

26 June 2018

## INTRODUCTION

1. This is the New Zealand Airports Association ("**NZ Airports**") cross-submission on the Commerce Commission's ("**Commission**") draft report "Review of Auckland International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" ("**Draft Report**").

2. The NZ Airports contact for this submission is:

Kevin Ward  
Chief Executive  
PO Box 11 369  
Manners Street  
Wellington 6011

Email: [kevin.ward@nzairports.co.nz](mailto:kevin.ward@nzairports.co.nz)

3. As with our previous submissions as part of this review process, NZ Airports has focussed its comments on regulatory framework issues raised by submissions on the Draft Report.

## EXECUTIVE SUMMARY

4. Each airline submission supports the Commission's draft view that Auckland Airport has not sufficiently justified its target return. They also argue that all returns above the WACC IM mid-point are excessive, and that at the conclusion of the review Auckland Airport will need to immediately lower prices to cease "overcharging", and to compensate for "overcharging" since 1 July 2017.<sup>1</sup>

5. NZ Airports believes that these submissions highlight that the Commission will need to carefully consider how it can present its final views in a manner that fairly and accurately informs interested parties about airport performance, bearing in mind that some important dimensions of airport performance are not a focus of this review. Regarding the focus of airlines' submissions on profitability:

- (a) Although the airlines' position is not surprising, it is a reminder that interested parties will seek to isolate profitability from other aspects of performance, and readily present or interpret the WACC IM mid-point as a "bright line" benchmark, which suits their broader ambitions for airport regulation.<sup>2</sup>
- (b) The use of the WACC IM mid-point as a bright line benchmark to skew assessment of performance is most starkly demonstrated by Air New Zealand's submission that airports exercise market power when negotiating property leases. This argument is new, and inconsistent with the historical position of airlines that property leases are a better reflection of competitive market outcomes.

---

<sup>1</sup> See Air NZ Submission, at 1; BARNZ submission at [2] and [4]; Qantas Group submission at 1.

<sup>2</sup> Although not relevant to the review, A4ANZ submitted that the regime should be changed to negotiate-arbitrate (A4ANZ Submission, at 3-4).

- (c) In contrast, the Commission has stated that the WACC IM mid-point is not a bright line benchmark. Further, although it is not yet convinced that Auckland Airport's target return is fully justified, it has acknowledged that not all of the additional return above the WACC IM mid-point is necessarily excessive.
  - (d) In its final report, the Commission will therefore need to find a way to more clearly demonstrate to interested parties that its "mid-point WACC estimate is not a bright line",<sup>3</sup> and to limit the opportunities for readers of its final report to misconstrue the findings, and marginalise the complexity and judgment that underlies the assessment of all aspects of airport performance.
6. NZ Airports believes that the following steps will help to provide a clearer picture of performance, and mitigate the strong tendency for interested parties to treat the WACC IM mid-point as a "bright line":
- (a) Avoid using headline numbers that are perceived (deliberately or mistakenly) to be calculations of excess returns.
  - (b) More qualitative analysis. Airports should be given credit where they have sought to carefully justify why their decision-making promotes the long-term benefit of consumers, even if the Commission is not finally convinced by their reasoning.
  - (c) Greater use of the flexibility the Commission has built into the target return assessment framework, and adopting a more holistic approach. The Commission is not required to make "bright line" findings if the context and circumstances suggest the position requires a more nuanced or qualified view. It may also need to present its findings as "likelihoods", reflecting the Commission's degree of comfort (or discomfort).
7. On the other hand, it will be unhelpful if the Commission seeks to establish its own estimate of an appropriate airport-specific target return. This goes beyond the bounds of the ID regime, and would be inconsistent with the assessment framework that the Commission has sought to establish. An airport-specific target return should be viewed in the broader context of an airport's performance, and in light of the difficulty with empirically justifying each individual airport-specific WACC parameter.
8. We know that airlines will oppose, and the Commission will be reluctant to adopt, any assessment approach that could be perceived as weakening incentives on airports to promote the long-term benefit of consumers. Our proposals will not do that. The Commission will remain perfectly entitled to identify concerns, which airports will seriously consider given that the threat of further regulatory intervention is a consequence of not providing the Commission and Government with comfort that airport performance is consistent with consumer interests.

### **LONG-TERM BENEFIT OF CONSUMERS**

9. The main substantive point in the airline submissions is that they consider that Auckland Airport is seeking excessive profits by targeting returns above the WACC IM mid-point.<sup>4</sup> In their view, this means consumers have been, and will be, paying too much.

---

<sup>3</sup> Commerce Commission Draft Report, at [A19].

<sup>4</sup> Board of Airline Representatives New Zealand, *Response to Draft Report on Auckland Airport's PSE3 pricing decision*, 29 May 2018 ("**BARNZ Submission**") at [2].

10. The challenge the Commission has put to airports is to justify target returns as being in the long-term interests of consumers. BARNZ strongly agrees that airports should provide evidence why any target return above the mid-point WACC benefits consumers.<sup>5</sup> The apparent simplicity of the airlines' position ignores the inherent complexity in meeting that challenge. For example:
- (a) Lower prices clearly benefit airlines as consumers of aeronautical services. But airlines do not seek to explain or establish how this will be a benefit for *all* consumers of aeronautical services. That is, there is no evidence available to airports on how any price reductions (or increases) are shared by airlines with passengers and shippers.
  - (b) Without that evidence, it is very difficult for airports to demonstrate how pricing differences between the WACC IM mid-point and their airport-specific target returns impact on the long-term benefit of *all* consumers.
  - (c) Airlines' short term commercial incentives are not always aligned with the long-term interests of passengers and other airport users, and are in fact different for various market sectors, or even routes, that airlines operate in. Views on what will provide benefits under the Part 4 purpose can also differ between airlines – as demonstrated by the fact that BARNZ says in its submission that peak pricing "may not have a noticeable effect" compared to Qantas' submission that differentiated pricing based on time of service may be successful in altering behaviour.<sup>6</sup>
  - (d) On the other hand, airports can have far more confidence in the benefits for *all* consumers delivered by the investment that the target return supports. Nevertheless, it remains very challenging to convert those benefits into WACC parameter adjustments in the way expected by the Commission.
11. Overall, the link between target returns and the long-term benefit of consumers is far from precise or direct. It is a complex relationship, which requires qualitative judgment of how pricing decisions made now will affect outcomes over the long-term.
12. In our view, reducing the risk of regulatory error should be a key benefit that information disclosure regulation provides for consumers. That is, it should provide an effective constraint on clearly excess profits, but where there are grey areas, the Commission does not need to take the risk of erroneously intervening, especially where it is clear that investment and innovation, service quality, and pricing efficiency are consistent with the Part 4 purpose statement.
13. That does not mean there is no risk of regulatory error under performance monitoring regulation. As the Commission has recently noted in the context of its review of asset beta in another sector:
- As a number of submitters and experts have noted, it is difficult to estimate beta with reliability and confidence. There is therefore an inevitable risk of getting an estimate of beta, *or a review of someone else's estimate of beta*, wrong.<sup>7</sup>
14. As NZ Airports has previously submitted, in the context of reviewing airport profitability (and broader performance), the long-term benefit of consumers is best served by the Commission

---

<sup>5</sup> BARNZ Submission at [13].

<sup>6</sup> BARNZ Submission at [34] and Qantas Group, *Qantas Group's Response to Draft Report on Auckland Airport's PSE3 Pricing Decision*, 29 May 2018, at 1.

<sup>7</sup> Commerce Commission, *Review of Fonterra's 2017/18 base milk price calculation – Emerging view on asset beta*, at 110.

seeking to ensure that it does not wrongly conclude that target returns are excessive, when they are not. Faced with an inevitable choice of erring one way or the other, it is better to risk erring on the side of wrongly concluding that target returns are acceptable, when they are not, rather than the other way around. Such a position is entirely consistent with the Commission's approach to WACC for other sectors under Part 4. It is also consistent with promoting the long term interests of consumers, by better promoting investment, innovation and service quality.

## RE-PRICING

15. Airlines have submitted that if the Commission considers in its final report that Auckland Airport will collect excessive returns, then Auckland Airport must re-price immediately and compensate consumers for any over-charging since 1 July 2017.<sup>8</sup> While it is not always clear, it appears that the airlines believe that any compensation or re-pricing should be to align Auckland Airport's target return in PSE3 with the WACC IM mid-point.
16. The airline position is clearly inconsistent with the nature and intent of the ID Regime. It also over simplifies complex pricing decisions. The airlines are silent on the fact that a 5 year pricing period could include some (or all) years of forecast under recovery, which airports may need to consider adjusting if the base for what is considered to be an acceptable return changes. That is, airlines should not assume that it is always the case that each year will be adjusted downwards.
17. If the airlines approach was adopted, it would mean that:
  - (a) per the IM Review, airports are at first encouraged to target returns that are justified in their airport-specific circumstances, consistent with the Commission's guidance that the WACC IM is not a "bright line" benchmark;
  - (b) following price-setting, the Commission then undertakes its review. This could be completed up to two years later;
  - (c) if the Commission is not convinced that the target returns are fully justified, airports (according to airlines) must immediately consult on price changes, and must apply the WACC IM mid-point. It appears that airlines expect this would be the only change to the pricing building-blocks, prior to a full price-setting consultation at the conclusion of the 5 year period; and
  - (d) when airports next consult on prices, they would in theory again be encouraged to target returns that are justified in their airport-specific circumstances, but in practice it would be difficult to do anything other than use the WACC IM mid-point (unless they were prepared to take the risk of being required to re-consult).
18. Such an outcome is a long way from the framework the Commission intended to establish at the conclusion of the IM Review. It would mean that (if the airlines' position was correct):
  - (a) the first negative finding by the Commission could effectively turn the WACC IM mid-point into the only acceptable target return for future price-setting events; and
  - (b) this would directly undermine the ID regime and framework established by the Commission, which empowers airports to have some degree of autonomy on pricing (with subsequent review by the Commission).

---

<sup>8</sup> See for example, BARNZ Submission at [11].

19. Clearly, the airline view is at the extreme end of the spectrum of potential outcomes of the review. But it does help to demonstrate that, if the Commission wishes for its new assessment framework to be effective over time, then it will need to present its findings in a manner that does not feed the airlines' desire for the WACC IM mid-point to be a "bright line" benchmark, and effectively precludes airports from seeking to establish appropriate airport-specific target returns at future price-setting events.

#### **IMPORTANCE OF JUDGEMENT**

20. NZ Airports believes that the Commission will need to be very careful how it presents its final views, so it achieves an appropriate balance between:
- (a) expressing concern about airport decision-making and rationales, if and when doing so is warranted; and
  - (b) not creating expectations that airports are required to respond in a manner that undermines the regulatory framework that the Commission has sought to establish (ie by establishing the WACC IM mid-point as a bright line benchmark that cannot be exceeded).
21. In our view, the key factors in the draft report that work against the Commission's position that "our mid-point WACC estimate is not a bright line" are:
- (a) the publication of headline numbers on "what *customers* can expect to pay". As set out above, the purpose statement refers to *consumers*, not customers, and it is far from clear what passengers as consumers pay. The Commission states that "customers" can expect to pay an additional \$65 million over PSE3, and that "customers" can expect to pay an extra 61 cents per flight. Putting aside our concerns about the material imprecision in these numbers, and that outturns may be different to projections, interested parties simply latch on to these numbers as "excess profits", which is wrong; and
  - (b) establishing an evidential threshold for WACC IM parameter adjustments at a level that strongly implies that the Commission believes the WACC IM mid-point is much more than a starting point for assessing profitability, and is in fact a bright line.
22. As previously submitted, NZ Airport believes the following will help:
- (a) More qualitative analysis. The Commission has placed an onus on airports to explain why their target return promotes the long-term benefit of consumers. Airports should be given credit where they have done so, even if the Commission is not finally convinced by their reasoning.
  - (b) Greater use of the flexibility the Commission has built into the target return assessment framework, and adopting a more holistic approach.
  - (c) More emphasis that any finding by the Commission that an airports target return has not been fully justified does not mean that all of the difference between that return and the Commission's WACC mid-point estimate is "excessive." This should include greater acknowledgement that there is a material degree of imprecision involved in estimating appropriate returns, and judgment is required.
23. On the other hand, it will be very unhelpful if the Commission seeks to establish its own estimate of appropriate airport-specific target returns (for each airport following price setting

events). This goes beyond the bounds of the ID regime, and would be inconsistent with the framework that the Commission has sought to establish. An airport-specific target return should be viewed in the broader context of an airport's performance, and in light of the difficulty empirically justifying each individual airport-specific WACC parameter.

24. Further, the Commission is not required to make "bright line" findings if the context and circumstances suggest the position requires a more nuanced or qualified finding. For example, as highlighted by the draft report's assessment of Auckland Airport's extensive reasoning and evidence for its target return, there is a clear difference between an airport that has:
- (a) disregarded the regulatory framework and / or made little effort to justify its target returns (where the Commission may be able to immediately conclude that the target return is inconsistent with the Part 4 purpose statement); or
  - (b) carefully engaged with the regulatory framework, and spent considerable resource demonstrating to airlines and the Commission that it has a legitimate rationale for its target returns (where the role of the Commission should be to identify any shortfalls in airport analysis, to help promote greater understanding of airport performance by all parties).
25. Put in another way, there is a scale of potential Commission findings:
- (a) clearly within the purpose statement;
  - (b) clearly outside the purpose statement; and
  - (c) between those two extremes, a grey area where definitive conclusions cannot be easily reached. In those cases, the Commission may be able to express a view on the "likelihood" of performance being consistent with the purpose statement.<sup>9</sup>
26. We know that airlines will oppose, and the Commission will be reluctant to adopt, any assessment approach that could be perceived as weakening incentives on airports to promote the long-term benefit of consumers. Our proposals would not do that. The Commission will remain perfectly entitled to identify concerns, which airports will seriously consider given that the consequence of not making the regime work is the threat of further regulatory intervention.
27. It seems to be overlooked that airports are interested parties who benefit from the Commission's reviews, and that they are also learning as the ID Regime evolves and develops.
28. What we ask for is that when presenting its findings, the Commission carefully considers whether it is at risk of reinforcing incorrect perceptions that the WACC IM mid-point is a bright line, and whether there might other ways to present information to help interested parties to understand the complexity and judgment that underlies the assessment of airport performance.
29. In that context, we note that Transpower has submitted that the pricing principles used to assess Auckland Airport's pricing could be applied to all regulated sectors, under the general rationale that there are strong parallels across the sectors. We don't have a view on Transpower's proposal, other than to say that we disagree that there are strong parallels

---

<sup>9</sup> This is based on the approach taken by the Commission to the assessment of Fonterra's asset beta in the *Emerging Views Paper* – we believe such an approach is also necessary for broader profitability assessment.

between airports and electricity or gas utilities. In our view, the complexity of airport service provision, and the complex consumer dynamics, are a key reason why airports are subject to information disclosure only.

### **IMPORTANCE OF CONTEXT**

30. We read with interest BARNZ's statement that it "supports the framework but believes that contextual factors should receive increased emphasis and be applied by the Commission to AIAL in its final report."<sup>10</sup>
31. NZ Airports strongly agrees that contextual factors should receive increased emphasis, as we explained in our submission. NZ Airports' concern is that the Commission's requirement for airports to provide extensive empirical evidence to justify the reason for, and size of, each deviation from individual WACC IM parameters means that, in practice, little or no flexibility is provided to consider airport specific context.<sup>11</sup>
32. Clearly, BARNZ thinks contextual factors will point in an opposite direction from NZ Airport's position. That is only natural. But the point remains that there appears to be common ground that there needs to be an "extra level" of contextual assessment.

### **COMMERCIALLY NEGOTIATED SERVICES**

33. Air NZ argues that individual property agreements outside of pricing consultation are not commercially negotiated, because there is an imbalance of negotiating power.<sup>12</sup> Presumably it would say the same about Wellington and Christchurch Airports – if the projected returns on those assets were higher than the WACC IM mid-point.
34. To our knowledge, this is the first time that Air NZ (or any of the airlines) have raised such concerns. They certainly did not raise concerns when, in the past, returns on leased assets were lower than for assets subject to pricing consultation. Indeed, BARNZ was historically of the view that leased assets were a better indication of competitive market outcomes:

It is BARNZ's experience that returns on the pricing asset base are the most relevant to the question of whether an airport is misusing its right to set charges as it sees fit under the AAA. Returns on leased assets are invariably influenced by market rate provisions contained in the lease agreement which link the rate for leasing the space to market rates charged for comparable space either in the proximity of the airport or in the nearest commercial centre. Price setting powers exercised under the AAA do not contain any such market comparator restriction. Airlines have experienced situations where the airport's target return under the building block methodology is double the average rental rates on a per square metre basis being paid by airlines for leasing space within the terminal building under market rates. For the airlines, it is the return on the pricing which is most relevant to assessing whether an airport is targeting the extraction of excessive profits.<sup>13</sup>

35. As we have set out in our submission, and as will be explained by each airport, the fact that pricing for property leases are set with reference to prevailing market rates, and at different times for different terms, means that returns on property lease assets will not align with the

---

<sup>10</sup> BARNZ Submission at [15].

<sup>11</sup> NZ Airports Association, Submission on AIAL Draft Report, 29 May 2018 at [61].

<sup>12</sup> Air NZ Submission, at 2.

<sup>13</sup> BARNZ, *Cross Submission on IM Review Draft Determinations*, 18 August 2016, at 7.

WACC IM mid-point determined at the time of aeronautical pricing consultations. This is in no way an indication that airports exercised undue market power at the time the leases were negotiated.

36. Air NZ's opportunistic submission is a stark illustration of how the WACC IM mid-point is being used as a bright-line benchmark to skew assessment of airport performance. Instead of starting from an understanding of market dynamics and circumstances in which prices for leased assets are set (as was historically the case), airlines are now starting and ending with the WACC IM mid-point, and are seeking to use it to argue that airports are exercising market power for services that historically did not cause concern.

#### **CONCLUDING COMMENTS**

37. NZ Airports is seeking through this review process to understand and engage with the Commission's views, so that it can better understand expectations for how airports can and should justify their decision-making as being for the long-term benefit of consumers.
38. NZ Airports is therefore disappointed by the airlines' attempts to characterise airports as intentionally seeking to extract monopoly rents under the ID Regime. As stated in our submission, airports are genuinely committed to understanding and applying the guidance provided by the Commission. If there is a difference in views at the conclusion of the review process, then that represents a genuine misjudgement of what was expected of airports by the Commission, and not an attempt by airports to operate outside the ID Regime.