Clarification on Conservativeness of the Salvage value

1. The details/ reference to the standard practise for the assumed salvage value of 48.59 at the terminal year.

   The salvage value taken represents 5% of fixed assets and the balance 95% has been depreciated over the lifetime of the project.

   Annex 45 of EB 41 states,

   "project IRR and equity IRR calculations shall as a preference reflect the period of expected operation of the underlying project activity (technical lifetime), or - *if a shorter period is chosen - include the fair value of the project activity assets at the end of the assessment period*. In general a minimum period of 10 years and a maximum of 20 years will be appropriate" (emphasis added).

   The Guidance also states,

   "The fair value should be calculated in accordance with *local accounting regulations* where available, or international best practice. It is expected that such fair value calculations will include both the book value of the asset and the reasonable expectation of the potential profit or loss on the realization of the assets" (emphasis added).

   In the instant case, IRR has been computed for 20 year period. It is a common practice among the financial institutions in India to take the salvage value at 5 to 10% of the cost of fixed assets as salvage value. This practice also finds support in a few articles published on the subject. *D. Gregg Dight*, in his article on *Appraising Equipment for Structured Finance Transactions Creating Residual Value Curves to Reflect Physical Depreciation, Obsolescence and Useful Life*, for example, states,

   > *"Salvage Value is a relatively basic concept defined as the recoverable value of an asset at the end of its useful life. There are rules of thumb that appraisers have developed over time based on experience and trends within many equipment markets. Most assets commonly seen in structured finance transactions will have a scrap value assumption of 5-10% of original cost. This estimate creates an "endpoint" to which a residual value curve can be constructed"[1] (emphasis added).*

   Considering the unique features of the project, in as much as the assets in hydropower projects are built for specific project site and the plant and machinery are subject to high wear and tear during the 20 year of operation and that no provision has been made for major repairs and maintenance in the cash flow, salvage value of 5% is quite conservative. Even if the salvage value is raised to 10%, the IRR does not cross the benchmark.

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[1] http://www.marshall-stevens.com/pdf/pub_ValueCurves.pdf

2. Details of the depreciation allowed as per Companies Act and Income Tax Act and the conservativeness of the approach followed.

Companies Act allows depreciation of 5.28% on straight line basis for plant and machinery[2]. Income Tax provides a choice of choosing between a straight line depreciation of 3.40%[3] or a WDV depreciation 15% on plant and machinery and 10% on buildings[4]. Companies Act depreciation is of no relevance as Income Tax calculations have to be based only depreciation rate prescribed under Income Tax Rules. This boils down to choosing between 3.4% straight line depreciation or 15% and 10% WDV depreciation. Higher the depreciation provided, lower the profit before tax, lower the tax, higher the cash inflow and higher the IRR. The worksheet is based on the WDV depreciation of 15% on plant and machinery and 10% on buildings. Hence, larger depreciation benefits have been accounted for in the initial years, reducing profit before taxation, thereby tax outflow and increasing the net cash inflow (as depreciation is added back in computing cash inflow). Hence, the approach adopted in the worksheet is conservative. Had the other option of 3.4% on straight line basis had been chosen, tax outflow would have been higher and consequently, IRR would have been lower.

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[2] Companies Act, Schedule XIV, Item II (i) (b) http://www.vakilno1.com/bareacts/companiesact/SCHEDULE%20659%20-%20674/sSCXIV%20-%20672.htm

[3] Income Tax Rules, Appendix IA, item No. (a) (i) http://law.incometaxindia.gov.in/TaxmannDit/DispCitation/ShowCit.aspx?fn=http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxRules/Rules2005/AppIa.htm

[4] Income Tax Rules, Appendix I, item I (2) and III (1) http://law.incometaxindia.gov.in/TaxmannDit/DispCitation/ShowCit.aspx?fn=http://law.incometaxindia.gov.in/DitTaxmann/IncomeTaxRules/Rules2005/APPENDIXI_new.htm