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### **Cross submission on problem definition submissions**

This cross-submission responds to the submissions from the three major airports and the NZ Airports Association.

As with the initial submissions, Air NZ has been involved in the preparation of the BARNZ cross-submission and endorses in full the views expressed in that response.

Air NZ would like however to comment on airport submissions relating to the WACC percentile range.

#### ***A point estimate?***

Airport submissions on the WACC percentile issue all claim that the current range represents an appropriate estimate and greater specificity in the form of an additional percentile estimate taking into account potential asymmetric effects of mis-estimating the WACC is unnecessary. However, in all the discussion on this issue, airports themselves focus on the point estimate at the top of the stated range, i.e. the 75<sup>th</sup> percentile, rather than the appropriate starting point – which, as the Commission has stated, is the mid-point. This is a direct consequence of the Commission’s approach during the s56G reviews where it focussed on the top of the range, and indeed, did not even consider returns based on the lower end of the range. It appears that airports consider the 75<sup>th</sup> percentile as the starting point and they could conceivably be justified in earning even higher returns on an ongoing basis.

NZ Airports claims that the approach adopted by the Commission during the s56G process has been a chilling factor and has resulted in airports focussing on a WACC “range” which is too low to promote investment. NZ Airports goes on to state that “the Commission has adopted the approach that all returns in excess of the WACC range are excessive.”<sup>1</sup> This is incorrect. Rather, the s56G reviews highlighted that none of the airports were able to demonstrate that a return above the 75<sup>th</sup> percentile WACC could be justified by superior performance or any other factor.

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<sup>1</sup> NZ Airports, Submission on Commerce Commission’s Input Methodologies Review: Invitation to Contribute to Problem Definition, 21 August 2015, p.38, para. 148-149

### ***Contextual Analysis and the Dual Till***

NZ Airports has also indicated a preference for the Commission to engage with it on how airport returns can be assessed in their proper market context. Indeed the call for a proper “contextual analysis” is a common theme among airport submissions. It is therefore surprising that the airports then claim that the influence of the dual till is an irrelevant consideration. That this fundamental feature of the airports context in the New Zealand regulatory framework can be ruled out as irrelevant is absurd.

NZ Airports asserts that taking this feature of the airports’ context into account in assessing whether an uplift to the WACC mid-point (i.e. a normal return) is required would amount to effectively regulating the non-aeronautical activities and result in non-aeronautical activities subsidise or compensate for lower returns on the regulated activities. This assertion is wrong.

The importance of the non-regulated revenues is in providing an additional source of revenue off the back of an investment in aeronautical activities. There is no benefit to consumers in providing an uplift to WACC above a normal return to incentivise investment when the incentive already exists in the form of those complementary revenue streams. This is not to say that the WACC for aeronautical activities should be set at an artificially low level. Rather, the Commission can be confident that a mid-point WACC is sufficient to provide a normal return on that aeronautical investment.

The Bush/Earwaker paper<sup>2</sup> prepared for NZ Airports also highlights that there is significant capex which will not impact on non-aeronautical revenues, or takes the form of asset replacement and renewal, and hence an airport “needs to be adequately incentivised to make such investment on a stand-alone basis, including by permitting the airport to earn a return in line with its WACC.”<sup>3</sup> This is actually an argument regarding the actual level of WACC rather than one advocating for an uplift to WACC above a normal return. We are not disputing the appropriateness of an airport earning a normal WACC over time. However, we do not consider a return above this normal WACC is appropriate. The framework advocated by NZ Airports results in exactly this outcome.

The fact that an investment may not have a direct complementary revenue stream is also something of a red herring. Any investment which impacts on the efficiency of airport operations or facilities for servicing airlines drives better airline operating performance, and enables investment by airlines in increased services, hence increased passenger volumes, resulting in increased revenues across the airport portfolio. Conversely, if an airport were to reduce investment in core aeronautical facilities, e.g. the airfield, below the optimum level this will impact on the quality and

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<sup>2</sup> Dr Harry Bush CB & John Earwaker, Evidence Relating to the Assessment of the WACC Percentile for Airports Prepared for the New Zealand Airports Association, August 2015 (Bush & Earwaker)

<sup>3</sup> Bush & Earwaker, p.37

level of service it can provide to airlines, and hence result in a loss of revenue across the airport portfolio as passenger numbers reduce.

### ***The role of consultation***

NZ Airports suggests that reliance on airline consultation as a means of guarding against under-investment is misplaced (while acknowledging its effective role in guarding against over-investment)<sup>4</sup>. This is due to concerns that incumbent airlines will not necessarily wish to see investment which increases capacity and therefore allows new entrant carriers into a market, thereby benefiting consumers through enhanced service offerings and lower prices.

This line of reasoning appears to conflate the issue of over- and under-investment, where NZ Airports has accepted the important role of airline consultation in guarding against over-investment. This is because any investment which is addressing capacity constraints which impact on the opportunity for new entrants will also impact on the efficient and effective operation of existing carriers. Additional contact stands are available for all carriers, as are additional runway slots made available by enhanced operational procedures. Where investment is required to alleviate capacity constraints all users (existing and future) benefit.

NZ Airports cites two examples of how airline views can diverge, thereby supposedly undermining airline consultation as an effective means of ensuring appropriate investment occurs:

- Low cost carriers not supporting investment in air bridges
- Air New Zealand opposition to investments that supported A380 aircraft on the basis that it did not intend to operate this type of plane

It is true that airlines operate in an intensely competitive environment and given the margins in the industry are extremely cost-conscious. Rather than using the examples cited by NZ Airports to justify an approach which results in a higher than normal return being accepted, these should be seen as a failure by the airports concerned to adopt a pricing structure which means that the costs of investments required to cater for a particular level of service are met by those users actually requiring them. In the case of the works required to facilitate the entry of A380s, once Air New Zealand was satisfied that the additional revenue from the additional MCTOW associated with those aircraft would meet the costs of the required investment, it was comfortable with the investment proceeding.

### ***Costs of Delayed Investment***

The Bush/Earwaker report also seeks to extrapolate, from experience in London, some measure of the costs to consumers of investment delays. It is important to

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<sup>4</sup> NZ Airports, p.36, para 144

note that the report itself notes that “The reasons for under-investment lay not in a shortfall in the returns allowed to the airports but in shortcomings in planning and policy processes and from environmental and other constraints.”<sup>5</sup>

This is an important point and highlights the need to exercise caution when considering the cost to consumers arising from these delays. The costs arising in London resulted from a lengthy and protracted delay in investment which impacted negatively on all parties, including the airlines operating at the time. Congestion costs and poor customer service are taken seriously by airlines who are impacted through operational inefficiencies, higher costs and also suffer reputational damage as a result of the inefficiencies and service quality. In such circumstances airlines are highly motivated to ensure appropriate operational and/or investment steps are taken to mitigate those costs.

It should also be recognised that there are consumer welfare implications associated with investment in excess of what is required to serve the market. As noted by Professor Sudarsanam in his 4 May 2014 Expert Report<sup>6</sup>,

Any loss function analysis of high airport charges should also take account of the fact that both airports’ and airlines investments serve consumer need and overall welfare losses and gains depend on both categories of investments. This means that investment incentives in the form of a higher WACC cannot be determined only on the basis of the investments that airports make. It is imperative that when the investments of airports and airlines are jointly considered, the percentile WACC must be chosen by the regulator to incentivise both categories of investments. It is probable that the optimal allowed WACC will be much lower than the level chosen to incentivise only the airports’ investment.

It should also be noted that notwithstanding the investment delays at London airports:

In its recent determination of the cost of capital for Heathrow and Gatwick, the CAA in its initial proposals chose a high percentile from its WACC range for price cap purposes (75<sup>th</sup> for Gatwick and 80<sup>th</sup> percentile for Heathrow). However in its final determination, it did not explicitly show any preference for such a high percentile and the final WACC selected was considerably below the levels initially proposed e.g. only 61<sup>st</sup> percentile in the case of Heathrow and 59<sup>th</sup> percentile in the case of Gatwick. This suggests that the

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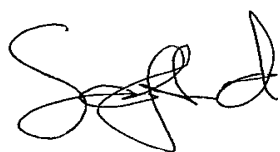
<sup>5</sup> Bush & Earwaker, p.7

<sup>6</sup> Report of Professor Puliyyur (Sudi) Sudarsanam, An Expert’s Report on the Use of a 75<sup>th</sup> Percentile from the WACC Range for Information Disclosure Requirements of Airports in New Zealand for the Purpose of Profitability Assessment by the Commerce Commission, 4 May 2014, para. 4.8.6 (Sudarsanam Expert Report)

case for a high percentile choice was not very persuasive to the UK regulator.<sup>7</sup>

We appreciate the opportunity to make this cross-submission. Please contact me if you have any queries relating to the above.

Yours sincerely



Sean Ford  
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<sup>7</sup> Sudarsanam Expert Report, para. 5.1.3