

Input methodologies review

Airports profitability assessment - workshop 1

Summary of views expressed

Date of publication: 18 December 2015

Purpose

1. This paper provides a summary of views as they were expressed by participants of the first of two workshops for the IM review in relation to the airports¹ profitability assessment (Airports workshop 1).

Workshop purpose and objectives

2. Airports workshop 1's purpose was to seek key stakeholder views on how airports profitability assessment could be performed. The discussions on the assessment indicator covered both the ex-ante and the ex-post profitability assessment.
3. The objective of Airports workshop 1 was for us to understand key stakeholders views on:
 - 3.1. the purpose and factors that will make the airports profitability assessment successful;
 - 3.2. options for assessing airports profitability; and
 - 3.3. how the airports input methodologies (IM) can support the potential approaches.
4. The airports profitability assessment discussed at Airports workshop 1 excluded the Market Value Alternative Use (MVAU) land valuation topic which is considered as part of the airports fast-track process.

Workshop format and process

5. Airports workshop 1 used a round table format to allow an open discussion and exchange of information between workshop participants. A full range of views was provided during discussions with workshop participants.
6. Any views expressed by our staff or our advisors at Airports workshop 1 were for the purpose of stimulating discussion, and were not intended to reflect the views of the Commission. The Commission's position will be provided in the draft decision.

Role of workshop in the consultation process

7. Airports workshop 1 was a step in our process for considering amendments to the airports IM determination as part of the IM review.² The indicative consultation

¹ References to airports in this paper are to those airports regulated under Part 4 of the Commerce Act 1986, being Auckland International Airport Limited, Christchurch International Airport Limited, and Wellington International Airport Limited.

steps events and indicative dates are outlined in our process update paper published 30 October 2015.³

8. The second workshop will be focused on seeking interested parties' views on resolving issues, raised during the problem definition phase and at Airports workshop 1, through amendments to the airports IM determination and in the context of a proposed approach to assessing airports profitability.
9. In June 2016, we intend publishing a draft decision on the IM determinations amendments and draft reasons. We intend to complete the IM review by December 2016.

Workshop date and venue

10. Airports workshop 1 was held on 1st December 2015 in the Sunderland room at Wellington Airport Conference Centre.

Outcome of the Airports workshop 1

11. Airports workshop 1 was attended by key airport services stakeholders and representatives from MBIE.⁴
12. Airports workshop 1 generally followed the agenda⁵ and the discussions were supported by the workshop papers.⁶ Due to the interrelated nature of the topics, issues were sometimes discussed and addressed in an alternative order to how it was outlined in the agenda and workshop papers.
13. We appreciated the open discussion and would like to thank participants for their contribution to the outcome of Airports workshop 1.
14. A summary of views expressed at Airports workshop 1 is included in Attachment C.
15. At conclusion of the workshop we invited participants to provide written comments on certain matters discussed at the workshop.⁷

² We will also consider what changes to the ID determinations may be necessary to support our proposed approach to the airports profitability assessment. Amendments to the ID determination will be considered as part of a separate consultation process.

³ Commerce Commission "Input Methodologies Review: Process update paper" (30 October 2015).

⁴ The list of attendees is attached to this document as Attachment A.

⁵ The agenda is attached to this document as Attachment B.

⁶ The workshop papers can be found at our website.

⁷ Refer to paragraph 28 of Attachment C

Attachment A: Workshop attendees

No.	Representing	Name
1	Auckland Airport	Adrienne Darling
2	Auckland Airport	Phil Neutze
3	Auckland Airport	Mark Jenkins, Estina Consulting
4	Air New Zealand	Sean Ford
5	BARNZ	Aaron Schiff, Schiff Consulting
6	BARNZ	John Becket
7	BARNZ	Kristina Cooper
8	Commerce Commission	David Rauscher
9	Commerce Commission	Florian Steinebach
10	Commerce Commission	Hamish Groves
11	Commerce Commission	Jo Perry
12	Commerce Commission	John McLaren
13	Commerce Commission	Kimberley Foo
14	Christchurch Airport	Tim May
15	MBIE	Autumn Faulkner
16	MBIE	Jason Le Vaillant
17	NZAA	Christopher Graf, Russel McVeagh
18	NZAA	Craig Shrive, Russel McVeagh
19	NZAA	Kevin Ward
20	NZAA	Kieran Murray, Sapere Research Group
21	NZAA	Mike Basher, Kooba Limited
22	Wellington Airport	Martin Harrington
23	Wellington Airport	Meena Parbhu

Attachment B: Workshop agenda

Ref	Start	Session topic and discussion points	Duration
1	9.00	Introduction and welcome	5 min
2	9.05	Purpose and Agenda <ul style="list-style-type: none"> • Purpose of the workshop • Overview of the agenda 	30 min
3	9.35	Purpose of the airports profitability assessment <ul style="list-style-type: none"> • Overview of the purpose of the airports profitability assessment in relation to the Part 4 purpose and purpose of information disclosure • The role of summary and analysis in the assessment process • Framework principles applicable to the airports profitability assessment • Other matters for consideration in determining an appropriate approach to assessing airport profitability • Outcomes of profitability assessment 	45 min
	10.20	Morning Tea	15 min
4	10.35	Lessons learned <ul style="list-style-type: none"> • Lessons learned from previous assessments of airports profitability • Other challenges identified 	60 min

Ref	Start	Session topic and discussion points	Duration
5	11.35	<p>Options for assessing airports profitability</p> <ul style="list-style-type: none"> • Overview of an internal rate of return for an enduring period • Overview of an annual IRR with a carry forward mechanism • Advantages, disadvantages and concerns of both approaches • Importance of separating profits • Alternative options to assessing airports profitability 	45 min
	12.20	Lunch	60 min
6	1.20	Options for assessing airports profitability - continued	45 min
7	2.05	<p>Incentives and risks</p> <ul style="list-style-type: none"> • Current airport incentives • Risk allocation in a regulatory context • Opportunities for the airports profitability assessment 	60 min
	3.05	Afternoon Tea	15 min
8	3.20	<p>Wrap-up</p> <ul style="list-style-type: none"> • Key issues covered • Next steps • Post workshop decision 	20 min

Ref	Start	Session topic and discussion points	Duration
8	3.40	IM review issues and workshop 2 <ul style="list-style-type: none">• Indexed revaluations• Depreciation• Land held for future use• Opening land valuation date	20 min

Attachment C: Summary of views

Introduction

1. This attachment is a summary of the views expressed at the workshop. The summary of views has been grouped as per the topics of the workshop. We note, however, that due to the interrelationship of the topics, the views as outlined below may have been covered off in an alternative order.

Purpose of the profitability assessment

2. There was general support for the purpose of the profitability assessment as outlined in the workshop papers (slides 8-15).
3. NZAA raised questions about how the ex-post and ex-ante assessments of profitability were to be considered. NZAA expressed the view that the focus should be on the ex-ante assessment of the next pricing period. There appeared to be confusion as to the purpose of the ex-post assessment.
4. As the discussion continued, both airports and airlines confirmed that airport's stakeholders are primarily interested in how the profitability of the next pricing period compared to the WACC, but that the level of profitability achieved is dependent on a range of factors (e.g. demand risk, risk allocation between airports and airlines). Airports noted this makes it difficult to assess whether the FCM principle was being followed.
5. Airports suggested that the profitability assessment of airports should largely occur in summary and analysis. Participants did not have any firm views on whether the profitability indicator should be contained in ID or reported on through summary and analysis.
6. NZ Airports expressed the view that summary and analysis was an important part of ID, and so could mitigate the need for complicated changes to disclosure requirements.
7. BARNZ noted that increased reliance on summary and analysis may require additional funding for the Commerce Commission.

Lessons learned from our summary and analysis

8. Workshop participants largely supported the lessons learned and challenges identified as outlined in the workshop papers (slides 17-23).
9. The following additional matters were noted by airports:
 - 9.1. Wellington Airport proposed that we should report in our summary and analysis on the information airports provide under ID on superior performance;

- 9.2. Auckland Airport recommended adding to the list of key issues that the current ID disclosures are insufficient to reflect commercial arrangements; and
 - 9.3. Auckland Airport noted that the smoothing factor may not be aiding transparency.
10. The following additional matters were noted by BARNZ:
- 10.1. The ID requirements should show both the profitability based on the regulated asset base as well as the pricing asset base, because the regulated asset base can be different from the pricing asset base due to the inclusion of leased assets only in the regulated asset base. BARNZ noted that it was not always clear if the quoted returns related to the regulated asset base or the pricing asset base. This was generally not supported by airports.
 - 10.2. The re-disclosure of depreciation information midway through a pricing period was unhelpful.

The approach to assessing airports profitability

- 11. There was a general understanding of the two alternative approaches to assessing profitability presented in the workshop papers and general agreement with the advantages and disadvantages identified for each alternative.
- 12. There was general support for the profitability assessment to represent a hybrid of the two approaches presented, being an IRR for the 5 year pricing period with some form of carry forward mechanism between the pricing periods.
- 13. There was general support for the carry forward to include, at a minimum, those amounts that were agreed to be carried forward by parties during consultation of the pricing decision.⁸
- 14. We did not conclude whether amounts not agreed to be carried forward during the price setting decision should be carried forward. NZAA raised concerns about it potentially affecting the incentive for parties to reach agreement during consultation on the price setting decision.
- 15. Workshop participants generally considered an enduring IRR approach may be more problematic to implement due to:

⁸ This topic was discussed further at the workshop. Please refer to paragraphs 19 – 27 for more details.

- 15.1. airports and airlines focusing in their profitability assessment largely on the pricing period; and
- 15.2. airlines were concerned that the impact of each year and/or individual pricing period on the enduring IRR becoming increasingly less important over the long term.
16. BARNZ, however, suggested an enduring IRR could be useful if disclosed alongside a carry forward mechanism. They saw value in this because the enduring IRR approach allows assessing the significance of an over or under recovery relative of the size of the airport, which would aide comparability between Airports. It was noted by Commission staff that another method for ensuring comparability between Airports would be to take into account the impact of the carry forward amount on the target IRR for the upcoming pricing period.
17. BARNZ also suggested that an enduring IRR could be limited to a period of 10-15 years (i.e. 2-3 pricing periods).
18. Workshop participants were asked to reflect on the merits of the discussed approaches to assessing profitability and respond in writing after the workshop on their preferred approach in light of the discussions at the workshop and the options put forward by the Commerce Commission.

The approach to considering incentives and risks in the profitability assessment

19. There was general support that a high level of prescription regarding the treatment of incentives and risks in the profitability assessment is not a desired outcome.
20. It was noted that airports generally considered incentives to be a subset of risks.
21. There were no conclusive views expressed on how quality incentives should be taken into account in the profitability assessment.
22. Commission staff noted that without up-front agreement on:
 - 22.1. the targets for quality, then it would be difficult to comment on whether performance was superior or inferior; and
 - 22.2. the rewards and penalties for under- or over-performance relative to those targets, then it would be difficult to comment on whether profitability appropriately reflected superior or inferior performance.
23. Commission staff requested that Airports consider the ways in which the targets be defined and ways in which superior or inferior performance be taken into account in profitability assessments, e.g., materiality of quality improvements to consumers.

24. There was a general understanding of the importance of identifying in the profitability assessment profits earned from managing risks.
25. There was also a general understanding of the importance of understanding who is managing risks and whether this was agreed during the pricing consultation. However, reaching agreement during the pricing consultation, and defining what is meant by 'agreement', was identified as a challenge. BARNZ noted that it may be more practical to identify instances in which there is significant disagreement.
26. Workshop participants did not reach a shared view on what approach or treatment was appropriate if there was no agreement or disagreement between parties on the allocation of risks. However, there was broad alignment between workshop participants that the principles outlined by us in the workshop papers (slide 43) should apply in those circumstances.
27. BARNZ commented that incentives, including quality incentives, should comprise consideration of performance both above and below that which was forecast.

Post workshop decision

28. In addition to the invite to participants to comment on specific issues as outlined in the workshop papers (slides 53-55), we invited participants to comment on the following topics by 5pm, Tuesday 22 December:
 - 28.1. how over- and under-performance relative to quality targets could be taken into account when assessing profitability, e.g., materiality of over- and under-performance to consumers;
 - 28.2. how agreements to risk allocations and incentives could be defined; and
 - 28.3. how the Commission should treat risks in the assessment of profitability when they are not underlined by agreements or when parties have been unable to come to an agreement.