ADSTEAM MARINE PRICE NOTIFICATION

ISSUES PAPER – APPROACH TO DETERMINING PRICES

The purpose of the issues paper is to seek the views of interested parties on Adsteam's approach to developing a revenue requirement for the ports subject to the current notification.

The Commission has published this issues paper on the particular issue of the approach to determining prices because:

- it is central to Adsteam's claim that prices increases are required; and,
- it can be resolved in the time allowed for the consideration of Adsteam's proposal.

This paper is structured so that the first section sets out the importance of the approach to determining prices to the Commission's process. The second section set out Adsteam's approach to developing its revenue requirement. The third section presents some alternatives to developing a revenue requirement. This is followed by a discussion and identification of the issues on which the Commission seeks a response.

Statutory criteria and Commission approach

The statutory criteria for assessing a notification are set out in section 17(3) of the PS Act. This section specifies that in assessing a notification, the Commission is required to have particular regard to:

17 (3) (a) the need to maintain investment and employment, including the influence of profitability on investment and employment;

(b) the need to discourage a person who is in a position substantially to influence a market for goods or services from taking advantage of that power in setting prices; and

(c) the need to discourage cost increases arising from increases in wages and changes in conditions of employment inconsistent with principles established by relevant industrial tribunals.

The Commission is of the view that in relation to these first two criteria, an important consideration is that in an open and competitive market economy efficient provision of services underpins investment and employment opportunity. Investment and employment in the national economy will be promoted when firms produce goods or services efficiently and charge prices which are at competitive levels.

Monopoly suppliers do not necessarily produce goods or services at efficient cost levels or at competitive prices. If higher than efficient prices are passed on to the competitive part of the economy, there is a resultant loss in allocative efficiency and potentially therefore in investment and employment opportunity.

The Commission considers that encouraging efficient pricing outcomes in line with more competitive conditions implies that price increases should *not* be in line with unit costs on top of a cost base which is too high due to inefficiency or excessive margins.

Given this broad context, the Commission in assessing price notifications will direct its attention to:

- the efficiency of the cost base that the declared company is working from to earn a return; and
- the reasonableness of the rate of return that the declared company is seeking.

Adsteam's Approach to Determining Price Increases

Adsteam argues that the price increases are necessary to recover cost increases incurred since the last notification and to restore profit margins.

Price increases are intended to achieve revenue increases as follows:

	Proposed Revenue Increases
Port Jackson	**26.3%**
Port Botany	**13.1%**
Melbourne	**23.4%**
Port Adelaide	**15.8%**
Brisbane	**11.7%**

Central to Adsteam's claim for price increases is the need to "…maintain a reasonable margin".[1] In its submission to the Commission, Adsteam argues that "… a margin on costs of 18% … is reasonable for the towage industry…"[2]. On Adsteam's analysis, average margins have eroded to a current 0.7%, which is clearly unsustainable."[3] Adsteam claims that margins have been eroded by the combined effects of a reduction in tug jobs and cost increases principally

[1] Refer to formal notification documents attached as Appendix A to the Adsteam submission to the ACCC.

[2] Adsteam Marine Ltd "Australian Competition and Consumer Commission Submission by Adsteam Marine Limited on towage prices in Brisbane, Port Jackson, Port Botany, Melbourne & Adelaide", December 2001, p.1.

[3] ibid.

associated with the provision of adequate tug boat services to larger ships requiring the use of larger, more powerful tugs.

In determining the cost base to which it applies an 18% margin, Adsteam has included a “capital charge”. This *capital charge* has been estimated as the cost that Adsteam would incur if it were to lease its tugs rather than own them. Charter fees are related to Adsteam’s estimate of the market values of the actual tugs that it employs at each port. The *capital charge* has been substituted for charter fees that Adsteam currently pays and for accounting measures of depreciation.

In summary, Adsteam develops its required revenue at each port using the following model:

"Capital Charge"
+ Operating Costs
+ an 18% margin on both the "capital charge" and operating costs
= Revenue Requirement.

It is through this model that Adsteam has measured that its revenues for the year ended 30 June 2001 provide the business with a 0.7% margin on costs.

Alternative Approaches

Based on financial information that Adsteam has provided to the Commission, alternative models for revenue determination may be developed. Such models may provide benchmarks for determining whether price increases are required in order to allow Adsteam a reasonable rate of return on its investment.

One model uses the market value of tugs as an asset base. A measure of economic depreciation (based on Adsteam’s estimate of the decrease in market value of its tugs from year to year) has also been used.

Cost of Capital (estimated as the market value of tugs x WACC[4])
+ Economic Depreciation
+ Operating Costs
= Revenue Requirement

Another model uses the actual cost of the tugs to Adsteam (adjusted for inflation) and applies straight line depreciation to that cost. The model therefore is:

Cost of Capital (estimated as the inflation-adjusted cost of tugs x WACC)
+ Straight-line Depreciation
+ Operating Costs
= Revenue Requirement

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[4] “Weighted Average Cost of Capital”

Discussion

Capital charges are a substantial component of total costs at all ports.

Capital charges per tug job increased significantly in 2001 relative to 2000. The increase in capital charges reflects investments in new tug boats by Adsteam in all ports except Port Jackson. With the exception of Port Jackson, the rise in capital charges per tug job in 2001 was a substantial contributor to Adsteam's claim for increased revenues.

Under "Capital Costs" Adsteam has included an estimate of what it describes as "arms length charter rate for a tug". Adsteam claims that this is a measure of the estimated opportunity cost of deploying a tug in a particular port. It is measured as the charter fees that Adsteam Marine would incur if it had to charter a tug on a commercial basis. This figure replaces the accounting measure of depreciation which Adsteam argues does not reflect the economic diminution of an asset's value over time. By calculating capital charges in all ports on the basis of an opportunity cost concept, Adsteam is attempting to achieve consistency in measurement of cost bases and be able to make meaningful comparisons across ports.

The charter rates have been estimated by Adsteam as percentage rate of the tug's market value. Adsteam's notification explains the rate as the target risk-adjusted annual rate of return applied to the current market value of a tug. It is represented as the rate of return that the owner of a tug boat would expect to earn from leasing tugs. Adsteam has provided the Commission with advice from an independent ship brokerage firm that this rate is approximately representative of leasing rates for tug boats. This advice did however, recognise that the charter rates comprised a return on capital and return of capital (depreciation).

The Commission's view is that the use of market values of assets has some merit in terms of an economic measure of assets employed in a business. Additionally, where market values for an asset can be observed over time a measure of economic depreciation can be made as the change in value from year to year. Adsteam, in confidential information provided to the Commission, estimated economic depreciation for each of its tugs (adjusted for inflation) and their market value in 2001. This measure can be adopted as a measure of economic depreciation in an analysis.

Adsteam has chosen to measure the economic cost of utilising tug boats by applying "market" lease rates to its fleet. This, in the Commission's understanding, means that notionally Adsteam does not own tug boats for the purpose of determining a price. As such, Adsteam determines its revenue requirement by adding a margin to total costs, in this case 18%, rather than applying a target rate of return to its investment base. On this basis Adsteam proposes price increases that will generate total revenue at each port consistent with a margin on total costs of 18%. Adsteam argues that a margin

on costs of 18% is "reasonable for the towage industry" (Adsteam notification, page 1).

In order to assess the reasonableness of the proposed revenues, Adsteam's total revenue requirements may be compared with a benchmark for revenue requirements derived under the building block approach[5]. This requires estimates of operating expenditures, return of capital (depreciation) and return on capital. For the purposes of this analysis, the following assumptions may be relevant:

- The market value of tug boats provided by Adsteam is used as an approximation of the Depreciated Optimised Replacement Cost of assets.
- The annualised average depreciation estimated by Adsteam for its tug boat fleet is used as a measure of economic depreciation, viz the loss of the assets' future earning capacity.
- A return on equity of 12.4%.
- There is no significant capital investment in each port other than the tugs.

Issues

The Commission seeks the views of interested parties on the following issues:

- Adsteam's approach to determining its revenue requirement;
- Comments on alternative approaches to assessing the reasonableness of Adsteam's rate of return associated with the proposed price increases;
- The appropriateness of using tug boat charter rates as a substitute for a measure of depreciation.
- An appropriate rate of return on equity for a harbour towage operation.
- Any other matter arising from Adsteam's price notification.

Timing

The Commission is required to make a decision on Adsteam's notification by 19 February 2002.

In order for the Commission to take submissions to this Issues Paper into account they must reach the Commission by noon Monday, 11 February 2002.

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[5] The ACCC's approach to applying the building block approach is set out in the *Draft Statement of Principles for the Regulation of Transmission Revenues* (May 1999) and the *Post-Tax Revenue Model* (October 2001).

Responses

Responses to this issues paper may be directed to:

Margaret Arblaster
General Manager – Transport and Prices Oversight
Australian Competition and Consumer Commission
GPO Box 520J
MELBOURNE VIC 3001

Fax: (03) 9663-3699

e-mail: margaret.arblaster@accc.gov.au