



Section 53B review of airport pricing decisions and expected performance for PSE3: submission on the draft report for Christchurch Airport

16 August 2018

1. Auckland Airport appreciates the opportunity to submit on the Commerce Commission's section 53B report on Christchurch Airport's third price setting event (PSE3) ("**Draft Report**").
2. In this submission, we set out a few key points, with a focus on assisting interested parties to better understand airport decision-making and performance. Summarising the specific circumstances of each airport, and the context in which they exercised judgement, is very important in this respect.
3. We consider that the findings in the Draft Report further demonstrate that:
 - a. airports are acutely aware of the Commission's Input Methodologies (IMs) when setting prices;
 - b. airports are seeking to understand and operate within the Information Disclosure (ID) Regime, by making decisions that they believe strike an appropriate balance between allowing them to take account of airport-specific factors, while staying within the guidance provided by the Commission; and
 - c. the ID Regime is delivering strong outcomes for consumers, albeit a work-in-progress over which we can continue to seek improvements.
4. In particular, we welcome the Commission's findings in the Draft Report that:
 - a. flexibility is appropriate when assessing target returns on other regulated (non-priced) services;
 - b. Christchurch Airport is not targeting excessive profits on its priced services over the PSE3 period; and
 - c. there are legitimate reasons to justify an airport-specific WACC estimate that departs from the WACC IM mid-point estimate (ie due to a different credit rating for Christchurch Airport).

We agree that non-priced services should be assessed differently to, and over a longer period than, priced services.

5. The Commission has correctly identified in the Draft Report that the prices for non-priced services are set differently than for priced services, and should therefore be subject to a more flexible form of assessment.¹ We emphasise that the differences between pricing of these services are fundamental, as set out in our submission on the draft report for Auckland Airport. Otherwise, we generally agree with the points raised by the Commission in paragraphs 118 – 124 of the Draft Report in support of its position.
6. It is important that the approach adopted by the Commission to assess non-priced services does not unduly pressure airports and their customers to change historic and current practices that meet customers' commercial objectives. The approach that we use to agree terms for non-priced services serves the purposes of the ID Regime, by enabling airports to act in the interests of our customers and passengers. We take the same approach to revenue setting for lease activities, including those that fall within other regulated activities, *and* those that sit within the non-regulated part of the business. We set this approach out in detail in our submission on the draft report for Auckland Airport.²

¹ Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report*, 19 July 2018 at [121].

² Auckland Airport, *Submission on the Draft Report for Auckland Airport's PSE3*, 29 May 2018 at [157] – [162].

7. We are concerned that using the same approach to assess priced and non-priced services would lead to unintended consequences or unproductive incentives, in particular that:
 - a. it could influence the way we set prices in a direction that was counter to the interests of our customers and passengers; or
 - b. airports (and/or our customers) would be incentivised against negotiating contracts completely; or
 - c. airports would be penalised or found to be targeting excess profits because the value customers place on the service we are providing could not be reflected in the prices we charge.
8. It would not be feasible, nor commercially sensible, for airports to move non-priced services to a standardised pricing arrangement (based on a five-year pricing period).³ We agree, therefore, that it would be inappropriate for the Commission to seek to assess these returns over a five-year pricing period.
9. In that context, it appears that the question now being appropriately asked by the Commission is not whether the ID Regime should provide incentives to change the method by which our prices for these services are set, but the best method to use to assess whether these prices (and the way they are set) are meeting the purposes of the ID Regime.
10. We agree with the Commission that, because contracts for other regulated services are set at different points in time, there are additional factors that make an assessment in accordance with each price-setting event more difficult.⁴ The Commission specifically identified that market conditions, rent review clauses and the environment in which the contracts were signed were examples of factors that were cause for separate treatment. We note that:
 - a. We encourage the Commission to monitor trends over time before making any strong conclusions on airports' target returns for non-priced services. The Commission should make its assessment for non-priced services separately and less frequently.
 - b. While returns for PSE3 for non-priced services may be greater than returns for priced services, this will not necessarily be true for each pricing period. Given that lease terms do not align with aeronautical pricing, the approach to assessing these returns should take into account the disparity from price period to price period, rather than isolating particular price periods which may provide false indications that returns on these services are excessive for that period.
 - c. The approach used to assess non-priced services should take into account the intangible value of the certainty in the length of the contract, lease, or licence for service. We work to ensure that the term-length for other-regulated services adequately considers the context of individual lease requirements, rather than aligning directly with each five-year price setting event. Each lease is considered within the context of the market structure and seeks to provide incentives for competitive product development for end consumers.
 - d. Feedback from customers has informed this approach. Our understanding is that customers are most concerned with obtaining exclusivity and certainty for the provision of a service. The length of the tenure in our service offerings is therefore particularly valuable to them.

³ Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report*, 19 July 2018 at [123].

⁴ Commerce Commission, *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Draft Report*, 19 July 2018 at [118].

11. In addition to the inconsistencies in tenure of the service, we note that customers of non-priced services generally have greater countervailing power relative to priced services.

- a. The overarching question to determine an appropriately proportionate approach to regulation (from the Yarrow advice) is the extent of risk that airports will take advantage of market power.⁵ Although we accept that non-priced services are regulated due to limited competition, the way terms are agreed means that, overall, Auckland Airport generally has little ability to exercise market power for its non-priced services.
- b. An Australian Productivity Commission paper on the Economic Regulation of Airport Services noted that:⁶

While an airport may be judged to have material market power in the airport market, it does not follow that it has material market power over all services and facilities provided on the airport.

- c. The Productivity Commission assessed the degree of market power that airports had over the provision of certain services and concluded that aircraft heavy maintenance facilities, flight catering, freight and ground equipment storage sites and commercial and retail activities had low degrees of market power.⁷
- d. Many non-priced services (predominantly aircraft and freight services) relate to activities in which airports have a low degree of market power, and should therefore be assessed differently. This position was made clear in the Productivity Commission's paper where it was stated that:⁸

Not all leases are created equally and it is important to distinguish between monopoly and locational rents, as locational rents do not present the same opportunity for an airport to exercise market power.

- e. Prices under leases are set on a market basis and are typically the result of extensive negotiations, which take into account specific contextual and commercial factors. For price reviews during the term of the lease, arbitration or other dispute resolution mechanisms are available in the event of unsuccessful negotiation or unexpected (and infrequent) differences in opinion. We set this process out in detail in Section 5 of our submission on the Commission's Draft Report for Auckland Airport.⁹
- f. Customers entering into leases for non-priced services do so on a voluntary basis, and are therefore able to 'opt-out' of those services if the terms offered by airports are unacceptable. Given the small number of airport customers for many of these services, customers are aware that they face limited competition for providing the service and therefore for the lease – in some cases they may be the only feasible service provider. The ability of customers to walk away from negotiations (and leave the service unfulfilled) is therefore significant. This materially increases the negotiating strength of customers and ensures that airports are incentivised to negotiate reasonably.

⁵ Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector*, February 2016 at page 2.

⁶ Australian Productivity Commission *Economic Regulation of Airport Services: Productivity Commission Inquiry Report*, 14 December 2011 at page 82.

⁷ Australian Productivity Commission *Economic Regulation of Airport Services: Productivity Commission Inquiry Report*, 14 December 2011 at page 84.

⁸ Australian Productivity Commission *Economic Regulation of Airport Services: Productivity Commission Inquiry Report*, 14 December 2011 at page 83.

⁹ See in particular paras [158] – [162] of Auckland Airport *Submission on the Draft Report for Auckland Airport 29 May 2018* at page 60.

12. To conclude, we are comfortable to work with the Commission, if required, to develop a long-term assessment model that is more appropriate for non-priced services.

It is important to better convey to interested parties that the WACC estimate is imprecise and that airports and the Commission are required to exercise judgement when estimating and assessing point estimate returns.

13. We understand that the Commission is seeking to distinguish its assessment of WACC and target returns, and agree with its approach to focus the Draft Report on an assessment of Christchurch Airport's target return.
14. It is pleasing that the Commission has found that Christchurch Airport is targeting an acceptable return on priced services for PSE3. However, under the Commission's assessment framework, the distinction between target returns and WACC is not made clearly, which is likely to cause confusion for interested parties.
15. A blurring occurs because, ultimately, the Commission equates a "sufficiently justified" WACC with the upper limit of an acceptable return. Christchurch Airport's target return was acceptable because it was below the Commission's view of a "sufficiently justified" WACC.
16. In taking this approach, the Commission misleadingly conveys that determining a "sufficiently justified" airport-specific WACC is a task capable of precision. The reality is that significant judgement is required, and, as conveyed by the standard error for the WACC IM, this judgement is inherently prone to error.
17. The approach the Commission has taken in Attachment A (and a number of headings in particular) reinforces a sense of artificial precision in the WACC estimation. The effect of this is to reinforce the WACC IM mid-point as a bright line and obfuscate the role of standard error. We encourage the Commission to be more explicit regarding the fact that any WACC point estimate comes with a standard error. The Commission identifies the existence of standard error in Table A4 of the Draft Report for Christchurch Airport, but only in the context of addressing evidence provided by Christchurch Airport's expert.¹⁰ Given the significance of standard error, we consider it would be helpful for interested parties for the Commission to explicitly address the uncertainty in its mid-point estimate. The WACC or profitability section could illustrate the uncertainty in estimating WACC by including a distribution curve around the mid-point. We are working on a proposal for inclusion in our cross submission on Auckland Airport's WACC, in light of the Draft Report for Christchurch Airport.
18. Our intent is to help to show the levels of confidence interested parties can have around the estimates of WACC and how this compares to the returns targeted. This stands in contrast to the analysis provided by the Commission, which misleadingly implies that WACC is capable of precise quantification, and does not rely on judgement with the inherent risk of error.
19. We are interested in the Commission's views on how the standard error associated with the mid-point WACC estimate features in its assessment. As we have previously submitted, we did not understand the decision to remove publication of the range to be an indicator that estimating WACC was now a more precise exercise, subject to less error, such that a reasonable range no longer existed. However, we did understand that the Commission's intent was to remove the 75th percentile as an upper limit of an acceptable range.

¹⁰ Commerce Commission *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 19 July 2018 at page 74.

20. The Commission has stated:¹¹

We do not intend to necessarily determine an alternative, company-specific, WACC estimate for an airport if we consider it has legitimate reasons for targeting a different return to its mid-point estimate. Instead, we consider it appropriate to base our profitability assessment on our mid-point WACC but allow for any legitimate differences between the individual airport's WACC and our benchmark WACC when reaching our conclusions on profitability.

21. The Commission went on to say that:¹²

We agree with NZ Airports that a degree of judgement is required when determining target returns, however we consider this judgement needs to be supported by evidence. As indicated in the quotes at paragraph A19 above, the onus is on airports to provide sufficient evidence to support any judgement calls they have made, in light of the Part 4 purpose statement.

22. We acknowledge these comments. However, it is not clear that the Commission is applying them in practice. It appears from the Draft Report that the Commission has determined an alternative WACC for Christchurch Airport (at the 52nd percentile), and has not acknowledged that the alternative WACC comes with its own distribution curve, nor that it must make a judgement around the level of confidence the Commission has that the target return is sufficient in the context.

23. We note also that the conclusions on profitability assessment in Appendix C focus on methodical review of the inputs into a WACC estimate. In our view there is an opportunity in the Final Report to further summarise the big picture context of the pricing decision, including the judgement calls that have been described by the airports and how these compare to the Commission's judgement. Again, a visual illustration of these may support increased understanding for all parties of how the Commission recognises that WACC exists within a reasonable range, and the extent to which the contextual analysis provides confidence that the target return is likely to be consistent with the long-term interests of consumers.

24. Putting aside accommodation for standard error, the Commission's draft findings on Christchurch Airport's WACC reinforces our concern that the WACC assessment approach precludes flexibility and does not allow each airport to target returns that are appropriately tailored to their circumstances. In particular:

- a. Airports are doing their best to work within the Commission's framework to demonstrate that airport-specific circumstances justify a higher or lower target return, but consider that the threshold implied by the Commission's Draft Report is impractical and difficult to understand.
- b. The risk for airports is that the Commission will find that the airport-specific asset beta estimates can never be justified without creating a precedent the Commission is uncomfortable with, and must therefore apply the global industry average. We submit that it cannot be right that both Auckland and Christchurch airports have the same systematic risk for PSE3 and, to a greater extent, that they are both equivalent to the Commission's international sample average.
- c. It appears that only minor costs of debt adjustments will be found to be acceptable. A potential outcome is that Christchurch Airport will justify a higher cost of capital than Auckland Airport, due to its higher debt premium. We cannot understand how the Commission could legitimately argue that this appropriately reflects the different circumstances of each airport.

¹¹ Commerce Commission *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 19 July 2018 at [A22].

¹² Commerce Commission *Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 19 July 2018 at [A23].

- d. We ask that the Commission stands back and re-considers whether it is clearly informing interested parties about the materially different circumstances that influence the exercise of judgement by each airport, or whether it is simply describing the application of an artificially precise mechanical assessment approach that is removed from commercial reality.
25. We think a core part of the problem is that the Commission's sector-wide WACC IM mid-point has become a precise bright line, with only minor adjustments for cost of debt acceptable:
- a. We understand that because the cost of debt is an observable measure, in which the difference between the airports' estimate and the Commission's benchmark can be easily demonstrated, the evidential threshold can be relatively easily met. By contrast, the Commission has noted that the cost of equity *cannot be observed directly*.¹³ Because the forward looking cost of equity is not observable, airport-specific differences are much more difficult to quantitatively establish.
 - b. Exercise of judgement on risk, including to accommodate potential estimation error at the model or parameter level or for asymmetric risks has been excluded. The result is that the Commission has materially increased the risk that it will be reinforcing perceptions that there is a precise bright line and forcing airports to target and report against that bright line.
 - c. This presents a material problem for the ID Regime. This heavily-technical assessment (that fails to take account of contextual analysis and an empirically estimated standard error) is likely to influence airport behaviour against the interests of consumers. Where returns are arbitrarily restricted, by what appears to be a hard benchmark, airports are put at risk of not having the financial capacity to invest in infrastructure and that the risk-adjusted returns don't justify investment that would be valued by consumers. This will have significant consequences on airports, passengers, and the country in the mid to long term future.
26. We support the position put forward by the New Zealand Airports' Association in its submission on the Draft Report. We are happy to work with the Commission on any of these issues further.

¹³ Commerce Commission *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [X25].