

20 June 2014

Mr Matt Todd  
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Dear Mr Todd

**Preliminary Assessment of Eastland Port**

As you are aware, the Commerce Commission has undertaken a preliminary assessment of the charges levied by Eastland Port on its forestry industry customers. This follows a complaint we received from the Eastland Port Forestry Industry Customer Group (EPFIGG). We have now completed that assessment and remain concerned about the extent of Eastland Port's price increases which occurred in 2012.

As a result of our preliminary assessment we are satisfied that a full inquiry under Part 4 of the Commerce Act is justified.

We are unable to immediately commence a Part 4 Inquiry given our other work commitments in the 2014 calendar year. Consequently we intend to commence a full Part 4 Inquiry into Eastland Port at the start of 2015. In early 2015 we will be contacting Eastland Port and EPFIGG to assess whether any material matters have changed which would change our view that we should initiate a Part 4 Inquiry into Eastland Port.

Attached to this letter are the reasons which have led to this view, which we will be releasing publicly.

Yours sincerely



Dr Mark Berry  
Chairman

cc. Peter Clark, PF Olsen

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## **Preliminary Assessment of Eastland Port**

### **What is the purpose of this assessment?**

1. This assessment lays out concerns we have about the pricing conduct of Eastland Port following a preliminary assessment under Part 4 of the Commerce Act.
2. In 2012 Eastland Port substantially increased the prices it levies on its forestry customers who use the port to export logs from the Gisborne region. On the evidence before us, we consider these prices may lead to excessive profits accruing to Eastland Port which is not in the long-term benefit of consumers.
3. To address these concerns we expect to commence work on a Part 4 Inquiry in 2015. It is not possible to immediately commence a Part 4 Inquiry given the Commission's other work commitments in the 2014 calendar year. In early 2015 we will assess whether any material circumstances have changed which will leave open the option of Eastland Port commercially resolving this issue with its customers.
4. We are also publishing our draft report which we provided to Eastland Port and Eastland Port Forestry Industry Customer Group (EPFICG) as part of our process.

### **Why has the Commission undertaken an assessment of Eastland Port?**

5. The Commerce Commission has undertaken a preliminary assessment of Eastland Port under Part 4 of the Commerce Act. This assessment was undertaken in response to a complaint received by the EPFICG concerning the extent of price rises notified by Eastland Port in 2012.

### **What process did the Commission follow in undertaking this assessment?**

6. After carrying out an initial assessment based on information received from EPFICG, the Commission issued a draft assessment. This was issued to Eastland Port and EPFICG to gather their views on the initial position of the Commission. At this stage the Commission did have some concerns with the conduct of Eastland Port but considered the benefits of regulation were unlikely to materially exceed the costs.
7. After considering responses received the Commission undertook further work including gathering and analysing further information from Eastland Port. This included the financial model used by Eastland Port in setting its prices.
8. This document ends the preliminary assessment.

## **Our Findings**

9. Having undertaken a preliminary assessment into Eastland Port the Commission is concerned that the prices levied by Eastland Port may result in excessive profits and therefore may not be in the long-term best interest of consumers.
10. The main factors which have led to this conclusion are:

- 10.1 The asset valuation which underlies the financial model used by Eastland Port.
- 10.2 The Weighted Average Cost of Capital (WACC) used within the financial model incorporates a small company premium which, in the Commission's view, and when combined with the asset values used by Eastland Port, is likely to lead to excessive profits.
- 10.3 The financial model used to calculate future prices is NPV positive, and is not justified in terms of any superior performance or expectation of superior performance by Eastland Port.<sup>1</sup>
- 11. In coming to this conclusion we have also carefully considered the requirement under a full Part 4 Inquiry that we consider whether the benefits of regulating the goods or services materially exceed the costs of regulation. In the current case we are considering a single business rather than a sector and concerns only relate to pricing and not quality of service or adequacy of investment.
- 12. Nonetheless we consider that the costs of a full Part 4 Inquiry are likely to be justified. In coming to this view we have also taken into account the potential wider deterrent impacts of addressing such conduct. In this case resolving the issue of how the Commission would address asset valuation for companies/sectors which have not previously been regulated would provide useful guidance.
- 13. Finally we note that our findings here come from a preliminary assessment. This is not a full Part 4 Inquiry and we recognise that a fuller inquiry may well come to a different finding. In this respect all we are addressing here is whether the evidence supports launching a full Part 4 Inquiry.

**Which questions did we address as part of this preliminary assessment?**

- 14. Part 4 of the Commerce Act lays out the issues the Commission has to address if we were to undertake a full inquiry. Section 52G sets out the test that needs to be met before the Commission is able to recommend to the Minister of Commerce that goods or services be regulated. It provides:

**52G When goods or services may be regulated**

- (1) Goods or services may be regulated under this Part only if-
  - (a) The goods or services are supplied in a market where there is both-
    - (i) little or no competition; and

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<sup>1</sup> Companies in workably competitive markets would only expect to achieve profits in excess of their estimated cost of capital as a result of superior performance. Where a company faces no or limited competition it can ensure it earns above an appropriate level of cost of capital other than as a reward for superior performance.



- (ii) little or no likelihood of a substantial increase in competition; and
  - (b) there is scope for the exercise of substantial market power in relation to the goods or services, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements); and
  - (c) the benefits of regulating the goods or services in meeting the purpose of this Part materially exceed the costs of regulation.
- (2) In any consideration of this test, the part of the test in subsection 1(c) need not be considered unless the parts of the test in subsection 1(a) and (b) are satisfied.
- 15. The Commission has provided public guidance on the framework for when and how we will conduct an inquiry under Part 4 of the Commerce Act.<sup>2</sup> This guidance states:
 

When deciding whether to hold an inquiry on our own initiative, we will conduct a preliminary assessment of a number of factors, including the levels of competition in a market (both current and future), the scope for suppliers to exercise market power, and the effectiveness of any existing regulation of that market.
- 16. The purpose of this assessment is not to comprehensively answer any of the relevant Part 4 Inquiry questions, but rather to determine whether this complaint crosses the threshold for initiating a full Part 4 Inquiry. We have therefore not sought to draw any firm conclusions in relation to any of the parameters of section 52G, but rather have assessed the possibility that those parameters could be satisfied if a full Part 4 Inquiry was commenced.

**Does Eastland Port face little or no competition and little or no likelihood of a substantial increase in competition?**

- 17. Under a Part 4 inquiry section 52G(1)(a) would require us to assess whether the goods or services supplied face little or no competition and there is little or no likelihood of a substantial increase in competition.
- 18. Given the relative isolation of the Gisborne region, the high cost of transporting logs by road and the lack of alternative transport infrastructure such as rail, we consider EPL faces limited or no competition. There are high sunk costs of investing in port infrastructure which also indicates there is little or no likelihood of a substantial increase in competition.<sup>3</sup>

**Are there other factors which limited the scope for EPL to exercise substantial market power?**

- 19. Under a Part 4 inquiry section 52G(1)(b) would require us to consider the scope for the exercise of substantial market power taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements).

<sup>2</sup> Commerce Commission, The Commerce Act: Regulation of Goods and Services, May 2011.

<sup>3</sup> Further information on this is available within our draft preliminary assessment.

20. Eastland Port is ultimately owned by Eastland Consumer Trust. The extent to which Eastland Port's ownership structure could be relied on as a constraint in the face of customer complaints, and given that the same structure does not exempt them from price-quality regulation for their electricity distribution business, seems limited.
21. We are aware of no other regulations which may limit their ability to exercise market power.

**Are the benefits of regulation likely to materially exceed the cost?**

22. Under a full Part 4 inquiry, section 52G(1)(c) would require us to consider whether the benefits of regulating the goods or services materially exceed the costs of regulation.

*What are the potential benefits of regulating Eastland Port?*

23. The complaint before us is squarely on the issue of price levels which may lead to excessive profitability at Eastland Port. In examining this issue we have also closely borne in mind that the purpose of Part 4 of the Commerce Act covers more than just constraining excessive profitability and in particular is also concerned with incentives to innovate and invest.<sup>4</sup>
24. In this case we have identified three factors which may indicate EPL's pricing is excessive and may lead to excessive profitability which would not be in the long-term best interest of consumers.
  - 24.1 The valuation of assets on which prices are based has been substantially increased.
  - 24.2 The estimate of the return investors require through the WACC is set too high.
  - 24.3 The prices set ensure returns are net present value (NPV) positive implying the returns exceed those required given the asset valuation and WACC.

*Why are we concerned with EPL's asset valuation?*

25. Asset valuation is a key input into determining whether revenues accruing to Eastland Port result in profits consistent with outcomes produced in workably competitive markets.
26. At this point the Commission is concerned that asset valuations at Eastland Port may have been increased in a manner that are likely to contribute to excessive profits. If under regulation we were to reduce the asset valuations used for setting target revenue this could imply considerable savings to consumers of Eastland Port of up to \$48 million over the period 2017 to 2026. However we also recognise that there *may* be longer term adverse impacts to consumers if this adversely affected efficient

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<sup>4</sup> Section 52A of Part 4 of the Commerce Act.

investment. We consider only a full Part 4 Inquiry could resolve this question which is of wider significance to investors of businesses which could be potentially regulated.

27. Eastland Port moved from a Discounted Cash Flow (DCF) basis of asset valuation to an Optimised Depreciated Replacement Cost (ODRC) basis in 2011.<sup>5</sup> This substantially increased their asset valuation. We have considered whether regulation would or would not roll back this asset valuation. In Part 4 decisions already made:
  - 27.1 we decided *new* replacement cost-based revaluations were not necessary, rather than disallowing *existing* valuations that had already been carried out for specialised assets, which is the case for Eastland Port;
  - 27.2 the existing replacement cost-based valuations for areas we currently regulate under Part 4 had already been endorsed under a pre-existing regulatory regime – there is no previous regime for Eastland Port; and
  - 27.3 we required the pre-existing valuation to be fit for purpose – meaning one that ensures that the entity would not be earning less than normal returns going forward: in this case there may be some possible questions whether that would be the case for the existing DCF calculations.
28. The most contentious part of rolling back asset re-valuation is the potential for expropriation of investor value. In this case the investor, Eastland Community Trust, paid \$18 million for the entire Eastland Port business in 2003 and the current asset valuation is \$86.7 million; there is a significant difference which appears to substantially exceed investment sunk into the port since its purchase. Nonetheless it is not straight forward to conclude that regulation would necessarily unwind asset valuation given the issues at stake. This may have important implications in terms of the signals it sends the wider market. In particular:
  - 28.1 investors may perceive the willingness of the Commission to unwind asset re-valuations as adding to the risk of investment in potentially regulated companies; and
  - 28.2 if we send a clear message we are unwilling to do this, asset re-valuation becomes a ‘safe’ way to increase prices without the risk of regulatory intervention.
29. This would likely be the key contentious issue with any fuller Part 4 inquiry. We note the recent High Court input methodologies merits appeals judgment which addressed asset valuation and seems to leave open the possibility of rolling back revaluations whilst bearing in mind the messaging to investors.

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<sup>5</sup> ODRC is used for other operational assets, land and buildings are valued at fair value based on valuer advice.



The setting of the initial RAB does, however, have an impact on the general investment environment for regulated industries and industries subject to the possibility of regulation. It sends signals about the behaviour of the regulator. This is a question of reasonable investor expectations. In our view, reasonable investor expectations should be met by following a carefully considered approach when setting a RAB, subject to there being no evidence that suppliers would be unable to recover the costs of their past prudent and efficient investments. (This does not imply that the cost of purchase of a regulated business as a going concern should necessarily be fully protected.)<sup>6</sup>

30. Clarifying the Commission's approach to setting asset valuation to companies which have not been previously regulated would itself provide greater predictability to investors.

*Why are we concerned with Eastland Port's estimate of WACC?*

31. The Commission has not attempted to estimate the appropriate cost of capital for Eastland Port as part of the preliminary assessment. We have taken the logic that has led Eastland Port to arrive at their cost of capital and asked the question as to whether, when combined with the asset values used by Eastland Port, this is likely to lead to excessive profits. In doing so we have drawn on our Cost of Capital IMs where appropriate.
32. In particular there were two main issues raised which relate to a cross-sectoral aspect of the Cost of Capital IM; the use of a small company premium and the Tax Adjusted Market Rate Premium (TAMRP).
  - 32.1 Eastland Port used a TAMRP of 7.5% whereas we have estimated this to be 7% in our Cost of Capital IM.<sup>7</sup>
  - 32.2 In workably competitive markets we do not consider a company can require a higher return on its goods or services merely by virtue of being small.<sup>8</sup>
33. In both of these respects we consider that the cost of capital applied of 10.9% may consequently be too high and should be adjusted downwards to 8.9% for the purposes of this preliminary assessment. A full Part 4 Inquiry would need to carry out a full assessment of the appropriate cost of capital for Eastland Port.

*Why are we concerned that Eastland Port's financial model is NPV positive?*

34. Based on our analysis of the financial model provided to us by Eastland Port, the prices were set at a level which provided estimated revenues which exceeded that required by their own estimate of cost of capital. The implication being the prices set recovered more revenue than investors require.

<sup>6</sup> *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289, paragraph [605].

<sup>7</sup> Our final estimate also incorporated the uplift over the period of the Global Financial Crisis detailed in the Cost of Capital IM, Commerce Commission, Input Methodologies (EDBs & GPBs) Reasons Paper, December 2010, paragraph 6.5.18.

<sup>8</sup> See Commerce Commission, Input Methodologies (EDBs & GPBs) Reasons Paper, December 2010, paragraphs 6.4.28 and 6.4.29.



35. This would not be possible in a workably competitive market unless the business consistently provided superior performance to its customers. Any above-normal profits would be expected to be competed away in the absence of superior performance which customers are prepared to pay a premium for.

*What are the wider benefits of undertaking a Part 4 Inquiry into Eastland Port?*

36. Clarifying the potential for regulation to be imposed on businesses that face limited or no competition could have a wider impact than just on Eastland Port. In this respect we note that clarifying the approach to asset valuation may provide important wider signals to those firms regarding when the Commission might be likely to undertake other Part 4 Inquiries.

*What are the costs of undertaking a Part 4 Inquiry into Eastland port?*

37. The Commission, Eastland Port and EPFICG would all incur direct costs from a full Part 4 inquiry, as would any other party who wished to participate. These costs can be substantial. Along side these costs there are other indirect costs which are less easy to quantify such as the potential impact on investment discussed under asset valuation.
38. A full Part 4 Inquiry would need to also assess the ongoing costs of regulation and related issues such as:
- 38.1 a qualitative analysis of all material long-term efficiency and distributional considerations;
  - 38.2 quantifying material effects on allocative, productive, and dynamic efficiency, as far as practical;
  - 38.3 quantifying material distributional and welfare consequences on suppliers and consumers, as far as practical;
  - 38.4 assessing the direct and indirect costs and risks of any type of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects, as far as practical;
  - 38.5 assessing the benefits of imposing different types of regulation in meeting the purpose of Part 4 against the costs of imposing those types of regulation; and
  - 38.6 considering what would be the most cost-effective type or types of regulation in the circumstances.
39. For the purposes of this preliminary assessment we have used the direct costs we have incurred in the past in undertaking regulation as a guide and have taken into account the potential wider costs in making our assessment.

*Why do we consider the benefits of regulating Eastland Port may materially exceed the costs?*

40. We have found that the potential benefits from regulating Eastland Port may materially exceed costs. Our initial estimates are shown in the table below broken down by the main areas of concern found in our preliminary assessment.

**Table 1: Estimated cost benefit analysis of regulating Eastland Port**

Scenario	NPV of net benefits (consumer welfare):  2017-26
NPV neutrality	\$11m
Asset valuation reduced	\$48m
WACC reduced	\$34m
Combined <sup>9</sup>	\$65m

41. This net benefit estimate does not include the potential wider costs that would be incurred. Nor does it attempt to quantify the potential wider benefits of carrying out this inquiry discussed in paragraph 36. Nor does it assess the net welfare costs of Eastland's behaviour (as opposed to the consumer welfare benefits). We have, however, taken into account these potential wider costs and benefits in reaching our conclusions. On balance we consider the benefits of regulation may well exceed the costs and this crosses the threshold for undertaking a full Part 4 Inquiry.
42. These estimated benefits differ substantially from our draft assessment. This reflects the additional information we collected from Eastland Port and in particular their financial model used for price setting purposes.
43. A full Part 4 Inquiry would investigate this in more depth and in particular gather further information on the elements listed under paragraph 38.

### **Next steps**

44. The Commission's next steps to resolve the issues raised by the preliminary assessment into EPL are seeking to achieve the benefits of Part 4 at least cost.
45. Our guidelines state:<sup>10</sup>

<sup>9</sup> As these three factors inter-relate, the NPV of net benefits of the individual factors do not add up to the combined NPV of net benefits.

...we must consider whether the likelihood of regulation under Part 4 is sufficiently high to justify the cost and uncertainty associated with a Part 4 inquiry...

46. As a result of our preliminary assessment we are satisfied that the likelihood of regulation under Part 4 is sufficiently high to justify the cost and uncertainty associated with a Part 4 Inquiry.
47. Our guidelines also state:<sup>11</sup>

...We also need to consider whether an alternative option is open to the Commission (or another body) that might achieve similar or better outcomes for that market more quickly or more cost-effectively.
48. It is not possible to immediately commence a Part 4 Inquiry given the Commission's other work commitments in the 2014 calendar year. Nonetheless we are also aware that delaying or not undertaking a Part 4 Inquiry implies a potential high cost to the forestry industry in the Gisborne region.
49. Consequently we have scheduled into our work plan the ability to carry out a full Part 4 Inquiry into Eastland Port at the start of 2015. This leaves a significant period of time for a commercial resolution of the concerns raised by the EPFICG by Eastland Port which may represent the lowest cost method for all parties.
50. In early 2015 we shall be contacting Eastland Port and EPFICG to assess whether any material matters have changed which would change our view of initiating a Part 4 Inquiry into Eastland Port.

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<sup>10</sup> Ibid 2

<sup>11</sup> Ibid 2



