

# Submission on Commerce Commission's input methodologies review draft decision

4 August 2016



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## EXECUTIVE SUMMARY

### Overview - full contextual assessment of performance is critical

1. Taken as a whole, the Commerce Commission's ("**Commission**") proposed package of changes to the input methodology ("**IM**") and information disclosure ("**ID**") requirements governing the regulation of airports under Part 4 of the Commerce Act 1986 ("**Act**"):
  - (a) Recognises that ID regulation is an effective form of regulation for the regulated airports;
  - (b) Signals the Commission's intent to apply ID regulation in a way that will encourage a full contextual assessment of airport performance; and
  - (c) Avoids making material changes to the IMs.<sup>1</sup>
2. These features of the draft decision of 16 June 2016 ("**draft decision**") are welcome.
3. However, some features of the draft decision appear contrary to the Commission's stated aim of reducing focus on numerical comparisons when assessing airport performance:
  - (a) A major focus is to establish a new forward-looking profitability indicator under the ID Determination; and
  - (b) Removing the weighted average cost of capital ("**WACC**") percentile range.
4. Essentially, we are encouraged that aspects of the Commission's approach to the WACC percentile should make for enhanced ID regulation. However, we are concerned that these two changes taken together create a real risk that assessment of airport performance will heavily focus on comparing disclosed returns to the mid-point WACC, which will become an inappropriate touchstone for assessing airport performance. The extent to which this risk occurs will depend on how the Commission undertakes profitability assessment in the future and whether it retains its intention to only publish a mid-point estimate.
5. The New Zealand Airports Association ("**NZ Airports**") therefore urges the Commission to firmly and consistently make clear that its intention is to achieve full contextual assessment of airport performance, consistent with the purposes of ID and Part 4.

### Regulatory Framework - ensuring a proportionate ID regime

6. NZ Airports is always open to considering ways to improve interested persons' understanding of airport performance, but encourages the Commission to critically consider whether its proposals to increase the amount of information disclosed are proportionate to the light-handed nature of ID regulation (compared to price control). In particular, it should rigorously ensure that a proposed change:
  - (a) Actually meets the purpose of ID (sometimes less information will better allow an assessment of whether Part 4 is being met);

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<sup>1</sup> Once the IM Review has concluded, we would welcome an opportunity to engage with the Commission on how the process may be improved for the next review. On one hand, the noticeable effort of Commission staff to constructively engage with stakeholders throughout the process has been a positive development. On the other hand, the amount of time and effort required by senior airport management to engage in the process is disproportionate given that the proposed substantive changes are relatively limited.

- (b) Maintains and improves the flexibility that should be a hallmark of ID regulation, and which will allow airports to take appropriate commercial decisions - as they would in a workably competitive market. That is to the long-term benefit of consumers; and
  - (c) Is rigorously assessed to ensure proportionality and to establish that the perceived benefits outweigh any additional complexity and cost. We support the Commission's stated intent to reduce complexity and compliance costs.
7. The proposal to introduce a new Schedule of disclosures for the pricing asset base (proposed Schedule 19) is a prominent example of a proposal that does not meet these tests. Airports have previously reported their forecast return on the consulted pricing asset base and do not consider that an additional Schedule with associated detail and complexity is required.
8. We also note the Commission's view that the purpose of ID (section 53A) does not have the same level of applicability to the Commission's review of input methodologies ("**IM Review**") as sections 52A and 52R.<sup>2</sup> We disagree with this view. In particular:
- (a) We believe that the Commission must always consider the purpose of ID when considering changes to an IM. It is critical to ensuring that an IM is proportionately tailored to be fit for purpose under ID regulation;
  - (b) To be fit for purpose, an IM must be designed to facilitate the disclosure of sufficient information to allow interested parties to assess whether the purpose of Part 4 is being met. It must not be designed for the purpose of directing pricing decisions; and
  - (c) Given the Commission's repeated views that ID regulation should exert pressure on suppliers to achieve the Part 4 purpose statement, failing to fully consider the purpose of ID when setting and applying IMs is a key reason why ID regulation can become *de facto* price control (which we understand the Commission is seeking to avoid).
9. We also encourage the Commission to keep in mind that under ID regulation, there is more scope for less specificity or precision in the IMs compared with price control regulation.

#### Commission's approach to WACC percentile should make for enhanced ID regulation

10. Our key points are:
- (a) We do not support the proposal to only publish the mid-point of the WACC estimate, and standard error. A better approach is to publish regular percentile increments and/or a distribution curve.
  - (b) To date, comparison of an airport's targeted rate of return to the Commission's WACC estimate has invariably been seen as the "starting point" and core of any airport profitability assessment. We believe the Commission must move toward a contextual assessment of airport performance (consistent with advice from Professor Yarrow) that recognises not only the uncertainty of any WACC estimate, but also incorporates an assessment of investment, innovation, efficiency and quality.
  - (c) In that context, the Commission's draft decision provides welcome clarification that its regulatory estimate of WACC is not to be seen as a bright line benchmark for the assessment of airport profitability. It is critical for achieving the Commission's stated intent that the mid-point (or any other percentile) is not afforded undue weight.

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<sup>2</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM review" (16 June 2016), para 67.

11. There are several reasons why we believe our approach will result in more effective ID regulation:
- (a) The regulatory estimate of WACC, like all estimates of WACC, is inherently uncertain, and the Commission is required to establish the ID regime in a way that fully informs stakeholders of the uncertainty in any estimate of the WACC;
  - (b) It more effectively applies the intent of section 53F, which provides that entities subject to ID only do not have to apply the WACC IM when complying with information disclosure requirements;
  - (c) ID regulation, as Professor Yarrow advised the Commission, is a light-touch form of regulation. Under ID regulation, compared with more heavy-handed forms of control such as price control, there should be a more proportionate approach to limiting adverse exercise of market power. In particular, this means that the regulatory WACC estimate:
    - (i) Must not have undue prominence or have the effect of essentially prescribing pricing; and
    - (ii) Should be just one factor in the broader contextual analysis that is required for an assessment of airport returns over time, measured against all of the Part 4 purpose objectives.
12. Our take on the draft decision, as it relates to the WACC percentile for airports, is that the Commission is seeking to provide a platform for future profitability assessments that better aligns with the light-handed nature of ID regulation (consistent with Professor Yarrow's advice). That is positive and welcomed by the airports. That should enable better outcomes for consumers.
13. Key to ensuring that airports have the confidence to set prices in a way that does not risk jeopardising optimal levels of investment and efficiency (contrary to the long-term interests of consumers) is further confirmation in the final decision that the Commission anticipates:
- (a) An increased recognition of airport-specific factors that influence an airport's own estimate of its WACC when it is assessing airport profitability;
  - (b) Having open and engaged discussions with airports around any comparisons between the new internal rate of return ("**IRR**") forward-looking profitability indicator and the Commission's regulatory WACC estimate; and
  - (c) Recognition that the regulatory mid-point WACC estimate has limited value as evidence of acceptable returns, and that it must be used with caution. Asymmetric social consequences ("**ASC**") remain relevant. We disagree that consultation requirements and the dual till mean the Commission can be less concerned about whether the regulatory WACC impacts investment. The Australian Competition and Consumer Commission ("**ACCC**"), in its 2013-2014 monitoring report, shows that under airport regulatory regimes with ID only and dual till, underinvestment remains a risk.
14. In our view, the Commission does not need to find all the answers now to all the potential issues that may arise when the Commission assesses performance. Airports understand that an effective ID regime requires them to engage responsibly and transparently explain their objectives and achievements for a range of factors, to allow an informed assessment by interested parties. In turn, our expectation is that the Commission will evaluate the airport

information disclosures with an open mind at the relevant time. We ask the Commission to confirm in its final decision that it will remain committed to ongoing engagement with interested parties to implement the framework for contextual assessment of airport performance.

**Profitability Assessment - ID changes must improve clarity and understanding**

15. The Commission has proposed a number of changes to the ID disclosures regulated airports are required to make. We support changes that, consistent with the purpose of ID, will:
  - (a) Present information in a way that is more useful for interested parties; and
  - (b) Enable better alignment between airport pricing decisions and disclosures.
16. Our key concern with the proposed IRR forward-looking profitability indicator is that it risks increasing the focus on numerical comparisons between targeted returns and the regulatory WACC estimate. But we do not oppose its inclusion if the Commission can provide comfort that it will not have this impact, and will simply be one part of a broader assessment of airport performance.
17. The Commission's proposed limited carry forward mechanism forms an appropriate part of the forward-looking profitability indicator. Its value lies in its ability to best allow airports to disclose what, following consultation with airline customers, they have done (or intend to do) in pricing. We note that it will nevertheless need to be used with caution because:
  - (a) A five year IRR assessment remains a short window or snapshot of airport profitability; and
  - (b) The closing investment value reflects a terminal value for the IRR calculation. However, it can only ever reflect the outcome of pricing decisions for the current pricing period, given that asset values for future pricing periods will be subject to future pricing consultations.
18. Further comments on the drafting changes proposed to the IM and ID Determinations will be provided on or before 18 August 2016. But our overarching message on these proposals is for the Commission to ensure that all of the amendments and additions it is proposing can be justified under its decision-making framework; notably in terms of proportionality and not increasing complexity.
19. NZ Airports welcomes the Commission's proposal to further consult on technical aspects of the proposed amendments ahead of its final decision. This should further assist to ensure that the package of proposed amendments best meets the twin goals of providing sufficient and transparent disclosure of information to interested persons, while also establishing a platform for full contextual assessment of airport performance that is appropriate for ID regulation.

## INTRODUCTION AND APPROACH TO SUBMISSION

20. The Commission has invited comments on its draft decision as part of its IM Review being undertaken pursuant to section 52Y of the Act.
21. The Commission has identified a number of areas, for regulated airports, where it considers that the disclosure requirements and IMs could be changed to improve the transparency of the information disclosed about airport pricing.<sup>3</sup>
22. NZ Airports welcomes the opportunity to respond to the changes proposed by the Commission in its draft decision.
23. NZ Airports represents 31 airport members and 28 non-airport members, including consulting and engineering firms, as well as other aviation-related organisations. Our purpose is to facilitate co-operation and information exchange between members, provide a forum for the discussion of issues affecting the airports and aviation industry, and advise and advocate for members on legislative and regulatory matters. We make this submission on behalf of our members who are registered airports, and who provide services that are regulated under Part 4 of the Commerce Act. Those airports (Auckland International Airport, Wellington International Airport and Christchurch International Airport) have been involved in the preparation of this submission.
24. The draft decision comprises a package of papers. While this submission should be treated as NZ Airports' submission to the Commission's full draft decision of 16 June 2016, it responds in particular to:
  - (a) The overarching framework paper (Framework for the IM Review);
  - (b) Topic paper six (WACC percentile for airports);
  - (c) Topic paper four (Cost of capital issues); and
  - (d) Topic paper five (Airports profitability assessment).
25. We have responded to the relevant Topic papers in the order outlined above and, for completeness, indicated at the relevant parts of the submission which aspect of the draft decision is being responded to. We have reviewed the Report on the IM Review, but have not separately submitted on it. Where relevant, we respond to that report within this submission.
26. The Commission is proposing changes to both the IMs for regulated airports (provided for in the IM Determination<sup>4</sup>) and the information disclosure requirements imposed on regulated airports (provided for in the ID Determination<sup>5</sup>). The Commission has helpfully identified whether changes proposed in the draft decision would be effected through changes to the IMs or through the ID disclosure requirements. NZ Airports has approached its submissions with that distinction in mind.
27. The Commission also released draft revisions to its IM and ID Determinations on 22 June 2016. NZ Airports will provide its submissions on the proposed changes marked-up to those Determinations in accordance with the timetable for submissions (by no later than 18 August 2016). However, to the extent that the amendments to the IM and ID Determinations implement changes also discussed in the draft decision paper, those proposed changes are

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<sup>3</sup> Commerce Commission "Input methodologies review draft decision: summary paper" (16 June 2016), para 60.

<sup>4</sup> Commerce Commission "Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (22 December 2010).

<sup>5</sup> Commerce Commission "Airport Information Disclosure Determination" (22 December 2010).

responded to in this submission (albeit without delving into the detailed level of drafting contained in the marked-up Determinations).

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## PART 1: DECISION-MAKING FRAMEWORK

30. In this section, NZ Airports responds to the Commission's "Framework for the IM Review" paper. NZ Airports (in a joint submission with the Electricity Network Association) has previously provided submissions on the Commission's decision-making framework for the IM Review, which should be read in conjunction with these submissions.<sup>6</sup>
31. Overall, NZ Airports acknowledges that the Commission has sought to consistently apply the framework throughout its draft decision. However, as we identify in our submissions on relevant Topic papers, it is not always evident that the Commission's framework supports proposed changes to the regime.
32. The key point that we make here is that ID regulation is light-handed and requires proportionality in regulatory decision-making. That includes:
- (a) Recognising that IMs for ID regulation should be focussed on providing transparency in performance by establishing clear disclosure requirements, rather than seeking to directly influence pricing approaches;
  - (b) Rigorously assessing any proposed new disclosure requirements to ensure the benefits in terms of promoting the purpose of ID (eg providing transparent and accessible information) outweigh additional complexity and compliance costs;
  - (c) Promoting flexibility in the disclosure requirements where appropriate, to allow (and not hinder) an airport to fully and transparently explain its decisions; and
  - (d) Ensuring that any regulatory responses to variations from forecast or regulator expected performance outcomes are relative to the scale of the variations and the contextual explanations provided by the airport.

### Nature of the framework

33. NZ Airports agrees with the Commission's view that the framework for the IM Review is bound by the statutory criteria in Part 4 of the Act: namely the purpose of Part 4 (section 52A) and the purpose of the IMs (section 52R).<sup>7</sup> In the case of the regulated airports, given the IMs feed into disclosure requirements in the ID Determination, and the Commission is proposing changes to the disclosure requirements, the statutory purpose of ID regulation (section 53A) must also form part of the relevant decision-making framework.
34. That is, we believe the framework applies to decision-making for both the IMs and disclosure requirements.
35. NZ Airports agrees with the Commission's stated overall approach to the decision-making framework:<sup>8</sup>

We consider that a conceptual framework which guides, rather than mechanically determines our decision-making strikes the right balance between prescription and flexibility. As we cannot foresee all situations and potential changes that might arise, we consider that the framework needs to be sufficiently general to provide guidance in as many situations as possible.

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<sup>6</sup> Electricity Networks Association and New Zealand Airports Association "Advice on legal questions and decision-making framework" (21 August 2015).

<sup>7</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 47.

<sup>8</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 50.

36. As NZ Airports has indicated previously, flexibility is a hallmark of effective ID regulation and so it is appropriate that is reflected in the Commission's decision-making framework. However, that should not be conflated with a flexible or optional approach to application of the statutory guidance to the review process. All changes proposed by the Commission ought to be assessed consistently under the decision-making framework (rooted in the statutory parameters provided in Part 4).
37. We agree with the Commission's view that the decision-making framework must take account of the role of an IM within the type of regulation it supports.<sup>9</sup> We remain of the view that, under ID regulation, there is more scope for less specificity or precision in the IMs compared with price control regulation.

#### Framework for assessing changes to IMs or ID requirements

38. In considering whether to change the IMs, essentially, the Commission states it must ask itself: is the IM trying to achieve the right thing in the right way?<sup>10</sup> To determine the answer to this question, the Commission states it must also ask itself:<sup>11</sup>
- (a) Is the policy intent still relevant and appropriate?
  - (b) Is the IM achieving that intent?
  - (c) Could the IM achieve the policy intent better if it were amended?
  - (d) Could the IM achieve the policy intent as effectively, but in a way that better promotes section 52R of the Act, reduces complexity, or reduces compliance costs?
  - (e) Do changes to other IMs require any consequential changes to the IM for internal consistency or effectiveness reasons?
39. We consider these questions provide a useful starting point.<sup>12</sup>
40. NZ Airports is of the view that a key consideration is that the perceived benefits of changing the IM and/or ID requirements must be carefully balanced against the possible increases in complexity or compliance costs. It is very likely that there will be some situations where an IM or ID requirement could be changed, but that the complexity or costs of implementing that change outweigh any potential benefits. That is, it is not axiomatic under the decision-making framework that a perceived improvement in an IM should be pursued.
41. It is therefore important that the Commission illustrates in its decisions how it has weighed the additional complexity or compliance costs with the proposed changes to the IMs or ID requirements to ensure that it is abundantly clear how, in the Commission's view, all changes ultimately promote the purpose of the IMs (section 52R) or ID (section 53A). In other words, the Commission should show that any changes it proposes to make are actually likely to make useful information more accessible and transparent for interested parties. That is not currently apparent in all instances where the Commission is proposing changes.

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<sup>9</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 116.

<sup>10</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 72.

<sup>11</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 73.

<sup>12</sup> Electricity Networks Association and New Zealand Airports Association "Advice on legal questions and decision-making framework" (21 August 2015), para 29.

42. We also support an approach that minimises change to the status quo. Although NZ Airports does not agree with all aspects of the current IM and ID requirements, if they are changed on an arbitrary basis and/or without principled and evidenced reasoning, the certainty principles underpinning both purpose statements (sections 52A and 52R) would be undermined.<sup>13</sup> That same risk applies from persistent, albeit relatively minor, tinkering.
43. In our view, the implied framework is that:<sup>14</sup>
- (a) Current IMs and the status quo provide the starting point for the review and change should only be made where there is good reason;
  - (b) The Commission must refer to its previous decisions and evidence when exercising its judgement;
  - (c) Change must not undermine the certainty, purpose and incentives to invest and innovate. This requires that:
    - (i) The Commission restates the core economic principles relied upon and the reasons in support of its decision;
    - (ii) Any change must be consistent with these economic principles;
    - (iii) These economic principles can only be abandoned if evidence is compelling;
    - (iv) The threshold for a change that may have a material impact (implied or direct) on regulated revenue should be high; and
    - (v) The threshold for a change that is unlikely to impact on regulatory certainty can be lower.

#### **Economic concepts that inform decision-making framework**

44. In Chapter 4 of the decision-making framework paper, the Commission outlines the key economic principles that provide "useful guidance" in giving effect to the Part 4 purpose.<sup>15</sup> These are:<sup>16</sup>
- (a) Real financial capital maintenance ("**FCM**"): providing regulated suppliers the expectation *ex-ante* of earning their risk-adjusted cost of capital, which provides suppliers with the opportunity to maintain their financial capital in real terms over time frames longer than a single regulatory period;
  - (b) Allocation of risk: allocating particular risks to suppliers or consumers depending on who is best placed to manage the risk unless doing so would be inconsistent with section 52A of the Act; and
  - (c) ASC of over-/under-investment: FCM is applied recognising the asymmetric consequences to consumers over the long-term of under-investment versus over-investment.

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<sup>13</sup> Electricity Networks Association and New Zealand Airports Association "Advice on legal questions and decision-making framework" (21 August 2015), para 18.

<sup>14</sup> Electricity Networks Association and New Zealand Airports Association "Advice on legal questions and decision-making framework" (21 August 2015), para 18.

<sup>15</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 118.

<sup>16</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 122.

45. NZ Airports agrees with these economic principles, and is of the view that these should inform all judgements the Commission has to make under the decision-making framework. The Commission says that the principles do not amount to a regulatory compact, but we cannot see how the Commission could legitimately depart from them.
46. We are concerned that the Commission discusses ASC only in relation to WACC estimates for regulated energy services. We acknowledge that the principle received its closest scrutiny during the 2014 WACC percentile decision.<sup>17</sup> However, for reasons discussed later in this submission, the economic principle of ASC is equally relevant to the decision-making framework applicable to regulated airports subject to ID regulation. The principle of FCM ought to be applied accordingly for airports when the Commission assesses airport performance.
47. Even if the Commission considers there are mechanisms to mitigate under-investment within ID only regulation, the investment challenges faced by airports globally suggest it would be inappropriate for a regulator to consider that this economic principle was not relevant at all.

#### **Next closest alternative approach**

48. The Commission has proposed the introduction of a next closest alternative ("**NCA**") provision to the IMs.<sup>18</sup> According to the Commission, this provision applies to all entities subject to Part 4 regulation and gives these parties the opportunity to apply an alternative approach when the prescriptive approach in the IM becomes unworkable.
49. NZ Airports believes that this is a sensible addition to Part 4 regulation.
50. In particular, we welcome the Commission's tacit acceptance that it is possible to satisfy the principles of the decision-making framework, other than through rigid adherence to the IMs. Certainly, we see no reason why the use of this alternative approach would not satisfy the decision-making framework (assuming the initial IM requirement did).
51. NZ Airports will provide more detailed submissions on the substance of this proposal with its submissions on the Commission's draft revised IM/ID Determinations.

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<sup>17</sup> Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 143.

<sup>18</sup> Commerce Commission "Input methodologies review draft decision: Report on the IM Review" (22 June 2016), decision GE01, para 50.

## PART 2: TOPIC PAPER 6: WACC PERCENTILE FOR AIRPORTS

### Overview

52. This part of NZ Airports' submission relates to all aspects of Topic paper 6: WACC percentile for airports.
53. Our key points are as follows:
- (a) We welcome the Commission's clarification that its regulatory estimate of WACC is no longer to be seen as a bright line benchmark for the assessment of airport profitability. It is critical for the effectiveness of ID regulation that the mid-point (or any other percentile) is not given undue weight;
  - (b) We support the Commission's intent to undertake a more comprehensive contextual assessment of airport performance (consistent with advice from Professor Yarrow). Key features of such assessment include:
    - (i) The uncertainty of any WACC estimate is recognised;
    - (ii) The regulatory WACC estimate must not have undue prominence or have the influencing effect of essentially prescribing pricing - it is just one factor among many;
    - (iii) Greater focus on airport-specific factors that influence an airport's own estimate of its WACC;
    - (iv) The Commission and interested parties meaningfully engage, with an open mind, on the explanations provided by airports for their specific pricing approaches;
    - (v) An assessment of investment, innovation, efficiency and quality is included (ie all of the Part 4 purpose statement objectives).
  - (c) We disagree with the Commission's proposal to publish the mid-point and standard error only. It is important for the ID regime to provide clear information to interested parties regarding the uncertainty in estimating WACC. The Commission's proposed solution does the opposite, and misleadingly conveys a sense of precision;
  - (d) To facilitate contextual assessment, and to avoid the risk that the mid-point becomes the new bright line profitability benchmark, we propose a more effective approach of publishing percentiles at regular increments and a distribution curve;
  - (e) We disagree with the Commission's views that under ID only regulation, there is less need to be concerned about ASC arising from the risk of mis-estimating the regulatory WACC. That is because:
    - (i) The regulatory WACC estimate has a strong influence on pricing decisions;
    - (ii) Dual till and consultation do not operate to eliminate this risk in the way assumed by the Commission; and
    - (iii) The potential costs to consumers of airport under investment are extensive.

- (f) Accordingly, we ask the Commission to exercise significant caution when using its regulatory WACC as part of profitability assessment, and to retain an open mind on the potential relevance of ASC to:
- (i) Airport price setting - estimating an airport-specific WACC is also an uncertain exercise, with a real risk of failing to attract capital for investment if it is under-estimated. Although airports must not be required to undertake quantification in the same way the Commission did for the energy sector when choosing the 67<sup>th</sup> percentile, they may nevertheless consult on potential options to account for these potential costs; and
  - (ii) Assessment of profitability - again, although the Commission should not undertake quantification to seek to establish a specific percentile, ASC is one reason why the Commission should be very cautious about using the mid-point of its regulatory WACC estimate as reliable evidence of returns that meet the purpose of Part 4.

### WACC percentile range

#### *Overview*

54. In this section, we explain why NZ Airports:
- (a) Recognises the issues that have arisen when using the WACC percentile range for profitability assessment in the past;
  - (b) Nevertheless disagrees with the Commission's concerns about the publication of a WACC range and believes it remains important for the IMs to require the publication of information that clearly conveys the uncertainty of the regulatory WACC estimate.

#### *Commission's problems with the WACC percentile range*

55. The Commission has reiterated some important matters regarding the regulatory WACC estimate:
- (a) It must be estimated because its components (such as the cost of equity) cannot be observed directly;
  - (b) This raises the prospect of estimation error, since it is not possible to know the true cost of equity;
  - (c) To illustrate the potential for estimation risk, the current IM includes a WACC percentile range based on the 25<sup>th</sup> to 75<sup>th</sup> percentile estimates of a probability distribution of the WACC estimate (determined using a standard error of the WACC); and
  - (d) The current IM does not specify how the WACC should be used by interested parties when assessing profitability.<sup>19</sup>
56. The problems identified by the Commission are that:
- (a) The upper limit of any range specified may become the *de facto* benchmark when assessing profitability; and

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<sup>19</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), paras 24 to 26.

- (b) There is limited and weak rationale for the use of the 75<sup>th</sup> percentile as the upper limit of the current WACC percentile range.<sup>20</sup>

57. In summary, as explained in the following sections, NZ Airports' response is that:

- (a) We agree that there should be less emphasis on the upper limit of any range and that there should be no *de facto* benchmark when assessing profitability. In particular, we agree that:
- (i) A specific point estimate or a precisely defined WACC percentile range applied to all airports in all situations is inappropriate; and
  - (ii) The appropriate percentile or range is potentially different for each airport, and it is unlikely to be consistent over time.<sup>21</sup>
- (b) However, we do not think the solution to the identified concerns is to avoid publishing a clear indicator of the WACC estimate's uncertainty;
- (c) There remains a strong rationale for publishing information that clearly conveys to interested parties that estimating the WACC is uncertain. We note that the existing range has been endorsed by the High Court, and has been maintained by the Commission for electricity and gas business information disclosures, for this purpose; and
- (d) The Commission has now clearly signalled a new (and positive) approach to profitability assessment under which no percentile should be given undue prominence, consistent with the established principle that the regulatory estimate of the WACC is not a bright-line benchmark. Reinforcing this approach, including through the way that the WACC is published, is the best way to deal with concerns about specific percentiles receiving undue prominence.

*Uncertainty in WACC must be clearly signalled to interested parties*

58. The key reason why we disagree with the Commission's proposed solution is that the uncertainty in estimating WACC must be fully and clearly conveyed to interested parties.

59. In its Airports IM Reasons Paper in 2010, the Commission acknowledged the inherent uncertainty of WACC estimates, and indicated that this was the reason for publishing a range:<sup>22</sup>

In estimating the cost of capital, the Commission recognises that this is an estimation process, which is likely to be imprecise.

...due to the imprecision of the cost of capital estimation, the Commission will estimate a range for the cost of capital.

...due to the uncertainty and standard errors associated with the key parameters used in the estimation of the cost of capital, the Commission will identify a cost of capital range.

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<sup>20</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), paras 28 to 32.

<sup>21</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 103.

<sup>22</sup> Commerce Commission "Input methodologies (Airport Services) reasons paper" (22 December 2010), paras [E1.28] to [E1.29] band [E1.14].

60. In its Merits Review judgment, the High Court similarly regarded the task of determining the cost of capital as a "search for spurious precision".<sup>23</sup> That is because, as the High Court held:<sup>24</sup>

The three formulas that underpin the cost of capital IMs, that is for the WACC, the cost of debt and the cost of equity, give an appearance of mathematical precision. The reality is, however, far from that. As these appeals show, the parameters in those formulas, far from being measurable or otherwise certainly determinable, reflect estimation processes of varying degrees of complexity.

61. When reviewing the WACC percentile for the electricity lines and gas pipelines sectors in 2014, the Commission also chose to maintain a range approach for information disclosure purposes because there was no basis to think that estimating the WACC had become more certain. The Commission noted:<sup>25</sup>

The WACC cannot be observed and must be estimated. The WACC range reflects and illustrates this uncertainty.

Submissions received on this topic raised questions about narrowing the WACC percentile range. In particular, Sapere noted that using the range of the 33<sup>rd</sup> to the 67<sup>th</sup> percentile would mean that there is only a 34% probability that our range contains the true WACC.

In response, all submissions (which were all from suppliers) on our revised Draft decision agreed it was more appropriate to retain the 25<sup>th</sup> to 75<sup>th</sup> percentile range than to adopt a narrower range.

62. Professor Yarrow's views are consistent with this rationale. As he identified, WACC estimates are derived from a series of propositions that contain significant speculative elements.<sup>26</sup>

63. Accordingly, it is important that the Commission's proposed solutions do not convey to interested parties that its estimate of WACC has somehow become more precise. As we discuss below, there is a high risk that this is exactly what the Commission's proposals will do.

*The Commission's proposed solutions*

64. The Commission proposes to amend the IM so that:

- (a) Only the mid-point estimate of WACC is published (ie there will be no range); and
- (b) The Commission's view of the standard error (0.0144) will also be published. This can be used to determine the probability distribution and any individual WACC percentile required.

65. NZ Airports disagrees with the Commission's view that "this approach is likely to contribute to an information disclosure regime that is best able to allow interested parties to assess whether airports are limited in their ability to extract excessive profits or not".<sup>27</sup> In NZ Airports' view, this proposal is likely to create a misleading impression for interested parties about the reliability and accuracy of the mid-point estimate because it fails to adequately highlight the uncertainty and judgment associated with either the mid-point estimate or the standard error

<sup>23</sup> *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289, para 1189.

<sup>24</sup> *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289, para 1188.

<sup>25</sup> Commerce Commission "Amendments to the WACC percentile range for information disclosure regulation for electricity lines and gas pipeline services reasons paper" (12 December 2014), paras 2.8.1, 2.3, 2.5.

<sup>26</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 5.

<sup>27</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 87.

estimate itself. The High Court expressed considerable doubt about the ability of the standard error, by itself, to provide adequate information to interested parties about the uncertainty associated with the mid-point estimate.<sup>28</sup>

...the Commission acknowledged that its use of standard errors had involved the making of judgements (rather than the pure application of statistical estimation techniques). It also involved assumptions about the probability distributions of the estimates. Consequently, the resulting confidence intervals and percentile figures should not be considered as having the precision that is implied by the terminology.

66. The result of the Commission's proposal to publish a standard error of 0.0144 and a mid-point is that interested parties will not have sufficient appreciation as to the degree of uncertainty and complexity in estimating the WACC. It is not reasonable to expect them to have statistical knowledge to make sense of the information. Without that knowledge, they are likely to resort to the mid-point as a "hard" number. That is contrary to the purpose of the ID regime, which is targeted at ensuring that information is readily available to interested persons to assess whether the purpose of Part 4 is being met.
67. In essence, NZ Airports believes the Commission has a duty to ensure the ID requirements fairly present all relevant information, which will not be achieved under the current proposal. The IMs must ensure that interested parties can meaningfully evaluate the information that has been provided by airports and make informed judgements about whether the purpose of Part 4 is being met. Moving away from a range towards a single point estimate (albeit with a standard error) runs the risk of interfering with that informed estimate by creating a misleading assumption about the accuracy of the WACC IM mid-point estimate as a reference point.
68. The clear risk under the Commission's proposed solution is that instead of the 75<sup>th</sup> percentile being the focus of any assessment, it will become the mid-point. In fact, the mid-point risks becoming an even stronger focus because:
- (a) Only the mid-point and standard error, and not a range, will be published;
  - (b) There is a proposed requirement for airports to "justify" any departure from the mid-point. This strongly - but erroneously - implies that the mid-point is the "correct" level of return; and
  - (c) The Commission is reluctant to accept that ASC require it to treat the mid-point with particular caution given the risk of mis-estimation (discussed in a later section).
69. We also raise another issue for the Commission to consider. It appears to us that the Commission's proposals to amend the ID Determination will breach the Act:
- (a) Currently, the IMs require the Commission to determine and publish an estimate of WACC. The airports are then required to include the relevant WACC estimate in their annual disclosures (which is compared to their disclosed returns). Under this approach, the airports are not required to apply the WACC IM when compiling their disclosures;
  - (b) The proposed ID amendments, which will also be effective for price setting information disclosures, will require an airport to disclose WACC percentile equivalents for their cost of capital and forecast IRR. As we understand it, airports will be required to apply the IM mid-point WACC and standard error to make these calculations. This is different to the current situation above;

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<sup>28</sup> *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289, para 1450.

- (c) The proposed approach breaches the Act because:
- (i) Section 53F(1) of the Act provides that airports do not have to apply WACC IMs; but
  - (ii) The proposed amendments require the airports to apply the WACC IM to calculate and disclose the percentile equivalents.<sup>29</sup>

70. The Commission may therefore wish to further consider whether its proposed approach to publish percentile estimates needs to be adjusted.

*NZ Airports' alternative solutions*

71. NZ Airports emphasises that it agrees with the Commission's direction of travel regarding the use of WACC estimates in profitability assessment. Our point is that its proposed amendments to the WACC percentile range are not a necessary or desirable step in that journey.

72. In order for the Commission to achieve its purpose of lessening focus on a rigid comparison between a regulatory WACC estimate and airport returns (which we support), and to instead allow a full contextual assessment in a manner that is accessible and transparent to interested parties, NZ Airports strongly believes the key solutions are:

- (a) To emphasise that profitability assessment will involve full contextual assessment - as the Commission is doing. This will provide a clear signal to all interested parties that it is wrong to focus on the regulatory WACC estimate as a benchmark for acceptable returns;
- (b) Publication of regular percentile estimates (potentially from the 5<sup>th</sup> to 95<sup>th</sup> percentile, but possibly at greater intervals of, say, every 10<sup>th</sup> percentile), to provide a clear signal to interested persons that the estimate of WACC is uncertain and that it is wrong to focus on any particular percentile. We think that this provides interested parties with the most meaningful information about the distribution of the regulatory WACC estimate. It also appropriately conveys the uncertainty that the Commission acknowledges is inherent in that estimate; and
- (c) The publication of a distribution curve for the regulatory WACC estimate would also be a helpful addition to information disclosure. If the Commission maintains the approach in its draft decision (ie to publish the 50th percentile only), then we think publishing a distribution curve is essential.

73. To summarise how we have arrived at this position:

- (a) NZ Airports has historically supported the publication of a WACC range;
- (b) Throughout the original IM process, we strongly encouraged the Commission to adopt a broader range than the 25th to 75th percentiles. We took this approach to the High Court, which considered that the current range was appropriate in the context of ID regulation and provided good information to interested parties;
- (c) On that basis, we started the IM review process by supporting the status quo – the current range – based on the evidence and information that was available at that time;

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<sup>29</sup> This compares to the current requirements, where the airports are simply required to disclose the WACC calculated and published by the Commission - that is, the airports are not required to apply the WACC IM.

- (d) Since then, Professor Yarrow provided expert views suggesting there was merit for an alternative approach – ie the publication of regular percentile estimates from the 5th to 95th percentiles. The Commission's emerging views indicated it was open to this alternative. This aligned with NZ Airports' views during the original IM process, and we expressed our strong support for this option; and
- (e) This did not mean that we considered a range was no longer required, as the Commission appears to suggest.<sup>30</sup> Rather, it meant that we considered a broader range was required, and that Professor Yarrow and the Commission's alternative option of publishing regular increments from the 5<sup>th</sup> to 95<sup>th</sup> percentiles achieved this.

74. We do not understand the Commission's logic for rejecting NZ Airports' preferred solution of publishing regular percentile increments. The Commission agrees that it will provide flexibility in profitability assessment and convey that a single WACC percentile is not appropriate for all situations. However, it believes its downfall is that "it maintains a focus on numerical percentile estimates", which it wishes to de-emphasise.<sup>31</sup> Yet under the Commission's preferred solution:

- (a) There is a strong focus on the mid-point as the appropriate starting point; and
- (b) Airports will be required to publish percentile equivalents, which strengthen the focus on numerical percentile estimates.

*Publication of a distribution curve*

75. NZ Airports believe that publication of a distribution curve for the regulatory WACC estimate would be a valuable addition to the ID regime. In our view:

- (a) It could complement publication of regular percentile increments; or
- (b) It will be essential if the Commission maintains its current approach of only publishing the mid-point and standard error.

76. As discussed above, the Commission has acknowledged the imprecision in the process of estimating the WACC. The uncertainty surrounding the Commission's point estimates of the parameters translates through to the estimate of WACC as there is an algebraic relationship between the parameters and WACC. The process of generating the estimates is a variable process that yields a different value each time an estimate is made. The estimate of WACC can therefore also be thought of as a variable process and as a result has a sampling distribution.

77. The point estimate of WACC by the Commission may be more or less than the mean value of the distribution of WACC, which is unknown. The Commission assumes that its estimate of WACC is unbiased. That is, that the expected value of the estimator is equal to the mean of the sampling distribution, and that the sample distribution is a normal distribution. This distribution does not allow for model error so the mean value may differ from the true WACC.

78. While the distribution can be calculated from the standard error and the mean, this requires manipulation of the data that requires a level of technical expertise and will not be straightforward for all interested parties. By publishing the distribution curve, the Commission will assist interested parties to assess if the purpose of Part 4 has been met. Interested parties will be able to:

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<sup>30</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 97.

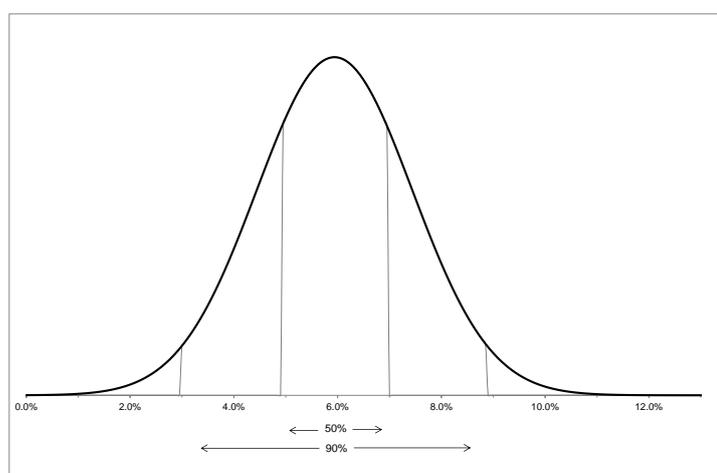
<sup>31</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 108.

- (a) Consider the airport-specific elements that may justify why an airport's estimated WACC in pricing differs from the Commission's estimated WACC; and
- (b) Observe and make judgments based on where an airport's estimated WACC and/or targeted return sits on the distribution curve, which is appropriate given the inherent uncertainty in estimating the WACC.

79. Figure 1 shows the type of illustration the Commission could publish.<sup>32</sup> The figure illustrates two confidence intervals around the Commission's estimate of WACC. These types of illustrations would assist interested parties to understand the probability that a targeted return exceeds the mean WACC.

80. A distribution curve could take the form of that set out in Figure 1:

**Figure 1: Proposed distribution curve**



- 81. The publication of this distribution will therefore illustrate to stakeholders the uncertainty associated with the parameter estimates of the WACC. At the same time, it removes the “focus on numerical percentile estimates” that the Commission wants to avoid.<sup>33</sup>
- 82. NZ Airports considers that publishing a distribution curve would therefore better assist in meeting the purpose of ID than only providing the WACC estimate and standard error. It would be more effective at providing sufficient information to allow interested persons to assess if the purpose of Part 4 is being met by ensuring that information is accessible and meaningful to interested persons.
- 83. If the Commission disagrees with NZ Airports that a distribution curve appropriately conveys the degree of uncertainty involved in the task of estimating the WACC, then NZ Airports would welcome the Commission proposing an alternative means by which to convey the uncertainty and range of WACCs that exist.

#### **Use of regulatory WACC estimate under ID for airports**

##### *Overview*

<sup>32</sup> The data in Figure 1 reflects the post-tax WACC for Auckland International Airport Limited and Christchurch International Airport Limited information disclosure year 2017. See Commerce Commission "Cost of capital determination for information disclosure year 2016 for Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end)" [2016], p 15.

<sup>33</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 108.

84. We now provide our views on how the regulatory WACC estimate should be used in profitability assessment.
85. Overall, NZ Airports welcomes the intent of the Commission's draft decision - to remove undue focus on comparing airport returns to the regulatory WACC estimate, and instead encourage assessment of airport-specific circumstances under a full contextual assessment.
86. The challenge for the Commission in making contextual profitability assessment real and effective is to make it clear to interested parties that the WACC estimate is just one factor among many to be considered in profitability assessment. Any judgment of excessive profitability must be based on some underlying analysis if it is not to be arbitrary.<sup>34</sup>
87. Put another way, the regulatory WACC estimate is simply one of many factors that ensure that sufficient information is readily available to interested persons to assess that the purposes of Part 4 are being met as per section 52A of the Act.
88. In that context, further key points we wish to emphasise are as follows:
- (a) The Commission's estimate of the WACC should be a light-touch indicator of acceptable returns, and not a bright line benchmark. The inherent uncertainty of the WACC estimate is a central reason for this;
  - (b) Comparing returns to the regulatory WACC estimate should not receive undue prominence in a broader contextual assessment of airport performance;
  - (c) Airport-specific contextual factors are important when considering an airport's targeted returns;
  - (d) Airports will be responsible for fully explaining their decisions. NZ Airports looks forward to the Commission meaningfully engaging with an airport's reasons for estimating a different WACC if or where that occurs. In particular, NZ Airports is encouraged by the Commission's commitment to considering airport-specific factors; and
  - (e) NZ Airports disagrees with the Commission's assumption that ASC will be less relevant for airports than other sectors. The nature of the consequences of under-investment are different for airports than other sectors, but no less severe. As such, social consequences of under-investment should be a relevant consideration when:
    - (i) An airport sets its pricing WACC and/or target returns (if it chooses to consult on options to account for the risk of ASC); and
    - (ii) The Commission undertakes *ex-post/ex-ante* profitability assessments using its regulatory estimate of WACC.

*How regulatory WACC should operate in the context of ID: advice from Professor Yarrow*

89. We understand that the Commission is seeking to provide a platform to undertake future profitability assessments in a manner that is much closer to that advised by Professor Yarrow (in comparison to the section 56G approaches).

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<sup>34</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 3.

90. We have previously submitted our view on what fully implementing Professor Yarrow's advice would mean for profitability assessment:<sup>35</sup>

There is an opportunity to remove the focus on technical and narrow discussions around the comparisons of returns with a WACC estimate (where the risk of regulatory error is high), and increase focus on assessing whether airports are delivering outcomes that are in the long-term interests of consumers.

91. Professor Yarrow's expert advice affirms that contextual factors are most important when considering an airport's targeted returns, and not comparing returns against a regulatory estimate of WACC.<sup>36</sup> That is because:

- (a) ID is designed to facilitate explanations of what airports have done, and what their intentions were. That can only be understood through contextual analysis; and
- (b) In NZ Airports' view, contextual analysis includes things such as the airport investment cycle, the level of airport investment, efficiency and quality of performance and external market factors.

92. Moreover, the role of the WACC estimate needs to be thought of in the context of the potential harm that ID regulation seeks to identify and regulate: adverse effects (on consumers) from the exercise of market power ("**AEEMP**"). Numerical comparisons between the regulatory WACC and forecast or achieved returns on their own do not assist in that enquiry. That is why such numerical comparisons ought only to be regarded as one part of that broader contextual assessment that seeks to identify and regulate the risks of AEEMP.

93. According to Professor Yarrow's evidence, the WACC estimate, by and of itself, is not an appropriate benchmark for judging profits.<sup>37</sup> Similarly, the Commission states that it continues to rely on its Emerging Views paper, in which the Commission outlined an attempt to reduce focus on specific WACC values.<sup>38</sup> On that basis, if the regulatory WACC estimate is used as a benchmark, as the Commission proposes,<sup>39</sup> then in NZ Airports' view it needs to be a light-touch benchmark only.

94. We agree that the excerpts from Professor Yarrow's advice cited by the Commission are important.<sup>40</sup> Other points made by Professor Yarrow that we think the Commission should have particular regard to are:

- (a) Regulatory WACC estimates should not have a privileged position in profitability assessment. Professor Yarrow is clear in his advice that it is wrong to assume that any positive deviation of target or actual returns from the regulatory estimate of the

<sup>35</sup> NZ Airports "Submission on Commerce Commission emerging views on the WACC percentile for airports" (16 March 2016), p 2.

<sup>36</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 20.

<sup>37</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 20.

<sup>38</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 62.

<sup>39</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 40.

<sup>40</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), paras 50 to 53.

WACC is indicative of excessive profitability. In part, this is due to the inherent uncertainty of the WACC estimate;<sup>41</sup>

- (b) There can be legitimate differences between an airport's targeted return and the WACC.<sup>42</sup> Professor Yarrow observed that, conceptually, the WACC is not a measure of return, and the Commission must not lose the "conceptual distinction" between an airport's rate of return and the WACC.<sup>43</sup> In particular, returns can be expected to be higher than WACC.<sup>44</sup> NZ Airports agrees, and believes that Professor Yarrow's findings provide an appropriate backdrop against which to consider the role of the regulatory WACC estimate in ID regulation. We acknowledge the Commission's statement that:<sup>45</sup>

We agree that care needs to be taken when using the WACC to assess profitability and our emerging views paper outlines how we are attempting to reduce the focus on specific WACC values.

- (c) A contextual and proportionate regulatory response is required if an airport's return (actual or targeted) diverges from the regulatory estimate of the WACC;<sup>46</sup>
- (d) In addition, NZ Airports considers that the following issues are important to any discussion of the concept of proportionality:
- (i) The concept of proportionality is broad and should be applied in such a manner. That is, small deviations from the regulatory estimate of the WACC should receive a proportionate regulatory response, in particular to reflect the inherent uncertainty involved in estimating the WACC; and
  - (ii) To that end, NZ Airports invites the Commission to consider the North American courts' test of only taking action in the event of "egregious deviation" as referred to by Professor Yarrow.<sup>47</sup>

95. By signalling a move away from a strict focus on numerical comparisons, and instead promoting proportionate contextual assessment of airport profitability as advised by Professor Yarrow, the Commission is promising to undertake analysis that much better reflects how NZ Airports envisaged ID regulation would originally be implemented under Part 4.

*Airport-specific factors are important*

96. We are pleased the Commission has acknowledged that airport-specific factors are directly relevant to its profitability analysis, and that it will engage with these factors when considering and reporting on airport performance.<sup>48</sup>

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<sup>41</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 20.

<sup>42</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 54.

<sup>43</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 11.

<sup>44</sup> Sapere "The distance between the "allowed rate of return" and the "cost of capital"" (16 March 2016), p 9.

<sup>45</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 62.

<sup>46</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 53.1.

<sup>47</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), pages 4, 8.

We consider that a precisely defined WACC percentile range applied to all airports in all situations is not appropriate for the IMs. Airport-specific factors should be considered when undertaking an assessment of whether individual airports are meeting the purpose of Part 4.

97. Being the complex businesses that they are, this is a welcome acknowledgement of the fact that airports are best-placed to consider the influence that unique factors and circumstances will have on each airport's pricing decisions.
98. NZ Airports understands that the Commission's approach requires:
- (a) Airports to engage responsibly, explaining their actions in a transparent way that enables a informed assessment by interested parties as per the purpose of ID;
  - (b) The Commission to be open minded when assessing airport profitability: that is, to consider airport explanations with an open mind and encouraging free dialogue. In that sense, key now is that the Commission is open to there being legitimate reasons why targeted returns may deviate from its regulatory WACC estimate mid-point;
  - (c) Airports' key concern has previously been that an undue focus on comparing the targeted rate of return to the Commission's WACC estimate would preclude more open and engaged dialogue on a broader range of relevant factors. NZ Airports now looks forward to such dialogue occurring in the future.

*Airport-specific WACC*

99. In this section, we provide our view on the following points:
- (a) The Commission's acknowledgement that airport pricing WACCs can depart from its estimate of regulatory WACC; and
  - (b) The Commission's view that there is limited scope for a general uplift to an airport's estimate of WACC.
100. The Commission has established a clear (and welcome) expectation that an airport's WACC (and also its targeted and actual returns) may legitimately differ from the mid-point regulatory WACC estimate.
101. In stating that airports are free to use their own airport-specific estimates of the WACC in pricing, the Commission is reflecting the legislative framework, which it has always acknowledged. The key new emphasis, which NZ Airports looks forward to seeing occur in practice, is that the Commission is promising to fully engage with the reasons why an airport may choose to adopt a WACC that departs from the WACC IM estimate.
102. Such a commitment would mean that when the Commission is considering if an airport is acting consistently with the long-term interests of consumers, airport-specific factors will be just as important as the regulatory WACC estimate.
103. Although the Commission is open to airports using estimates of WACC that depart from the IM estimate of WACC, it explains why it believes a general uplift to an airport's WACC is unlikely to be appropriate. Essentially, the Commission's rationale is that:
- (a) An uplift to compensate for asymmetric risk faced by the airport may be appropriate;

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<sup>48</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 82.

- (b) However, because airports can determine an appropriate WACC that promotes investment, the "under-investment" problem does not arise in the same way as for entities subject to price control (where the Commission's regulatory WACC estimate determines allowable revenues). Accordingly, an airport should simply determine its own WACC that it considers appropriate - and therefore should not need to apply a general uplift to its own estimate of WACC. For example, the Commission states:<sup>49</sup>

As a result of using its own estimate of WACC to set its prices, it is not apparent why an airport would defer investment because the WACC (which it sets for itself) is too low.

104. NZ Airports believes the Commission's position fails to appreciate the complexities and challenges airports face when they determine pricing WACCs. Airports cannot directly observe their own WACC, which is why they too may estimate a WACC range.
105. Airports are complex capital-intensive businesses for whom a mis-estimation of the WACC can have significant flow-on effects on investment and for consumers. Airports are conscious that although they do not know the market's expectations of returns on equity and debt, the returns targeted by the airport will influence the market's willingness to subsequently invest. If an airport's WACC estimate and target return is set too low, an airport is likely to face difficulties in attracting the necessary capital and shareholder support that it will need to fund its investment portfolio. Accordingly, the potential negative consequences are real and significant for consumers where under-investment occurs as a result of an airport's pricing WACC estimate being set too low.
106. In that context, the Commission should be open minded if airports take ASC into account in some fashion when determining a pricing WACC within their range - in the same way the Commission is open to considering business-specific asymmetric risks (such as for catastrophic events). This does not mean that each airport can reasonably be expected to run the type of extensive quantification analysis undertaken by the Commission for the energy sector's regulatory WACC, but it should at least remain open to them to choose (and explain) methods to accommodate the risk of ASC.

*Justification of returns*

107. The Commission has noted its view that the key consideration for the Commission when assessing any departure from the regulatory WACC estimate is the extent to which it promotes the long-term benefit of consumers, and that any reasoning for setting a targeted return above the mid-point needs to consider this purpose.<sup>50</sup>
108. In taking this approach, NZ Airports will expect the Commission to:
- (a) Consider all objectives under the Part 4 purpose statement; and
- (b) Take a broad view on how methodologies may better promote the purpose statement, as it is under this review. For example, a methodology that is more robust and accurate to suit airport-specific circumstances will promote the purpose of Part 4.
109. Subject to those caveats, airports are comfortable with providing reasons for any difference in estimated WACC (such as, for example, airport-specific and contextual factors), as well as business and pricing decisions that influence determination of the overall target return. We

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<sup>49</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 67.

<sup>50</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 63.

recognise that this information will aid informed assessment by stakeholders in furtherance of the purpose of ID (section 53A of the Act).

110. However, NZ Airports is concerned that the Commission's language of requiring "justification" for any difference between an airport's WACC estimate and the Commission's WACC estimate further implies an unwarranted degree of accuracy of the mid-point as a benchmark of acceptable returns. As we discuss in a later section, we believe that the profitability assessment framework needs to recognise that the mid-point is subject to a material risk of mis-estimation.
111. Further, although airports will of course consider consumer interests when making their decisions, the onus will be on the Commission to prove that targeted returns that happen to be above the regulatory WACC estimate are *not* in the long-term interests of consumers (ie are contrary to the purpose of Part 4). As discussed above, there would need to be clear evidence to support such a finding, and it will not be sufficient to simply point to returns being higher than the regulatory mid-point, especially in light of the risk of ASC for consumers if the Commission wrongly diagnosing excess profits (discussed in the next section).

### Consideration of the rationale for an uplift to the regulatory WACC

#### Overview

112. In Chapter 5 of Topic paper 6, the Commission explains:
- (a) Why it considers the ability of the WACC IM to constrain investment is more limited for airports than other sectors;
  - (b) Why its consideration focuses on asymmetric consequences to consumers from mis-estimating WACC; and
  - (c) The potential relevance of a quantitative model.
113. This section of the submission explains NZ Airports' position that:
- (a) Both NZ Airports and the Commission agree that the mid-point WACC risks being mis-estimated by the Commission;
  - (b) Despite the Commission's welcome assurance that the mid-point regulatory WACC estimate will not be rigidly applied as the benchmark for acceptable returns, it will still impact on incentives to invest in regulated services. The current unknown is the strength of the link between the mid-point estimate and pricing and investment decisions - not whether there is any link at all;
  - (c) There are significant costs to consumers if airports under-invest in their aeronautical activities;
  - (d) It is therefore inappropriate for the Commission to adopt a position that it need not worry about whether its use of the mid-point estimate fails to promote investment in accordance with the purpose of Part 4, on the assumption that airports can set their own return and/or other factors will compensate for regulatory error; and
  - (e) The solution is for the Commission to clearly acknowledge that when undertaking profitability assessment, it will need to exercise significant caution before concluding that any returns above the mid-point are excessive. Certainly, it would be contrary to the long-term interests of consumers to presume or deem that to be the case.

*Potential for the regulatory WACC estimate to constrain airport investment*

114. The Commission seeks to justify its view that the mid-point of its WACC estimate is an appropriate "starting point" for profitability assessment because there is a low risk of it constraining airport investment.
115. NZ Airports disagrees. Key reasons are that:
- (a) As the Commission itself acknowledges, the IMs influence pricing decisions. The WACC IM, and the Commission's application of this in the section 56G reviews, had a proven impact on pricing in the case of Wellington International Airport Limited, which reset its prices in 2014 following the section 56G review;
  - (b) Airports come under strong pressure from airlines to apply the mid-point regulatory WACC in pricing;
  - (c) If the Commission determines that an airport is targeting excess profits because its returns are higher than the regulatory WACC mid-point, then that is a strong incentive on the airport to price in accordance with the regulatory WACC estimate;
  - (d) It is wrong to think that consultation protects against the risk of under-investment - it is more likely that airlines will seek a lower pricing WACC; and
  - (e) NZ Airports therefore believes there is a risk that the Commission's assessments of profitability can cause an under-investment problem, particularly if it wrongly diagnoses that an airport is targeting excess returns.
116. The Commission acknowledges the potential for negative consequences for consumers from mis-estimating the WACC in the context of the energy sector. However, in the context of airports it considers that:<sup>51</sup>
- The link between the WACC under information disclosure and the impact on airport behaviour is a more complex relationship...However, we do not consider the link between our mid-point estimate of WACC and investment is as strong as the case of a supplier subject to a price-quality path.
117. In our view, there will always be a link between the mid-point estimate of WACC and airport investment. The variable is the strength of the link. The link will be strong if the Commission maintains a section 56G review-type approach to profitability assessment. For example, the Commission has previously stated:<sup>52</sup>
- We do not agree with BARNZ's (Board of Airline Representatives NZ) argument that information disclosure can never be effective at limiting excessive profits, simply because information disclosure is not price control. We recognise that airports can set prices as they see fit under the AAA. However...Parliament intended that information disclosure would influence price setting by airports. In Auckland Airport's case, our conclusion is that information disclosure has done so, and done so effectively.
118. The Commission also appears to accept that its regulatory estimate of the WACC can have an influence on an airport's pricing and investment decisions:<sup>53</sup>

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<sup>51</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), paras 117, 119.

<sup>52</sup> Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), para 2.11.

<sup>53</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 118.

Clearly, the level of our estimate of WACC will have some effect on airport behaviour. For example, Wellington airport revised its prices following our review of its performance in the s 56G report. We recognise this could, potentially, adversely affect investment where we have mis-estimated the WACC.

119. The Commission also advised Ministers that it used the 75<sup>th</sup> percentile to assess profitability to reflect the "uncertainty of estimating the true cost of capital **and in light of the direct consequences** of estimation error on pricing and investment" (emphasis added).<sup>54</sup> Similarly, in its IM Reasons Paper, the Commission noted the need for asymmetric consequences to be taken into account when estimating the WACC.<sup>55</sup>
120. It will inevitably remain the case in practice that the mid-point regulatory WACC estimate will maintain a prominent influencing role in price setting consultations and subsequent profitability assessment by the Commission.
121. For example, Air New Zealand has submitted previously to the Commission that it sees no commercial justification for paying more than the regulatory estimate of the WACC on investment.<sup>56</sup> Similarly, BARNZ has submitted:<sup>57</sup>

There is...no reason to depart from the mid-point WACC estimate when assessing the appropriateness of the level of profitability being targeted by an airport.

122. Air New Zealand and BARNZ's positions, plus the threat of further regulation, mean that the Commission's estimate of WACC therefore has a real and significant effect on an airport's ability to target returns that will attract new investment.
123. The impact of the regulatory WACC estimate on investment under ID will materially depend on the Commission's approach to ID and how it assesses airport conduct. The Commission appears to accept this,<sup>58</sup> but NZ Airports is concerned that the mid-point becomes the starting and end point for any future assessment. It is therefore critical that the Commission undertakes its profitability assessment differently in the future.

### Consultation

124. The Commission's view that consultation protects against under-investment is strongly opposed by NZ Airports:<sup>59</sup>
- (a) It is contrary to practical experience to expect airlines to be willing to pay above the Commission's regulatory WACC estimate. As referred to above, Air New Zealand has previously advanced its clear view that it sees no commercial justification for paying more than the regulatory WACC estimate on investment;<sup>60</sup>
  - (b) If that level of WACC is not sufficient to fund the required investment, yet airlines are not prepared to pay anything above that, it is hard to see how consultation can bridge the gap and ensure the investment goes ahead; and

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<sup>54</sup> Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), para E27.

<sup>55</sup> Commerce Commission "Input methodologies (Airport Services) reasons paper" (22 December 2010), para E12.1.

<sup>56</sup> Air New Zealand "Emerging views on the airport WACC Percentile" (11 March 2016).

<sup>57</sup> BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p 3.

<sup>58</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 120.

<sup>59</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 122.2.

<sup>60</sup> Air New Zealand "Emerging views on the airport WACC Percentile" (11 March 2016).

- (c) In addition, if the Commission reinforces that the mid-point is the relevant starting point, then it will be even more difficult to engage with airlines on alternative approaches for different projects.

#### Dual till

125. In the Commission's view, the "value of complementary revenue streams is perhaps the strongest rationale for the limited ability of our [the Commission's] estimate of WACC to constrain airport investment."<sup>61</sup> The Commission's reasoning for this view is that airports:<sup>62</sup>
- ...are subject to a dual till structure (whereby they can earn significant amounts of revenue from unregulated complementary activities) - this means that aeronautical investments are likely to take place even in instances when the regulated return is too low if the difference can be made up from complementary unregulated revenue streams.
126. Because the Commission believes the returns airports anticipate from non-aeronautical activities will be higher than those obtained from aeronautical activities, it appears to think it should not be concerned about underestimating the WACC, because airports will still invest to obtain non-aeronautical revenues.
127. NZ Airports disagrees. Our position is that:
- (a) Such an approach fails to properly apply Part 4 of the Act; and
- (b) It is based on a broad assumption that all investment brings non-aeronautical revenue. That is not robustly supported by evidence.
128. NZ Airports believes that using complementary revenue streams as a reason to risk setting regulatory WACC too low fails to properly apply Part 4 of the Act because:
- (a) Part 4 directs the Commission to focus on incentives for regulated activities through the methodologies and Determinations that apply to those activities only;
- (b) Part 4 attempts to limit the situations in (and purposes for) which the Commission can have regard to a company's unregulated businesses - eg cost allocation IMs must not affect investment in unregulated businesses and where consolidated financial information is required this can only be used to monitor compliance of the regulated business with ID requirements; and
- (c) Taken as a whole, Part 4 does not allow the Commission to make decisions that will not promote the Part 4 purpose statement in relation to the regulated business, on the basis that such regulatory failure will be offset by other naturally occurring incentives.
129. Put another way, the Commission is creating a regulatory risk that the monitoring point for airport returns is set too low, potentially leading to airport pricing that is too low, and is refusing to provide regulatory compensation/protection for that risk. By doing so, it is effectively requiring airports to use their unregulated businesses as a buffer or risk offset to protect itself, and consumers, against the potential consequences of a regulatory risk on investment in regulated services. This then risks constraining unregulated investment because the returns

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<sup>61</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 123.

<sup>62</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 122.1.

that can be achieved are not sufficient to meet commercial objectives and compensate for low regulated returns.

130. In addition, the Commission's position relies on the unsubstantiated assumption that the dual till factor will have a "significant effect" on airport investment decisions.<sup>63</sup> Although the Commission acknowledges that NZ Airports has previously submitted that the dual till has limited relevance to aeronautical investments which have no major impact on passenger throughput or flow-on effects to non-aeronautical profits,<sup>64</sup> it does not engage on the conceptual merits of these arguments, but merely observes that BARNZ has a different view.<sup>65</sup>
131. In NZ Airports' view, the position adopted by the Commission is not supported by robust evidence. We do not dispute that there is evidence suggesting the market places a higher value on airports' unregulated business and/or that the prospect of benefits to the unregulated business can provide additional incentives for airports to invest in some, but by no means all, aeronautical activities. The point we have repeatedly made is that the situation is far more complex than the Commission suggests.
132. We have considered whether it is possible to provide empirical evidence to refute the Commission's generalised assumptions about the impact of the dual till on incentives to invest in regulated activities. However, given the complexity of the relationship between activities, which will differ on a project by project basis, we believe that that amount of resource that would be spent compiling such evidence would be highly disproportionate given that:
- (a) This should be a light-handed ID regime;
  - (b) Dual till incentives should not receive undue prominence within the broad range of factors that are relevant to full contextual assessment of performance; and
  - (c) The Commission is committed to placing less emphasis on numerical comparisons between airport returns and its estimate of WACC.
133. Nevertheless, based on their investment experience, the airports remain strongly of the view that the Commission has over-simplified that relationship between regulated and non-regulated activities, and that the impact of the dual till is more complex and far less pervasive than it assumes.
134. We also note that the ACCC is unconvinced that investment at the airports it monitors is occurring at the required pace. In its 2013-2014 monitoring report, the ACCC noted that:<sup>66</sup>

...despite continued investments, it is not clear that the nature, size and timing of investments have added sufficient capacity to avoid congestion or accommodate forecast growth. Increased passenger growth and aircraft movements over time have begun to place pressure on existing aeronautical assets at a number of monitored airports.

[...]

In the long-term, the most efficient way of alleviating aeronautical congestion is through timely investment to expand capacity. Although most of the monitored airports have plans in place to address aeronautical congestion issues through capacity

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<sup>63</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 148.

<sup>64</sup> NZ Airports "Submission on Commerce Commission's input methodologies review: Invitation to contribute to problem definition" (21 August 2015), para 156.

<sup>65</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), paras 147, 148.

<sup>66</sup> Australian Competition & Consumer Commission "Airport Monitoring Report 2013-2014" (April 2015), p 23, 24.

expansions, it appears that some of these investments have not occurred in a timely manner. For example, Brisbane Airport undertook an extended process in committing to the construction of its new runway, while Perth Airport was delayed in investing in new facilities to address passenger growth and ongoing quality of service issues.

135. The ACCC's comments, and in particular the example of Brisbane Airport, show the potential costs of under-investment. These risks are real and have clear negative consequences, including where airports are subject to light-handed monitoring, consult with their airline customers and operate a dual till (as is the case in New Zealand and Australia).
136. Given the limited evidence in support of its preliminary view, we invite the Commission to keep an open mind on this matter, and to substantively engage on the conceptual merits of NZ Airports' previously submitted positions on the significance of the dual till before concluding that there is a limited ability for the regulatory WACC estimate to constrain aeronautical investment.

#### **ASC are relevant to WACC IM**

137. In light of its view that the regulatory WACC estimate is unlikely to cause an under-investment problem, the Commission is of the view that there is no need to apply an uplift to the regulatory WACC estimate to account for ASC.
138. Although we do not wish the Commission to quantify a specific WACC percentile as it did for energy businesses (because that becomes a benchmark bright-line), we nevertheless think ASC remain relevant under ID regulation.
139. The potential for the Commission to mis-estimate WACC remains real in the ID context, and NZ Airports believes that:
- (a) Such mis-estimation will impact on investment incentives; and
  - (b) There will be significant asymmetric consequences for consumers from mis-estimating the WACC.
140. Accordingly, in NZ Airports' view, ASC need to be considered when the Commission conducts *ex-post/ex-ante* profitability assessments using its regulatory WACC estimate. The asymmetric consequences of under-investment provide a good reason to not rely on the mid-point WACC estimate as strong evidence of acceptable returns.
141. In practice, what this means for profitability assessment is that in addition to taking into account airport reasons for why their returns may deviate from the mid-point WACC, the Commission will also need to factor into its assessment that the regulatory mid-point estimate could be wrong. Due to the existence of ASC, the Commission will need to be particularly cautious before concluding that an airport is targeting excessive returns simply because they are above the mid-point.

#### *ASC are real for airports*

142. The Commission also suggests that ASC will be lower for airports than for other sectors because underinvestment will only result in reduced service quality with lower costs to consumers. In making this assumption, the Commission has not addressed the evidence provided by Dr Harry Bush and John Earwaker ("**Bush/Earwaker**") on behalf of NZ Airports.

143. For example, Bush/Earwaker carefully articulated the consequences of under-investment in the airport sector.<sup>67</sup>

Service reliability takes a different form than in other utilities, with a greater likelihood of cumulative, incremental degradation, particularly congestion, delays and poor service. Resulting costs arise in terms of length and unpredictability of passenger journey times, and in passenger dissatisfaction with airport facilities.

144. Bush/Earwaker provides further evidence of the extensive and diverse nature of the costs of under-investment in airports:

- (a) The impacts of under-investment can be long-lasting and pervasive.<sup>68</sup> That is, once apparent, there is no 'quick fix' to the under-investment. This evidence stands in direct contrast to the Commission's view that solutions to problems can be found before the cost to consumers becomes too large;<sup>69</sup>
- (b) The costs of delay, including wider economic impact. The evidence refers to UK examples citing significant economic costs of delay due to capacity constraint;<sup>70</sup>
- (c) Higher fares for passengers. Higher fares are necessary to reconcile increasing passenger demand for flights with the constrained supply caused by lack of runway/apron capacity;<sup>71</sup> and
- (d) Choice of routings. Greater choice and additional capacity are made possible by additional capacity.<sup>72</sup> Additional capacity can also enable greater competition and innovation in business models, such as the growth of low cost airlines.

145. The Commission does not directly engage in any significant detail with this evidence, preferring instead to form the view that any deterioration in quality is likely to build up over time and be visible to consumers.<sup>73</sup> Among other things, that ignores the fact that in the context of a five year pricing period, by the time any such degradation is addressed by the regulatory framework, the cost and time required to address and reverse the degradation will, per the Bush/Earwaker evidence, likely be substantial and prolonged.

146. The Commission forms its views despite the Bush/Earwaker evidence being clear that while the nature of airport impacts from under-investment differs from other industries, (in that they suffer incremental degradation of services rather than, for example, catastrophic outages), those airport impacts are tangible and can be very significant. NZ Airports also believes that the positive benefits of airport investment are relevant, such as the wider economic impact and driver of choice and capacity, as outlined in the Bush/Earwaker evidence.<sup>74</sup>

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<sup>67</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, p 7.

<sup>68</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, p 21.

<sup>69</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 133.

<sup>70</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, pages 8, 11.

<sup>71</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, p 11.

<sup>72</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, pages 12, 13.

<sup>73</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 133.

<sup>74</sup> Dr Harry Bush and John Earwaker's submission on the problem definition paper "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, pages 14, 33.

147. Accordingly, there is no reason why the principles the Commission has applied to the energy sector, being that the mis-estimation of the WACC can result in a "material asymmetry of outcomes",<sup>75</sup> are not also applicable to the airport sector.
148. The Commission also comments on the potential quantification of costs, and responds to the Sapere evidence, which was submitted as an indicator of the results that more extensive analysis was likely to produce - ie that quantification would justify an uplift to WACC to the same extent as the energy sector. The Commission notes its concerns with the US and UK studies that form part of the 'top down' approach. However, the Commission does not respond to the 'bottom up' evidence submitted in the Sapere evidence, the key features of which are five minute delay, number of passengers affected and the value of time per passenger.<sup>76</sup>
149. Further, its reasons for dismissing the top down approaches are not compelling and are inconsistent with the approach taken by Oxera when advising the Commission on the percentile for the energy sector. For example, Oxera did not seek to adjust data from the US to ensure that only costs directly attributable to electricity network under-investment were included. Sapere has advised us that its top down approach sought to follow the Oxera approach as closely as possible. Neither approach seeks to establish the cause of the costs in the studies used.
150. To conclude, in our view:
- (a) In dismissing the relevance of ASC, the Commission heavily relies on its view that under ID only, the regulatory WACC has less impact on airport investment decisions and therefore does not cause an under-investment risk. As discussed above, we think this is an erroneous assumption;
  - (b) The potential costs of airport under-investment are pervasive and extensive, as per the Bush/Earwaker evidence. The Commission has not adequately engaged with the evidence adduced by Bush/Earwaker;
  - (c) It is likely that if a full quantification estimate was undertaken, the costs are such that they produce the same asymmetry as in other sectors, despite manifesting in a different way, as per the Sapere evidence. The Commission has only partially engaged with Sapere's evidence and its reasons for disregarding it are not compelling; and
  - (d) We therefore ask that, when undertaking profitability assessment, the Commission remain open to:
    - (i) Accepting that the regulatory WACC estimate, and inappropriate use of it by the Commission and interested parties, can cause an under-investment problem with asymmetric costs for consumers; and
    - (ii) Therefore using the WACC estimate with caution, bearing in mind the potential adverse consequences for consumers if it is relied on as a firm upper benchmark for acceptable returns.

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<sup>75</sup> Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 128.

<sup>76</sup> Sapere "Asymmetric impact on consumers from underinvestment by airports - an indicative view" (report prepared for NZ Airports, 17 March 2016).

### PART 3: TOPIC PAPER 4: COST OF CAPITAL

151. This part of NZ Airports' submission relates to Topic paper 4: Cost of Capital.
152. NZ Airports does not propose to comment on a number of the cost of capital parameters covered in Topic paper 4. However, our silence on matters should not be taken as agreement with the Commission's approach. Rather, it indicates our view that:
- (a) There is now a long history of debate and High Court precedent on numerous cost of capital matters, and it is therefore unhelpful to seek to re-litigate them now; and/or
  - (b) As a general proposition the purpose of the IMs (section 52R of the Act) is unlikely to be materially furthered by frequent "tinkering" in search of the 'perfect' (ie precise) parameter - that likely does not exist; and/or
  - (c) The Cost of Capital IM is not applicable to price setting and it is quite possible that the airlines and airports will consider factors and methodologies beyond the IM during price consultation (eg BARNZ suggestions around cost of debt calculations).
153. Our main focus for submissions on Topic paper 4 is on estimation of the asset beta for airports (Chapter 4 of Topic paper 4). In particular, we remain unconvinced that the Commission's downward adjustment of 0.05 is justified. We also comment briefly on some other parameters.

#### Updated asset beta for specified airport services

154. For the "raw" asset beta for specified airport services, the Commission has updated its airports comparator sample. That has resulted in a lower average beta of 0.63 (down from 0.65).<sup>77</sup>
155. It is appropriate for the Commission to update its asset beta comparator sample, given the passage of time since the 2010 IMs were determined. We also agree with the Commission following the same approach to sampling (eg a broad sample set) to the extent possible.
156. We would add that:
- (a) It is self-evident that the Commission's sampling technique does not seek to identify an asset beta that is specific to New Zealand regulated airports as a group, or individually. Indeed, the asset betas in the sample set vary greatly, due to unknown market factors; and
  - (b) As airports may be setting prices some time after the Commission updates its sample set for the purpose of establishing the IM asset beta (and leverage), its value as a guide to determining an airport-specific WACC may be further limited.

#### Downwards adjustment to the average sample asset beta

157. The Commission has proposed to continue applying a downward adjustment of 0.05 to the average asset beta of its sample set, ostensibly because the regulated (ie aeronautical) activities of the three New Zealand airports are considered by the Commission to have a lower beta than the sample airports' overall (multi-divisional) business. The Commission therefore proposes a downwards adjustment to the asset beta for NZ airports from 0.63 to 0.58.<sup>78</sup>
158. In NZ Airports' view, the downwards adjustment remains unjustified by robust evidence, and contradicts Dr Lally's expert advice. NZ Airports acknowledges the difficulty involved in the task

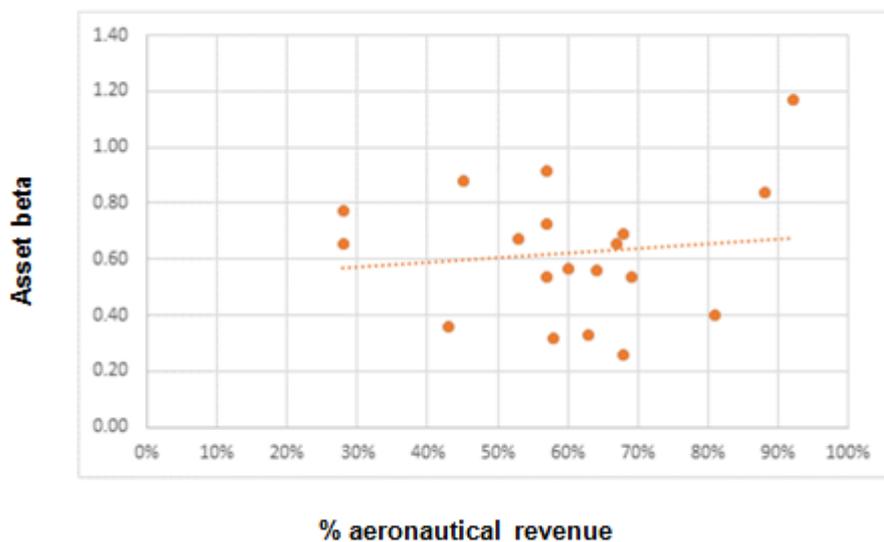
<sup>77</sup> Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 393.

<sup>78</sup> Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 420.

of calculating the downwards adjustment. In our view, that is a good reason to not make any adjustment.

159. The rationale for the Commission's assumption that the three regulated New Zealand airports would have a lower beta than the sample airports' overall business is not strong. In support of its assumption, the Commission relies on Figure 8, which displays the relationship between asset beta and the percentage of aeronautical revenue for firms in the comparator sample.<sup>79</sup> In the Commission's view, this graph shows that as aeronautical revenue increases, the asset beta of the airport as a whole decreases; in other words, that there is a strong relationship between asset beta and the percentage of aeronautical revenues an airport earns. The Commission uses this relationship to support its view that the average asset beta of its comparator sample should be treated as an upper bound.<sup>80</sup>
160. However, we have been unable to replicate the Commission's Figure 8 based on the information that is included in the draft decision. When we plotted the regulated revenue percentages of the sample companies listed in Table 8 against the asset betas included in the appendices to the draft decision, the trend line in fact suggests that there is a weak positive relationship between asset beta and the percentage of revenue from aeronautical activities.<sup>81</sup>

**Figure 2: Revised graph demonstrating relationship between asset beta and percentage of aeronautical revenues for airports comparator sample**



161. If our analysis is correct, Figure 2 suggests that the Commission's assumption that the three New Zealand airports' regulated businesses would have a lower asset beta than the average overall (multi-divisional) asset beta from the sample set could be misplaced. If that is the case, it appears that the Commission's founding assumption may not be correct. This reinforces that the Commission should not seek to make a downwards adjustment to the asset beta for airports unless it can point to strong evidence that justifies any such adjustment.

<sup>79</sup> Represented at page 106, Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016).

<sup>80</sup> Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 412.

<sup>81</sup> Although it is not clear, the potential error in the Commission's Figure 8 may have arisen because the order of the sample companies listed in Table 8 (which shows the percentage of regulated activities for each company in the sample) is different to the order of the sample companies in Figure 8.

162. We also question the comparability of the Auckland Airport and Queenstown Airport data used by the Commission to support its position. Although a full analysis of this information has not been possible, we understand that the Deutsche Bank report appears to use the standard CAPM and not the Brennan-Lally CAPM. It is therefore very difficult to draw conclusions from this information about the beta that would apply under the Brennan-Lally model. In addition, this observation and analysis is also based upon the asset beta estimate of one broker report for one airport only. Any broader inferences and conclusions about the sample or industry-wide relationship between overall beta and the asset beta for aeronautical services must therefore be treated with caution.
163. Having commissioned expert advice from Dr Lally on, among other things, the appropriateness of the Commission's existing practice of applying a downwards adjustment of 0.5 to the average asset beta for its sample set, it appears the Commission's draft decision is at odds with that advice - which supported a maximum adjustment of 0.03.
164. In coming to its position, the Commission notes that "the appropriate magnitude of the downwards adjustment is unclear".<sup>82</sup> In doing so it is recognising that its calculation of the downwards adjustment is made "on balance" and is "uncertain", as opposed to being based on objective and robust evidence.<sup>83</sup>
165. In assessing the Commission's adjustment of 0.05, Professor Lally observes that:<sup>84</sup>
- ...the estimates of the two underlying parameter values are very imprecise, and the point estimate for the average weight on regulated services is also low, leading to an extremely imprecise estimate for the beta reduction.
166. Nonetheless, in undertaking a review of the Commission's downwards adjustment of 0.05, Professor Lally concludes that only a downwards adjustment of 0.03 is justified.<sup>85</sup> This estimation is influenced by Professor Lally's estimate of two parameters:<sup>86</sup>
- (a) The average proportion of airport value arising from that of regulated services; and
  - (b) The average asset beta for the unregulated services of the comparator airports.
167. Professor Lally notes that the Commission does not reveal its estimates for the two parameters.<sup>87</sup> That makes it very difficult for interested parties to objectively assess the basis on which the Commission has made its downwards adjustment.
168. The crux of our concern is that, in the face of expert evidence suggesting that arriving at any downwards adjustment is highly uncertain, the position adopted by the Commission in its draft decision signals a level of certainty that is not supported by the evidence available to it. Put another way, the finding does not follow the Commission's prior expressed principles of requiring strong empirical evidence before making these sorts of adjustment.

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<sup>82</sup> Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 419.

<sup>83</sup> Commerce Commission "Input methodologies review draft decision: Cost of capital issues" (16 June 2016), para 420.

<sup>84</sup> Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission, 25 February 2016) p 28.

<sup>85</sup> Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission, 25 February 2016) pages 25 - 28.

<sup>86</sup> Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission, 25 February 2016) p 27.

<sup>87</sup> Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission, 25 February 2016) p 27.

### Cost of debt

169. To estimate the cost of debt, the Commission proposes to:
- (a) Continue to use the prevailing risk-free rate, but use three months of data instead of one month;
  - (b) Modify the debt premium methodology implementation by:
    - (i) Using three months of data instead of one month;
    - (ii) Removing the government ownership limitation on relevant bonds; and
    - (iii) Having regard to the Nelson-Siegel-Svesnsson curve when estimating the debt premium; and
  - (c) Change issuance costs from 35 basis points to 20 basis points.
170. We appreciate that the Commission believes that these are all incremental improvements to its methodologies, and are therefore consistent with its regulatory framework.
171. At this stage, NZ Airports has a neutral view. Our concern is that the proposed changes amount to tinkering on matters where it cannot be observed whether it leads to more robust and accurate outcomes or not. We will review submissions from other stakeholders with interest.

### Term Credit Spread Differential ("TCSD")

172. NZ Airports is comfortable with the proposal to remove the term credit spread differential from the information disclosure requirements, because it is an example of where the benefits do not outweigh the cost of calculation.

### Leverage

173. The Commission's updated comparator sample has resulted in leverage being adjusted from 17% to 19%.
174. NZ Airports notes its understanding that:
- (a) The leverage is an average from a broad international sample set; and
  - (b) There is no evidence to suggest that it represents an efficient leverage that should be used by airports in New Zealand when estimating their WACC.
175. As the Commission is aware, airports have previously advanced the case that a downwards adjustment to asset beta should result in a corresponding increase in leverage. We are further considering whether the Commission's sample set provides empirical support for that position, and may provide further views in cross submissions (and/or at the Commission's WACC workshop it proposes to hold in September).

## PART 4: TOPIC PAPER 5: AIRPORTS PROFITABILITY ASSESSMENT

### Overview

176. In this section, NZ Airports responds to the Commission's Topic paper 5: Airports profitability assessment. Our key points are:
- (a) ID regulation influences price setting. However, that influence should only be via the transparency and accountability that ID promotes - and not due to the regulator seeking to directly influence pricing decisions;
  - (b) Accordingly, we support changes to the ID requirements that will make disclosures easier to understand, and allow airports to more readily explain their pricing approaches. Airports remain committed to full and transparent disclosure;
  - (c) Conversely, we do not support changes that impose unnecessary complexity and compliance costs, or prescribe approaches that risk limiting the availability of pricing approaches that are appropriate for airport-specific circumstances;
  - (d) The proposed **forward-looking profitability indicator** has the potential to improve transparency in the disclosure of targeted profitability. However, the way it is implemented will be key to its success. Key challenges include:
    - (i) Recognising that it is just one factor in a broad contextual assessment over time, including analysis of annual disclosures, to build a full picture of airport performance;
    - (ii) A superficial comparison of the profitability indicator to the mid-point WACC as a determinative assessment of acceptable profitability must be avoided; and
    - (iii) Allowing for the limits on what it can tell interested parties. A five-year IRR remains a snapshot of performance, and a key input (closing investment value) is based on assumptions and/or indicated intent.
  - (e) The proposed limited **carry forward mechanism** is appropriate, provided that it provides airports with flexibility to best explain their pricing approaches. That includes:
    - (i) Allowing airports to determine and disclose the value of unforecast revaluations in real terms since the commencement of ID regulation; and
    - (ii) Maintaining the principle that all other risk sits with airports, unless an alternative arrangement has been established in pricing. Airports can continue to disclose a summary of customer views on alternative arrangements, without the need to specify the "degree of acceptance" or a requirement for airlines to comment on this at a later date.
  - (f) The proposed solutions for **asset valuation** and **alternative depreciation** are appropriate, including the setting of the initial regulatory asset base ("RAB") for land and the availability of alternative methodologies with equivalent effect. However, instead of prescribing a single approach, we encourage the Commission to consider whether more flexibility can be provided for airports to choose a disclosure method that best allows them to explain the impact of the pricing approaches;

- (g) The proposed solution for **assets held for future use** will allow airports to transparently disclose efficient pricing decisions without being at risk of false findings of excess returns;
- (h) The proposed addition of a **pricing asset base disclosure** will not, in our view, assist interested persons in an assessment of airport performance, and will add unnecessary complexity and compliance costs. It is not justified under either the Commission's regulatory framework or its decision-making framework;
- (i) There will be practical challenges with disclosure of **forecast pricing incentives**, as they are generally more complex than the Commission anticipates. It will be important that only high level and qualitative disclosure is required; and
- (j) The Commission should more clearly explain its expectations regarding the **restatement of asset values**. It appears, but it is not clear, that it expects the transitional Schedule (which does not apply to Wellington International Airport Limited), to deal with this.

#### How airports are regulated

177. In its introduction and process paper (Chapter 2 of the draft decision) the Commission provides an overview of how airports are regulated, its responsibilities when regulating airports, and the interaction between the Airport IMs Determination and the Airport ID Determination.

178. Much of the discussion is not contentious. However, we thought it important to address some points made by the Commission regarding the relationship between ID and airport price setting that concern us.

#### *AAA consultation and ID regulation influences airport decision-making*

179. The Commission is very familiar with NZ Airports' views on the relationship between the Airports Authorities Act 1966 ("**AAA**") and regulation under Part 4. Key points are that:

- (a) Consultations are extensive and intensive, with well-resourced airlines bringing considerable pressure to bear on airport pricing and investment decisions; and
- (b) The IMs and ID requirements also influence pricing decisions considerably. To think that in practice airports are free to adopt different approaches than those contemplated by the IMs is to divorce the reality of price setting from its commercial and legal contexts. Any departure from the IMs must be carefully considered, and fully explained during consultation and explained in the airport price setting disclosures. Experience shows that airlines are not open to approaches that depart from the IMs, unless it results in beneficial short term outcomes for them.

180. Accordingly, we are surprised and disappointed with the Commission's observation that:

"airports are only required to consult (rather than negotiate) on charges and irrespective of airlines' views, airports are free to set prices as they see fit."<sup>88</sup>

181. That is incorrect, both legally and commercially. Airports must fully consider airlines' views, and must have a robust foundation to support a different approach. It is not dissimilar to the Commission's approach to its own consultation processes, where it cannot simply ignore the views of submitters.

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<sup>88</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 31.

*The relationship between section 4A of the AAA and Part 4*

182. We agree with the Commission's view that section 4A of the AAA and Part 4 of the Act should co-exist, and that ID is intended to have an impact on price setting. However, as we have consistently advised the Commission, that impact properly occurs via the transparency and accountability that effective ID regulation brings - and not by the regulator seeking to set IM and ID requirements for the purpose of influencing price setting, which would be unlawful.
183. As discussed in our response to Topic paper 6: WACC percentile for airports, the degree of influence that the IMs have over price setting is one reason why the Commission is incorrect to think that its WACC IM estimate does not risk causing an under-investment problem.

**Forward-looking profitability indicator**

*The Commission's problem definition*

184. In its problem definition paper the Commission observed:<sup>89</sup>
- There is no forward-looking profitability assessment indicator to assist interested persons to assess if airports are targeting excessive returns when setting prices.
185. It considered that:<sup>90</sup>
- To address this issue and improve the assessment of profitability, the information disclosure Determination could be modified and expanded to include a forward-looking profitability assessment indicator.
186. The Commission now proposes in Chapter 4 of Topic paper 5 to amend the ID requirements to require airports to disclose a new forward-looking profitability indicator for future pricing period. The Commission is of the view that if a forward-looking profitability indicator can provide a good reflection of an airport's targeted returns, then airports are less likely to target profits that are excessive.<sup>91</sup>
187. In response, NZ Airports:
- (a) Recognises that the ID regime is relatively new, and that, while the regime largely operates effectively, there will invariably be scope to improve the regime (subject to satisfying the Commission's decision-making framework);
  - (b) Also recognises that, as was encountered by the Commission in its section 56G reviews, challenges can arise in assessing targeted returns. However, those challenges arise from the nature and complexity of the airport business, and reinforce the importance of ensuring that the disclosure framework allows sufficient flexibility for airports to describe the approaches that have been taken; and
  - (c) Believes that differences between the IM compliant disclosures required for ID and the commercial approaches adopted in pricing are capable of being explained through the broader disclosures that airports provide.<sup>92</sup>

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<sup>89</sup> Commerce Commission, "Input methodologies review invitation to contribute to problem definition" (16 June 2015), para 341.1.

<sup>90</sup> Commerce Commission, "Input methodologies review invitation to contribute to problem definition" (16 June 2015), para 345.

<sup>91</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 153.

<sup>92</sup> NZ Airports "Airport Profitability Assessment Workshop 1: Post Workshop Submission (22 December 2015), para 33(b).

188. Accordingly, in our view it is important that the introduction of a new forward-looking profitability indicator will genuinely assist interested persons to assess airport performance. In making this decision, the Commission must apply its decision-making framework. Assuming it is satisfied that this proposal passes the test included in that framework, our submission proceeds on the basis that the Commission is committed to introducing a forward-looking indicator.
189. Our focus is therefore on ensuring that it is flexible enough to be workable, and does not impose unnecessary complexity and compliance costs. The challenge will be the implementation of this proposal.
190. We also note that the draft decision is silent on how the proposed changes to the forward-looking profitability indicator will flow through to *ex-post* disclosure requirements. We understand that the Commission proposes to consider that topic in due course. In the meantime, we encourage the Commission to not lose sight of the fact that full contextual assessment of airport performance must take place over time and *ex-post* disclosures should form an important part of that analysis.

*Five-year IRR the preferred approach*

191. The Commission is proposing to introduce a requirement that airports disclose an *ex-ante* IRR for the current pricing period in price setting disclosures, similar to the IRR used by the Commission in its section 56G reports.<sup>93</sup> This will include:<sup>94</sup>
- (a) An opening investment value;
  - (b) A forecast closing value; and
  - (c) Forecast cash-flows over the duration of the pricing period.
192. The IRR mechanism proposed by the Commission seems workable. In particular, NZ Airports is supportive of an IRR indicator that matches the length of a pricing period, with the inclusion of a limited carry forward mechanism to allow assessment across pricing periods where appropriate.
193. By contrast, an enduring IRR profitability indicator that spans multiple pricing periods is not necessary and will involve complexity in developing a corresponding WACC.<sup>95</sup> It is welcomed that the Commission has recognised the concerns expressed previously by NZ Airports (and BARNZ) regarding the use of an enduring IRR and has decided not to pursue this option.<sup>96</sup>

*Forward-looking indicator is just one part of an overall assessment*

194. In the draft decision, the Commission refers to the IRR indicator as a "headline indicator" that is to be used as a "starting point" for any subsequent summary and analysis undertaken by the Commission.<sup>97</sup> As above, the Commission is of the view that this IRR indicator can also "influence price setting such that the returns targeted are not excessive".<sup>98</sup>

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<sup>93</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 155.

<sup>94</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 167.1.

<sup>95</sup> NZ Airports "Airport Profitability Assessment Workshop 1: Post Workshop Submission (22 December 2015), para 18.

<sup>96</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 190.

<sup>97</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 149, 151, 168.1 and 176.

<sup>98</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 168.3.

195. We welcome this important acknowledgement from the Commission that any forward-looking profitability indicator must be used with caution when assessing airport performance. Or, put otherwise, when assessing whether returns being targeted by an airport are to the long-term benefit of consumers (per section 52A).

196. A forward-looking profitability indicator cannot be regarded in isolation and ought not to be afforded undue prominence:

- (a) First, as Professor Yarrow has advised the Commission, while forward-looking disclosures are valuable, the reality of the limitations on the usefulness of information disclosed on an *ex-ante* basis cannot be overlooked:<sup>99</sup>

The types of information disclosed in *ex-ante* and in *ex-post* reviews exhibit significant differences. In the latter case, it is largely a matter of evaluating what has happened in the past, whereas **the former involves a much greater reliance on forecasts of the future and/or of statements of intent as to future conduct**. This gives rise to a difficult tension for *ex-ante* disclosure processes. On the one hand, it is reasonable to infer that information relating to forecasts and intentions tends to be speculative in nature, and hence to give it less weight in deciding how a regulator should respond to it. On the other hand, as explained above, *ex-ante* assessment tends itself to be given greater weight when risks of AEEMP are perceived to be reasonably high and when the additional administrative resources involved in undertaking the necessary exercises are warranted by the potential benefits of prophylactic regulatory influence (emphasis added).

- (b) That means that when the Commission (or an interested person) is considering *ex-ante* forecasts, it is essential that such assessment considers all of the relevant evidence, and in particular is one part of a broader contextual analysis, and does not lend itself to a superficial comparison of IRR to WACC. NZ Airports has emphasised the importance of undertaking a comprehensive analysis of airport performance and the danger of simply comparing the WACC to the IRR;

- (c) Both the WACC and IRR values have limitations and cannot be used to complete a comprehensive and fulsome assessment of airport performance. As Professor Lally advised the Commission, there are many sources of false signals of monopoly pricing.<sup>100</sup> Further, Professor Yarrow has stated that best practice policies are focussed on problems that are likely to occur only when market power and its exercise rise above threshold levels at which any further increases tend to become harmful, not when they deviate from zero;<sup>101</sup>

- (d) Professor Yarrow's advice to the Commission also illustrates that deviation between targeted rates of return and WACC can be legitimately explained:<sup>102</sup>

On this count alone it would be wrong to assume that any positive deviation of actual (*ex-post*) or targeted (*ex-ante*) rates of return from the WACC is indicative of excess profitability.

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<sup>99</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 5.

<sup>100</sup> Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule "Review of WACC issues" (report to the Commerce Commission, 25 February 2016) p 14.

<sup>101</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 2.

<sup>102</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 2.

- (e) Professor Yarrow explains that the Commission should undertake a general economic assessment in order to fully understand such deviations (consistent with NZ Airports' view that only a proper contextual analysis provides an informed assessment of whether or not returns being targeted by an airport are in the long-term interests of consumers):<sup>103</sup>

General economic assessment of the relevant market context should inform the interpretation of the scale of deviations of business rates of return, whether calculated on an *ex-ante* or an *ex-post* basis, from WACC estimates.

- (f) Given that a general economic assessment is necessary for the Commission to perform a meaningful assessment of airport performance, it is important for the Commission to avoid focussing solely on the values or estimates of WACC and IRR in a granular way that is divorced from the wider context:<sup>104</sup>

Adjustments to the WACC assessments themselves, for example by choosing a 75th percentile estimate rather than a 50th percentile estimate, may both create confusion as to what is going on and give rise to a risk of an undue focus on narrowly technical, financial issues (e.g. uncertainties surrounding WACC estimates) to the neglect of wider economic factors that are, or should be, relevant to assessment in a particular case.

197. Further, it is important to recognise that the introduction of a forward-looking IRR profitability indicator in and of itself will not:

- (a) Cure the inherent difficulties associated with the *ex-ante* assessment of targeted returns (and the inevitable mismatch between forecast and actual returns); or
- (b) Remove the inevitable degree of complexity involved in profitability assessment.<sup>105</sup> It is clear from the advice of Professor Yarrow that the Commission should be slow to draw any conclusions on targeted returns based on the forecast profitability indicator alone. It should reserve judgement until it has the full picture of airport performance - including *ex-post* assessment of actual outcomes.

198. The Commission states in its draft decision that it wants to "understand the difference and rationale" underpinning the variance between targeted returns and its mid-point WACC.<sup>106</sup> The IRR will only take the Commission so far in this assessment.

199. Therefore, based on the above, and the clear words from the Commission that the IRR forward-looking profitability indicator is a "headline indicator" and a "starting point" in the assessment of airport profitability, its introduction to ID may provide some modest gains in terms of the overall assessment. But, there is a high risk that it will come at a cost, as it will encourage interested parties to inappropriately judge airport performance by simply comparing the disclosed IRR to the Commission's mid-point WACC.

200. In that context, we would invite the Commission to clarify its statement in the draft decision that:<sup>107</sup>

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<sup>103</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 3.

<sup>104</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 3.

<sup>105</sup> NZ Airports "Airport Profitability Assessment Workshop 1: Post Workshop Submission (22 December 2015), para 13.

<sup>106</sup> Commerce Commission "Input methodologies review Draft decision: Airports profitability assessment" (16 June 2016), para 151.

In any subsequent summary and analysis we may need to adjust the IRR provided under information disclosure in a way that is more consistent with targeted returns inherent in an airport's pricing decision. However, it is our intent to try and make the proposed new indicator as good as possible in the first instance.

201. This statement appears to be at odds with the Commission's recognition elsewhere that the forward-looking IRR can only be a headline indicator. Furthermore, we are concerned that it indicates a view from the Commission that if the IRR does not fully capture an airport's pricing approach, it can be adjusted to 'better reflect' the pricing approach. Or put otherwise, that the IRR will be treated as something more than just a starting point. That would represent a dangerous development, contrary to the purpose of ID. Accordingly, these adjustments are not merited. The carry forward mechanism proposed by the Commission is, as we understand it, meant to ensure the Commission does not need to make any adjustment.
202. Finally, Professor Yarrow has stated, in his advice to the Commission, that since the airport determines prices, it is reasonable that the burden of articulation falls first on the airport operator, particularly in *ex-ante* exercises.<sup>108</sup> NZ Airports accepts this. As submitted previously, the IM review provides the Commission with an opportunity to provide confidence to airports as to how their performance will be assessed and how variation from forecasts will be treated.<sup>109</sup> By introducing the requirement to produce and explain an IRR (which is an additional compliance measure for airports), the Commission has an opportunity to provide the airports with the confidence that their explanations of the extent to which the IRR is a good reflection of targeted profits will be seen as valuable to the Commission and be factored into its assessment of airport performance.

#### Carry forward mechanism

##### *NZ Airports supports the mechanism*

203. The Commission's proposal is to supplement the IRR forward-looking profitability indicator with a carry forward mechanism in the ID requirements that can be used to adjust the opening investment value and the forecast closing investment value used in an IRR calculation.<sup>110</sup>
204. NZ Airports accepts, in principle, that this mechanism is likely to offer an effective way for the Commission to be able to assess the impacts of relevant adjustment (eg risk allocation) on an airport's forecast profitability. While the introduction of the carry forward mechanism will impose greater prescription on the *ex-ante* information disclosure requirements regulated airports are subject to, the mechanism has advantages compared to potential alternatives:
- (a) It allows airports to disclose how they propose to manage risk when setting airport pricing (on the default basis that airports are best placed to manage risk) and/or to pursue risk sharing arrangements (we provide submissions on this below); and
  - (b) It is consistent with the relevant economic principles that inform the Commission's decision-making framework - namely FCM and NPV=0.

<sup>107</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 179.

<sup>108</sup> George Yarrow's expert advice on airport WACC percentile "Response to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector" (report to the Commerce Commission, February 2016), p 1.

<sup>109</sup> NZ Airports "Submission on Commerce Commission's input methodologies review: Invitation to contribute to problem definition" (21 August 2015), para 33.

<sup>110</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 167.

205. A key proviso to our support for the carry forward mechanism is that the airport must disclose its treatment consistent with its approach in pricing.<sup>111</sup> That is crucial to ensure that the carry forward mechanism reflects what has occurred in pricing (which is, of course, set following consultation under the AAA):<sup>112</sup>

the carry forward mechanism can also be used to adjust the forecast closing investment value in an IRR calculation **to reflect decisions made by airports** impacting charges of the current and future price setting events that are not already reflected in the forecast closing asset base. This is important in order to derive a forecast closing investment value that is a good reflection of the remaining capital to be recovered (emphasis added).

206. This approach is also in line with the Commission's stance on risk sharing. We read the Commission's draft decision as endorsing this approach.

#### Forecast closing investment value

207. The draft decision states that the forecast closing investment value reflects the remaining capital to be recovered (at the end of the pricing period). It should, according to the Commission, comprise:<sup>113</sup>

the forecast closing asset base used by airports when setting prices, reflecting an airport's assumed time profile of capital recovery; and

any adjustments reflecting decisions made by airports that affect charges of the current and future price setting events that are not already reflected in the forecast closing asset base. This is important in order to derive a forecast closing investment value that is a good reflection of the remaining capital to be recovered.

208. The Commission's amended disclosures require specific comment from airports on why the closing investment value best represents the airports' future revenue recovery expectations. In our view, that provides the airports with the opportunity to provide context and explanation for the pricing decisions - ie to make the carry forward mechanism meaningful.

209. We would, however, invite the Commission to acknowledge in its final decision that the forecast closing carry forward adjustment can necessarily only be assessed as an indication of intent at that time. Otherwise, there is a real risk that the lines between pricing and ID are blurred, as the forecast closing investment value would risk having undue influence on the airport's setting of charges, pursuant to the AAA, for the next pricing period. Consultation undertaken by airports on pricing in the future cannot be restricted to, or narrowly based on, the assumptions from the previous pricing period. Rather, airports are required by the AAA to have an open mind and cannot have predetermined views about pricing inputs or approaches.

210. It follows that the price setting process should take into account the actual circumstances at the time, rather than the circumstances that were predicted to exist at the time. If decisions are made in the future that are different to those that were predicted, then the airports will provide reasons for this. During the section 56G process, airports were concerned about the importance that the assumptions about pricing decisions in the next pricing period had on the Commission's assessment of forecast returns.<sup>114</sup> An airport will, of course, be required to provide explanation and reasons for any subsequent deviations from that forecast closing investment value.

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<sup>111</sup> NZ Airports Airport Profitability Assessment Workshop 1: Post-Workshop Submission (22 December 2015).

<sup>112</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 172.2.

<sup>113</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 159.

<sup>114</sup> NZ Airports, Feedback on Commerce Commission section 56G review process, 24 April 2014, para 19(a)(iii).

211. NZ Airports will provide specific comments on the proposed amendments to IM and ID Determination definitions and mechanisms relevant to the introduction of the carry forward mechanism in its submissions due on 18 August 2016.

#### *Time profile of capital recovery*

212. This aspect of the Commission's review of the IMs has highlighted the inevitable challenges that arise when trying to assess the pricing approaches adopted by airports within an IM compliant disclosure. NZ Airports is therefore open to the Commission's consideration of how, consistent with the Commission's decision-making framework, changes can be made to improve ID so that airports can more transparently disclose the impact of their pricing decisions on assessed returns.

#### *Asset valuations*

213. In Chapter 5 of Topic paper 5, the Commission is of the view that there is a problem with the current IM as it allows the value of the asset base to differ between *ex-ante* and *ex-post* disclosure purely due to the different treatment of asset revaluations (as *ex-ante* disclosures are required to adopt the approach to asset valuations used in price setting, whereas *ex-post* disclosures must adopt the approach to asset revaluations prescribed in the IMs).<sup>115</sup> As stated above, NZ Airports is open to proportionate changes to the IMs that will increase the transparency of information disclosed *ex-ante* and *ex-post* without adding undue complexity or cost.

214. NZ Airports supports the draft decision's proposal to:

- (a) Amend the IMs to allow airports to apply either CPI-indexation or an un-indexed approach to the RAB roll forward, depending on the approach taken by airports in pricing.<sup>116</sup> In particular, this means the approach taken to indexation could change over time if the circumstances require; and
- (b) Amend the ID Determination to allow airports to apply different indexation for assets used in different business activities.<sup>117</sup> Auckland International Airport Limited will provide further views on this proposal, including the Commission requiring restatement of asset values, as it most adversely affects it.

215. We agree with the Commission's assessment that providing airports with the flexibility to align the approach to indexation used in pricing with that used for the purpose of annual ID disclosures has the benefit of improving transparency of returns for interested persons. Alignment between the *ex-ante* and *ex-post* disclosures also minimises the risk of having to restate asset values, which airports are plainly keen to avoid.<sup>118</sup>

#### *Alternative methodologies with equivalent effect*

216. NZ Airports supports the proposal to allow airports to apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively

<sup>115</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 201.

<sup>116</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 214.

<sup>117</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 223.

<sup>118</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 216.2.

complex or costly.<sup>119</sup> Under the Commission's proposal, alternative methodologies can (rightly in our view) only be applied if they do not detract from the purpose of Part 4.

217. The risks associated with implementing this alternative methodology will arise from the detailed drafting of the key concepts, and interpretation of that drafting. We propose to provide detailed comments on the drafting proposed in the draft IM Determination, but note that we see the core issues to get right as being:

- (a) What exactly is meant by "equivalent effect"; and
- (b) The level of evidence needed to show that something is equivalent. We believe that such evidence should be focused on explaining the process used when applying the alternative methodology.

218. Furthermore, in our view, the goal of flexible and proportionate regulation will be best achieved by allowing an airport to use an alternative methodology when it has reasonable grounds to believe that it would be likely to give an equivalent effect.

*Forecast CPI*

219. The Commission is of the view that the decision between an indexed and un-indexed approach to revaluations can affect the time profile of capital recovery and the implied exposure of real returns to inflation risk.<sup>120</sup>

220. We will seek further clarification, during the technical consultation phase, of the Commission's proposed amendments to manage this implied risk. Although the proposed information disclosure requirements are relatively clear, the Commission's explanation of its intended approach is clouding our understanding. In particular:

- (a) The Commission says it has proposed changes in Chapter 6 of Topic paper 5 to allow an airport to manage exposure to inflation risk. Chapter 6 suggests that inflation risk only arises if airports are not indexing their asset bases, and expresses the view that a solution under ID is likely to be an unnecessary complication. We agree;<sup>121</sup>
- (b) Nevertheless, Chapter 6 also says that an airport which does not revalue its asset base can use the carry forward to protect itself and customers from inflation risk, in the way as explained under scenario 2.<sup>122</sup> But scenario 2 is an airport that indexes its asset base. This explanation is unclear to us;
- (c) Chapter 6 says that the Commission expects an airport to use the unbiased CPI forecast discussed in Chapter 5 when determining the amount to be included in the carry forward adjustment to the opening investment value.<sup>123</sup> We would appreciate further clarification on the circumstances in which the Commission envisages this would occur;

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<sup>119</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 306 to 309.

<sup>120</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 220.

<sup>121</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 362.

<sup>122</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 362.

<sup>123</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), footnote 122.

- (d) Returning to Chapter 5, to give effect to its decision to allow an airport to manage exposure to inflation risk, the Commission proposes to introduce a definition of "forecast CPI" to the IMs "which can be used to calculate the returns airports are targeting by way of compensation for inflation risk." An airport must apply this definition if it chooses to manage its exposure to inflation risk by *using an un-indexed approach*. According to the Commission, this allows an objective calculation of the difference in returns that airports would have recovered *ex-post*.<sup>124</sup> Again, it is not clear to us what the Commission is proposing.

221. The Commission's explanations of its proposed additions to the ID Determination are more straight-forward. Airports will be required to:

- (a) Provide information on the approach used to revalue assets and the forecast value of assets; and
- (b) Disclose the IM-consistent forecast of CPI and the forecast value of revaluations that would have been projected had this methodology been applied at an asset category level.<sup>125</sup>

222. To conclude, we understand that the proposed amendments to the ID Determination are intended to aid interested persons to understand airport profitability in light of revaluation approaches adopted in pricing. However, we are very concerned that this additional information will in fact confuse interested parties, especially in light of the Commission's unclear views and the Commission's reasons for it, on how it intends forecast CPI to be used to manage inflation risk under ID.

223. We ask the Commission to clarify its intent and consider whether the benefits of complexity outweigh the cost and potential confusion.

#### **Non-standard depreciation**

224. NZ Airports is comfortable with the Commission's proposals for disclosure of non-standard depreciation. In particular:

- (a) The use of non-standard depreciation is consistent with the Commission's key economic principles underpinning the IMs. In particular, it enables airports to take commercial approaches in pricing that are consistent with the NPV=0 principle;<sup>126</sup>
- (b) The Commission's intent under this IM Review is to provide airports with additional flexibility to disclose information in a way that best reflects their pricing approach.<sup>127</sup> We welcome the recognition that the option of disclosing non-standard approaches to depreciation promotes this intent;
- (c) The Commission has recalled the challenges it encountered during the section 56G process understanding Christchurch International Airport Limited's use of non-standard depreciation. It needs to be remembered that those disclosures were the first of their sort under ID, and the regime was very much still bedding in. Any

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<sup>124</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 221.

<sup>125</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 223.

<sup>126</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 122.

<sup>127</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 65.

concerns surrounding disclosures involving the use of non-standard depreciation are, in our view, now significantly diminished;

- (d) Nevertheless, we understand the Commission's desire to introduce high level "principles" into the IMs to help ensure that airports who use non-standard depreciation in pricing appropriately explain their approach in their disclosures; and
- (e) NZ Airports is keen to ensure these are drafted as principles and not prescriptive rules. We will carefully review the drafting of the principles and discuss possible scope for simplification in our submission on the IM and ID Determinations.

#### **Ex-post effects of risk allocation**

##### *Overview*

225. Essentially, Chapter 6 of Topic paper 5 is about how risk sharing arrangements should result in adjustments to the opening investment value that is an input into the IRR calculation. In NZ Airports' view:

- (a) Making adjustments for unforecast revaluations is not consistent with outcomes in workably competitive markets. However, we do not oppose the Commission's proposed approach for ID purposes;
- (b) The Commission's proposed approach to other risk sharing arrangements is appropriate; and
- (c) Although we appreciate the Commission has been careful to only require disclosure of the "degree of acceptance" of alternative risk sharing arrangements, we believe it would be better to simply require airports to continue to provide a summary of airline views. Otherwise, there is a risk that airlines will be incentivised to disagree with the airport's views on their degree of acceptance.

##### *Unforecast revaluations*

226. The Commission is proposing to include un-forecast revaluation gains (or losses) in "real terms" in the carry forward adjustment to the opening investment value.<sup>128</sup> This is to account for the risk that actual revaluations may vary from forecast<sup>129</sup> if actual values increase at a rate greater than that forecast in the price setting event disclosures.<sup>130</sup>

227. Although the general principle is clear, a range of implementation scenarios can arise (as recognised by the Commission) due to the different revaluation approaches in pricing. NZ Airports believes it would be helpful to discuss the scenarios to provide further clarity for all interested parties during the technical consultation phase.

228. In our view, competitive markets do not require wash ups of revaluations. This is due to the principle of NPV=0 applied on a forward-looking basis. As property owners, the airports have always advocated that all risks of property ownership, including revaluation risks, best sit with the airport. This stance is supported by economic rationale: the risk should be allocated to the

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<sup>128</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 348.1.

<sup>129</sup> Although the general principle is clear that a range of scenarios can arise (as recognised by the Commission due to the different revaluation approaches in pricing), NZ Airports believes it would be helpful to engage with the Commission on those the scenarios to provide clarity for all airports during the technical consultations.

<sup>130</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 353.

party best placed to manage, mitigate or absorb the risk.<sup>131</sup> However, NZ Airports provides comments here on the basis that the Commission is committed to a different view for ID purposes.

229. In those circumstances, we accept the Commission's proposal for carry forward of unforecast revaluations that, where appropriate, can be spread over multiple pricing periods. However, its approach must be consistent whether the out-turn results in a loss or a gain - ie the carry forward goes both ways - with airports to explain and justify the time from which they are carrying forward such real gains/losses. We would welcome confirmation from the Commission that this is how it sees this risk allocation mechanism operating.
230. Subject to a more detailed review of the proposed amendments to the ID Determination, it appears that the Commission has not expressed a view on the point from which unforecast revaluations should be calculated - eg what the "start date" should be.
231. In NZ Airports' view, a principled approach would be to make the calculation as from the commencement of ID regulation, so that the determination of unforecast revaluations is aligned with the Commission's FCM principle.

#### Alternative risk sharing arrangements

232. NZ Airports agrees with the Commission's position on "default risk allocation" principles. Specifically, the Commission is proposing that risks should be allocated to suppliers or consumers depending on who is best placed to manage the risk, unless doing so would be inconsistent with section 52A of the Act.<sup>132</sup> As such, the default risk allocation is that, where an airport has not identified any alternative risk allocation, the risk that actual out-turns are different from forecasts is assumed by the airport.<sup>133</sup> As discussed above, we accept that the Commission has a different view on revaluations (including real unforecast revaluations).
233. As outlined above, this position aligns with NZ Airports' previous submissions that the risk should be allocated to the party best placed to manage, mitigate, or absorb the risk.<sup>134</sup> Airports have the ability to determine the use of their resources, and managing those resources is one of the core capabilities of airport operators.<sup>135</sup> To be clear, this does not mean that airports are carrying all risks over the long-term.
234. NZ Airports has previously submitted that there may be, from time to time, circumstances in which prices are set, following consultation with airline customers, on a basis that reflects a departure from the default risk allocation.<sup>136</sup> Consultation obligations under the AAA mean that the alternative risk allocation will have been robustly assessed by the airports and airlines.
235. NZ Airports agrees with the Commission's reasoning that:
- (a) The *ex-post* effects of risk allocation arrangements in an airport's previous price setting disclosure are best addressed in the adjustments to the opening investment value of the subsequent price setting disclosure;<sup>137</sup> and

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<sup>131</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 21.

<sup>132</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 335.

<sup>133</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 337.

<sup>134</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 21.

<sup>135</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 22.

<sup>136</sup> NZ Airports "Airport profitability assessment post-workshop submission" (22 December 2015), para 24.

<sup>137</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 371.

- (b) Adjustments to the opening investment value should only be made where the allocation of risk is different to that of the default risk allocation (eg where a carry forward or wash up was signalled) and these have been explained in airports' price setting event disclosures.<sup>138</sup>

236. Moreover, the Commission's confirmation that it is not in a position to comment on the value of the carry forward adjustment is appropriate.<sup>139</sup> The Commission should comment only on the appropriateness of the airport's method for calculating the carry forward.<sup>140</sup>

*Degree of acceptance*

237. The Commission has proposed that the airports must disclose the "degree of acceptance" of risk sharing arrangements (or put otherwise, departures from the default risk position).<sup>141</sup>

238. It remains unclear to us why the Commission considers it appropriate, under ID requirements, to understand the airlines' view of risk allocation arrangements. Whether or not any airline may accept an approach is not relevant to whether it promotes the long-term benefit of consumers (airlines' and consumers' interests are by no means aligned). Further, it is the airport's decision-making that is under assessment, and therefore its rationale and reasons should be more important.

239. As the Commission points out, airlines are able to provide their views during consultation and subsequently to the Commission in any event.<sup>142</sup> Providing a mandated right of response in the ID requirements on "the degree of acceptance" may create a risk that airlines will have an incentive to provide different views on acceptance at different stages.

240. NZ Airports considers that this is best addressed with each airport continuing to provide commentary in the price setting disclosures. Airlines and BARNZ can make contact with the Commission should they have a different view. We ask the Commission remove this proposal from the ID requirements.

241. As a second best alternative, we ask the Commission to:

- (a) Confirm that where the airports assume the risk, no disclosure is necessary; and
- (b) Change the requirement to disclose the "degree of acceptance" to a requirement to simply summarise airline consultation feedback. Requiring airports to point to a level of acceptance creates uncertainty as for several reasons the outcome of the consultation process cannot be described as one point on a sliding scale of acceptance:
- (i) There can be a very large number of airline customers that are consulted during price setting events;
  - (ii) Not all those airline customers may agree;

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<sup>138</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 344 and 348.2.

<sup>139</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 385.

<sup>140</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 103, 197.

<sup>141</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 348.3.

<sup>142</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 376.

- (iii) Those that do agree may not have the same reasons for agreeing;
- (iv) Some will not engage or comment at all; and
- (v) Some views are provided with a preference or commitment to confidentiality.

#### Treatment of forecast over and under-recoveries

242. Chapter 7 of Topic paper 5 discusses the Commission's proposal for adjustments to the closing investment value to appropriately reflect forecast over and under-recoveries that are intended to be offset in future pricing events.
243. NZ Airports:
- (a) Is comfortable with the Commission's proposed use of adjustments to the closing investment value. In particular, we understand (and would welcome confirmation in the final decision) that it could be used to:
    - (i) "Spread" unforecast revaluations over multiple periods in accordance with FCM and to avoid implied price shocks;
    - (ii) Signal an intention to unwind Auckland International Airport Limited's moratorium; and
    - (iii) Track other commercial concessions; and
  - (b) Disagrees with the proposal to require airports to disclose the "degree of acceptance" of forecast over and under-recoveries, for the reasons discussed above.

#### Assets held for future use

244. In Chapter 8 of Topic paper 5, the Commission is proposing to introduce the value of, and revenue from or associated with, assets held for future use ("**AHFU**") on a forecast basis in the ID Determination.<sup>143</sup> If the revenue is derived from airport activity charges this will trigger the disclosure requirement (where revenue is obtained from, for example, property rentals, the forecast information will not be required). We interpret this as an acknowledgement by the Commission that it can make economic sense, and be consistent with the Part 4 purpose, for AHFU charges to be established.
245. NZ Airports is, at a high level, supportive of the Commission's proposal. Airports will provide information on the rationale underpinning the inclusion of any such revenue in their price setting disclosures.<sup>144</sup>
246. As this is a matter of particular relevance to Auckland International Airport Limited, we understand it will submit on this topic in further detail.

#### Pricing asset base disclosure

247. In Chapter 9 of Topic paper 5, the Commission has proposed to add a new Schedule 19 to the information disclosures Schedules. This must be completed following a price setting event.

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<sup>143</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 451-453.

<sup>144</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 481.

248. Schedule 19 is intended to reflect airports' targeted profitability based on pricing assets.<sup>145</sup> Airports are also required to explain any differences in profitability based on the pricing asset base and RAB.<sup>146</sup> As such, NZ Airports is concerned that this Schedule could create additional complexity if it requires reference to profitability outcomes from assets where the price setting process does not align with how airports set prices for airlines, and passengers, under the AAA.
249. Furthermore, applying the Commission's decision-making framework, NZ Airports believes that the introduction of Schedule 19 is unjustified for the following reasons:
- (a) The inclusion of an additional schedule similar to Schedule 18, but solely relating to the pricing asset base, effectively duplicates the work required for this existing Schedule. It risks confusing interested persons as to the purpose of and differences between each Schedule, contrary to the purpose of ID. Airports are already required to explain in the price setting disclosure how revenues are generated from the assets not included in the pricing asset base consulted with airlines;
  - (b) An interested party, other than airlines, assessing airport performance is likely to use the information contained in the current, and proposed, Schedule 18, as that covers the entire regulated business; and
  - (c) Airports are already providing information in summary form in the price setting disclosures that allows interested persons to reconcile the RAB and the pricing asset base. From a practical perspective, in order to disclose the forecast outcomes for the total RAB in the current Schedule 18, airports must prepare separate forecasts for pricing assets to consult with airlines, and other regulated assets to enable the totals to be determined for disclosure;
250. For all of the above reasons, it appears to us that Schedule 19 does not assist to make information more accessible and helpful for interested parties. The difference between Schedules 18 and 19 is non-pricing activity - in essence, revenue from leased assets used to provide regulated activities. The contribution of those activities is not a material proportion of the total regulated assets or revenues, and substantially less than revenue from aeronautical charges.
251. Finally, the Commission also refers to the difficulty BARNZ expressed in terms of being able to reconcile the pricing asset base forecasts. Again, NZ Airports refers the Commission to the existing pricing setting disclosures, which show the separation of pricing and non-pricing forecasts. Furthermore, BARNZ and the airlines receive substantial detailed information from the airports during AAA consultation. Producing yet a further schedule of information for BARNZ is not required to enable assessment of the airport achievement of the Part 4 objectives.

#### Timing of cashflows

252. The Commission is proposing to specify mid-year timing assumptions for all revenue and expenditures for price setting event disclosures.<sup>147</sup> However, airports can deviate (if an explanation is provided).
253. NZ Airports does not oppose this.

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<sup>145</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 514.1.

<sup>146</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 514.2.

<sup>147</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 551.

## Other adjustments to an airport's Price Path

### Pricing incentives

254. In Chapter 11 of Topic paper 5, the Commission is proposing a new requirement in the price setting event disclosures to provide 'high level' disclosure of the total value of pricing incentives. This is in response to the Commission's apparent concern that *ex-ante* and *ex-post* disclosures may not be "transparent" due to "other adjustments" an airport can make to its price path.<sup>148</sup>
255. At this point, the decision includes commercial concessions and route incentives. The Commission is focusing on these two factors but states that "there may be additional ways in which the price path may be adjusted that are yet to be identified".<sup>149</sup>
256. Specifically, airports must disclose the forecast total annual dollar amount of route incentives in the same manner as the *ex-post* ID requirement to disclose financial incentives (commercial concessions can be disclosed in the carry forward mechanism).<sup>150</sup>
257. Because airports already forecast the volume of flights that will meet the requirements for route incentives in order to forecast demand, revenue and prices, the Commission considers this information to be "relatively simple" to calculate.<sup>151</sup>
258. NZ Airports disagrees with this proposal and the Commission's analysis of its simplicity. The reality of determining route incentives in pricing and how they might be disclosed is more complex:
- (a) Publication of airline incentives may result in unintended/unknown consequences. As was appreciated during the original consultation on annual disclosures, there are commercial sensitivity issues with this information being disclosed. For example:
    - (i) Airlines assessing their share of airport discounts or incentives could ask for higher discounts; and/or
    - (ii) Airports could provide fewer discounts following comparison to other airports or, as a consequence of (a) above, would be wary of the cost of offering discounts or incentives to a single airline having a cross-market flow-on effect as other airlines seek to access comparable discounts or incentives; and
    - (iii) Disclosing this information could also discourage airlines planning new routes or services from undertaking early planning discussions with airports to avoid early disclosure of the new services. That would be contrary to the fostering of airline/route competition, and so contrary to the long-term benefits of consumers;<sup>152</sup>
  - (b) Forecast incentives are generally more complicated than the Commission's solution anticipates. It is not simply a case of forecasting reductions in standard charges;

<sup>148</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 558.

<sup>149</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 574.

<sup>150</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 587.

<sup>151</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 588.

<sup>152</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), figure 1, p 22.

- (c) However, if an airport's volume forecast includes projections for routes that the airport is seeking to stimulate and which are likely to require route incentives, a provision may need to be made for the possible allowance and potential timing. An airline may not know ahead of time whether the airline/airport goals would be best supported by discounts or contributions to marketing. Therefore, any disclosures around forecast incentives will only be proportionate and effective if made at a very high level;
- (d) There may be incentive arrangements that are not reflected in the pricing forecasts (eg over and above base volumes) and therefore should not, or cannot, be disclosed;
- (e) Irrespective of whether incentives are included or excluded from forecasts, disclosure is complicated by several factors including:
  - (i) Incentives could be growth-based where discounts or rebates are applied for results achieved above forecast;
  - (ii) Incentives could be payable for new routes or services not included in the pricing forecasts;
  - (iii) Incentives or payments may be conditional on airlines taking particular actions; and
  - (iv) Route development is a long dated activity. As such, the revenue stream associated with the route incentive is expected to be generated over a long period of time; and

259. For these reasons, we cannot support the Commission's currently proposed disclosure requirements.

#### **Initial RAB**

260. In Chapter 12 of Topic paper 5, the Commission is proposing to make a change to the IM decision by introducing a pragmatic proxy for the initial RAB value for land as at 2010.<sup>153</sup>

261. NZ Airports agrees that the final value produced by an interpolation is only likely to be "slightly less" accurate than a MVAU land valuation.<sup>154</sup> We agree that requiring airports to undertake a 2010 MVAU land valuation would result in airports incurring significant, and ultimately unnecessary, costs.

262. NZ Airports is of the view that interpolation represents a sensible approach to 2010 MVAU proxy. This decision is in line with the High Court judgment in the Merits Review and represents a solution that is widely accepted in the industry.<sup>155</sup>

#### **Transitional arrangements**

263. The Commission is proposing transitional arrangements for the information disclosures based on the amended IM and ID Determinations. These arrangements are catered to Auckland

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<sup>153</sup> Commerce Commission "Input methodologies review draft decision: Report on the IM review" (22 June 2016), para 154.

<sup>154</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 620.

<sup>155</sup> NZ Airports "Submission on Commerce Commission's input methodologies review: Invitation to contribute to problem definition" (21 August 2015), para 194; BARNZ "Submission by BARNZ on problem definition paper for the input methodologies review" (21 August 2015), p 2.

International Airport Limited and Christchurch International Airport limited, both of whom will set prices in 2017.

264. According to the draft decision, the Commission is proposing amendments to the ID Determination to require Auckland International Airport Limited and Christchurch International Airport Limited to:<sup>156</sup>
- (a) Restate key information provided in the financial disclosure in accordance with the amended ID and IM Determinations; and
  - (b) Explain the difference between the preparation of each component in the transitional Schedule.
265. The Commission's intention is that if the historic disclosure does not reflect the most recent IM and ID requirements, the explanations provided by airports would instead compare the components disclosed in Schedule 18 and the information contained in the new transitional Schedule.<sup>157</sup>
266. The transitional Schedule does not raise concerns in and of itself. However, the requirement to make restatements for up to five years of historical disclosures goes beyond what is strictly required for a transitional Schedule. We understand Auckland International Airport Limited and Christchurch International Airport Limited will each comment on this further.
267. NZ Airports will provide more detailed comments on the proposed changes to the ID Determination in a later submission.

#### **Comments on Specific Decisions in the Report on the IM Review**

##### *Decision AV43 – Financing cost on works under construction - airports*

268. The Commission refers to the original 2010 decision which required that:<sup>158</sup>
- “Airports must capitalise financing costs on works under construction consistent with GAAP, at a rate no greater than the Airport's estimate of its post-tax cost of capital.”
269. In the Report on the IM Review, the Commission is clear that it does not propose to amend this decision. We agree with this approach, and support the existing IM on this point. However, the marked-up amendments to the asset valuation IM have made changes to this provision, and reflect an amended decision where the cost of financing would be determined from borrowing costs, rather than the post-tax cost of capital. We understand this is an error in the marked-up Determination, and the Commission does not propose to amend this part of the IM.
270. We invite the Commission to confirm that these changes are not intended. We will address these issues in submission on the ID and IM Determination.

##### *Decision CC24 – Remove allowance for TCSD*

271. We indicated earlier that we accept the Commission's proposal to remove this allowance for airports.

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<sup>156</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para A10.

<sup>157</sup> Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para A12.

<sup>158</sup> Commerce Commission "Input methodologies review Draft decision: Report on the IM review" (12 June 2016), page 123.

272. The Commission advises in the Report on the IM review that it will give effect to this change through its consideration of the ID Determination.
273. We note that the Commission has not proposed this change in its amendments to the ID Determination or ID Schedules.
274. We will propose these amendments in our response to the ID drafting.

**Other IM Decisions or IMs that remain unchanged**

275. NZ Airports note that there are a number of other IM decisions impacting airports addressed in the Report on the IM Review including:
- (a) Several other IM decisions (eg capital contributions, disclosure of rationale for proxy cost allocation allocators); or
  - (b) IMs that remain unchanged (eg allocating not directly attributable costs);<sup>159</sup> and
  - (c) Several that the Commission found no reason to consider changing (eg allocating directly attributable costs, initial RAB values for non-land assets, finance leases and intangible assets).<sup>160</sup>
276. NZ Airports has not identified any specific concerns. However, we will address any concerns on the proposed amendments to the IM or ID Determinations in our submission on those.

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<sup>159</sup> Commerce Commission "Input methodologies review draft decision: Report on the IM review" (22 June 2016), Part 2, p 113 onwards.

<sup>160</sup> Commerce Commission "Input methodologies review draft decision: Report on the IM review" (22 June 2016), Part 3, p 163 onwards.