Without a "mandatory regulatory" requirement, WaterNSW cannot justify this level of expenditure which would ultimately be required to be borne by our customer base. WaterNSW understands that other water utilities may have other regulatory requirements which necessitate this level of investment, however, this is not currently the case for WaterNSW.

This alternative approach, is not, from a practical perspective, something that WaterNSW would support or adopt in the near term.

[5] Page 1.