Research and information

ACCC seminar questions asset valuation approach to access pricing

On 26 March 1996 the Commission convened a half-day seminar in Canberra titled *Valuation of assets — relevance to access pricing and rate regulation*, which was attended by representatives of Commonwealth and State policy and regulatory agencies and professional accounting research bodies.

The seminar was an initial attempt, at Commonwealth level, to explore whether 'deprival value' was a useful asset valuation concept in determining whether and how returns on the capital invested in infrastructure facilities should be rewarded when an arbitrator or regulator sets a price for access to a facility. 'Deprival value' was recommended as a principle for asset valuation in a 1994 study for the Commonwealth and State Steering Committee on National Performance Monitoring of Government Trading Enterprises.

The issue is fundamental to the Commission determining its approach to pricing issues under the access provisions (Part IIIA) of the Trade Practices Act, and is of similar interest to State regulators and industry reform instrumentalities sponsored by the Council of Australian Governments (COAG) in such diverse areas as gas, electricity, railways, water supply and airports. Hence the issue has implications for both government and privately owned service providers.

Introduction of concepts and objectives

The first speaker at the seminar was *Mr Graham Carpenter,* Queensland Treasury Assistant Under Treasurer and the convener of the study sub-committee. He explained that the objective of the 1994 study was to establish a consistent framework for comparison of indicators of financial performance of government trading enterprises (GTEs) (earnings ratios and debt:equity ratios).

'Deprival value' was defined as the value to the entity of the future economic benefits the entity would forgo if the entity were deprived of the asset. Mr Carpenter said that deprival value represented a move from historic cost to a market-value concept, the value used being a surrogate for market capitalisation of the entity. (The historic cost of an asset is the original cost of the purchase, delivery and installation of the asset, including pre- and post-installation capital expenditure.) According to Mr Carpenter, historic cost was of limited use in performance monitoring of GTEs because of the long life of the asset base.

Mr Carpenter reported that a survey of State jurisdictions indicated that deprival value has mostly been accepted in principle, with agencies and departments moving towards using it in published accounts.

Mr George Carter, Special Adviser (Accounting) to the Commonwealth Department of Finance, and a member of the study sub-committee, said that in the Commonwealth jurisdiction the use of deprival value was encouraged but not mandated. Companies owned by the Government, such as Telstra, are subject to the reporting requirements of the Corporations Law.

Mr Carter said that 'deprival value' was not so much a valuation method as a way of selecting which method of valuation to use, depending on the circumstances. (Selling prices, buying prices, current replacement costs or

reproduction costs and net present value can be used, and there are rules for choosing the greater or lesser of two values.) He said that the Commonwealth had not formally adopted deprival value as there were implementation issues still under debate, for example in relation to the value of lands under railways and roads. In order to overcome the 'fruit salad' of valuations in present published accounts, valuation methodology is to be discussed as part of the trial of whole-of-government accrual accounting. A working party is deliberating on the relevance of deprival value to pricing policy and measurement of efficiency.

Application of valuation methods to the electricity industry

Mr Richard Robinson of the Commonwealth Department of Finance addressed the question of how deprival value came to be adopted by COAG as the preferred approach for valuing National Electricity Grid assets for network pricing purposes. The starting point was the February 1994 COAG meeting which agreed there should be a uniform approach to the pricing and regulation of the grid, including common asset valuation methodologies and rates of return. Consideration of how to achieve this coincided with the recommendations of another COAG sub-committee on the use of the deprival value framework for national performance monitoring of GTEs.

From the Commonwealth perspective, the adoption of deprival value for use in electricity grid pricing regulation could largely be attributed to a recognition that this uniform basis for the measurement of asset values and costs for performance monitoring of GTEs could also provide the required common approach to asset valuation for the monopoly elements of the grid. The deprival value model also took into account factors such as whether and how the service potential of an asset would be replaced if lost, and was seen by the Commonwealth as addressing to some extent the issue of uneconomic investment in monopoly assets. (The service potential of an asset is its economic utility to the entity, based on the total benefit expected to be derived by the entity from the use, and/or through sale, of the asset.)

The development of detailed proposals was the responsibility of the National Grid Management Council (NGMC), which recently issued the draft National Electricity Market Code of Conduct. The Code includes a complex adaptation of deprival value that appears to be based on the written down replacement costs (revalued five yearly) of networks if they were 'optimised' (that is, assets were assumed to be reconfigured) to meet existing and forecast demand in the most efficient way. Cost and rate-of-return estimates based on these deprival values would form part of a formulae-determined, CPI-indexed revenue cap for pricing purposes.

According to Mr Robinson, the approach has raised a number of questions of concern to the Commonwealth as to whether there are sufficient incentives for efficiency (including the adequacy of the efficiency incentive 'X' in the CPI-X index factor) in what appears to be a largely rate of return based approach to price setting. These questions are being pursued with the NGMC as part of its process of consultation on the draft Code.

Mr Robinson pointed out that the grid will initially be under separate price regulation by New South Wales and Victoria. However, there is a need in the interests of regulatory certainty to quickly address the uniform price regulation regime which is to apply by 2001.

In regard to the approach to be taken to access pricing issues across industries, Mr Robinson considered that the different characteristics of industries (such as the electricity grid, compared to, say, rail corridors and gas pipelines) were likely to raise different regulatory issues requiring unique solutions.

Mr Geoff Swier, a private consultant and Deputy Director of the Electricity Supply Industry Reform Unit of the Victorian Treasury, discussed case examples of pricing changes arising from the corporatisation and rationalisation of the New Zealand electricity transmission and distribution systems, and privatisation of the Victorian system.

According to Mr Swier, New Zealand had established a system of regulation providing for decentralised tariffs and open access, based on industry guidelines underwritten by the threat of

Commerce Commission price control. Asset valuation had been based on optimised deprival value (ODV or optimised replacement value), the outcomes of which had become contentious because distribution businesses and some major users located at a distance from loci of transmission had faced steep power price rises.

The response had been to reconfigure the asset valuation so as to indirectly adjust prices rather than to directly adjust the pricing method. This process had made high demands on management time, information sources and engineering and economic judgment. It had been of questionable worth because the assets had been sunk costs anyway. The Commerce Commission had also encouraged the development of rate-of-return pricing (as a corollary to the asset valuation method) but, according to the speaker, this approach has the negative effect of providing incentives for over-investment in the asset base.

In Victoria, price setting had initially made use of optimised depreciated replacement cost for valuing assets and deriving tariffs centrally, but the prices thus arrived at had been skewed to address policy constraints such as delivery prices to rural users. CPI-X price caps had then been put in place. The choice of valuation method reflected the privatisation objective of the Victorian Government, the policy constraints mentioned and scope to negotiate network tariffs downwards.

Mr Swier concluded that optimised deprival value was theoretically sound but, in practice, materiality of valuations had to be defined at the outset. He recommended making a single (whole entity) valuation of assets. Pricing had to take account of policy constraints and should be addressed directly rather than waste management time on asset revaluation. Maximising productive and dynamic efficiency was more important in regulating utilities than attempting to use asset valuation as an instrument of allocative efficiency. He suggested that developing yardstick comparisons of performances of utilities without using asset valuation figures could be very useful, although this may not be an easy task. He also said that the electricity industry was in a transitional phase and in time there would be a market for rights to capacity.

A critique of applying asset valuation to access pricing

Professor Murray Wells, Director of the Graduate School of Business in the University of Sydney, took the audience to the fundamental access issue: an access regime is intended to break down monopolies of services by making better use of the capacity of 'bottleneck' facilities. These monopolies arise because it is uneconomic to physically duplicate these services. If monopoly facilities can be made available to competing users, ultimately it should create a better deal for the consumer. Therefore the objective of regulation is to simulate competition in the output of a monopoly service, both in terms of price and maintaining quality of service.

Professor Wells questioned the presumption that valuation of assets and control of the facility's rate of return were the most efficient mechanisms for regulatory control of a monopoly facility.

As noted by Mr Carter, 'deprival value' embraces a suite of valuation methods. Of these, according to Professor Wells, market selling price was not relevant for bottleneck facilities because there was no market for their main assets. Net present value (NPV) was ruled out as the basis for valuing assets for access pricing and tariff regulation purposes because it made an assumption about what the entity would earn, and that was what the regulator was trying to determine in setting an access price. So using NPV was circular. That left replacement cost, which required a 'convoluted' set of calculations to arrive at the replacement cost of a capital base that in reality was likely to have been built up over time by various injections from government. According to Professor Wells, it was a fantasy to compare such a calculation to a private sector capital base.

If ODV was taken as the method of valuation, the concern remained that ODV was the calculation of the value of what the entity did not have and might like to have. How could the entity's capital base be evaluated using this concept and could any meaningful comparisons between utilities be made?

Professor Wells commented that ODV, as applied in the draft National Electricity Market Code of Conduct, made assumptions about replacement that did not correspond with reality: for example, overhead lines are assumed to be restrung even if they would have to be laid underground. In general, it was pointless to evaluate the financial performance of an entity according to a technology that it could not afford to adopt. For access pricing purposes, it was contradictory to assume away spare capacity (in the process of 'optimising' the facility) when it was the objective of access regimes to make that spare capacity available to other users. Deprival value, in Professor Wells' view, was not capable of independent audit because the auditor had to make the same assumptions for calculation of assets as made by the entity's managers. Audit was not intended to be a mere check of arithmetic.

An alternative proposal

In Professor Wells' view the debate over how to apply deprival value was intractable and unproductive. Professor Wells proposed that, for purposes of comparison, calculation of return on revenue and physical benchmarks of performance be used. For access pricing purposes, he proposed that the regulator work back from the price at which the monopolist was putting its own products in the market, using a notion of capacity to pay and with knowledge of industry pricing norms, to arrive at a reasonable charge for access to the monopoly facility. The return on revenue to the monopoly facility owner was also useful in access pricing because it gave the regulator a context in which to assess the user's capacity to pay.

Summing up and a way forward

Responding to Professor Wells' speech, *Commission Chairman Professor Allan Fels*, indicated that he shared concerns about utilising, for price regulation, concepts with net present value built in to them, because of the problem of circularity. Further, the cost of capital concept was designed for identifying cut-off points for new investments. Professor Fels did not accept that the approach was equally applicable to price regulation. He said that in the light of the profound questions that had been raised, he was surprised at how little debate there had been in Australia on the issues in the last 10–15 years, apart from a little debate over Telstra access prices and the use of CPI formulae in price regulation.

In summing up the seminar, *Commission Deputy Chairman Allan Asher* said that it appeared that the performance monitoring study had had wider implications than intended by the participants. He reminded seminar participants of the real urgency for the Commission to resolve the issues: the Commission could be called on at any time to arbitrate a dispute, should that arise, over prices for access to the Moomba-Sydney Pipeline System. Further, the Commission had been asked to authorise, in the next few months, the National Electricity Market Code of Conduct, which incorporates asset valuation provisions. While the Commission would not go too far into questioning the fundamentals of asset valuation when assessing the application, it would ensure that the subject was pursued externally.

Mr Asher concluded by saying that four principles should, in his view, apply to access pricing:

- consistency in approach;
- the imperative of using efficiency signals to foster customer involvement;
- capacity of the methodology to produce repeatable results; and
- respect for the rules determined by government.

National electricity market

In March 1996 the Commission published an issues paper which sets out the framework and issues it will need to assess when evaluating the competitive nature and public benefits to be derived from the rules governing the operation of the proposed national market for electricity.

The National Grid Management Council (NGMC) is expected to lodge an application with the Commission in July 1996 seeking authorisation of arrangements for the operation

of the national electricity market. It will also be submitting undertakings for access to the transmission infrastructure.

These market arrangements and access undertakings will take the form of an industry code of conduct. The code will cover all aspects of the national market, including market operation rules, system security, network connection, network pricing, metering, dispute resolution and monitoring of compliance and reporting. It also will provide transitional arrangements for jurisdictions to move to a fully competitive national market.

The paper was designed to promote discussion about the competition and access issues that may arise in the new market. The issues paper was the first step in the Commission's process of public consultation, prior to fulfilling its statutory obligations. It has to determine whether the code should be authorised and the access undertakings accepted.

Interested parties were invited to comment and make submissions to the Commission on the overall market arrangements, the general public benefit of the proposed arrangements as well as any of their anti-competitive effects. They were also invited to comment on the proposed access regime in terms of the requirements of the Trade Practices Act.

Although the closing date for comments was 24 April 1996, if you have a material interest not previously drawn to the Commission's notice you can follow developments by applying to join the mailing list.

The issues paper is intended to be read in conjunction with the draft code of conduct and specifically the NGMC's *National Electricity Code Outline and Rationale*, which are available from the NGMC. The draft code is also on the Internet at *http://electricity.net.au/*.

The Commission has also produced a paper which addresses the key issues that have arisen from submissions on the issues paper, and the Commission's preliminary analysis of the competition and access issues raised in the Code.

The issues paper and the paper entitled *National Electricity Market Code of Conduct — Comments and issues arising* are available free from all Commission offices.

Correspondence on access pricing issues can be sent to:

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Survey in Dubbo on refunds

An informal survey conducted by the Commission in Dubbo's central business district in April 1996 indicated that some retailers may be misrepresenting the rights of a consumer to a refund. The survey was done by the Commission's Tamworth office. It intends to do similar surveys in other cities in the region.

In one shop a sign warned: 'We exchange goods but we don't refund money'. A consumer who bought goods from this shop and later found them to be faulty would be entitled to a refund. Under the Trade Practices Act, consumers are entitled to a refund from the retailer if the goods are of unmerchantable quality, are not fit for their purpose or fail to match a description or sample. The seller can offer to replace or repair them but the consumer has the right to insist on a refund. Signs such as the one mentioned, or the even balder statement 'No refunds', exclude consumers from their rights to a refund and therefore are likely to constitute a breach of the Act.

If a retailer refuses to provide a refund under these circumstances, consumers can pursue an action under the Trade Practices Act or alternatively an action with a Consumer Claims Tribunal. A tribunal has the power to determine the matter on the evidence presented and

make an order that is fair and equitable to both parties.

Retailers who breach s. 53 of the Trade Practices Act face penalties which include fines up to $200 000 for the company and $40 000 for individuals.

A booklet on refund rights and obligations is available free from all Commission offices.

ACCC approach to banking

At a banking conference in Sydney, February 1996, Commission Chairman Professor Allan Fels said that the Commission would continue with the case-by-case approach to banking mergers.

Discussing recent banking activity which had been considered by the Commission, particularly the Westpac/Challenge merger, Professor Fels said the Commission had concluded that the relevant geographic area of the market was regional. (See former Trade Practices Commission *Bulletin* 83, October 1995, pp. 28–30; *ACCC Journal* 1, pp. 15–22.)

But the Commission's view is not a static one. The view that the Commission formed in the Westpac/Challenge matter is open to reconsideration as technology changes, as customer behaviour also changes, and perhaps also as regulation changes.

Examples of changes in technology can already be seen such as in the opening of a completely Internet-based bank in the United States and, in Australia, the introduction of an Internet banking service by a regional bank to complement its other tele-banking operations.

Developments such as these could, over time, affect the geographic dimension of market definition, but, in the Commission's view, the market for retail banking services is still properly classed as a regional one. The propensity of customers to switch to interstate suppliers in response to local price rises, for example, is a factor used to define the geographic scope of the market.

If the market evolves in ways that have been suggested, the Commission will assess it accordingly in future bank acquisitions.

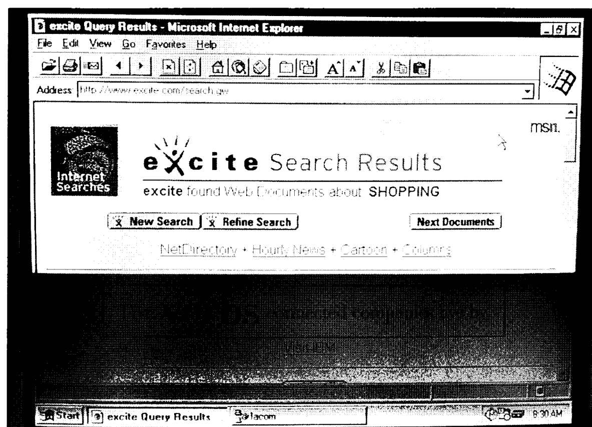
In relation to bank fees, the Prices Surveillance Authority had been critical of charges that were related to balance size of accounts. Professor Fels said the banks were moving in the right direction with the introduction of no-frills accounts, albeit slowly. He said that there was a degree of competition in financial services — to this extent consumers should review their needs and shop around banks, credit unions and building societies for the best deal.

The Chairman reminded the conference that the Prices Surveillance Authority had recommended that any changes to fee structures occur in a revenue-neutral way. The Commission would be very concerned if changes in bank fee structures claimed to be cost-justified led to higher net profits.

On-line trading

At a conference in Sydney, April 1996, Commission Deputy Chairman Allan Asher said that the Commission was turning its attention to the conduct of electronic commerce.

Mr Asher said that, as with many new frontiers, the pursuit of commerce had run ahead of legal and enforcement solutions, attracting 'bandit' and 'cowboy' elements which had created a genuine concern for consumers and ethical on-line retailers.



The Commission would be active in prosecuting firms which engaged in fraudulent and misleading conduct toward on-line consumers. The Commission has also developed, and is developing further, strong networks with overseas agencies in order to deal with sharp practices originating overseas or in Australia.

Mr Asher called on the industry to set up its own mechanisms to protect the consumers using its services, such as setting up a Consumers Issues Committee which could:

- liaise with consumer affairs agencies such as the Commission;
- talk with relevant consumer/community groups;
- look at systematic problems from complaints data;
- study and research trends in comparable overseas markets/industries; and
- do the above on a continuing basis to allow the industry to be proactive in preventing problems rather than reactive.

Mr Asher said that establishing confidence in the integrity of on-line traders was crucial to establishing mass acceptance of this form of commerce. Ways must be found to 'vet' ethical operators or at least identify those that are bound by appropriate industry standards.

Mr Asher said the development of the Internet Code of Conduct by the Internet Industry Association of Australia was very encouraging. Such codes achieved speedy, flexible, cost-effective and market sensitive solutions to many problems encountered by consumers and retailers. He hoped similar codes would be developed for the international on-line marketplace.

New publications

Steel mill products inquiry report

A Commission inquiry has found that changes in steel markets over the past decade have removed the need for prices surveillance of BHP's steel mill products.

The inquiry report recommends that the Commonwealth Government revoke the declaration of three companies that are part of BHP Steel. The companies have been declared — and their prices vetted — under the Prices Surveillance Act since 1986.

The Commission's recommendation was based on a number of developments since the initial declaration of the steel products. These were:

- lower tariffs on steel products and increasing imports for some products;
- continuing technological developments which are likely to make entry to the product markets more feasible in future;
- falling real average prices of the declared steel products;
- smaller price increases relative to building products and manufactured goods generally;
- prices for a substantial proportion of declared products had been restrained in recent years;
- customers acknowledged significant improvements in services;
- substantial improvements in productivity; and
- no evidence of sustained high profitability.

The report suggests informal monitoring would be adequate to track the impact of industry developments on steel prices in Australia. BHP has agreed to provide suitable information and this can be supplemented by data from other sources.

The Commission's decision takes into account the wider array of measures available to the new statutory authority under the national competition regime. Direct measures to protect competition are available, if required, under the Trade Practices Act. It also retains the option of reverting to price surveillance or formal price monitoring should substantial pricing problems emerge in the future.

It is the Government's role to determine whether the recommendation is adopted and the declaration revoked.

Copies of the report are available for $10 from all Commission offices.

Air fares monitoring report

Deregulation of Australia's domestic airlines has delivered substantial benefits in terms of air fares and service for passengers, according to a Commission survey of developments since the dismantling of the two-airline policy in October 1990.

The Commission report is a summary of the results of its monitoring of air fares from 1990 to 1995.

The report found that average fares are lower, there is a bigger array of ticket options, the frequency of flights has improved, especially on the main routes, seating capacity has expanded and the airlines now fly to more destinations. The report concludes that the airlines are now far more responsive to the varying demands of passengers.

However, the biggest gains for consumers were achieved in the periods of intense competition when there was a third airline operating in the market. The report tracks the impact of the Compass airlines on fares, flight arrangements and market shares.

The report is wary about more recent trends in the domestic industry. It notes that the two airlines, Qantas and Ansett, have identical pricing structures (for full and discount fares) and thus the services they provide have become their prime method of competing for market share. It also observes that, in the absence of a third operator, there has been a recent upward trend in average air fares and substantial increases in economy fares.

Because of these developments, the Commission believes it should continue to monitor price movements in the domestic airline industry.

The report concludes that deregulation has removed the shield of protection for the two main airlines and forced them to compete for market share, respond to the demands of consumers and improve the efficiency of their operations in order to ensure their long-term economic viability.

Copies of the report are available for $10 from all Commission offices.

Exercise cycle product safety guide

The Commission recently published a product safety guide for exercise cycles. The guide is targeted at manufacturers, wholesalers, importers and retailers of exercise cycles.

Exercise cycles must comply with the mandatory consumer product safety standard, Australian Standard 4092–1993 *Exercise cycles — safety requirement.* This guide should be read in conjunction with the standard. The mandatory standard covers the supply of all exercise bikes, including those supplied for sale to consumers, those for hire and hire purchase, those supplied to gymnasiums, and used ones.

Exercise cycles have been responsible for hundreds of accidents, particularly to children. Injuries have included broken fingers and, in some cases, amputations. The standard aims to reduce the chance of injury by requiring that hazardous moving parts are guarded, and creating safety requirements for seats and seat supports, sharp edges and points, and markings and instructions.

Exercise cycles which do not meet the standard cannot legally be supplied in Australia. The Commission has acted in the past when it discovered cycles that did not comply with the standard. The Trade Practices Act provides for penalties of up to $200 000 for corporations and $40 000 for individuals supplying goods that do not meet a mandatory standard.

Exercise Cycles Product Safety Guide is available for $10 from Commission offices.