BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND

21 December 2015

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Dear John and Hamish

Post profitability workshop comments

At the conclusion of the workshop on airport profitability assessment held 1 December, Commission staff requested that participants respond on several questions relating to the process for assessing airport profitability over time and how agreements (or disagreements) on the allocation of risk should be reflected in these profitability assessments.

The approach to assessing airport profitability over periods

Commission staff put up two alternative propositions to stimulate discussion proposing that profitability could either be assessed over multiple periods using an enduring IRR or an annual IRR with a carry forward mechanism. During discussion on the day a general preference among stake-holders emerged of using a 5 year IRR with limited items carried forward to the next period (primarily matters where it had been agreed that risk be transferred or matters relating to assets such as unforecast revaluations or wash-ups for the timing of significant capital projects). However, BARNZ indicated that it wished to consider the matter further before indicating any final view.

Having undertaken that further consideration and checked with members, BARNZ supports using a five year IRR, with a limited set of items carried forward to the next period, and considers that this methodology would best promote the purpose of s52A, and represents the most appropriate balance between the various competing objectives contained in the purpose statement. Specifically this approach should provide regulated suppliers with incentives to out-perform forecasts due to their ability to retain any benefit (or suffer any short-fall) and thus incentivise efficiency, while at the same time protecting consumers from the possibility of providers not treating unforecast revaluations properly or using their charge setting power to bias forecasts in order to extract excessive profits. The ability to carry items forward from one 5 year period to the next will also provide the Commerce Commission with the necessary mechanism to be able to reflect commercial agreements between consumers and suppliers or undisputed consultation outcomes in the analysis which the Commission undertakes, thus encouraging workably competitive outcomes.

BARNZ considers that this five year IRR, and identification of what matters are being carried forward, should in the first instance be undertaken by the airports, and be disclosed, as part of the information disclosure requirements. This disclosure can then be reviewed and analysed (and if necessary adjusted) by the Commission in its s53B analysis (or other required analysis). This review would include the Commission identifying whether there were any disputed matters of risk allocation and either confirming or reallocating the airport's allocation of that risk.

BARNZ considers that it is important that this work first be undertaken as part of the airport's information disclosure requirements so that it is available to interested persons in a timely and regular manner. There is no statutory timeframe or dedicated budget for the Commission to undertake its s53B analysis, therefore this work can be given low priority or not receive sufficient resource when other matters intervene. For example, there has not as yet been any s53B analysis undertaken of the annual disclosures prepared by the three airports, although s53B was used by the Commission in 2015 to review WIAL's recent price setting event and CIAL's revised price setting disclosures.

The matters which BARNZ considers should be carried forward at the end of each 5 year IRR analysis into the forward looking profitability assessment for the next pricing period are the following:

- Unforecast revaluations (positive and negative);
- Timing differences of major capital expenditure projects which were forecast to cost $30m or more;
- The effect of an airport using an alternative time profile of capital recovery where there is a rationale considered appropriate by the Commission;
- Any permitted commercial agreement reached between airlines and airports (eg deferred timing of capital recoveries via an alternative time profile of capital recovery on a particular investment);
- Any under-taking by an airport to a wash-up on a risk as recorded in the price setting disclosures prepared by the airports; and
- Any risk, where there was a material disagreement by a substantial volume of the airport's customers over the airport's adopted approach, where the Commission considers it is appropriate to carry forward the difference between the forecast and actual outcome in respect of that risk.

The Commission has indicated that when allocating risks for price quality regulated industries it seeks to allocate them to those best placed to manage them, which includes considering factors such which party has control over the probability of occurrence, the ability to mitigate the costs of occurrence and the ability to absorb costs where they cannot be mitigated.

There is an additional factor which BARNZ considers needs to be taken into account in the case of industries only subject to information disclosure (particularly in the case of airports which also have the statutory right to set prices as they see fit). This factor is whether the forecasts are made independently of and uninfluenced by the decision-maker, or whether they were made by or were able to be adjusted by the decision-maker or biased in favour the decision-maker. For example, the front-end loading of capital expenditure projects in the early years of a pricing period where the projects are actually more likely to be undertaken in the later years of the pricing period will significantly advantage the airport in terms of being able to receive a return on and of capital which has not yet been invested and the asset is not yet in use.

Allocations of risks and incentives in the assessment of profitability

The Commission asked for comment on:

- How agreements on risk allocations and incentives could be defined?

- 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?

There is a significant contextual factor which colours the answer to these two questions – namely that consultation over airport charges is merely that – consultation. It does not require agreement. It does not usually involve formalised agreements (although there are exceptions such as the Terminal Services Charges Agreement that applied at Auckland Airport from the late 1970's until 2012 and the Wellington Deed that applied from 1998 until 2002).

The airports have the statutory right to set charges. The outcomes of pricing consultations therefore usually involve a decision document being released by the airport. This decision document would usually record any decisions made by the airport with regard to risk allocation. What the Commission should investigate is whether or not the risk allocation decisions made by the airport were disputed during consultation by the airlines or were considered reasonable.

In the context of a consultation process, which does not require agreement, BARNZ considers it is the concept of dispute or disagreement that the Commission should be looking for, as opposed to an agreement. For example, when Wellington Airport committed to wash-up arrangements as it set charges in 2007 (with respect to any potential delays in construction of the Rock and if unforecast revaluations up to a certain level occurred) these arrangements were adopted by the airport at the very end of the consultation process as it set charges in response to concerns airlines had raised during consultation. This was at the final step or conclusion of the consultation process. There was a commitment by the airport, but no agreement. In fact there was no further provision in the consultation process for airlines to respond. Consultation was at an end. The risk allocation approach was the airport's self-developed response to ongoing concerns which airlines had expressed over potential benefits being able to be retained by Wellington Airport if the airport's forecasts were wrong on these two matters.

During consultation each airline (or BARNZ on behalf of the airlines it represents) will raise any matters where they disagree with what is proposed by the airport. Due to its complexity, the consultation process usually involves the exchange of fairly detailed written documents – proposals in the case of the airports with supporting material, and assessments of those proposals or submissions by each airline (or BARNZ on behalf of the airlines it represents). There should be ample record of matters in dispute, and (hopefully but not always) a record of matters where an airline (or BARNZ on behalf of the airlines it represents) considered the airport's approach on a particular issue reasonable or largely reasonable.

Another key contextual factor which colours how to define agreements over risk and allocation is s30 of the Commerce Act. Airlines are in competition with one another and therefore have to ensure that consultation remains just that, and does not cross the boundary to become a contract, arrangement or understanding between airlines over the price at which they would acquire airport services. An exemption is provided in s33 for joint acquisitions, but not all airport services are jointly acquired. Going forward, the proposed new collaborative activities exemption should provide greater scope for agreement on efficiency enhancing initiatives. However, agreement between airlines on some matters will remain something that cannot legally occur. BARNZ is able to utilise the statutory ability provided in s2A of the Airport Authorities Act to represent a number of airlines, but other airlines not

represented by BARNZ make their own individual submissions and may well have a different point of view. There will not always be complete accord. Therefore what the Commission should be attuned to is material disagreement by a substantial volume of the airport's customers.

In essence, BARNZ considers that the Commission should:

- Amend the information disclosure requirements to require airports to:
    - disclose any decisions made by the airport regarding the allocation of risk in the disclosures following a price setting event, including the rationale for those decisions and any agreement reached, or dissenting views expressed by substantial customers during consultation; and
    - disclose the actual outcome of those risk allocation decisions in the annual *ex post* disclosures.
- As part of its analysis and monitoring work, examine the responses by airlines made during the consultation process (or request airlines to provide a summary of their views) on the risk allocation approach adopted by the airport, looking for agreement or approval by airlines or any material disagreement expressed by a substantial volume of the airport's customers.
- If there is a material disagreement by a substantial volume of the airport's customers over the risk allocation approach adopted by the airport, then as part of its profitability assessment undertaken under s53B (or other future requirement), the Commission should examine the appropriateness of the risk allocation decisions made by the airport in the light of the purpose of Part 4 to determine the most appropriate treatment of the risk (or risks) in dispute.
- Include within the disclosure requirements a specific mechanism or formula for how adjustments for risk allocation decisions should be treated in the forward looking profitability assessments in the Commission's view.

BARNZ does not consider it necessary to define what is meant by *'a material disagreement by a substantial volume of the airport's customers.'* We believe this is best determined in the context of a particular issue. However, we note that if a definition is desired such concepts are usually defined with reference to aircraft movements, passenger volumes and volume of carriers. For example, the Belgium Royal Decree in 2004 regarding Brussels Airport requires at least two unconnected companies, each representing at least 1% of annual movements or 1% of annual passenger numbers and which jointly represent at least 25% of annual movements or 25% of passenger numbers during the last calendar year. In the present instance, New Zealand already has the concept of substantial customers which represent 5% of identified airport activity revenue, so, if a definition was desired it would be sensible to make use of this existing definition.

We trust the above comments are clear and helpful to the Commission. As always, we are willing to clarify or expand upon any particular matter.

Yours sincerely

John Beckett
Executive Director