

Air NZ Limited

Cross-submission

Commerce Commission “Draft report to the Ministers of
Commerce and Transport on how effectively disclosure regulation
is promoting the purpose of Part 4 for Wellington Airport”

Commerce Act 1986, Part 4

Section 56G Review of Wellington International Airport



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Introduction

1. The Commission has received submissions on its draft report from Auckland International Airport Limited, Christchurch International Airport Limited, Wellington International Airport Limited, the New Zealand Airports Association, BARNZ, Qantas and Air New Zealand.

Executive summary

2. The airport and NZAA submissions generally adopt similar themes which, for the most part, echo previous submissions made by the airports.

	Airport submission	Air NZ response
1	There has been insufficient guidance from the Commission as to how it would assess the effectiveness of the information disclosure regime.	Using the IMs to assess the effectiveness of ID is the most logical approach. The Commission has given more than sufficient notice of this.
2	There has been insufficient time and disclosure to allow a proper assessment of performance.	The Commission must make the assessment “as soon as practicable”. The airports’ pricing applies for five years and can be assessed as soon as it is determined.
3	The Commission is incorrect to assert that ID will have its most immediate and noticeable effect on pricing.	The objectives in s 52A(1)(a)-(d) must be balanced. This does not preclude the Commission recognising that the effect on limiting excessive profits can be assessed immediately based on the airports’ 5 year pricing determination.
4	The Commission is giving undue significance to the high level of disagreement between airlines and airports about prices.	The considerable disagreement is particularly relevant as it goes directly to excessive profiteering by the airports in contravention of s 52A(1)(d).
5	Lower returns will undermine the incentives to invest.	Incentives to invest must be balanced against other considerations. The 50 th percentile of the WACC range is a generous starting point.
6	The Commission is making assumptions about WIAL’s behaviour in 2017 which inevitably biases its analysis towards a finding that WIAL is “misbehaving”.	WIAL has shown no inclination to resile from its positions on MVEU, revaluation gains and high target returns. It is reasonable to raise concerns about the likelihood of this behaviour continuing.
7	Applying the WACC resulting from the Commission’s WACC IM is inappropriate.	The Commission’s WACC IM is appropriate, and already incorporates several assumptions favourable to the airports.

Has there been sufficient guidance from the Commission?

3. Airports claim that they have had no clear visibility of how the Commission will assess the effectiveness of the ID regime. Air NZ is mystified at these claims.

4. It has always been clear that the Commission, when undertaking its analysis of airport disclosures, will assess those disclosures against the benchmark established by the IMs, including the WACC IM developed by the Commission.¹ Divergence between outcomes forecast by the airports using their own methodologies, and outcomes based on the IMs and a workably competitive market benchmark, would clearly indicate whether or not ID was effective.
5. While airports are free to adopt alternative methodologies in designing and establishing their pricing frameworks and outcomes, what has always been apparent is that those outcomes will be assessed against the outcomes flowing from applications of the IMs. This was an explicit intent of Parliament when considering the Commerce Amendment Bill – the Bill was amended in the Committee stage specifically to “ensure that input methodologies would be set out in sufficient detail to allow affected suppliers to reasonably estimate the impact on their business.”²
6. Throughout the consultation process with WIAL, BARNZ assiduously applied the IMs against WIAL’s framework and highlighted the discrepancy between the outcomes from applying the two approaches. WIAL cannot now credibly claim that it could not have known what the outcome of the Commission’s analysis would be.
7. WIAL also implies that a lack of guidance from the Commission means that its behaviour has not been able to be influenced. This implies that in the face of clear guidance WIAL would have set different prices to achieve a different level of forecast revenues. Even if the improbable proposition that the publication of the IMs was not clear guidance was accepted, there is clear evidence that WIAL does not intend to change its behaviour. WIAL is in denial. The WIAL response to the draft report has been to continue to dispute the Commission’s assessment of excess profits and reaffirm its belief in the appropriateness of its valuation approach, its treatment of revaluations and its excessive WACC. This ongoing behaviour clearly supports the Commission conclusion that ID has been ineffective in preventing excess profits, and that it is likely to be ineffective in the future. In fact the clear direction from the IMs and the credible threat of further regulation has been ineffective in preventing excess profits and it would be reasonable to infer that, absent real regulatory change, the level of excess profits could increase further.

Has there been sufficient time to assess the effectiveness of ID?

8. Air NZ has commented previously on the airports’ submissions that there has been insufficient time to assess the effectiveness of the Part 4 regime:

“3.7.3 Given the vulnerability of consumers in this monopoly market and the scale of excessive profits, the timing of the review is designed to identify early signs that the light handed regulation is failing or succeeding, particularly in light of each airport’s pricing decision.

3.7.4 The s 56G review was known by WIAL when setting its prices, yet it has not influenced its behaviour. This is a clear indication, 15 years after an issue in this sector was first confirmed by the regulator, that the current light

¹ Commerce Commission, *Information Disclosure Airport Services Final Reasons Paper*, 22 December 2010, para 2.16, p.15 (“ID Reasons Paper”)

² Commerce Amendment Bill, Report from the Commerce Committee, p. 4

handed regulation is ineffective. The abundance of information available at this stage of the process (as correctly identified by the Commission in its Process and Issues Paper) means that more time to assess the effectiveness of ID is possibly the only review outcome not rationally available to the Commission.”³

9. The Commission has rightly identified that suppliers subject to effective information disclosure regulation are incentivised to “ensure their performance is consistent with the desired outcomes from workably competitive markets to avoid any direct limitations on their behaviour.”⁴ Given that WIAL has deliberately chosen to adopt a pricing approach which will result in excess profits, notwithstanding its awareness of the IM framework and the Commission’s approach to assessing airport pricing decisions, it is clear that it considers there is no “credible threat” of further regulation. ID has therefore clearly been ineffective and no further time is required to reach this conclusion.
10. The Act draws a clear link between the setting of prices by the airports and the assessment by the Commission, by requiring the Commission to review and report on the effectiveness of information disclosure regulation “as soon as practicable” after prices are set. This link determines not only the timing, but also the substance; the Commission is expected to be able to produce a meaningful report in the timeframe permitted.

Will the greatest impact of ID be on profits and efficiency gains?

11. The airports claim that the Commission’s methodology and analysis lead it to an inappropriate focus on limiting the ability to extract excessive profits and dispute the Commission’s contention that “information disclosure is likely to have the greatest impact on Wellington Airport’s incentives to earn excessive profits, and to share efficiency gains with its consumers.”⁵ -

“we are concerned that the Commission’s reliance on [IMs] in this way gives them undue prominence, and contributes to the Commission’s unsubstantiated conclusion that ID should have the most noticeable and immediate impact on prices”⁶

“it is wrong to say that ID should therefore have the most immediate and noticeable impact on prices”⁷

12. The Commission has clearly spelt out why it has reached this conclusion – “because there are input methodologies that allow profitability to be assessed on a consistent basis across suppliers and over time, as well as providing a benchmark for assessing returns through the cost of capital input methodology.”⁸

³ Air NZ, *Cross-submission to the Commerce Commission*, 20 July 2012, pp.18-19

⁴ Commerce Commission, *Draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport*, 2 November 2012, para. 2.7, p.13 (“Draft report”)

⁵ *Ibid*, para 2.10, p.13

⁶ New Zealand Airports Association, *Submission on the Commerce Commission Draft Report on the Section 56G Review of Wellington Airport*, 30 November 2012, para. 40, p.10 (“NZAA Submission”)

⁷ Auckland Airport, *Auckland Airport’s Submission on the Section 56G Review Draft WIAL Report*, 30 November 2012, para. 24, p.11

⁸ Draft report, footnote 13, p. 13

“The effectiveness of information disclosure at limiting excessive profits can be seen more immediately. This is because:

Wellington Airport has set its revenue requirement, and therefore its expected profits, for the next five years; and

The input methodologies also provide us with a benchmark of the profitability that would be expected in a workably competitive market.”⁹

13. Air NZ agrees with the Commission’s reasoning and conclusions on this issue and notes that this is consistent with the Commission’s reasoning and conclusions in the Input Methodologies Reasons paper.¹⁰ The airports however appear to consider that, having established the IMs through a comprehensive consultation process, the Commission should now set them on the shelf and apply a different – airport-specified - approach to assessing the outcomes identified through ID.
14. Air NZ notes that part of this approach by the airports is a renewed effort to force the Commission to give unwarranted priority to incentives to invest over the other regulatory objectives set out in s 52A(1) of the Act. The issues with this approach have been addressed in previous submissions by Air NZ (e.g. section 3.6 of Air NZ’s 20 July 2012 Cross-submission). The Commission also concisely summarised the interrelationship between the regulatory objectives in the IM Reasons Paper:

“A balancing between the limbs in paragraphs (a) – (d) of the part 4 Purpose is clearly required. Ensuring that regulated suppliers have the opportunity to receive at least a normal return on their new investments provides the incentives for them to make those investments in the first place. Where those investments are made at an efficient level and time, and are employed to provide services at the appropriate quality, then consumers will benefit over the long term. On the other hand, it is not usually in consumers’ interests to face prices which recover costs which have never been incurred, or the costs of investments that have been made well in advance of being needed. The main reason economic regulation is required is to counter the market power of firms (i.e. the ability of firms that are not faced with competition of the threat of competition to charge excessive prices and/or reduce quality – paragraph 1.2.15)”¹¹

Is a high level of disagreement on prices expected?

15. Air NZ believes that there is strong evidence that the high level of disagreement on prices/airport revenues should not be expected and is not part of normal purchaser supplier tension. In particular:
 - The airlines deal with many other monopoly suppliers and accept fair prices without similar disagreement. Recent examples of prices agreed and supported by Air NZ is the increase in the New Zealand Civil Aviation Authority charges necessary to support ongoing investment in its activities

⁹ Ibid, para. 2.14, p.14

¹⁰ Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2010, para 2.8.1, p.38 (“IM Reasons Paper”)

¹¹ Ibid, para. 2.6.32, p.36

and increases to Airways' charges at Queenstown and Auckland to support enhanced operational capability at those airports.

- The airlines' disagreement is focused on the variance between WIAL's forecast revenue and the revenue which would have been expected using the IMs published by the Commission
- Airlines have many critical supplier relationships which are characterised by partnerships based on mutual interest. Examples include aircraft manufacturers and catering. Airlines understand the need for critical suppliers to make adequate returns so that they can invest and innovate. These relationships are not characterised by ongoing disagreement on prices.

16. The reason for the high level of disagreement is the continued use of the price setting authority in the AAA to set prices which generate excess profits. This is one of the key behaviours that information disclosure is intended to address and its persistence is clearly relevant in assessing the effectiveness of information disclosure.

Would lower returns reduce the incentive to invest?

17. The airports imply that if prices were set to generate profit levels consistent with the 50th percentile of returns generated by the IMs, that incentives to invest would be undermined.¹²

18. Air NZ notes that:

- The WACC IM was set by the Commission using its extensive knowledge of airports and other industries and the advice of experts. In the Reasons Paper the Commission stated that "In assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (mid-point) on the range".¹³ There is no basis for concluding that investment would be undermined by returns consistent with the IMs.
- The airports acknowledge that a considerable portion of their revenues come from non-aeronautical businesses which benefit from additional volume. This creates a further incentive to invest.
- There is an implication that consumers should incur the certain loss that comes from excess prices, to avoid the possible loss that could occur from underinvestment. This is inconsistent with balancing the Part 4 regulatory objectives and the Commission's observation that "in workably competitive markets ... not all risks can be passed on to the consumers and firms will have to manage some of the risks themselves"¹⁴

How will WIAL behave in future?

19. Airports have taken umbrage at the Commission using WIAL's forecast of the closing asset value for PSE2 as the terminal value in its IRR calculation, considering this to be an unjustified assumption which does not allow for behaviour change. Air NZ considers the Commission is fully justified in using that

¹² NZAA Submission, para. 38, p.9

¹³ IM Reasons Paper, para E11.58, p.337

¹⁴ Ibid, para. E11.53, p.336

value given WIAL's past behaviour, its stated attitude to the IMs and its response to the Commission's draft report.

20. Airport pricing is currently conducted under the Airport Authorities Act which the NZAA contends includes incentives for the airports to adopt approaches consistent with outcomes in workably competitive markets.¹⁵ If this contention were true, no difference should be expected between pricing outcomes based on the AAA approach – as WIAL's PSE2 pricing decision is – and pricing outcomes reflecting the IMs (which are also intended to be consistent with workably competitive markets). Yet the Commission's preliminary conclusions show that the differences are significant.
21. The airports simply do not accept that their previous pricing decisions have not reflected outcomes consistent with those in workably competitive markets and that the main reasons for this relate to the asset valuation methodologies adopted, the manner in which asset revaluations have been accounted for, and the level of return being sought.
22. All available evidence indicates that WIAL will continue to set prices using land values based on an MVEU methodology without fully accounting for the resulting revaluations gains and a target return in excess of what could be expected in a workably competitive market.¹⁶ The Commission has rightly identified WIAL's excess profits as being attributable to these two issues which have been at the heart of airline concerns over previous pricing outcomes at WIAL, and expects that this will continue to be the case in the future. Air NZ concurs with the Commission's view.

What is an appropriate target return?

23. WIAL considers that the Commission has, in applying its own evaluation of the cost of capital, "seemingly ignored the ... factors which WIAL considers provide reasonable explanations for the variation in WIAL's forecast performance from the Commission's assessment using the IM's."¹⁷ In WIAL's view it is perfectly justified, due to WIAL specific factors, in applying a profitability target some 245 basis points or 35% higher than that evaluated by the Commission as providing a reasonable return.
24. Air NZ notes that the Commission addressed the issue of firm-specific versus industry benchmarks in the IM Reasons Paper:

"6.2.5 Firms in workably competitive markets are price-takers not price-makers. In such markets, firms cannot expect to earn returns above the cost of capital for an extended period. Nor can firms expect to dictate to the market what the rate of return will be. A firm pricing its product on the basis of its own excessive (i.e. inefficient) estimate of the cost of capital will lose sales and profits to competitors. In workably competitive markets, the price of products is determined by the cost of capital for suppliers in general, not the

¹⁵ NZAA Submission, para. 23(a), p.6

¹⁶ See for example, WIAL's *Executive Summary & Key Issues*, p.3 "MVEU and current asset values are more reflective of a competitive market", and "its returns should be assessed on its own WACC"

¹⁷ WIAL, *Substantive Submission to the Commerce Commission in relation to its Draft report to the Ministers of Commerce and Transport on how effectively information disclosure is promoting the purpose of Part 4 for Wellington International Airport Limited*, 30 November 2012, para. 241, p.52 ("WIAL Submission")

cost of capital for an individual supplier. This is particularly relevant where a supplier has constraints on its capital structure. These constraints may elevate the estimated cost of capital for such suppliers above the cost of capital at which less constrained suppliers can access capital. A supplier which sets prices based on a higher estimate of its cost of capital than the actual cost at which capital is available in an industry cannot expect consumers to pay these higher prices. In workably competitive markets, inefficient costs (of capital or otherwise) are borne by the supplier, not the consumer.

6.2.6 Firms in workably competitive markets continue to innovate and invest as this offers the prospects of improved returns, even if the benefits are eventually competed away. And investors remain willing to invest so long as the returns are as good as those available from comparable investments elsewhere.

6.2.7 In summary, a key outcome from workably competitive markets is that it is the market's view of the cost of capital that matters, not the cost of capital specific to one producer, or a producer's view of the cost of capital. Further, where investors choose to have a diversified portfolio of returns, they care principally about how an investment contributes to the risk of their overall portfolio, rather than the specific risks which affect a single investment (as that can be diversified away)."¹⁸

25. Air NZ considers the Commission's view as set out above remains robust.
26. Air NZ also reiterates its earlier submissions that the Commission's WACC IM already provides a measure of upward bias in favour of the airports. As such, allowing an additional allowance above the top of the range evaluated by the Commission would not provide an appropriate balance between the regulatory objectives of the Part 4 Purpose Statement. Once again, WIAL's approach highlights the ineffectiveness of the ID regime in promoting the purpose of Part 4.
27. It should also be noted that the Commission's assessment is "a conservative estimate of the IRR which is in favour of Wellington Airport"¹⁹. Further, as detailed in the BARNZ submission on the Commission's report, the Commission has made an "Array of Assumptions" in the airport's favour.²⁰ As such the actual outcome of WIAL's pricing decision will likely be an even higher return than suggested by the Commission's analysis, and an even wider gulf between that outcome and what could be expected in a workably competitive market.

Is Benchmarking Relevant?

28. WIAL has made much of benchmarking work which it claims indicates that its charges are appropriate.²¹ Air NZ notes that WIAL's reliance on this work as the determinant of whether its pricing is appropriate is at odds with its stated position at the commencement of this Review:

¹⁸ IM Reasons Paper, paras. 6.2.5-6.2.7, p.108-9

¹⁹ Commerce Commission, Draft report, para. I17, p.129

²⁰ BARNZ, *Submission by BARNZ on Commerce Commission Draft Report on how Effectively information disclosure regulation is promoting the purpose of Part4 in relation to Wellington Airport*, 30 November 2012, pp.11-14

²¹ WIAL Submission, para. 76, p. 16,

“251. Benchmarking can be a useful means of obtaining indicators of market positioning or to identify performance outliers. However, benchmarking should not be used to form detailed conclusions on specific airports and should be used in conjunction with other measures of assessing performance.

252 The [Australian Productivity Commission] included a discussion on benchmarking in its recent report on Australian airports. Some key points the APC made with regard to benchmarking were:

- ‘Benchmarking identifies airports’ relative performance. Benchmarking indicators can inform airport management about relative performance against similar overseas and Australian airports.
- Benchmarking can also be used by regulators to foster yardstick competition – although such efforts, for airports, have not been successful.
- To be useful, airports should be benchmarked against a sample of Australian and overseas airports that share similar characteristics.
- There are numerous impediments to effective benchmarking. These include differences across airports, data limitations and competing methodologies.
- Unless benchmarking is constructed and interpreted carefully, there is a risk that inaccurate policy inferences will be drawn from unreliable estimates.’²²

29. The Commission’s analysis of WIAL’s charges against the “benchmark” of a workably competitive market reflected by the IM’s clearly demonstrates that the charges are not appropriate. This analysis is a far superior basis for reaching a conclusion on WIAL’s performance and forming accurate “policy inferences”.

²² WIAL, *Wellington International Airport Limited Submission to the Commerce Commission Section 56G Process and Issues Paper*, 6 July 2012, p.47