

4 August 2016

Keston Ruxton
Manager Input Methodologies Review
Commerce Commission
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Dear Keston,

Submission on Airport for Input Methodology Review Draft Decision

In exercising its responsibilities to set input methodologies under Part 4 of the Commerce Act, the Commerce Commission has to determine what methodologies are most likely to promote outcomes in the long term benefit of consumers. This involves the Commission exercising a balancing role, as set out in s52A(1)(a) to (d). On the one hand, the Commission needs to ensure that its input methodologies create sufficient incentives for regulated suppliers to innovate and invest and to improve efficiency, but, on the other hand, the input methodologies also need to ensure that those regulated suppliers are limited in their ability to extract excessive profits and have incentives to share efficiencies and quality improvements with customers. In addition, the Commission needs to ensure that the input methodologies promote certainty as per s52R and enable information disclosure requirements to be specified that are able to ensure interested persons have sufficient information readily available to assess whether the purpose of Part 4 is being achieved.

For the most part, BARNZ believes the Commission has struck the appropriate balance and has developed methodologies which will help produce outcomes in the long term benefit of consumers as well as contributing towards improved certainty and transparency. In particular, BARNZ members¹ support the Commission's proposed changes to:

- Create a forward looking profitability indicator so as to create greater transparency around the level of profitability being targeted by airports.
- The creation of a carry-forward mechanism to adjust the opening investment value at the commencement of a price setting period for any unforecast revaluation gains or losses in the previous period.
- Enabling the carry forward mechanism to be used to reflect other risk sharing arrangements between airports and their customers such as capex wash-ups.
- Specify principles around when it is appropriate to use non-standard depreciation and require a greater level of disclosure around the justifications for an airport adopting a non-standard approach.

¹ Air Calin, Air China, Air New Zealand, Air Tahiti Nui, Air Vanuatu, Airwork, American Airlines, Cathay Pacific Airlines, China Air, China Eastern, China Southern, Emirates, Field Air, Fijian Airways, Jetstar, Korean Air, LATAM Airlines, Malaysia Airlines, Philippine Airlines, Qantas, Singapore Airlines, Tasman Cargo Airlines, Thai Airways International, United Airlines, Virgin Australia.

- Require disclosure of the airport's targeted profitability on the pricing asset base as charges are set.
- Specify a timing for cash-flows that reflects a closer approximation to actual revenues and expenditures.
- Maintain a relatively steady set of inputs to the WACC calculation, albeit with a more realistic allowance for the cost of obtaining credit, however focusing on a mid-point of the WACC range as the starting position, with any movements away from the mid-point needing to be clearly justified by the airport as producing outcomes in the long term benefit of consumers.

However, there are two areas where BARNZ considers that the draft decision by the Commission will not produce outcomes in the long term benefit of consumers. These areas both relate to proposed uses of the new carry forward methodology:

- First, the proposal that the carry forward methodology could be used to record revenues associated with assets held for future use.
- Second, the lack of any guidance or principles around in what circumstances it is appropriate (and what justification or disclosure needs to be provided) for an airport to target an under-recovery in a pricing period, with the intention of rolling that under-recovery forward in the carry-forward balance, and subsequently recouping it in a future pricing period.

Revenues associated with assets held for future use

BARNZ supports assets held for future use remaining outside the RAB. However, if an airport decides to charge a return on a particular asset held for future use, in advance of the asset actually being used to provide the regulated service, then schedule 4 already provides an appropriate mechanism enabling this revenue to be recorded, set off against the holding costs of the future use asset, and disclosed. In this situation BARNZ would expect the airport to justify the appropriateness of the advance charging in terms of it reflecting outcomes of competitive markets as well as producing long term benefits for consumers – otherwise BARNZ (at least) would be opposing the proposed charges.

Given the presence of the schedule 4 table, BARNZ does not see the need for a change to permit the carry forward methodology to be used for revenues associated with assets held for future use. If the airport is able to identify the value of an 'upfront recovery' from within an unbundled charge so that it can be recorded in the carry forward mechanism (which is what the Commission is proposing), then BARNZ does not understand why this level of certainty is not sufficient to enable that recovery to be recorded in the existing schedule 4 table recording the value of assets held for future use.

Moreover, the effect of using the carry-forward methodology, as opposed to the schedule 4 asset table, is that the value of the asset held for future use will continue to increase at the full cost of holding it, with the revenue only appearing separately in the carry forward balance, and not being set off against the increasing value of the asset held for future use. BARNZ does not consider this is in the long-term interests of consumers because the long term outcome is one of a higher asset value. In broad terms, the Commission's carry-forward option would result in consumers in the short-term paying the holding costs of assets held for future use; consumers in the medium term receiving the benefit of what was paid by those earlier consumers (ie the carry forward balance) through charges being lower due to the carry-forward balance being offset against required revenue; and consumers in the long-term receiving no benefit at all once the balance of the carry-forward has been fully consumed or offset and having to pay a return on the fully capitalised holding costs of the now in use

asset (which is higher than it would have been had the revenues on the future assets been recorded in schedule 4).

BARNZ therefore fundamentally opposes the Commission's proposed alternative of using the carry-forward mechanism to record any return charged on assets held for future use. We consider the existing facility in schedule 4 is sufficient, provided that the definition of net revenue is clarified, and an ex ante disclosure is required at the time prices are set, as well as the current historical disclosure.

Use of the carry forward methodology to record targeted under- or over-recoveries

BARNZ is concerned over the lack of constraints or guidelines around the Commission's proposal that any forecast under-recoveries (or over-recoveries) that are intended by airports to be recouped (or off-set) in future pricing periods can be included in the carry forward mechanism.

In BARNZ's view the open-ended nature of this proposal creates a very strong incentive for an airport, as a matter of course, to over-state its forecast costs and under-state likely demand, so as to create a situation where it can both increase unit charges (and likely over-recover if demand eventuates at a more realistic forecast and costs are actually incurred at a more realistic level) and also claim a perceived 'under-recovery' which it can then indicate it intends to later recover. The limitless nature of the proposed roll-forward of such targeted 'under-recoveries', unconstrained by time, by amount, by circumstance, by the need for agreement or support from users, by regulatory over-sight of the appropriateness of the forecasts or by actual outcomes, combines to create a situation where airports will have a significantly increased incentive to over-state forecast costs, under-estimate forecast volumes and thus create this perceived targeted under-recovery, which they can then roll forward, even if it does not actually eventuate, and 're-recoup' it later through increased charges, together with the return they accumulate on the carried forward amount in the meantime.

The lack of constraints on the carry forward mechanism in relation to over and under recoveries intended to be off-set in future pricing events means that this provision undermines the s52A(1)(d) objective of limiting the ability of regulated suppliers from extracting excessive returns.

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.

Concluding remarks

These points, as well as others, have been set out by BARNZ in the following table which is based on the structure of the Commission's summary table in the Executive Summary of Chapter 5.

We trust that this letter, and the accompanying table, clearly set out BARNZ's positions on the Commission's draft decision in relation to the airports topic. If the Commission has any queries, please do not hesitate to contact BARNZ.

Yours sincerely,

John Beckett

John Beckett
Executive Director