Thank you for the opportunity to comment on the Exposure Draft (ED) relating to the “Proposed Technical Information Paper 2 – Depreciated Replacement Cost”. This response is on behalf of the global Ernst & Young organisation which as well as providing accounting, audit and tax services, includes professionals who provide valuations of businesses, property, plant & equipment, financial instruments and intangible assets.

Ernst & Young is supportive of the IVS aim to identify concepts and principles that are applicable to all types of valuation in order to improve consistency, transparency and therefore confidence in the valuation process. As requested our attached response addresses the specific questions and then the paragraphs within the paper.

Should you have any questions please contact me on +1 404 817 5474.

Yours faithfully

Robert J. Stall, ASA
Principal - Americas Director
Capital Equipment Valuation
Valuation and Business Modelling
Questions for Respondents

1. It is proposed that this Exposure Draft will replace the current GN8 “The Cost Approach for Financial Reporting - (DRC)”. As the name suggests GN8 only covers the use of the cost approach for financial reporting purposes. This exposure draft proposes that a properly applied cost approach can be applied in a wide variety of circumstances.

   *Do you agree with the argument that the cost approach, if properly applied, can be used as a method to arrive at market value for a variety of purposes other than financial reporting?*

   EY Response: We agree with the argument. However, each individual appraisal is subject to facts and circumstances specific to each analysis and all three approaches to value should be considered and reconciled in any valuation analysis along with their hierarchies of value.

2. This Exposure Draft identifies depreciated replacement cost as the most common method of valuation under the Cost Approach. An alternative view is that this is the only method of applying the cost approach.

   *Which of these views do you support? If you believe that there are other valuation methods that fall under the Cost Approach, please describe them.*

   EY Response: There are two methods to derive current cost new in the cost approach. It is essential that the appraiser understand the difference between reproduction cost new and replacement cost new. Replacement cost new is defined by the American Society of Appraisers (ASA) as the current cost of a similar new property having the nearest equivalent utility as the property being appraised, whereas reproduction cost new is the current cost of reproducing a new replica of the property being appraised using the same, or closely similar, materials¹. Replacement cost new is generally developed through a direct cost method, whereas reproduction cost new is developed through a trending method. Depreciation applied to the reproduction/replacement cost can be performed in many different ways including using market derived curves as a percentage of replacement cost.

3. GN8 in the 2007 edition of IVS identifies the three main types of deduction for obsolescence as physical deterioration, functional obsolescence and external obsolescence. In this Exposure Draft external obsolescence has been replaced with economic obsolescence. Supporters of the proposed change argue that the term economic obsolescence is most commonly used to describe this form of obsolescence. Those who support the existing definition argue that the term external obsolescence more clearly requires all factors that arise from changes to the environment in which the asset operates to be considered, regardless of whether they have a direct economic impact.

¹ Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets, pp 44.
Which of these views do you support?

EY Response: We consider these terms synonymous. We believe economic obsolescence includes all forms of external obsolescence. While others may believe that economic obsolescence only accounts for cash flow profitability this is only one factor in determining all forms of economic/external obsolescence.

4. The exposure draft provides that where the purpose of the valuation is governed by regulations that preclude adjustment for all forms of obsolescence, for example valuations for tariff setting purposes of regulated monopoly assets, the outcome does not represent market value and should not be described as such.

Do you agree that a cost approach valuation that does not identify and quantify all forms of obsolescence is not a measure of market value?

EY Response: An analysis that does not consider all three approaches to value or apply all forms of obsolescence, as appropriate, should not be considered a market value. An analysis that does not identify all forms of obsolescence should be defined to the terms of the definition being applied in the analysis.
Commentary on Exposure Draft (By Paragraph)

INTRODUCTION

1. The depreciated replacement cost (DRC) method is the most common valuation method under the cost approach. It can be applied to a wide range of asset types. It is frequently used when there is either very limited or no evidence of sales transactions. It may be used to estimate a variety of different bases of value.

   We would suggest that a formal definition of depreciated replacement cost be tendered and distinguish between the indirect and direct methods of the cost approach in the beginning of the TIP, perhaps in a preamble.

   DRC may be defined as: the value derived from the replacement/reproduction cost after the application of all forms of obsolescence (physical, functional and economic).

2. The cost approach estimates value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction. It is based on the principle of substitution, ie that unless undue time, inconvenience, risk or other factors are involved, the price that a buyer in the market would pay for the asset being valued would not be more than the cost to assemble or construct an equivalent asset.

   We would suggest revising the paragraph to state: “The cost approach estimates value using the economic principle that a buyer will pay no more for an asset than the cost to obtain a new asset of equal utility, whether by purchase or by construction. It is based on the principle of substitution, ie that unless undue time, inconvenience, risk or other factors are involved, the price that a buyer in the market would pay for the asset being valued would not be more than the cost to purchase or construct an equivalent asset.”

   In addition, we would suggest further clarifying undue time, inconvenience and risk factors in terms of how they are measured.

3. The DRC method is a common application of the cost approach. In assessing what it might be prepared to pay for the subject asset, a potential purchaser may consider as an alternative to acquiring the subject asset, the cost to construct a similar asset having the same functionality. This represents the maximum that a potential purchaser would be prepared to pay for the subject asset if it were new at the date of valuation. Often the asset being valued will be less attractive than the alternative that could be purchased or assembled because of age or obsolescence. Where this is the case, adjustments will need to be made to the cost of the alternative asset. These adjustments are collectively known as depreciation.

   No Comments

WHEN TO USE THE DRC METHOD

4. The DRC method is most commonly used for the valuation of specialised assets. This is because transactions involving the sale of specialised assets are relatively infrequent and when they do occur, the assets are often sold as part of a going concern business. In such situations, the values attributable to each individual asset may not be agreed by a buyer or seller as part of the transaction and in any event are typically not disclosed.
General comment for paragraphs 4-10: We would suggest that because valuation is facts and circumstances based that the term “specialised” not be so broadly used given that the DRC applies to a much broader asset base than just specialised assets.

Many of these paragraphs could be included within a preamble or introduction section to initially introduce these terms.

5. Specialised assets may belong to various classes, including structures, buildings and installations, as well as intangible assets.

We would suggest that specialised assets may also include personal property.

6. While specialised assets are often used to generate cash flows (i.e. to produce benefits or economic returns for the owner), the cash flows attributable to individual specialised assets are often not separable from those of the entity or business. Even where a cash flow can be identified for a small group of assets, identifying the cash flow attributable to individual assets within the group may also be problematic.

We would also suggest adding to the last sentence “...based on the level of aggregation.” If the unit of value is of a higher level, then an Income Approach may actually be more feasible. This may also be affected by the level of significant intangibles in the aggregated unit.

7. For this reason it is often difficult to apply the income approach as the primary approach to the valuation of individual specialised assets. The income approach can however provide a useful method to identify economic obsolescence at the business level.

We would suggest adding that “Income can be used as the primary approach to value, but more often it corroborates value or measures economic obsolescence.”

8. It is also important to recognise that the fact that an asset can be regarded as specialised should not automatically lead to the conclusion that a DRC method should be adopted. To the extent it is possible to apply other valuation approaches it is appropriate to consider these as either primary or cross-checking methods.

No Comments

9. The DRC method may also be an appropriate method when the asset has recently been acquired new or has been newly constructed.

No Comments

10. Use of the DRC method is not normally appropriate if the asset being valued is clearly redundant or obsolete as the fundamental premise of the cost approach that a buyer would require an asset of equal utility would not apply.

Certain industries, such as utilities, often have redundant assets as a normal course of business. In these exceptions the DRC method would be appropriate even though the asset is clearly redundant.
REPLACEMENT COST

11. The first step in applying the DRC method is to establish the nature of the equivalent asset that the hypothetical buyer would consider as an alternative to the asset being valued. This then determines whether a replacement cost or a reproduction cost should be used in estimating the cost of the alternative asset. In this TIP these terms have the following meanings:

Replacement cost - The current cost of a similar new asset having the nearest equivalent utility as the asset being valued.

Reproduction cost - The current cost of reproducing a new replica of the asset being valued using the same, or closely similar, materials.

*We suggest excluding “the nature of” in the first sentence of this paragraph.*

12. Replacement cost is normally the most appropriate basis of cost assessment as most buyers would only be willing to pay for an alternative asset providing the equivalent utility to the asset being valued (the “subject asset”). Any features of the subject asset that are redundant or that provide no economic or other benefit to a buyer would not be part of the specification of the alternative to which it is being compared (the “equivalent asset”).

*No comments*

13. It is appropriate to use the reproduction cost in situations where the reproduction cost of the subject asset is lower than its replacement cost or where the equivalent utility could only be provided by a replica of the subject asset. An example where the latter might be the case is if the subject asset was nearly new, or if its exact design and features were an integral part of the benefit that would accrue to an owner. An example of the latter would be an iconic building where the design was of greater importance than the functionality of the accommodation within it. In these circumstances, reproduction would be the only form of replacement acceptable to a market participant. Such situations are quite rare in practice.

*Replacement cost new is often, but not always lower than reproduction cost new. If it is the intention to illustrate a general point regarding fixed assets, we would urge caution with the use of examples that appear real property specific and exclude personal property.*

14. Where the actual cost of acquiring or constructing the subject asset exists and there is a reliable record of cost fluctuations between the date on which this cost was fixed and the valuation date, this can be used to provide an appropriate indication of replacement cost. It should be noted however that indexation of historic costs can be inaccurate, especially over longer periods.

*We would suggest adding to the last sentence: “over longer periods”... and may not be accurate current cost benchmarks.*

15. Historic costs may not be a reliable guide to replacement cost as these may include costs other than those attributable to the purchase, installation and commissioning of the subject asset. Historic costs may also represent the cost attributed to the asset following a business merger or other earlier purchase rather than the original cost of creating the asset.

*We agree with the intentions of this paragraph, however, certain terms, such as ‘historic cost’ should be specifically defined. We would also suggest that you consider editing the sentences to begin “Costs may...” as opposed to “Historic costs may...”*
ASA defines Historic Cost as - the cost of a property when it was first placed into service by its first owner.

We offer the following revised version of the second sentence:
“Additionally, the cost basis may not be a reliable guide because it may not represent historic cost due to prior impairments through accounting based adjustments or allocations.”

16. Replacement costs should capture all of the costs that would be incurred at the date of valuation by a typical market participant seeking to create a similar asset. These costs can be broadly described as follows:
   ▶ Direct costs such as:
      - materials
      - labour
      - freight
      - duty, etc.
   ▶ Indirect costs such as:
      - design, legal and other professional costs;
      - engineering, procurement and construction management costs;
      - interest during construction; and
      - entrepreneurial profit margin.

We would suggest clarifying that the premise of value may have an impact on these elements including, indirect costs such as labour, freight etc. As this paragraph is currently worded, it assumes a value in-use concept versus a piece-meal concept.

17. To the extent that typical market participants fund the construction of a similar asset with some portion of debt, the interest during construction component is usually calculated having regard to:
   ▶ Typical market participant debt/equity ratios for similar construction projects. Interest during construction is calculated in respect of only that portion of the total constructions cost that would be funded by debt.
   ▶ Typical market participants’ cost of debt.
   ▶ Typical construction periods for similar construction projects. This will determine the maximum period over which interest costs will be incurred.
   ▶ Typical draw down schedules on debt facilities over the assumed construction period for similar construction projects. Because the entire portion of the debt incurred will not usually be drawn down at the commencement of the construction project, it is necessary to reflect the approximate timing of debt draw downs to calculate the interest during construction.

We generally agree with this statement but care must be taken not to double count IDC in the event it is not expressed as part of the capital cost of acquiring an asset/ accounting treatment of market sector participants.

18. In the context of the valuation of certain assets the inclusion of an “entrepreneurial profit margin” may be warranted. This element represents the amount of economic benefit required to motivate the asset owner to create the asset. Care should be taken however to ensure that this “entrepreneurial incentive” includes only those economic benefits directly related to the subject asset. It would be inappropriate to include economic benefits that relate to any other asset(s). To the extent the economic benefit relates to a group of assets working in concert to generate income, this will likely be captured as part of goodwill.

No Comments
COMPONENTISATION

19. An asset may be broken down (componentised) into multiple components. Componentisation is generally appropriate where:
   - An asset has components that have useful lives that are materially different to other components of that asset
   - The components are material to the value of the asset
   - It is possible to reliably measure the value of the components

No Comments

20. The level of componentisation adopted will also be dictated by the available information and the purpose for which the valuation is intended.

No Comments

21. There are many approaches to componentisation adopted in practice varying from detailed cost segregation analyses to macro valuation approaches. Whilst there is no single correct approach to componentisation, a more granular (componentised) approach will be likely to produce a more robust valuation outcome than a macro approach.

No Comments

DEPRECIATION

22. It is important to understand that the word “depreciation” is used in a different context in valuation compared to financial reporting or tax law. In financial reporting depreciation is a charge made against income to reflect the use of an asset. This charge is spread on a systematic basis over the useful life of the asset to the entity. Certain tax regimes also provide for “depreciation charges” to be offset against taxable profits. These are distinct usages of the word and are subject to specific definitions and procedures set out in the relevant accounting standard or tax law. In the context of the DRC method, depreciation refers to adjustments made to the cost of an equivalent asset to reflect any comparative obsolescence that affects the subject asset and has no regard to the accounting policies or tax profile of the owner.

We would suggest that the second sentence be revised to state: “In financial accounting...”

23. Depreciation may be all-encompassing or analysed separately for:
   - Physical deterioration
   - Functional obsolescence
   - Economic obsolescence

We disagree with this statement that depreciation may be all encompassing. Physical, functional, and economic have very specific definitions and should be analysed and quantified, as appropriate, separately.

PHYSICAL DETERIORATION
24. Physical deterioration is the loss in value resulting from the reduction in the capacity of an asset to continue to provide the goods or services for which it was designed due to wear and tear, deterioration, physical stresses, and similar factors.

No Comments

25. It can often be measured by considering the stage of the asset's anticipated total physical life from new that has been reached at the valuation date. Physical deterioration may be constant or vary over the life of the asset. This can result from variations in the intensity of use to which the asset is subjected at different stages of its life. Any such variation is likely to be reflected in the level of maintenance costs.

No Comments

26. The physical deterioration of the asset is not viewed in absolute terms, but within the context of the impact on its ability to continue to provide the goods or services for which it was designed, otherwise known as its service potential. If the service potential of an asset is undiminished a degree of physical deterioration may not adversely affect the value.

We are unsure as to the nature of this paragraph. If the intent of this statement to suggest that an asset's remaining useful life is unaffected by its age assuming the asset continues to provide goods or services, then we would disagree with this statement. Adjustments should be made for the physical age of an asset.

FUNCTIONAL OBSOLESCENCE

27. Functional obsolescence (sometimes called technical obsolescence) is the loss in value resulting from inefficiencies in the subject asset compared to a more efficient or less costly asset. Functional obsolescence often arises because of advances in technology. A machine may be capable of replacement with a smaller cheaper equivalent that provides a similar output; a modern building may be more energy efficient because of superior insulation and modern services.

See paragraph 30 commentary.

28. Functional obsolescence can be measured by considering either the excess operating cost of the subject asset compared with a modern equivalent or the excess capital cost of replacing the subject asset compared with a modern equivalent.

This paragraph seems to imply that you cannot have both excess operating cost and excess capital cost.

We suggest revising to read: “Functional obsolescence can be measured by considering (deleted either) the excess operating cost of the subject asset compared with a modern equivalent and/or the excess capital cost of replacing the subject asset compared with a modern equivalent, as appropriate.”

29. Examples of excess operating cost in respect of machinery and equipment include:
   - the subject asset may require more operators compared to a currently available replacement asset.
   - The subject asset may have a lower rate of productivity compared to a currently available replacement asset.
   - The subject asset may produce more scrap or waste material compared to a currently available replacement asset.
30. In each case the present value of the excess operating costs in terms of labour, inefficiency or consumption of raw materials is used to arrive at a measure of functional obsolescence.

*We suggest adding a couple of pertinent points to this paragraph. It should also be noted that the present value should be applied over the remaining useful life of the asset and that the penalty should not exceed the cost-to-cure the functional obsolescence identified within the asset.*

31. An example of excess capital cost is where the subject asset is over-engineered for its required function. Over-engineering can arise where methods of construction or materials of construction have improved since the subject asset was originally put into service meaning that a modern replacement providing similar service potential would cost less (i.e. where replacement cost is lower than reproduction cost).

*No Comments*

32. Another example of excess capital cost is where the subject asset has excess capacity compared to the reasonably foreseeable demand. The cost-to-capacity method can be used to make the necessary functional obsolescence adjustment. Under the cost-to-capacity method the replacement cost of an asset with an actual or required capacity can be determined by reference to the cost of a similar asset with a different capacity. This methodology recognizes that not all costs vary with size on a linear basis. For example, if the cost of a 2,000 hp locomotive is X it does not necessarily mean that the cost of a 4,000 hp locomotive is X times 2 or the cost of a 1,000 hp locomotive X divided by 2. The exponent (or cost-to-capacity factor) can be determined by analysing published and historical costs of similar assets of different sizes and capacities.

*No Comments*

33. One asset’s capacity may be limited by the capacity of another related asset and thus may be curable functional obsolescence.

*See comments on paragraph 30.*

34. Care should be taken to avoid double counting of depreciation. If the replacement cost is based on a modern equivalent this will already assume that any redundant features of the subject asset would not be replaced by a market participant thus making further adjustment for the functional obsolescence associated with these features unnecessary.

*Similar to paragraph 28, this paragraph seems to imply that you cannot have both excess operating cost and excess capital cost. Excess operating cost penalties may still need to be applied.*

35. Optimisation is a term that is sometimes used to describe the process of adjusting the replacement cost to reflect that an asset may be functionally obsolete or overengineered, or that the asset may have a greater capacity than that required. The concept of optimisation is one given some prominence in valuations of monopoly assets for regulatory pricing purposes in certain regimes.

*The “optimisation” appears to be specific to regulatory assets. Further comment should be made as to its applicability to other industries. Typically, we would think that this type of “optimisation” would be captured in excess capital cost.*
ECONOMIC OBsolescence

36. Economic obsolescence is the loss in value caused by factors which are external to the asset itself. Such factors often relate to the economics of the industry in which the business operates or the business in which the asset is employed.

*When quantifying business-specific margin-based economic obsolescence penalties, we would suggest that the margins of market participants within the industry be considered in comparison to the business being appraised.*

37. Adverse changes in the economic environment, new legislation or regulation, or the fear or risk of such changes, increased raw materials or labour costs or reduced product sales receipts may also contribute to economic obsolescence. These factors may be specific to a particular location or may be more generally experienced throughout an industry sector.

*No Comments*

38. Negative movements in gross margin (the difference between an operation’s revenues and the cost of the raw materials it uses) may be an indicator of economic obsolescence.

*No Comments*

39. Economic obsolescence can be calculated on a percentage basis by comparing the actual operating level of the asset to its rated capacity. The economic obsolescence adjustment is deducted after physical deterioration and functional obsolescence because economic obsolescence is independent of the asset(s).

*We agree with the intention of this paragraph, however, caution must be exercised to make sure there is no double counting or confusion with the quantification of functional obsolescence. For example, a bottleneck in a production line would have an effect on the actual operating level as compared to the rated capacity which would not be considered economic obsolescence, but functional obsolescence.*

*We would suggest clarifying that the economic obsolescence is external to the asset as well.*

40. Economic obsolescence may also be assessed for some assets by considering whether the going concern business could afford to pay a market rent for the assets and still generate a market rate of return having regard to the value of the asset.

*No Comments*

41. Economic obsolescence may arise when external factors affect an entire business, (i.e. all tangible and intangible assets of the entity or cash generating unit, rather than individual assets). Where this is the case it can be measured using a discounted cash flow or other present value technique.

*We would suggest that further clarification be added as to when economic obsolescence may arise. For example, economic obsolescence may apply to a specific segment of a business rather than in aggregate.*
42. If economic obsolescence is measured by reference to the performance of the whole business, in order to estimate the value of an individual asset using the DRC method the economic obsolescence will have to be allocated to individual assets. Cash or cash equivalents do not suffer obsolescence and are not adjusted. Marketable assets (e.g. land, marketable financial assets, etc.) are not adjusted below their market value determined using the market approach. Illustrative examples of adjusting for economic obsolescence at the whole business level are included in the Annexe to this Exposure Draft.

No Comments

43. The value of a specialised asset will not be below its value for an alternative use, including for scrap, salvage or recycling, less the costs of clearance including decommissioning and any decontamination required.

We agree with the nature of this paragraph with respect to specialised assets. Additional comment should be made with respect to the floor values for non-specialised assets.

44. It is acknowledged that economic obsolescence is typically the most difficult form of obsolescence to identify and quantify. However its impact may be very significant. It would be inappropriate to report the outcome of a DRC valuation of a specialized asset as market value unless economic obsolescence is considered, measured and applied. Market evidence and the methods used to estimate economic obsolescence should be properly disclosed in the report.

No Comments

ASSET LIFE

45. Depreciation of the replacement cost is often measured by comparing the remaining life of the subject asset at the valuation date with its expected total life.

No Comments

46. The remaining life can be measured by time alone or by the number of units produced or consumed in a given period. The remaining life can also depend on either physical or economic factors, or a combination of both. The physical life is how long the asset, ignoring any potential for refurbishment or reconstruction, could be used before the asset would be completely worn out or beyond economic repair. The economic life is how long it is anticipated that the asset could generate returns or provide a financial benefit. The remaining life for valuation purposes will be the lower of the physical life and economic life where these do not coincide.

We would revise the last sentence to read: “The remaining life for valuation purposes will be the lower of the physical life or economic life where these do not coincide.”

47. Some assets may have a residual value at the end of their remaining life as determined above. This may be equivalent to scrap or salvage value or a value that reflects the ability of the asset to contribute to the ongoing operation of a business with increased maintenance and operating costs.

We understand the objective of this paragraph. However, the second sentence may be too ambiguous and open to interpretation. Further clarification may need to be provided.
48. In assessing the remaining life, it may be assumed that routine servicing and repairs are undertaken, but the possibility of materially extending the life of the asset by significant refurbishment or the replacement of components is disregarded except where this is part of the normal life-cycle of the asset.

No Comments

49. For some classes of asset a regular pattern, or profile, of depreciation can be determined over the whole life of the asset, thus enabling the appropriate rate of depreciation at the valuation date to be determined. Typical depreciation profiles include:
   ▶ Straight-line: this deducts the same proportion of the original cost for each period of the estimated life of the asset.
   ▶ Diminishing value: this deducts a constant percentage rate from the cost at the start of the previous period over the estimated life of the asset.
   ▶ S-curve: this deducts different percentage rates for each period over the estimated life of the asset. An example would be where initial depreciation is higher, reduces in the middle years and then increases again towards the end of the asset’s life.

   If the “S-curve” is an Iowa survivor curve reference, this bullet should be more general as there are many different types of Iowa survivor curves. An additional, curve not mentioned in this paragraph, is a market based curve, which can be developed as a percentage based on a comparison of the source documentation whether it be historical cost or replacement cost.

50. Depreciation and estimates of the remaining life may be influenced by market trends, the intentions of market participants or both. The application of the DRC method should replicate the deductive process of a potential buyer with limited comparable sales for reference. Depreciation profiles adopted in a DRC method should therefore seek to reflect market dynamics.

   In paragraph 49 three examples of depreciation profiles are provided. Each of these profiles account only for physical deterioration. In the final sentence of paragraph 50 it should be noted that all market dynamics should be reflected in an analysis. Other market dynamics such as economic / external obsolescence would need to be explored and quantified separately.

51. For some assets market-derived depreciation profiles can be determined from a regression analysis of market sales prices for similar assets compared to replacement costs and capture by default the impact of all forms of obsolescence.

   We agree with this statement, however, there can still be asset-specific functional and economic obsolescence issues. Additionally, the appraiser would still need to follow standard market approach procedures in adjusting the comparables to the subject base.

52. For some assets a units-of-production or cycles-based depreciation method may provide a better measure of the consumption of service potential. However this method has some limitations because values are typically required at the individual asset level. It is not always possible to measure units-of-production or cycles at this level because each different type of asset may be replaced on a cycle that reflects the rate at which that item deteriorates over time having regard to various factors such as intensity of use.

No Comments
53. It is also often problematic to assess the life of individual assets (and complete facilities) measured in terms of units of production or cycles, and therefore, whilst it may be possible to determine the number of units produced or life consumed as at the date of assessment it may be difficult to determine the total number of units that will be produced over the entire life of the asset. There are also difficulties in applying a units-of-production or cycles-based method in respect of assets such as buildings, site improvements and non-production (service and support) assets.

No Comments

VALUATION CONSIDERATIONS

54. All appropriate enquiries to obtain a full understanding of the economics of the industry or service line in which the subject asset is employed should be made. An understanding is also necessary to understand the relative advantages or disadvantages of the asset in relation to comparable assets utilised elsewhere in order to properly assess its remaining life, physical deterioration, economic and functional obsolescence.

No Comments

BASES OF VALUE

We would suggest using “Premises of value” for section title.

55. The DRC method can be used to give an indication of value on a variety of bases. If the purpose of the valuation requires a market basis, such as market value or fair value for financial reporting purposes it is important that all the valuation inputs are based as closely as possible on market derived data. For example, the replacement cost should reflect the cost that a market participant would have to pay to acquire an equivalent asset providing the level of utility that a market participant would expect; deductions for obsolescence should be made by reference to the market and views of market participants. It is particularly important that proper regard is had to economic obsolescence based on metrics for the appropriate sector, not just on the financial performance of the current owner which may or may not be typical of market participants generally.

We would suggest defining bases as “Premise of Value”

56. When a market basis of value is required it may also be necessary to consider whether the highest and best use of the subject asset is for the existing or an alternative use. If the asset potentially has a higher value for an alternative use the DRC method may not provide an appropriate measure of market value because a market participant would not be considering the cost of replacing the existing asset with an equivalent alternative but instead the economic benefits accruing from the alternative use.

No Comments

57. An example of the above would be a specialised real property where changes in the locality since its original construction may mean that the property interest may be purchased by someone who would have no intention of continuing the current use but would use the site for a different purpose. Under this scenario the market value would be the higher of:

- the value of the land for the alternative use less the costs of closure, decommissioning and clearance of the existing buildings. The value of the land for the alternative use is likely to have been derived by using either a market approach or an income approach.
The value of the whole of the specialised property derived using a DRC method, based on the cost of acquiring an equivalent alternative facility for the same use, less depreciation.

We would suggest revising the first sentence to state “An example of the above would be a specialized buildings and improvements...” Land would not qualify as specialized.

58. In this example care should be taken to avoid confusing the two approaches. It is particularly important to make a clear distinction between the value of the land element of the subject asset for the alternative use derived using other valuation methods and the cost of acquiring equivalent land suitable for replacing the existing asset under the DRC method.

No Comments

59. In various circumstances a basis of value other than market value may be required to be estimated such that all forms of obsolescence will not need to be identified and quantified in respect of individual assets. For example, valuations for tariff setting purposes of regulated monopoly assets and certain statutory purposes are commonplace in many jurisdictions around the world and often stipulate a DRC method at their core but one that does not capture all forms of obsolescence. These include water and wastewater infrastructure, gas pipelines and distribution networks, power stations, rail infrastructure, telephone networks, etc. The outcome of such valuations does not provide a measure of market value and should not be described as such.

The final arbiter of market value is what a market participant would pay. Such a market value (or allocation to tangible assets) may be at, above, or below what a DRC value may provide. Hence, the last sentence is not helpful.