

28 November 2017

Introduction

1. This is New Zealand Airports Association's ("**NZ Airports**") submission on the process and issues paper that was released as part of the review of Auckland International Airport Limited's ("**Auckland Airport**") and Christchurch International Airport Limited's ("**Christchurch Airport**") third price setting events (July 2017 - June 2022) ("**Issues Paper**").
2. The NZ Airports contact for this submission is:

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3. NZ Airports' comments focus on the regulatory framework issues and matters that are relevant to the regulated airports in general. Auckland Airport and Christchurch Airport will provide separate submissions specific to their price setting events.

Executive Summary

4. NZ Airports is generally comfortable with the approach for the review proposed by the Commerce Commission ("**Commission**"). However, we request an extension for cross submissions **until 22 December 2017**.
5. Key views covered in this submission include:
 - (a) that the review is an important part of an effective information disclosure regime under Part 4 of the Commerce Act 1986 ("**ID Regime**");
 - (b) section 53B of the Commerce Act 1986 ("**Act**") provides the Commission with flexibility to run an efficient and cost effective review. We encourage the Commission to maintain a tight focus for this review, and to not expand the topics for consideration set out in the Issues Paper;
 - (c) the price setting disclosures are the key information source for the review. Auckland Airport and Christchurch Airport have fully and transparently explained their decisions in accordance with the purpose of Information Disclosure, as this contributes to an effective ID Regime;
 - (d) the focus should be on assessing the pricing decisions made by airports based on the information that was available to them at the time – including available Commission guidance;

- (e) the review should not criticise airport decisions if airports could not have reasonably anticipated the reason or basis for that criticism when they set prices (for example, if the Commission provides new guidance on how it assesses aspects of performance);
- (f) it is appropriate to select a few performance areas for focus, but it is important to consider the full extent of information provided by the airports in relation to each of those performance areas, to provide a balanced view of performance;
- (g) it will not be helpful to speculate about future airport decision-making as a means of assessing the third price setting event ("PSE3") decisions (analysis of actual outcomes over time is the better approach); and
- (h) the review should not provide a forum for consultation participants to raise new concerns or put forward new evidence or arguments that were not put to the airports during the consultation process. The review should not have the effect of repeating or extending consultation on the airport pricing decisions.

Purpose of the Review

6. The Commission notes that:
 - (a) section 53B(2)(b) of the Act requires it to publish summary and analysis as soon as practicable after the price setting disclosure is received;
 - (b) the purpose of summary and analysis is to promote greater understanding about the performance of each airport, their relative performance, and changes in performance over time; and
 - (c) the supply of regulated airport services is influenced by the ID Regime, and the requirement to publish summary and analysis confers an ongoing, active role on the Commission.¹

7. NZ Airports agrees. We believe that summary and analysis under section 53B of the Act is an important part of maintaining an effective ID Regime. In particular, the review provides an opportunity to:
 - (a) provide further confidence to consumers that airports are achieving the objectives of the Part 4 purpose statement; and
 - (b) identify any concerns for airports to address going forward, as each regulated airport is committed to ongoing improvements in performance.

8. The wording of section 53B of the Act makes it clear that the Commission should focus on reviewing the airports' price setting disclosures. In practice, that means focussing on understanding the decisions made by airports, and the reasons for them at the time the decision was made. Constructive engagement in this review could provide lessons that influence future airport decision making. However, we do not think that this review should provide an opportunity to criticise airport performance if airports could not have reasonably anticipated the reason or basis for that criticism when they set prices.

¹ Commerce Commission *Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services* 20 October 2017, paras 1-5.

Focus of the Review

9. The Commission has explained why it believes its obligation under section 53B of the Act is different to that under section 56G, and that it has greater flexibility on how the review is carried out under section 53B.²
10. NZ Airports agrees. Section 53B of the Act does not require the Commission to consider all aspects of performance at one time, or conduct a process that is as extensive and time-consuming as the section 56G reviews.
11. The Commission has previously signalled that it planned to use section 53B of the Act to undertake summary and analysis following price setting events, with the aim of providing similar benefits to the section 56G process.³
12. NZ Airports is comfortable with that approach, and we encourage the Commission to ensure that any review process is as efficient and cost-effective as possible. A focussed and targeted review can still be sufficiently rigorous to provide comfort to interested persons that airports are subject to effective monitoring by the Commission.
13. NZ Airports understands the basis for the proposed focus areas for the review, subject to the comments in the following paragraphs. Consistent with previous Commission guidance, we anticipated that the review would focus on whether airports are restricted in their ability to extract excess profits. We acknowledge that the price setting disclosures provide the most detail about expected profitability, prices, and forecast operating and capital expenditure.
14. That said, the disclosures also include valuable information about quality, innovation and efficiencies, which provide important rationale and context for the airport pricing decisions. This information should also inform the Commission's analysis, to provide a balanced view of airport performance.
15. Although we believe it would be unduly costly, and time consuming, to review and report on whether airports are meeting each limb of the purpose statement (as under section 56G), it is nevertheless important to ensure that profitability (and other performance areas subject to review) are considered in their proper context. The full explanation provided by the airports in their disclosures must be analysed and then summarised by the Commission.
16. Accordingly, to help satisfy the purpose of section 53B – promoting greater understanding of performance – we ask the Commission to ensure that, when considering all of the focus performance areas:
 - (a) relevant context is considered and summarised for consumers, including:
 - (i) performance areas that are not subject to the review, but which are relevant to understanding performance on profitability (including quality, innovation and efficiencies);
 - (ii) the information that was available to the airports at the time they set prices, which set their expectations of how performance would be reviewed. This includes guidance from the Commission, and views provided by customers during consultation. Conversely, we do not consider it appropriate for a summary and analysis of pricing decisions to

² Commerce Commission *Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services* 20 October 2017, paras 13-18.

³ See, for example, Letter from Dr Berry to Hon Craig Foss on 13 February 2014.

include information, evidence or arguments that were not available when prices were set; and

- (iii) performance trends and developments over time, taking into account evidence of airport conduct and outcomes. This may mean that some decisions need to be considered in their historic context, while for others it may be too early to definitively summarise their outcomes.
- (b) although the Issues Paper focuses on identifying issues to be subject to review, equal weight is given to analysing and summarising positive performance outcomes.

Timeframes for undertaking the review

- 17. Generally, the timeframe and process proposed appear workable in light of the proposed scope of the review. However, we would appreciate the Commission being open to some flexibility on timeframes if necessary – for example, we have been informed by Wellington Airport that resourcing may be an issue throughout 2018, as it will be undertaking pricing consultation. We also request that submissions and cross submissions are not due during School Holiday periods (e.g. April).
- 18. Our only immediate concern is the tight timeframe between the date that submissions on the Issues Paper are due (28 November 2017) and the date that cross submissions are due (12 December 2017).
- 19. The cross submissions provide an important opportunity to understand and respond to any further issues raised by interested persons, and is the last opportunity to provide further relevant information and views prior to the draft report for Auckland Airport.
- 20. In light of this, we request an extension for cross submissions **until 22 December 2017**. We consider that this will not hinder or delay the overall process and timeframe for the review. In particular, we would be comfortable receiving the proposed update (if required), soon after the New Year holiday period.

Consultation

- 21. Our preceding comments address the Commission's questions at paragraphs 32.1 and 32.2 of the Issues Paper.
- 22. The Commission has also asked for views about the way that airports have taken account of interested parties' views in their pricing decisions (paragraph 32.3 of the Issues Paper).
- 23. NZ Airports expects each airport to comment on its own responsiveness to customer views during consultation. However, we wish to make the following overarching points:
 - (a) Consultation under the Airport Authorities Act is a key part of the overall ID Regime.
 - (b) It provides flexibility for airports and customers to engage on solutions to complex challenges, as the regulatory structure was designed to promote. Airline views (and views of other stakeholders) are valued by airports, as they genuinely inform and influence decision-making.
 - (c) Consumers should take comfort that the input methodologies, and the prospect of

review by the Commission following price setting, also materially guide and influence airport decision-making.

- (d) In summary, if the ID Regime is implemented as intended by Parliament, then airports and airlines will have flexibility to engage on approaches that are appropriate in the unique circumstances of each airport, and the Commission's monitoring and reporting role should provide consumers with independent assurance that their long term interests are being promoted.

24. We hope that this review will not amount to a re-litigation of consultation discussions, or provide a forum for new issues to be raised by consultation participants.

Specific Considerations for Auckland Airport and Christchurch Airport

25. This section combines the specific considerations identified by the Commission that apply to both Auckland and Christchurch Airports. The sections that follow address the considerations that are specific to each airport. In making comments, NZ Airports has focussed on the regulatory framework issues arising from the Commission's proposals. Auckland and Christchurch Airports will separately address the specifics of their price setting events in their own submissions.

Assessment of Profitability

Question: *Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland and Christchurch Airport?*

26. The relevant amendments to the Input Methodology ("IM") and ID Determinations were designed to provide:
- (a) a clear and consistent mechanism for airports to transparently disclose their target profitability; and
- (b) certainty for airports, at the time they set prices, on how their target profitability would be assessed by the Commission.
27. We are therefore concerned by the Commission's suggestions that it plans to estimate each airport's "expected return for its third price setting event based on [its] understanding of the airport's forecasts and compare this to the airport's disclosed target return."⁴
28. We are not sure what this means. It is unclear based on the Commission's proposed approach:
- (a) what different or additional factors the Commission will consider to estimate an expected return for each airport for PSE3; and
- (b) what steps the Commission will take if it does identify a difference between its expected return and each airport's disclosed return.
29. The airports fully expect the Commission to assess their target returns using the disclosures

⁴ Commerce Commission *Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services* 20 October 2017, para 43.

made by the airports. However, NZ Airports does not understand how the Commission's proposed use of different or additional factors will help interested parties understand the airports' conduct and intent when they set prices.

30. It would make sense to us if the Commission's intent was limited to making relevant adjustments to the disclosed Internal Rate of Return ("IRR") if it concluded that the carry forward mechanism did not accurately reflect pricing decisions (discussed below). However, this is not our understanding of what the Commission has said.
31. The Commission also states that "we intend to consider the impact of different views on forecasts and projections and may perform scenario analysis". We do not think this will be helpful to promote understanding of airport decision-making and conduct.
32. We recall that the Commission undertook scenario analysis during the section 56G reviews. However, the Commission appeared to acknowledge that there was very limited utility in doing so:⁵

We have tested a number of alternative scenarios for areas that have been identified by airlines as having greater risk, in particular the asset values used in our IRR analysis and Auckland Airport's passenger forecasts. We have not placed any weight on any of the results from our sensitivity analysis in forming our conclusion on the effectiveness of information disclosure in limiting the ability of Auckland Airport to earn excessive profits. At this stage we have no reason to consider that the land valuations or passenger forecasts used by Auckland Airport in setting its prices for PSE2 are unreasonable.....

...

Although some scenarios exhibit apparent excess returns (and excess revenues), we do not consider those results affect our conclusion that information disclosure regulation is effective in limiting Auckland Airport's ability to earn excessive profits, because that conclusion depends on our assessment of Auckland Airport's conduct (ie whether it is *seeking* to earn an acceptable return).

[Emphasis added]

33. The Commission's focus should therefore be on the decisions that airports have made – not hypothetical scenarios. In our view, undertaking scenario analysis now will not assist interested parties to understand airport performance.

Cost of Capital

Question: <i>Is Auckland and Christchurch Airports' targeted return appropriate and why?</i>
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34. NZ Airports submits that Auckland Airport's and Christchurch Airport's approach to Weighted Average Cost of Capital ("**WACC**") and targeted return, as described in their disclosures, is consistent with the approach established by the Commission in the Input Methodologies Review ("**IM Review**").

⁵ 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, paras E29, E33.

35. At the conclusion of the IM Review, we understood the Commission to have materially changed the way it would assess airport profitability (in comparison to the section 56G review approach). In particular, we understood that:

- (a) The Commission's regulatory WACC is a starting point only (it is not a "hard" number) and there can be legitimate reasons to depart from it. The Commission, in its IM Review, decision stated:⁶

We consider the mid-point WACC represents our starting point when assessing returns for profitability analysis. However we continue to consider that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate and, as mentioned in paragraph 80.3, we now require airports to provide evidence to explain such differences. This too will form part of such an assessment.

...

This solution provides flexibility to enable any assessment to take into account different contextual factors affecting the airport's required return expectations, or the expectations of a particular project.

- (b) The Commission's approach was heavily informed by Professor Yarrow's advice that it was important to consider airport-specific contexts when making judgements about airport profitability, and that:⁷

Any assessment exercise should properly take account of a range of relevant factors, which it is reasonable to expect will be brought to the attention of the Commission by the airports themselves, as part of any information disclosure exercise.

- (c) Unlike for electricity and gas businesses, this is not about establishing the correct "uplift" to the regulatory mid-point WACC to account for asymmetric social consequences. It is about the airport determining a pricing WACC that, in light of its specific circumstances, best promotes the long term interests of consumers.⁸

- (d) The Commission has not sought to provide express guidance on when a pricing WACC and/or targeted return that is higher than the regulatory mid-point estimate may be appropriate. It is for the airports to provide their reasons in their disclosures, which should be specific to the circumstances of the airport at the time of the estimate. The Commission recognised that an airport may target returns above (or below) its own airport-specific WACC, because:⁹

it is possible that there may be other justifiable reasons for targeting a return above the mid-point (for example, a potential margin due to asymmetric risks not incorporated in the WACC calculation).

36. NZ Airports submits that Auckland Airport and Christchurch Airport have, consistent with the

⁶ Commerce Commission *Input Methodology review decisions – Topic Paper 6 – WACC percentile for airports* 20 December 2016, paras 87-91.

⁷ As cited by the Commerce Commission in *Input Methodology review decisions – Topic Paper 6 – WACC percentile for airports* 20 December 2016, paras 46 to 47.

⁸ Commerce Commission *Input Methodology review decisions – Topic Paper 6 – WACC percentile for airports* 20 December 2016, paras 59 to 65.

⁹ Commerce Commission *Input Methodology review decisions – Topic Paper 6 – WACC percentile for airports* 20 December 2016, para 129.2.

approach established by the Commission, fully explained in their disclosures why they believe they have adopted an appropriate pricing WACC and targeted return that is specific to their individual circumstances.

37. We now expect the Commission will be open minded in assessing those reasons. We also suggest that the Commission will need to be reasonable in assessing the evidence and information used by the airports to make their decisions. As the Commission has accepted following the High Court merits review decision, it is not possible for each and every element of WACC or targeted returns to be rigorously established by empirical evidence. Ultimately, reasonable judgement informed by available evidence is required.¹⁰
38. It is possible that, at the end of the review, the Commission will have concerns about the airport-specific WACC chosen by an airport. If so, the Commission will still need to acknowledge that it has established a new framework that encourages airports to take airport-specific approaches, and the airports should not be criticised for seeking to comply with that framework.
39. Finally, we note that the Commission wishes to review the expert reports obtained by the airports. Auckland and Christchurch Airports will respond to these requests. NZ Airports notes that both Auckland Airport and Christchurch Airport have explained in their disclosures the considerations they took into account, and judgement they exercised, when estimating their WACC and setting their targeted return. It will be important for the Commission to review the expert reports in light of those explanations, and not in isolation.

Carry forward mechanism

Question: *Did Auckland and Christchurch Airports make effective use of risk allocation adjustments? In particular, were any risk allocation adjustments proposed by stakeholders during consultation but not implemented and what was the rationale for the proposed adjustments?*

40. NZ Airports accepts that the Commission will wish to assess whether the use of the carry forward mechanism under the ID Regime accurately reflects each airport's decisions on risk allocation.
41. Auckland Airport and Christchurch Airport will address in their submissions any risk allocation adjustments proposed by stakeholders during consultation. We trust that the review process will not provide an opportunity for airlines to raise new risk allocation adjustment proposals that were not raised during consultation.
42. NZ Airports acknowledges that the Commission would like to understand how risk allocation proposals were considered during pricing consultation. Nevertheless, NZ Airports' understanding following the IM Review process is that there should be no expectation or presumption that risk allocation adjustments will be used. Airports have relied on Commerce Commission guidance provided during the IM review process, including at the workshops in Wellington.
43. The Commission has previously noted that:¹¹

Our risk allocation principle is that, ideally, particular risks should be allocated to

¹⁰ Commerce Commission *Input Methodology review decisions – Topic Paper 6 – WACC percentile for airports* 20 December 2016, para 23.

¹¹ Commerce Commission *Input Methodology review draft decisions – Framework for the IM review* 16 June 2016, para 129.

suppliers or consumers depending on which are best placed to manage them. Workably competitive markets tend to manage risks efficiently by allocating identified risks to the party considered best placed to manage them. Applying this principle in the context of Part 4 regulation tends to promote the s 52A(1)(a)-(d) outcomes for the long-term benefit of consumers in a manner similar to the way those outcomes are promoted in workably competitive markets.

44. The "default" position, therefore, is that risk is allocated to airports because they are best placed to manage it. At the time prices were set, the Commission had appropriately refrained from providing any guidance on circumstances in which alternative risk allocation should be used.

Demand Forecasts

Question: *To what extent does the demand forecast, presented by Auckland Airport and Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?*

45. Demand forecasts are a key part of each airport's pricing decision. We consider that the Commission should be very cautious about reopening the forecasts used by airports when they have been developed by airports and rigorously tested through:¹²
- (a) the commissioning of independent experts;
 - (b) the requests for information from airlines; and
 - (c) extensive consultation with airlines, including the opportunity for airlines to review draft forecasts and provide feedback/supporting evidence.
46. Although the Commission notes that airports have an "incentive to be more conservative in projecting demand for services" so that they earn greater returns,¹³ it omits to note that airlines have an incentive to be optimistic in their forecasts to minimise prices.
47. At the time prices were set, the demand forecasts used by airports were their best estimates. The airport's price setting intent should be assessed on the basis of those forecasts. As discussed above, in that context, NZ Airports believes that scenario analysis would be unhelpful.

Considerations Specific to Auckland Airport

Assets Held for Future Use

Question: *Are there concerns in relation to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing for Auckland Airport's returns on its assets held for future use appropriate?*

48. NZ Airports understood that the introduction of new ID requirements in 2016 was to

¹² Christchurch International Airport Limited *Pricing Disclosure 1 July 2017 to 30 June 2022* 14 August 2017, para 122; and Auckland International Airport Limited *Price Setting Disclosure* 1 August 2017, page 14.

¹³ Commerce Commission *Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services* 20 October 2017, para 62.

recognise that charges such as Auckland Airport's proposed Runway Land Charge ("**RLC**") could be legitimate, and that the ID Regime needed to allow for transparent assessment of such charges, and their impact on profitability.

49. Although Assets Held for Future Use ("**AHFU**") remain excluded from the RAB, the Commission previously said:¹⁴

Airports can expect to be able to earn a full return on and of the costs of holding and developing [assets held for future use], without profits appearing excessive, provided they are eventually commissioned for use to supply airport services.

An airport may include revenues associated with assets held for future use at a future price setting event. If this happens, in order to create transparency around these early over-recoveries, an airport could use the carry forward mechanism to adjust the forecast closing investment value provided it intends to offset these over-recoveries in a later period.

50. NZ Airports also understands that the treatment of AHFU under the IM Determination was in recognition of the (indirect) incentives it provides. In particular, it was intended to avoid imprudent land acquisitions and/or an airport holding land indefinitely without developing it. The High Court recognised that the IMs were an "all or nothing" approach, and that it can be appropriate to include some of the value of AHFU in the RAB prior to commissioning (because price smoothing ahead of soon to be commissioned assets can be economically efficient).¹⁵
51. Auckland Airport has transparently disclosed its intention regarding the RLC in its price setting disclosure:¹⁶

Auckland Airport has included a Runway Land Charge in its Standard Charges. This charge relates to a forecast recovery of the holding costs associated with a proportion of Auckland Airport's assets held for future aeronautical use.

52. NZ Airports would be concerned if, after the Commission has spent considerable time and effort developing a new disclosure mechanism, an airport was subsequently challenged for using it when it has sought to carefully explain why the approach is in the long term interests of consumers.
53. We note that other airports could also legitimately implement different approaches to AHFU in different circumstances. We encourage the Commission to continue to be flexible in its consideration of proposed pricing approaches for AHFU.

Pricing Efficiency

Question: Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?

54. The Commission notes that "Auckland Airport's pricing structure does not currently incentivise any change in peak demand".¹⁷ It also suggests that changes in peak demand

¹⁴ Commerce Commission *Input methodologies review draft decision: Airports profitability assessment* 16 June 2016, para 516.

¹⁵ *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, at [919].

¹⁶ Auckland International Airport Limited *Price Setting Disclosure* 1 August 2017, pages 54-55.

¹⁷ Commerce Commission *Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services* 20 October 2017, para 78.

could allow Auckland Airport to delay the need for a second runway. NZ Airports believes that this proposal raises a broader framework issue, in that it suggests the Commission may seek to reach views on whether different pricing methodologies should have been adopted. In response, NZ Airports submits that:

- (a) It is appropriate for the Commission to consider the information available to an airport at the time it set prices (including views provided by airlines), and the airport's reasons for the decisions it made.
- (b) On the other hand, it would be inappropriate to try to make firm conclusions on whether it would have been better for an airport to decide upon a different charging structure. This is especially the case if the Commission's conclusions were materially influenced by information or views that were not before the airport at the time it set prices. Pricing options associated with responding to demand (such as peak charging) require consideration of complex issues, and cannot be isolated from the broader price setting context. There are also significant practical implementation challenges. The consultation process is well suited to allowing airports and airlines to fully consider all of the relevant complexities.
- (c) Our views are consistent with the Commission's role under section 53B to monitor and analyse what decisions airports have made in their price setting, rather than the decisions that they have not made.

Appropriateness of Investment

Question: *Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?*

- 55. NZ Airports is very encouraged to see that Auckland Airport has committed to a significant investment programme over PSE3, and beyond, to provide capacity and quality to meet future growth. We are confident that each regulated airport will continue to ensure that they appropriately invest to provide quality services in a growth environment.
- 56. All airports in New Zealand, and the tourism industry more broadly, have a strong interest in the regulated international airports providing world class facilities, with capacity to efficiently handle more and more aircraft and passengers over time.
- 57. Indeed, the fact that Auckland Airport has made this commitment to new investment should be celebrated as a success of the ID Regime. It would be bad for the New Zealand economy (noting that tourism is our number one export earner) for the ID Regime to operate in a way that deters investment by the regulated airports, which would harm the long term interests of consumers.
- 58. It appears that the Commission will focus on its view that the significant investment programme presents additional risks when compared to a more "business as usual" approach to investment. We have provided our views on risk allocation above. In short, there should be no expectation or assumption that the size of a capital expenditure programme requires risk allocation adjustments.