

How Markets WorkSM

Commerce Commission: Gas Control Inquiry Asset Valuation Issues

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The Commission's Task

Is it *necessary or desirable* for gas services to be controlled *in the interests of acquirers*?

To determine this, the Commission intends comparing:

- Prices without control – business plans, etc
- Prices with control – reference to “competitive” prices

The challenge will be to determine the prices likely to prevail under “workable” competition.

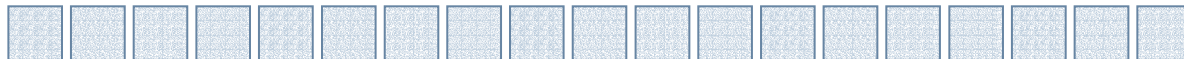
The Commission proposes a “building block” analysis with ODRC and historical cost asset valuations.



Prices under workable competition

The *Hypothetical New Entrant Test* provides the appropriate framework for estimating competitive prices:

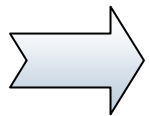
- **Marginal cost – post entry – does not reflect prices under workable competition;**
- **Prices in competitive markets are determined by *entry* opportunities;**
- **Hypothetical new entrant test estimates the price that reflects a sustainable competitive equilibrium**



ODRC and the Hypothetical New Entrant Test

ODRC = maximum asset value consistent with the costs that a hypothetical entrant would incur in order to serve the market

A business earning WACC on ODRC cannot be pricing excessively, since no-one can offer a sustainably lower price.



competitive forces *would not* lead to lower prices.

[ODV]...is a superior methodology for revealing monopoly pricing behaviour...

Ministry of Commerce, 1994

ODRC – Practical Application

Many regulators use ODRC to estimate competitive prices:

- ACCC (1999) *“DORC...is consistent with the price that would prevail in the industry in long run equilibrium...”*
- Byatt Report (UK, 1986) *“The value of assets to a business means what potential competitors would find it worth paying for them...This will be a net replacement cost...”*

Case study: Moomba to Sydney Pipeline

A hypothetical new entrant test (with ODRC) was found to be more practicable than an historical cost based assessment.

NCC concluded the pipeline had been charging tariffs in excess of the hypothetical new entrant price and concluded there was evidence of monopoly pricing.

Historical Cost – Inappropriate & Arbitrary

Inappropriate –

Historical cost provides little or no information regarding prices under competition

Highly Sensitive to Arbitrary Assumptions –

Information limitations require *arbitrary* starting point – major issue for NGC

Arbitrary depreciation schedule will significantly affect valuation

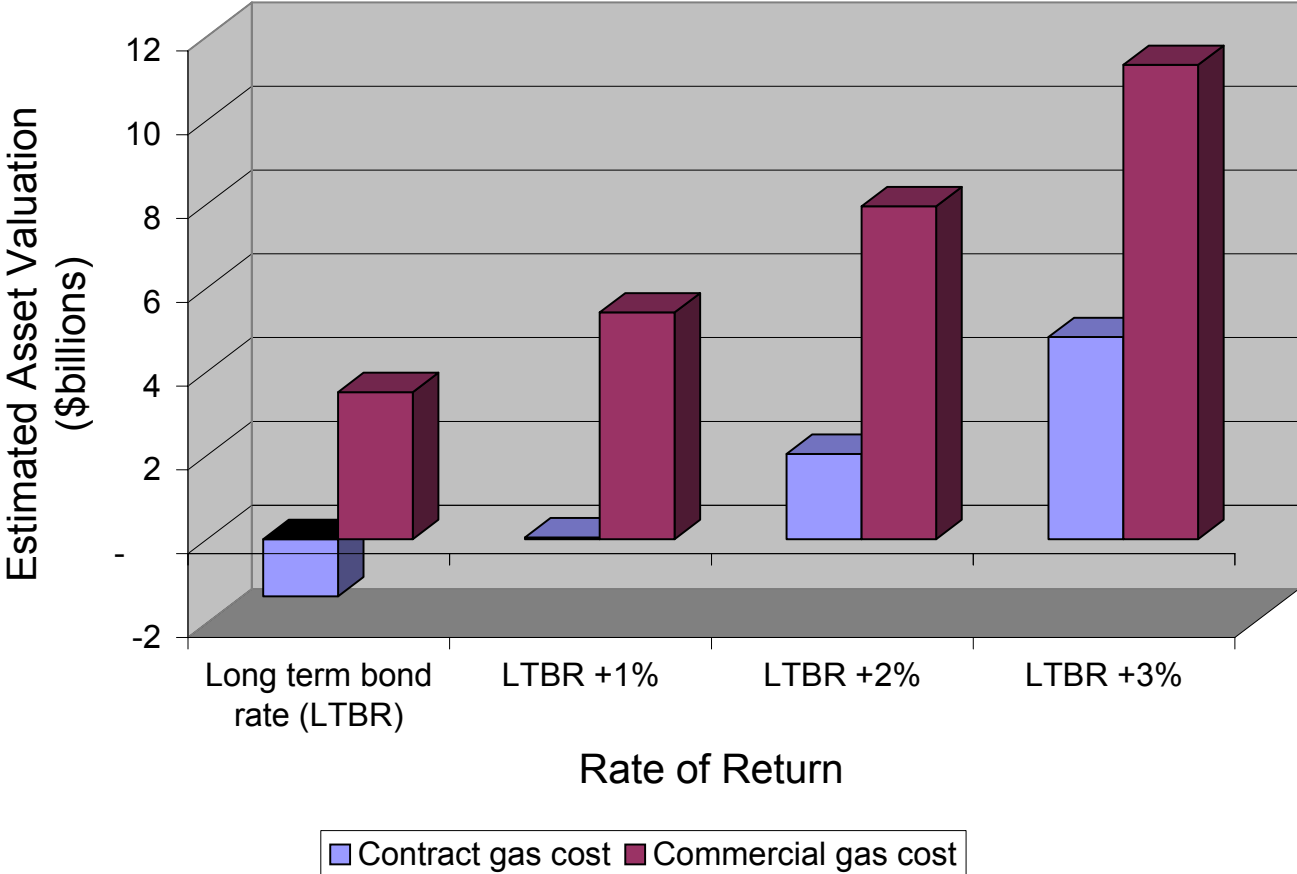
Assumptions on starting point, returns and revenue allocation will significantly affect conclusions

Historical Cost – Attempted Application

Case Study – The Victorian Gas Transport System

Objective =
written down
value
reflective of
past returns

Outcome =
wide range of
potential
valuations



Consistent Treatment of Assets

Easements, Land

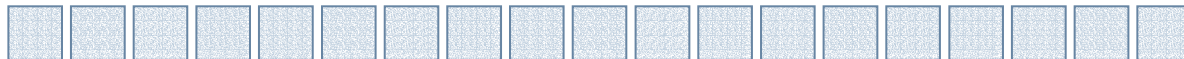
No rationale for treating easements differently from other assets.

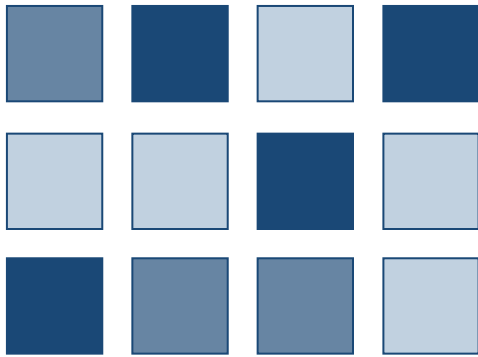
Practical difference is that land and easement assets do not depreciate but rather their valuation reflects supply and demand in the market for land.

Intangibles

Identifiable intangible assets should be treated on an ODRC basis.

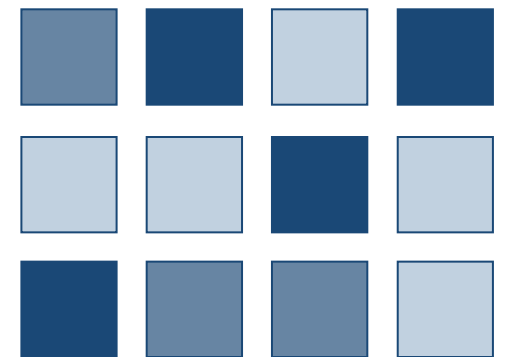
Superior efficiency and capability are better treated through additional returns.





NERA

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