

Cross-submission on Commerce Commission's input methodologies review draft decision

18 August 2016



INTRODUCTION

1. The Commerce Commission ("**Commission**") has invited cross-submissions on submissions responding to its draft decision of 16 June 2016 ("**draft decision**") as part of its review of input methodologies ("**IM Review**") being undertaken pursuant to section 52Y of the Commerce Act 1986 ("**Act**").
2. This cross-submission by the New Zealand Airports Association ("**NZ Airports**") responds primarily to the submissions made by aviation sector participants: Air New Zealand, the Board of Airline Representatives New Zealand ("**BARNZ**") and the International Air Transport Association ("**IATA**").
3. NZ Airports intends to provide any cross-submissions on the IM review Topic paper 4: Cost of capital issues in accordance with the timetable for submissions (by no later than 25 August 2016).
4. The NZ Airports contact for this submission is:

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OVERVIEW

5. There is a great deal of common ground between NZ Airports and other parties. However, as is natural for a cross-submission, we focus on specific points of difference raised in the submissions.
6. In this section we comment on key themes in the submissions. In particular:
 - (a) The information disclosure ("**ID**") regime is centred on providing transparency as to what airports have done in pricing. Changes to curtail or narrow the flexibility of ID and to require excessive detail will not assist transparency, as they are likely to contribute to a mismatch between pricing approaches and disclosures. This makes it particularly important to carefully assess that the benefits of new requirements exceed the costs;
 - (b) Submissions from aviation sector participants place undue emphasis on numerical comparisons when undertaking an assessment of airport performance. That approach is at odds with the Commission's clear commitment to undertaking a contextual assessment of airport profitability, which in our view is the starting point for an assessment of airport performance; and
 - (c) Focus on numerical comparisons alone risks providing the wrong incentives for innovation and investment, contrary to the Part 4 purpose.

Conflation of ID and pricing

7. A common theme throughout BARNZ's submission is that there should be less flexibility and greater prescription in the Commission's price setting disclosure proposals. That is because, in BARNZ's view, flexible disclosure requirements will allow airports to adopt pricing approaches that are inconsistent with the purpose of Part 4.

8. For example, BARNZ submits that:¹

BARNZ considers that the Commission needs to place tight guidelines around when it is appropriate to target such under (or over) recoveries with the intention to later recoup them, and over what sort of time-frame. BARNZ would be highly concerned to see this provision be used as a matter of course or in an inappropriate manner to enable excess returns to be earned – which is what we think the currently proposed lack of constraints and guidelines will result in.

9. BARNZ's submissions blur the line between pricing and ID. Its approach appears, in places, to indicate a desire for ID requirements to more tightly constrain pricing approaches, which conflicts with the Commission's appropriate approach of ensuring that the ID requirements allow airports to fully and transparently disclose their pricing approaches.
10. The key point is that disclosure is a first step. Airports are fully aware that the way the Commission assesses the approach taken by airports is an important second step in its review of airport performance. It is therefore incorrect to think that a lack of tight guidelines in the pricing setting disclosure requirements will mean that the appropriateness of airports' decision-making is not subject to close scrutiny.

Submissions focus on numerical comparisons

11. BARNZ's concerns arise because of its focus on numerical comparisons as the key to understanding airport performance (notwithstanding its correct submission that the Commission needs to balance all four limbs of the Part 4 purpose statement when setting the IMs). The submission raises concerns about the carry forward mechanism giving airports the ability to earn excess profits, because it might produce the 'wrong' number in the context of the forward-looking profitability indicator. Those concerns are unfounded and come about through not fully recognising the Commission's stated commitment to a contextual assessment of airport profitability, of which the forward-looking profitability indicator is one part.²
12. We therefore remain concerned that a key risk arising under the Commission's proposals is that interested parties' starting point and end point for assessing airport performance will be to compare the disclosed internal rate of return ("IRR") to the mid-point WACC estimate.

Incentives for investment

13. IATA's submission observes that economic regulation can provide the wrong incentives, such as limiting incentives to innovate and invest in order to ensure that such measures "do not exceed the "acceptable" level of return".³ NZ Airports agrees. This reflects our concern that assessment of profitability through pure numerical comparisons risks creating a regulatory environment where innovation and efficiency is stifled to avoid the risk that an airport is perceived to be earning excess returns. Again, however, the IATA submission (like BARNZ's) fails to observe that this concern is properly addressed through the contextual assessment of airport performance that we understand is front and centre of the Commission's approach to profitability assessment under its draft decision (and not by imposing additional performance metrics).

¹ BARNZ "Submission on Airport for Input Methodologies Review Draft Decision" (4 August 2016).

² Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 140.

³ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

WACC PERCENTILE RANGE

Mid-point of the WACC range and justification of returns

14. BARNZ is of the view that the "starting position" for assessment of an airport's profitability is the mid-point of the weighted average cost of capital ("**WACC**") range.⁴ NZ Airports believes that no percentile should be given undue prominence in assessing airport performance: the better approach is to start with a contextual assessment. As explained in our submission of August 4 on the draft decision, the challenge for the Commission will be to ensure its regulatory estimate of WACC does not become a bright line benchmark when assessing airport profitability. In particular, we agree with the Commission that:
- (a) A specific point estimate or precisely defined WACC percentile range applied to all airports is inappropriate; and
 - (b) The appropriate percentile or range is potentially different for each airport, and is unlikely to be consistent over time.⁵
15. The Commission's clear signal that profitability assessment will be undertaken under an approach that does not afford any percentile undue prominence is welcome.
16. However, BARNZ's views add to our concern about the mid-point receiving undue prominence. BARNZ asserts that:⁶
- ...any movements away from the mid-point need[ing] to be clearly justified by the airport as producing outcomes in the long term benefit of consumers.
17. NZ Airports disagrees with the approach to assessing returns advocated by BARNZ, namely requiring "clear justification" for any differences between an airport's WACC estimate and/or target returns and the Commission's WACC mid-point estimate. This implies that the regulatory mid-point WACC is the "right" target return for an airport, and that anything else is automatically presumed to be "wrong" or "excessive" until proven otherwise. Returns that are different to the regulatory mid-point WACC should not automatically be deemed to require justification. Instead, the supporting information supplied by airports is part of the exercise of determining what a normal return is for each airport.
18. BARNZ's view stands in contrast to not only the inherent uncertainty involved in the WACC estimate but also the Commission's proposal to undertake comprehensive contextual assessment of airport performance in accordance with the expert advice of Professor Yarrow. Features of such assessment include:
- (a) The regulatory WACC estimate must not have undue prominence or, in effect, prescribe pricing. It is just one factor among many;
 - (b) The uncertainty of any WACC estimate is recognised;
 - (c) More emphasis on the impact that airport-specific factors can have on an airport's estimate of its WACC;
 - (d) The Commission and interested parties meaningfully engaging on the explanations provided by airports for their specific pricing approaches; and

⁴ BARNZ "Submission on Airport for Input Methodologies Review Draft Decision" (4 August 2016).

⁵ Commerce Commission "Input methodologies review draft decision: WACC percentile for airports" (16 June 2016), para 103.

⁶ BARNZ "Submission on Airport for Input Methodologies Review Draft Decision" (4 August 2016).

- (e) An assessment of all of the Part 4 purpose statement objectives - ie investment, innovation, efficiency and quality.
19. Further, as the Commission has acknowledged, multiple approaches can be consistent with the Part 4 purpose statement. In those circumstances, judgement must be exercised as to the best approach.
20. Airports of course consider consumer interests when reaching consulted outcomes. And the disclosures and explanations provided by airports will allow a full contextualised assessment of those consulted outcomes. As discussed in our submission:
- (a) Airports that adopt pricing approaches that differ from the IMs should not be presumed to be taking inappropriate approaches (the IMs are not a default arbiter of consulted outcomes);
- (b) Interested parties must evaluate consulted outcomes with an open mind. This is particularly the case when considering an airport's target return. All interested parties will receive an explanation of the reasons why an airport's targeted return may differ from its own WACC (which is, itself, just an estimate), and why that return may also differ from the regulatory mid-point WACC; and
- (c) This view is consistent with Professor Yarrow, who made it clear that differences between an airport's return and the mid-point WACC estimate are not evidence of excessive pricing, and should not be treated as such by the Commission or other interested parties.⁷

PROFITABILITY ASSESSMENT

Use of the carry forward mechanism

21. While supporting the creation of a carry forward mechanism, BARNZ expresses concern that the:⁸
- ...ambit of the carry forward mechanism proposed by the Commission is too wide and has insufficient safeguards to prevent it from being used as a mechanism to enable excessive profits to be extracted.
22. We do not think BARNZ's stated concerns are justified under the Commission's draft decision:
- (a) Airports need to consult on the underlying pricing or risk-sharing arrangements that are subsequently reflected in the disclosed carry forward mechanism. That is, the underlying pricing arrangements that are disclosed as a carry forward cannot be put in place by an airport after they have made their pricing decision.
- (b) BARNZ also misconstrues the purpose of the proposed carry forward mechanism. The mechanism is designed to ensure that an airport's disclosures best track what an airport is doing in pricing: it is a mechanism to improve transparency. That will be achieved by supplementing the IRR forward-looking profitability indicator with a carry forward mechanism that can be used to adjust the opening investment value and the

⁷ 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.

⁸ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

forecast closing value used in an IRR calculation.⁹ The mechanism is therefore designed to offer an efficient means by which the Commission can assess the impacts of relevant adjustment on an airport's forecast profitability.

- (c) Indeed, the introduction of the carry forward mechanism is likely to impose greater prescription on the *ex-ante* ID requirements regulated airports are subject to.
- (d) As we have described above and as the Commission made clear in the draft decision, a full contextual analysis by the Commission and interested parties of the information disclosed by airports will take place. It is at this point that judgements will be made by interested parties about the returns airports are earning. In other words, airports understand that their decisions will always be subject to scrutiny. It is therefore incorrect for BARNZ to assert that the "ambit of the carry forward" is such that it will somehow provide a new freedom for airports to earn excess returns.
- (e) Furthermore, the disclosure of *ex-post* returns and performance are transparent to interested persons to assess and evaluate. As a result, there is no ability to "game" returns as BARNZ is suggesting.

Use of carry forward mechanism to record revenues associated with assets held for future use

- 23. For *ex-ante* disclosures, the Commission is proposing that if charges are set for assets held for future use ("**AHFU**"), then the revenues must be shown as an offset in the forecast AHFU disclosure that is required in schedule 18 (schedule 18 provides *ex-ante* disclosure for the pricing period).
- 24. We understand that BARNZ supports the Commission's proposal for revenue earned from AHFU to be separately tracked outside the regulated asset base ("**RAB**") and pricing revenue. This is welcomed by NZ Airports.
- 25. We note that BARNZ refers to schedule 4 as the appropriate mechanism to track AHFU. We agree this is the case for *ex-post* disclosures, but note the new requirements in schedule 18 are also required for *ex ante* tracking (and we assume that BARNZ accepts this).
- 26. BARNZ nevertheless raises issues with the potential use of the carry forward as an alternative option to account for revenue being earned on AHFU. For example, it says a problem is that the value of the AHFU will continue to increase at the full cost of holding it because the revenue is not set off against the increasing value of the AHFU.¹⁰ NZ Airports believe this concern can be adequately addressed by airports fully explaining how the carry forward amount has been calculated, which can be assessed when the Commission carries out its summary and analysis processes to consider whether the carry forward amount is sufficient to achieve an equivalent outcome as under the separate tracking approach.
- 27. We also appreciate that the Commission's preferred approach is for airports not to use the carry forward - ie it should only be used if for some reason an airport cannot separately identify the revenue associated with the AHFU. We see the value of the Commission's proposal as being that it sensibly allows airports to use an alternative approach if that will better reflect their pricing decisions as they relate to AHFU.

⁹ Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 167.2.

¹⁰ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

Use of carry forward mechanism to record targeted over and under-recoveries

28. BARNZ expresses concern about the use of the carry forward mechanism to record targeted over and under-recoveries. BARNZ's primary concern is that:¹¹

...the open-ended nature of this proposal creates an incentive for an airport as a matter of course to over-state its forecast costs and under-state likely demand, so as to portray a perceived 'under-recovery' for the airport to identify as a shortfall it intends to later recover.

29. BARNZ has also argued that the closing carry forward has a "limitless nature" with no constraints on time, and has requested that the Commission places tight guidelines around the use of the carry forward, particularly in relation to the time-frame.¹²

30. The assertion that airports will have incentives to inflate cost forecasts and understate demand "as a matter of course" is inaccurate and without foundation.¹³ Forecasts used in price setting are subject to robust engagement during consultation, with considerable airline input. They are transparently disclosed and can be scrutinised by the Commission as part of its assessment. Indeed, during the section 56G process, the Commission routinely found that airports' demand forecasts were reasonable and reflected expectations of future demand. For example, in its Final s56G Report on Christchurch International Airport Limited, the Commission considered:¹⁴

...that Christchurch Airport's overall demand forecast for PSE2 is unlikely to result in returns higher than forecast. Therefore, with hindsight, Christchurch Airport's demand forecast for PSE2 does appear to be reasonable. We also consider that the demand forecast for PSE1 was reasonable.

[...]

...these concerns raised by airlines have not been realised.

31. In addition, BARNZ's submission does not consider that the carry forward is ultimately a disclosure mechanism designed to aid transparency. When the Commission undertakes an assessment of the price setting disclosure, any approaches taken in pricing that the Commission does not consider to be in the long term interests of consumers can be identified.
32. By way of solution to the perceived problem, BARNZ proposes placing "greater guidelines around when it is appropriate to target such under or over recoveries", such as limiting the use of the mechanism to "unusual situations where its use may result in more efficient pricing".¹⁵
33. NZ Airports agrees that the carry forward should not allow airports to adopt inefficient pricing approaches. We are clear that it will not do that. However, by seeking to prescribe limitations on the occasions on which airports can use this disclosure approach, the Commission and interested parties may be deprived of the benefits the carry forward can provide.

¹¹ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

¹² BARNZ "Submission on Airport for Input Methodologies Review Draft Decision" (4 August 2016).

¹³ BARNZ "Submission on Airport for Input Methodologies Review Draft Decision" (4 August 2016).

¹⁴ Commerce Commission "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport" (13 February 2014), paras F149 and F152. See also "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport" (8 February 2013), para D39 and "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), paras F78 - 82.

¹⁵ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

34. That is because restricting an airport's ability to adopt the proposed disclosure mechanism increases the risk of an airport's disclosures not aligning with the approach taken in pricing. That is contrary to the purpose of ID and the policy intent underlying the carry forward mechanism.¹⁶ Our submission emphasised that key to the workability of the carry forward mechanism is that the airport must be able to disclose matters consistently with its approach in pricing.
35. The adoption of such guidelines is therefore not necessary or justified under the Commission's decision-making framework.

Unforecast revaluation gains or losses

36. BARNZ supports the Commission's proposal for carry forward of unforecast revaluation gains or losses but only from in the previous period. As per our previous submission, we understand and support the Commission's proposal to allow the carry forward of unforecast revaluations (gains or losses) from the start of ID regulation (2010). This will align with the Commission's principle of financial capital maintenance.¹⁷
37. BARNZ also caveats its support by asking what the situation would be if an airport was not revaluing assets, but subsequently decided to switch its approach - would it remain the case that only "real" revaluations should be carried forward?
38. In our view, it would be helpful to further discuss unforecast revaluations during the technical consultation phase - to confirm the Commission's intent on how different scenarios should be treated, and then to ensure the definition of unforecast revaluation is appropriately drafted. For example, another scenario that does not appear to be covered by the definitions is where an airport has forecast periodic land revaluations - the definitions appear to require the whole periodic revaluation to be treated as unforecast, rather than the difference between actual and forecast.¹⁸

Degree of acceptance for risk-sharing arrangements

39. BARNZ "fundamentally disagrees" with the Commission's proposal to limit the disclosure of the degree of acceptance of risk allocation to being "only in the event that an airport has included a carry forward adjustment to the opening investment value reflecting alternative risk allocations".¹⁹ BARNZ believes that disclosure requirements should cover "any disagreement over the absence of a risk-sharing arrangement," and that the Commission should indicate that it will assess, as part of summary and analysis, decisions by airports not to adopt risk allocation proposed by airlines.²⁰
40. We oppose any proposals to impose mandatory disclosure requirements for the "degree of acceptance" or for alternative risk sharing arrangements or decisions not to adopt proposed alternative approaches. That is because:

¹⁶ In considering whether the IM or ID amendments are seeking to achieve the right thing in the right way, one consideration the Commission has set for itself is whether the amendment is achieving its policy intent (Commerce Commission "Input methodologies review draft decision: Framework for the IM Review" (16 June 2016), para 73).

¹⁷ NZ Airports Association "Submission on Commerce Commission's input methodologies review draft decision" (4 August 2016), para 231.

¹⁸ This is discussed in more detail in our submission on the draft IM and ID determinations - see NZ Airports "IM and ID determination submission" (18 August 2016), p 5.

¹⁹ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

²⁰ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

- (a) Mandatory disclosure requirements are likely to be unworkable. Different airlines have historically had (and are likely to continue to have) different views on different proposals, so it can be an onerous task to identify the "degree of acceptance"; and
- (b) It creates incentives for consultation participants to provide views with the aim of influencing subsequent ID analysis, instead of genuinely engaging for price setting purposes. It would be unfortunate if ID requirements provided incentives to not reach common ground in consultation.
41. In our view, BARNZ's proposition is also inconsistent with the Commission's underlying policy. While ID regulation does not prescribe risk allocation, the Commission has sought to establish some core principles for risk allocation - which apply to all regulated sectors. Unforecast revaluations aside, we agree with the Commission's starting point that for airports it is appropriate that if there are no alternative risk sharing arrangements in place, then airports wholly assume the risk.²¹
42. In those circumstances, it makes no sense to require airports to make disclosures about decisions to follow the "default position" established by ID. To the extent that explanation and justification is required, it is about decisions to depart from the default assumptions.
43. BARNZ's proposal therefore goes beyond the remit of ID regulation (which as Professor Yarrow advised the Commission is a low-end form of regulatory control to address the risk, or eventuation of the risk, of adverse effects arising from the exercise of market power).²² The rationale behind BARNZ's opposition to the Commission's proposal and its suggested response does not appear to us to support additions to ID that will facilitate outcomes in the long term interest of consumers.
44. As expressed in our submission, airlines are already able to provide their views during consultation and subsequently to the Commission if they so choose. This view aligns with that of BARNZ during the Profitability Workshop process. There, BARNZ submitted:²³
- During consultation each airline (or BARNZ on behalf of the airlines it represents) will raise any matters where they disagree with what is proposed by the airport...the consultation process usually involves the exchange of fairly detailed written documents - proposals in the case of the airports with supporting material, and assessments of those proposals or submissions by each airline...
45. We are pleased that BARNZ has previously acknowledged the extensive and comprehensive process airlines and airports undergo during consultation. Airports welcome robust and informed discussion during consultation, which is a process that provides ample opportunity for airlines to provide their views. Those views are always taken into consideration by airports and inform airports' decision-making.
46. To conclude, NZ Airports is not seeking to stop BARNZ and other airlines providing views to the Commission on the adoption (or non-adoption) of alternative risk sharing arrangements by airports. We anticipate that they can and will do so as part of any summary and analysis process. Our point is simply that there should not be a mandatory ID obligation for airports to disclose airlines' "degree of acceptance" (or non-acceptance).

²¹ Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), paras 335 to 345.

²² 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.

²³ BARNZ "Submission on Post profitability workshop comments" (21 December 2015), p 3.

47. BARNZ also proposes that the Commission introduce a compulsory carry forward to wash-up for the timing of major capex projects.²⁴ As we have previously submitted, any mandatory carry forward for capex is an unnecessarily blunt tool and risks being contrary to the purpose of Part 4. It would risk disincentivising efficient investment and constraining market development.²⁵

Alternative methodologies with equivalent effect

48. BARNZ states that it does not oppose the introduction of the alternative methodologies with equivalent effect provision. However, it submits that it should only be able to be implemented with the prior leave of the Commission.²⁶ In its view, this would align the alternative methodologies with equivalent effect provision with the requirements for the next closest alternative. BARNZ is concerned that airports would have the freedom to develop an alternative methodology without the permission of the Commission.
49. NZ Airports opposes the imposition of this additional requirement because the Commission's proposal can be formulated in a way that provides sufficient safeguards, namely:
- (a) An alternative methodology applied must:
 - (i) Be likely to produce an equivalent effect to the methodology that would otherwise apply; and
 - (ii) Be consistent with the purpose of Part 4 of the Act; and
 - (b) Schedule 18 (xiv) of the pricing disclosures following a price setting event requires airports to include a description of, and explanation for, any alternative methodologies with equivalent effect that have been applied.
50. Given these requirements, it is not going to be the case that airports can use this provision with the Commission being unaware of the airport's approach and circumstances. Therefore, a formal requirement for the Commission to provide leave to use the alternative methodology is likely to be unwieldy and onerous for both airports and the Commission.
51. BARNZ's concern appears to be that airports will use this provision frequently to avoid IM requirements. Our understanding is that the Commission is providing this option for airports to use on the rare occasions that circumstances make applying an IM unduly onerous. Therefore, it seems that both NZ Airports and the Commission are of the view that this provision will be used sparingly, and as currently proposed will not be capable of being used as a tool to circumvent IM requirements as and when airports wish.
52. BARNZ also questions why the Commission has created provisions for a next best alternative and an alternative approach with equivalent effect. Our understanding is that they serve different purposes. As such, both provisions are necessary. As the Commission explains in the Report on the IM Review and the draft decision:
- (a) Next closest alternative:²⁷
 - (i) The next closest alternative provision allows for an alternative approach to be applied when the prescriptive approach in the IMs become unworkable.

²⁴ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

²⁵ NZ Airports Association "Airport Profitability Assessment Post-Workshop Submission" (22 December 2015), p 11.

²⁶ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

²⁷ Commerce Commission "Input methodologies review: Report on the IM Review" (22 June 2016), pp 13, 14.

"Unworkable" refers to situations where the prescriptive approach set out in the IM cannot be reasonably implemented as intended. The next closest alternative provision aims to provide flexibility while maintaining certainty of the *material* effect of the IMs.

- (ii) As the name suggests, the next closest alternative is not constrained to producing outcomes that the IM would produce. The next closest alternative can result in an equivalent or non-equivalent outcome to the prescriptive approach.
 - (iii) This is a general provision and can be applied by all companies regulated under Part 4.
 - (iv) The next closest alternative will be formulated by the Commission, and can be determined following a request from a supplier.
- (b) Alternative methodologies with equivalent effect:²⁸
- (i) Airports can apply alternative methodologies with equivalent effect where the application of the asset valuation IMs would prove prohibitively complex or costly. The inclusion of alternative methodologies with equivalent effect is intended to result in a reduction in complexity and compliance costs for complying with the IMs while still promoting the purpose of Part 4.
 - (ii) As the name suggests, the outcome of the alternative methodologies with equivalent effect must be likely to be the same as if the existing IMs have been applied. This is in order to give effect to existing IM decisions.
 - (iii) This provision is specific to the roll forward of the RAB for capex, disposals, depreciation and revaluations specified in the asset valuation IMs.
 - (iv) The alternative methodology with equivalent effect is applied by airports, subject to specific criteria.

Depreciation

53. BARNZ has submitted that the proposed IM principles for non-standard depreciation should include a great deal more prescription regarding the justifications that must be provided by airports. For the reasons set out in our submission on the draft decision, we disagree. The Commission's proposed principles are sufficient to guide airports on how to make transparent disclosures that will allow their decisions to be fully assessed by interested parties. BARNZ's proposals will not further assist in that regard - and instead will constrain airports' ability and willingness to disclose alternative depreciation methodologies.
54. BARNZ has also pointed out that the proposed IM principles for non-standard depreciation do not expressly address whether non-standard depreciation has to be applied to the RAB as a whole or can be applied to a particular asset or groups of assets.
55. Although there was some historic confusion, airports now understand that the IM Determination (both existing and with proposed amendments) anticipates that depreciation is applied at the individual asset level.

²⁸ Commerce Commission "Input methodologies review: Report on the IM Review" (22 June 2016), p 50 and Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 306.

56. Further, the Commission has framed the problem definition for this issue as a lack of transparency around the use of non-standard depreciation, rather than the way it has been applied to an asset base.²⁹
57. NZ Airports agrees with BARNZ that non-standard depreciation should be reserved for a situation where straight-line depreciation does not give a good representation of the recovery of capital. That provides useful commercial flexibility in ID. However, BARNZ is seeking greater prescription and narrowing around when non-standard depreciation can be used. This is at odds with the Commission's stated goal to ensure transparency through alignment between ID and pricing.
58. BARNZ has also requested that airports disclose the standard straight-line depreciation profile with the non-standard profile on an *ex-ante* basis for 10 years. The rationale for this proposal is that a comparison is needed for this length of time to provide sufficient transparency to interested persons. NZ Airports is of the view that this timeframe has been put forward without any objective justification. Further, BARNZ's assertion that a timeframe of 10 years is appropriate when balancing transparency and preparation costs is misguided. The transparency sought by the Commission is achieved through the application of the seven other non-standard depreciation principles, and the costs associated with compiling this information are underestimated by BARNZ. As such, BARNZ's proposal does not satisfy the Commission's decision-making framework against which it assesses changes to the IMs and ID requirements.

Capex / opex

59. IATA contends that:³⁰
- ...an immediate priority of the Commission must be to develop further guidance on how to assess whether CAPEX and OPEX is being incurred efficiently.
60. In its view, having clear guidelines can "greatly help" in measuring airport performance.³¹ In particular, including criteria in the ID and IM that needs to be applied to assess what capital expenditure ("**capex**") can enter the RAB is seen by IATA as a key tool in maximising capex efficiency.³²
61. In response, NZ Airports submits that the extensive and robust consultation that airports undertake with substantial customers under the Airport Authorities Act 1966 ("**AAA**"), combined with the Commission undertaking a proper contextual assessment of airport performance, will provide an effective means to assess whether an airport's capex and operating expenditure is efficient and not contrary to the long-term interests of consumers.
62. This view corresponds with that taken by the Commission in the *IM (Airport Services) Reasons Paper*. There, the disclosure of forward looking information on planned capex was determined to be sufficient.³³

...the ID Determination requires disclosure of forward looking information on planned capex. This should allow interested persons to monitor whether suppliers are planning to invest when and where required to meet consumer demands, and whether that have appropriate incentives to invest and improve efficiency.

[...]

²⁹ Commerce Commission "Input methodologies review draft decision: Airports profitability assessment" (16 June 2016), para 245.

³⁰ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³¹ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³² IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³³ Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" (December 2010), C6.6, p 161.

In light of this the Commission does not consider that additional approvals or tests, as suggested by NZIER, are necessary in terms of meeting the Part 4 Purpose and the purpose of ID.

63. In addition, the Commission noted that under the AAA, airports are already subject to a requirement to consult on capex of greater than 20 per cent of the value of the airport company's assets within the given accounting period.³⁴ In practice, airports consult on capex thresholds at lower levels than this statutory threshold.
64. We also note IATA's use of capex performance graphs which chart a trend of declining capex forecasts.³⁵ IATA comments that the decreasing trend in forecast capex expenditure "may come about as a result of airports deferring investment".³⁶ Understanding capex and operating expenditure trends and drivers is a complex task so there are risks in seeking to interpret summary graph data. We nevertheless agree that there is a risk that efficient investment may not take place if too great a focus is placed on headline profitability indicators (ie a numerical comparison to a WACC estimate) as opposed to a proper contextual analysis.
65. For completeness, we disagree with:
- (a) IATA's assertion that there is any existing decreased efficiency in operating or capital expenditure;³⁷
 - (b) BARNZ's claim that there is no "direct regulatory oversight" regarding capex.³⁸ Clearly, the consultation undertaken by airports in accordance with the AAA, as well as ID reporting, mean that this is an inaccurate statement; and
 - (c) BARNZ's assertion that there is a "strong financial incentive on airports to over-forecast capex".³⁹ Summary and analysis undertaken by the Commission, as well as consultation with airports' substantial customers, means this is not an issue in practice.
66. There is, however, some common ground between IATA's submission and NZ Airports' views. That is, care needs to be taken to ensure that the right incentives are provided by regulation - and the risk of being found to be earning excess profits can undermine incentives to invest, innovate and be more efficient.
67. However, the additional prescription as advocated for by IATA would not be a solution to this problem. Rather, like the Commission, our view is that robust engagement during consultation and undertaking a full contextual analysis of airport performance will enable interested persons to assess whether all aspects of the Part 4 purpose statement objectives are being met.

Time profile of capital recovery

Asset revaluations

68. BARNZ, like NZ Airports, supports the proposal to allow airports to disclose asset revaluations in a manner consistent with its pricing decisions.

³⁴ Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" (December 2010), footnote 327, p 161.

³⁵ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³⁶ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³⁷ IATA "Submission on Draft Decision Papers and Report on the IM Review" (4 August 2016).

³⁸ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

³⁹ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

69. BARNZ also supports airports having the ability to make different choices for different parts of the asset base - but limited to the asset category level. NZ Airports supports Auckland International Airport Limited's submission on this point. That is, airports are comfortable making the disclosure at the asset category level, but it needs to be accepted that if ID is to follow pricing decisions, then some assets within a category may be revalued and others not. Airports can explain such treatment in their disclosures.

Forecast CPI

70. BARNZ supports the proposal to require disclosure of "IM compliant" CPI forecasts. NZ Airports welcomes BARNZ's confirmation that "there has not in practice been any material issue regarding the forecasting of CPI, due partly to the presence of readily available objective forecasts in the market and also to the fact that the Commission's approach to forecasting CPI used in other regulated sectors has been available to use as a reference point since 2010".⁴⁰
71. This reinforces our view that the proposal to require disclosure of "IM compliant" CPI forecasts serves no useful purpose and cannot be justified under the Commission's decision-making framework, namely its requirement that the benefits of any changes outweigh the costs of change. As discussed in our submission, the Commission's rationale for this requirement is unclear, and there is a risk that the disclosure will confuse, rather than assist, interested parties.

Pricing assets

72. NZ Airports is not surprised that BARNZ supports the proposal to require separate disclosure for the pricing asset base (schedule 19).
73. In response, our views are as follows:
- (a) We acknowledge that airports set standard aeronautical charges using an asset base which is a subset of the full RAB. However, the focus of the price setting disclosure is properly on the entire regulated business, and the disclosed information is already provided at a segmented level across the three categories of regulated activities. We are not convinced that adding further layers of detail is a useful addition to the ID regime. As set out in our submission and Auckland International Airport Limited's submission, there is a risk that the proposed schedule 19 disclosure will simply introduce further complexity; and
 - (b) The better approach under ID is to require a single forward-looking disclosure at the RAB level - consistent with the scope of the service being regulated. Airports will continue to explain the methodologies and approaches they have used to set prices under the existing information disclosure requirements, which provides clear transparency of how the total required return for regulatory activities has been generated.

Cost allocation

74. NZ Airports supports the submission made by BARNZ on this topic, which, in our view, is seeking to ensure that the threshold for use of a proxy cost allocator in place of the causal allocator is not made too prohibitive.
75. In our view, the intent of the IM, as currently drafted, was to support what was happening in practice, because evidence showed that there was constructive engagement between airports and airlines on cost allocation, with positive outcomes for consumers. BARNZ's proposed

⁴⁰ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).

amended definitions of proxy cost and asset allocators, which will allow use of a proxy allocator where it is impractical to use a causal allocator, is consistent with that intent.

76. We do not support the Commission's proposed amendment to require additional explanation where a proxy allocator is used. As BARNZ acknowledges, the proposed additional disclosures simply require "greater explanation", and we do not believe this serves any real purpose.⁴¹
77. We also think that the constructive engagement between airports and airlines on cost allocation distinguishes regulated airports from regulated electricity and gas businesses. In particular, and as described earlier in this submission, the AAA mandates airport consultation with its customers. This is robust and comprehensive. We encourage the Commission not to make changes to the airport cost allocation IM simply because it is proposing to amend the electricity and gas IMs. Accordingly, we submit that the cost allocation IM for airports should not be amended.

⁴¹ BARNZ "Submission on the Commerce Commission Proposed Changes to the Input Methodology and Information Disclosure Determinations in relation to the Airport Topic" (4 August 2016).