

CIAL CROSS SUBMISSION FOLLOWING WELLINGTON AIRPORT CONFERENCE – 17 AUGUST 2012

EXECUTIVE SUMMARY

- 1 Christchurch International Airport Limited (*CIAL*) welcomes the opportunity to make this cross submission following the Wellington Airport Conference, held on 7 August 2012.
- 2 *CIAL* is also a party to, and has contributed to, the New Zealand Airports Association's (*NZ Airports*) cross submission following the Wellington Airport Conference. *CIAL*'s cross submission should be read in conjunction with the *NZ Airports* cross submission.
- 3 The contact person for this cross submission is:

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- 4 We comment on the following issues:
 - 4.1 Framework issues relating to the section 56G review (*Review*), namely:
 - (a) The role of the Input Methodologies (*IMs*) in the Review;
 - (b) Ex ante profitability assessment;
 - (c) The role and content of the section 53B reports;
 - (d) Further regulation of services supplied by airports;
 - (e) Dual till approach to the Review; and
 - (f) The complementarity of the Airports Authorities Act (*AAA*) and the information disclosure regime.
 - 4.2 Issues general to all airports, namely:
 - (a) Tighter specification of Schedule A; and
 - (b) Treatment of the costs of litigation.
- 5 As a general reflection on the discussion at the Conference, the repeated comments that the *IMs* have not influenced the airports and promoted the Part 4 Purpose did not ring true to us. While we cannot speak for the other airports, and we have not yet completed our pricing consultation, we can say that the *IMs* have been front and centre in our pricing process considerations. They have framed our pricing proposals, been considered by management and our board, and provided a framework for our

discussions with airline customers. This has provided a discipline to ensure that we are sure we are presenting an accurate picture of our business and our costs, appropriately investing for the future, aiming for a reasonable return, and sharing gains with our customers. We expect that WIAL and AIAL have had the same experience.

- 6 Another theme from the Conference was how little attention was paid to the way that information disclosure preserves the incentives that airports currently have to take risks, invest scarce capital in facilities that meet the needs of all airlines and the travelling public, encourage airline competition and participate in initiatives to grow tourism and stimulate economic growth across local regions. These investments in facilities, airline competition and growth are not always exactly aligned with the interests of the incumbent airlines, and are likely to be constrained under more heavy handed regulation. But all of these activities advance the purpose of the Act, and it is a measure of the effectiveness of information disclosure that it preserves the commercial space for the airports to pursue these objectives.

FRAMEWORK ISSUES

Role of the IMs in the Review

- 7 Towards the end of the conference, Dr Berry touched on one of the more significant issues that the Commission faces in the Review. The question he asked was essentially "what is the role of the IMs in the Review?".¹
- 8 This issue has developed within a context in which, generally speaking:
 - 8.1 the airlines have tended to insist that airports must apply the IMs in pricing decisions; and
 - 8.2 the airports acknowledge that the IMs are a key consideration in pricing decisions – and the IMs have accordingly influenced pricing decisions – but there is no compulsion to apply the IMs in pricing.
- 9 As a starting point, CIAL accepts that the IMs are relevant to the Commission's exercise of assessing how effectively information disclosure is promoting the Part 4 Purpose. CIAL does not expect the Commission to ignore its own view of the inputs that are consistent with promoting the Part 4 Purpose.
- 10 There are, however, other important parts of the picture which need to be considered in deciding on the appropriate role of the IMs in the Review:
 - 10.1 The IMs are unlikely to represent the sole outcomes that are consistent with workably competitive market outcomes, especially when considered in light of the Commission's view of workable competition. In the Airports IMs Reasons Paper, the Commission commented that "unlike 'perfect' models of competition – in which very specific 'equilibrium' outcomes arise as a result of a number of strict and unrealistic underlying assumptions – 'workable' competition encompasses a wide range of outcomes".² The Commission also quoted in its

¹ Commerce Commission *Wellington Airports Conference Transcript* (7 August 2012), p. 152 lines 10-26.

² Commerce Commission *Input Methodologies (Airport Services) Reasons Paper* (22 December 2010), para 2.5.3.

reasoning the following statement of its expert advisors:³

It is not to be expected, therefore, that a workable or effective competition standard will be narrowly prescriptive as to the types and forms of economic organisation and business conduct that might be considered consistent with such competition.

These views suggest that there are likely to be pricing inputs which, while not being consistent with the IMs, are consistent with promoting the Part 4 Purpose. The Commission has expressed the view that asset valuation is one particular example where a number of valuation outcomes are conceivably consistent with workably competitive market outcomes.⁴

- 10.2 The test of the effectiveness of information disclosure cannot be whether it replicates price control i.e. an effective information disclosure regime is not necessarily one in which pricing outcomes are effectively the result of a strict application of the IMs.
- 10.3 There is significant risk in making an assessment against the IMs the overriding focus of the Review:
- (a) The Commission will also need to consider the positives that come from allowing commercial decision-making under an information disclosure regime – including better risk-taking and investment decision making, the role airports play in stimulating airline competition and other downstream markets, and the role they play in stimulating economic growth across their region. Retaining these incentives is an objective and an advantage of information disclosure regulation, relevant to assessing its effectiveness. A strict application of the IMs would undermine this dynamic.
 - (b) Assessing the effectiveness of information disclosure in promoting the Part 4 Purpose suggests a greater focus on outcomes rather than inputs. This is not to say that it is appropriate to ignore inputs into pricing. CIAL accepts that inputs are partially determinative of outcomes. But it is ultimately outcomes which are the measure of whether performance and behaviour are consistent with the Part 4 Purpose. The outcomes of CIAL's 2012 proposed price reset are yet to occur but these will be influenced by uncertain variables such as passenger volumes and the return of tourism activity to the South Island following the effects of the Canterbury earthquakes.
- 11 Taking the points above into consideration, CIAL's view on the appropriate role of the IMs in the Review is as follows:
- 11.1 The IMs are relevant to the assessment of how effectively information disclosure is promoting the Part 4 Purpose;

³ Commerce Commission *Input Methodologies (Airport Services) Reasons Paper* (December 2010), para 2.5.4.

⁴ Commerce Commission *Input Methodologies (Airport Services) Reasons Paper* (December 2010), para 4.2.28.

11.2 The key question likely facing the Commission is how it should interpret an airport's decision not to use an IM. In CIAL's view, a decision by an airport not to use an IM:

- (a) should not be interpreted as being inconsistent with promoting the Part 4 Purpose. As the Commission acknowledges, workable competition produces a broad range of outcomes and there may be a number of approaches to inputs that fall within that range;
- (b) should not be viewed in isolation. There may be occasions where the Commission is concerned that the outcomes from a pricing decision are not consistent with promoting the Part 4 Purpose. In such instances, the Commission needs to assess the inputs and forecast pricing outcomes as a package, rather than being drawn into an individual input by input assessment.

11.3 An assessment of pricing inputs against the IMs should not be the overriding focus of the Review:

- (a) Though such an assessment is relevant to the Review, it does not exhaust the range of issues that need to be considered when assessing the effectiveness of information disclosure. There are aspects to performance and behaviour, many of which reflect positively on airports, which are not captured by an assessment against the IMs (e.g. willingness to invest for the future and promote airline competition);
- (b) Assessing the effectiveness of information disclosure in promoting the Part 4 Purpose suggests a greater focus on outcomes is required rather than inputs.

Ex ante profitability assessment

- 12 At the conference, Commission staff asked whether the ex ante profitability assessment should be conducted using the mid-point or 75th percentile of the cost of capital range.⁵

Relevance of ex ante profitability assessment

- 13 The Commission staff's question raises a broader issue concerning the relevance to the Review of an ex ante profitability assessment. In carrying out the Review, the Commission would ideally possess a sufficient time series of data results from annual disclosures. However, as the Commission has recognised, this is not the case.⁶
- 14 In these circumstances, there is a temptation to place too much weight on ex ante profitability assessments. It is important to emphasise however that ex ante assessments are not a substitute for ex post assessments. Conclusions based on actual outcomes are relatively definitive, whereas conclusions based on forecast outcomes are very much contingent.
- 15 With these considerations in mind, CIAL is supportive of the Commission's position in the Update on Process and Scope Paper in which it stated that it would expressly acknowledge the limitations concerning the lack of time series data in its report to the

⁵ Commerce Commission *Wellington Airports Conference Transcript* (7 August 2012), p. 75 lines 14-17.

⁶ Commerce Commission *Airport Services – s56G Reports Update on Process and Scope* (27 July 2012), para 25.

Ministers.⁷ At the least, this section of the report should note that any conclusions as to performance are contingent on a number of highly uncertain variables (particularly for CIAL, given the ongoing effects of the Canterbury earthquakes), and this requires any conclusions drawn to be viewed with caution.

Which WACC point estimate should be used?

- 16 Given the question asked by Commission staff at conference, it seems likely that the Commission will place some weight on the ex ante profitability assessment. In that case, CIAL's view is that the uncertainty associated with an ex ante assessment justifies the use of a higher point estimate than the midpoint estimate the Commission would ordinarily use when conducting an ex post assessment. The assessment will be one of comparing uncertain forecast outcomes (contingent on highly uncertain variables) with an uncertain industry-wide WACC estimate.
- 17 The snapshot nature of the period under assessment suggests a higher point estimate is appropriate. Airports are effectively multi-period businesses and the period being assessed is a relative short period of time in that context. As we have highlighted a number of times, airports adopt long-term pricing strategies to match the life of their assets, under which returns in one period may deliberately differ from other periods. Adopting a higher point estimate is one way of being sensitive to that dynamic.
- 18 The asymmetrical costs of an inaccurate WACC estimation are also relevant here. The result of an ex ante assessment based on a WACC that underestimates the true cost of capital for a supplier could be an unnecessary triggering of further costly regulatory intervention. On the other hand, the cost of an assessment based on a WACC that overestimates the cost of capital may be the continuation of the status quo, under which airports are disciplined by the twin regulatory constraints of information disclosure and consultation under the AAA.
- 19 Finally, to give some context to this discussion, CIAL notes that its return on investment in its only annual disclosure under the new regime (for the year ending 30 June 2011) was significantly lower than its projected return when it reset its prices in 2009 (6.94% actual vs. 8.62% projected). This lower return reflected the phased implementation of price increases owing to the effects of the Global Financial Crisis on the aviation sector, and higher operating costs and lower demand than forecast due to the Canterbury earthquakes. This result illustrates the high level of contingency inherent in the forecast outcomes on which ex ante assessments are based.

The role and content of the s 53B reports

- 20 In this section, CIAL responds to the question "What do airports expect would be in the Commission's s 53B summary and analysis reports?" As CIAL has previously submitted to the Commission, CIAL considers the s 53B reports to be a crucial part of the information disclosure regime.⁸ The Commission's commentary will help to contextualise what are effectively annual snapshots of businesses with long-term strategies to match the life of their assets. CIAL is therefore pleased to take this opportunity to comment on the appropriate content of the s 53B reports.
- 21 Section 53B(2) provides:

⁷ Commerce Commission *Airport Services – s56G Reports Update on Process and Scope* (27 July 2012), para 25.

⁸ CIAL *Submission on Commerce Commission Input Methodologies Discussion Paper* (7 August 2009), paras 34-37; CIAL *Cross Submission Following Input Methodologies Conference* (15 October 2009), paras 56-61.

If a supplier of goods or services is subject to information disclosure regulation, the Commission—

...

- (b) must, as soon as practicable after any information is publicly disclosed, publish a summary and analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.

22 The section provides the key parameters for what s 53B reports should contain. Specifically, the reports are for the purpose of promoting greater understanding of:

22.1 the performance of individual regulated suppliers;

22.2 their relative performance; and

22.3 the changes in performance over time.

23 A further constraint is the purpose of information disclosure in s 53A i.e. to ensure that sufficient information is readily available to interested persons to assess whether the Part 4 Purpose is being met. The s 53B reports are key to meeting that objective.

24 Below we discuss the content that will be necessary to meet each of the purposes specified in s 53B(2).

Promoting greater understanding of the performance of individual airports

25 Of the three purposes of the s 53B reports, promoting greater understanding of the performance of individual airports is the most important.

26 CIAL has previously commented that it sees the annual commentary in the reports as the “most significant opportunity and risk in the new regime”.⁹ The opportunity is to transform the raw data of the disclosures into a set of coherent and easily understood messages about the performance of the individual airports over time. The key to that task is to wrap important context around what are annual and static snapshots of performance.

27 The risk is that the commentary becomes focussed on the short term, with a crude analysis of annual returns against the Commission’s estimate of WACC. This will not promote greater understanding of performance.

28 Turning to the detail, CIAL sees the following as important issues to be covered in the reports:

28.1 The level of new investment and the timing of recovery of long term assets. CIAL expects that the Commission would comment on CIAL’s performance in light of CIAL’s new Integrated Terminal. A significant part of CIAL’s current proposed price reset is how much of the cost of the new terminal it should recover in the upcoming pricing period relative to subsequent pricing periods. This is one of the key factors which make it necessary for the Commission to focus on long term performance.

⁹ CIAL Cross Submission Following Input Methodologies Conference (15 October 2009), para 56.

28.2 The impact of forecast variables – volume, operating and capital expenditure. Significant deviations from forecasts and the impact on performance (including return on investment) will need to be explained.

28.3 Unusual or extraordinary events. The Canterbury earthquakes are an obvious example of how extraordinary events impact performance.

Promoting greater understanding of relative performance

29 CIAL interprets this element as requiring the Commission's s 53B reports to promote greater understanding of the relative performance of the airports that are regulated under Part 4 i.e. Christchurch, Wellington and Auckland International Airports.

30 The Commission will need to approach this particular task with caution. Each airport has unique characteristics, risk profiles, business opportunities, and cost pressures. Probably the two most significant differences between the three airports are their respective positions in the investment cycle (especially with respect to terminal investment) and their commercially appropriate cost of capital.

31 These differences do not make comparisons impossible, but they do make them complex and emphasise the need for caution.

Promoting greater understanding of changes in performance over time

32 This element requires the Commission's s 53B reports to promote greater understanding of changes in performance over time. CIAL expects that this task will be relatively simple.

33 It is possible to construe this element as a subset of the requirement to promote greater understanding of the performance of individual airports. What it does is emphasise that performance needs to be assessed over time, rather than static, annual snapshots of performance.

34 It also suggests to CIAL that Parliament was aware that it would take time for information disclosure to fully express itself and for the incentives that the regime creates to work. The element loses its value if definitive conclusions about airport performance are drawn before the regime becomes fully operative and effective.

Further regulation of services supplied by airports

35 BARNZ suggested in submissions that, as part of the Review, the Commission should consider whether any other services should be made a specified airport service under section 56A for the purpose of Part 4. At the conference, this issue was discussed briefly.¹⁰

36 We agree with Dr Berry that the matter is plainly outside the statutory scope of the Review.

37 As a general comment, this is a very serious suggestion from BARNZ, and even the exercise of properly considering the case for any new regulation would be expensive and time consuming. The activities in question are competitive ones. Proponents of further regulation bear a greater burden than simply asking for a regulatory review of undefined services.

¹⁰ Commerce Commission *Wellington Airports Conference Transcript* (7 August 2012), pp. 134-137.

Dual till approach appropriate for Review

38 CIAL rejects Air New Zealand's contention that a single till approach for the Review is required.

39 The clear intent of the Part 4 legislation applying to airports is to preserve a dual till approach to regulation. This has been recognised by the Commission:¹¹

...the nature of the Act and the Commission's interpretation of it is to go to a dual till approach...

40 There is a limited departure from the clear intent of Part 4 in s 53D, under which a supplier may be required to disclose information relating to its non-regulated business. This provision, and the information that may be required to be disclosed under it, is tightly prescribed so that the information can only be required for the purpose of enabling the Commission to monitor compliance with information disclosure regulation.

41 Parliament intended a dual till approach to underpin the regulation of airports. There is no reason to depart from that in this Review. A robust cost allocation IM has been determined by the Commission which:

41.1 has not been appealed by the airlines or airports, indicating that the methodology has wide acceptance;

41.2 has been appropriately applied in pricing, without significant controversy.

The complementarity of the AAA and the information disclosure regime

42 At the conference, a question was raised concerning the "harmony" of the AAA and information disclosure regimes. Dr Berry commented that:¹²

the theme seems to be coming out of the airport responses that they're faced with two almost conflicting regimes; the AAA and our information disclosure regime, and you're finding that the two are not in harmony and your position is to have preference for the AAA regime in the decision path you follow; is that a reasonable observation or not?

43 CIAL disagrees with the observation above. Both legislative regimes are intended to constrain the exercise of market power and they complement each other in this common purpose. The AAA regime provides the requirement for consultation (requiring the provision of adequate information on which the proposed price reset is based, and the right to be heard and to have those views taken into account), whereas information disclosure provides for transparency. Neither of these processes are in conflict.

44 Information disclosure is having a positive impact on the AAA processes (i.e. consultation and price-setting) by arming airline customers with more detailed information and compelling airports to robustly consider the IMs in pricing decisions. In turn, the outcomes of the AAA processes are made transparent through price setting event disclosures.

¹¹ Commerce Commission *Input Methodologies Airports Workshop Transcript* (18 February 2010), p. 84 lines 15-16. See also Commerce Commission *Invitation for Airports Post-Workshop Submissions* (22 February 2010), question 22: "Commissioner Duignan noted that the Commission's interpretation of the legislation was that it took a dual till approach".

¹² Commerce Commission *Wellington Airports Conference Transcript* (7 August 2012), p. 54 lines 25-31.

- 45 Information disclosure also has a broader role to play than just in relation to the AAA processes. It is full time operative compared to the 5-yearly AAA processes. In this respect, information disclosure provides an ongoing discipline of the decision making of airports.
- 46 The suggestion that the two regimes are in conflict may stem from a misunderstanding of the s 4A statutory clarification that each airport may "set charges as it from time to time thinks fit". This provision is not, as the airlines seem to suggest, an additional licence conferred on the airports to price however they like.
- 47 The purpose of the provision is more procedural in nature. It allows an airport to recover its charges without the threat of repetitive legal protest from the airlines that the airport is something of an "essential facility" and cannot simply post prices.
- 48 The reality is that the prices that airports ultimately decide upon are not influenced by the existence of s 4A. When setting prices, s 4A is not seriously considered by the CIAL board and management – more important is CIAL's obligation to consult in good faith, and the unquestioned need to give real and substantial consideration to the IMs and the responses received from the airlines.

ISSUES GENERAL TO ALL AIRPORTS

Tighter specification of Schedule A

- 49 A question was raised by the Commission at the conference as to whether tighter specification of the land valuation methodology in Schedule A of the IMs is desirable and, if so, whether it is possible.
- 50 CIAL is not sure that tighter specification of the methodology could solve the difference of view on planning that separated WIAL and the airlines. CIAL notes that incentives will always exist for airlines to dispute the application of IMs. Tighter specification is not necessarily an appropriate response to such behaviour.
- 51 The Commission has a role to play in ensuring that the IMs are properly applied by airports when making disclosures. So long as IMs have been properly applied, and information relating to their application is made available (e.g. through disclosure of valuation reports), the objective of information disclosure will be satisfied.

Treatment of the costs of litigation

- 52 The Commission questioned whether it is appropriate for airports to include the costs of litigation (e.g. merits review litigation) in their forecasts of operating costs.
- 53 In its revised pricing proposal, CIAL has included costs of litigation in its forecast of operating expenditure. We have done so because we believe it is appropriate for CIAL to recover the costs of any litigation that is associated with aeronautical regulation, as a cost of running an airport business in New Zealand under the current regulatory regime.
- 54 A relevant question here is whether the airports would recover such costs if the supply of specified airport services occurred within a competitive market. Obviously, costs associated with regulation would not be incurred in such a market, but they are equivalent to costs which are necessary to incur in the best interests of the business i.e. the nature of the costs is that all businesses acting reasonably in their self-interest would incur them.

- 55 A relevant example would be the lobbying costs of trucking businesses seeking a lesser allocation of road user charges. Because all businesses in that market acting reasonably in their self-interest would incur the lobbying costs, each business would be able to recover the costs in their charges to customers.
- 56 Accordingly, the costs of litigation should be viewed as costs which would be recoverable by a business in a workably competitive market.