



The Chairman
Commerce Commission
PO Box 2351
Wellington

Dear Sir

Cross submission to the Commerce Commission on Price Control Study of Airfield Activities

1 Introduction

- 1.1 This cross submission focuses on the pricing principles and the asset valuation methodology for specialised assets contained in the Commission's draft report.
- 1.2 This cross submission does not attempt to address all points made by those interested persons who have made submissions but simply addresses some key points which reflect the Port Company Reform Working Groups ("PCRWG") point of view.
- 1.3 These submissions are made by an organisation that represents users of specialised assets (wharves and other specialised assets owned by seaports), in the context of a concern that seaports (like other owners of specialised assets), take advantage of a monopoly position. The PCRWG's position is that:
 - a. high prices (economic rents) for use of airports (and ports) add significant costs to firms in participating in a New Zealand market, and adversely impacts on their ability to compete in the national or international markets;
 - b. users simply want reasonable charges i.e. equivalent to those that would prevail in a competitive market; and
 - c. the prospect of achieving that will be enhanced by pricing principles and asset valuation methodologies based on sound economic principles, such as those advanced by the Commission in its draft Report.

2 Pricing Principles

- 2.1 The monopolists¹ that have made submissions reject the Commission's proposal pricing principles. For example, the Auckland International Airport Limited ("AIAL"):
 - a. says that the statement that "today's consumers should only bear today's costs" has little or no relevance in a market which is characterised by investments and assets which are very large, lumpy and have long lives (and will, therefore, be used to

¹ Christchurch International Airport Limited, United Networks Limited, Wellington International Airport Limited, Auckland International Airport Limited.

provide services well into the future).² However, as will be illustrated below, the statement of Alfred Kahn (a regulatory economist of international standing does not support this position (as a matter of principle)) on behalf of the AIAL. He accepts that today's users should only bear today's costs – being those costs caused by today's users;³

- b. argues against the principle that prices should allow for a “normal rate” of return by saying that “it could well be argued” that “normal” returns are in fact the absolute minimum shareholders should reasonably expect – in order to increase shareholder wealth and achieve a real value add, a return in excess of WACC is required and it should be achieved by companies if they are to be regarded as better than just “normal”.⁴ However, this “argument” is not in fact made (it is only noted that it “could” be made) and of course, it over looks the point that the argument cannot be made. AIAL, as a monopolist in relation to airfield activities, is to be constrained to a rate of return that returns, as it would prevail in a competitive market – ie “normal”. Here the WACC will allow for the “best” rate of return that could be expected given the risk profile faced by similar businesses;
- c. accepts the principle that prices should “cover” efficient operating costs, by noting they should **include** efficient operating costs and argues that this “may” be less appropriate in practice, because it is important to bear in mind that the “average (normal) firm will only be averagely efficient”.⁵ This is not a compelling response to the Commission's pricing principle that prices should cover efficient operating costs and no more. A firm competing in a competitive market will in the medium term, earn only a competitive rate of return (the “normal” return) and will recover only efficient operating costs; and
- d. no objection is taken to the principle that prices should send signals for determining whether new investment (or divestment) would be efficient.

Thus, the AIAL, as the interested person that would be most affected by the pricing principles should they be adopted, has not provided any compelling reasons why they should not be adopted

- 2.2 It must be noted that Alfred Kahn in his statement on behalf of AIAL does not reject the pricing principle that “today's consumers should only bear today's costs”. Instead, he only takes issue with the Commission's interpretation of that principle, on the basis that it proposes to exclude costs for which today's use of the Auckland Airport is unequivocally responsible.⁶ This is in effect an endorsement of the Commerce Commission's pricing principles. Alfred Kahn's position is summarised at page 6 of his statement as follows:

“My academic writings, occasional public statements and testimony consistently expound the proposition that ideally efficient rates would (and regulated rates should) track **short run marginal costs** (including congestion costs); and that where short run marginal cost pricing is **impractical**, efficient

² Para 4.9, page 57, AIAL Submission dated 14 August 2001.

³ Para 1.1.3, Page 4, Statement of Alfred E Kahn on behalf of Auckland International Airport Ltd, dated 10 August 2001.

⁴ Para 4.13, Page 58, AIAL Submission dated 14 August 2001.

⁵ Para 4.11, Page 57, AIAL Submission dated 14 August 2001.

⁶ Page 6, Statement of Alfred E Kahn on behalf of Auckland International Airport Ltd, dated 10 August 2001.

costs would be based on their surrogate, long run incremental costs. The latter include costs associated with the construction of additional capacity **when and as those costs become reasonably predictable.**" (Our emphasis).

- 2.3 The key points to note are:
- a. pricing should reflect short run marginal costs;
 - b. pricing should depart from short run marginal costs only where such short run marginal cost pricing is impractical; and
 - c. costs associated with the construction of additional capacity (as surrogate long run incremental costs) should only be included **when and as those costs become reasonably predictable**. Unless and until they become reasonably predictable, they should not be included.

In this regard, it is submitted that where the construction of additional capacity for assets dedicated to particular users becomes reasonably predictable, the users of the dedicated assets who will benefit from the additional capacity will be readily identifiable; the investment in the additional capacity should then be a matter of a bilateral contract between the asset owner and those users who will benefit, so that they can make a cost / benefit analysis of the additional capacity. In the case where the assets and the additional capacity are not dedicated to any one particular group of users, but are enjoyed by all users (e.g., numerous users of airfield facilities), the cost of the new investment in the additional capacity should be unbundled from other "today's costs" so that they are transparent to all users, so that they can make a cost/benefit analysis, and influence the asset owner's decision-making by the exercise of their countervailing market power. This implies the very least, an information disclosure regime.

3 Valuation of specialised assets

- 3.1 The submissions in response to the Commission's preliminary view, that specialised assets should be valued at historic costs, argue that replacement cost methodologies have greater regulatory support in the Australasian regulatory environment. For example, the report for AIAL by NERA (in support of the use of ODRC rather than historic cost), says that ODRC is widely used to value assets within infrastructure industries; forms part of the required approach to asset valuation for New Zealand electricity line businesses under the ODV methodology; is widely recognised as appropriate for valuing infrastructure assets within Australia; Australian state based regulators rely on ODRC; and ODRC has been used by the ACC in its 2001 decision on Sydney Airport Corporation Limited's pricing proposal.⁷
- 3.2 The short point is that in the New Zealand regulatory environment, the ODV methodology is prescribed by information disclosure regimes for the valuation of assets for information disclosure purposes only (to enable valid comparisons and benchmarking); not for pricing purposes.
- 3.3 In support of the Commission's position, we make the following specific points made against ODRC:

⁷ Para 5.2, Pages 19 – 20, "Price Control Study of Airfield Activities: A Critique", NERA report for Auckland International Airport Limited, dated August 2001.

- a. pricing on the basis of an ODRC/ODV asset valuation enables an inflated assessment of optimisation and asset lives, thus leveraging up prices. In the electricity and gas sectors, bypass has occurred which implies prices above the cost of bypass;
 - b. the New Zealand experience shows, there is no doubt that ODRC/ODV has resulted in high revaluations of assets and, therefore, wealth transfer from users to asset owners; and
 - c. pricing on the basis of ODC/ODV asset valuation has resulted in early and unnecessary price increases.
- 3.4 The fact of the matter is that ODRC/ODV methodologies requires a valuation of assets based on the replacement cost of assets when they are not due for replacement for up to some 30 to 50 years i.e. when the costs are not reasonably predictable. This transfers potential future costs (e.g. for replacement and/or additional capacity) onto today's users before they can be reasonably predicted – contrary to the economic principles articulated by Alfred Khan.

4 Conclusion

- 4.1 The NZSE is firmly of the view that the economic development of New Zealand will be best promoted by adopting the following in relation to pricing of specialised assets:
- a. specialised facilities (such as airfields, aprons etc in the context of airports) must be maintained and, therefore, there must be adequate incentives for new capital expenditure where warranted. This can be achieved by a price control regime which rewards new investment by allowing a commercial “normal” rate of return on capital invested; and
 - b. the prices imposed on users of those assets must not exceed the minimum level, consistent with providing this incentive i.e. the minimum commercial “normal” rate of return. If asset owners can increase prices on the basis of ever increasing revaluations of sunk cost fixed assets based on replacement costs and subjective assessments of optimisation, with no compensation to users for the ever increasing revaluation gains recovered through increased prices, New Zealand's long term development will be irretrievably damaged: Profit margins of a wide range of firms engaged in economic activities which depend upon the use of such specialised assets for their operation will decrease, causing firms to reduce activities or exit from markets, reduce employment opportunities, thus leading to reduced economic activities generally.

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