

Australian Infrastructure Financial Management Guidelines

POSITION PAPER 1

ASSET CONSUMPTION AND ASSET RENEWAL

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Principal Authors John Howard, David Hope
Contributing Authors Chris Champion, Dr Penny Burns

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1. SCOPE

This position paper explores the issues relating to financial reporting of asset consumption and asset renewal for long lived (> 10 years) infrastructure.

2. ISSUES

Financial reporting of asset consumption is often confused with asset renewal.

Asset consumption is reported as depreciation expense in financial reports. It is reporting on consumption of past investments over the life cycle of the assets, which can be up to or over 100 years. Annual depreciation is a long term average and experiences minimal variation over time.

Depreciation (asset consumption) is used to allocate cost (actual or revalued) over the life of the asset. For local government, councils must generate sufficient income from rates and other sources to achieve a balanced operating position inclusive of depreciation expense.

Asset renewal projections are estimates of cashflow required for provision of services in the future. Asset renewal cashflow is variable over time as it depends on services and service levels to be provided in the future, as well as the age and condition profile of the asset stock.

Renewal estimates are based on the cost or renewing/replacing the asset along with expected timing of that event, in order to produce a forward cashflow for the asset management plan.

The ratio of annual depreciation to asset capital expenditure on asset renewal is often recognised as a measure of sustainability of not-for-profit entities such as local governments. This measure does not accurately report 'sustainability' as it compares a long term average figure of asset consumption with variable annual expenditure on asset renewal.

This paper documents the basis of calculation and use of depreciation expense in reporting asset consumption and its difference with asset renewal cashflow projections.

3. REQUIREMENTS FOR ASSET CONSUMPTION / DEPRECIATION

Guidance in recognising and reporting on assets is provided by Australian Accounting Standards. The main standard applicable to infrastructure assets is AASB 116 Property Plant and Equipment, issued in July 2004. Under AASB 116, property plant and equipment are 'tangible items that are held for use in the production of goods or supply of services, or for administrative purposes ... and are 'expected to be used in more than one period'.¹ Relevant definitions and commentary from the Standards are summarised below.

3.1 Definition of an asset

"An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."²

There are three specific elements that define an asset:

- Future economic benefits – in the case of public sector entities, future economic benefits (or service potential) are the goods and services to be provided by the asset, whether or not the entity receives a net cash inflow for their provision.
- Control by the entity - control means the ability of the entity to benefit from the future economic benefits or to restrict the access of others to those benefits.
- Occurrence of past event – the asset must be in existence. A contract to purchase an asset does not give rise to an asset, nor does the intent to acquire an asset. The asset must have been purchased, acquired or transferred to the control of the entity prior to the date of the financial report.

3.2 Recognition of an Asset

"An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably."³

The two essential components of recognition:

- Probable future economic benefits – probable means that it is more likely than less likely that the benefits will be realised.
- Reliably measured – reliability means the faithful representation of the underlying transactions or events, without bias or error. Essentially, a third party would come to a similar value if presented with the information relating to the transactions or events.

3.3 Measurement at Recognition

"An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost."

Aus15.1 Notwithstanding paragraph 15, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition."⁴

Note: AASB 116 defines fair value as "...the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction."

¹ AASB 166 6, p12

² AASB, 2004, Framework for the Preparation and Presentation of Financial Statements, Para 49(a).

³, op cit, Para 89.

⁴ AASB 116 – Property Plant and Equipment, Para 15

“16. The cost of an item of property, plant and equipment comprises:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;*
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and*
- (c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.*

17. Examples of directly attributable costs are:

- (a) costs of employee benefits (as defined in AASB 119 Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;*
- (b) costs of site preparation;*
- (c) initial delivery and handling costs;*
- (d) installation and assembly costs;*
- (e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and*
- (f) professional fees.*

23. The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date...⁵

Paragraph 19 sets out items that are not elements of the cost of an asset:

“19. Examples of costs that are not costs of an item of property, plant and equipment are:

- (a) costs of opening a new facility;*
- (b) costs of introducing a new product or service (including costs of advertising and promotional activities);*
- (c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and*
- (d) administration and other general overhead costs.⁶*

3.4 Measurement after Recognition

Unusually, Australian Financial Reporting Standards provide two bases for the measurement of assets after their initial recognition. The first basis is cost and the second basis is fair value at the date that the measurement is made. These bases are set out in AASB 116 – *Property Plant and Equipment* at paragraphs 29 to 31:

“29. An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

Cost Model

30. After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model

31. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the

⁵ AASB 116, Paras 16-27

⁶ AASB 116, Para 19

*carrying amount does not differ materially from that which would be determined using fair value at the reporting date.*⁷

There is a strong presumption that public sector entities will use fair value, adjusted for any subsequent depreciation amounts and impairment losses. However, there are many examples where councils have chosen to apply the cost basis for assets with useful lives that do not exceed ten years. Issues associated with revaluation are further discussed in Position Paper 6 – Revaluation.

Note: **Useful life** is defined in AASB 116 as “... (a) the period over which an asset is expected to be available for use by an entity; or (b) the number of production or similar units expected to be obtained from the asset by an entity.”⁸

3.5 Depreciation of Assets

Two definitions in AASB 116 – Property Plant and Equipment are useful to understand the concept of depreciation. They are:

“Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

*Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.*⁹

Depreciation provides two key information sets for public sector entities:

- The rate at which the entity’s asset base is used up; and
- Information for the pricing of services.

In the context of asset capitalisation, depreciation is an important determinant of the current fair value of an asset. Paragraphs 43 to 62 of AASB 116 – *Property Plant and Equipment* provide guidance in applying the concept of depreciation in valuing assets.

“50. The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51. The residual value and the useful life of an asset shall be reviewed at least at the end of each annual reporting period and, if expectations differ from previous estimates, the changes(s) shall be accounted for as an change in an accounting estimate in accordance with AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors.”

“60. The depreciation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity.”

“61. The depreciation method applied to an asset shall be reviewed at least at the end of each annual reporting period and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. ...”¹⁰

The review of residual life and useful life of an asset to reflect the consumption of future economic benefits is further discussed in Position Paper 7, Determining Remaining and Useful Lives.

⁷ AASB 116, Paras 29-31

⁸ AASB 116, Para 6.

⁹ Op cit, Para 6.

¹⁰ Op cit Paras 50-51, 60-61

4. DISCUSSION ON ASSET CONSUMPTION / RENEWAL

4.1 Asset Consumption

Asset consumption is reported as depreciation expense. Depreciation is the allocation of the depreciable amount of an asset over its useful life. The depreciable amount is the cost (or amount substituted for cost) less residual value. Depreciable amount is the value of economic benefits (or service potential) of the asset consumed over the asset's useful life. The cost of an asset is the purchase/construction cost plus cost of bringing the asset into service plus an estimate of the cost of removing the asset and restoring the site where the entity is obligated to do so.

Depreciation reports the consumption of past investments in infrastructure over their useful life at either historical cost or revalued 'fair value'.

Depreciation is used to allocate cost (actual or revalued) over the life of the asset.

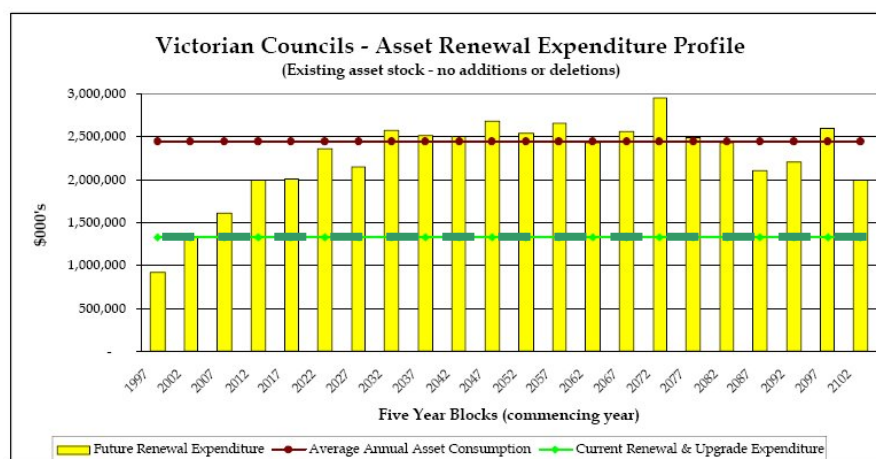
4.2 Asset Renewal

Asset renewal is required to sustain service provision from infrastructure beyond the initial life of the asset. Asset renewal projections are generally based on forecast renewal (by replacement, refurbishment or reconstruction) of assets to maintain desired service levels. Renewal projections are dependent on various factors including:

- Age profile of the asset stock
- Condition of the asset stock
- Service level performance
- Usage
- Demand and augmentation need
- Changing user preferences
- Economics and cost of service delivery

Actual renewals will depend on available funding and acceptance of changes in service levels. These factors are discussed in Position Papers 2. The variability of asset renewal projections over time was identified in *Facing the Renewal Challenge* and is illustrated in Fig 1. The yellow bars indicate estimated renewal cashflow needs which can be compared to the red line showing the Annual Average Asset Consumption or Annual Depreciation Expense and Current Renewal and Upgrade (Capital) Expenditure as a dark green dashed line.

Fig 1. Asset Renewal Profile Victorian Councils
Source. 'Facing the Renewal Challenge', Fig 1.1 p 9



4.3 Asset Renewal Costs

Asset renewal costs are not necessarily the same as the recognised cost or revalued amount. This issue is explored in greater detail in Position Paper 6 – Revaluation. Renewal costs to sustain the same level of service can be affected by factors such as:

- Restoration costs where improvements have been erected on the site over an underground pipeline asset.
- Change in standards where renewals must comply with current standards that did not exist when the asset was acquired including,
 - Environmental Protection Acts requiring controlled treatment and disposal of materials from site works,
- Site working conditions such as provision for traffic control, limitations on access to sites and working hours,
- Removal of 'old' materials when the asset is renewed.
- Changes in technology.
- Relocation of other utility services,
- Increased workplace health and safety standards,
- Currency of valuations. Assuming a 3% annual increase in costs, Councils adopting a 5 year revaluation cycle can see their asset values understated by 14% in the fifth year of the cycle. Councils who have not revalued their assets since initial recognition in 1996, can see their asset values understated by 29% in after 12 years.

The above factors will generally lead to renewal cost greater than the cost or revalued amount used for valuation and depreciation expense calculation.

Low cost renewal methods can be used for renewal of some assets. These include:

- Sealed road pavement recycling and stabilisation with cement, lime or other product.
- Sealed road pavement renewal by light ripping the surface, adding a pavement material layer to restore the pavement profile and seal the surface.
- Structural lining of drainage, water and sewerage pipelines. MacPherson and Kennedy¹¹ report structural relining of 300 mm stormwater pipelines in Logan City Council (Qld) at a cost of approx \$100 / lin m compared to replacement at \$270 / lin m.

The selection of low cost renewal methods can only be done after proper engineering investigation of alternate renewal treatments.

The variability of asset renewal costs to asset values can range significantly from greenfield asset value.

4.4 Asset Upgrade Costs

Asset renewal is restoration of the service potential of the asset and is generally planned as 'like for like'. In reality asset renewal is often combined with asset upgrade to provide a higher level of service.

Asset management plans should identify asset renewal separately from asset upgrade and expansion.

Where asset upgrade is incorporated into asset renewals, this will add additional costs for the higher level of service costs due to:

- Change in standards where renewals must comply with current standards that did not exist when the asset was acquired including,
 - Disability Discrimination Act requiring incorporating a lift for disability access in building renewal (lift is an upgrade)

¹¹ 2005, Fig 4, Appendix 4, p 11.

- Traffic regulations requiring greater road pavement depth and stronger bridges to accommodate increased vehicle mass limits (increased pavement depth and increased bridge dimensions are upgrades),
- Improved hydrology (rainfall) records and knowledge requiring drainage pipes of a larger capacity (increase in pipe size is an upgrade),
- Community Art legislation requiring the incorporation of public art assets into renewal projects (art works are an upgrade)
- Growth in demand for services from increased population and usage including,
 - Increased traffic volumes requiring wider road pavements (additional width is an upgrade),
 - Increased land usage density and demand for on street car parking requiring for kerbing and shoulder/lane sealing with road renewal (increased width and new assets are an upgrade),
 - Increased usage of libraries requiring additional floor space in building renewals (additional floor space and services are an upgrade),
- Community demands for higher service levels requiring replacement of 1.2m wide asphalt footpaths with 1.5m wide brick/segmental pavers (additional unit cost and width is an upgrade),

4.5 Asset Expansion Costs

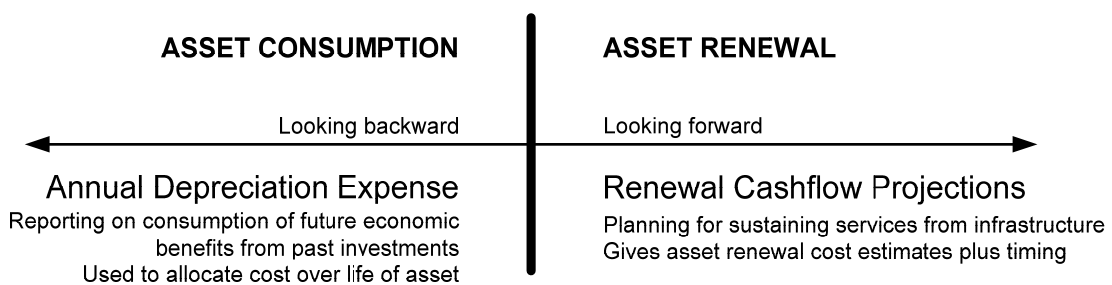
As well as asset renewal which sustains services at the same level of service and asset upgrade, which provides a higher level of service, service entities regularly provide new assets which expand asset services to new residents and users. The effect of asset renewal, upgrade and expansion on future service, cost and revenue is shown in Table 1.

Table 1. Service, Cost and Revenue Effects of Asset Renewal, Upgrade and Expansion

	Service Effects	Cost Effects	Revenue Effects
Asset Renewal	Sustains services at the same service level.	Generally no increase in operating expenses. Has the potential to reduce maintenance expenditure in the short – medium term through design.	No effect on revenue.
Asset Upgrade	Enhancement of an existing asset to provide a higher level of service.	Increases future operating and maintenance costs.	Generally, no effect on revenue, although limited revenue may be generated from fees from increased usage and/or higher user fees.
Asset Expansion	Extension of an asset at the same level of service as is currently enjoyed by residents to a new group of users.	Increases future operating and maintenance costs.	May be associated with additional revenue from the new user group.

Conceptually, asset consumption and asset renewal can be viewed at looking backward and looking forward as illustrated in Fig 2.

Fig 2. Conceptual View of Asset Consumption and Asset Renewal

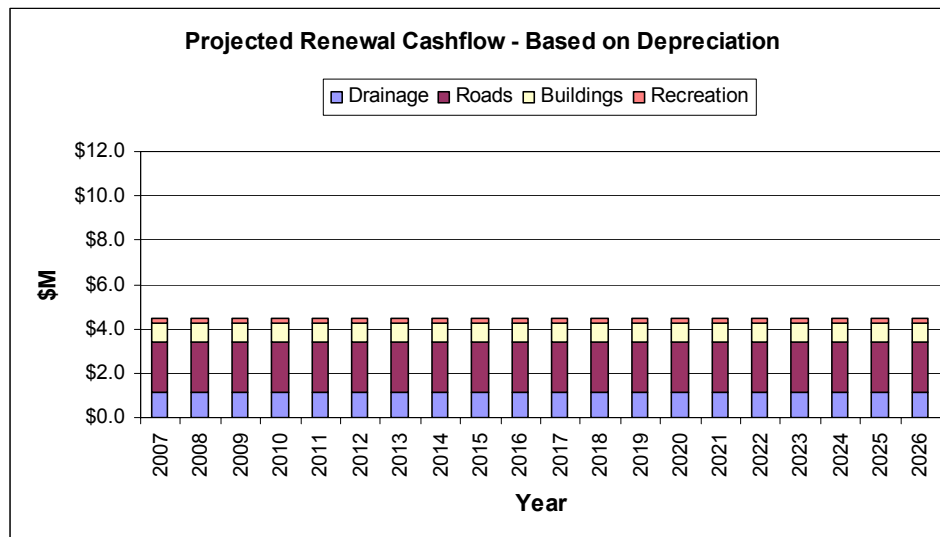


5. OPTIONS FOR RENEWAL PLANNING

5.1 Use depreciation for renewal planning

This option would see entities using annual depreciation expense for renewal planning. A typical renewal cashflow for a network of assets is shown in Fig 3.

Fig 3. Projected Renewal Cashflow, Based on Depreciation Expense



The advantages and disadvantages of this option are shown in Table 2.

Table 2. Option 1, Advantages and Disadvantages

Advantages	Disadvantages
Simple process, requiring few resources.	Process is flawed as it provided NO information whatsoever for planning purposes
Gives a comparison with 'average' renewal costs which may be useful as first indicator of funding position i.e. funding is 20% of the average need.	Does not take into account estimated renewal costs nor renewal timing.
	Overstates amount of renewal needed in early years and encourages unnecessary renewal spending.
	Understates the amount of renewal needed in later years and fails to indicate the funding levels needed to ensure service levels remain functional.

5.2 Use asset replacement values for renewal planning

This option would see the use of replacement values held in entities' asset registers for renewal planning. Renewal cashflow needs are projected from replacement values held in asset registers and remaining life, where remaining life is estimated useful life of each asset minus age. The output is a schedule of renewal costs based on replacement values held in the asset register and remaining life. A typical renewal cashflow for a network of assets is shown in Fig 4.

Fig 4. Projected Renewal Cashflow, Based on Asset Register Data

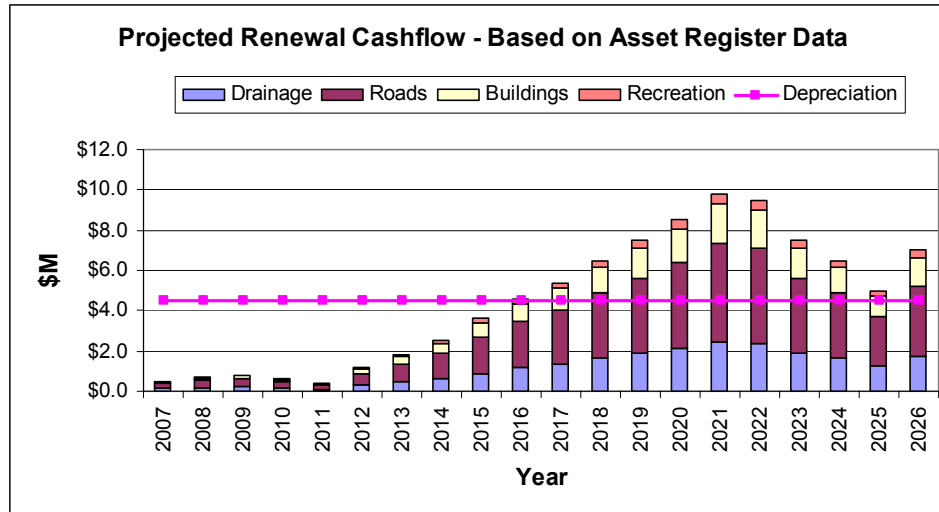


Table 3. Option 2, Advantages and Disadvantages

Advantages	Disadvantages
Simple process, involving available data in asset registers	Data in asset register may not be current values
Accounts for variability in timing of projected renewals based on available data in asset registers	Does not take into account estimated renewal costs for individual or group(s) of assets

5.3 Use separate valuation/depreciation and asset renewal processes

Option three identifies the valuation/depreciation process and asset renewal process as separate procedures.

This requires asset renewal strategies to be developed and estimates of renewal prepared from investigation of projected renewal costs as well as estimates of remaining life from service life analysis. This data is presented in an Asset Management Plan. It will require asset renewal costs being identified for assets (or similar groups or assets), reviewing remaining life from condition or service life analysis and preparing a schedule of asset renewals. A typical renewal profile based on adopted renewal strategies for the network of assets detailed in Table 4 is shown in Fig 5.

Table 4. Renewal Strategies and Renewal Cost Estimates

Asset Category	Renewal Strategy	Renewal cost
Drainage	Structural relining.	Based on relining estimates for individual pipe sizes and access structure renewals.
Roads	<p>Urban arterial and collector roads – asphalt resurfacing and heavy patching of 5% of pavement at 12 year cycle, reconstruction and upgrade to current standards at 60 year cycle.</p> <p>Urban residential roads – flush reseal and heavy patching of 3% of pavement at 15 year cycle, pavement recycling + cement stabilisation at 75 year cycle.</p> <p>Rural roads – flush reseal and heavy patching of 3% of pavement at 18 year cycle, light ripping, add 100 mm of natural gravel and seal at 72 year cycle.</p>	<p>Arterial & collectors – resurfacing and heavy patching* at 12 year cycle, – pavement reconstruction based on replacing 150 and 250 mm pavements with 450 mm pavement plus service relocations</p> <p>Residential – resealing and heavy patching* at 15 year cycle, – pavement recycling and stabilisation at 75 year cycle.</p> <p>Rural – resealing and heavy patching* at 18 year cycle, – pavement renewal with additional material and seal at 72 years.</p>
Buildings	Refurbishment or replacement to suit individual service needs and current legislative requirements	Based on individual renewal and upgrade estimates for each building asset.
Recreation	Refurbishment or replacement to suit individual service needs and current legislative requirements	Based on individual renewal and upgrade estimates for each recreation asset.

Note: Renewal cost estimates are examples only and are not representative of all councils.

* The treatment of heavy patching as maintenance or capital renewal expenditure will depend on a council's capital threshold policy. This is further discussed in Position Paper 5 Capitalisation Policies.

Fig 5. Projected Renewal Cashflow, Based on Estimated Renewal Cost and Remaining Life

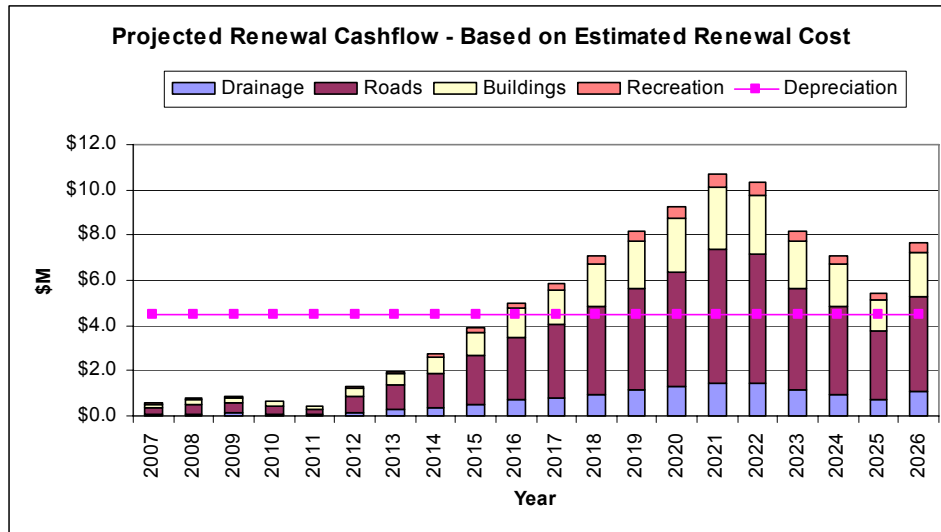


Table 5. Option 3, Advantages and Disadvantages

Advantages	Disadvantages
Renewal projections are based on actual estimates of renewal costs and remaining life based on individual asset condition and service life	Requires resources to investigate renewal strategies and estimate renewal costs. These are usually documented in an Asset Management Plan.
Greater knowledge of remaining life can be used to improve useful life estimates and accuracy of financial reporting of asset consumption as depreciation expense	Requires estimation of remaining life based on condition or service live for individual (or grouped) assets. This is discussed in Position Paper 7, Determining Remaining and Useful Lives.
Planning using most accurate information can avoid costly over or under expenditure in capital renewal and ensure revenue is matched to present and future service delivery needs.	

In summary, Option 3 provides the most accurate renewal cashflow projections based on actual renewal costs and timings.

6. SUMMARY

6.1 Asset Consumption

The community depends on services provided from infrastructure for its quality of life. Services from infrastructure include transport, flood control, recreation and culture.

As the services are provided to the community, these infrastructure assets are consumed (used up) over their life. This consumption of assets is reported as depreciation expense in councils' financial reports.

AASB 116, 60 specifies that depreciation is to reflect the consumption of future economic benefits. To account for the consumption of future economic benefits, AASB 116, 51 requires an annual review of the residual value and useful life and adjustments made to reflect any change in expectations.

Depreciation expense is used to allocate 'cost' (actual or revalued) of the asset over its life. 'Cost' is the cost to place the asset in service or for revalued assets, the cost of a modern equivalent asset that will provide the same level of service.

Councils and other infrastructure service providers must generate sufficient revenue from taxation, rates and charges to achieve a balanced operating position inclusive of depreciation. In this way, consumers of the infrastructure assets, pay for their share of assets consumed in the reporting period (financial year).

6.2 Asset Renewal

Asset renewal is required to sustain service provision beyond the original life of the asset. If the service provided by the asset is still required at the end of its life, the asset must be renewed. If the service is no longer required, the asset should not be renewed.

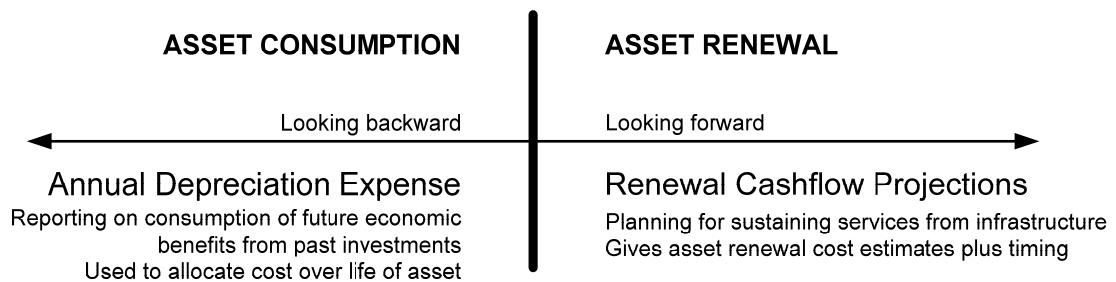
Cashflow required for asset renewal is variable over time as it depends on the services and level of services to be provided in the future as well as the condition and age profile of the asset stock.

Three methods of predicting asset renewal were discussed in this Position Paper together with advantages and disadvantages.

- Renewal projections based on depreciation expense – this does not take into account estimated renewal costs nor renewal timing. It overstates the amount of renewal needed in early years and encourages unnecessary renewal spending. It understates the amount of renewal needed in later years and fails to indicate the funding levels required to ensure service levels remain functional.
- Renewal projections based on existing asset register data – this method gives an indication of future renewal cashflows and timing of expenditures based on age and useful life estimates held in the asset register. Its accuracy is affected by the currency of asset values held in the asset register. It does not take into account the estimated renewal cost of individual (or groups of) assets nor the actual remaining life of the assets.
- Renewal projections based on estimated asset renewal costs for individual or group of assets and timing of expenditure – this method gives the most accurate estimate of funding required to ensure service levels remain functional.

7. RECOMMENDED POSITION

1. Asset consumption and asset renewal be recognised as two different concepts.
 - a. Asset consumption may be seen as 'looking backwards'. Asset consumption is reported in financial terms as annual depreciation expense, which reports on the consumption of future economic benefits from past investments. Depreciation is used to allocate the cost of consumption of the asset over its life.
 - b. Asset renewal is looking forward. Planning for sustaining services from infrastructure requires asset renewal cashflow projections. Asset renewal projections are based on estimated renewal costs and timing of renewals required to sustain services.



2. Depreciation of infrastructure assets is to be reported in accordance with Australian Accounting Standards. This may be summarised as follows.
 - a. Recognition at 'cost' to place the asset in service. For donated assets, 'cost' is fair value as at date of acquisition.
 - b. When revalued to 'fair value', revalued to the cost of a modern equivalent asset to deliver the same level of service;
 - c. Depreciated over its estimated useful life;
 - d. Depreciation method to reflect the consumption of future economic benefits;
 - e. Annual review of residual value and useful life and adjustments made to reflect any change in expectations.
3. Asset renewal future funding requirements are to be based on services and level of services required to be provided to the community in the future. Cashflow projections for providing agreed levels of service to the community are to be documented in asset management plans and used as input for long term financial plans.
4. Asset renewal cashflow projections are to be based on estimated cost of renewal and estimated remaining life for individual or groups of assets.

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Project contacts

John Howard, Project Manager, johnhoward.jra@bigpond.com M 0427 949 035

IPWEA National Office

Chris Champion, IPWEA CEO, cchampion@ipwea.org.au M 0407 207 934

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