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Confidential version

Commerce Act 1986

Preliminary assessment of whether to initiate a Part 4 Inquiry into port services provided by Eastland Port

Draft report

Date: 25 October 2012

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

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Executive Summary

1. This report sets out the Commerce Commission's conclusions arising from consideration of concerns raised regarding the conduct of Eastland Port. This report provides the Commission's reasons for not initiating an inquiry under Part 4 of the Commerce Act 1986[1] (Part 4 Inquiry) into whether economic regulation should be imposed on Eastland Port.

2. On the 17 April 2012 Eastland Port Forestry Industry Customer Group wrote to the Commerce Commission raising concerns about the conduct of Eastland Port. The Commerce Commission considered the material provided and other publicly available material and has reached a conclusion that a Part 4 Inquiry into Eastland Port should not be initiated.

3. In reaching this conclusions the Commission has carried out a preliminary assessment of each part of the full test for a Part 4 Inquiry laid out in section 52G of Part 4 of the Commerce Act, namely:

    3.1 whether the goods or services are supplied in a market where there is little or no competition and little or no likelihood of a substantial increase in competition;

    3.2 whether 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

    3.3 whether the benefits of regulating the goods or services in meeting the purpose of Part 4 materially exceed the costs of regulation.

4. The evidence before us does not show that the benefits of regulating Eastland Port are likely to materially exceed the costs associated with this regulation.

5. Nonetheless the Commission does have concerns that Eastland Port faces limited or no competition and that their recent pricing behaviour may be suggestive of excessive pricing to the detriment of customers.

6. The Gisborne area is predicting large growth in the forestry industry. This growth may, in future, change the balance of the costs and benefits of regulation. The Commission may reconsider its decision if predicted growth continues in the Gisborne forestry industry.

[1] All statutory references in this report are to the Commerce Act 1986, unless otherwise indicated.

1. Introduction

7. This report lays out the reasons why the Commerce Commission does not intend to initiate a Part 4 Inquiry into Eastland Port.

8. The analysis within this report has been undertaken to allow us to come to a view as to whether further resources should be dedicated to this issue. The analysis is therefore focussed on an assessment of the likelihood of regulation being warranted rather than detailed quantitative analysis of Eastland Port's conduct and market position. We believe our analysis is sufficient to arrive at a conclusion regarding the likely net cost of regulation and is appropriate given the substantial resources that would be incurred in carrying out a full Part 4 Inquiry.

9. The remainder of this section describes the complaint received, the Commerce Commission's understanding of the sector being examined and the process followed in undertaking this high level assessment.

How we investigated this complaint

10. The Commission received a complaint from Eastland Port Forestry Industry Customer Group (EPFICG) concerning the conduct of Eastland Port Limited (Eastland Port).[2] This complaint is concerned with the level of price rises imposed by Eastland Port for the port charges levied on the export of logs. Consequently this complaint has been considered as a potential Part 4 Inquiry.

11. As part of our assessment we have considered the information provided by EPFICG which includes an expert report from KPMG as well as materials provided to EPFICG by Eastland Port and other publicly available information. We have not at this point sought further information, either direct from Eastland Port, or from other interested parties.

The Regulatory framework for a Part 4 Inquiry

12. A Part 4 inquiry can be triggered by the Minister of Commerce or under our own initiative. The purpose of a Part 4 Inquiry is for the Commission to assess whether or not economic regulation under Part 4 should be imposed in relation to specified goods or services, and then make a recommendation to the Minister.

13. Section 52I of the Commerce Act 1986 (Act) sets out the framework of a Part 4 Inquiry, namely it provides that when conducting an inquiry into particular goods or services the Commission **must** consider:

    (a) whether the test in section 52G is satisfied in relation to the goods or services; and

    (b) if that test is satisfied, whether the goods or services should be regulated.

[2] Eastland Port is also referred to as Gisborne Port, throughout this report we refer to Eastland Port except where we use quotations.

14. Section 52G sets out the preliminary test that needs to be met before goods or services may 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

(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.[3] 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 guidance also notes that:

…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...

...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.

17. This report lays out our findings from that assessment of the likelihood of regulation. 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 <u>possibility</u> that those parameters could be satisfied if a full Part 4 Inquiry was commenced.

[3] Commerce Commission, The Commerce Act: Regulation of Goods and Services, **[DATE]**.

Eastland Port's business and the complaint against it

18. The subject of the complaint is Eastland Port.[4] This is a commercial port which represents approximately 0.5% of goods exported from New Zealand by port and just over 4% by volume. The vast majority of goods exported are logs.

Eastland Group history and price setting

19. Eastland Group Ltd, the parent company of Eastland Port, is (indirectly) 100% owned by the Eastland Community Trust which also owns and operates the Eastland Network electricity lines business and Gisborne Airport. Eastland Group purchased the port from the Gisborne District Council in 2003 for $18m. In 2011 Eastland Port reported a net profit after tax of $4.65m on total assets of $86.7m.

20. Following advice from PWC, in July 2011 Eastland Port proposed that future port charges be based on a building blocks pricing methodology and began a consultation process with customers and other stakeholders. This consultation led EPFICG to raise concerns with Eastland Port. It is this event (and the attendant substantial price increase) which has prompted the complaint to the Commerce Commission.

21. These new prices were confirmed by the board in February 2012, applying from 1 November 2011. Eastland Port have communicated to EPFICG that they consider the matter resolved and are not prepared to provide any additional information.[5]

The complaint against Eastland Group

22. The EPFICG is comprised of customers who export forestry products through Eastland Port. Their primary concern relates to price increases which came into effect in November 2011. EPFICG would like us to determine what the prices should be and have these revised and backdated to November 2011.

23. EPFICG is concerned about the extent of price increase and believes that Eastland Port's wharfage and log storage charges are the highest in New Zealand by a margin of over 40%.

24. These concerns led EPFICG to commission KPMG to examine Eastland Port's pricing methodology and as such they have committed some substantive resources to this issue.

Previous investigations into ports relevant to this analysis

25. The MED examined whether seaports should be subject to regulation under Part 4 in 2002. MED rejected a Part 4 inquiry into market power for seaports largely on the basis of existing competition.[6] This review covered all seaports rather than Eastland Port individually.

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[4] The port is referred to as both Eastland and Gisborne Port.

[5] Letter from Eastland Port to PF Olsen dated 21 March 2012.

[6] There is a summary of this report in the Productivity Commission report and this is contained in Annex 1.

26. The Productivity Commission also recently examined the port sector in its review of freight services. This did not directly address the issues we are considering.

Our preliminary analysis

27. The remainder of this report provides our preliminary analysis of the questions laid out by Part 4 of the Act. This includes:

    27.1 does Eastland Port face little or no competition;

    27.2 the scope for Eastland Port to exercise substantial market power; and

    27.3 do the benefits of regulating Eastland Port materially exceed the costs.

2. Does Eastland Port face little or no competition

28. 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.

Framework for preliminary analysis

29. Establishing whether a company faces little or no competition usually requires first defining a relevant market and then understanding the position of the company in question within that market.

30. This test is a high hurdle and is not meant to capture all businesses that may face limited competition and retain some market power.

How likely is it that Eastland Port faces little or no competition?

31. EPFICG considers that Eastland Port is a monopoly not subject to constraints from competition.

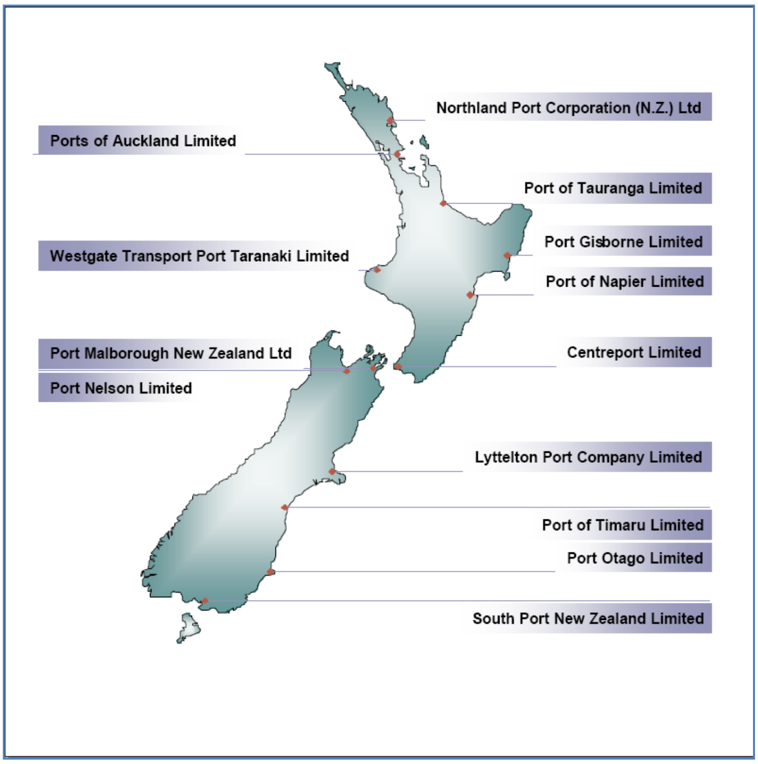
> In respect of export of forest products, especially logs, [Eastland Port] has the power to behave as a monopoly, given the very high cost of transport of forest products to either Napier or Tauranga, except at the extremities of the region serviced by [Eastland Port]. This absence of competitive constraint means that Eastland Port has substantial market power.[7]

32. The smallest possible 'candidate' relevant market is port services for forestry products in the Gisborne area. In this market, Eastland Port would be the only provider of these services.

33. The main evidence and considerations here are related to geographic market definition. Do the nearest adjacent commercial ports of Napier and Tauranga act as competitive constraints? Both these ports currently store and ship logs. The main aspects of the available evidence on their ability to compete are noted below.

[7] Letter to the Commission from Peter Clark of 17 April 2012.

Figure 1: Location of New Zealand Commercial Ports



Source: CRA, Port Companies and market power a quantitative analysis, April 2002, Figure 1.

33.1 In 2002 the MED commissioned a review of the market power of port companies.[8] This review highlighted that land transport costs were critical for isolated ports and noted:

> Geography and lower quality roads also isolate Port Gisborne, and we understand that the port has not used the available rail network for two years. In addition, the port mainly exports forestry products from its immediate hinterland, which tends to favour export through Gisborne rather than through other ports further away.
>
> In 1999/2000 Port of Gisborne increased its prices for infrastructure services by 20% with little if any change in sales volumes from key customers. Normally a 5-10% price increase is taken as a benchmark for determining whether a firm has market power. To say, however, that market power was abused or exercised in an anti-competitive manner in this case is more problematic.

33.2 The costs of transporting logs from the Gisborne area to the two closest alternative ports (Napier and Tauranga) are likely to be relatively high. Logs are a heavy bulky good and transportation costs could be expected to be high (relative to other types of goods).

33.3 In practice 92% of the Gisborne region's exports leave via Eastland Port and of this logs represents 97% of the port's business by volume.[9]

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[8] Charles River Associates Ltd (2002), Port Companies and Market Power – a Qualitative Analysis.

33.4 There was a rail link between Gisborne and Napier which could transport logs.[10] However, following an assessment of whether the line was economic to operate, and wash outs in several places in March 2012, the line was mothballed by the operator (KiwiRail) in October 2012.[11]

33.5 There is some evidence that the larger Forestry companies containerise processed timber product and ship from Napier. This implies there may be a real choice for some product which is being exercised.[12]

34. The weight of available evidence would tend to favour Eastland Port facing little or no competition.

35. The likelihood of increased competition for Eastland Port appears small. Ports can be characterised as long-term investments involving substantial sunk costs. Consequently it seems at least plausible that no new competing port will be built in the Gisborne area.[13]

36. The evidence on countervailing power from purchasers of port services suggests customers do not have a good bargaining position with Eastland Port. In particular, the imposition of price increases in face of customer opposition and refusal to discuss this further by Eastland Port does not suggest customers hold a strong negotiating position.

37. On a preliminary analysis, it is plausible that Eastland Port faces little or no competition, and this will continue into the future, in supplying port services for the export of forestry products. A Part 4 Inquiry would need to consider further the key issue of the relative economics of transporting logs from Gisborne to the nearest alternative ports.

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9 Reported in Eastland Group's Annual Report 2011.

10 KiwiRail's Gisborne to Napier link has published statistics on annual tonnage of timber. This was 196,000 tonnes in 2006/07 dropping to none in 2009/10. Source: Buchanan Environmental Services Ltd Report to Hawkes Bay Regional Council.

11 Refer http://www.kiwirail.co.nz/news/184/130/KiwiRail-to-mothball-Napier-Gisborne-line.html.

12 A Gisborne to Napier Coastal Shipping study by Warwick Walbran Consulting Ltd, *Gisborne to Napier Coastal Shipping Study for Eastland Infrastructure*, Revision 1 – March 2010, noted that the one of the largest forestry customers Hikurangi Forest Farms (HFF) advised that much of their product will be containerised and that, in their view, it was unlikely that Eastland Port would build container handling facilities at Gisborne.

13 The 2002 CRA study concluded that entry into the provision of port infrastructure, particularly in the case of establishing a new port, involves significant risk given the large sunk costs involved. As a result, the provision of port infrastructure is necessarily less contestable than operational port services. The study also noted that a new port at Tolaga Bay was in development stages. We have been unable to track down any evidence on this which was sourced to a Dominion Post article.

3. The scope for Eastland Port to exercise substantial market power

38. Under a full 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).

Framework for preliminary analysis

39. Our preliminary analysis looks at the conduct of the company in question that led to the complaint and what other constraints may exist on its behaviour.

40. One question which can also be looked at in a preliminary analysis is whether the alleged conduct is consistent with the available facts and with the exercise of substantial market power. This analysis could also be carried out under the s 52G(1)(a) competition test but we have considered it here as it is potentially behavioural evidence relevant to both.

Has Eastland Port the scope to exercise substantial market power?

41. The two main questions we have considered are whether constraints exist from current regulations and whether the ownership structure of Eastland Port may reduce incentives to exercise substantial market power. We have also considered the reported conduct of Eastland Port and whether that is consistent with the exercise of substantial market power.

Are any existing regulations in operation which may constrain Eastland Port

42. The Productivity Commission report on international freight services provides some information on regulation of ports. There currently is no economic regulation (or financial information disclosure). The Productivity Commission recommended information disclosure requirements be developed by the Transport Ministry, in particular to disclose Economic Value Added (EVA) measures. The recommendation for greater transparency was provided in the context of financial underperformance of ports (rather than in the context of excessive profits). [14]

43. In summary there is the prospect of some future information disclosure requirements on port financial information. At this stage it is does not look like such disclosure would act as a significant regulatory constraint on any excessive pricing.

Does the ownership structure of Eastland Port constrain incentives to excessively price?

44. A potential constraint on exercise of market power is that Eastland Port is owned by Eastland Community Trust (ECT)[15] whose objectives are:

> To preserve the value of the capital of the Trust Fund.
>
> To provide for the people of Gisborne (the beneficiaries) by

[14] New Zealand Productivity Commission, International Freight Transport Services Inquiry, April 2012

[15] We understand that control rights for the trust are owned by Gisborne District Council and the Productivity Commission treated Gisborne Port as being owned by the Council.

> Paying and subsidising the installation, maintenance, or supply of electricity to areas of the district that have excessive charges compared with the majority of consumers.
>
> Supporting business, community and other initiatives which are likely to encourage or sustain economic growth within the district, or may directly or indirectly benefit the people of Gisborne.

45. The objective of encouraging economic growth may blunt Eastland Port's incentives to excessively price.[16] ECT also owns Eastland Network, a non-exempt electricity distribution business subject to price-quality regulation as well as information disclosure under Part 4. 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.

Evidence on the conduct of Eastland Port

46. The conduct of Eastland Port also provides some evidence as to whether their ability to exercise market power is constrained. The basic complaint against Eastland Port is that they have raised prices excessively. The price increase was based on a building blocks methodology for pricing following advice from PWC.

47. We have not undertaken any financial modelling nor do we have the information to do so. For a preliminary analysis we have simply looked at the likelihood of the price increase being an issue based on the information provided by EPFICG. There is mixed evidence to corroborate that the prices may be excessive. Evidence from EPFICG includes:[17]

    47.1 The Weighted Average Cost of Capital (WACC) used by Eastland Port for the price setting may be high. PWC advised Eastland Port on the WACC they should use for future price setting. PWC have advised Eastland Port and Eastland Port appear to have adopted a "small company premium" of 2% to their WACC.[18] The Commission has already considered and rejected the contention that such a premium should apply under Part 4.[19]

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16 This may depend on how much forestry would in practice be discouraged by increased transport costs. Port charges may have very limited impact.

17 A fuller list of the areas of contention identified by KPMG in their report to PF Olsen is available in Attachment A.

18 This is despite PWC's definition of a small company holding assets of below $50 million and Eastland Port's assets being in excess of this.

19 Commerce Commission, Input Methodologies (Airport Services) Reasons Paper, 22 December 2010, Paragraphs 6.4.26 to 6.4.28.

47.2 The WACC is also calculated using a Market Risk Premium of 7.5%; the Commission has determined that a Market Risk Premium of 7% is more appropriate.[20]

47.3 KPMG believe (but are not certain) that Eastland Port may have used a nominal WACC rate as a real WACC in their pricing model and thereby inflated their prices.

47.4 It appears that Eastland Port has significantly revalued its assets over time. They purchased the assets in 2003 for $18 million, in 2007 they were valued at $85.9 million and in 2011 $86.7 million.[21] Further, revaluation gains between 2007 and 2011 may not have been treated as income.

47.5 We note that the price at which Gisborne Port was purchased in 2003 may also have been discounted given at the time the port was subject to an adverse safety report by the Maritime Safety Authority.[22] It was reportedly in need of substantive investment at that time. It is unclear how much investment has occurred between 2003 and 2011 during which the volume of business increased approximately three fold.

48. Whilst not the only source of concern from the KPMG report,[23] the WACC and asset valuation have the potential to result in a significant over-estimate of required revenue on a building blocks approach. This would tie in with the 2011 price increase being reportedly very material.[24] Any such conclusion, however, needs to be interpreted with caution:

48.1 The large reported increases in demand for port services in this area should be expected to result in price rises in workably competitive markets with capacity constraints. Tonnage is reported to have increased by 25% over the previous year.[25] Eastland Port's website notes volumes have increased 100% over the past three years.

48.2 Another potential explanation for price rises is within the PWC report to Eastland Port:

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20 See Commerce Commission, Input Methodologies (Airports) Reason Paper, December 2010. These are not the only potential issues with the calculation and use of WACC that may result from a full investigation into Eastland Port's pricing methodology.

21 It appears that the 2011 revaluation is unlikely to have caused a significant price rise. It is more likely that applying a building block methodology using revised asset valuations is more significant.

22 See 2001/02 Financial review of the Maritime Safety Authority of New Zealand Report of the Transport and Industrial Relations Committee, http://www.parliament.nz/NR/rdonlyres/68D1F720-6BD7-472B-8CF9-4F7BC8B20AB7/13812/DBSCH_SCR_2437_27291.pdf

23 Their full findings are laid out in Annex 1, these largely relates to areas of uncertainty of how the financial model Eastland Port has used works.

24 EPFICG have informed us that they estimate the NPV of the price increase represents incremental revenue of $78 million and that prices at Eastland Port will now be 40% higher than other ports in New Zealand.

25 Eastland Group Annual Report 2011.

> Eastland Port's ROI has averaged 5.3% over the 2006-2011 period and the March 2011 Weighted Average Capital Cost (WACC) report indicated a fair value return of 10.9%. Typically below target returns are indicative of either under-charging of port users or excessive operational expenditure[26]

48.3 It is at least plausible that recent substantive price rises reflect in part past under-recovery of economic costs.[27]

49. Within a preliminary analysis it is not possible to definitively establish that Eastland Port does have substantial market power that is not constrained by offsetting factors, but it does seem likely that is the case. We would need further information from Eastland Port to reach a view which would form part of a Part 4 inquiry. The evidence concerning conduct does, however, raise significant questions as to how Eastland Port has set their port charges. In our view, Eastland Port's recent pricing behaviour is suggestive of excessive pricing to the detriment of consumers.

[26] Letter from PricewaterhouseCoopers to Eastland Group Limited of 13 September 2001, paragraph 13.
[27] Although this may not be the case if revaluation gains had been treated as income.

4. Do the benefits of regulating Eastland Port materially exceed the costs

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

Framework for a preliminary analysis

51. A full Part 4 inquiry analysis would mean examining the main benefits of regulation against the costs of regulation. The Act also specifically mentions other considerations.

> **52I Commission inquiry into particular goods or services**
>
> (2) As part of an inquiry into particular goods or services, the Commission —
>
> ...
>
> (b) must, when carrying out the analysis required by section 52G(1)(c), undertake a qualitative analysis of all material long-term efficiency and distributional considerations.
>
> (3) As part of that qualitative analysis, the Commission must, as far as practicable,—
>
> (a) quantify material effects on allocative, productive, and dynamic efficiency; and
>
> (b) quantify material distributional and welfare consequences on suppliers and consumers; and
>
> (c) assess the direct and indirect costs and risks of any type of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects.

52. A preliminary assessment of the costs and benefits of imposing regulation only really allows for a sense of scale and our analysis includes:

    52.1 an estimate of the benefits based on simplifying assumptions;

    52.2 an estimate of costs based on the Commission's costs of similar work; and

    52.3 some sensitivity analysis.

53. We have not attempted to separately identify material effects on allocative, productive and dynamic efficiency. We have focused on the potential distribution and welfare impacts from excessive pricing.[28] This reflects the complaint we have received which did not raise concerns about Eastland Port's cost efficiency or investment decisions.[29]

[28] Consistent with the regulatory objectives of sharing efficiency gains and limiting excessive profits set out in section 52A(1)(c) and (d).

[29] Hence not assessing the potential benefits against the corresponding regulatory objectives set out in section 52A(1)(a) and (b).

54. From this an element of judgement can be applied as to the likelihood that benefits will materially exceed costs.

Indicative cost-benefit analysis of regulation of Eastland Port

55. A Part 4 Inquiry and subsequent regulation of Eastland Port would be expensive. We have estimated indicative costs and benefits from the regulation of Eastland Port. We have included the costs associated with price-quality regulation and information disclosure regulation.

Indicative costs for regulating Eastland port

56. The table below sets out our indicative costs based on relevant costs from other work undertaken by the Commission. In some areas we have no precedent to rely on and here we have estimated the potential costs.

Table 1: Cost estimates for Regulating Eastland Port

Cost component	High level assumption	Estimated cost (including overheads)
Setup Costs		
S52G (Competition) Test	Estimate based on milk review.	$150,000
Specification of regulated services	No precedent. New sector and industry. Includes single/dual till consideration, definition/specification of regulated services	$20,000
Determination of input methodologies	Assume 18 month consultation period with sector. To cover Asset Valuation/Cost of Capital/Cost allocation/Tax Methodologies	$2,000,000
Assess the costs and benefits of different forms of regulation (information disclosure, price quality regulation, negotiate arbitrate)	Estimate of one off cost based on current work	$20,000
Section 52P determinations - ID only	Based on cost of Airports ID over 18 months. May be some leverage off Airports ID, but likely to be offset by significant new work on quality	$1,500,000
Section 52P determinations - Price-Quality Regulation	Assumes additional cost to information disclosure	$2,000,000
Ongoing costs		
Information disclosure and summary & analysis	Based upon Airports	$150,000 per annum
Price-quality regulation	Compliance costs	$40,000 to $80,000 per annum
	Reset costs	$1,500,000 every 5 years

57. These costs are substantial and reflect the fact that Eastland Port would be a single Port in a sector whereas our other areas of regulation benefit from economies of scope from regulating multiple companies within a sector.

58. These costs do not include estimates for the costs that would be incurred by Eastland Port and other firms that may be involved were Eastland Port regulated.

Indicative benefits from regulating Eastland Port

59. The potential benefits from such regulation are difficult to estimate with accuracy. We have taken three separate estimates to gain a sense of scale.

59.1 An indicative price drop based on information from Eastland Port's 2011 Annual Report. This annual report noted EBIT of $8.1 million in 2011 up from $5.4 million in the previous year. This was attributed to a 25% volume increase. As a rule of thumb we could estimate a 20% price increase implies revenues of $2.2 million per year.[30]

59.2 Eastland Port's WACC includes a 2% uplift due to a small firm premium.[31] They have also included a market risk premium of 7.5% rather than our estimate of 7%. These combined effects indicate a reduction in revenue of $1.7 million per year from regulation.

59.3 Eastland Port's asset valuation may be overstated. Eastland Port increased their assets valuation from $85.9 million to $86.7 million between 2010 and 2011. The original purchase value was much smaller. It is difficult to approximate what a realistic reduction in value may be (if any). As a sensitivity test we have reduced this by 10%. The cumulative impact of including this with the 2% WACC adjustment is $2.5 million per annum.

59.4 We have not attempted to estimate other second order effects such as the additional taxation which is passed on to consumers from increased asset valuation.

Are benefits likely to materially exceed costs?

60. The focus of this assessment is upon costs and benefits overall, rather than on individual companies for which the impact is likely to be substantive.

61. Part 4 requires the Commission to quantify both distribution and welfare impacts on suppliers and customers. A distributional impact is where increased prices lead to a wealth transfer from customers to suppliers; this is sometimes referred to as consumer welfare losses. Overall welfare impacts look at how increased prices can lead to a loss of output which is a loss to the New Zealand economy overall. These are sometimes referred to as total welfare losses or deadweight losses.

62. Total welfare impacts are smaller than consumer welfare impacts. The Act does not lay out how these should be balanced where there is a small overall welfare loss and a large distributional transfer from customers to suppliers.

63. Assuming for the moment that Eastland Port is able to exercise substantial market power, we would expect the majority of the overcharge to represent a transfer of wealth from port users to Eastland Port. As a test to gauge this we have adopted an assumption that 33% of the benefits accrue as total welfare to the economy. This is a

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30 A pure price increase impact should be akin to a pure volume increase impact. Given we only have EBIT not revenues and costs, this is an approximate impact. This is smaller than the complainant's estimate of $75 million net present value.

31 Whilst Eastland Port have stated in communication to PF Olsen that forecast returns are 2.65% below their cost of capital, this is still a relevant sensitivity for the purposes of an indicative estimate.

very approximate assumption and we would normally expect total welfare impacts to be much smaller than consumer welfare impacts. [32]

64. The table below looks at the resulting net benefits over 10 years using a discount rate of 7%. Here we have assumed:

64.1 the set up costs are spread over the first 18 months; and

64.2 benefits will not accrue until the set up costs have been incurred.

Table 2: Net benefits under different welfare standards

Net benefits test over 10 years	Welfare Standard	
	Consumer Welfare	Total Welfare
20% price decrease	$3.5m	-$4.6m
2% WACC reduction	$1.1m	-$5.4m
WACC & asset valuation	$5.5m	-$4.0m

65. The table illustrates that over ten years, potential benefits to consumers vary between $1.1 million and $5.5 million. These numbers are unlikely to be precise but give a sense of scale. Changes in total welfare as a result of regulation are negative.

66. It is possible a full Part 4 Inquiry may not lead to regulation. This means costs would be incurred without any benefits being produced. To gain an indication of this we have taken the first year's costs as incurred in full and then probability weighted the remaining costs and benefits at a 75% and 50% likelihood of regulation.[33] The results are reported below. This is applied against a consumer welfare impact of regulation only, total welfare impacts are negative.

Table 3: Summary of indicative net benefits over 10 years

Net benefits (Consumer Welfare Standard)	No probability adjustment	75% probability	50% probability
20% price decrease	$3.5m	$0.7m	-$0.8m
2% WACC reduction	$1.1m	-$0.2m	-$1.4m
WACC & asset valuation	$5.5m	$3.1m	$0.7m

67. The Act requires benefits to materially exceed costs.[34] We have not included the costs that would be incurred by Eastland Port or its customers.[35] One way to address

[32] We do not have sufficient information to more accurately approximate the difference between Consumer Welfare effects and Total Welfare effects. This is largely dependent on the reduction in volume associated with prices being too high.

[33] This is not a view on the likelihood, but rather sensitivities to gain a sense of the impact on the cost benefit analysis.

[34] 52(G) (1) (c) "the benefits of regulating the goods or services in meeting the purpose of this Part materially exceed the costs of regulation."

[35] The Act specifically requires these costs to be considered under 52(I)(3)(c) "assess the direct and indirect costs and risks of any type of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects".

this is to ask if over a ten year period costs to interested parties would exceed the net benefits. These need to be assessed alongside other relevant considerations including:

67.1 on a consumer welfare standard, 10 year net benefits vary between $1.1 million to $5.5 million;

67.2 on a total welfare standard, 10 year net benefits are likely to be negative;

67.3 these estimates are reduced if we take into account the probability a full Part 4 inquiry may not recommend regulation of Eastland Port;

67.4 any litigation costs if Eastland Port appealed our input methodologies decisions. These costs can be substantial;

67.5 other potential costs which have not been quantified including increased uncertainty for regulated businesses, their own suppliers and downstream customers, which may discourage investment; and

67.6 the benefits estimates would substantially increase if growth in the forestry industry in the Gisborne area continued at recent levels.[36]

68. The cost benefit analysis is most sensitive to the assumptions which underlie the benefit estimates which can only indicate scale and are subject to significant uncertainty. Nonetheless, on the evidence before us, there does not appear to be a robust case that the benefits of initiating a Part 4 Inquiry (which are ultimately passed through to customers) would materially outweigh the costs.

69. This would seem consistent with the size of the business; it is a fairly small commercial port that we are considering, as opposed to a sector of ports.

70. A key uncertainty within this assessment remains the growth in the forestry industry in the Gisborne area. The benefits of regulation estimates are sensitive to this growth assumption. Whilst this analysis is also sensitive to the unquantified costs highlighted above, it is possible that substantial and sustained growth into the future may change the balance of the cost benefit analysis. We do not believe, at this stage, this is enough to incur the costs of a full Part 4 Inquiry. We could revisit this if growth substantially alters the volume of business at Eastland Port in the future.

71. In conclusion the initial cost benefit analysis of regulating Eastland Port is not supportive of undertaking a full Part 4 Inquiry at this time.

[36] If we assumed growth continued at 25% a year until 2020 indicative net benefits can be as high as $30 million but can still be negative on a total welfare appraisal.

Attachment A: KPMG Analysis of Eastland Port's pricing methodology

A.1 KPMG was retained by PF Olsen to analyse the information provided by Eastland Port in support of their price increases. KPMG's recommendations to PF Olsen where:

- Write to Eastland Port stating on advice from KPMG CF:
  - The WACC adopted by Eastland Port is likely to be materially higher than the WACC the Commission would consider appropriate for return on investment measures and pricing;
  - The asset values adopted by Eastland Port may not accord to the approach adopted by the Commission in setting opening asset values under an Information Disclosure monitoring regime;
  - The asset valuations undertaken by Opus and Logan Stone do not appear to have been prepared for "pricing purposes" but more conform to the requirements of financial accounting reporting purposes. Some assets (e.g., seawall) may be double counted
- Requesting Eastland Port to provide their pricing model. This would enable us to more critically evaluate, inter-alia:
  - The key drivers of the revenue and cost assumptions, including the reasonableness of forecasts of ship visits, wharf tonnage and other revenue and cost driver assumptions;
  - The form of WACC (i.e., nominal versus real) and consistency of the definition and application of the WACC with respect to cash flow input assumptions;
  - Review of return on investment calculations;
  - Check if revaluation gains are included as part of economic income;
  - Check to ensure the building block model meets the NPV = 0 test; and
  - Undertake sensitivity analysis with respect to changes in key assumptions.
- Request Eastland Port to provide copies of its historical financial statements since 2003. This is to enable us to undertake a high-level historical analysis of "return on investment" that also includes asset revaluation gains.

A.2 KPMG's detailed findings for PF Olsen are summarised in the table below.

Comment	Directional impact on prices
Building block model findings	
Eastland Port's pricing methodology may not be consistent with purpose statement in the Act to share efficiency gains with customers and lower prices	Prices will be too high
The building block model may not incorporate expected asset revaluations in the determination of the economic return to Eastland Port	Prices will be too high
The building block pricing model has not been provided to Eastland Port's customers	Directional impact on prices uncertain. In the absence of the pricing model Eastland Port's customers are unable to: • Test the key revenue cost drivers and other critical assumptions. • Test the model meets the NPV = 0 test. • Review the model for mechanical accuracy. • Verify the treatment of expected revaluation gains. • Verify treatment of new capital expenditure.
Weighted Average Cost of Capital	
The WACC estimated by PWC would likely exceed the Commerce Commission 50^{th} percentile estimate of an appropriate WACC for ports by approximately 2%.	A higher WACC increases prices and returns to Eastland Port.
Eastland Port's pricing methodology refers to WACC of 10.9% being a real or inflation adjusted estimate	PWC advice on WACC is 10.9% nominal. A real WACC of 10.9% will increase prices and returns to Eastland Port

Comment	Directional impact on prices
Asset Values	
Logan Stone's land values appear predominantly suitable for financial accounting purposes and not sufficiently rigorous for price setting purposes. Asset values are 2009 valuations.	Directional impact uncertain
Opus valuations appear predominately suitable for financial accounting purposes and not sufficiently rigorous for price setting purposes.	Directional impact uncertain. However prices will likely be too high if operational assets are valued according to pre-2011 valuations.
Logan Stone and Opus appear to "double count" some asset values – e.g. seawall.	Will increase prices and returns to Eastland Port.
Process to determine asset valuations at the next price review date is unclear and not transparent.	PWC advise Eastland Port that a consistent approach to asset valuation should be applied. The ability of Eastland Port to set and/or change the approach to determine asset values at the next price review date enables Eastland Port to earn potential excess returns.
New capital expenditure. The treatment of assets to be constructed or developed under the building blocks model is not clear.	Current customers may be obliged to "pay" to enable Eastland Port to earn its WACC on assets under construction, notwithstanding such assets may not yet be commissioned in providing port services.
Return on Investment	
Historical return on investment figures proffered by Eastland Port may not include revaluation gains.	An analysis of historical returns that includes asset revaluation gains may conclude that Eastland Port has earned historical returns above its WACC. This would suggest that with new revised prices, Eastland Port will earn excess returns over the fair life of its assets.
As above, Eastland Port's building block model does not recognise expected asset revaluations	PWC and the Commission both recognise asset revaluations as part of economic income. Failure to recognise will increase prices and returns to Eastland Port.

KPMG's engagement was with PF Olsen Limited and KPMG accepts no responsibility to any other party. The financial and non financial information set out within KPMG's report has been provided by the management of PF Olsen Limited. KPMG have prepared their report on the basis of that information and nothing in this report should be taken to imply that KPMG has verified any information supplied to it, or has in any way carried out an audit of the information for the purpose of this report. Accordingly KPMG do not accept responsibility for the accuracy or completeness of such information.

The report was prepared solely for the use of PF Olsen Limited. KPMG expressly disclaims any and all liability for any loss or damage of whatever kind to any person acting on information contained in this report, other than PF Olsen Limited.

Attachment B: Extracts from the Productivity Commission recommendation on Ports

Productivity Commission's summary of the MED's advice to Ministers on regulation of seaports

Commerce Commission inquiry

Officials do not recommend the Minister of Commerce direct the Commerce Commission to undertake an inquiry into port companies' market power. An inquiry, while having the benefit of providing a rigorous quantitative analysis of port companies' returns and guidance on appropriate valuation methodologies, would also impose significant costs. (p.8)

Information disclosure

Officials do not recommend introducing an information disclosure requirement as difficulties in targeting the particular transactions of concern could result in distortionary effects where competition is workable and effective, would not necessarily provide useful information to captive customers and would impose additional compliance costs. (p.9)

Mandatory dispute-resolution regime

Officials do not consider alternative disputes resolution regimes are desirable. Voluntary mediation can be entered at any time by commercial parties. It does not require government intervention. Mandated ADR regimes could result in significant costs. (p.10)

No intervention

Officials consider that maintaining the status quo is a legitimate policy option given the deficiencies associated with other options and the limited nature of the problem. (p.11)

Attachment C: Relevant provisions from Part 4 of the Commerce Act 1986

Subpart 2—Regulating particular goods or services

52E Overview of process if regulation imposed on goods or services

- (1) The process for imposing regulation under this subpart on particular goods or services involves the following steps:
    - (a) the Commission holds an inquiry into whether, and if so how, to regulate the goods or services, and then makes a recommendation to the Minister under section 52K:
    - (b) the Minister considers the Commission's recommendation and decides whether or not to recommend to the Governor-General that regulation be imposed and, if so, which type or types of regulation:
    - (c) if the Minister decides to recommend regulation, an Order in Council may be made under section 52N that makes the goods or services subject to regulation and identifies the type or types of regulation that apply:
    - (d) for each type of regulated goods or services, the Commission makes a section 52P determination specifying how the applicable type or types of regulation apply to a supplier of the regulated goods or services.

  (2) This section is only a guide.

  Section 52E: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

52F Effect of goods or services being subject to regulation

- (1) If goods or services are subject to regulation of a particular type, every regulated supplier of those goods or services must comply with—
    - (a) the requirements of this Part relating to that type of regulation; and
    - (b) every section 52P determination applying to the supplier.

  (2) Sections 86 to 87C (which relate to offences and civil proceedings relating to contraventions of this Part) apply to a regulated supplier on and from the date on which the supplier is obliged to comply with a relevant section 52P determination.

  (3) The Commission is entitled to exercise any of its powers under this Act for the purpose of monitoring compliance by regulated suppliers with regulation under this Part.

  Section 52F: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

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

- (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.

Section 52G: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

Commission inquiry

52H How inquiry triggered

- (1) The Commission—
  - (a) must hold an inquiry if required to do so by the Minister; and
  - (b) may hold an inquiry on its own initiative.

  (2) Any requirement by the Minister must—
  - (a) be in writing; and
  - (b) specify the date by which the Commission must make a recommendation under section 52K to the Minister.

  Section 52H: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

52I Commission inquiry into particular goods or services

- (1) In conducting an inquiry into particular goods or services, the Commission must consider—
  - (a) whether the test in section 52G is satisfied in relation to the goods or services; and
  - (b) if that test is satisfied, whether the goods or services should be regulated; and
  - (c) if so, how the goods or services should be regulated, including—
    - (i) how the goods or services should be defined; and
    - (ii) which type or types of regulation (as set out in section 52B(2)) the goods or services should be subject to; and
    - (iii) how that type or those types of regulation should apply to suppliers of the goods or services.

  (2) As part of an inquiry into particular goods or services, the Commission—
  - (a) must determine (and then apply) input methodologies for the supply of the goods or services, in accordance with subpart 3; and
  - (b) must, when carrying out the analysis required by section 52G(1)(c), undertake a qualitative analysis of all material long-term efficiency and distributional considerations.

(3) As part of that qualitative analysis, the Commission must, as far as practicable,—

- (a) quantify material effects on allocative, productive, and dynamic efficiency; and
- (b) quantify material distributional and welfare consequences on suppliers and consumers; and
- (c) assess the direct and indirect costs and risks of any type of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects.

(4) As part of an inquiry, the Commission must, when considering which type of regulation might be imposed,—

- (a) assess the benefits of imposing different types of regulation in meeting the purpose of this Part against the costs of imposing those types of regulation; and
- (b) consider what would be the most cost-effective type or types of regulation in the circumstances.

(5) During an inquiry, the Commission may have regard to any other matters it considers necessary or desirable for the purpose of the inquiry.
Section 52I: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

52J Process of inquiry

- (1) At the start of an inquiry, the Commission must publish in the *Gazette* a notice setting out,—
  - (a) in the case of an inquiry required by the Minister, the Minister's requirements; and
  - (b) in the case of an inquiry on the initiative of the Commission, the terms of reference for the inquiry.

(2) The notice must set out indicative time frames and key steps.
(3) During the course of an inquiry, the Commission—

- (a) may publish, in whatever way it considers appropriate, further notices, consultation documents, or papers; and
- (b) must give interested persons a reasonable opportunity to give their views; and
- (c) may hold 1 or more conferences; and
- (d) must have regard to any views received from interested persons within any time frames set.

(4) Before the end of an inquiry, the Commission must publish a proposed recommendation for consultation.
Section 52J: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).

52K Commission's recommendation following inquiry

- (1) At the end of an inquiry, having considered the matters in section 52I, the Commission must make a recommendation to the Minister on whether, in its opinion, the goods or services should be regulated.
  (2) If the recommendation is that particular goods or services should be regulated, the recommendation must state the following:
  - (a) how the goods or services should be specified:
  - (b) which type or types of regulation should apply to the goods or services:
  - (c) what input methodologies apply:
  - (d) if information disclosure regulation is recommended, the material provisions of the information disclosure requirements:
  - (e) if negotiate/arbitrate regulation is recommended, the material provisions of the negotiation process and arbitration process:
  - (f) if default/customised price-quality regulation is recommended, the default price path and quality standards:
  - (g) if individual price-quality regulation is recommended, the material provisions to apply.

  (3) The Minister must publish the Commission's recommendation, and may do so in whatever way he or she considers appropriate.
  (4) To avoid doubt, a recommendation by the Commission is not a determination of the Commission.
  Section 52K: inserted, on 14 October 2008, by section 4 of the Commerce Amendment Act 2008 (2008 No 70).