

4 November 2002

The Chairman
Commerce Commission
PO Box 2351
Wellington

Dear Sir

Submission on Review of Asset Valuation Methodologies: Electricity Lines Businesses' System Fixed Assets

This submission is made on behalf of the Captive Port Customers Group ("CPC") Group, which represents the interests of a number of shipping, stevedoring, shipper and shipping agency customers of New Zealand ports.

The CPC Group welcomes the opportunity to comment on the Commerce Commission discussion paper on asset valuation methodologies for electricity lines businesses' system fixed assets. Following on from the foundation laid in the Commission's August 2002 final report on airfield activities, the discussion paper represents an important step forward in ensuring that owners of monopoly infrastructure assets are subject to clear rules and guidelines concerning the valuation of their assets for charging purposes. The use of an appropriate valuation methodology that is based on sound economic principles is clearly a critical component in ensuring that consumers pay only fair and reasonable charges for infrastructure goods and services in markets where competition is limited.

Members of the CPC Group have for a number of years experienced problems with port companies abusing their monopoly power in relation to non-testable services. This experience has been well documented and has also been the subject of court proceedings. One of the manners in which port companies have sought to exploit 'captive' users has been through overcharging, in many cases through the introduction of ODV asset valuation methodologies to justify increases in already high returns. A study by Simon Terry & Associates earlier this year concluded that some ports companies were extracting excess profits from the users of port services to the tune of around \$30 million per year. Unlike electricity lines businesses and airports, however, port companies are not required to disclose information to allow for the fair negotiation of prices.

The CPC supports the evaluation criteria proposed in the discussion paper. The proposed criteria of efficiency, identification of excess profits and cost effectiveness are consistent with the purpose statement in Subpart 1 of Part 4A of the Commerce Act. They are also consistent with the broad scheme of the Act as provided in the overarching purpose statement in section 1A. While the discussion paper is concerned with the application of these principles in the context of electricity lines businesses, we believe that the proposed criteria are also appropriate for assessing asset valuation methodologies across other infrastructure industries where concerns about monopoly power and excess returns arise.

The CPC Group notes that the Commission has not expressed a preference for any particular asset methodology for electricity lines business in the discussion paper. In light of this, we would like to submit the following in support of historic cost approaches to the valuation of specialised assets generally for pricing purposes:

- For formerly government-owned infrastructure businesses, opening asset values should be based on vesting book values at the date of privatisation. Vesting values most accurately represent investor expectations and are therefore the appropriate method for determining opening valuations. This approach accords with international practice, particularly in the United Kingdom and the United States.
- Going forward from the establishment of an opening value, the historic cost of an asset base can be easily determined through adjustments for additions, disposals and depreciation. Indexing for inflation is also straightforward.
- Historic cost approaches are less costly to determine than under ODV/ODRC as they do not require continual verification of replacement costs and optimisation assessments.
- A ‘used and useful’ test is an appropriate measure of capital efficiency.
- Historic cost valuations cannot, unlike replacement cost methodologies, be easily manipulated and can be objectively verified by independent audit.
- In terms of dynamic efficiency, the case for historic cost approaches is strongest in sectors where technological change is incremental and more predictable, such as sea ports and airports.

We would also submit the following against the use of ODV/ODRC approaches:

- ODRC only has merit for pricing purposes where competition from entry is likely. This is unlikely to apply in market where infrastructure investment is costly, for example electricity transmission, airports and sea ports.
- The use of replacement cost valuations is particularly inappropriate for assets with extremely long lives, for example wharves, breakwaters, airport runways and certain fixed electricity lines assets. Today’s users should not be forced to pay charges based on replacement costs that will not be reasonable predictable for some decades.
- ODV/ODRC approaches carry with them a real risk of inefficient asset by-pass. Regulators are likely to face difficulties in attempting to effectively guard against this risk.
- The use of ODV for information disclosure purposes does not mean that it should be used for pricing purposes. However, were the existing application of ODV for disclosure deemed relevant, this argument can only apply to industries where that existing application is mandated by the government.

There is no doubt that the use of ODV/ODRC in New Zealand has resulted in high and unnecessary revaluations of specialised assets that have been used to ‘justify’ premature pricing increases and transfer wealth from users to asset owners. This is illustrated most recently by the Commission’s work in relation to airports and is also evident in our industry. At a minimum, the choice of methodology should be consistently applied across the life of the assets. Owners should not be able to switch methodologies midway through the life of a sunk asset to justify price increases and expropriate excessive returns from users.

The CPC thanks the Commission for the opportunity to comment on the discussion paper.

Yours faithfully

Captive Port Customers Group
 Paul Nicholas
 Secretary
 Email: pjn.nzsf@xtra.co.nz