

**Submission on Commerce Commission's
Input Methodologies Review: Invitation to
Contribute to Problem Definition**

21 August 2015

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INTRODUCTION

1. The New Zealand Airports Association ("**NZ Airports**") welcomes the Commerce Commission's ("**Commission**") approach to this review of input methodologies ("**IM Review**"). In particular, NZ Airports appreciates the Commission's effort to identify all relevant issues at the beginning of the review process, through both its problem definition paper and the Forum.¹ This should make for a more targeted review of the issues that properly merit detailed consideration as part of the Commission's review.
2. NZ Airport's submissions on the Commission's problem definition paper are framed, in broad terms, in accordance with the Commission's approach to the issues, and cover the following:
 - (a) NZ Airports' views on the appropriate approach to the IM review, having regard to the purpose and objectives of the airport regulatory regime.
 - (b) NZ Airports' views on WACC topics, covering both general issues and the WACC IM percentile for airports.
 - (c) Respond to the Commission's problem definition on airport profitability assessment.
 - (d) Comments on reducing complexity and compliance costs.
3. This submission is accompanied by an expert report from Dr Harry Bush CB² and John Earwaker³, "*Evidence relating to the assessment of the WACC percentile for airports*" ("**the Bush/Earwaker Report**"), commissioned by NZ Airports. The Bush/Earwaker Report considers and discusses factors that will be relevant to any evaluation of the range and choice of WACC percentile in the IM Review. Our commissioning of this report demonstrates that the WACC range and percentile is a key topic of concern for NZ Airports (and we would welcome further updates on the intended consultation process at the earliest opportunity).
4. NZ Airports looks forward to engaging with the Commission on the relevant issues during the review process.
5. The NZ Airports contact for matters regarding this submission is:

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³ Director, First Economics; advisor on regulation for twenty years within the UK and overseas aviation industry.

EXECUTIVE SUMMARY

Approach to the review

6. NZ Airports is committed to the long term success of the Information Disclosure ("ID") regime. The regime is already effective, but the Commission's IM Review provides an opportunity to carefully consider improvements to the IMs and the ID requirements for airports. This opportunity will be maximised by framing the right issues in the right way, and by considering solutions with a fully informed understanding of the issue they seek to address.
7. In that context, NZ Airports' approach to the IM Review can be summarised as follows:
 - (a) we will support changes to the IMs or ID Requirements if it can be demonstrated that they will improve disclosure in a way that better promotes the Part 4 purpose. That means the IM Review must be focussed on issues where improvements contribute to promoting the long term benefits of consumers;
 - (b) we will not support changes to the IMs or ID requirements that introduce greater complexity and prescription into disclosures, detract from a full contextual assessment of airport performance, or inhibit or prevent airports from taking commercial approaches that deliver optimal long-term consumer benefits; and
 - (c) where challenges with assessing performance are identified, it should be explored whether they can be addressed by establishing clearer guidance on how information can be usefully disclosed - via the Commission's summary and analysis process or otherwise. Airports are committed to such ongoing engagement.
8. In NZ Airports' view, a successful IM Review will, among other things:
 - (a) facilitate a deeper and broader understanding of airport performance by interested parties;
 - (b) incentivise airports to promote the long term benefit of consumers. Key in this respect is facilitating and accommodating ongoing market growth through competition among airlines (which provides consumers with the lowest total travel cost and more travel choices); and
 - (c) establish a better understanding by interest parties as to how the Commission will assess airport performance, including how it will factor in the necessary contextual analysis, over the longer term.
9. As the first review of its kind, the precedent established by the IM Review will be important for providing regulatory certainty. This means ensuring all proposed change is robustly tested before being adopted. Natural and anticipated challenges in assessing complex businesses under an ID regime do not necessarily provide evidence of a need for change. The Commission believed it had established a robust and balanced initial regime, so it will need to carefully explain any changes that could upset that balance.

10. Applying those criteria, NZ Airports' views on the key issues raised by the Commission are summarised as follows.

Cost of Capital

11. The WACC IM is a key topic for NZ Airports under this review. To date, it has been applied as a bright line threshold by the Commission when assessing profitability. It is therefore, rightly or wrongly, a key part of the ID regime. Accordingly:
- (a) it is important to ensure technical aspects of the WACC IM are determined and set appropriately, and that volatility is minimised;
 - (b) but this must not turn into a quest for the "perfect" WACC IM, which does not exist. This review should not lead investors to believe that the Commission will seek to materially amend the WACC IM at each review;
 - (c) there needs to be clear evidence that a problem exists and that the benefits of change will outweigh the costs; and
 - (d) in that context, NZ Airports has identified the use of "spot market" rates in relation to the cost of debt and equity, and asset beta standard errors, as topics that might be explored further.
12. NZ Airports has focussed its attention on the proposal to reconsider the WACC range and/or establish a specific point estimate. We do not believe this proposal is merited under the IM Review.
13. The Commission ought to have regard to the following factors in deliberating whether to revisit the WACC percentile:
- (a) the Commission's rationale for the use of a WACC range for ID remains fundamentally sound and was endorsed by the High Court. Its approach does not raise issues that warrant, or would benefit from, assessment during this review. As discussed in the Bush/Earwaker expert report, there is no reason to suggest that the current 25th to 75th WACC percentile range is not appropriate;
 - (b) there are considerable differences between the airport and energy sectors and the applicable regulatory frameworks, such that the approach taken for price-quality path regulation does not automatically translate into ID. In particular, the requirement for airports to set prices under the Airport Authorities Act 1966 ("**AAA**") provides a substantial point of difference;
 - (c) the need to promote contextual analysis under ID, and not entrench a bright line indicator. The WACC IM should only provide a benchmark for the assessment of airport returns. This was confirmed by the Commission during the Merits Review proceedings:

The Commission is required to publish the WACC estimate, but it is also required to publish a "summary and analysis ... for the purpose of promoting greater understanding of the performance of individual

regulated suppliers". **In other words, the Commission must put the WACC estimate in context. This context will include reference to the airports' own methodologies and estimates, which are required to be disclosed and which are therefore part of the information the Commission is required to summarise and to analyse.** [Emphasis added]

- (d) the inherent difficulties in attempting to select an additional, "optimal" point estimate within the WACC range, and the risk of introducing a high degree of false precision into the Commission's airport profitability assessment exercise; and
- (e) matters such as airport-airline consultation and the dual till are irrelevant to the choice of WACC range and/or point estimate. At the very least, they do not operate to mitigate the impact that under-estimating the WACC will have on airport investment decisions and on airports being properly incentivised to facilitate competition, ie the factors that can achieve the greatest long-term benefit for consumers.

Profitability assessment

14. Key points NZ Airports discusses on this topic are as follows:

- (a) We accept that the Commission's perception is that tailored airport pricing approaches present challenges when assessing profitability (target and actual). We are comfortable exploring ways to address those challenges. However, airports' ability to use tailored approaches to pricing suitable for their individual circumstances and which promote consumer benefits is a distinct benefit of the ID regime, which must not be discouraged.
- (b) We believe that the Commission should first reframe the profitability issues. The Commission has moved too quickly to narrowly define the issues in the way presented in the problem definition paper. In particular, we are concerned that the Commission appears to have so conclusively decided at this early stage of the process that the *ex-post* profitability indicator has proven to be ineffective. From our perspective, that proposition is not substantiated or explained in the problem definition paper (and nor was it in the Commission's 30 July 2015 forum). We encourage the Commission to revisit its view.
- (c) NZ Airports first needs to better understand what the challenges are from the Commission's perspective, so that appropriate solutions can be considered. We would prefer to explore potential solutions within the current rules first, before deciding that rule changes are required. That would include relying on the guidance provided under the s56G review process, and any further enhancements under future summary and analysis.
- (d) That is because additional prescription is unlikely to be helpful to assessing airport performance and/or promoting the long term benefit of consumers. It is unlikely to remove the need for deeper contextual analysis. We would therefore welcome further guidance on how the necessary contextual analysis of profitability will be carried out in the future.

15. Overall, NZ Airports supports a focus on seeking ways to promote ongoing discussion and understanding, and airports are committed to engaging on such matters. This approach has a better prospect of facilitating transparency and a more sophisticated understanding of performance than changes to the IMs or ID requirements.
16. NZ Airports sets out its views on the secondary profitability assessment issues in section 4 of its submissions. A number of these issues (including, for example, the use of different approaches to price setting, the treatment of assets held for future use) play an important role in the ID regime and will benefit from inclusion, and engagement, in the IM Review.

Reducing complexity and compliance costs

17. NZ Airports supports exploring ways to reduce complexity and compliance costs. We have provided some initial comments on the areas that we believe could be explored as part of a separate work stream with the Commission and other interested parties.
18. If the Commission is open to considering the matter further, we believe we could identify ID requirements that could potentially be removed, and/or refined, on the basis that the information:
 - (a) is not justifying the complexity or cost required to produce it; and
 - (b) is not necessary to enable interested parties to form a view of an airport's performance.

SECTION 1: APPROACH TO THE IM REVIEW

19. In summary, this section explains why NZ Airports will support changes to the IMs or ID requirements that:
- (a) are necessary to help provide clearer and more useful information to interested parties; and/or
 - (b) are relevant to promoting beneficial outcomes for consumers.
20. It also explains why we will not support changes to the IMs or ID requirements that:
- (a) introduce greater complexity and prescription into disclosures;
 - (b) detract from a full contextual assessment of airport performance, as is contemplated by the Act, and instead promote a focus on "lining up" pricing decisions with the IMs; or
 - (c) inhibit or prevent airports from taking commercial approaches that deliver optimal long term consumer benefits.
21. The Commission has asked whether separating energy from airports work would cause any complications.⁴ We support separate work streams. At this stage, general WACC issues appear to be the only topic where there may be some overlap in connection with methodology (albeit there will, equally, be a number of issues concerning application of the methodology that should be addressed for airports only).

Framing of issues

22. The Commission's problem definition paper provides welcome transparency on the issues it considers require consideration in the IM Review. The Forum also helped to flesh out some of those issues.
23. That said, it is unclear whether all potential issues identified by the Commission have been fully explained. As an example, the Commission's preliminary view that the backward-looking profitability indicator has proven "ineffective",⁵ while a strong statement, has not been explained by the Commission. Putting aside NZ Airports' disagreement with this view,⁶ the statement appears to be unsubstantiated, given that airports are yet to receive the Commission's feedback on annual disclosures.
24. The Commission's thinking on the IM and ID issues relevant to airports appears to be relatively advanced. Some high level solutions, notably on issues relevant to the assessment of airport profitability, are already proposed by the Commission. NZ Airports appreciates that the Commission is familiar with many of the issues potentially relevant to airports in the IM Review,

⁴ Commerce Commission *Problem Definition - Airports; Review of input methodologies* (30 July 2015), at paragraph 20.

⁵ Commerce Commission *Problem Definition Paper*, at paragraph 303.2

⁶ NZ Airports notes that the annual and price setting disclosures have been prepared in accordance with the Commission's ID Requirements (which incorporate the IMs) and enable comparison between airports and over time. In addition, each of the airports has prepared supporting commentary to their disclosures to enable improved understanding by interested persons.

and that its thinking may be more advanced than for the energy sectors. However, at this early stage of the review, NZ Airports encourages the Commission to maintain its focus on problem definition, to ensure it is fully receptive to stakeholder views on how the issues that merit consideration should be framed. Getting the framing right will be important for building appropriate solutions.

25. More generally, NZ Airports believes that the approach to the IM Review, across all of the issues relevant to airports, needs to be shaped by the core tenets of: the purpose of Part 4 of the Commerce Act 1986 ("**Act**") - promoting the long term benefit of consumers via *all* of the (a) to (d) objectives; and the objective of the ID regime - the provision of sufficient information to allow assessments of whether the purpose of Part 4 is being promoted.
26. Our submissions on each topic provide our views on how the specific issues should be framed.
27. Finally, in approaching the review process, we note the Commission has recognised that some of the issues proposed for evaluation in the IM Review (eg around the assessment of returns) will not entail changes to the IM itself, but rather the ID requirements. NZ Airports is comfortable with that approach. For simplicity we refer to the process encapsulating both as the IM Review throughout this submission.

Outcomes sought from the IM Review

28. The IM Review provides a good opportunity to constructively discuss the extent to which the ID regime (including IMs) should be refined to secure its ongoing success. NZ Airports is committed to engaging with stakeholders and the Commission to secure this objective.
29. The airports ID regime remains relatively new, and given the scale of the undertaking in establishing the regime, there will be scope for improvements to be made. The IM Review therefore ought to focus, in the case of airports, on how lessons learned so far can improve the helpfulness of information that is disclosed by airports.
30. With that in mind, NZ Airports is willing to support incremental improvements, which are consistent with the objectives of the ID regime, and would demonstrably contribute to the overall purpose of Part 4.⁷
31. That said, NZ Airports does not consider the ID regime, or IMs, to be ineffective. To the contrary, as the airports' responses to the Commission's reviews of airport price setting events have attested, the ID regime is already functioning well. To the extent the Commission demonstrates that the regime would benefit from some incremental improvements, NZ Airports hopes that stakeholders will share a degree of consensus on where the most effective improvements can be made.
32. In NZ Airports' view, a successful IM Review will lead to the following outcomes:
 - (a) facilitating a deeper and broader understanding of airport performance by interested parties;

⁷ See Russell McVeagh, *Input Methodology Review: Advice on legal questions and decision-making framework*, 21 August 2015.

- (b) ensuring the ID regime is more aligned with the role that airports have in maximising consumer benefit;
- (c) enabling the ID regime to respond effectively to commercial realities faced by airports;
- (d) a regime that incentivises, or at least does not disincentivise, airports to facilitate and accommodate ongoing market growth through competition among airlines (which provides consumers with the lowest total travel cost and more travel choices); and
- (e) a better understanding by airports as to how the Commission will assess airport performance, including how it will factor in the necessary contextual analysis, over the longer term.

33. In that context, NZ Airports welcomes the Commission's acceptance that the ID regime is not just about headline airport charges and profitability.⁸ We are keen for it to implement that acceptance. It would be a disappointing outcome if the review focussed on profitability, at the expense of other equally important determinants of airport performance. The Act makes clear that Part 4 is designed to promote investment, innovation, quality and efficiency.⁹ Those criteria are all important aspects of the regime; and drive outcomes which enhance the long-term interests of consumers.

34. The Commission has yet to provide feedback on airports' historical performance (via the summary and analysis process), and so the IM Review provides the Commission with an opportunity to provide confidence to airports as to how their performance will be assessed, and how variations from forecasts will be treated. It also provides the Commission with an opportunity to demonstrate it understands that assessing airport performance will often require a deeper understanding of context, which cannot only be presented in spreadsheets. NZ Airports will encourage the Commission to demonstrate that it will consistently assess the full breadth of performance measures that, in combination, promote the long term interests of consumers. Airports will continue to work with the Commission to deepen its understanding of the airport sector.

Potential complexities acknowledged

35. A prominent theme of the problem definition paper is that there are challenges in assessing airport profitability, in particular where airports have chosen to take a tailored pricing approach.

36. NZ Airports is keen to work with the Commission and interested parties to address such challenges. However, the solutions must help to provide clearer and more useful information, and not compound the challenge by introducing greater prescription and complexity. In this regard, we would emphasise that disclosures have been prepared in accordance with the Commission's ID requirements (which incorporate the IMs), and enable comparison between airports and over time. In addition, each of the airports has prepared supporting commentary to their disclosures to enable improved understanding by interested persons. The key issue

⁸ Commerce Commission Presentation, *Problem Definition - Airports; Review of input methodologies* (Commerce Commission Forum, Te Papa, Wellington, 30 July 2015).

⁹ Commerce Act 1986, s 52A(1).

seems to be the level of supporting narrative that is provided with the disclosures and also completion of the s53B summary and analysis reports. Together, these will assist interested persons in assessing whether the purpose of Part 4 has been met.

37. In that context, it is also important to recognise that such challenges are likely to be largely attributable to it still being relatively early days for the ID regime. It is also relevant to note that:
- (a) airports face complex challenges when setting prices on a five year forward-looking basis. It is inevitable that many forecasts that underpin those forward looking pricing decisions will not turn out exactly as predicted (and this is even more so the case for longer term assessments). When assessing profitability, examining the causes of those variances is important, as many are outside of the airport's control; and
 - (b) the fact that ID regulation appropriately provides airports with the ability to take a tailored approach to their pricing means that, particularly in the early stages of ID, assessing airport performance may not be as straightforward as for other Part 4 sectors. Important distinctions from other Part 4 sectors include that airports:
 - (i) operate in a context where a significant benefit to end consumers is delivered by fostering competition between airlines (ie airport users) in a context where airports, while being essential, account for only a relatively small share of industry costs;
 - (ii) offer a discretionary product in a discretionary market, as distinct from demand for utilities where the product is not discretionary. This means, for example, that there are stronger incentives for airports to understand customer and market requirements, and to respond to them in order to increase customer demand - that is, they have natural incentives to promote the long-term benefit of consumers; and
 - (iii) product or service offerings are not homogeneous unlike utilities. Combined with the offering of discretionary products, this means a more diverse range of factors will be relevant when assessing performance.

38. Consideration was given, when forming the regime, to the added complexity that taking a tailored approach to pricing may entail. For example, special importance was placed on ensuring that the WACC IMs should not be binding, despite the fact that assessing airport performance may be more difficult as a consequence.¹⁰ It is therefore important that the Commission does not seek to reduce its analysis of airport performance to focus on alignment with the IMs, to the detriment of a full contextual assessment focussed on the right objective (ie the long term benefit of consumers).

Commission's decision-making framework

39. NZ Airports' views on the Commission's decision-making framework and legal issues are contained in the legal submission prepared by Russell McVeagh on behalf of NZ Airports and the

¹⁰ Commerce Amendment Bill, Report of the Ministry of Economic Development, 4 July 2008, p 25.

Electricity Networks Association. The following elaborates on our views from an ID only perspective.

40. This review is the first of its kind. This means that the approach adopted by the Commission to this review stands to have a material impact on the development of the regime - and the provision of regulatory certainty. An approach to the IM Review which signals an inclination towards change and flux at each review without fully demonstrating the benefits of such change, thereby creating substantial uncertainty, risks diminishing investor confidence and chilling investment in airports. Such an outcome is inconsistent with the objectives of Part 4 and risks undermining the effectiveness of the ID regime. We are keen to avoid this outcome, which would not be in the long-term interests of consumers.
41. NZ Airports believes the optimal way to enhance the ID regime (including the IMs) is to establish clear stakeholder expectations (via agreed principles or guidance where necessary) on what information would be most usefully disclosed under existing rules. Such an approach should be preferred to changing the rules, where possible.
42. NZ Airports considers this is a realistic and achievable approach, as the existing ID determination requires the airports to disclose all relevant information. The airports are able to provide fulsome disclosures, and can (and do) include additional voluntary disclosure where appropriate. Accordingly, there should be flexibility under the current IM and ID requirements to change the way information is disclosed and/or provide additional information to address most assessment challenges. That includes the important role played by the Commission in summary and analysis of disclosed information.
43. We understand from participating in the Forum that the Commission is open to flexible approaches to addressing identified issues, which we appreciate.
44. If in any case the Commission considers the rules should be changed to require disclosure of new information, we ask that it first clearly explain why disclosure under the current IMs and/or ID requirements is insufficient, and/or how assessment challenges cannot be remedied under the existing rules. It should also explain how the proposed new information will assist to promote the purpose statements (in both s52A and s53A of the Act).
45. Accordingly, when considering the potential for changing IMs ID requirements during this review, the Commission should:
 - (a) take a rigorous approach before deciding that the benefits of making a change (measured against Part 4/ID objectives) outweigh the costs and risks involved;
 - (b) ensure any changes are proportionate and reflect the objectives of the regime. That means measuring the degree of the perceived 'problem' against the effects and potentially unintended consequences that may occur as a result of the proposed changes; and
 - (c) robustly test proposed changes against the desired outcome. Again, further explanations from airports, ongoing discussions, and summary and analysis may be more useful than changes to the IMs or ID requirements.

46. The central objectives and considerations applied by the Commission in establishing the ID regime also provide an important starting point, from which the Commission's review ought to be approached. These are highly relevant to any consideration of potential changes to the regime:
- (a) the overarching purpose of the ID regime was to implement a regulatory framework that best promotes the purpose of Part 4 of the Act - the long-term benefit of consumers;¹¹
 - (b) within that overarching purpose, the key was to develop an ID regime that enables meaningful assessment of airport performance over time;¹²
 - (c) the vehicle for that meaningful assessment is the provision of sufficient information for interested parties. In forming the regime, the Commission was guided by four key considerations:¹³
 - (i) relying, where possible, on existing information gathering practices to promote a cost-effective information disclosure regime;
 - (ii) ensuring consistency of data over time, to promote comparability of performance and therefore more meaningful assessment;
 - (iii) providing for a degree of flexibility, so that airports can present as realistic a picture as possible of their actual performance for interested persons to assess; and
 - (iv) ensuring the airports make any underlying assumptions or rationale explicit, so that interested persons can make an informed assessment of whether the purpose of Part 4 is being met.
 - (d) additionally, the Commission recognised when developing the regime that there is a trade-off between flexibility and prescription. Ultimately, the Commission considered that the scheme struck the right balance between sufficient prescription to provide useful information to stakeholders and, on the other hand, allowing airports sufficient flexibility to disclose information in a way that reflects their commercial practices.¹⁴
47. Further factors that the Commission ought to have regard to in its review of the IMs (as relevant to airports) include:
- (a) the current pricing disclosure requirements were set in the knowledge that airports would take different approaches in pricing;¹⁵ and

¹¹ Section 52A Commerce Act. See also: Ministry of Business, Innovation and Employment "Effectiveness of Information Disclosure Regulation for Major International Airports" (August 2014) p 5.

¹² Ministry of Business, Innovation and Employment "Effectiveness of Information Disclosure Regulation for Major International Airports" (August 2014) at 5.

¹³ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper* (22 December 2010) at 2.37.

¹⁴ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper* (22 December 2010) paragraph 5.13.

¹⁵ Commerce Amendment Bill, Report of the Ministry of Economic Development, 4 July 2008, p 25.

- (b) formulaic requirements will not always best promote the purpose of Part 4: it is paramount that the review does not seek to establish greater prescription, thereby making the ID regime a more onerous form of regulation, if it is not sufficiently certain that this will deliver greater long-term benefits for consumers.

SECTION 2: ISSUES RAISED BY THE HIGH COURT ON COST OF CAPITAL

49. In its problem definition paper, the Commission indicates that the WACC IM should be included in the IM review because the High Court concluded that it could potentially benefit from further analysis.¹⁶
50. At this stage, the Commission does not consider the issues raised in the Merits Review judgment have identified any specific new problems that were not considered during the original IM consultation (with the exception of the use of the 75th WACC percentile).
51. For the most part, NZ Airports is not seeking material change to the WACC IM. We nevertheless think the Commission needs to be careful to treat *all* of the High Court's comments on WACC equally. Its apparent willingness to dismiss the Court's advice to reconsider various aspects of the WACC is in contrast to its willingness to review the use of the 75th WACC percentile (which NZ Airports covers in section 3 below).¹⁷ This is despite the fact that the Court found that the 25th to 75th percentile range for ID was appropriate. In the interests of establishing regulatory certainty and predictability, the Commission will need to carefully explain any differential treatment of the Court's views.
52. We are conscious that WACC was not a topic at the Forum, and that it will be subject to separate detailed consideration (and NZ Airports looks forward to guidance from the Commission on the timetable and process for that work stream). Accordingly, in this section NZ Airports sets out the principles and objectives that will guide its subsequent engagement on WACC topics, and identifies some issues that it believes merit further consideration under the IM Review.
53. In summary:
- (a) The WACC IM has been applied as a bright line threshold by the Commission when assessing profitability. It is therefore, right or wrongly, a key part of the ID regime.
 - (b) It is therefore important to ensure technical aspects of the WACC IM are determined and set appropriately, and that volatility is reduced.
 - (c) But this must not turn into a quest for the "perfect" WACC IM, which does not exist. This review should not lead investors to believe that the Commission will continually seek to amend the WACC IM over time.
 - (d) Accordingly, there needs to be clear evidence that a problem exists and that the benefits of change will outweigh the costs.
 - (e) In that context, NZ Airports has identified the use of "spot market" rates in relation to the cost of debt and equity, and asset beta standard errors, as topics that might be explored further.

¹⁶ *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC [11 December 2013].

¹⁷ For example, the Court also raised legitimate questions about the tendency of the Simplified Brennan-Lally version of the capital asset pricing model to underestimate the returns on low beta stocks. See: *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC, [11 December 2013], at [1704].

WACC under ID Regulation

54. The Commission's approach to evaluating forecast profit outcomes for airports has established the Commission's WACC range as a critical benchmark to be considered by airports. While airports theoretically are not directed as to how they set prices, the AAA consultation requirements, and now the WACC IM, ensure considerable discipline and constraint in the airport price setting process. In particular, experience with the ID regime is showing that:
- (a) the Commission considers the WACC IM provides the best estimate of a normal return over the life of long-lived assets; and
 - (b) if airports target returns above the Commission's benchmark WACC range, then they will be assessed as being excessive, and the ID regime found ineffective.
55. The WACC IM therefore has had, and will continue to have, a material constraining effect on the pricing decisions (and, indirectly, the investment decisions) airports take. That being the case, it is important the technical aspects of the IM are determined and set appropriately.
56. At the same time, in the interests of regulatory stability and predictability, the Commission should avoid pursuing changes in the search of the "perfect IM", which does not exist. Consistent with NZ Airports' comments above on the Commission's approach to the IM Review, changes to the IMs without rigorous testing and assessment are likely to have a detrimental impact if both investors and interested parties perceive that the detail of IMs are subject to change at each review over the lifetime of infrastructure investments. That is, from an industry wide perspective, it is in the interests of all parties to maintain investor confidence in the IMs, and specifically that they are adequately designed to preserve the ability of regulated suppliers to earn normal returns consistent with workably competitive market outcomes.
57. As the Commission is aware, NZ Airports' approach to the WACC IM is that it is better to be broadly right than precisely wrong.¹⁸ Accordingly, changes seeking to import greater precision into the WACC IM are unlikely to be helpful, and could ultimately be misleading (as discussed below).
58. Further, developments in other Part 4 sectors do not automatically translate to the airports ID regime. For example, a WACC point estimate is required to set price paths under the DPP regime applying to the energy sector, but is not needed to assess performance under ID only. Accordingly, NZ Airports cautions against importing issues on the cost of capital in other sectors into the airports WACC IM without carefully considering whether that is appropriate for the airports sector and the ID regime.
59. In circumstances where the WACC IM has been set and then upheld by the High Court, NZ Airports believes that key threshold questions for the Commission to consider are whether:
- (a) there is evidence of a material issue that needs to be addressed; and

¹⁸ NZ Airports, *Further work on the cost of capital input methodologies: Response to invitation to provide evidence on the WACC percentile*, 5 May 2014; NZ Airports, *Proposed scope, timing and focus for the review of input methodologies, and further work on the cost of capital input methodology for airports*, 20 March 2015.

- (b) there is clear, substantiated evidence that the benefits of making such a change will outweigh the costs involved.

60. In NZ Airports' view, applying the appropriate decision-making framework,¹⁹ in the case of the WACC IM, these conditions are only likely to be met when it can be shown that market conditions or international best regulatory practice have changed, or if there are other factors that mean that the WACC IM is not aligned with commercial reality. As we explain below, we consider that certain matters pertaining to the WACC *may* meet this threshold and may consequently be worth exploring. However, as we explain in section 3, there is *not* a sufficient basis to reconsider the bounds of the WACC range.

Potential WACC issues to be explored

61. NZ Airports has identified three discrete topics with the Commission's 'high level' conceptual approach to estimating the WACC, the effectiveness of which may be worth considering at this stage of the review:

- (a) the reliance on "spot market" interest rates drawn from a very narrow window in time to determine the entire cost of debt allowance (ie the risk free rate and debt risk premium (DRP));
- (b) the reliance on "spot market" interest rates for the base rate component of the cost of equity, which is then combined with a tax-adjusted market risk premium (TAMRP) derived using a long-term historical average; and
- (c) the estimation of the asset beta standard error (in particular, the impact on the WACC range).

Cost of debt

62. A potential issue that NZ Airports would like to explore further with the Commission is its reliance on spot market interest rates for calculating the cost of debt parameter of the regulatory WACC. The spot market rates are drawn from a relatively arbitrary window of time immediately prior to the regulatory/price setting period. Specifically, the IM assumes that an airport raises all of its debt in a one month period leading up to a price reset. That is clearly not the case.

63. In reality, airports will have raised debt over longer periods than the single month assumed by the current IM.²⁰ Moreover, if it happens that they did so at times when interest rates and/or risk premiums were higher than those prevailing during the one month window in question the methodology will assume, wrongly, that the prevailing low spot rates were fully reflected in airports' own financing costs (and likewise if spot rates happen to be higher).

¹⁹ See Russell McVeagh, *Input methodology review: Advice on legal questions and decision-making framework*, 21 August 2015.

²⁰ In reality, if left to its own devices, no business would ever contemplate having 100% of its debt roll over in a one month period. To do so would expose it to prohibitive levels of refinancing risk. Any firm that structured its debt such that its entire portfolio matured in a single month would automatically fail to achieve an investment grade credit rating – let alone the A- credit rating assumed in the WACC IM.

64. This means that, under the current IM, an airport may end up being assessed against a benchmark that does not necessarily bear much resemblance to its actual cost of debt, or the efficient cost of debt for the industry. The resulting potential for ‘false positive/negative’ findings of excess profits is clear. Under the current regime the potential for such errors is assuaged to some extent by the application of a reasonably broad WACC range.²¹ This increases the probability that an airport’s ‘true WACC’ will lie somewhere in that window.
65. That important ‘safety valve’ would be removed (or at least partially so) if the WACC range is narrowed. This would exacerbate the potential for false findings of over- (or under-) recovery. NZ Airports would consequently be very concerned by any changes to the IM that combined a narrowing of the WACC range with the continued heavy reliance on spot rates.
66. To be clear, that is not to say the WACC range could reasonably be narrowed if less emphasis is placed on spot rates when setting the cost of debt. As section 3 explains, it could not. It is simply to say that, presently, the existence of that range provides some protection from the vagaries arising from the reliance upon spot rates.
67. With that qualification, NZ Airports considers that the potential benefits of a cost of debt methodology, which more closely reflects the debt financing costs that airports actually incur, should be explored. In that context, we note that the Commission's approach is now out of step with existing regulatory practice in the UK and Australia. In an effort to focus more closely on actual debt management practices, regulators in those jurisdictions have moved away from using spot rates to setting the cost of debt to the adoption of long-term trailing averages.
68. For example, the Australian Energy Regulator ("**AER**"), the UK Office of Gas and Electricity Markets ("**Ofgem**") and the Economic Regulation Authority of Western Australia ("**the West Australian ERA**") have defined strategies of issuing 10 year fixed rate BBB bond evenly through time. As a result, the cost of debt allowed is:
- (a) for the AER and Ofgem, an annually updated trailing average of interest rates on 10 year BBB debt over the previous 10 years; and
 - (b) for the West Australian ERA, which has also assumed a strategy of implementing an interest rate swap overlay, the annually updated 10 year trailing average of debt risk premiums (which is reset every year), plus the five year swap rate plus swap transaction costs.
69. NZ Airports’ preliminary view is that it is possible that the WACC IM might be improved if it was modified to resemble more closely the methodologies that have been introduced in these other jurisdictions. The resulting estimates could provide a better, more stable representation of airports’ actual debt financing costs and thus a more accurate estimate of an efficient mid-point WACC. When combined with the current range in the context of the contextual approach described in section 4 this is likely to facilitate the most robust, commercially realistic assessment of profitability.

²¹ Although, for the reasons set out above, this range would be likely to be wider still if all relevant sources of uncertainty were taken into account when determining the WACC distribution.

Cost of equity

70. The current WACC IM calculates the cost of equity by combining a risk free rate derived from government bond yields measured over a one month window (as per the current methodology for the cost of debt), with a long term average estimate (or “historical average”) of the TAMRP. This “mixing and matching” of spot rates and long-term averages is potentially problematic because the TAMRP is not constant through time and is typically higher when government bond yields are low (and vice versa).
71. This means that when the risk free rate is at very low levels – as it is now, and is likely to be for the foreseeable future – there is good reason to think that the “current” TAMRP is above its long term average rate. Even if this phenomenon is not necessarily observable “on average” over the long-term, there is good reason to believe it is true right now. That represents a potential problem, since application of the current IM will again not accurately reflect an airport’s actual financing costs.
72. Mixing a “current” risk free rate with an “historical” TAMRP can instead be expected to result in a mid-point regulatory WACC that that is below the ‘normal’ level. This is not necessarily an insuperable problem for the functioning of the ID regime at present because of the existence of a reasonably broad WACC range. Despite this additional source of downward bias, an airport’s ‘normal WACC’ may still fall somewhere within that estimated 25th to 75th percentile range, even if the “mid-point” estimate is a material underestimate.
73. However, that does not mean that there is no merit in exploring ways to arrive at an estimate of the cost of equity that is more commercially realistic. Moreover, for the reasons outlined earlier, if any narrowing of the WACC range was countenanced, such changes may be essential, since the potential for false findings of over- or under-recovery might otherwise increase to unacceptable levels.
74. To that end NZ Airports has been advised that, with the exception of the Australian Competition and Consumer Commission, no other regulator in the US, UK or EU mixes current risk-free rates with historical average MRP estimates to set the cost of equity. The overwhelming majority either use current estimates for both, or, to the extent that they rely on historical average MRP estimates, they also rely on historical average risk free rate estimates.
75. As observed by the High Court in the Merits Review, there are a number of different models that can be used to estimate the cost of equity.²² On this basis, it is open to the Commission to adopt more ‘internally consistent’ approaches to setting the risk free rate and TAMRP when calculating the cost of equity. Accordingly, NZ Airports would like the IM Review to have regard to the latest evidence on this matter and apply the appropriate framework tests (as articulated in the joint submission from NZ Airports and the Electricity Networks Association, dated 21 August 2015).

²² *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289, at [1082].

Estimation of the asset beta standard error

76. There is a significant risk of estimation error with the WACC estimate, due to the difficulties associated with estimating the standard error.²³ NZ Airports is concerned that the Commission's existing asset beta 'standard error' estimate may not sufficiently reflect the wide margin of variation across different airports. If the standard error is understated in the Commission's determination of the WACC range, then this will result in a WACC distribution that is narrower than it should be (discussed further in section 3).
77. The Commission's existing standard error estimate for asset beta of 0.16 was selected through judgement, rather than the application of statistical analysis. While NZ Airports does not object to this as an approach, it is nevertheless disconcerting that the Commission applies a standard error to the airport asset beta broadly equivalent to that of 0.13 - 0.14 for the energy sector.
78. As explained in the Bush/Earwaker Report, there are certain characteristics of airports that suggest estimating asset beta is more difficult, such that the Commission may not have made sufficient allowance for margin of error. For example:
- (a) Airports exhibit less homogeneity than gas and electricity businesses, which makes it difficult to identify any commonalities in the risk profiles, e.g., there is significant variation in, among other things, their traffic mix, the degree of competition faced from other airports, and their breakdowns of aeronautical versus retail revenues. Further, if the Commission relies on comparator analysis (which it has), there can be no assurance that the average comparator bears a close resemblance to the risk profile of the regulated airport.²⁴
 - (b) In that context, the Commission's comparator sample of asset betas for gas and electricity is much larger and shows far greater uniformity than the airport comparators. It is therefore surprising that the standard errors are broadly similar, as the comparator samples suggest a more pronounced differentiation.²⁵
 - (c) The asymmetry of risks that airports face around costs, volumes and revenues over a long-term horizon, e.g., airports are more susceptible to macroeconomic shocks than regulated energy businesses, since air travel is more of a discretionary product than an essential service (especially for leisure passengers).²⁶
79. As observed in the Bush/Earwaker Report, making insufficient allowance for margin of error is important because:²⁷

any mis-statement of the "standard error" in the Commission's allowable WACC for the three regulated airports will result in a misidentification/mislabelling of WACC percentiles and a misunderstanding of the probability that the Commission has underestimated the true WACC.

²³ Commerce Commission, *IM Reasons Paper*, at paragraphs 6.7.3 to 6.7.6.

²⁴ Bush/Earwaker Report, section 2.2, p. 21; section 2.3.1, p. 23.

²⁵ Bush/Earwaker Report, section 2.3, p. 23.

²⁶ Bush/Earwaker Report, section 2.4, p. 26.

²⁷ Bush/Earwaker Report, section 2.1, p. 20.

80. NZ Airports would value the opportunity to explore with the Commission the proposition that a much higher standard error should be applied to the asset beta for airports than that applied for the energy sector, and the interrelationship with the WACC range. Beyond that, this issue also highlights the overall uncertainty inevitably associated with WACC estimation. In particular, it emphasises the risks associated with narrowing the existing WACC range or introducing a particular “point estimate” – matters which we explore in the following section.

SECTION 3: THE WACC PERCENTILE RANGE FOR AIRPORTS

Introduction

81. The proposal to reconsider the WACC percentile range for airports is a key topic for NZ Airports, which is why we have discussed it in some detail here, even though it was not a Forum topic.
82. According to its problem definition paper, the Commission proposes to consider whether:
- (a) the current WACC percentile range (25th to the 75th percentile) is an appropriate benchmark for measuring airport profitability under the ID regime;²⁸ and
 - (b) an additional point estimate, within the appropriate range, should be published to provide further guidance when assessing airport profitability (we call this the "point estimate").²⁹
83. Clearly, this proposal follows the Commission's previous work in relation to the energy sector, which arose from the High Court comments on the WACC range, and resulted in the selection of the 67th percentile for pricing purposes.
84. In this submission, NZ Airports explains why it considers that:
- (a) it is inappropriate to consider establishing a bespoke "point estimate" for the airport ID regime or to narrow the existing WACC range;³⁰ and
 - (b) the Commission should take comfort that further work in this regard is unnecessary, since the available evidence (discussed later in this section) shows that:
 - (i) once all relevant uncertainties and cash-flow risks are recognised it is unlikely that retention of 75th percentile as the upper limit of the WACC range will, in conjunction with the current IM midpoint and standard error estimates, lead to airports being able to disguise "above-normal" returns under ID; and
 - (ii) the social costs of under-estimating the true WACC in any case significantly outweigh the costs of over-estimation, which justifies retaining the 75th percentile even if there is some chance of above-normal profits being disguised (which is very unlikely).
85. Any changes to the existing WACC range, or the introduction of a specific point estimate within that range, stand to have a significant impact on the benchmark against which the Commission monitors and analyses airport pricing behaviour and returns on investment. Although other matters beyond price and profitability (eg innovation and customer experience) are key airport performance indicators, the Commission's approach to assessment of airport performance to date treats the WACC percentile range as a cornerstone of the ID Regime. It follows that, in the

²⁸ Commerce Commission, *Problem Definition paper* at paragraph 365.

²⁹ Commerce Commission, *Problem definition paper*, at paragraph 365.

³⁰ This is the case irrespective of whether it implements the potential changes set out above (ie to the calculation of the WACC distribution, the costs of debt and equity, and the asset beta).

interests of regulatory certainty and predictability, a robust rationale is required before any departure from the status quo is considered.

86. NZ Airports is of the view that there is value in the Commission stepping back and first exploring:
- (a) whether it is appropriate to consider greater prescription for the WACC IM for the purposes of airport ID regulation; or
 - (b) rather, whether to accept that there will always be uncertainty surrounding the true “socially optimal WACC”³¹ and to address that through maintaining the current range (albeit potentially in conjunction with reforms to the costs of debt and equity, and the asset beta described above).
87. The Commission should also consider whether there are a sufficiently compelling benefits that outweigh the risks of regulatory error - for example, whether change will improve the ability of interested persons to judge whether normal returns are being earned (instead of increasing the prospect of misjudgement) and, more generally, will promote outcomes consistent with the objective of Part 4 of the Act.
88. In refining the problem definition, the Commission ought to have regard to the following factors in deliberating whether to revisit the WACC percentile:
- (a) the Commission's rationale for the use of a WACC range for ID remains fundamentally sound and was endorsed by the High Court. Its approach does not raise issues that warrant, or would benefit from, assessment during this review;
 - (b) there are considerable differences between the airport and energy sectors and the applicable regulatory frameworks, such that the approach taken for price-quality path regulation does not automatically translate into ID;
 - (c) the need to promote contextual analysis under ID, and not entrench a bright line indicator;
 - (d) the inherent difficulties in attempting to select an additional, "optimal" point estimate within the WACC range, and the resulting introduction of a high degree of false precision into the Commission's airport profitability assessment exercise; and
 - (e) matters such as airport-airline consultation and the dual till are irrelevant to the choice of WACC range and/or point estimate. At the very least, they do not operate to mitigate the impact that under-estimating the WACC will have on airport investment decisions and on airports being properly incentivised to facilitate competition, ie the factors that can achieve the greatest long term benefit for consumers.

³¹ That is, a percentile that represents the “true” mid-point WACC, with an appropriate uplift to compensate for all relevant asymmetric cash-flow risks and a further appropriate uplift to reflect any asymmetry in the social costs of under- versus over-estimating the WACC.

The High Court endorsed the WACC Range

89. As the Commission has acknowledged, the use of a WACC range for airports recognises that:
- (a) there is considerable uncertainty associated with estimating WACC - the "true" WACC is not known. That is, there is no single "correct" level of an acceptable return for an airport business (or for all airport businesses);³²
 - (b) there is additional uncertainty with any assessment of airports' actual levels of profitability. For example:
 - (i) returns in competitive markets often either fall below or exceed the mid-point of the cost of capital,³³ but that in itself is not informative; and
 - (ii) the profitability measures (such as ROI) can fluctuate on a yearly basis.³⁴

90. Indeed, for essentially these reasons, the High Court endorsed a range approach:³⁵

The estimation of WACC is, all accept, a complex task involving significant exercising of judgement and is open not only to the possibility of error, but also to there being a range of views. We think the Commission's approach under ID regulation reflects that reality, and will provide an appropriate level and range of information to interested persons consistent with the s 53A purpose.

91. Any narrowing of the WACC range, or the introduction of additional prescription in the form of a specific percentile estimate for monitoring purposes, will contravene the High Court's position and the Commission's reason for establishing the range in the first place. That is, it will increase the prospect of material error, when there is no reason to think that uncertainty in estimating the WACC has or can be reduced.

92. NZ Airports also notes that the Commission has previously considered narrowing the WACC range (to the 33rd to 67th percentile) for gas and electricity businesses, and declined to do so on the basis that:

- (a) narrowing the WACC range would be inappropriate as it would convey a greater sense of precision and confidence about the WACC estimate than was justified:³⁶

The potential variation in disclosed ROIs ex post is likely to be higher than the uncertainty in estimating the WACC ex ante, given the various factors affecting actual supplier profitability performance. **A narrower range of 33rd to 67th percentile might imply that we expect ex post ROIs to always fall within that range, which is not the case.** [Emphasis added]

³² Commerce Commission, *IM Reasons Paper*, at paragraph E1.24.

³³ Commerce Commission, *IM Reasons Paper*, at paragraph E11.58.

³⁴ Commerce Commission, *IM Reasons Paper*, at paragraph E11.60.

³⁵ IM Judgment, at [1491].

³⁶ Commerce Commission, *Proposed amendment to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services*, 30 October 2014, at [2.4.1].

- (b) the existing percentile range (25th to 75th percentile) remained useful for assessing profitability, *ex post*: Those considerations apply equally, if not more acutely to airports in the context of the present review.³⁷

93. At this problem definition phase of the review, the Commission's assessment of the WACC percentile for airports raises a key threshold question. If the Commission now wishes to change its established approach to the WACC range, as endorsed by the High Court, then it will need to provide a compelling reason why the Court was wrong. As we discuss below, the fact that it has reconsidered the percentile for the energy sector does not provide a sufficient basis.

The energy sector approach is inappropriate for Airport ID

94. The application of a specific percentile estimate (the 67th percentile) for gas and electricity businesses subject to price-quality path and information disclosure regulation is predicated on the particular characteristics of those sectors. The airport context is very different, including the applicable form of regulation. This means that the Commission's reconsideration of the percentile estimate for gas and electricity should not be followed for the airport WACC IM.

95. The most important distinction is that “non-exempt” gas and electricity businesses are subject to *binding* price/quality paths under Part 4. The regulatory WACC point estimate consequently forms a key “building block” in their revenue allowances - and there must necessarily be a single “point estimate”. That being the case:

- (a) any “uplift” on the mid-point estimate must be justified on the basis of the uncertainties surrounding the true WACC and asymmetries in cash-flow and social costs that exist in that specific context; and
- (b) it is clearly appropriate for “non-exempt” businesses to report against that specific percentile estimate in their information disclosures, since it feeds directly into their respective revenue allowances.

96. It is similarly understandable for those gas and electricity businesses that are not subject to price control (“exempt” businesses) to also report outcomes against that specific percentile. For example, as put by the Commission in its problem definition paper:³⁸

For electricity and gas business subject to information disclosure, we had separately determined our best estimate of the WACC that takes into account asymmetric risks of mis-estimation (the 67th percentile) **because it was used for setting prices for those businesses subject to price-quality regulation.** [Emphasis added]

97. Plainly, airports are *not* subject to price control. NZ Airports submits that the AAA, which provides that airports can set prices as they see fit, is a key reason not to transplant the energy sector approach into the airport ID regime. That is, it distinguishes airports from “exempt” electricity businesses, which do not operate under a comparable statutory regime.

³⁷ Commerce Commission, *Proposed amendment to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services*, 30 October 2014, at [2.4.2].

³⁸ Commerce Commission, *Problem Definition paper*, at paragraph 390.

98. This does not mean that airports subject to Part 4 have complete freedom to set prices as they see fit. The consultation process with airlines ensures that every airport price setting process is extensively scrutinised and challenged. The addition of the ID regime, and the Commission's approach to profit evaluation within this regime, very clearly constitutes further scrutiny of airport pricing (as demonstrated by the responses to the Commission's s56G reviews).
99. It is important that the Commission remains cognisant of the full extent of these differences as it embarks on the review. If the Commission decides to contemplate changes to the WACC range and/or a point estimate, it will need to substantiate why, and how, doing so for a sector only subject to an ID regime is in the long term interests of consumers, as well as rational, useful and lawful.
100. NZ Airports believes that a key purpose of imposing ID only on airports was to avoid the high risk of regulatory error involved in setting WACC. Although the risk of such error is necessary for price control regimes, it can appropriately be avoided for ID only by using an appropriate range.

A guide for contextual analysis versus a bright line indicator

101. All interested parties appear to accept that the WACC IM must produce a benchmark WACC estimate that indicates whether suppliers have an opportunity to earn at least a normal return (ie that which could be expected in a workably competitive market) over the life of long-lived assets. This expectation is an important part of promoting incentives to invest.³⁹ Investment, in turn, is a key determinant of airport performance, capable of driving airline competition, all to the benefit of consumers.
102. As discussed above, NZ Airports believes that given the uncertainties involved in estimating a WACC that indicates normal returns, a broad range coupled with contextual analysis is required to guard against false findings of excess returns.
103. Such an approach best ensures that the AAA and ID regime under Part 4 work together as a single cohesive regime. Airports should be able to retain their flexibility to adopt tailored pricing approaches, and they will be held to account (including by adverse findings by the regulator) through full and clear disclosure.
104. A point estimate, in conjunction with a rigid approach to the IMs, will risk undermining that balance: airports will be compelled to treat the point estimate as the allowable target return, even when there may be sound reasons to adopt a different approach. This is contrary to:
- (a) the AAA itself;
 - (b) Parliament's intent, – as embodied in s53F of the Act – that the Commission must not establish an expectation that airports must price in accordance with a target benchmark WACC; and
 - (c) the position taken by the Commission in its submissions in the Merits Review proceeding (discussed below).

³⁹ Commerce Commission, *Airports Input Methodologies Reasons Paper*, December 2010 at E1.21-E1.24.

105. Essentially, the concerns NZ Airports had at the time the ID regime was being developed are now being compounded. That is:

- (a) the WACC IM would be treated as a target rate of return by the Commission and interested parties; and
- (b) if airport returns were above the Commission's estimate, then this would be treated as a bright-line indicator of airports earning excessive profits.

106. Airports were assured that this would not be the case. Rather, the understanding was that airports were not required to strictly apply the WACC IM in pricing, since ID regulation was intended to promote transparency around pricing and investment decisions, including the rationale and justifications for those decisions.⁴⁰

107. Helpfully, this was confirmed during the Merits Review proceedings. The Commission was clear that it would put the WACC estimate in context, including by reference to the airports' own methodologies and estimates:⁴¹

The Commission is required to publish the WACC estimate, but it is also required to publish a "summary and analysis ... for the purpose of promoting greater understanding of the performance of individual regulated suppliers". **In other words, the Commission must put the WACC estimate in context. This context will include reference to the airports' own methodologies and estimates, which are required to be disclosed and which are therefore part of the information the Commission is required to summarise and to analyse.** [Emphasis added]

108. The Commission also submitted that:⁴²

The WACC IM provides a basis for comparison with the actual methodologies used by the airports in determining cost of capital. This will encourage airports to be explicit about the assumptions and rationales used in their own modelling, and give interested parties (such as airlines in consultation with the airports over charges) some information for testing the airports' own assessments.

109. In NZ Airports' view, the Commission's submissions in the Merits Review proceedings reflect the ideal role of the WACC IM for ID regulation, namely:

- (a) the WACC IM provides a basis for comparison with the actual methodologies used by airports, and is intended to encourage airports to be explicit about the assumptions and rationales used in their own modelling;⁴³
- (b) airports are required to disclose the approaches they take in pricing under the ID Determination. The role of the WACC IM is to provide interested parties with information and a "tool" to assist with their evaluation of an airport's own assessment of its cost of capital and assess the appropriateness of that approach;⁴⁴

⁴⁰ Commerce Commission, *IM Reasons Paper* at paragraph E1.21-E1.24.

⁴¹ Commerce Commission submissions, 6 August 2012, Volume 2 at [89].

⁴² Commerce Commission submissions, 6 August 2012, Volume 2 at [68].

⁴³ Commerce Commission submissions, 6 August 2012, Volume 2 at [68].

⁴⁴ Commerce Commission submissions, 6 August 2012, Volume 2 at [68]-[69], [81].

- (c) if there are genuine reasons why the rate of return differs from the cost of capital estimate determined by the WACC IM, airports are able to explain these to stakeholders;⁴⁵ and
- (d) the Commission will consider a range of information when assessing airport performance, and will not apply the WACC IM as a "target rate of return" or a "specific returns benchmark" that airports ought to achieve.⁴⁶
110. The Commission's approach to the s56G review process has reduced airport confidence that the contextual analysis will occur.
111. The Commission helpfully confirmed that the 75th percentile of the WACC range was an appropriate benchmark to assess profitability on a forward looking basis. For example, in the Wellington Airport final s56G report, the Commission noted that the 75th percentile estimate:⁴⁷
- Allows for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment.
112. On the other hand, despite the Commission's submissions in the Merits Review proceedings, the regulatory WACC range was clearly treated as a "target rate of return" band or a "specific returns benchmark" that airports must not exceed. Specifically, "excess returns" were quantified as being:⁴⁸
- [A]ny amount above returns expected in recovering the IM compliant cost of capital.
113. Although the Commission did accept in the subsequent Auckland and Christchurch Airport processes that it was possible to justify returns above the WACC IM range as not being excessive, it has not provided any guidance on how that could be done.
114. Accordingly, NZ Airports has good reason to be concerned that the selection of a specific point estimate will be used as a target return benchmark that the Commission will expect airports not to exceed. Such an approach would be contrary to Parliament's intent. A WACC range ought to be retained, and guidance on contextual analysis introduced, to avoid this.
115. Nevertheless, in the problem definition paper the Commission expresses the key issue as being that the IMs do not currently specify how the published WACC percentile estimates should be used as a benchmark for the profitability assessment, or which part of the WACC range should be used to evaluate whether excessive profits are being made.
116. NZ Airports does not consider those to be sufficient reasons to consider change. It notes that:

⁴⁵ Commerce Commission submissions, 6 August 2012, Volume 2 at [83].

⁴⁶ Commerce Commission submissions, 6 August 2012, Volume 2 at [80].

⁴⁷ Commerce Commission, *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport: Section 56G of the Commerce Act 1986*, 8 February 2013 at paragraph E31.

⁴⁸ Commerce Commission, *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, Section 56G of the Commerce Act 1986*, 8 February 2013, p.83, footnote 144.

- (a) in the Merits Review proceedings, the Commission submitted that sufficient certainty *was already provided* by the WACC IM:⁴⁹

The airports cost of capital IM is sufficiently detailed for the airports to forecast how the Commission will calculate the cost of capital in undertaking its analysis and reporting functions under information disclosure regulation. Further, the Court of Appeal's decision related to price-quality regulation where the cost of capital IM has a binding effect on regulated businesses. **The application of the IM is therefore more (not less) important for suppliers in that context than in the context of information disclosure.** [Emphasis added]

- (b) any attempt to provide greater prescription for monitoring purposes, particularly in the form of a specific point estimate within the WACC range, may become an unhelpful search for precision that does not exist, or would be misleading – as discussed below one simply cannot know if any point estimate will correspond to the true “socially optimal” WACC.

117. As set out above, we would prefer engagement on how airport returns can be assessed in their proper market context, to facilitate a broader and deeper understanding of airport performance, rather than an undue focus on a single metric around which there will always be significant uncertainty. To that end, NZ Airports would welcome an opportunity to engage with the Commission and interested parties to develop a clearer and deeper understanding of how this contextualised assessment will be achieved in the future via the Commission's summary and analysis role. Greater certainty as to when returns above the upper limit of the WACC range will be treated as being superior performance or a product of market conditions, and not excess returns, would be welcome. Similarly, how the Commission will view factors that lead to under recovery will also be important.

It is not realistic to move from a range to greater precision

118. We understand that the Commission agrees that no amount of empirical analysis will produce a definitive point estimate of the “socially optimal” WACC percentile.
119. NZ Airports believes that the risk of error for airports is particularly high. Accordingly, its view is that the most efficient, pragmatic approach in the context of an ID regime is to accept that there will always be uncertainty surrounding the true socially optimal WACC and to address that through maintaining the current WACC range.
120. There are compelling reasons to retain the existing range – the 25th to the 75th percentile – or, potentially, to increase the upper limit.⁵⁰ However, it is critical that the percentile estimates are drawn from an appropriate WACC distribution. This is because the 75th percentile of an unduly “narrow” distribution that does not reflect all relevant forms of uncertainty will produce a lower WACC than the 75th percentile of a “wider” distribution that does capture all of those uncertainties (and conversely for the 25th percentile).⁵¹

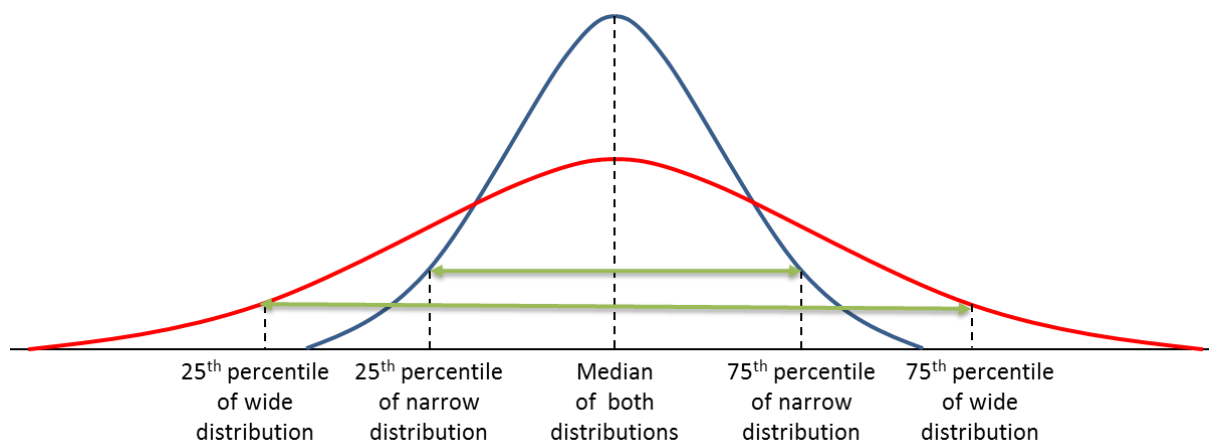
⁴⁹ Commerce Commission submissions, 6 August 2012, Volume 2, at [77].

⁵⁰ In contrast, there is no evidence to suggest that the range should be narrowed or the upper limit reduced.

⁵¹ See CEG, Economic Review of Draft Decision on the WACC Percentile, A Report for NZ Airports, August 2014, section 5.2.

121. As CEG explained in its report of August 2014,⁵² even if the Commission's IM specifies an appropriate WACC percentile range (which, is arguably not currently the case), if the distribution from which those percentile estimates are drawn does not account for all of the relevant sources of estimation uncertainty, it will get the wrong answers. For example, the 25th and 75th percentiles of the IM WACC distribution (which might resemble the "blue" distribution in the figure below) might actually be, say, the 40th and 60th percentiles of a more accurate WACC distribution (which might resemble the "red" distribution). This is illustrated in the Figure 1 below.

Figure 1: WACC distribution



122. CEG also identified several reasons to believe that the assumed distribution of uncertainty around the mid-point WACC is currently too narrow, (ie that it does not take sufficient account of all relevant sources of uncertainty, and therefore resembles more closely the "blue" distribution in the figure above). These include:⁵³
- (a) By any reasonable interpretation, the standard error associated with estimating a cost of debt at a given time for a BBB bond at any maturity is many multiples of the standard error assumed by the Commission in the IMs (ie the IM implies that there is close to zero uncertainty surrounding the estimate of the cost of debt). Moreover, it is also true that an efficient business' cost of debt will likely reflect to some extent the historical market conditions when debt was raised, which may increase or decrease efficient costs relative to the costs measured during the one month window specified by the IMs (see further discussion below).
 - (b) The Commission's existing standard error estimate for the asset beta for airports, which feeds into the WACC range, does not sufficiently reflect the wide margin of variation across different airports which exists in determining an appropriate asset beta (discussed in section 2).
 - (c) The WACC distribution assumed in the IM ignores the impact of the potential for model error in determining the WACC – despite the fact that the Commission has

⁵² These matters were explained in detail in: CEG, *Economic Review of Draft Decision on the WACC Percentile*, A Report for NZ Airports, August 2014.

⁵³ *Ibid*, pp.53-54.

accepted that there is the potential for such error (this was also acknowledged by the High Court in the Merits Review proceedings).

- (d) The estimates of uncertainty do not capture variations in market conditions over time (ie the risk free rate, the TAMRP and the cost of debt will vary through time as conditions in financial markets vary). Consequently, investors' WACC will differ to that estimated by the Commission at the beginning of the regulatory period. In this regard, the airports understand that the divergence between historical average estimates of the TAMRP and forward looking estimates (such as associated with the dividend growth model) is much greater than when the standard error for the TAMRP was set under the initial IMs.

123. This means that, if there was to be any review of the percentile range for airports, there should also be a review of the assumed distribution of uncertainty, in order to ensure that the Commission is actually establishing the WACC range at those levels. Otherwise it will actually be setting a *different* range. This would be especially problematic if the Commission retains its current bright line methodology for identifying "excess returns".
124. Specifically, if the Commission characterises all returns in excess of the upper limit of its IM WACC range (ie the 75th percentile) as "excess returns" and does not account for these sources of uncertainty in its WACC distribution, there is the clear potential for "false positives". For example, the Commission might conclude that an airport had earned a return in excess of the 75th percentile of its IM WACC distribution when, in fact, its return was below the 75th percentile of the *true* WACC distribution.
125. This potential for error would be exacerbated by any decision to reduce the upper bound of the WACC percentile range from the 75th percentile (a step that NZ Airports would oppose strongly for the reasons set out in more detail in section 3).
126. For these reasons, NZ Airports believe that if the Commission does seek to revisit the WACC range, then it cannot do so in isolation. It would also need to revisit the methodologies that affect its estimate of the distribution around the mid-point WACC, so that it accounts for all relevant sources of uncertainty (eg asset beta standard error, as discussed above).

The 75th percentile should remain the upper bound of the WACC range

127. NZ Airports believes that the weight of current evidence is sufficiently strong to suggest that the existing WACC range is appropriate for ID purposes and, in particular, that the 75th percentile represents an appropriate (albeit conservative) upper bound. This is because:
- (a) a variety of asymmetric cash-flow risks mean that even if the IM predicts accurately the mid-point WACC (which it arguably does not, for the reasons set out above), airports may not expect to earn a return equal to that level over time without additional compensation, e.g., a major downturn in traffic due to macroeconomic shocks may make it difficult to earn a normal return on capital, or investments to accommodate larger aircraft may be stranded if those planes prove to be unpopular;⁵⁴

⁵⁴ A detailed account of non-diversifiable cash-flow risks not compensated through existing IMs is set out in: CEG, *Economic Review of the Draft Decision on the WACC Percentile*, A Report for NZ Airports, August 2014, section 5.3.

- (b) the adverse effects of under-estimating WACC are likely to be substantially greater than the adverse effects of over-estimating WACC, due to the asymmetry of social consequences arising from under- versus over-investment (remembering that this asymmetry may arise because one is more likely than the other and/or because it is more costly). The airport specific consequences of setting allowed returns too low are discussed further below (and canvassed in detail in the Bush/Earwaker Report⁵⁵); and
- (c) the retention of the current range is consistent with the purpose of Part 4 of the Act, since it will provide a greater assurance that airports will be able to innovate and invest in their facilities, and once all relevant uncertainties and cash-flow risks are recognised it is highly unlikely that retention of 75th percentile as the upper limit of the range will lead to airports earning excess profits.

128. These factors are likely to more than justify the retention of the 75th percentile. NZ Airports therefore does not consider that it would be an efficient use of time and resources to explore this matter further. Any quantitative analysis that the Commission undertakes to evaluate an alternative upper WACC percentile, or a precise "optimal" percentile, will need to identify all of the costs of setting the WACC percentile at the wrong level. It is highly unlikely that, at the end of that exercise, the Commission could reasonably be satisfied that an alternative would be better than the existing range, in light of the many practical complications described above.

129. Furthermore, as the following sections illustrate, the potential downside costs of inappropriately reducing the upper limit of the WACC range from the 75th percentile or introducing a "point estimate" below that level are substantial. NZ Airports would consequently urge the Commission to exercise a great deal of caution before proceeding.

The need to incentivise investment

130. The Commission has asked interested parties to provide both their views and evidence as to:

- (a) the impact of the WACC estimate on incentives to invest;⁵⁶ and
- (b) in particular, the form and estimates of the magnitude of the costs to consumers from under-investment in regulated airport infrastructure.⁵⁷

131. Airports are "capex heavy" businesses, where significant investment is required upfront to account for the lead times involved with developing and maintaining airport infrastructure, and to future-proof the airport experience for the benefit of both airline consumers and passengers. There are several ways in which investment incentives may be adversely affected if the IM WACC is set too low and an airport is consequently not confident of recovering its costs:

- (a) in some cases, efficient investments might be cancelled, e.g., some investments are of the "now or never" variety and, if the WACC is set below an airports true cost of capital, those opportunities will be lost forever, to the detriment of airport users and the broader economy;

⁵⁵ Bush/Earwaker Report, section 1, pp. 5-19.

⁵⁶ Commerce Commission, *Problem definition paper*, at paragraph 404.1.

⁵⁷ Commerce Commission, *Problem definition paper*, at paragraph 404.2.

- (b) in other cases, investments may be delayed beyond the point at which it would have been optimal for them to take place, e.g., airports may have the capacity to put certain investments “on hold” if the WACC is set too low, which will mean that customers must wait for higher quality services and/or reduced air fares, as the case may be; and
- (c) in some circumstances, airports may substitute the most efficient investments for lower cost options, e.g., they may make inefficiently small investments in additional terminal capacity, which mean that the *next* expansions will be needed sooner than would otherwise be the case, giving rise to even more costly disruptions (all of which is arguably inconsistent with the s52A purpose requirements).

132. In all instances, the costs of these forms of under-investment if the WACC is set "too low" are likely to outweigh significantly the costs resulting from over-investment if the WACC is set “too high”. Moreover, there is no reason to think that the probability of under-investment is mitigated by any airport specific factors. We consider that, if anything, many features of the industry serve to increase the probability of under-investment. We elaborate below.

Adverse effects of under-investment

133. The costs of under-investment at airports could potentially have considerable detrimental effects on the long term interests of airports customers and the wider New Zealand economy. The adverse resultant outcomes will also take a different form to those in, for example, the energy sector.

134. The Bush/Earwaker Report discusses, at length, evidence of the costs of under-investment in airport businesses, drawing on recent examples at UK airports. The types and extent of costs considered apply in New Zealand. A key finding is that in totality the costs from under-investment in airport infrastructure are potentially very significant.⁵⁸ Although the costs of under-investment may be less catastrophic in nature compared to an electricity network outage, they are cumulative, incremental, multi-dimensional and pervasive.

135. The impacts of under-investment at airports can be summarised as including:

- (a) Cumulative, incremental degradation in service reliability as capacity fails to keep up with demand, including congestion, delays and poor service.⁵⁹

capacity constraints may bite at lower levels of throughput if incremental investment is not undertaken in a timely way. For example, failure to invest in taxiway or stand improvements may mean that supply constraints apply at lower levels of runway usage. Some of the negative delay, connectivity and fares impacts seen at Heathrow would then prevail. In the Heathrow case, reaching 99 per cent runway usage followed investment in associated airfield infrastructure in the 1990s to enable greater use of runway capacity. Without such timely investment economic costs would have arisen at lower levels of flight and passenger throughput.

⁵⁸ Bush/Earwaker Report, section 1.5, p.18.

⁵⁹ Bush/Earwaker Report, section 1.1, p.5; 1.3.8, p. 13.

- (b) Under-investment in particular areas of an airport's business can lead to more generic service shortfalls, where bottlenecks in some areas will necessarily have knock on effects in other areas. In this way the whole, or a substantial part, of the airport service offering is diminished.⁶⁰ As noted in the Bush/Earwaker Report, this is particularly pronounced because:⁶¹

Airports are complex operational entities, with multiple processes and facilities that need to be operating in balance with one another. Failure to invest in one area can produce constraints in others.

- (c) The costs of under-investment tend to fall disproportionately on passengers, where consequences can range from occasional flight cancellations to higher passenger airfares, delays, poor service and ambience, and a reduced choice of destinations. However, all parties (airports, airlines and the regulator) stand to suffer from both economic and reputational damage as a result of service failings caused by under-investment.⁶² The Bush/Earwaker Report observes:⁶³

[...] the relationship between under-investment and associated detriment is unlikely to be linear. This is most readily apparent in the area of delay where increasing throughput in constrained facilities is likely to lead to more than proportionate (potentially exponential) increases in costs, particularly to passengers. But it also applies, more qualitatively, to passengers' subjective assessments of the airport (and those propagated through the media). The cumulative effect of individual detriments may over time have a more than proportionate reputational impact on the airport but also on other key players in the aviation sector. Airport performance can affect - for good and ill - the commercial reputations of airlines as well as those of policy and regulatory decision makers in the aviation sector.

- (d) Given service failings at airports tend to manifest on an on-going basis rather than as one-off interruptions, and involve long lead times to remedy, airport under-investment therefore has the potential to have long-term ramifications for the wider economy.⁶⁴

136. The Bush/Earwaker Report also highlights that if airports do not have sufficient facilities (ie runway capacity and additional slots at the airport) to accommodate increased airline competition, created by airline entry and new routes, travel cost to consumers will be higher.⁶⁵ In the UK context, the Bush/Earwaker cite evidence of 2012 ticket prices at Heathrow being 18 per cent higher than other London airports, and 23.8 per cent higher than other European hub airports, on account of its runway constraint.⁶⁶

137. There is also evidence from New Zealand which demonstrates the significant reduction in consumer airfares that occurs when airline competition increases. For example:

⁶⁰ Bush/Earwaker Report, section 1.1, p.5.

⁶¹ Bush/Earwaker Report, section 1.5, p.19.

⁶² Bush/Earwaker Report, section 1.1, p.6.

⁶³ Bush/Earwaker Report, section 1.5, p.19.

⁶⁴ Bush/Earwaker Report, section 1.1, p.6.

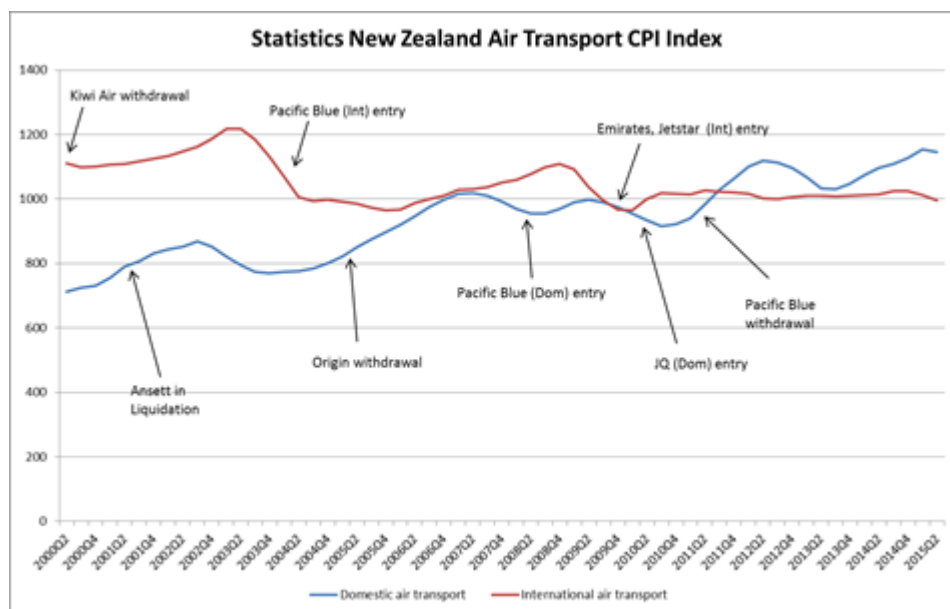
⁶⁵ Bush/Earwaker Report, sections 1.3.4-1.3.5, p. 10.

⁶⁶ Bush/Earwaker Report, section 1.3.6, p.11.

- (a) The entry of low-cost carrier "Freedom Air" to provide direct trans-Tasman services from Dunedin in the 1990s, in competition with Air New Zealand's indirect direct trans-Tasman services, generated passenger demand and strong market growth on the Dunedin routes, and resulted in real benefits to passengers in the form of lower airfares.⁶⁷
- (b) Market analysis of the Auckland-Singapore route passenger volumes and average fares from 2004 to 2011 indicates the benefits of airline competition. The periods during which more than one carrier provided capacity to the route demonstrated evidence of growth in passenger volumes and reductions in average fares. However by contrast, the period during which the route was operated by one single carrier alone illustrated the ability a sole operator had to increase fare levels and constrain demand.⁶⁸
- (c) When Jetstar announced its entry into domestic regional routes earlier this year, Air New Zealand's chief sales and commercial officer, Cam Wallace, commented that the airline would match any fare reductions Jetstar introduces on regional flights and "wouldn't allow itself to be undercut".⁶⁹ Qantas chief executive, Alan Joyce has stated that fares dropped 40 per cent in New Zealand when Jetstar began flying the main trunk routes and that similar reduction was expected this time around.⁷⁰

138. The impact on consumer airfare pricing from increases and decreases in airline competition is also illustrated by the below chart on domestic / international air fares.

Figure 2: Changes in airfare pricing (2000-2015)



⁶⁷ NZ Airports, *Submission on the Application by Virgin Blue Group and Air New Zealand for Authorisation of Alliance*, 2 July 2010, at paragraph 23: <http://www.nzairports.co.nz/w/wp-content/uploads/2010/07/NZ-Airports-Submission-MOT-Virgin-Blue-Group-and-Air-NZ-Alliance-2-July-2010.pdf>

⁶⁸ NZ Airports, *Submission to Ministry of Transport on North Asian Airline Alliance Application*, 27 July 2012: <http://www.transport.govt.nz/assets/Import/Documents/NZCX-submission-NZ-Airports.pdf>.

⁶⁹ See "Air NZ 'ready for a fight' with Jetstar", 19 June 2015, <http://home.nzcity.co.nz/news/article.aspx?id=208486>.

⁷⁰ See also "Air NZ 'ready for a fight' with Jetstar", 19 June 2015, <http://home.nzcity.co.nz/news/article.aspx?id=208486>.

139. It would be incorrect for the Commission to assume that the impact of under-investment in the airport sector is less acute than was recognised for gas and electricity businesses. Rather, the Commission's rationale, that customers are better off paying a little more to reduce the risk that returns will come out below the WACC and thus reducing the likelihood that adverse outcomes will materialise, can and should be equally applied when thinking about the WACC IM for airports.⁷¹

Reliance on airline consultation and ID only is misplaced

140. The Commission has suggested that:

- (a) consultation with a small number of engaged customers (airlines) is "likely to help ensure that appropriate levels of investment are taking place;⁷² and
- (b) the WACC choice is likely to have less of an impact on airports' investment decisions (due to their ability to set their own prices) as compared to price-quality regulated businesses.⁷³

141. The implication of both propositions is that, when ID only applies, there is less need to apply an uplift to the mid-point of the range to guard against under-investment.

142. Both concepts are, however, in our view misplaced, as the following explains.

Airline consultation

143. The Commission's proposition is in fact the opposite of what typically occurs in practice, as airlines may have:

- (a) a strong incentive to lobby against additional investment; and
- (b) neither the incentive, nor the ability, to encourage an airport to undertake additional investment.

144. In other words, while airline consultation plays an effective role in guarding against over-investment, it is unlikely to mitigate the risk of under-investment. In terms of the former, there are numerous cases of where airlines have sought to delay or prevent investment from proceeding. Such opposition can be expected to continue in the future – and be particularly strong if the WACC IM is lower than the level airports propose is required to deliver airports a normal return and therefore allow investment to proceed. This may reduce the probability – and the attendant expected costs – of any over-investment arising from any WACC uplift.

145. As further outlined in the Bush/Earwaker Report, there are a number of reasons why airport-airline consultations do not provide a sufficient safeguard against the potential costs of under-investment:

⁷¹ Commerce Commission, *Amendment to the WACC percentile for price-quality regulation*, Reasons Paper, 30 October 2014, at [5.79] and [5.81].

⁷² Commerce Commission, *Problem Definition paper*, at paragraph 395.2.

⁷³ Commerce Commission, *Problem Definition paper*, at paragraph 395.1.

- (a) There is limited incentive for airlines to support investment projects where this has the potential to increase airline entry and competition at the airport. For example, airlines stand to benefit from increased market power if airline entry is restricted as a result of investment projects.⁷⁴ This will obviously be even more the case where a single dominant airline has the most substantial influence in such processes and stands to lose the most from greater airline competition.⁷⁵ As the Bush/Earwaker Report records:⁷⁶

Airlines operating at an airport will have less interest than an airport operator (and passengers) in investments which might increase airline entry and therefore competition at the airport. This is likely to be more true where the number of airlines is already limited, and there is therefore a market position to be protected. To the extent that there is market power at the airport such airlines may wish effectively to share in that power by restricting airline entry and the choice that would give passengers.

- (b) There is a divergence between airline and passenger interests, where airlines cannot be relied to act in the interests of all airport consumers. For example, airlines tend to focus more on the costs that they bear rather than those that apply to consumers generally. This means that the airlines may, and do, oppose investment that can improve the customer airport experience, which is not related to the airline operations. An example may be that airlines may not be concerned with congestion in waiting areas, provided aircraft boarding processes are not delayed, nor with congestion upon arrival.⁷⁷
- (c) There is a divergence between airline and airport market positions and horizons. For example, airports tend to invest in infrastructure for long term returns, while airlines rather operate in markets which are more consumer-focussed and susceptible to the short term economic environment. This is not surprising given their assets are extremely mobile and, in most cases, can be redeployed to different locations or to provide different services at the same airport, on relatively short notice.⁷⁸
- (d) The diversity of the airline market rebuts the presumption that airlines have common positions and objectives. This is particularly pronounced where, for example, there is a mix of low cost carriers and legacy airlines at an airport. As such, there will be a divergence in views on how, when, and in what areas, the airports should invest.⁷⁹ For example:

⁷⁴ Airlines have natural incentives to constrain airport investment so as to limit airport capacity. For example, a former chief economist at Qantas recently analysed the impact of a congested airport on airline economics, noting that if airlines could live with a congested airport, this would "stifle some of the capacity that's coming into the market (and that will be a benefit to airlines)": Media article, Doug Nancarrow, 29 November 2013, available at: <http://www.aviationbusiness.com.au/news/why-airport-congestion-is-good-for-airlines-even-if-they-don-t-know-it>.

⁷⁵ Bush/Earwaker Report, section 3.4, p. 30.

⁷⁶ Bush/Earwaker Report, section 3.4, p. 30.

⁷⁷ Bush/Earwaker Report, section 3.3, p. 29.

⁷⁸ Bush/Earwaker Report, section 3.5, p. 30.

⁷⁹ Bush/Earwaker Report, section 3.6, p. 31.

- (i) there have been instances in the airport sector when low cost carriers have not supported investments in air bridges; and
 - (ii) Air New Zealand has previously opposed investments that supported A380 aircraft on the basis that it did not intend to operate this type of plane.
- (e) The airlines are generally limited in their ability and industry knowledge to offer meaningful contribution for airport infrastructure and innovation projects. While they may provide useful input on airport decision-making from an airline perspective, they are not experts in airport operations, infrastructure and development.⁸⁰
146. Even if airlines wanted investment to proceed (and were willing to pay more than the WACC IM implied), the airports would still face the uncertainty of how the Commission would assess its target and actual returns on such investment. The Commission has, to date, provided no guidance on when returns above its WACC range can be acceptable. This uncertainty would be a further "chill" on such investments.
147. To this end, since such outcomes have the potential to produce undesirable outcomes for both investors and consumers, it would be imperative to have "on record" recognition from the airlines that they were willing to accept higher prices for such investment. As a matter of commercial practice, it seems quite unlikely that airlines would be willing to provide such an undertaking and, put simply, it does not reflect a sound regulatory outcome to pursue such a risky strategy.

ID only still creates risk

148. The broader issue is that if the ID WACC range is set "too low", the statutory power to set prices "as they see fit" will be insufficient to promote investment by airports. In suggesting that an uplift to guard against under-investment may not be needed under ID only, the Commission appears to be suggesting that airports can ignore the WACC IM because they will continue to price above the WACC IM range in order to proceed with investment.
149. However, the s56G process has demonstrated that this is not the case. The WACC IM presents a very real limit on airport pricing decisions, as the Commission has adopted the approach that all returns in excess of the WACC range are excessive. The s56G reviews also suggest that it would be unsafe for an airport to assume that there will be no adverse consequences from targeting returns in excess of those implied by the WACC IM.
150. Therefore, if the Commission decides to persist on a journey in search of greater precision and sets the WACC range and/or point estimate too low, there will be a strong incentive to under-invest.
151. For the Commission's assumption to be true, it would be imperative to provide (at the outset) some form of express assurance and guidance for any potential or future departure from the WACC IM in airport target or actual returns.

⁸⁰ Bush/Earwaker Report, section 3.7, p. 31.

152. NZ Airports notes finally that the mere possibility that the Commission might reduce the WACC percentile may be all that is needed to give rise to the costs described above. Indeed, if the Commission spends a significant portion of the IM review process (which can be expected to span more than a year) considering whether to revisit – and potentially reduce – the WACC, this may make airports less inclined to invest until that uncertainty is resolved. The potential for such “chilling effects” is one of the main reasons why we urge the Commission to step back and consider the foundational questions set out above before embarking on any such course.

Dual till not relevant

153. The Commission has noted suggestions that the dual-till structure of the airports reduces the likelihood of under-investment in the regulated business, and therefore mitigates the risk of under-estimating WACC (upper limit of the range and/or a point estimate).⁸¹

154. This is a simplistic assertion and is misplaced. We appreciate that the Commission is raising questions for comment at this point, but we are concerned that it appears to have been influenced by stakeholder assertions made in the past without sufficient evidence or analysis.

155. The assumptions underlying the Commission's assertion that non-aeronautical revenues will safeguard an aeronautical investment are that:

- (a) the aeronautical investment will generate non-aeronautical revenues;
- (b) such non-aeronautical revenues will generate *super* normal profits; and
- (c) such supernormal profits will be of a sufficient magnitude to offset any deficit earned on the aeronautical investment.

156. In addition to being problematic from an economic perspective, it raises regulatory framework issues. In particular:

- (a) The AAA and Part 4 clearly establish a dual till business structure for the airports. The Commission only has power to require disclosure of information about the regulated activities (there are only very narrow exceptions under Part 4 that allow the Commission to require disclosure of consolidated information).⁸²
- (b) Accordingly, the Commission's task of promoting the purpose of Part 4 is confined to regulated activities. This means that it must ensure (among other things) that airports earning a normal return on their regulated assets are not assessed as earning excessive returns. Equally, it must ensure that under-recovery is not assessed as a normal return.
- (c) As discussed earlier in this section, the risk of error in relation to regulatory WACC is real, and the consequential risks of under-investment are real and significant for the airport sector.

⁸¹ Commerce Commission, *Problem Definition paper*, at 395, 395.3.

⁸² We note that s56A of the Commerce Act provides a mechanism to add services into the regulated till. That power is though reserved to the Governor General under the Order in Council process and first requires Ministerial recommendation.

- (d) The Commission has an appropriate regulatory mechanism to mitigate those risks. It uses a WACC IM range to better ensure that the "true WACC" is within its estimate of a normal return on regulated assets. If it decided not to use that mechanism due to the presence of unregulated activities, then it will breach the statutory requirement to exercise its powers in relation to regulated activities only.
- (e) That is because it would require the non-regulated activities to bear the risk of under-recovery for regulated activities. Put another way, the Commission could be requiring the non-regulated activities to subsidise or compensate for lower returns on regulated activities. This would also impact on an airport's decisions in relation to non-regulated activities. Such outcomes effectively amount to regulating the non-regulated activities, which the Commission does not have power to do. In particular:
- (i) the Commission would be ignoring the available and recognised regulatory mechanism to mitigate regulatory error to and to provide incentives to invest in regulated activities. It would be increasing the risk of under recovery for regulated airport assets, and would be failing to promote the purpose statement in the same way it has for regulated activities in the energy sector;
 - (ii) instead, the Commission would be choosing to set its regulatory rules so that risks which are specific to the regulated business (ie, risks that arise through setting of the regulatory WACC, and which affect regulatory investment only) are imposed on the non-regulated business;
 - (iii) this would effectively mandate that an airport's non-regulated business provides a "buffer" that mitigates the risk of regulation undermining incentives to invest in the regulated business; and
 - (iv) it would dictate to airports that their commercial activities are required to provide compensation for regulatory risks.
- (f) In summary, if such an approach resulted in the WACC for regulated activities being lower than it otherwise would (it is far from clear this is the correct outcome), then it would mean that the presence of non-regulated activities has a punitive or adverse impact on the regulated activities, contrary to the separation established by the statutory dual till.
157. If the Commission takes a different view on the regulatory framework, then we ask that it provides its legal analysis as early as possible in the process so that interested parties have an opportunity to consider and respond to it.
158. The assumed impact of the dual till is also unduly simplistic from an economic perspective.
159. There are a number of factors that cast doubt on the extent to which the dual till will safeguard against under-investment. As the Bush/Earwaker Report highlights:
- (a) There will always be a need for airport investments that are for aeronautical facilities, and which will have no major impact on passenger throughput or flow-on effects to

non-aeronautical profits.⁸³ The dual till thus has limited relevance to these types of investments (ie safety-related investments such as runway-end safety areas, asset and airfield maintenance and improvements, and facilities for the servicing of aircraft). There needs to be a continued, sufficient incentive for airports to make these investments on a stand-alone basis, which will include allowing an airport to earn a return in line with an appropriate WACC.⁸⁴ The Bush/Earwaker Report notes:⁸⁵

As well as identifying the types of investment where the existence of commercial revenues at the airport is likely to make little or no contribution to the relevant business cases, **it is worth taking a more helicopter view of the nature of airport aeronautical investment and the extent to which it can be regarded as capacity enhancing and therefore likely to lead to more commercial revenue.** The returns that the New Zealand airports make for information disclosure purposes categorise investment according to whether it is concerned with capacity growth or asset replacement and renewal. The business case for the latter (which incorporates some but not all of the investment types identified above) is likely to be relatively unaffected by commercial revenues (except to the extent that there are secondary effects from passenger well-being from, for example, enhanced terminal ambience or more efficient processing enabled by newer facilities). **Yet investment in asset replacement and renewal is significant at all airports. Moreover, it varies over time and between airports. A WACC that therefore under-remunerated aeronautical investment could affect the majority of investment at all airports in some years, and in one case the majority of investment in all years based on recent past and prospective plans.** [Emphasis added].

- (b) Moreover, competition will often force non-aeronautical services to be supplied at a price that reflects a normal return. There is no reason to presume that non-aeronautical services provide a surplus that can cross-subsidise aeronautical services. In fact, in today's evolving market realities preclude the advantages that locational rents at airports once gave. In recent times, the growth of "digital retailing" and other structural factors relating to demographics and market maturity have contributed to a slowing of growth in passenger retail spend at airports, dampening any uplift in non-aeronautical airport activities.⁸⁶
- (c) For investments that are shared between both aeronautical and non-aeronautical activities, the costs attributed to commercial activities still affect the "bottom line performance" of the airport. There is an incentive for airports to therefore lean against the cost of such investments in the same way as any other commercial organisation: that is, it is artificial to assume that simply because it has a non-aeronautical element that an airport will want to incur the costs of investment.⁸⁷ Just like any other commercial business, airports have a limited volume of capital

⁸³ Airport information disclosures show that this 'maintenance' category of capital expenditure is a significant ongoing proportion of total capital expenditure.

⁸⁴ Bush/Earwaker Report, section 4.3, p. 34-35.

⁸⁵ Bush/Earwaker Report, section 4.3, p. 35.

⁸⁶ Bush/Earwaker Report, section 4.3, p. 35.

⁸⁷ Bush/Earwaker Report, section 4.3, p. 35.

expenditure to commit over any given period, which means they rigorously evaluate all investment decisions.

160. Viewed together, these factors suggest that the dual till structure provides no safeguard in incentivising an airport's willingness to invest.
161. As the foregoing illustrates, the dual till is certainly not a determinative factor for limiting, or constraining, a WACC range for regulated activities. Indeed, it should be deemed irrelevant. NZ Airports invites the Commission to disregard this issue now, before it invites any further unnecessary and costly consideration of the matter.

SECTION 4 - AIRPORTS PROFITABILITY ASSESSMENT

Introduction

162. The Commission has identified airport profitability assessment as an area for consideration in the review. In its problem definition paper the Commission identifies, what it considers to be, the two main issues in assessing airports profitability.⁸⁸
- (a) the *ex-post* profitability indicator has proven to be ineffective when airports use alternative approaches to pricing (and should be changed from return on investment ("ROI") to internal rate of return ("IRR")); and
 - (b) the absence of a forward looking profitability indicator (also IRR) in the ID regime to assist interested persons to assess if airports are targeting excessive returns.
163. In response, the key points NZ Airports discusses in this section are:
- (a) We accept that the Commission's perception is that tailored airport pricing approaches present challenges when assessing profitability (target and actual). We are comfortable exploring ways to address those challenges.
 - (b) We believe that the Commission should first reframe the profitability issues. The Commission has moved too quickly to narrowly define the issues in the way outlined above. In particular we are concerned that the Commission appears to have so conclusively decided at this early stage of the process that the *ex-post* profitability indicator has proven to be ineffective. From our perspective, that proposition is not substantiated or explained in the problem definition paper (and nor was it in the Commission's Forum). We encourage the Commission to revisit its view.
 - (c) NZ Airports first needs to better understand what the challenges are from the Commission's perspective, so that appropriate solutions can be considered. We would prefer to explore potential solutions within the current rules first, before deciding that rule changes are required. That is because additional prescription is unlikely to be helpful to assessing airport performance and/or promoting the long term benefit of consumers. Instead, we would welcome further guidance on how the necessary contextual analysis of profitability will be carried out in the future.
164. The Commission also identifies for consideration a suite of secondary issues that affect profitability assessments. NZ Airports' views on these issues are also outlined in this section of its submissions.

Principles to guide consideration of profitability assessment

165. In any assessment of airport profitability under the ID regime, it is important not to focus on profitability in a vacuum and in an overly mechanistic way. The assessment of airport profitability requires a contextual analysis that takes into account all of the Part 4 objectives.

⁸⁸ Commerce Commission, *Problem Definition Paper*, at paragraphs 303, 348-349.

166. Beyond that, it is important for the Commission to have regard to the following matters when framing the profitability assessment issues:
- (a) The policy underlying the relevant IMs and the Commission's assessment of profitability is now well understood. Certainty is a principle that all parties involved in the IM process value. At this stage in the evolution of the ID regime, NZ Airports would caution against materially disturbing the status quo.
 - (b) Airports are providing full and extensive disclosures at present and are open to identifying how best to describe what actions have been taken. The s56G process has helped with understanding of relevant issues with assessing profitability and how a clear disclosure can address these. NZ Airports and its members are committed to full and meaningful disclosure. The summary and analysis process will enable further engagement in the future.
 - (c) Market developments outside of an airport's control can impact on the profitability assessment. Airports are able to (and do) explain such matters in their information disclosures.
 - (d) In an ID regime, overly prescriptive rules and requirements are generally unhelpful. An effective ID regime allows airports to accurately describe the pricing decisions they have made and for the impact of those decisions on profitability to be clearly understood. Greater prescription introduces more complexity, which inevitably requires further explanation; all of which risks creating a less effective ID regime. Therefore, the Commission should try to keep its rules, disclosure statements, and profitability assessments as simple and clear as possible, with a focus on retaining flexibility for airports to explain their decisions in a manner that best allows interested parties to understand them. That would be consistent with the Commission's recognition that greater prescription in information required to be disclosed may only go so far in addressing the problem of the different pricing approaches taken by airport.⁸⁹
 - (e) A robust assessment of airport performance requires a significant degree of qualitative assessment across the full range of the Part 4 purpose statement objectives. The use of a prescriptive formula will not provide the level of detail required for interested parties to make valuable conclusions.
167. Importantly, airports' ability to use tailored approaches to pricing and other commercial decisions is a distinct benefit of the ID regime. This is because the operation of an airport involves a range of complex, interlinked activities.⁹⁰ Flexibility is needed so that Airports can present as realistic a picture as possible of their actual performance.⁹¹ As explained earlier in this submission, the Commission considered that its original formulation of the ID requirements struck the right balance between sufficient prescription and flexibility to disclose information in

⁸⁹ Commerce Commission, Letter to Minister of Commerce re Final s56G report Christchurch Airport, 13 February at paragraph 12

⁹⁰ Commerce Commission, *ID Reasons Paper*, at paragraph 2.19.

⁹¹ Commerce Commission, *ID Reasons Paper*, at paragraph X4.

a way that reflects airports' commercial practices.⁹² It must therefore be able to clearly demonstrate that any changes that will disturb that balance will nevertheless result in a better ID regime.

Challenges in profitability assessment

168. An evaluation of airport profitability under ID requires an understanding of the commercial realities airports encounter, so that business complexities can be accommodated. Regardless of what approach is taken, it is important to recognise that ROIs or IRRs will always only go so far and proper profitability assessment will always require contextual analysis, which is rooted in commercial common sense: there will always be mismatch issues with any profitability assessments between the number that is produced by a formula and what occurred in reality.
169. As NZ Airports has previously explained numerous factors need to be considered in relation to "mis-match":⁹³
- (a) an airport may, following consultation, establish revenue expectations that are NPV negative in some years and NPV positive in others;
 - (b) annual returns can vary from target returns for all sorts of reasons, including variations from traffic or operating cost forecasts for example;
 - (c) operational, compliance and regulatory requirements can lead to unanticipated increases in costs; and
 - (d) at the time of pricing, an allowance could have been made for asymmetric risks that did not subsequently eventuate or, conversely, an event took place that was not allowed for in WACC or forecast cash flows.
170. There are also uncertainties that arise from the comparison of airports' annual returns with a WACC that is updated annually by the Commission, due to market factors outside airports' control. This is because the actual annual returns are the product of pricing decisions made every five years and in accordance with a WACC estimate at that time. The regulatory WACC can therefore be different to both the estimate used by airports to set their prices, and will be different to the Commission's WACC estimate at the time those prices were set. Therefore, without commentary from the Commission, there is always going to be a question around how useful the comparison of headline figures is.
171. NZ Airports supports providing full information to assess profitability, and measures that effectively contribute to addressing the inherent complexities in profitability assessment. However, the Commission needs to consider carefully the mechanisms that are appropriate for the separate *ex ante* and *ex post* analyses.
172. At this stage of the review, it would be preferable to focus on how seeking ways to promote discussion could lead to a more transparent approach, and sophisticated understanding of performance, than changes to the IMs or ID requirements to introduce a prescriptive formula to

⁹² Commerce Commission *Information Disclosure Reasons Paper* at paragraph 5.13.

⁹³ Auckland Airport, *Submissions on Cost of Capital*, 11 June 2012, at paragraph 6.11.

assess profitability. In this regard, NZ Airports endorses the Commission's comments at the IM forum that flexibility in itself is not a bad thing: the issue is determining how to promote transparency, understand where the differences are and what implications they have.⁹⁴

Ex-post profitability

173. NZ Airports would be concerned if the Commission's view is that the tailored approaches that airports take immediately render the *ex-post* profitability indicator as ineffective. In our view, ineffectiveness would mean that the indicator has failed to detect conduct that is contrary to the long term interests of consumers (which has not occurred), and not simply that analysis the disclosed returns is difficult.
174. In any event, the ID regime is still in its early stages and the Commission (and airports alike) have only limited experience of applying the *ex-post* profitability assessment. Summary and analysis of annual disclosures is yet to be undertaken. This makes the Commission's view of proven ineffectiveness all the more surprising.
175. Although NZ Airports considers that the status quo *ex-post* profitability disclosure requirements are sufficient to meet objectives of ID, this is not to deny that the use of the ROI indicator could be refined and evolved. However we suspect that using the summary and analysis process, including through the establishment of guiding principles and better commentary, will be a more effective mechanism than changing prescriptive disclosures. Solutions that will add complexity to profitability assessment, or undermine the certainty that has been established will not be helpful. But, in any event, first the problem needs to be properly discussed and defined.
176. In that context, the Commission should recall that the effectiveness of the *ex-post* profitability indicator was considered when IMs were being developed. Many of the issues now in play were foreseen in those discussions, namely that there were risks that the headline figures produced by annual disclosures may give a misleading picture of airport profitability. By way of further illustration:
- (a) the Commission expressly recognised ROI in excess of the cost of capital is, on its own, was not indicative of excessive profits as costs can vary from year to year, while short-term profits above the WACC may simply reflect superior efficiency or innovation;⁹⁵
 - (b) it also noted that because WACC is a forward looking estimate, a snapshot analysis of returns in any single year does not give an accurate picture of whether an airport is earning reasonable returns over the life of its assets;⁹⁶
 - (c) the Commission's experts stated that recognising the inaccuracies of using headline figures when assessing profits was the simplest way of proceeding;⁹⁷ and

⁹⁴ IM Review Forum Transcript at page 312 as per Hamish Groves (Commerce Commission).

⁹⁵ Commerce Commission, *ID Reasons Paper*, at paragraph 3.23.

⁹⁶ Commerce Commission, *IM Reasons Paper*, at paragraph 6.2.2-6.2.3.

⁹⁷ George Yarrow *Review of Input Methodologies (Airport Services) Draft Reasons Paper*, June 2010 at paragraph 14.

(d) in the Merits Review, the Commission stated that it must put the WACC estimate in context which includes reference to the airports' own methodologies and estimates.⁹⁸

177. As a result, it was clear from the beginning to all parties involved that it would never be a case of simply comparing the annual disclosed return to the WACC IM for that year. It was always contemplated that assessing an airport's returns would need to take into account a range of additional contextual factors that impact disclosed profitability measures over time. A formula was never going to produce full and effective disclosures on its own.
178. The Commission appears to be of the view that an IRR indicator could be more effective than a ROI measure. That is an issue to explore: We note that the Commission itself has acknowledged that the ROI measure, including the way it treats revaluations, is effectively a close approximation to an IRR calculation that is calculated over a single year.⁹⁹ There may be other approaches that should also be considered.
179. In exploring such issues the key consideration should be not to introduce greater prescription to the assessment of returns. There will always need to be some qualitative and or contextual analysis, which involves referring back to pricing decisions, rationales and assumptions, and considering what has happened since then. Neither ROI nor IRR will remove the need for explanation of the full commercial context. This leads NZ Airports to the view that seeking ways to promote discussion will typically lead to a much more transparent approach and sophisticated understanding of performance than changes to the ID requirements.
180. On the other hand, an ongoing rigid focus on seeking to line up numbers will reduce confidence that profitability will be properly and fully assessed.

Forecast profitability

181. The Commission has defined the problem as: "there is no forward looking profitability assessment indicator".¹⁰⁰ This is not accurate. The airports are required to include, and explain, forward looking profitability assessments in their price setting disclosures, with the numerical forecast information disclosable in Schedule 18 of the ID Determination.
182. While the current disclosure may not be a form preferred by the Commission, framing the problem in the way the Commission has leads to only one solution - implementing a different indicator. It also demonstrates the Commission has not fully assessed the status quo before deciding there is a problem, and what the solution might be. The development and consideration of solutions should properly be reserved for a later stage in the IM review.
183. We recognise that the Commission is looking to provide more transparency about target profitability. However, it is important to stress the introduction of a target profitability indicator is not going to remove the complexity involved in the assessment as discussed above in the context of *ex post* profitability.

⁹⁸ Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 89.

⁹⁹ Commerce Commission *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*, ("Auckland 56G Review") at footnote 172.

¹⁰⁰ Commerce Commission, *Problem Definition paper*, at paragraph 303.1.

184. The starting point to frame the issue is to fully consider the status quo, which includes:
- (a) full disclosures of tailored airport pricing methodologies following price setting events;
 - (b) additional voluntary disclosure to fully explain variances from the IMs and the relevant rationale;
 - (c) summary and analysis by the Commission, which should involve an opportunity for interested parties to seek further explanation on any matters that are unclear. The Commission's position is that future assessment of airport conduct under s53B will achieve similar outcomes as the s56G review;¹⁰¹ and
 - (d) In NZ Airports view, although we did not always agree with the Commission's approach, the s56G process nevertheless provided clearly guidance on how the Commission would assess target profitability, including where airports adopted non-IM compliant approaches.
185. The Commission helpfully explained at the forum that a new forward looking IRR disclosure was required so:
- (a) airports have certainty as to how the Commission will assess profitability; and
 - (b) interested parties have transparency.
186. NZ Airports believes both objectives can be achieved under the status quo arrangements described above.
187. Moreover, the promotion of transparency may not be best served by new ID requirements. Introducing IRR into the ID regime will likely involve the difficult task of developing rules about the "right" inputs to the IRR analysis when airports adopt tailored pricing approaches. Even then further contextual analysis will be required in any case. In short, it would appear to risk increased complexity without any compelling prospect of enhanced transparency.
188. The focus of the review should be on seeking ways to promote discussion and understanding. This will lead to a much more transparent approach and sophisticated understanding of performance than changes to the IMs or ID requirements. It should not be, as the problem definition paper unhelpfully implies, a discussion about an element of the IMs or ID requirements that is "missing" and must therefore be added.
189. Taking a longer term view, it is more sensible to engage with the Commission and interested parties if and when new issues come up around forecast profitability, rather than trying to reduce the issue to a rigid and complex formula in advance.

¹⁰¹ Commerce Commission, *Summary and analysis of Wellington Airport's third price setting event*, 30 June 2015, ("**Wellington PSE3 disclosure**") at paragraph A6.

Secondary issues

Land valuation variation and compliance ambiguities

190. Land valuation issues have been fast tracked and so are not discussed in depth in this submission. NZ Airports will provide its views on these important issues in that separate process.
191. That being the case, NZ Airports simply highlights at this stage that there are some aspects of the MVAU land valuation method that illustrate the complexities inherent in hypothetical concepts. Any test that involves predicting hypothetical events demands expert judgement. The use of judgement means there may be legitimate differences in opinion. These differences are not due to the IM itself, and do not indicate a problem with the IM. They stem from the nature of a task that requires prediction and professional judgement.
192. The Commission included checks and balances in the IM to ensure that valuers acted independent and professionally. This is occurring. Accordingly, we urge the Commission to exercise a great deal of caution before taking the disruptive step of introducing greater prescription into the IM in an effort to reduce variation.
193. In terms of addressing compliance ambiguities, our focus will be on ensuring that this does not require changes to valuations that comply with the existing IMs - as this would amount to a change in approach rather than clarification.

Setting the initial RAB date

194. NZ Airports supports the presentation on this topic made by Auckland Airport during the Forum.
195. To recap the issue:
- (a) the Commission's original position regarding the initial RAB was that assets should be valued as at 2009. This included land with a new IM Compliant MVAU;
 - (b) however, in the Merits Review proceedings the High Court agreed with airport submissions that the correct date should be 2010 for land (not for specialised assets);¹⁰²
 - (c) the IM Determination has been amended so that the initial RAB for land is as at 2010;
 - (d) airports do not currently have IM compliant MVAU valuations undertaken as at 2010, but do have compliant MVAU valuations from nearby dates; and
 - (e) they have therefore suggested alternative approaches to avoid the inefficiency of carrying out a historic MVAU valuation to establish a 2010 value.
196. We welcome the Commission's acknowledgement that there is merit in using an alternative approach, given the availability of recent land valuations both before and after 2010.

¹⁰² IM Judgment, at [891] and [892].

197. Various informal discussions have been ongoing between airports, airlines and the Commission about a possible alternative approach. The principle of determining an initial RAB by using the airports' existing valuations to obtain a pragmatic proxy for land as at 2010 seems to be a sensible way to implement the Court's decision. This can be done by interpolating existing 2009 and 2011 valuations.
198. This is consistent with feedback from the s56G review process, indicating that a later asset valuation of 2010 instead of 2009 would not change the conclusions for any of the three airports.¹⁰³ That suggests to NZ Airports that this ought to be an uncontroversial proposition and takes into account the fact that:
- (a) no party wishes to create inefficiencies for their own business when these could be reasonably avoided; and
 - (b) airports are supportive of transparency provided that it is meaningful and efficient for all involved.
199. Auckland Airport's presentation sought to draw out views on whether this position was affected by the prospect of amendments to the MVAU IM following this review. We understand that BARNZ remains largely comfortable with a pragmatic approach.
200. NZ Airports also welcomes BARNZ's willingness to not seek a retrospective application of any amendments resulting from this review. Applying the fundamental legal principle that legislation should not have retrospective effect, and given that IMs exist to provide certainty, changes to the Schedule A rules should not be retrospective. It would be poor regulatory practice to require in 2015 a new 2010 land valuation.
201. Therefore, NZ Airports encourages the Commission to further consider the benefits of not requiring new valuations for disclosure purposes (either at the date of the initial RAB, or on a forward-looking basis).

Use of different approaches to price setting

202. The Commission is of the view that when airports use alternative approaches to setting prices (ie non 'building blocks' approaches) assessing and comparing profitability during a set period becomes problematic.¹⁰⁴ The Commission has indicated that different methods, adopted by different airports, make it difficult to assess whether excess profits are being earned.
203. As discussed above, NZ Airports acknowledges tailored pricing approaches introduce complexity into profit evaluation. However, we are of the view that this is a necessary feature of the regime where airports seek to promote long term benefits for consumers.
204. One interpretation of the Commission's viewpoint, which NZ Airports does not consider to be appropriate, is that it is preferable for all airports to follow an IM compliant building blocks approach to pricing. Rather, the starting point for assessment of these issues in the review is that airports are not required to apply the IMs when setting prices. As discussed at paragraph

¹⁰³ BARNZ, *Impact of IM judgment on s56G reports for airports regulated under Part 4 of the Commerce Act*, 24 July 2014.

¹⁰⁴ Commerce Commission, *Problem Definition paper*, at paragraph 312.

101 it is integral to the effectiveness of the ID regime that airports have flexibility in making pricing and other commercial decisions. Among other things, airports are complex capital intensive businesses, subject to a myriad of asymmetric commercial risks including substantial one-off risk events.¹⁰⁵ Within that pan-sector complexity, each airport has its own unique set of circumstances (whether re-establishing demand following a natural disaster, addressing rising land values, or accommodating risk-sharing with airlines). Against that backdrop, the ability to take a non-building-blocks approach to pricing decisions is a key feature of the current legal and regulatory framework that NZ Airports considers should be retained and promoted.

205. Although the Commission has correctly identified depreciation, asset revaluations and leased assets as areas where airport pricing decisions have diverged in some parts from the IMs, the list could expand in the future as airports seek to reach the most appropriate pricing decisions in response to customer feedback and their individual circumstances at any given pricing event. This cautions against trying to solve for all possible variances in advance. Rather, as discussed above, airports should simply be encouraged to describe, as accurately as possible, the decisions they have made and the rationale for those choices. This will allow any future assessment challenges to be addressed through constructive engagement if and when they arise - the appropriate option for an ID only regime.

Non-standard depreciation

206. Currently, the IMs allow airports flexibility in choosing a depreciation methodology between straight line depreciation and non-standard depreciation.¹⁰⁶ When opting for non-standard depreciation, an airport must submit a disclosure that specifies how the affected assets will be depreciated.¹⁰⁷ This process is in line with the principles of ID.
207. We understand that the Commission sees greater use of non-standard depreciation as a potential solution to the "mis-match" challenges (although a comment in the Commission's s53B decision for Christchurch airport creates some equivocality as to the Commission's otherwise apparent positive view).¹⁰⁸
208. The Commission noted at the forum that there is merit in the use of non-standard depreciation.¹⁰⁹ BARNZ was in agreement, noting that there is no reason to be opposed to the use of non-standard depreciation and that it should not be ruled out.¹¹⁰
209. NZ Airports further notes that Christchurch Airport was encouraged to use non-standard depreciation by the Commission. In its s56G report, the Commission expressed concern over Christchurch Airport's use of standard depreciation in its pricing disclosure and suggested that a

¹⁰⁵ Bush/Earwaker Report, Section 1, p.4.

¹⁰⁶ IM Determination, at clause 3.4(2).

¹⁰⁷ See *IM determination* definition of "non-standard depreciation disclosure" at clause 1.4 and its treatment at clause 3.4(3)(a)(iii); *ID determination* at clause 1.4 and Schedule 4(b).

¹⁰⁸ Footnote 19 states: "*the calculation of implied depreciation using Christchurch Airport's forecasts may not be considered appropriate for annual information disclosures.*"

¹⁰⁹ IM Review Forum transcript at page 327 as per John McLaren (Commerce Commission), and at page 328 Aaron Schiff (BARNZ Economic Consultant).

¹¹⁰ IM Forum Review at page 328 as per Aaron Schiff (BARNZ Economic Consultant).

non-standard approach would allow interested persons to better assess the impact of Christchurch Airport's levelised pricing approach on expected returns.¹¹¹

210. NZ Airports essentially sees the issues for exploration in this area as concerning how airports explain the non-standard methodology in information disclosure to ensure profitability assessment remains effective.
211. Reflective of the fruitful discussion at the forum on this issue, NZ Airports is supportive of principles being developed to guide the application and explanation of non-standard depreciation.¹¹² We understand this would be information only, and outside the IM and ID requirements. Indeed, this type of approach embodies the type of constructive engagement that NZ Airports supports to address all "mis-match" challenges, as discussed earlier in this submission.
212. In summary, non-standard depreciation is a workable and positive alternative that gives airports flexibility that should be present in an ID regime and NZ Airports is committed to exploring how to ensure the use of any such alternative is effectively communicated and disclosed to interested persons.

Revaluation approaches

213. The Commission indicates in the problem definition paper that the use by airports of non-standard approaches to asset valuations means that the regulatory assessment of profits is different to the price setting assumptions.¹¹³
214. At the problem definition stage, relevant considerations to have regard to in assessing the issue of non-standard revaluation approaches are:
- (a) revaluations can impact on profitability of regulated activities; and
 - (b) as with all non-standard approaches that factor into pricing, disclosure can be made in a way that overcomes these issues and provides an effective understanding of the true commercial position. In most cases, it is the context and the narrative provided by the airports that actually helps interested parties understand the performance of the airport.
215. The Commission's indicative solution is to provide greater flexibility in annual disclosures so that they align with the approach taken in pricing. NZ Airports is open to exploring this further.
216. However, it is unlikely to be a full substitute for the need for additional explanation or disclosure. Airports have sought to explain these differences in approach in their annual price setting disclosures (and go beyond simply filling in the ID template) and will continue to do so in

¹¹¹ Commerce Commission, *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport* at paragraphs E24-28 and E56.

¹¹² Review Forum transcript at page 330 as per John McLaren (Commerce Commission) and at page 331 as per Auckland Airport.

¹¹³ Commerce Commission, *Problem Definition paper*, at paragraph 316.

future disclosures to ensure stakeholders have an effective understanding of airport profitability.¹¹⁴

Wash-ups

217. The Commission has identified some uncertainties about how wash-up arrangements will affect both forward-looking and *ex-post* profitability assessments.
218. The Commission's principles to apply to wash-ups are:¹¹⁵
- (a) wash-ups are intended to be NPV neutral, but can have a significant impact on the return attributed to an individual pricing period;
 - (b) where wash-ups are made at the end of a pricing period, the Commission's approach to date has been to carefully consider which pricing period the wash-up should be attributed to. That is, the immediate past pricing period, or the pricing period over which the wash-up is "returned" to airlines through reduced charges; and
 - (c) if the wash-up represents a return of revenue over-recovered from airlines through charges in a past pricing period, the Commission typically considers that it should affect the assessment of profitability for that period, rather than affecting forward-looking profitability measures.
219. In many instances wash-ups are not contemplated on a range of building blocks inputs, on the basis that the airports are best placed to manage risks associated with variances to forecast. However, where there is clear intent for a wash-up to occur, it would be helpful to have greater certainty in respect of how that wash-up will be treated in profitability assessment.
220. During the s56G review of WIAL the Commission applied this approach, which effectively unwound the approach WIAL took to the wash ups for PSE2. NZ Airports does not consider it appropriate, or necessary, for the Commission to recast the outcomes achieved by airports in specific years or pricing periods. The Commission's effective role, among other things, is to assess the returns airports are earning over time, not in specific pricing periods.
221. We propose that this issue is considered further in the later stages of the IM Review, in the context of discussions concerning appropriate approaches to assessing returns.

Unforecast revaluation gains

222. BARNZ provided a presentation on this issue at the Forum and suggested potential solutions, which included amending ID requirements, such that unforecast revaluation changes were included in income for future pricing periods.
223. NZ Airport's initial view is that the BARNZ solutions do not provide a workable mechanism to address the issue. However, NZ Airports is open to engaging on this issue during the IM Review. To facilitate further discussion, we note the following points that will need to be recognised:

¹¹⁴ IM Review Forum transcript at page 319 as per Auckland Airport, and at 321 as per Wellington Airport.

¹¹⁵ Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, at Attachment F.

- (a) the Commission requires unforecast revaluation gains to be included as income for annual disclosure purposes; and
- (b) it may be inappropriate to recognise unforecast revaluation gains in a single pricing period as large variations may significantly impact airport cash requirements for the next pricing period, which could disincentivise investment and lead to volatility in pricing.

224. Development of any solution needs to consider principles around how forecasts may be adjusted in the profitability analysis to reflect the presence or absence of unforecast revaluations.

225. NZ Airports is open to engaging on this issue during the review.

Land held for future use

226. NZ Airports welcomes the inclusion of this issue in the scope of the review. We support the presentation on this topic made by Auckland Airport during the Forum.

227. To recap the issues:

- (a) The IM states land is to be excluded from the RAB unless it is currently used in the supply of specified airport services.
- (b) However, the Commission also notes that no specific treatment is implied by the reference in the IM reasons paper to workably competitive markets.¹¹⁶
- (c) Although the IM allows holding costs to be accrued and entered into the RAB upon commissioning, those could be significant, especially when combined with a significant land value entering the RAB.

228. There are commercial challenges in excluding land held for future use from the pricing asset base until commissioned (that is, if airports adopt the IM approach in pricing). NZ Airports shares Auckland Airport's concern that there is a risk that it will be difficult to achieve a commercial approach that allows for the full recovery of the asset's value and the holding costs that have been incurred when new capacity is commissioned into use. If the IM approach was followed in pricing, this would imply a huge step-change in prices, which is likely to upset airlines and potentially negatively affect consumers.

229. The IM approach makes it difficult to explore alternatives because disclosed returns are assessed against an asset base that does not include the value of the future use asset. Furthermore, if assets held for future use were not allowed to be included, the current issue of capacity constraints could also cause higher prices for services supplied using existing land. This is recognised by the Commission.¹¹⁷

230. The position is further complicated by the Merits Review judgment, which stated that:¹¹⁸

¹¹⁶ *IM Reasons paper*, at paragraph 4.3.74 and 4.3.76.

¹¹⁷ *IM Reasons paper*, at paragraph 4.3.76.

¹¹⁸ IM Judgment, at [908], [913], [914], [919].

- (a) it can be prudent and sensible for firms to acquire assets for future use and that this can involve significant expenditure;
 - (b) the regime could constrain the incentive the airports might otherwise have to acquire land for future use imprudently or hold such land indefinitely without developing and commissioning it; and
 - (c) price smoothing ahead of reasonably imminent commission of future assets may be economically efficient.
231. NZ Airports invites the Commission to consider, at this stage of the review, what other net present value neutral options there are for earning returns on assets held for future use. In particular, if a smoothed price path is implemented and effectively explained in the information disclosure, then the issue becomes how that "non IM compliant" approach will be assessed by the Commission.
232. One approach that merits evaluation is the articulation of principles that provide guidance on how to assess assets for future expansion. Such principles might include considerations as to whether:
- (a) the land is prudently and efficiently held;
 - (b) holding it today it generates positive expected cost savings compared to not holding that asset;
 - (c) there is a genuine reasonable expectation of that future expansion;
 - (d) The pricing method is transparent; and
 - (e) The pricing method is net present value neutral over time are.

Leased assets

233. Activities that involve leased assets are included in the definition of 'specified airport services' for the purpose of ID regulation. The Commission has raised the issue of the exclusion of lease assets and associated revenue from the pricing asset base and from pricing disclosure statements, when they are included in the RAB and regulatory profit for ID profitability assessment purposes.
234. The Commission appears to be confusing two different issues:
- (a) The Act defines regulated services and requires the airports to present information on all of the services in their information disclosures. This is what currently occurs.
 - (b) However, the pricing of the different airport services is undertaken in accordance with the AAA requirements and a different approach may be more appropriate.
235. Airports are right to price leased assets separately, where specific users or tenants have been identified. In fact, in those circumstances, airports have no other option. Moreover, this is:

- (a) consistent with efficient pricing; and
- (b) does not mean that these assets and the associated revenues should be treated separately when assessing overall airport profitability.

236. The disclosure statements already require some segmented reporting, which identifies the revenue associated with lease and concession income, and provides sufficient information for interested parties. Similarly, in price setting disclosures the airports have provided detailed disclosure of the separate outcomes for activities that are not included in the pricing consultation with airlines.

Discounted approaches to price setting

237. The Commission has indicated a view that discounting pricing (relative to returns under the IMs) complicates the profitability assessment process.¹¹⁹

238. However, NZ Airports would highlight that the ultimate purpose of ID regulation is to promote the long term benefits of consumers.¹²⁰ In a competitive market discounts are given to foster long term business success, which can result in over recovery in future periods to offset the discounts. The airport therefore earns its target return over long term. Further, a discount regime may entice new customers leading to higher than expected demand and competition, thereby improving travel prices (and services) available to customers. Even if airports benefit from over-performance from higher than expected traffic, this is behaviour that should be encouraged. Ultimately, discounts and commercial concessions are clearly in the long-term interest of consumers, and the ID regime should not disincentivise this behaviour.

239. Transparency is important, provided it does not compromise commercial confidentiality (which is usually required by airlines to protect their information). But, if all parties are clear on the nature of the concessions that have been made, and understand the principles or reasoning underpinning them, it will be immaterial if a party departs from them over the long term.

240. Moreover, this does make a case for changes to the IMs or ID requirements. Indeed, it is important the Commission does not lose sight of the ultimate purpose and become too focussed on the internal mechanics of the IM regime. In that regard, NZ Airports notes that it is not necessary to alter the disclosure regime to introduce a new layer of complexity in "tracking" these concessions over time to ensure they are not clawed-back. Airports should be able to openly discuss the effects of discounts as they arise.

241. At this point, greater clarity is required from the Commission on the principles that will guide the assessment of historical under and over-performance. The Commission's position on this issue suggests that it is interested in focussing on under-performance and is not considering how it will take into account over-performance.

¹¹⁹ Commerce Commission, *Problem Definition paper*, at paragraph 330.

¹²⁰ Commerce Act 1986 section 52A.

Intra-period cash flow timing assumptions

242. The Commission's position on this is clear. The current ID requirements assume end-of-year cash flow timing assumptions, and the Commission has signalled that it intends to move to a mid-year assumption.
243. NZ Airports will provide further views on this issue during the course of the review.

SECTION 5: REDUCING COMPLEXITY AND COMPLIANCE COSTS

244. NZ Airports supports the topic of reducing complexity and compliance costs.
245. Given that it appears that for airports the Commission will run an ID review in parallel to the IM Review, NZ Airports proposes that the Commission establishes a separate work stream with the airports to provide an opportunity to consider efficiencies that may be achieved in the process to prepare, particularly, annual disclosures.
246. NZ Airports has provided several illustrative examples of items that could be considered for amendment in the Table 1 below.
247. To be clear, the airports are not seeking to withhold any information on regulated activities. Rather, the intent is to achieve efficiencies where possible and to ensure the information produced is useful for interested persons.

Table 1: Illustrative examples for discussion

Prospective Efficiency	Reason to Consider
Reduce differences from GAAP accounting	<p>Requires additional training for new staff and monitoring of separate rules, and creates additional manual processes in addition to existing record keeping. If differences from GAAP are not material, then is possibly unnecessary.</p> <p>For example, depreciation on asset additions and disposals is recognised for part years in GAAP and tax requirements, but is not for ID. This means it is not possible to account for the RAB/Tax RAB in the fixed asset module of the accounting system (without system customisation), instead requiring time consuming spreadsheet based manual processes.</p>
Consider whether annual update of all information required, eg terminal capacity	<p>The annual disclosures require publication of terminal areas for a range of different areas. This is detailed information that can incur external costs to prepare or review.</p> <p>Consider whether the capacity information gets set each time a price setting event occurs and is only amended between periods if there is a material change in facilities.</p>
Consider whether more information than is necessary is provided for consumers	<p>The ASQ survey and capacity and utilisation information all addresses service quality and airport performance. Is there too much information for interested persons to evaluate?</p>
Consider whether unnecessary information is provided	<p>Traffic statistics include a considerable level of detail and take time to prepare. Is this level of detail warranted?</p>

Prospective Efficiency	Reason to Consider
	Similarly, Schedule 10a breaks out the costs into Corporate Overheads, Asset Management and Airport Operations and Asset Maintenance. Does this result in useful or comparable information?

248. These are just examples and if the Commission agrees to establish this work stream the airports, and other interested parties, would need the opportunity to undertake their own detailed reviews of the disclosure requirements.
249. We request that the Commission consider the establishment of a separate work stream to consider this topic as part of the next phase of this consultation.