NZ AIRPORTS

SECTION 56G REVIEW OF CHRISTCHURCH AIRPORT: POST-CONFERENCE SUBMISSION

19 June 2013

INTRODUCTION

1. The Commerce Commission ("**Commission**") held its conference on Christchurch International Airport Limited ("**Christchurch Airport**") on 24 May 2013, as part of its review of the Information Disclosure ("**ID**") regime under section 56G of the Commerce Act 1986 ("**Act**"). This post-conference submission is made by the New Zealand Airports Association ("**NZ Airports**") on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch Airport (together, "**Airports**").

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OVERVIEW

3. The discussion at the Conference was heavily focused on the pricing methodology adopted by Christchurch Airport. This reflected that Christchurch Airport has adopted a long-term pricing model which it believes, in light of its unique circumstances, will best promote the long-term benefit of consumers.

4. In NZ Airports' view, debates over aspects of airport pricing such as pricing methodology are healthy and to be encouraged. These debates highlight the value of ID regulation in providing a flexible regulatory regime where individual airports remain able to explore and adopt innovative and tailored pricing approaches which appropriately respond to complex operating environments.

5. NZ Airports canvasses two main aspects of the Conference discussion in this submission. In particular, we are keen to ensure that:

   (a) an appropriate approach is taken to assessing the effectiveness of ID regulation in the context of Christchurch Airport's long-run pricing approach;

   (b) the Commission is aware of the uncertainty and risks that continue to be created by the treatment of asymmetric risk (in advance of an event occurring), and the treatment of the costs that result from such events occurring in the context of the ID regime.

6. We expand briefly on these points in this submission. We have not addressed the topics of quality, innovation, efficiency and investment because, consistent with the Wellington and Auckland Airport processes, it appears to be generally accepted that ID regulation is working well in these areas to promote the right incentives and outcomes. We acknowledge some specific matters were raised during the Conference, which we anticipate Christchurch Airport will address in its submission.[1]

ASSESSING THE EFFECTIVENESS OF ID REGULATION IN THE CONTEXT OF A LONG-RUN MODEL

Different approaches should be positively recognised in an ID regime

7. During the Conference, Christchurch Airport explained that it has adopted a pricing model that it considers to be appropriate for its unique circumstances. Christchurch Airport explained that its long-term pricing approach:

   (a) seeks to find a balance between cost recovery and responding to market conditions;

   (b) Is intended to deal with the pricing implications of major long-term investment in a way that smoothes prices over time while recognising that future prices cannot be fixed; and

   (c) involves a price path that is informed by its pricing model as well as based on commercial judgement in light of the needs of its customers and the Christchurch region (particularly in a post-earthquake environment).

8. These are sensible and appropriate factors for an airport to consider when setting charges and considering its pricing approach. NZ Airports submits that it is exactly the type of approach under the Airport Authorities Act 1966 that should be encouraged. Taking such considerations into account is an important part of ensuring that decisions are made in the long-term benefit of consumers in the way contemplated by the purpose statement for Part 4.

9. Airport pricing involves complex decisions that must balance the needs of all interested parties and recognise the importance of promoting the long-term benefit of consumers across a range of diverse, interacting performance areas. There is no set answer, approach, or method of making decisions that will be appropriate for all airports in all circumstances.

10. Different parties will have different views, including on economic issues, where a range of types of behaviour may be consistent with outcomes produced in workably competitive markets. Similarly, where economic opinion is divided on a complex issue (such as adjustments for the global financial crisis), different approaches can be rationally and reasonably justified by reference to expert advice.

11. Ultimately, an individual airport should fully consider its options and adopt a package of decisions that it considers to be best suited to the needs of all stakeholders, following consultation with substantial customers. ID regulation was specifically intended to allow this behaviour to occur, while providing information about airport decisions for interested parties (so those parties can make their own assessments about the choices that have been made). This includes key matters such as the choice of pricing methodology.

12. As such, the use of a long-run pricing model by Christchurch Airport is an appropriate pricing approach in an environment characterised by major capital investment. Similarly, Christchurch Airport's decision to tailor its pricing decision to its individual circumstances (such as through the use of an airport-specific asset beta) is appropriate in an ID framework. This does not

[1] We note the Commission has asked interested parties to discuss the appropriate WACC date for its IRR analysis. NZ Airports refers to its cross-submission on the Auckland Airport Draft Report (14 June 2013) at paragraphs 15-17.

meant that either approach is the only appropriate approach, but rather they are approaches which are consistent with behaviour adopted in competitive markets.

Assessing airport performance requires a focus on the time prices were set

13. It appears from the discussion during the Conference that the Commission is considering how best to assess the effectiveness of ID regulation in light of Christchurch Airport's long-term pricing approach.

14. NZ Airports is concerned that the Commission's line of questioning at the Conference highlights the limitations of the prescriptive analytical approach it is using to assess performance, which attempts to squeeze the tailored approaches taken by each airport into a single assessment model.

15. As such, we are concerned that the Commission's section 56G review process appears to have become less about understanding and examining the decisions and behaviour of each airport, and more about how an individual airport's decisions can be adjusted in a way to fit into the Commission's formulaic profitability model. These concerns increase when the Commission continues to rely heavily on assumptions about future conduct.

16. In NZ Airports' view, the correct approach when assessing the effectiveness of ID regulation is for the Commission to:

    (a) acknowledge that airports are free to adopt pricing methodologies that are appropriate for their individual circumstances, and are required to disclose their price setting practices as part of the ID requirements;

    (b) examine whether the information that is provided about Christchurch Airport's pricing methodology provides sufficient information for interested parties to assess the approach that was used; and

    (c) meaningfully engage with the methodology used by Christchurch Airport in its assessment of the effectiveness of ID regulation.

17. In this way, the Commission can continue to appropriately focus on the impact of ID regulation on the decisions and behaviour of airports in light of the understanding that existed at the time prices were set. For Christchurch Airport, such an approach recognises that:

    (a) Christchurch Airport made its pricing decisions based on economic theory combined with commercial judgements and a desire to adopt a tailored and smoothed pricing approach over the life of its assets.

    (b) At the time of pricing, Christchurch Airport considered that its forecast returns were fair, reasonable, and within an appropriate level having regard to the regulatory framework. In particular, we note that:

        (i) Christchurch Airport explained during the Conference that it checked its forecast revenue against various methods of calculating the cost of service to ensure that it was likely to earn an appropriate return, including referencing its model against an estimated cost of service calculated in accordance with the Commission's input methodologies.

        (ii) Christchurch Airport provided evidence at the Conference that the results of these cross-checks reinforced its belief that it was not seeking excess returns when it made its pricing decisions.

18. For these reasons, we continue to encourage the Commission to recognise that, while modelling can be a guide, it is only one part of an assessment of the impact and effectiveness of ID regulation. The multiple ways in which ID regulation has a constraining effect on the behaviour of airports (including airports' ability to extract excess profits) should be reflected in the Commission's conclusions.

Assumptions about future pricing must be grounded in evidence

19. For completeness, we note that the Commission has continued to ask interested parties for their view on likely future pricing decisions so it can determine the closing asset base for its IRR profitability analysis. NZ Airports has been clear in the section 56G review process to date that we consider it is inappropriate for assumptions about potential future approaches to negatively impact an assessment of current performance. However, where the Commission is relying on assumptions about future conduct, it is important that it rely on the best evidence for those assumptions.

20. In the case of Christchurch Airport, this evidence comes from its statements about how its long-run pricing approach is intended to operate. For example, during the Conference, Christchurch Airport was clear that it expected actual prices to converge with the long-run constant price under its model in a way that is designed to achieve a NPV=0 outcome. It is these statements that should carry the most weight with the Commission, along with the recognition that (as highlighted during the Conference):

    (a) prices cannot be fixed now for all time;

    (b) airports retain an obligation to consult with substantial customers on a regular basis; and

    (c) it is appropriate and responsible for airports to respond to changing market conditions over time.

TREATMENT OF ASYMMETRIC RISK

21. There was some discussion at the Conference of the appropriate treatment of demand shocks and recovery of costs in a post-earthquake environment. In our view, this discussion provides a further example of the uncertainties and risks created by the Commission's current approach to asymmetric risk.

22. In particular, in light of the fact that no allowance has been made for asymmetric risks in the cost of capital input methodology or in the Commission's approach to assessing airport returns, there is considerable uncertainty as to whether:

    (a) If any airport elects to make allowances for these risks in advance, such decisions will be factored into the Commission's analysis and monitoring; and

    (b) airports will be able to fairly recover unexpected costs and deal with demand shocks associated with catastrophic events, without that behaviour being assessed as not in the long-term interests of consumers.

23. In NZ Airports' view, the Commission cannot ignore asymmetric risks when assessing whether airports are limited in their ability to extract excess profits. We consider the appropriate solution is for the Commission to engage with and examine the approaches taken by the individual airports to provide for asymmetric risks in advance, and the methods used by the airports to deal with the consequences of any catastrophic events after the fact.