

AIRPORT PROFITABILITY ASSESSMENT POST-WORKSHOP SUBMISSION

22 DECEMBER 2015

1. The Commerce Commission ("**Commission**") has invited comments on the issues discussed at its Airports Profitability Assessment Workshop held on 1 December 2015, as part of its review of input methodologies ("**IM Review**") under section 52Y of the Commerce Act 1986 ("**Commerce Act**"). Having further reflected on the matters discussed at that Workshop, the New Zealand Airports Association ("**NZ Airports**") now welcomes the opportunity to provide its views on how airport profitability assessment could be improved to provide greater transparency for interested parties, consistent with the statutory objective of information disclosure regulation.¹

2. The NZ Airports contact for this submission is:

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Overview

3. NZ Airports considers that the current information disclosure regime is effective and fit for purpose. It has been effective in its contribution to outcomes where airport performance and profitability align with acceptable outcomes in a workably competitive market. That said, the information disclosure regime for airports is still in a relatively early stage and so NZ Airports recognises that there is potential to enhance the existing disclosures to provide increased transparency around airport performance.

4. Any proposed refinements to the profitability assessment framework should be guided by, and evaluated against, the following considerations:

(a) The Airports Authorities Act 1966 ("**AAA**") provides flexibility for airports to adopt commercial approaches that deliver the best long-term outcomes for all users of airports. The complementary information disclosure regime must accommodate the airports' ability to use tailored pricing approaches and take flexible commercial decisions to support outcomes that reflect the circumstances of individual airports. It should recognise that the operation of an airport involves a range of complex, interrelated activities. These are key benefits of information disclosure-only regulation.

¹ s53A Commerce Act.

- (b) Transparency of airport performance and pricing decisions within a regulatory period enable interested parties to sufficiently assess whether the Part 4 purpose is being met.
5. Importantly, any amendments should not go beyond that which are necessary to provide sufficient transparency. They must not result in rigid or complex formulaic disclosure requirements that disincentivise the very outcomes that the complementary AAA and information disclosure regimes seek to facilitate. Rather, any refinements to the information disclosure regime should be confined to providing greater transparency in disclosures:
- (a) to better enable interested parties to assess airport performance within the IM framework;
- (b) to recognise non-standard pricing approaches, including:²
- (i) risk sharing arrangements established through consulted price setting;
- (ii) moratoriums on asset revaluations; and
- (iii) non-standard depreciation approaches.
- (c) to understand variances between airports' forecast and actual returns for:
- (i) building block inputs (eg variations between actual and forecast outcomes); and
- (ii) any new forward looking profitability indicator (ie between forecast returns and actual returns).
6. NZ Airports recognises that the Commission has concerns about the absence of a forward looking profitability indicator (which the Commission considers makes it difficult to assess *ex ante* whether an airport is targeting excessive returns). NZ Airports is open to exploring with the Commission and airlines ways to address those concerns, including:
- (a) revision of the forecast information disclosed in Schedule 18 of the ID Determination to better align with the approach we now understand the Commission takes to profit assessment; and
- (b) a forward looking, internal rate of return ("IRR") indicator for a five year pricing period in price setting disclosures.
7. In this submission NZ Airports provides its high level views on the specific aspects of profitability assessment that were discussed at the recent Workshop. These views do not purport to provide a detailed framework for any refinements to the information disclosure regime; rather they seek to convey NZ Airports' position on the key concepts underpinning the relevant issues and proposals.

² Commerce Commission, *Problem Definition - Airports; Review of input methodologies*, (30 July 2015), at paragraph 310 - 313.

8. NZ Airports understands that the Commission (rightly) considers changes to the disclosures to be outside of, albeit potentially related to, the IM Review, and proposes to deal with any proposed changes to information disclosure in a separate process. We would be pleased to elaborate on the views expressed in this submission ahead of the Commission formulating any proposed specific changes to information disclosures.

Summary and analysis

9. Although summary and analysis of annual disclosures is yet to be undertaken, the Commission has previously recorded its view that future assessment of airport price setting under s53B will achieve similar outcomes to those in the s56G review.³ As NZ Airports noted in its Problem Definition submission, the s56G reviews provided useful clarity to the airports as to how the Commission will assess profitability on an *ex ante* basis.⁴
10. In considering any refinements to enhance assessment of airport profitability it is important to recognise that the summary and analysis process plays an important role in providing sufficient information to ensure that the purpose of information disclosure is met. To the extent that assessing an airport's returns requires taking into account a range of additional factors that impact disclosed profitability measures over time (which will invariably be the case), summary and analysis by the Commission provides an opportunity for:
- (a) the Commission to contextualise the *ex-ante* price setting disclosures, and consider price setting against outcomes over time; and
 - (b) the airports to explain in further detail the reasons for any complexities, if and when they arise.
11. By contrast, adding further complexity and prescription to the profitability assessment to seek to account for all potential contingencies and variations (ie airports' alternative pricing approaches) will be almost impossible to achieve, and is in any event unlikely to be helpful. Indeed, this is likely to lead to an outcome which obfuscates rather than illuminates an understanding of airport profitability.

***Ex-ante* profitability indicator**

12. NZ Airports understands the Commission is concerned that there is no forward-looking indicator to assist interested parties to assess whether airports are targeting excessive returns in price setting.⁵ Currently, forecast information is disclosed in Schedule 18.
13. NZ Airports is not convinced that a new *ex-ante* mechanism can remove the inevitable degree of complexity involved in profitability assessment. It is nevertheless open to exploring with the Commission a new forward looking profitability indicator. More specifically, NZ Airports could support the inclusion of an *ex ante* forecast IRR (using both pricing and IM inputs), disclosed at the start of a pricing period, indicating returns targeted for the five year pricing period.

³ Commerce Commission, *Summary and analysis of Wellington Airport's third price setting event*, 30 June 2015, ("**Wellington PSE3 disclosure**") at paragraph A6.

⁴ NZ Airports, Submission on Commerce Commission's Input Methodologies Review: Invitation to Contribute to Problem Definition, 21 August 2015, at paragraph 166(b).

⁵ Commerce Commission, *Problem Definition Paper*, at paragraph 303.1.

14. Where required, this could be supplemented by explanations where:
- (a) pricing departs from the IMs; or
 - (b) there are differences between the Regulatory Asset Base ("**RAB**") for information disclosure and the pricing asset base.
15. NZ Airports considers that a forward looking indicator of this nature (with limited carry-forwards, further commented on below) enables the monitoring of actual outcomes for each pricing period by:
- (a) providing for a more direct comparison of differences in the outcomes for pricing and IM approaches, including the rationale for those differences; and
 - (b) comparing the Commission's WACC determination at the time prices are set with the returns forecast for the pricing period and explaining any material variations.
16. In addition, the airports could include greater detail in the Other Factors aspect of Schedule 18, as the Commission has indicated it would prefer.

Assessment of profitability across pricing periods

17. The Commission has indicated that it may on occasion need to consider profitability across multiple pricing periods. NZ Airports considers that is likely to arise only in limited circumstances. NZ Airports therefore believes carry-forwards between pricing periods should occur only in limited and pre-defined circumstances, namely where pricing that reflects a material change to the default risk allocation (pursuant to which, risk is borne by the airport) is applied.

No need for an enduring IRR

18. An enduring IRR profitability indicator that spans multiple pricing periods is not necessary and will not be effective on account of:
- (a) the Commission's indication during the Workshop that a "double-layer" of disclosure (eg pricing period and enduring) may not be justified when airports and airlines tend to focus their profitability assessment within a single pricing period;
 - (b) the risk that an enduring IRR could, over the long-term, diminish the importance of the impact that each pricing period has on the profitability assessment;
 - (c) the fact both airlines and airports consider that the airport is best placed to manage most risks (with some limited exceptions) within a pricing period;
 - (d) the complexity involved with developing a corresponding enduring WACC; and
 - (e) the resounding support for, and agreement to, an IRR for a five year pricing period expressed by stakeholders at the recent Workshop.

Risk allocation means a carry-forward approach has a limited role

19. In commercial settings, prices may be set on an *ex ante* basis (on expected costs), or *ex post* (on actual values), or on both *ex ante* and *ex post* bases.
- (a) Prices based on expected values are common. Under this approach, prices are set for a period without change. Should the Commission's NPV=0 principle be applied to *ex ante* pricing approaches, it would require that expected prices cover expected costs on an NPV basis. Under these types of approaches, the transacting parties assume the risk that actual volumes and costs might diverge from forecasts until prices are reset.
 - (b) In other commercial arrangements, final prices are not known until the actual costs of providing the service are known. 'Time and material' contracts take this form. If the NPV=0 principle were applied to such contracts, it would be applied so that actual prices equal actual costs at the completion of the pricing period. Under these types of agreements, the parties assume the risk that actual prices might diverge from expected prices.
 - (c) Some other agreements allow for elements of both *ex ante* and *ex post* pricing. For instance, an *ex ante* pricing agreement might specify particular issues or events that would trigger a re-negotiation of the price, or a method for altering prices if certain events arise.⁶ If a NPV=0 test was applied to these types of pricing structures, some arrangement would be necessary to reconcile adjustments where services are supplied to more than one party, or where customers enter or exit the market during the pricing period.
20. Hence, the risk that costs or prices may vary over the term of the pricing period from the values assumed at the start of the period is allocated differently depending upon whether prices are set *ex ante*, *ex post*, or the pricing approach allows for elements of both *ex ante* and *ex post* pricing.
21. An important function of the commercial terms for supplying services is to allocate risk to superior risk bearers. NZ Airports agrees that allocating risk to the party best placed to manage, mitigate, or absorb the risk, increases the overall gains from the transaction.⁷
22. Auckland, Wellington and Christchurch airports typically set prices on an *ex ante* basis; that is, airports bear the risk that actual costs and cost drivers will diverge from expected costs and cost drivers. There are sound reasons for expecting airports to be better placed than the airlines and passengers to manage, mitigate or absorb the risk of unexpected variations in airport forecasts. The airports hold the rights to determine the use of their resources (ie control or manage the risk). Managing those resources is one of the core capabilities of airport managers; airports are likely to have better information in relation to changes in resource costs, and so should be

⁶ The New Zealand wholesale electricity market, for example, sets initial charges on metered quantity data with a process for reconciliation within a defined period should meter data be corrected. This arrangement reflects the traditionally high rate of error in initial meter readings, and the Electricity Industry Participation Code 2010 specifies detailed procedures for the reconciliation process.

⁷ Commerce Commission, Airports IM Review, Profitability Assessment Workshop, IM review issues and workshop 2, 1 December 2015, page 43.

better placed to anticipate the extent of any variation in values and to take mitigating action. For example:

- (a) as investors in long-life assets, airports are likely to be better placed to absorb many short-term cost variations than their customers; by contrast
- (b) airlines and passengers have neither the rights to determine how airports use resources, nor the need to develop capabilities to manage these resources; and
- (c) in many instances airlines and passengers would be poorly placed to absorb unanticipated changes in price.

Accordingly, the current *ex ante* pricing structure is explicable in economic efficiency terms.

23. There is no basis in economic efficiency, when evaluating an *ex ante* pricing arrangement, to allocate some of the impact of a risk of changes in costs to parties that did not accept the risk, unless the pricing arrangement explicitly provides for such a reallocation. The efficiency of an *ex ante* pricing arrangement can only be assessed on an *ex ante* basis, as this ensures that the party to whom risks are assigned bear the loss or benefit should the risk materialise. It does not matter if those unexpected cost increases or decreases are higher than the amounts possibly contemplated by the parties at the time the risks were allocated.
24. These risk allocation principles are clear, and will usefully inform the airports' decision-making when price setting going forward. Accordingly, *ex ante* clarity can be provided as part of price setting disclosures of which risks fall to the airport and which fall to airport users. For the most part, risks will be borne by the airport. On rare occasions, pricing may be set on a basis that reflects a risk allocation that differs from the default. It is only in those circumstances that a carry forward of overs and unders between pricing periods may be appropriate.

Requirement for consultation

25. Discussion at the recent Workshop centred on whether the concept of "agreement" to an alternative risk allocation (from the default) was a useful indicator of whether a carry-forward exception should be invoked. While NZ Airports agrees that a principled basis is to look at consulted outcomes, agreement is not an appropriate concept to introduce.
26. In essence this is because "agreement" is not a concept that fits within the AAA price setting framework. Rather, the AAA regime was expressly designed on the basis that it was inappropriate to expect airports and airlines to agree on prices, and that the best option was for airports to retain the ability to make decisions on charges and investment following robust and fair consultation.⁸ Accordingly, for the purposes of information disclosure, there should not be a requirement to disclose whether or not "agreement" is reached on alternative risk-sharing arrangements.
27. The notion of reaching an "agreement" *per se* with, and between, airline and other users is also not workable in practice. For example:

⁸ Airport Authorities Amendment Bill 1997(23-2) (7 December 1995) 552 NZPD 10508.

- (a) individual airlines also regularly hold different views on how much risk their business is prepared to take on, which will likely depend on factors such as whether they are an incumbent or new entrant at the airport, or use the airport as a core base/hub or not;
 - (b) pricing assumptions and forecasts might not always receive explicit opposition from airlines, which is not the same as agreement; and
 - (c) a requirement for evidence of "agreement" would invariably give rise to incentives on the part of airlines not to agree - ie it risks introducing regulatory "gaming".
28. For those reasons, carrying forward overs and unders across pricing periods ought to only be permitted when consulted outcomes in pricing have resulted in a specified, alternative allocation of risk between the airports and its users.
29. If there is no departure from the default position that risk is borne by airports then, in NZ Airports' view, there is no justification for an alternative mechanism for allocating risk under information disclosure. Rather, the position ought to be that airports bear the over and under at the end of the pricing period from risks allocated to them.
30. The Commission is able to use summary and analysis of disclosures to assess whether airports failed to develop unbiased forecasts or appropriately share risk, and to distinguish between risk upsides and extreme profits if returns are above WACC. When doing so, we would expect the Commission's risk allocation principles to be applied.
31. Transparency around any alternative risk-sharing arrangements can be provided in information disclosure. If necessary, the Commission will also be able to seek further information from airports. It will be able to assess:
- (a) on an *ex ante* basis, the appropriateness of alternative risk-sharing arrangements at the time of a price setting disclosure, and in commentary accompanying any forward looking profitability indicator; and
 - (b) on an *ex post* basis, the actual returns for the period in accordance with the disclosed arrangement.

Unforecast revaluations

32. It is clear from the first profitability Workshop that the treatment of forecast and unforecast revaluations in disclosures will be a matter to consider if a carry-forward mechanism is introduced into information disclosure. Although the topic of unforecast revaluations has been raised, there appears to be a lack of clarity regarding what these "unforecast revaluations" are, and what the issue under information disclosure is. We seek to provide some clarity below to guide further discussions on this topic.
33. As the Commission is aware, currently:

- (a) the IM Determination requires that all actual revaluations are recognised as income in the airports' annual disclosures.⁹ Revaluations will be due to CPI indexation, or updated land valuations (in accordance with the IMs);
- (b) airports are not required to adopt IM approaches for AAA pricing and may consider that a different economic approach is justified for their own circumstances (the rationale for which are fully explained by the airports in their price setting disclosures);
- (c) forecast revaluations are required to be provided in Schedule 18 of the price setting disclosures. These are provided on the asset base used for pricing purposes, which may not be the same as the RAB; and
- (d) accordingly, "unforecast revaluations" only arise in the context of price setting.

34. However, if the approach to revaluations prescribed by the IM is aligned with the approach adopted by an airport for pricing, then for the purposes of information disclosure this would provide an opportunity to:

- (a) provide greater clarity for interested persons;
- (b) enable improved transparency from the airports in disclosing and commenting on forecast revaluations (see below at 36) and actual revaluations; and
- (c) improve the Commission's ability to analyse airport performance, both including and excluding revaluations.

In principle solutions for discussion at Workshop 2

35. To enable a clear and transparent approach in information disclosures NZ Airports proposes discussion of the following prospective amendments to the IM/ID Determinations at Workshop 2:

Forecasting revaluations

36. Changes to Schedule 18 could include provision of a RAB forecast when prices are set. A consequence would be that the airports would disclose revaluation forecasts for the RAB.

Consistency of information disclosure and pricing approaches

37. Establishment of a RAB revaluation forecast will not fully resolve the complexity that arises if an airport's pricing approach to revaluations is different from the IM approach. This is particularly the case in the situation of Auckland Airport's revaluation moratorium, where it is more complicated for interested parties to evaluate Auckland Airport's actual profitability outcomes.

38. Potential inclusion of unforecast revaluations in a carry-forward mechanism would be easier if greater flexibility was provided in the IM treatment of revaluations. This could involve:

⁹ Commerce Act (Specified Airport Services Input Methodologies) Determination 2010, Consolidating all amendments as of 14 November 2014, Commerce Commission, 30 March 2015.

- (a) accommodation of valuation moratoriums; or
- (b) adoption of revaluation forecasts using an alternative forecast approach to CPI.

39. Providing this flexibility in the IM would not reduce the effectiveness of the information disclosure regime because the fundamental principle will remain that all revaluations included in the RAB must also be included in disclosed income. However, it would improve the ability of all parties to evaluate airport outcomes because RAB revaluation forecasts and actual outcomes will be presented on a more consistent basis.

Timing of unforecast revaluations

40. If the Commission was to accept NZ Airports' proposal for a RAB forecast disclosure for a price setting period, then consequently variations from forecast revaluations will occur during a pricing period. These variations will be unforecast revaluations on account of:

- (a) variations in the index (eg CPI) used for the forecast; and
- (b) revaluations arising from updated MVAU land valuations.

41. All actual revaluations will be included in disclosed income. However, the current IM requirement that this occurs in the year the revaluations are undertaken leads to possible variances in the disclosed returns earned by an airport for that year or period, which would have to be addressed in summary and analysis. The prospective variance would arise from the inclusion of unforecast revaluations in the RAB terminal value in the IRR calculation (ie an IRR that is above or below the IRR forecast for the price setting period).

42. If the information disclosure approach seeks to recognise all (large) unforecast revaluations in a single pricing period, then this will likely result in a mismatch with the actual pattern of recovery by the airports over the life of the assets.

43. If an airport was to align its pricing approach to information disclosure and amend its required revenue to respond to unexpected revaluation changes, or otherwise recognise substantial revaluation gains in a single pricing period, this would:

- (a) increase volatility in the cash revenue required from airlines and passengers;
- (b) increase volatility in pricing; and
- (c) substantially reduce cash revenue and adversely impact an airport's ability to invest in further assets.

Unforecast revaluation disclosure

44. Therefore, NZ Airports proposes that the potential inclusion of further flexibility in the IM (ie to allow pricing revaluation approaches to be aligned with disclosures) be discussed at Workshop 2. This should provide a better platform to develop a solution for unforecast revaluations that would continue to ensure that all revaluations are reported as income in annual information disclosures, and could:

- (a) provide airports with the flexibility to spread the inclusion of unforecast revaluations in the RAB, and income, for a period of up to the expected life of assets (or average life for a class of assets);
- (b) be subject to full disclosure in the same manner as the non-standard depreciation approaches;
- (c) depending on the extent of flexibility provided, enable recognition in a carry-forward approach if this was implemented; and
- (d) avoid distortion of IRRs or cash flows during individual pricing periods.

Carry-forward mechanism

45. Where alternative risk sharing arrangements are established in consulted pricing outcomes, transparency would need to be enabled within the information disclosure regime to reflect the carry-forward or wash-up outcome. We consider carry-forwards are likely to be relatively specific, rather than general, in nature (and as noted in 17 will be the exception rather than the norm).

Carry-forward mechanism - capex

46. We comment specifically on a carry-forward for capital expenditure ("**capex**") as this was the example raised at the Workshop.
47. While there was some discussion of capex wash-ups generally at the Workshop, the airlines were nevertheless clear that they do not want exposure to wash-ups on *all* capex items. In this respect, sufficient flexibility should be provided for transparency of tailored risk sharing arrangements, which are likely to be limited and specific in nature, rather than apply to full building block inputs.
48. It would be important in the context of capex that a carry-forward mechanism reflects any risk sharing arrangement that arises from consultation, and does not blur the boundaries between:
- (a) overs and unders that arise due to outturns different to those forecast, where following a consulted pricing outcome airports are holding all the upside and downside risk; or
 - (b) where a more efficient solution, rather than incurring capex, has been developed by the airport, which could be in conjunction with the airlines, after consultations were concluded.
49. To illustrate:
- (a) absent any allocation of risk to airlines from consulted pricing outcomes, if actual passenger volumes for the pricing period are:
 - (i) higher or more accelerated than forecast in the peak, leading to the need for increased and/or earlier capex; or

- (ii) lower or delayed in comparison to forecast, potentially leading to reduced or delayed capex;

then, as those risks sit with the airport, overs and unders lie where they fall at the end of the pricing period. This encourages the airport to continue to test the efficiency of capex and opex trade-offs throughout the pricing period, ultimately impacting the RAB when prices are next reset; and

- (b) establishment of a capex forecast in pricing consultation is only part of the discussions that are undertaken with airlines for large capex projects. Extensive discussions are usually undertaken in respect of specific project design, costing and timing requirements, which can lead to variations from forecast. These are typically a risk carried by the airport.

50. Furthermore, airports are also likely to carry the risk for unforecast capex which can arise from:

- (a) changes to regulatory requirements (eg for security reasons requiring additional or new facilities); and
- (b) airlines where they wish to change their business model (eg such as the innovation shown by Air New Zealand with the introduction of self check-in in New Zealand).

51. Any mandatory carry-forward mechanism for capex is an unnecessarily blunt instrument and risks being contrary to the Part 4 purpose. It would risk not only disincentivising efficient investment (based on new information), but also risk constraining market development (where it is facilitated, or accommodated, by airports).

52. Accordingly, NZ Airports is firmly of the view that there should only be carry-forwards for capex in information disclosure if this is to reflect a consulted AAA outcome.

Recognition of superior performance on quality standards

53. NZ Airports understands from the Workshop that the Commission considers that recognising and rewarding superior performance by airports can be challenging.

54. NZ Airports agrees that the concept of superior performance in the airport context is not as straightforward as it is for other regulated industries, eg electricity distribution businesses. Airport performance is multifaceted and goes beyond meeting narrowly targeted quality standards. Indeed, given an airport's services are comprised of various interrelated activities, an evaluation of superior performance needs to include a collective assessment of those interrelated but diverse services for reliability, innovation, efficiency in pricing and passenger throughput.

55. That is not to say that superior performance by airports should not be recognised and rewarded. However, rather than being assessed and quantified against a pre-determined formulaic mechanism, superior performance should be evidenced and assessed through disclosures.

56. Put another way, if the *ex ante* profitability assessment indicates appropriate target returns, then actual returns over the regulatory WACC should be presumed to be evidence of superior performance, including on quality. It would only be if disclosures, or summary and analysis, provides evidence to the contrary that such returns could then potentially be considered to include excess returns.
57. That being the case, NZ Airports submits that there ought to be a presumption in profitability assessment that if an airport earns above WACC, this is on account of either earnings from upside risk that have been borne by the airport, or superior performance. That is appropriate given that disclosures will provide the opportunity for:
- (a) a review of target profitability in forecast returns at the start of a pricing period; and
 - (b) airports to explain any variations from those returns forecast under any new forward looking profitability indicator, during and at the end of the pricing period.
58. Therefore, the Commission will be well placed to assess whether any returns above the WACC estimate are due to excessive profits.
59. NZ Airports would be pleased to discuss its submissions further with the Commission and looks forward to engaging with the Commission in further detail in any process to make refinements to the information disclosure regime.