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Retail-Minus Pricing (aka ECPR) panned by UK's Competition Appeal Tribunal

January 2007

In 350 pages of judgment in October and December 2006, the Tribunal has provided a treasure trove of conclusions on several issues, one of which is ECPR/retail-minus pricing. Here is appellate confirmation of increasing disquiet with this regulatory model

Summary

Prominent competition judge, Sir Christopher Bellamy, sang quite a swan song when he held back on leaving his job as President of the UK Competition Appeal Tribunal, before moving to Linklaters.

He did this to deliver (along with 2 distinguished colleagues) the final of 2 "turning-point" judgments: around 350 pages in the October and December decisions in *Albion Water Ltd v. Water Services Regulation Authority and Dŵr Cymru*.[1]

That this is a water supply case illustrates how competition and regulatory principles have a wide reach.[2]

Several important issues were covered, one of which is noted in another article on our website: *Margin (Price Squeeze): a Landmark UK Judgment*.

Here we are focusing on an alternative to cost-based regulated pricing, based on the so-called Baumol-Willig Rule: ECPR (Efficient Component Pricing Rule) also known as "*retail-minus*" pricing.[3]

This appellate decision shows that any decision to implement ECPR in its basic form needs to be considered very cautiously, in light of its adverse features. If there isn't to be a move to a different methodology, the approach to retail-minus should often be modified to minimise the problems inherent in ECPR, and supplemented by regulation of the retail price.

A retail-minus regime should be "*complemented by additional safeguards, including imputational requirements, to ensure compliance with the control on an ex ante basis and to prevent gaming by the incumbent*"[4]

The Tribunal was heavily critical of the regulator's approach in the decision under appeal. This included a strong attack on ECPR pricing generally and specifically on its application in this case.

The Tribunal concluded that ECPR (which sets the price payable to the incumbent by the competitor at the incumbent's price on the retail market less avoidable costs) would not work in isolation where the incumbent has significant market power (SMP). ECPR is only a partial solution. To make it work, essential also is regulation of the retail price itself. However even if the retail price is regulated, the Tribunal came to negative conclusions about whether ECPR would succeed in engendering competition and in achieving the

[1] [2006] CAT 36 (18 December 2006): http://www.catribunal.org.uk/documents/Jdg1046Albion181206.pdf (and [2006] CAT 23 (6 October 2006): http://www.catribunal.org.uk/documents/Judge1046Albion061006.pdf

[2] For an Australian water supply example, see the complaint lodged with the ACCC in relation to Sydney Water: http://www.accc.gov.au/content/index.phtml/itemId/770624

[3] As we note below we are primarily dealing with the "basic" form of retail-minus (applying Baumol-Willig) and not the more developed retail-minus versions, many of which have evolved to overcome problems with the basic model. The "basic" model is that which applies under the NZ Telco legislation and in this instance.

[4] Adopting the words of the NZ Commerce Commission when it describes the solution generally adopted in other countries where retail-minus is in place: Report to Select Committee para 44, referred to below.

relatively limited positive outcomes put forward by ECPR proponents.

Often, only a "*super efficient*" competitor (a rare beast) could succeed (and a merely "*efficient*" competitor could not). Thus, ECPR often has the effect of shutting out real competition (as the Tribunal said, it throws the baby out with the bathwater).

Thus, even having the minimum (regulated price plus ECPR), frequently will not achieve appropriate competition outcomes.

As the Tribunal notes, ECPR is a controversial methodology which has been criticised in other contexts for having adverse effects on competition.[5]

New Zealand fills an important role in the judgments, and in the development of ECPR internationally. This is particularly because of the controversial acceptance, in the early '90s, of the Baumol-Willig Rule in the Privy Council decision, *Telecom v. Clear*.[6] In this article we will deal with the implications of the NZ position for the international scene, and note an error by the Tribunal. We will overview a recent report by the NZ Telco regulator on retail-minus, which contains excellent insights, including an international overview of assistance in many jurisdictions.

Disclosure

Among our clients, we act for parties that seek to reduce the imposition and impact of ECPR. However, this article has not been prepared on instructions from clients.

Overview of this article

We will deal with preliminary points to clarify what we are addressing, to minimise confusion. Then we'll overview ECPR/retail-minus pricing principles for those that are not fully familiar with them.

The article then covers the Tribunal's approach to ECPR and related issues such as the approach by others. We'll cover this in some detail, and use quotes from the judgments to illustrate the points, in view of the numerous issues and complexities. This is not sound-bite territory.

5 preliminary points:

- The case (and this article) focuses on that most common of situations: where pricing is regulated when the incumbent has SMP. The incumbent in *Albion* is a monopoly. One of the criticisms of the ECPR model is that it was designed for already contestable markets with low barriers to entry, and so, it is said, it is unsuited to SMP-scenarios.

- When talking about Retail-Minus or ECPR, we are referring to the "basic" model. This applies the Baumol-Willig Rule, used in the controversial *Telecom v Clear* Privy Council decision. The extracted or "minus" costs are the avoidable costs of the incumbent. In part to overcome the deficiencies of this model, some regulators have developed more comprehensive "retail-minus" models. See for example, the Irish Telco regulator's January 2006 retail-minus model to price wholesale broadband access. It adopts a detailed formula which, contrary to the "basic" model, has the primary aim of avoiding margin/price squeeze.[7]

- While the CAT ultimately decided the appeal on the facts of the case (because it was not required go wider than this), its views on wider issues (such as on ECPR generally) are amply set out. Additionally, the CAT was considering ECPR in the context of EU and UK competition legislation, including Part II of the Competition Act 1998. This takes the typical sort of pro-competition approach seen internationally, including encouragement of competition by reference to the interests of consumers.[8] Thus, the conclusions are of broader application including internationally.

- Having noted that, while there are general principles applicable internationally, regard must be had of course to the specifics of each industry, the particular issues,

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[5] *Albion* October judgment para 31.

[6] [1995] 1 NZLR 385

[7] http://www.comreg.ie/publications/default.asp?nid=102246&ctype=5

[8] See for example para 658 of the October judgment in *Albion*

relevant legislation, etc. The general principles are the starting point. While the thrust of the CAT's decision is against ECPR, there will be situations where it is appropriate: but they need to be carefully justified, given the negative aspects of ECPR. That's really the main message: the suitability of ECPR should be cautiously approached in light of its adverse features, reflected in this pivotal appellate decision.

- This article can only briefly summarise the analysis in these carefully reasoned and lengthy judgments. If you would like more detail, don't hesitate to contact us.

What is ECPR (aka "*retail-minus*" pricing)?

The Tribunal provides a convenient summary.

Quoting the regulator in the *Albion* case, the Tribunal noted[9] that ECPR (in a water supply context but the principles apply generally):

> *"can be summarised by a simple equation in which the access price is given by the incumbent's final product price less the costs it would avoid by providing access. For example, a new entrant wishing to access an incumbent's arterial and local distribution network would be charged the difference between the incumbent's final product price and the avoidable costs of resources, treatment and customer service."*

The Tribunal continued[10]:

> *"ECPR is known in shorthand as a "retail-minus" approach. The theory of ECPR, as we understand it, is that if the final product price is £10, and the incumbent avoids costs of £3 by not supplying the final customer itself, then the access charge should be £7. In those circumstances, a more efficient entrant will enter the market if his other costs are less than £3 (say £2). This lower cost will then enable the new entrant to charge the final customer (say) £9. In these circumstances, so it is said, entry is "efficient", since the product in question is being supplied at the lowest total cost to society (£9 rather than £10), while at the same time the incumbent is recovering all his common and fixed costs, including "sunk" costs, as well as a return on capital. This theory was developed in the 1990s by Professors Baumol and Willig in the USA, and is sometimes known as the "Baumol-Willig rule".....*
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> *An important feature of ECPR is that the incumbent makes the same profit irrespective of whether the new entrant enters the market or not. In effect, the entrant pays the incumbent in perpetuity for all the revenues (including profits) that the incumbent had previously received, less the costs which the incumbent has avoided as a result of the fact that it is the new entrant, rather than the incumbent, which is now supplying the customer. A further feature of ECPR is that the margin within which the new entrant has to operate is never higher than the incumbent's "avoidable" cost of supplying the customer in question. Out of the margin created by the incumbent's "avoidable" cost, the new entrant has to meet his own total costs, including any fixed costs."*

The Tribunal then highlighted[11] the problem of calculating the correct amount for the "minus" component:

> *"A major difficulty in this case has been imprecision in the use of the term "avoidable costs". "Avoidable" costs are in simple cases equated to marginal or incremental costs, but this would not necessarily apply in all cases. "Avoidable costs" are normally assessed on a "forward looking" basis. Whether a cost is "avoidable" rather than fixed depends on the time period assumed and the proportion of the market no longer supplied."*

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[9] October judgment in *Albion* para 639.

[10] At paras 640-641.

[11] At para 642.

What happened in the *Albion* case?

We have set out the factual detail in our companion article on price squeeze[12]. See the diagram in this article. In short, a water utility monopoly, Dŵr Cymru, had supplied, for many years, non-potable water to Shotton Paper. Shotton is a newsprint manufacturer and one of the largest Welsh water customers (its water needs exceed those of a town with 35,000 inhabitants). Dŵr Cymru obtained the water, to be supplied to Shotton, from a nearby water utility (United). It transported the water to Shotton over a 16km pipe owned and operated by Dŵr Cymru.[13]

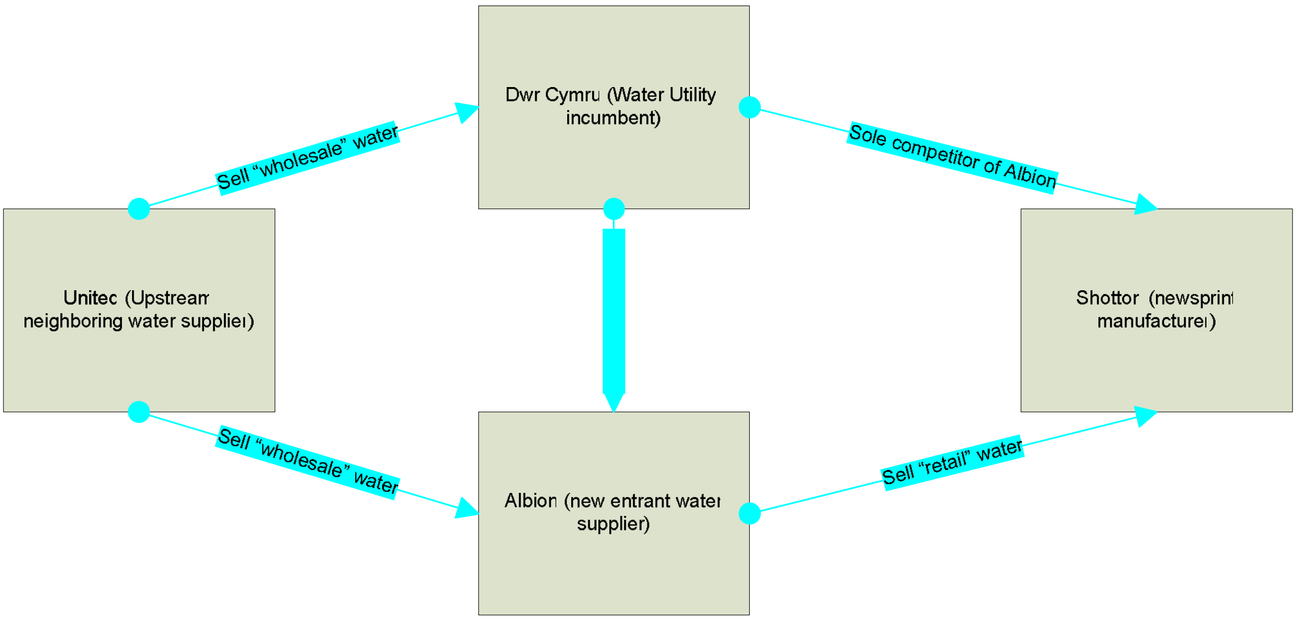
Legislation designed to increase competition in the water sector (with its natural monopolies) was introduced. Relying on that legislation, Albion sought to supply water to Shotton instead of Dŵr Cymru. It agreed with Shotton to do so. It also bought a water supply from United. It wanted to use Dŵr Cymru's 16km pipe to transport the water to Shotton.[14] So, Dŵr Cymru was to be a common carrier of the water over that pipe.

Enter the regulator. The decision on what pricing methodology to use for provision of the common carriage over the 16km pipe, and then calculation of the price based on that methodology, was its responsibility. It decided to apply ECPR, but it did not regulate the retail price.

However, as is required under the ECPR model, the regulator needs to decide what the retail price is (that is, the retail price based on the incumbent's own choice of retail price). Where the incumbent does not sell the upstream product at retail, this requires the regulator to impute a notional price.

Dŵr Cymru did not have a separate retail service for carriage over the 16 kms of pipe. So a notional price had to be imputed. In broad terms, the retail price was imputed at Dŵr Cymru's retail price for supply of the water at retail, less the cost of the water no longer supplied directly to it by United.

Further, the regulator decided to determine the "minus" part of the "retail-minus" formula, based on marginal costs. It was said that no costs were avoided because this one customer (Shotton) was supplied by Albion instead of the incumbent. Thus the minus component was zero.



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[12] *Margin (Price Squeeze): a Landmark UK Judgment.*

[13] It undertook some other functions too.

[14] There were some miscellaneous other steps and services involved.

It was accepted by all (including the incumbent and Dŵr Cymru) that this meant that Albion would not be able to supply (as this would not be financially viable), it would have to get out of the market, and there would be no competitive supplier, thereby leaving Dŵr Cymru as a monopoly supplier. If Albion had to pay United the same price for water as Dŵr Cymru paid United, Albion could make no profit, let alone meet its own costs.

But the position was even worse as it appeared that Albion would end up paying more for the water supply from United than Dŵr Cymru paid.

Was the imputed retail price too high?

Regulation of the retail price is not – directly - an ECPR issue: deliberately so. But, to put the CAT's decision in context, it had to decide whether the ultimate price paid by Albion was abusive under the pro-competition legislation. A factor in that assessment is the appropriateness of the imputed retail price.

The Tribunal concluded that:

- the "retail" price used by Dŵr Cymru was not shown to have been reasonably related to Dŵr Cymru's costs; and
- the evidence strongly pointed to the conclusion that the retail price was excessive.

Now to mesh this to the ECPR calculation. For closely related reasons, the CAT concluded that the notional retail price that was imputed was excessive. For those that need to get into the detail of imputing retail price, there is valuable material in the judgment.

Was the "minus" deduction (zero) too low?

While not having to finally resolve this issue, the CAT was negative about this conclusion. This was a demonstration of how hard it is to implement the ECPR model (so that, for example, an appropriate "minus" factor is derived). Again, the judgment contains valuable material, including a focus around the time frame over which avoidable costs are to be assessed (short, medium or long-term). There are cart-before-the-horse problems in assessing the optimal figure.

The very real difficulties in these calculations are also overviewed by the NZ Commerce Commission in its report noted below: the Commission has extensive experience in this area, against a background of NZ being the ultimate "early adopter" of ECPR back in the early 1990s, around the time of *Telecom v Clear.*

We will now focus on the more generic issues raised about ECPR. We'll follow the same order that the Tribunal used.

Key Advantages and Disadvantages of ECPR

The Tribunal noted[15] that "*… the perceived advantages of ECPR were that entry would occur only when entrants have lower total costs than the incumbent's avoidable costs. It thus ensures that the incumbent's common costs continue to be fully funded, and that stranded assets are avoided.*"

However, the Tribunal then went on to note[16]:

> *"On the other hand, there appeared to the Tribunal to be some five features of an ECPR-based approach which gave rise to concern as to whether an ECPR approach is compatible with the introduction of effective competition: (i) the risk of entrenching monopoly rents or inefficiencies in the retail price; (ii) the possible lack of the dynamic effect of competition, resulting from the fact that, as the Director recognises, the dominant incumbent is indifferent as to who supplies the customer; (iii) the raising of barriers to entry; (iv) the risk of a price squeeze; and (v) difficulties in properly identifying the "minus" element in the retail-minus calculation."*

We have dealt with the fourth item (the risk of a price squeeze) in our other article today which notes that a retail-minus approach not only may not be the **solution** to price/margin squeeze but in fact may **create** a price squeeze.

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[15] October judgment para 650.

[16] October judgment para 650.

Productive, allocative and dynamic efficiencies

The Tribunal analysed the suitability of ECPR within this standard economics framework[17], to reflect pro-competition drivers.

A brief description of each, adopting the Tribunal's own wording, is as follows:

- **Productive Efficiency***:* In competitive markets, firms have an incentive to produce goods and services at the lowest cost, since firms that have higher costs than their rivals are less likely to survive. This leads to **productive efficiency**, where goods are produced at the lowest possible cost to society.[18]

- **Allocative Efficiency***:* A further benefit of competition is to make prices more closely reflective of costs. In competitive markets, this in turn signals to customers the costs of supply, achieving a more appropriate relationship between demand and supply. This gives rise to "*allocative efficiency*".[19]

- **Dynamic Efficiency***:* This concept sees competition as involving and leading to innovation of products and process as part of the continual pursuit of customers' business (the long run benefits of competition). Closely related is that the dynamism of competitive process itself tends over time towards lower costs, lower prices and more innovation.[20]

In *Albion*, the CAT said that there was a key difference between the approach of the incumbent's expert (Professor Armstrong) and the competitor's expert (Dr Marshall). The incumbent focused on static equilibrium analysis (which deals with **allocative** and **productive** efficiency). That deals with a given state of affairs in a market rather than the competitor's focus: **dynamic** efficiency (the process by which a market moves from one state of affairs to another)[21].

While the incumbent acknowledged that ECPR would only achieve **productive** efficiency, the competitor said it wouldn't even achieve that, let alone allocative and dynamic efficiencies. The CAT agreed with the competitor on this. We'll set out more detail below, but the following extract overviews the position (and the CAT largely agreed with what Dr Marshall said for Albion)[22]:

> *"Professor Armstrong [for the incumbent] saw "efficient entry" in terms of the assumption that lay behind his model, and indeed the Authority's whole approach, which was that under ECPR market entry was only "efficient" if it could take place without increasing the water industry's total costs in the short run. In other words ECPR aimed for "productive efficiency" in the short run, but neither "allocative" nor "dynamic efficiency", even if entry might reduce costs over the longer run. Dr Marshall [for the competitor], on the other hand, saw ECPR as likely in practice to preclude entry by firms who would, by any normal standards, be regarded as "efficient". In her view, ECPR was unlikely to achieve even the theoretical "productive efficiency" relied on by the Authority. More importantly, according to Dr Marshall, ECPR was unlikely in practice to foster the competitive process, or lead to gains in terms of lower costs, lower prices, better service or more innovation. In other words, in technical terms, as Dr Marshall saw it, ECPR would not achieve "allocative" or "dynamic" efficiency either. Professor Armstrong, for his part, emphasised that ECPR was solely concerned to achieve "productive efficiency", emphasising the role of the regulatory process in controlling*

[17] October judgment paras 657-658. The CAT however noted the respective merits of these 3 types of efficiency must be considered in the particular circumstances of the industry such as proper funding (and sharing of cost) for infrastructure and public service obligations (October judgment; para 666)

[18] October decision para 659.

[19] October judgment para 660.

[20] October judgment para 663.

[21] October judgment para 664.

[22] October judgment para 665

prices and thus achieving "allocative efficiency" by that route."

ECPR: the international experience

Before returning to the efficiency analysis, the Tribunal turned to international experience with ECPR. The Tribunal tracked the history of ECPR following the *Telecom v Clear* decision in the early 90's, and the formulation of the Baumol-Willig Rule.[23] It concluded that there was little adoption of ECPR internationally, referring to OECD material on the topic. The CAT referred to the international experience with ECPR; the considerable controversy it attracts (academically and as a matter of regulatory practice); and a US Supreme Court decision confirming that the FCC decision had not acted unreasonably in preferring a costs-based pricing model instead of suggested alternatives other than ECPR.

It concluded[24]:

> *"…against that background, a rule which has in various circumstances been rejected because of its adverse effects on competition,* ***and has the unusual distinction of being actually banned in New Zealand****, should not be accepted by the Tribunal without careful scrutiny. As we have said, all will depend on the facts of this case"* (emphasis added)

The emphasis in bold highlights an error in the reasoning. ECPR was not banned in NZ[25]. In fact quite the opposite happened, with the basic ECPR approach (retail price minus avoidable costs) adopted for many Telco services. As recently as December 2006, new legislation, which brings in BT/Openreach-style operational separation, has added yet more ECPR-priced Telco services[26].

Additionally, NZ does not have what the Tribunal considers is that other essential limb to supplement ECPR: regulated retail prices where there is SMP. We deal with this in the next section of this article.

New Zealand's Telco regulator (the Telecommunications Commissioner, functioning within the Commerce Commission) mounted a strong case that the 2006 amendment should move away from ECPR. See Appendix 1 in the Commission's submission to the Select Committee considering the Bill[27].

This is an excellent summary, of considerable relevance beyond New Zealand given the experience with implementing the basic ECPR model going back to the early 90's, and NZ's pivotal role in building this model. The Commission's analysis covers the experience in other jurisdictions in addition to those covered in the *Albion* judgments. The Commission identified a number of issues with ECPR, many of which overlap with the CAT's conclusions (and more besides).

So New Zealand remains a relatively rare adopter of ECPR in its basic form. The Commission does not have a statutory discretion to move away from the basic model, unlike other examples that it gives in its report (such as the Irish model noted above at footnote 6 which, contrary to ECPR, is designed to stop margin/price squeeze).[28]

Does ECPR risk preservation of monopoly profits, inefficiencies and cost misallocations?

Yes, said the Tribunal, and therefore an essential partner for ECPR where there is SMP, is regulation of the retail price:

> *"It does not seem to be disputed in this case that an ECPR approach to access prices needs to be*

[23] October judgment para 724-739

[24] October judgment para 739

[25] As the Schedule, referred to in para 732 of the October judgment, itself confirms.

[26] Telecommunications Amendment Act 2006 (NZ)

[27] http://www.comcom.govt.nz//IndustryRegulation/Telecommunications/GeneralInformation/ContentFiles/Documents/492059_4.pdf

[28] The Commerce Commission notes at para 45 of App 1 of its report that the NZ version of ECPR (the basic version) *"does not prevent potential price squeezes by the incumbent"* and therefore other retail-minus regimes are generally *"complemented by additional safeguards, including imputational requirements, to ensure compliance with the control on an ex ante basis and to prevent gaming by the incumbent".*

> *accompanied by a system for the regulation of retail prices which ensures a reasonable relationship between those prices and the costs of supply….The essential reason is that if the retail price which forms the basis for the "retail-minus" calculation already contains excessive profits, or reflects inefficiencies, or reflects costs that have been misallocated, the risk with an ECPR approach is that all those "monopolistic" consequences are simply embedded in the access price and passed on to the new entrant in that price. As Dr Marshall [expert for Albion] points out, and we accept, if such is the case even the "productive efficiency" theoretically sought by ECPR will be compromised by the continuing misallocation of resources implicit in the retail price used in the ECPR calculation….Professor Armstrong [expert for the incumbent] also accepted Dr Marshall's position that, in practice, ECPR must be accompanied by effective price regulation. He expressly accepted that ECPR is only a "partial rule"*[29]

Why does the Competitor often have to be "*super-efficient*"?

One of the key problems with ECPR is that it insulates the incumbent from competition as it requires the new entrant to indemnify the incumbent indefinitely for any loss of revenues (except for "*avoidable costs*"). This effectively requires the new entrant to support both the incumbent's overheads as well as its own. Thus, even if the "*minus*" calculation is correctly undertaken (it was not in the *Albion* case), the new entrant often has to be "*super-efficient*" as compared with the incumbent.[30]

While the Tribunal was able to deal with the matter on is own facts[31] (including the zero reduction for avoidable costs), a firm theme emerges, which is critical of the ECPR approach in this respect.

The Baumol-Willig model was developed on the assumption that there was a contestable market (ie: no significant barriers to entry).[32] There was some debate between the experts about the model in this respect, but the CAT considered that the net effect was that ECPR, due to the reality (at least on the facts in that case) that only a "super-efficient" competitor could survive, tended to eliminate or prevent entry to the market.

Of course each case will differ and in some cases the "minus" and other circumstances may be sufficient to enable a merely "efficient' competitor to compete, and this case with its zero "minus" deduction is at the extreme. But the need for the competitor to meet all its fixed and direct costs out the margin created by the incumbent's assumed margin for avoidable costs is a heavy burden, frequently requiring "super-efficiency". The CAT noted this can have the following effect[33]:

> *"Having, as it were, given with the one hand by opening the market to competition, there is a risk of taking away with the other hand if the conditions of entry are drawn so tightly that competition never occurs. In such circumstances, the benefit of competition would never be realised."*

In coming to this conclusion the CAT emphasised the interests of the consumers and the advantages of choice and competition.

Dynamic effects of Competition

This is a particularly important part of the analysis, given the importance of dynamic efficiency in an analysis such as this.

The CAT concluded that ECPR is not conducive of dynamic efficiencies and that there are other ways of achieving the right balance. At para 797 of the October judgment:

> *"Dr Marshall expresses the view that ECPR as applied in the Decision [of the regulator] will "fatally compromise" any dynamic process of competition tending towards innovation, lower*

[29] October Judgment paras 740-742

[30] See for example the summary in para 32 of the October judgment.

[31] October judgment paras 762 to 781

[32] October judgment para 762.

[33] October judgment para 768

costs and lower prices, as envisaged in paragraph 24 of the Consultation Paper. Quite apart from the problem of passing through monopoly profits or inefficiencies in the access price, and the prevention of market entry, already discussed above, ECPR bankrolls all the incumbent's costs and insulates the latter from the disciplines of the market indefinitely. This creates a one-sided market in which the incumbent does not compete, but the new entrant bears all the risks. We share Dr Marshall's view that those are very far from normal competitive conditions. …

It was not disputed on behalf of the Authority that ECPR does not aim to produce the "dynamic efficiency" benefits normally associated with the competitive process. The Authority accepted that ECPR does not expose the incumbent to any loss of profit, and does not give the incumbent the possibility of responding to competition. Ultimately the incumbent is indifferent as to who gets the business. As Professor Armstrong saw it, the incumbent remained passive, and was "not particularly active participant in the competitive process"….. It was not disputed by the Authority that under ECPR there was no parity between the entrant and the incumbent, the latter being insulated from the risk of competition in perpetuity. Mr Hope also accepted, very fairly, "there is no level playing field in terms of the costs position of the undertaker and of the entrant." …It was further accepted by the Authority that under ECPR a new entrant would need to be "super-efficient" as compared with the incumbent."

All these points are major deficiencies of ECPR and call for real care before the model is used.

This leads, said the CAT, to a central conceptual problem[34]:

"The proponents of ECPR consider the main goal to be to minimise any risk of raising total costs of supply in the short run; only if this is achieved is entry deemed to be "efficient" under ECPR. ....As Professor Armstrong says: "efficient entry by definition is entry that is profitable under ECPR"   On the other hand, the Chapter II prohibition [the pro-competition legislation in the Competition Act 1998] is concerned with effective competition, that is to say the whole competitive process affecting price, service, innovation and customer choice. That process, in general, tends towards lower costs and prices than prevail under monopoly conditions. For that reason practices by monopolists which restrict or distort the conditions for market entry are scrutinised with care under the [pro-competition legislation].....

.....Although the entry of a further competitor may to a certain degree add to total costs in the short run, the general assumption of competition policy is that in the longer run the competitive process will lead to lower costs overall. What the Authority describes as "the duplication" of fixed costs is not normally regarded as a problem. As Dr Marshall points out, in competitive markets a certain duplication of fixed costs is inherent in the fact that there are a number of competitors each of whom has their own costs and overheads. But, in normal circumstances, competitive markets will still produce goods and services at lower costs than will be the case if the market is monopolised. Similarly, we would be reluctant to assume, as does the Authority, that there is little scope for innovative developments in the water industry. ......In those circumstances it seems to us that there is a potential clash between the narrow short run productive efficiency sought in theory through ECPR, and the wider dynamic competition benefits and level playing field which the Chapter II prohibition is designed to safeguard. At the very

[34] October judgment para 801 to 803

> *least, a pricing policy which insulates the incumbent in perpetuity from competition; which requires the new entrant to support the incumbent's overheads as well as its own, and to indemnify the incumbent indefinitely against any loss of revenues (except as regards "avoided costs"); and which requires the new entrant to be "super-efficient" as compared with the incumbent requires close scrutiny under the Chapter II prohibition."*

This again emphasises the need for strong caution before ECPR is implemented. But the CAT didn't have to go that far to decide the issue in this case[35]:

> *"However, in our view we do not need to decide whether ECPR is in all circumstances intrinsically contrary to the Chapter II prohibition, because we have already held above that the particular way ECPR has been applied in this case cannot be safely relied on since it would: (i) preserve retail prices which do not appear to be reasonably related to costs, and which the evidence strongly suggests to be excessive; (ii) would effectively preclude any effective competition or market entry; and (iii) gives rise to difficulties in relation to "avoided costs".*

But what about the incumbent's need to recover sunk infrastructure and related costs, fund investment programmes and recover a contribution to common overheads?

This is a variation on the same theme. The key point is that there are other ways of encouraging competition while encouraging investment by the incumbent. As the CAT said[36]:

> *"However legitimate the need to fund the industry's infrastructure costs and protect ineligible customers from significant price increases, there is, side by side with that, a [pro-competition] policy decision to introduce the possibility of competition……[T]here is a balance to be struck. If, as we have found above on the facts of this case, that balance is struck in a way which eliminates existing competition, or prevents virtually any new entry to the market, it is hard to see how any effective "balance" has been struck: on the contrary, in those circumstances the rules have been tipped all one way, in favour of the incumbents. In our view, however legitimate the objective of enabling the industry to fund its infrastructure and other relevant costs, the approach in the [regulatory Authority's] Decision tends "to throw the baby out with the bathwater". It does so by effectively eliminating any reasonable prospect of market entry. On the evidence in this case the approach in the Decision also maintains a retail price which is not shown to be cost-based and which the evidence strongly suggests to be excessive."*

The Tribunal emphasised that the right balance could be struck in ways that did not involve the deficiencies of ECPR. The Tribunal said: "We have no reason to doubt Dr Marshall's evidence that there are other ways of recovering infrastructure and related costs."[37]

Other issues raised by the regulator and the incumbent

The Tribunal despatched the following arguments by the incumbent and the regulator:

- ECPR minimises risk in relation to stranded assets: in this particular instance the Tribunal demonstrated that the contrary applied[38]. The fact that the competitor would contribute toward the cost of the service over the pipeline (via common carriage) reduced the stranded asset risk rather than increased it.

- ECPR maintains costs subsidies implicit in regional averaging. As the Tribunal noted:

[35] October judgment para 803
[36] October judgment at paras 806 to 808

[37] October judgment para 807

[38] Paras 809-815 October judgment.

"In the literature, the classic situation where the use of ECPR is indicated, according to its proponents, is where there are mandated cost-subsidies which it is thought to reserve".[39] The example given is a cross subsidy between (lower cost), business and (higher cost) household customers. ECPR avoids the cherry picking risk. The Tribunal concluded that this issue did not apply here. The Tribunal did not have to decide the issue of whether cross subsidies would ever be an issue. However, what emerges from the decision is that great caution is required before cross-subsidy issues drive ECPR.

Conclusion

This appellate decision confirms that any decision to implement ECPR in its basic form needs to be considered cautiously, in light of its adverse features. If there isn't to be a move to a different methodology, the approach to retail-minus should often be modified to minimise the problems inherent in ECPR, and supplemented by regulation of the retail price.

A retail-minus regime should be "…complemented by additional safeguards, including imputational requirements, to ensure compliance with the control on an ex ante basis and to prevent gaming by the incumbent"[40]

We welcome your feedback on this article and any enquiries in relation to its contents. This article is intended to provide a summary of the material covered and does not constitute legal advice. We can provide specialist legal advice on the full range of matters contained in this article.

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[39] October judgment para 816.

[40] Adopting the words of the NZ Commerce Commission when it describes the solution generally adopted in other countries where retail-minus is in place: Report to Select Committee para 44, referred to above.