The Allen Consulting Group

29 November 2006

Mr Gary Potts
Presiding Commissioner
Price Regulation of Airport Services Inquiry
Productivity Commission
PO Box 80
BELCONNEN ACT 2616

*By email: airportpricing@pc.gov.au*

**RESPONSE TO BRISBANE AIRPORT'S COMMENTS IN RELATION TO THE ALLEN CONSULTING GROUP**

The purpose of this email is to put on record our response to Brisbane Airport Corporation Limited's (BACL) comments in relation to the work that the Allen Consulting Group has undertaken on asset valuation matters for Virgin Blue that were made during the public hearings in Sydney on 30 October 2006. While we would expect robust debate about important matters like airport pricing, BACL's comments were not directed to providing an alternative perspective on the implications of economic principles for the matter at hand, but rather on casting doubt on our professional integrity. We take such matters seriously, particularly when raised in a public forum where there is little opportunity to understand the allegations being made, let alone to respond in a meaningful way. We understand that BACL's remarks were confined to the statements made during the public hearing, and so we have addressed those remarks.

At the outset, I would point out that what our firm may have said in previous matters is irrelevant to the matter that is currently before the Commission. Our reports for Virgin Blue have not asserted that our opinions in these matters should be accepted without challenge, but have presented logical argument, demonstrating how economic principles can be applied to address the problem confronting the Commission, and further demonstrating the empirical application of those principles (with full referencing of source data). BACL's comments have not addressed in any way the merits of the work that we have undertaken, nor the results of our empirical analysis.

Turning to the representation of our previous work, BACL's claim appears to be that the source of inconsistency in our advice is that we have reached different conclusions about how infrastructure assets should be valued for regulatory purposes. BACL's key contention seemed to be that we had recommended the application of an 'optimised depreciated replacement cost' (ODRC) valuation in a previous matter, which differs to the method that we concluded was most appropriate for the Australian airports' aeronautical assets in our reports for Virgin Blue. We reject the assertion that we have applied different principles to the valuation of assets for regulatory purposes in our work for Virgin Blue than we have in previous advice. What BACL appears not to have understood is that when the same principles are applied in an unbiased manner to different sets of facts, then different answers may result.

The Allen Consulting Group Pty Ltd
ABN 52 007 061 930

Melbourne
Level 4, 128 Exhibition St
Melbourne VIC 3000 Australia
Tel: (61-3) 9654 3800
Fax: (61-3) 9654 6363
www.allenconsult.com.au

Sydney
Level 12, 210 George St
Sydney NSW 2000 Australia
Tel: (61-2) 9247 2466
Fax: (61-2) 9247 2455

Canberra
Level 12, 15 London Circuit
Canberra ACT 2600 Australia
GPO Box 418 Canberra ACT 2601
Tel: (61-2) 6230 0185
Fax: (61-2) 6230 0149

Perth
Level 21, 44 St George's Tce
Perth WA 6000 Australia
Tel: (61-8) 9221 9911
Fax: (61-8) 9221 9922

Brisbane
Level 11, 77 Eagle St
Brisbane QLD 4000 Australia
PO Box 7034 Riverside Centre
Brisbane QLD 4001
Tel: (61-7) 3221 7266
Fax: (61-7) 3221 7255

In affiliation with Economists Incorporated, USA

In our first report for Virgin Blue, we set out in some detail the economic principles that are relevant to the setting of the initial regulatory asset value for infrastructure assets.[1] As noted, the main prescription of economic principles is that a value for past assets must be determined to provide certainty over the treatment for future investment. Regarding the value itself, a trade off must be confronted. On the one hand, a lower value will minimise efficiency losses, as the price need only be high enough to ensure the assets do not leave the industry – which can be met with a very low price for sunk assets. On the other hand, as a regulator's current decisions may signal to investors how its discretion may be exercised in the future, efficiency is enhanced by decisions that a wider audience would consider to be reasonable in all of the circumstances, an important dimension to which is to avoid creating windfall gains or losses.

Clearly, the principles set out above do not point towards a 'mechanical' solution to setting an initial regulatory asset value, but rather require the specific context of the particular industry or firm to be considered. We have concluded in a number of previous matters (although not the one referred to by BACL – see below) that an estimate of the 'ODRC' for an asset would be the appropriate method for setting a starting regulatory value for infrastructure assets where the pre-existing prices for the entity were high. As 'ODRC' provides an estimate of the value that an asset would have if traded in a competitive market, using it as a valuation method is equivalent to concluding that the entity should reduce prices to the level that it would be able to charge in a competitive market (or, alternatively, not to set prices above the level at which customers would be made better off if the existing assets were scrapped and built anew). We consider that this outcome would be widely viewed as reasonable, and describes the situation for much of the eastern states electricity transmission and distribution infrastructure.

However, where factors like government ownership imply that the pre-existing prices are low, there is little force to the argument that a substantial upward revaluation of assets (and consequent increase in prices) would be considered by a wider audience to be reasonable. Moreover, if a privatisation has occurred in the meantime – and so the revaluation would bring with it substantial windfall gains – such a revaluation would be viewed by a wider audience as an unreasonable outcome. In this situation, a widely used method for setting the initial regulatory asset value is to select a value that is consistent with the current level of prices, so that certainty about the recovery of future costs is created, while not avoiding any unnecessary 'shocks'. This method has become known as the 'line in the sand method', and has been used to set initial regulatory asset values in many situations, including two of the Victorian gas businesses, the Victorian urban water businesses, the NSW gas distribution business, the NSW urban water businesses and the WA gas distribution business (with the method in this case, ironically, being recommended by BACL's current advisers). We were advisers to the Victorian Essential Services Commission for the gas and water matters and to the WA regulator in relation to its gas distribution matter. We applied this well-used method to determine an initial regulatory asset value for the airports' aeronautical assets, and for the reasons set out above and in our reports for Virgin Blue, consider that it would generate an outcome that a wider audience would consider to be reasonable.

Turning now to the specifics of BACL's claim, the previous report of ours that it has referred to appears to be a report that we provided to the ACCC about the valuation of electricity transmission assets in 2003.[2] However, as the introduction to this report made clear, our brief was not to advise on how assets should be valued *at a point in time* for regulatory purposes, but rather how assets should be re-valued *over time*, as was made clear in the following statement:[3]

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1 Allen Consulting Group, 2006, Productivity Commission Review of Airport Pricing: Behaviour of the Airports Since Removal of Price Control and Compliance with Review Principles 1 and 3, July, pp. 16-17; Allen Consulting Group, 2006, Productivity Commission Review of Airport Pricing: Issues Arising from the Draft Report, October, p. 10.

2 The Allen Consulting Group 2003, Methodology for Updating the Regulatory Value of Electricity Transmission Assets, Report to the Australian Competition and Consumer Commission, August.

3 ACG, Op. Cit., p. 10.

> The issue that is addressed in this report is whether the Commission should continue to reset the regulatory value of regulated transmission assets at an estimate of their ODRC value into the future, either at each periodic revenue cap review or at longer intervals. The alternative approach to updating regulatory values based on ODRC estimates is to merely to adjust the previous regulatory value to reflect capital expenditure, depreciation and disposals over the period, that is, in the same manner as book values of assets are carried forward in Australia for financial accounting purposes.

Clearly, to evaluate different methods, an assumption about the starting point was required, which was that the ACCC would set the starting value for the assets at ODRC, consistent with its earlier views:[4]

> The assumption in this report that the Commission will reset the regulatory values of the regulated transmission assets at an estimate of their ODRC values implies that the selection between the methodologies for updating the regulatory asset bases should not be expected (ex ante) to lead to a windfall gain or loss to the regulated transmission providers.

Irrespective of the ACCC's previous views, however, we noted our view throughout the report that economic principles do not provide an unambiguous answer to the setting of an initial regulatory asset value, which was even included in the 'introduction' to the report:[5]

> Setting an initial regulatory value with reference to cost for the assets that are already exist at the time those assets become regulated formally has been one of the most contentious issues for Australian regulators. It is a matter for which economic principles do not provide an unambiguous answer.

Thus, rather than being inconsistent with the views we set out in our reports for Virgin Blue, the report to which BACL has referred demonstrates the consistency with which we have described and applied the relevant economic principles.

We consent to this letter being posted on the Commission's website.

Yours sincerely,

Jeff Balchin
**Director**

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[4] ACG, Op. Cit., p. 11.
[5] ACG, Op. Cit., p. 11.