



**Submission to the Commerce
Commission in respect of the
Commission's Draft Report on Price
Control of Airfield Activities**

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1 Introduction and summary

1.1 Submitter

This submission is from UnitedNetworks Limited ("UnitedNetworks"), Private Bag 102977, North Shore Mail Centre, Auckland 1333. Our contact is:

Jennie Vickers

Manager, Legal and Regulatory

DDI: (09) 919 4241

Mobile: (021) 274 9737

Email: jennie.vickers@unitednetworks.co.nz

UnitedNetworks is a public company listed on the New Zealand Stock Exchange. It is one of New Zealand's top ten companies as measured by market capitalisation. Its main shareholder is UtiliCorp United Inc which has a 70.2% shareholding. The UnitedNetworks Shareholders' Society Inc holds 10.7%, with the balance held by institutional investors and approximately 20,000 individual shareholders.

UnitedNetworks is New Zealand's largest electricity and gas distribution company, servicing approximately 50% of all gas consumers (120,000), and 30% of all electricity consumers (500,000) in New Zealand. We also have fibre optic telecommunications networks in Auckland and Wellington.

1.2 Summary of submission

In its draft report "Price Control Study of Airfield Activities at Auckland, Wellington, and Christchurch International Airports" dated 3 July 2001, the Commission sets out a general framework for assessing whether price control under the Commerce Act is warranted. This framework does not appear to be specific to airports. It would seem to signal the Commission's approach to price control in general. From UnitedNetworks' perspective, the Commission's approach developed in the draft report has potential implications for how the Commission may address its regulatory responsibilities in the electricity industry, which may also have a flow-on effect in the gas industry.

This submission sets out UnitedNetworks' views on the Commerce Commission's approach to price control as described in the Commission's draft report. Our focus is on policy issues. We do not comment on specific estimates in the Commission's draft. Our comments are summarised as follows:

- The price control methodology as described in the Commission's draft report focuses on the measurement and control of inputs. The test used by the Commission is implicitly rate of return regulation, which is being discarded in many other jurisdictions due to its efficiency reducing properties. This form of regulation diverts firms' attention from meeting customer needs in terms of a fair end price, service

quality and product differentiation, and weakens their incentives to minimise costs or use their assets in more efficient ways (e.g. by using existing electricity or gas assets to deliver telecommunications services).

The Commission should avoid imposing rate of return regulation, and consider carefully how a more innovative and targeted regime could enhance efficiency. In our view, a more efficient approach to price regulation would be output-based and customer-oriented. It would retain the many efficiency enhancing features of normal market processes, while at the same time identifying and correcting where possible any efficiency reducing behaviour. This would be consistent with the approach recommended by the Ministerial Inquiry into Electricity. After an extensive review of overseas regimes, the recommendation was that “the Commerce Commission should be responsible for the content and design of the information disclosure regulations, focussing on output and performance indicators that are meaningful to consumers” and that “Our overall conclusion is that targeted price control, in combination with the other measures we recommend, is likely to be just as effective as universal price control, and much less risky in terms of economic cost.”¹

- The concept of the Commission’s efficiency test is sound, that is, a regulatory change should be initiated if, and only if, it creates a net efficiency benefit. However, there are notable flaws in the Commission’s implementation of the efficiency test, as outlined below.
- The Commission’ choice of a hypothetical “nirvana” market outcome, as a benchmark for the status quo and price control outcome, is distracting and can be misleading. A better approach would be to compare the two feasible worlds (the status quo and price control) directly to assess the extent to which price control would in fact enhance efficiency.
- In estimating how price control might affect allocative efficiency, the Commission assumes a simple average price—ignoring the importance of price structure. Price control might reduce average prices but at the same time lead to a less efficient pricing structure, and thereby possibly reducing rather than increasing allocative efficiency.
- In estimating how price control might affect productive efficiency, the Commission simply assumes that 1% of current operating expenses would be saved under price control. This assumption is without analytical backing and is contrary to most practical experience and research in this area that suggest price control weakens incentives for cost saving and therefore reduces productive efficiency.
- The Commission assumes the indirect costs of price control to be 50% of the gains potentially available (in nirvana). This assumption implies that, but for the direct cost of price control, price control should be automatically chosen, thus ignoring any adverse effects price control

¹ Report of the Ministerial Inquiry into Electricity, June 2000, pages 42 and 45

may have on market outcomes. If applied more widely to a market economy, this approach would probably result in many sectors being placed under price control.

- The Commission proposes to value “specialised airfield assets” at historic cost instead of replacement cost. The proposed change, in our view, would be efficiency reducing. The replacement cost approach allocates risks more efficiently. The historical cost approach can have some unintended consequences, in that inter-company transactions for the relevant assets could be used to inflate historic costs dramatically. Further, the act of changing the valuation methodology for what appear to be inadequate reasons undermines its stability over time. Stability of valuation methodology is critical to minimise the cost of capital for entities subject to, or potentially subject to, price control.

2 Summary of The Commission’s approach to price control

To determine whether price control is warranted under the Commerce Act, the Commission’s conducts two tests:

- The benefit to acquirers test: Would price control benefit the acquirers of the services under consideration?
- The efficiency test: would price control have a net efficiency benefit?

Since price control redistributes wealth from producers to acquirers, the first test has a lower hurdle than the second. That is, if the second test is met, then it is most likely that the first would be met as well. We focus on the efficiency test in this submission.

The Commission conducts the efficiency test by first comparing the inefficiencies under the status-quo relative to a hypothetical world of maximum efficiency (“nirvana”), and then estimates the extent to which these inefficiencies would be reduced if price-control were imposed.

Specifically, the Commission takes the following steps:

1. Compares the status quo outcome with the nirvana outcome in terms of allocative, productive, and dynamic efficiencies;
2. Estimates inefficiencies present in the status quo world relative to nirvana (the elimination of these inefficiencies is thought to be the maximum potential efficiency gains achievable with price control);
3. Assumes that 50% of the maximum potential efficiency gains can be achieved through price control (the remaining 50% is thought to be the indirect cost of price control); and

4. Estimates the direct costs of price control which comprise administrative and compliance costs.

If the efficiency gains in (3) exceed the direct costs in (4), then price control is said to produce a *net* efficiency gain.

3 Detailed Comments on the Commission's approach

3.1 Moving towards output-based regulation

The price control methodology as described in the Commission's draft report focuses on the control of inputs and is a rate of return regulation of the form that is being discarded in many other jurisdictions due to its efficiency reducing properties.

As will be seen in our later discussion, this input-based regulation diverts firms' attention from meeting customer needs in other dimensions such as service quality and product differentiation. It also weakens firms' incentives for cost reduction and product innovation. It is our view that the Commission should avoid imposing a rate of return regulation and take a more innovative approach to any form of regulation.

A better approach to price regulation would retain the many efficiency enhancing features of the normal market process. For instance, the regulation would be output based, that is it would place more emphasis on the extent to which a service under consideration meets customer needs, including the customer's willingness to pay the price for the quality of service delivered. The regulation would preserve the firms' incentives and flexibility to meet customer demand, and at least cost. At the same time, the regulation would aim to identify any efficiency reducing behaviours, and where feasible correct for them.

3.2 Comparing two feasible worlds

The Commission's general approach of applying an efficiency test appears sound. Nevertheless in implementing the efficiency test the Commission chooses a hypothetical nirvana world as the reference point to assess the efficiency of price control. This is, in our opinion, unnecessary and misleading. The question facing the Commission is whether price control would be an improvement on the status quo in terms of economic efficiency. The relevant comparison should therefore be one of the two feasible worlds: price control versus no price control (status quo).

We note that in its discussion about the direct costs of price control, the Commission recognises that the relevant cost to consider is the "additional" cost that price control may incur relative to the cost incurred under the status quo. This direct comparison of two regulatory alternatives focuses attention on the critical decision (i.e. the choice of regulatory alternatives) and should be applied generally in the Commission's analysis of the effects of price control. In other words,

instead of asking what inefficiencies are present under the status quo relative to nirvana, and how price control would affect the inefficiencies, the Commission should consider directly what efficiency implications can be expected from moving from the status quo to price control.

3.3 Taking into account the implications of pricing structure for allocative efficiency

In its analysis of allocative efficiency, the Commission assumes a single unit price for the service under the status quo and price control. This assumption ignores the implications of different price structures on allocative efficiency and may lead to biased results.

Allocative efficiency requires that each customer pays a price that is equal to the marginal costs of supplying the last unit of purchase. However, if production is characterised by high fixed cost, marginal cost pricing will not allow the firm to recover its total costs. To at least break even, the firm will need to charge above marginal cost prices.

The firm could, for instance, price at marginal cost but levy an additional fixed charge to recover fixed costs. This would achieve allocative efficiency if no customers are forced out of the market by the fixed charge. The firm could set linear prices but price discriminate in accordance with the Ramsey principle (i.e. place higher mark-up on those customers with low price elasticity). This does not achieve full allocative efficiency but is more efficient than a non-discriminatory linear pricing structure. The firm could also use a more sophisticated pricing structure that combines non-linear pricing and the Ramsey principle to avoid too high a fixed charge.

The implementation of these pricing structures is feasible under the status quo, but may be restricted with price control. By assuming a single unit price, the Commission fails to account for the benefits from flexibility in pricing structures under the status quo, thus overstating the efficiency gains from price control. If pricing structure is properly accounted for, it is possible that price control (depending upon how it is implemented) may reduce allocative efficiency because it reduces the firm's flexibility to implement efficient pricing structures. In electricity, pricing structure flexibility has already been significantly reduced by the Government's stated preference in its Government Policy Statement of December 2000² that all retailers should offer at least one tariff to domestic consumers with a fixed charge of no more than 10% of the bill of the average domestic consumer.

3.4 Understanding the mechanism through which price control affects productive efficiency

The governance of a firm, exercised by shareholders, is the primary driver of productive efficiency. A shareholder, with rights to the value of the firm after all other claims on the firm have been met (often referred to as the residual claimant), is the party that is most directly affected by changes in

² Issued under section 26 of the Commerce Act.

productivity, and therefore the party with the strongest incentives and ability (through the Board elected by it) to drive productivity improvements. This is especially true for those companies whose shares are publicly listed and are thereby subject to ongoing scrutiny by capital market analysts and investors.

In its analysis of productive efficiency, the Commission does not explain how price control might affect the firms' incentives with respect to cost reduction. It merely assumes that price control can improve productive efficiency, and for the purpose of illustration, the Commission assumes that the efficiency gains equal 1% of operating costs excluding depreciation.

It is important, in our view, that the Commission demonstrates a clear understanding of the mechanism through which price control would affect productive efficiency, otherwise its assumption about the productive efficiency gains obtainable by price control are without foundation.

In our view, price control would affect productive efficiency by changing the incentives faced by the firm. While it is possible that price control may put pressure on the firm to reduce costs in order to meet a given profit target, it would at best be only a short-term stimulant. Over time, since price control tends to set prices on the basis of the firm's costs, the firm is likely to have weaker incentives to reduce their costs as the rewards from doing so are diminished.

We therefore find the Commission's estimate of production efficiency gains obtainable by price control unconvincing. Practical experience demonstrates that price control is more likely, over time, to reduce a firm's attention to productive efficiency than improve it. Further, in the electricity distribution sector, an inefficient form of regulation would impede the realisation of significant cost reductions from industry rationalisation.

3.5 Accounting for potential adverse effects of price control

In its discussion of the cost of price control, the Commission assumes that the indirect cost of price control is 50% of total inefficiencies under status quo (relative to nirvana). This implies that the indirect costs can never be greater than the inefficiencies present under the status quo, or in other words, in the absence of the direct costs (administrative and compliance costs), price control would always create a net efficiency benefit. This assumption is obviously extreme and is likely to lead to biased results. As discussed above, price control can limit a firm's ability to implement efficient pricing structure, and weaken a firm's incentive to reduce costs. Both would mean that price control might reduce efficiency, that is, the indirect cost of price control could be greater than 100% of the potential efficiency gains. By putting an (unjustified) upper limit on the indirect cost estimate of price control, the Commission's approach creates a bias in favour of price control. If this approach were applied more widely, it would probably suggest that it would be efficiency enhancing to impose price control on many sectors in a market economy.

3.6 Maintaining stability in asset valuation methodology

In its draft report, the Commission proposes to value “specialised airfield assets” at optimised depreciated historic cost (ODHC) instead of optimised depreciated replacement cost (ODRC). It is not clear from the draft report why the Commission has switched to a different valuation methodology.

In the electricity and gas sectors the ODV approach (which incorporates ODRC) for information disclosure purposes has been prescribed for some years. We recognise that this degree of prescription has not been present with airports, but in practice ODRC is widely used. In our view, the proposed change of valuation methodology will be efficiency reducing.

Both methodologies, if applied properly, would allow asset owners to recover the full cost of investment without making excess returns. However, the time profile of prices and risk allocation would be different under the two methodologies. The efficiency implications of the different time profiles and risk allocations would depend on particular circumstances, but on balance the ODRC methodology is likely to be more efficient.

A perceived advantage of the ODHC methodology may be that historical costs can be measured with greater reliability than replacement costs. However, this reliability is likely to be illusory, as inter-company transactions could be conducted in such a way to inflate the historical cost values. In fact, the ODHC methodology may artificially induce asset trades because assets will be more valuable to sell to another firm for that firm to include in its rate base at a higher value, up to the point where the resulting prices are too high for the market to bear.

From both the perspective of the asset owner and those who purchase the services of the asset, it is important that the valuation methodology for setting prices is stable over time. Substantial investments have been made in New Zealand on the understanding of stability in this valuation methodology. Further, any change would result in the loss of investments in the systems that support the existing valuation methodology, and a requirement to incur additional cost to develop new systems. Therefore the onus should be on the party who proposes a change of valuation methodology to demonstrate unambiguous efficiency gains from the change. In the absence of clear justification for change, stability of valuation methodology must be preserved.

4 Conclusion

In summary, we consider the Commission should re-think its approach to price control to avoid imposing rate of return regulation. It should consider a more innovative and targeted approach to regulation that retains many of the efficient features of normal market processes, while also identifying and correcting (where possible) for efficiency reducing behaviour.

We understand the design and implementation of a more efficient regulatory approach is likely to require constructive engagement by industry. UnitedNetworks would welcome the opportunity to do so.