

CROSS-SUBMISSION ON COMMERCE COMMISSION'S INPUT METHODOLOGIES REVIEW: INVITATION TO CONTRIBUTE TO PROBLEM DEFINITION

4 SEPTEMBER 2015

1. The Commerce Commission ("**Commission**") published its Invitation to Contribute to Problem Definition paper on 16 June 2015, as part of its review of input methodologies ("**IM Review**") under section 52Y of the Commerce Act 1986 ("**Act**"). The New Zealand Airports Association ("**NZ Airports**") welcomes the opportunity to make this cross-submission, which, in particular, responds to submissions made to the Commission by the Board of Airline Representatives New Zealand ("**BARNZ**").
2. The NZ Airports contact for matters regarding this submission is:

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Overview

3. A central theme of the BARNZ submission is a preference to introduce greater prescription and complexity to the Information Disclosure ("**ID**") regime. In particular, BARNZ:
 - (a) seeks the introduction of new IMs and amendments to existing IMs;
 - (b) seeks amendments to ID requirements that blur the distinction between pricing approaches and separate profitability assessment; and
 - (c) therefore seeks to remove the discretion that airports may apply when making pricing decisions.
4. NZ Airports has explained in its submission why this would be an undesirable evolution of the regime. The end result of such an approach would:

- (a) disincentivise airports from taking commercial approaches, contrary to the long-term benefits of consumers;
 - (b) detract from a full contextual assessment of airport performance, as contemplated by the Act; and
 - (c) go beyond the purpose of the ID regime, which is limited to providing *sufficient* information about airport investment, service, pricing and returns.
5. BARNZ also advocates for greater prescription and complexity in the IMs and the ID regime to address issues that have not been substantiated as being problematic. In those circumstances, the Commission should confirm at the earliest opportunity that it declines to consider amendments or other changes to address such issues.
6. To the extent that, as a consequence of the problem definition phase of the review, issues are properly substantiated as meriting further consideration, then NZ Airports (together with Auckland, Wellington and Christchurch airports) will seek to work with the Commission and the airlines to consider pragmatic and effective solutions. We plan to develop proposals for improving ID that are consistent with the framework and approach set out in our previous submission. NZ Airports would be supportive of a workshop for interested parties to engage on the potential solutions.
7. The following provides our views on the specific topics raised by BARNZ.

Pricing Methodology IM

8. BARNZ has submitted that the Commission should develop an IM to provide guidance on how to implement a levelised pricing path over multiple pricing periods.¹ That is, a new pricing methodology IM should be determined.
9. NZ Airports opposes this suggestion and believes such a step would materially undermine the clear position regarding the proper place of pricing methodologies under ID regulation as stated by the Commission at the time the ID regime was established for airports:²

The Commission has taken a flexible but transparent approach to disclosure requirements of prices and pricing methodologies. Suppliers of specified airport services are not required to apply a particular pricing methodology but are required under the ID Determination to disclose information about the pricing methodologies that they do use.

10. This approach was consistent with the Commission's approach of providing for a degree of flexibility in the ID regime so that airports can present as realistic a picture as possible of their actual performance.³ And such approaches can be modified or altered to take account of stakeholder feedback (as was effectively achieved by Christchurch Airport in response to the Commission's concerns around disclosure of its second price setting event).

¹ BARNZ *Submission by BARNZ on Problem Definition Paper for the Input Methodologies Review*, 21 August 2015, at p. 5.

² Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010, at paragraph X13.

³ Commerce Commission *ID Reasons Paper*, at paragraph X4(c).

11. NZ Airports is not opposed to further consideration of how levelised price paths should be disclosed and subsequently assessed, provided it is carried out consistently with the Commission's established approach to ID.
12. However, BARNZ's proposal for the introduction of a new IM is at odds with an ID context. Under the ID regime, the IMs:
 - (a) only apply to airports when disclosing annual financial information;⁴ and
 - (b) apply to the Commission when monitoring and analysing the disclosed information.
13. Accordingly, BARNZ's suggestion that a pricing methodology could provide "guidance on how to implement a levelised pricing path" is not appropriate. The IMs are not to be used to determine or guide how airports set pricing paths. Any approach to the contrary will strengthen the *de facto* price control features of the ID regime.
14. In any event, even if a pricing methodology was only used (appropriately) by the Commission to assess disclosed information, it would not be a useful addition to ID:
 - (a) a pricing methodology IM is unlikely to provide the level of regulatory certainty and transparency that BARNZ is seeking because:
 - (i) it is not realistic to presume that there is only one possible approach to levelised price paths or that all other flexible pricing approaches could be addressed through an IM;
 - (ii) as was the concern with the WACC IM when it was first developed, it is not possible to know in advance how the Commission will use/apply the IM in its assessment of returns; and
 - (b) the recent section 53B summary and analysis process indicates that the Commission accepts that the airports are able to make meaningful and accessible disclosures where levelised price paths are adopted. Consistent with a key theme in our previous submission, engaging on issues as and when they arise via the summary and analysis process, and maintaining an appropriate degree of flexibility, is likely to be far more beneficial for consumers than seeking to develop a fixed or "bright line" rule in advance.
15. NZ Airports also notes the points, raised by Christchurch Airport in its cross-submission, opposing BARNZ's proposal for a new IM for levelised pricing, which we support and endorse.

Non-standard depreciation

16. BARNZ submits that it would be useful for the Commission to expand its IM for depreciation to guide the use of non-standard depreciation (including disclosure requirements). In addition,

⁴ Section 53F of the Act provides that suppliers subject only to ID regulation do not have to apply pricing methodology or WACC IMs in accordance with section 52S of the Act (which, in turn, requires airports to apply IMs in accordance with the ID Determination). We note, however, that the ID Determination requires airports to disclose the WACC determined by the Commission in accordance with the WACC IM.

BARNZ considers the Commission should consider developing a "non-mandatory detailed model solution" for airports using non-standard depreciation.⁵

17. BARNZ's suggestion is misdirected in a similar manner to that discussed above in relation to pricing methodologies. The depreciation IM should not be amended as part of an effort to guide airport pricing decisions, as the IM is only relevant to disclosure.
18. Consistent with discussions at the Forum and the views expressed in its problem definition submission,⁶ NZ Airports remains open to the idea of the Commission articulating principles or examples to guide airports in disclosure of non-standard depreciation, including accompanying contextual explanations, to maintain transparency for interested parties when alternative pricing methods are used. The summary and analysis process should allow for relevant feedback and guidance to be provided in this respect.
19. Further prescription, in the form of greater complexity and specificity in the IM, is not likely to be effective. Instead, NZ Airports supports the retention of the status quo, as:
 - (a) the existing IM provides airports with the flexibility to choose whether to adopt a straight line depreciation or non-standard depreciation method, so long as they provide full supporting explanations and justifications; and
 - (b) even with any additions to the IM, additional explanation in disclosures will be required, and as BARNZ notes, this is (and will remain) key.
20. Finally, we agree with BARNZ that the focus should be on transparent disclosure of alternative depreciation approaches, and not seeking to use non-standard depreciation as a tool to seek to "align" returns from tailored pricing approaches with "IM compliant" approaches.

Asset allocator

21. BARNZ submits that the IM relating to the allocation of costs that are not directly attributable to the regulated - ie aeronautical - services is too broad, and needs to be amended to reflect the benefit obtained from such assets by unregulated activities.⁷
22. NZ Airports disagrees with that submission (which is misplaced) and notes that:
 - (a) this issue has not been raised by BARNZ in any of multiple fora where it could have been raised - ie, including the recent Forum, in response to the Commission's open letter on the IM Review, or in the section 56G review process - which suggests it is not a matter of real concern;
 - (b) BARNZ appears to be seeking to revisit an issue that was raised, and resolved, during the original IM consultation through the IM requirement that cost and asset allocators be based on current "causal relationships". That is, an allocation approach which requires operating costs and asset values to be allocated based on causal factors, with

⁵ BARNZ, *Submission on Problem Definition*, at p.5, 10.

⁶ NZ Airports, *Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition*, 21 August 2015, at paragraph 211.

⁷ BARNZ, *Submission on Problem Definition*, at p. 14.

the likely result that all services bear a portion of shared costs associated with the provision of those services;⁸

- (c) the Commission at the time was of the view that a greater level of prescription was not appropriate, and noted that:⁹

in order to ensure consistency with outcomes in workably competitive markets, the cost allocation IM needs to provide flexibility for Airports to reflect their business models.

- (d) BARNZ has not identified evidence of a *new* problem relating to asset allocations in practice. Its allegation that the current IM is not achieving the s52A(1)(d) outcome is unsubstantiated.

23. Accordingly, no credible basis has been advanced for the Commission to consider amendments to the IM.

WACC percentile

24. BARNZ's views on the WACC percentile applicable to airports are clear; namely that the mid-point WACC estimate provides the best estimate of a normal return, and that there should be no uplift.¹⁰ In particular, it believes that the dual till business structure negates any need for an uplift, and other regulatory obligations require airports to invest.

25. NZ Airports' strong views to the contrary are set out in its previous submission. However, we highlight here that the impact of the dual till on airports' investment incentives is nowhere near as straightforward as BARNZ suggests. Its consideration of the issue is too simplistic, and is based on assertions rather than evidence. Among other things, BARNZ's submission:

- (a) assumes that the mid-point estimate is the true WACC and ignores both the risks and implications, as highlighted in the expert report attached to NZ Airports' earlier submission ("**the Bush/Earwaker Report**"), that are associated with mis-estimating the WACC range;¹¹
- (b) presumes that capital for airport investment is freely available. This is an erroneous assertion. Airports operate like any other commercial business and are constrained in the amount of capital expenditure they are able to commit over any given period;
- (c) acknowledges that when faced with constraints, there are rational choices airports could make which would reduce service levels (such as building contact stands, as compared to the increased use of remote stands, or aspects of passenger (and other airport visitor flows) in the terminal), yet is dismissive of the service level impacts of these choices on consumers;

⁸ Commerce Commission, *IM Reasons Paper*, at paragraphs 3.3.2, 3.3.9.

⁹ Commerce Commission, *IM Reasons Paper*, at paragraphs 3.3.10, 3.3.15.

¹⁰ BARNZ, *Submission on Problem Definition*, at p. 15.

¹¹ For example, if investment is either delayed or cancelled, airports stand to incur incremental degradation in service reliability with substantial detrimental impacts on consumers in the form of higher airfares, flight cancellations, poor service, terminal and runway congestion and delay.

- (d) presupposes that in the event service standards fall below specified levels, airports have adequate incentives in the form of public and airline pressure to maintain facilities and services at satisfactory levels. As set out in NZ Airports' earlier submission (and as supported by the Bush/Earwaker Report), airlines are likely to be more effective at constraining investment, and if the pace of investment is delayed there are often long lead times to rectify the service impacts; and
- (e) misrepresents the relationship between aeronautical investment and non-aeronautical revenues by failing to recognise that some categories of aeronautical investment, which are potentially substantial, have no flow-on effect to non-aeronautical activities (as articulated in the Bush/Earwaker report).

26. In NZ Airports' view, the purpose of the current WACC range is to guard against the very real risk of the regulatory WACC being too low and undermining incentives to invest in competition enhancing capacity. When measured against the potential adverse impacts for consumers if investment does not occur, a broad WACC range that incentivises satisfactory service levels is far better than a specific estimate which risks service levels being compromised.
27. In that context, we note that even if any savings were passed on to passengers as a result of airports being forced to lower their returns, which cannot be presumed, the savings would be miniscule in comparison to the savings passengers experience due to airline competition that is supported by airport investment in capacity. Headlines trumpeting Air NZ slashing fares ahead of Jetstar's arrival on regional routes, and \$9 price wars, are prime examples of this.¹²
28. Finally, NZ Airports agrees with BARNZ that: "*the creation of certainty through the specification of input methodologies...promote[s] incentives to innovate and invest.*"¹³ It is striking that BARNZ's proposal to significantly change the WACC IM will materially undermine that objective, to the detriment of the long term benefit of consumers.

Forward-looking profitability indicator

29. BARNZ's submission supports the development of a forward-looking profitability assessment indicator to be disclosed as part of an airport's price setting disclosure. BARNZ cites the Commission's reasoning that the experience during the section 56G review process demonstrated how complex the profitability assessment can be when airports take tailored approaches to pricing.¹⁴
30. However, BARNZ's submission does not provide further explanation or evidence. This may be a reflection of the Commission's approach in the problem definition paper of framing the issue narrowly and seeking to promote discussion on proposed solutions.
31. NZ Airports reiterates that it is not opposed to the idea of exploring both this issue and potential solutions further with the Commission and interested parties. However, at this early

¹² See New Zealand Herald, *Air New Zealand slashes fares ahead of Jetstar arrival*, 23 August 2015, available at http://m.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11501709; Stuff, *Air NZ joins \$9 price war, Jetstar announces new NZ routes*, 31 August 2015, available at <http://www.stuff.co.nz/timaru-herald/business/71582558/Air-NZ-joins-9-price-war-Jetstar-announces-new-NZ-routes>.

¹³ BARNZ, *Submission on Problem Definition*, at p. 3.

¹⁴ BARNZ, *Submission on Problem Definition*, at p. 6.

stage of the review, NZ Airports encourages the Commission to focus on properly identifying and framing the issues to allow a range of appropriate solutions to be considered.

Airports use different methodologies to set prices

32. BARNZ supports the Commission's suggestion for a "disclosed difference approach"¹⁵, and proposes further prescriptive amendments.¹⁶
33. Again, although NZ Airports is not opposed to considering solutions to challenges in assessing disclosures, we are concerned about the extent and specificity of BARNZ's proposals.
34. Ahead of consideration of any such solutions, it is important that *all* parties fully understand exactly what the challenges are, and the extent to which they cannot reasonably be addressed through existing disclosures (including through additional explanations).
35. Assessing an airport's returns will inevitably involve some qualitative and or contextual analysis, including via reference to previous pricing decisions, rationales and assumptions. However, NZ Airports disagrees that there is a need for further prescription in the form of more detailed and lengthy disclosures:
 - (a) a strict approach of seeking to line up numbers will reduce confidence that profitability is being properly and fully assessed; and
 - (b) BARNZ's suggestion for an additional disclosure to include a summary of outcomes from historical pricing periods is already addressed by annual disclosures, which sufficiently provides this analysis.
36. NZ Airports recognises that the Commission is seeking solutions through this process, and airports are committed to putting further thought into alternative solutions. Accordingly, it considers that a constructive approach is to schedule a separate airports-airlines workshop with the Commission, once airports (and airlines) have had an opportunity to develop their thinking further.

Land valuation

37. NZ Airports does not agree with BARNZ's submission on the land valuation issues outlined in the BARNZ submission.¹⁷ Given land valuation issues have been fast tracked, NZ Airports proposes to engage on these issues in the standalone work-stream.

Pricing incentives

38. BARNZ proposes amendments to the ID definitions and schedules to more transparently disclose how financial incentives relate to disclosed costs and revenues, and how they are then measured as discounts against the prices set by airports.¹⁸ BARNZ fails to identify and fully explain any problem with the current disclosure of pricing incentives.

¹⁵ Commerce Commission Presentation, *Problem Definition - Airports; Review of input methodologies* (Commerce Commission Forum, Te Papa, Wellington, 30 July 2015), slide 28.

¹⁶ BARNZ, *Submission on Problem Definition*, at p. 6-7.

¹⁷ BARNZ, *Submission on Problem Definition*, at p. 8.

¹⁸ BARNZ, *Submission on Problem Definition*, at p. 13.

39. In that context, airports are clear and consistent in treating pricing incentives as an offset to revenue. Other non-price incentives are recorded in the airport's cost base or financial forecasts.
40. Further, in response, NZ Airports notes that:
- (a) the existing ID requirement to disclose the value of total financial incentives incurred, with a separate disclosure of the value of pricing incentives, was subject to considerable debate and scrutiny throughout the original IM consultation, before being determined by the Commission at the time IMs were set.¹⁹ Rather than demonstrating that there is a *new* problem with the existing ID requirements, BARNZ appears to be seeking to re-litigate that determination;
 - (b) if there was a requirement to further detail what discounts are included within those disclosed incentives, as well as a measure of those discounts against the prices actually set by airports at the beginning of a pricing period, in order to comply the airports could be at risk of:
 - (i) compromising confidentiality agreements with airline customers;
 - (ii) jeopardising the prospect of new entrants; and
 - (iii) potentially facilitating breaches of competition law.

Wash-ups

41. BARNZ has proposed additional, prescriptive changes to be made to the ID schedules in respect of wash-ups, including:²⁰
- (a) a line in the forecast revenue requirements of the price setting disclosures specifically for wash-ups; and
 - (b) a new disclosure schedule which discloses actual outcomes, including a line enabling adjustment to be made to revenues earned in the previous pricing period to reflect the effect of any wash-up.
42. NZ Airports disagrees that there is a need for further prescription:
- (a) when wash-ups are included in pricing, they are transparently disclosed by airports under existing price setting disclosures, and so there is no need for prescription in *ex post* disclosures;
 - (b) wash-ups are, in any event, a *prospective* notional adjustment mechanism used in pricing, used to reflect risk sharing. They are not in themselves actual transactions;
 - (c) historical disclosures cannot and should not be retrospectively adjusted to reflect wash-ups where airports have both earned revenues and incurred costs (reflective of the risk sharing between supplier and users of airport services); and

¹⁹ Commerce Commission, *IM Reasons Paper*, at paragraphs 3.82-3.88.

²⁰ BARNZ, *Submission on Problem Definition*, at p. 12.

(d) when wash-ups occur, they ought to be neutral across pricing periods - that is, the issue only arises under a short term focus on adjusting revenue for particular periods. The Commission's ability to monitor actual returns over the long term means it has all sufficient information to place wash-ups in context.

43. NZ Airports considers that BARNZ's proposals regarding wash-ups are a prominent example of it seeking to add layer upon layer of complexity into the ID regime, and blurring the distinction from price setting. We encourage the Commission to put the BARNZ proposal in perspective and prioritise issues where there is value in addressing them as part of the IM Review.

Leased assets

44. BARNZ proposes that leased assets and associated costs and revenues be disclosed in a separate schedule outside of the main Regulatory Asset Base ("**RAB**") (like assets held for future use) so that the performance of pricing assets can be seen not only in annual disclosures, but also in pricing disclosures.²¹

45. In NZ Airports' view, there is no principled regulatory rationale for this proposition. It is another layer of complexity for complexity's sake.

46. The focus of the Commission's profitability analysis for ID purposes is required by the Act to be on all regulated activities. Activities that involve leased assets are included in the definition of 'specified airport services' - and such assets should be included in the RAB. There is no basis for seeking the Commission to separately identify assets based on the way prices are set for particular customer classes.

47. BARNZ's attempts to draw parallels with assets held for future use is also flawed: leased assets need to be factored into return on investment calculations undertaken for disclosure purposes, as they are commissioned and used to provide regulated services.

48. NZ Airports considers that leased assets are appropriately recorded in annual and price setting event disclosures and further analysis is unwarranted.

Unforecast revaluations

49. Following BARNZ's presentation of potential solutions for this issue at the Forum, it suggests (as its preferred solution) a time restriction for when land revaluations undertaken under Schedule A can enter the asset base - on the first day of a new pricing period. This will result in the income from any unforecast land revaluation being taken into account in the same pricing disclosure period as the new valuation first impacts the targeted levels of profitability.²²

50. On this issue, NZ Airports notes that:

(a) it is yet another prominent example of BARNZ seeking to add a layer of complexity to ID;

²¹ BARNZ, *Submission on Problem Definition*, at p. 11.

²² BARNZ, *Submission on Problem Definition*, at p. 12-13.

- (b) the issues advanced by BARNZ are, in effect, about the Commission's approach to target profitability assessment, rather than disclosures themselves. To the extent there are challenges in the timing "mis-match" between pricing decisions and disclosure assessments, NZ Airports is confident that there are alternative ways to address BARNZ's concerns. NZ Airports is open to exploring such options in the next stages of the review process (as suggested above); and
- (c) it would be wrong amend to the IMs to remove unforecast revaluations, simply because BARNZ has concerns about the way the Commission assesses target profitability. It would be a disruptive change that undermines the certainty IMs are intended to provide.

51. NZ Airports considers that the existing annual disclosures appropriately disclose the treatment by airports of any actual asset revaluation in the year that a valuation takes place. In addition, the rationale and financial modelling for price setting is well understood by airlines and is able to be robustly challenged in consultation.

Discounting

52. BARNZ has sought clarification from the review about how the level of discount (from prices set under an IM consistent building blocks approach) should be measured. In particular, what level of WACC should be used as the starting point.²³

53. The Commission should have regard to the following factors in considering BARNZ's submission:

- (a) Airports earn their target returns over the long-term. Discounts and commercial concessions are clearly in the long-term interest of consumers, and the ID regime should therefore not disincentivise this behaviour.
- (b) It is important the Commission does not become preoccupied with seeking to introduce layers of complexity for the purposes of "tracking" these concessions over time. A better approach is for airports to disclose what is *currently* happening in practice.
- (c) The Commission and interested parties are able to analyse long-term outcomes under the ID regime, which, in turn, enables an assessment of whether the Part 4 objectives are being met.

54. NZ Airports considers that the assessment of discounting is best addressed as part of the Commission's summary and analysis reviews.

Cash-flow timing assumptions

55. BARNZ submits that the ID requirements relating to intra-period cash-flow timing assumptions should be amended to reflect mid-year cash flows.²⁴

²³ BARNZ, *Submission on Problem Definition*, at p. 13.

²⁴ BARNZ, *Submission on Problem Definition*, at p. 13-14.

56. While there could be merit in exploring this issue further with the Commission and interested parties, NZ Airports would encourage the Commission to:
- (a) clarify whether its position on this issue is to follow the approach taken in its section 56G analysis, or is seeking to adopt a similar approach as that taken for gas and electricity businesses; and
 - (b) consider whether changing the ID requirements to reflect mid-year cash flows is appropriate for airports.