Orion

Orion’s cross-submission in regard to:

The Commerce Commission’s draft report: Price Control Study of Airfield Activities at Auckland, Wellington and Christchurch International Airports

31 August 2001

1. Orion

Orion New Zealand Limited is an electricity distribution company based in Christchurch, with line assets extending across Christchurch, Central Canterbury and Banks Peninsula.

2. Orion's Interest

Orion's interest in the matter of the airport study is focused on the valuation method proposed by the Commission in regard to specialised airfield assets. Orion believes that the draft report's consideration of alternative valuation methods is significantly flawed and leads to an erroneous conclusion.

3. Concern at Process

We note that the financial models contained in the Commission's draft report appear to have been sourced from a key protagonist, and a party likely to gain financially from the Commission's draft finding. This was not made known to all participants in the process.

Orion is seriously concerned about the process undertaken by the Commission and seeks a response from the Commission in regard to this dubious process.

4. Cross-submission

This cross-submission summarises the submissions made by seven parties in support of Historic Cost as a basis for valuing specialised airfield assets. Orion opposes the use of Historic Cost for this application and supports the use of ODRC.

Summary of submissions supporting Historic Cost

1. <u>Business New Zealand:</u>

The following is the salient excerpt from Business NZ in relation to the asset valuation methods employed by the Commission:

"3.7 Overall, we can agree in principle with the key finding of the Commission's draft report that inefficiencies exist in the market for airfield activities caused by airports exercising their substantial market power. However, this is predicated on the assumption that the Commission's analysis is proven to be correct. While we do not wish to delve too much into the detail of what is a lengthy and complex report, we note that the Commission's conclusion would have been influenced by a number of assumptions that were made in the analysis, particularly in the asset valuation, calculation of rates of return, and the benefit cost analysis. These assumptions will be open to debate.

3.8 The Commission's approaches to the valuation of specialised airfield assets on historical cost basis and the optimisation of land held for further development are fundamental when considering whether an airport is over-recovering. The practical implications are particularly significant for AIAL (the economic justification for price control on AIAL essentially hinges on one issue – the optimisation of the land set aside for a second runway). In principle, although, we agree with the Commission's approach on asset valuation and we believe that it should be applied consistently across other infrastructure industries, such as electricity, ports, gas etc."

This submission merely restates that the Commission's finding hinges around the use of Historic Cost. The submission does not show or prove why Historic Cost is appropriate, and then leaps to a conclusion that the Commission's approach should be used with a range of other infrastructure assets.

The point made in the middle of paragraph 3.8 is pertinent. Regardless of how it is valued, the optimisation step should determine whether or not to include the value of land set aside for a second runway. This is a quite separate issue from the debate over Historic Cost versus ODRC.

In summary, Orion submits that the Business NZ submission does not usefully contribute to the debate on the choice of asset valuation methodology for specialised airfield assets.

2. <u>Federated Farmers of New Zealand (Inc):</u>

This submission also quotes at length from the Commission's draft report and paraphrases the arguments used in the draft report. For example:

"2.14 The Federation strongly endorses the approach of the Commission in this respect. It would be totally inappropriate to include the replacement cost of the assets in forming the asset base as this would run contrary to the general principle that today's users should only pay for the costs associated with today's assets. Basing asset valuations on historical cost would still provide incentives to invest in specialised resources. Such an approach would result in prices being charged to today's "users" of services reflecting the cost of providing those services, but would not involve paying for the (possibly) upgraded services supplied to tomorrow's users."

The submission does not explain why replacement cost is inappropriate. The suggestion that today's users should only pay for the costs associated with today's assets is contradicted by Federated Farmers' support for Historic Cost. Historic Cost is likely to reflect the economic cost 20 years ago, not the economic cost of today.

This submission misses the point that consumers of a monopoly service should pay prices based on assets valued as modern equivalent assets so that they are not paying for more expensive old technology.

In summary, Orion submits that the Federated Farmers submission does not contribute any substantive new arguments to the debate on the choice of asset valuation methodology for specialised airfield assets.

3. New Zealand Shipping Federation:

This very brief submission supports the use of Historic Cost instead of optimised deprival value (ODV) as it would *"…greatly assist port users."* Orion questions whether port users would really benefit from the resulting under-investment and poor pricing signals in the longer term, arising from the use of Historic Cost. No further arguments are presented to support this choice of methodology.

4. Todd Energy Limited

This very brief submission consists almost entirely of direct quotes from the Commission's Draft Report. Todd Energy argues that no valuation methodology has been mandated by government for airfield activity and therefore one cannot argue that ODRC is one of the 'accepted' valuation methodologies.

Orion rejects Todd Energy's argument, because:

- ? The New Zealand Accounting Standards Review Board has recently established Financial Reporting Standard 3 (2 March 2001) under the Financial Reporting Act 1993. The standard promulgated by this statutory body requires assets to be valued at *"fair value"* and endorses depreciated replacement cost as an acceptable estimate of fair value *"where the fair value of an asset is not able to be reliably determined using market-based evidence";*[1]
- ? ODRC is used in other jurisdictions and in other industries;
- ? ODRC is supported by strong economic efficiency arguments (see Conclusion).

Orion therefore submits that ODRC is indeed an 'accepted' method for valuing such assets.

5. <u>Silver Fern Shipping Limited</u>

This brief submission restates the arguments of the Commission's Draft Report, including those made in support of the use of Historic Cost.

In summary, Orion submits that the Silver Fern Shipping Limited submission does not usefully contribute to the debate on the choice of asset valuation methodology for specialised airfield assets.

6. <u>Simon Terry Associates Limited</u>

This submission makes seven assertions in bullet point form in relation to ODRC. Orion's comments follow each:

- ? *"Pricing on the basis of an ODRC asset valuation, potentially inflated by the scope for "considerable discretion" in assessment of optimisation, valuation and asset lives, tends to push prices up to bypass levels, and above bypass where there are barriers to entry;"*

  Orion has found very limited scope for discretion in it's experience

[1] Refer FRS3 2 March 1993, Clauses 4.10, 4.23 and 7.1

in valuing electricity distribution assets. If there are any concerns regarding discretion, these could be addressed by the use of a handbook. The audit process, which itself is subject to scrutiny, further limits discretion. In the electricity industry, robust disclosure of valuation reports mitigates any perceived risk of valuation bias.

Under ODRC, asset values are established independently of price. However the consequent prices represent the prices that would be charged by another efficient operator in the market. If this player had the same history as the existing player, then clearly there is every likelihood that a new player could bypass an existing player. In reality, where an existing player has been there for some time, the depreciation of the existing assets under ODRC will mean that it is highly unlikely that prices could be pushed up to those reflecting (new) bypass costs.

? *"ODRC is not required to secure financial sustainability going forward and hence is not required to incentivise new investment;"*

No argument is made to support this assertion. Orion asserts that failing to place appropriate values on resources is economically inefficient and will indeed lead to under-investment.

? *"ODRC pricing can lead to financial unsustainability going forward in the presence of technological progress which lowers the cost of modern equivalent assets;"*

This is one of the STRENGTHS of ODRC. Modern equivalent assets are identified to mimic closely the cost of an efficient new entrant into a competitive market. If these costs are zero, then the ODRC is zero and no one, including government, should be expected to support an asset that has been replaced by normal market mechanisms. It is peculiar indeed for this submitter to make this argument.

We note that, assets in competitive markets effectively change hands at ODRC, not Historic Cost.

? "*Returns on sunk-cost assets are rents, not costs, and belong in the "plus", not the "cost", part of a cost-plus pricing formula;"*

Sunk assets have value. If users were deprived of them, then they would place real value on their return. This is the basis of ‘deprival value’. The assets are replaced to service when they reach the end of their useful life. Therefore they are every much as valid a cost as any other.

Returning to the essence of economic efficiency, by failing to attribute real value to sunk assets, resources are under-valued and under-investment will occur.

? *“Under New Zealand conditions application of ODRC frequently implies steep upward revaluation of assets and associated windfall wealth transfers from customers to asset owners;”*

If a seller has sold assets at an unsustainably low price, this is not a matter for a regulatory agency. A regulatory body’s role is to ensure that the prices charged in the future ensure sustainable services and are economically efficient.

The introduction of ODRC or ODV has enabled assets to be valued at their true value, today. Yes, in some cases, prices have increased as a result, but if this did not happen the consequent service would have been undervalued. Such distortions would lead to inappropriate downstream investment decisions by users of the service. Furthermore, such distortions usually lead to further bad investment decisions for the economy.

? *“Accordingly, far from deferring rate shocks, a shift to ODRC pricing tends to precipitate an early and unnecessary rates shock;”*

Orion contends that it is an unsustainable, low asset value in the past that would create any price shock, rather than the correction to a figure that reflects an economically efficient value (e.g. ODRC). This argument appears to be in relation to a transition, rather than to the valuation method itself.

? *“Replacement-cost-based pricing unjustifiably loads potential future costs onto today’s users of the service.”*

Orion rejects this argument. It is economically efficient and desirable for marginal costs to be signaled to users via the associated prices.

Orion notes that Simon Terry Associates then state: *“All of these points are well grounded in the relevant economics literature.”*

However they do not link this assertion to specific references in the literature and their arguments appear to be at odds with those of expert economists submitting on behalf of the airports.

The central issue is that of economic efficiency. Orion rejects the use of Historic Cost and questions how its use could lead to more efficient investment. We believe that it will not.

7. Board of Airline Representatives of New Zealand

The detailed comments from BARNZ in relation to the question *'Is it correct to value specialised airfield assets at depreciated historic cost?' are*:

"15.1 BARNZ considers that there are a number of different methodologies to value assets and agrees with the Commission that there are arguments for and against the use of historical cost and the use of ODRC. Whichever methodology is adopted, it is important that it is applied consistently and in an internally logical manner.

15.2 BARNZ agrees with the Commission that it is not appropriate to value specialised airfield assets at opportunity cost, since the zero opportunity cost would not provide appropriate signals. A return on and of the actual amount invested will reward the investor for the actual capital employed and provide the right signals for investment and efficiency.

15.3 However, it is worth noting that there are some circumstances where using historical costs will tend over time to inflate prices compared with the competitive outcome. This will happen where the real costs of producing assets with the same functional capacity decline over time as a result of improvements in technology."

The BARNZ submission is ambivalent to the valuation methodology used, seeking consistency in application only. They go so far as to express concerns over the use of Historic Cost.

Conclusion:

Orion submits that the arguments in support of the use of Historic Cost in relation to the valuation of specialised airfield assets are very weak, and furthermore, the submissions made in support of Historic Cost reveal this.

The central issue is that of economic efficiency. Orion rejects the use of Historic Cost and questions how its use could lead to more efficient investment. We believe that it will not.

Orion restates that ODRC is a more appropriate valuation method because:

1. ODRC mimics the value resulting from normal commercial activity in a competitive market. Anything less than this value has economic efficiency implications, leading to poor resource allocation through under-investment and hence to sub-optimal standards of service;

2. A suppressed value, such as that based on historic cost, will also lead to under-investment in substitutes (e.g. other airports, sea ports etc) therefore reducing competition. It will also lead to over-investment by users in dedicated assets and systems that are dependent on the use of that airport, and will result in unnecessary congestion;

3. The New Zealand Accounting Standards Review Board has recently established Financial Reporting Standard 3 (2 March 2001) under the Financial Reporting Act 1993. The standard promulgated by this statutory body requires assets to be valued at *"fair value"* and endorses depreciated replacement cost as an acceptable estimate of fair value *"where the fair value of an asset is not able to be reliably determined using market-based evidence";*

4. ODRC has a proven track record in other jurisdictions and industries;

5. The ODRC methodology is aligned with, and enhances, modern asset-management practices. In contrast, Historic Cost is irrelevant to modern asset-management practices.

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