Christchurch International | airport Limited

SUBMISSION ON DRAFT REPORT
ASSESSING HOW EFFECTIVELY INFORMATION DISCLOSURE
IS PROMOTING THE PURPOSE OF PART 4
FOR WELLINGTON AIRPORT

30 November 2012

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INTRODUCTION

1 Christchurch International Airport Limited (*CIAL*) welcomes the opportunity to make a submission to the Commerce Commission (*Commission*) on the Commission's Draft Report to the Ministers of Commerce and Transport (*Draft Report*) on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited (*WIAL*).

2 CIAL's focus in this submission is on the framework adopted by the Commission in assessing the effectiveness of information disclosure, rather than on the particular circumstances relating to WIAL.

3 We have read and support the submission being made by the New Zealand Airports Association (*NZ Airports*).

EXECUTIVE SUMMARY

4 CIAL is supportive of the Part 4 information disclosure regime. We see it as an investment in transparency and better long-term understanding of the performance of our sector.

5 The question required by section 56G is a difficult one to answer. By its nature, information disclosure works indirectly through the creation of incentives over time. Yet section 56G requires the Commission to consider the effectiveness of information disclosure at a very early point in the life of the regime.

6 We agree with the way the Commission has in this review used the IMs as a reference point but not insisted on their application in pricing (which would amount to requiring price control outcomes). In this submission we highlight improvements that can be made to the framework in the draft report, so that the picture presented to the Minister fairly represents the information available.

7 The key improvements include:

7.1 Recognising the starting point of a well functioning sector, and the role that airports have played in delivering facilities, improved services and airline competition to travellers and business.

7.2 Being clear about the differences associated with ex post and ex ante assessments of returns.

7.3 Being very cautious about making assumptions as to how airports may behave, and likely prices and returns, after 2017. The equivalent exercise would be to make a prediction in 2007 of how CIAL priced this year. In 2007 we could not have predicted the GFC, the Christchurch earthquake, the delays in commissioning our new integrated terminal, the Commission's information disclosure regulation, and the challenging market faced by our airline customers.

7.4 Recognising the IRR calculated in the draft report is sensitive to the closing asset value used in the analysis and the assumption that future prices would be set to recover that value. This means the IRR in the draft report is driven by the assumption made about prices yet to be set in 2017, rather than the prices set in 2012.

7.5 Using an IM WACC reference point that is logically comparable to the IRR calculated, and being aware of the differences between the industry-wide benchmark and individual airport WACCs.

8 IN CIAL's view the best opportunity to assess the effectiveness of the information disclosure regulation is at the next price setting round in 2017. At that point, a track record of disclosures will have been developed, outcomes identified over a series of time periods, clear expectations will be set for any subsequent price reset, and the incentives created by the information disclosure regulation can be expected to work. This is consistent with the analysis in the draft report, which demonstrates that the assessment of airport returns is driven by the assumptions made as to pricing in 2017 rather than returns during the 2012 – 2017 period.

9 In the remainder of this submission we make some comments on the general framework used in the draft report, and then provide our comments on the key questions addressed in the attachments to the draft report.

GENERAL FRAMEWORK

Context

10 We agree with NZ Airports that the draft report should have started with an assessment of the aeronautical services market. There is good evidence that the sector has created, and continues to create, good outcomes for travellers, exporters and importers, and the wider economy.

11 Airports have taken risks and invested scarce capital in facilities and long life assets (for example, our new integrated terminal development at a cost of $215 million), that have improved, and will continue to improve, airline competition and meet the growing and changing needs of the travelling public. They have also participated in initiatives to grow tourism and stimulate economic growth in both their local regions and for New Zealand as a whole. These investments in facilities, improving competition and stimulating growth, are not always exactly aligned with the incentives of incumbent airlines, but airports have played this role because they have the economic need and flexibility to do so.

12 This is an important context for any assessment of how information disclosure can be expected to promote the purposes of Part 4. The starting point is a need to ensure the sector continues to generate good outcomes, rather than a reaction to a perceived problem that needs to be addressed.

13 For this reason, the Commission should take care not to assume sub-optimal market outcomes presently exist. We disagree with language in paragraph 2.15 of "moved closer" to the outcomes sought by Part 4, for example. This assumes performance that is not already consistent with the outcomes sought by Part 4.

Role of information disclosure

14 CIAL supports the Part 4 information disclosure regime. It is more robust and useful to stakeholders than the information disclosure regulation under the AAA. It is also more onerous, intrusive, and costly for CIAL. However we see this as an investment in transparency and better long-term understanding of the performance of our sector by interested persons.

15 It is not clear to us why the Commission thinks that information disclosure is likely to have the greatest impact on an airport's incentive to earn excessive profits, and to share efficiency gains with its consumers. From CIAL's perspective, the incentives created by publishing accounts and metrics endorsed by the Commission apply across range of outcomes in the Part 4 purpose statement, including operational efficiency, quality, investment, innovation, and financial returns.

Role of the IMs

16 CIAL agrees with the general approach the Commission has taken to the relevance of the IMs. First, the IMs provide a benchmark and reference point in the assessment. Second, the focus is on market outcomes (and not the particular combination of inputs used). Third, this is not price control and as such price control outcomes are not appropriate for information disclosure. However, when considering the effectiveness of the IMs, the Commission needs to consider the trends over price periods - rather than discrete periods in isolation.

17 In relation to WACC, CIAL acknowledges the Commission expressed its draft conclusion in terms of the "margin" between the airports IRR and the benchmark WACC, and allowed a role for justification of extraordinary returns. Given the benchmark

represented by the IMs may not encompass all the outcomes that are consistent with workably competitive market outcomes, this is appropriate. However, paragraph X13.2 goes too far to the extent is suggests that any departure from the Commission's WACC IM is evidence of excessive returns. We discuss below our concerns with how the draft report assesses the margin between the airports IRR and the benchmark WACC.

18 A relevant qualification that needs to be recorded by the Commission in its report to the Minister is that the conclusions are on the basis of the current IMs –the Commission should note the outcome could change due to the merits review presently being considered by the court.

Relevance of airline disagreement

19 CIAL disagrees with the relevance and the authority that the Commission has accorded to the bare fact of disagreement by airlines at the end of a price consultation process.

20 The draft report does not provide any evidential foundation for concluding that continuing disagreement by the airlines is, of itself, proof that the airport involved has been unreasonable. An equally possible outcome, common in CIAL's experience, is that the airline is simply applying pressure (as it is entitled to do) to achieve a reduced price outcome. If the Commission wants to distinguish between the two possible reasons for continuing disagreement it will need an evidential foundation to do so.

21 Relevant here is the submission the Commission received from Dunedin International Airport Limited (DIAL). As the Commission will recall, DIAL drew to the Commission's attention the strong public statements made by airline representatives impugning DIAL's price decision. DIAL asked the Commission to view those expressions of continuing disagreement in light of the fact that DIAL had used all of the Commission's IMs, only departing where the departure was favourable to the airlines. Clearly, expressions of continuing disagreement by the airlines are not a reliable indicator of unprincipled decision-making.

Ex ante and ex post assessments

22 Care needs to be taken to recognise the differences in making an ex post assessment of airport performance (ie PSE1) and an ex ante assessment (ie PSE2).

23 When looking back over PSE1 and making an ex post assessment, the Commission will need to bear in mind:

23.1 it is inappropriate to sheet home to the airport responsibility for variations from forecast revaluations or demand volumes. Absent any risk sharing arrangements, the other parameters in the building blocks model require airports to bear both the up and downside of variations; and

23.2 the building blocks model is all about creating the incentive for the investor to earn an ex post return greater than WACC. This is the implication of setting reasonable opex and capex forecasts, and then allowing the investor to retain any efficiency gains for the period.

24 Both of these factors need to be grappled with in any assessment of PSE1. In addition, the prices applicable to this period were determined prior to the advent of IMs and the ID regime. These prices considered a range of factors including commercial and economic judgement made well before the IM and ID determinations in December 2010.

25 Given the different considerations in making an ex post and ex ante assessment, it is not clear to CIAL whether it is legitimate to make an assessment over the 2010 to 2017 period. This spans both an ex post and ex ante assessment. It also includes prices and other outcomes in the 2010 to 2012 period that the Commission cannot expect to have been influenced by the information disclosure regulation.

26 CIAL is also surprised that the Commission has drawn conclusions as to likely outcomes in PSE3. There is very little evidence of what is likely to happen in 2017 / 2018, and this is very hard to predict - particularly for a sector undergoing significant change, both from a competitive market outlook and due to a rapidly evolving business model – legacy carriers' vs low cost carrier participants.

27 The equivalent exercise would be to make a prediction in 2007 of how CIAL priced this year. In 2007 we could not have predicted the GFC, the Christchurch earthquake, the delays in commissioning our new integrated terminal, the Commission's information disclosure regulation, and the challenging market faced by our airline customers. Yet all of these very significant factors materially influenced our judgment in setting prices this year.

Transitional period

28 NZ Airports' submission explains the limitations of assessing the effectiveness of information disclosure at this early stage in the new regime. CIAL endorses that discussion.

29 We are conscious that this implies the next opportunity to assess the effectiveness of the information disclosure regime may be in 2017, when the airports reset their prices. This seems appropriate to CIAL, for two reasons. First, an information disclosure regime is about generating transparency, creating incentives, and empowering stakeholders to engage with infrastructure providers in a discussion about the right thing to do. This necessarily requires building up a track record and a picture of performance and outcomes over time.

30 Second, as discussed below the analysis in the draft report of IRR and the conclusions drawn on the level of returns is heavily dependent on the 2017 closing asset value, and the assumption that future prices will be set to recover that value. In other words, the analysis is driven by an assumption about the prices that will be set in 2017 rather than the prices set in 2012 and the likely annual returns in the years prior to 2017.

IS WELLINGTON AIRPORT OPERATING EFFICIENTLY? (ATTACHMENT B)

Trends in opex vary with infrastructure life cycle

31 When assessing absolute levels of opex, and trends in opex at a particular airport, the Commission needs to be aware that trends in opex vary with the infrastructure life cycle.

32 In the early years of a facility the focus is on capex, and levels of opex (for example, maintenance) are comparatively low. Toward the end of the life of a facility, opex will be more prominent. This dynamic needs to be factored into the Commission's assessments of the relative performance of airports that are at different stages of their infrastructure investment lifecycle.

Airport-specific factors result in different levels of opex

33 In addition, there are a range of factors that might result in different levels of opex between airports, and these need to be considered. For example:

33.1 the business model applied – relative ratio of in-sourced to outsourced services;

33.2 the mix of international to domestic processing;

33.3 the relative ratio of aeronautical to commercial activity, where shared fixed costs may be spread across a varying range of activities;

33.4 whether there is a curfew or not; and

33.5 the impact of events created by climatic variations (for example, snow or not).

IS WELLINGTON AIRPORT INVESTING EFFICIENTLY? (ATTACHMENT C)

Processes around capex investment are relevant to investment efficiency

34 When assessing whether efficient levels of investment are occurring, the Commission should give weight to the processes around capex investment, which assist to identify efficient levels of investment. These processes include:

34.1 the AAA process for major capex; and

34.2 the price consultation process for other forecast capex.

35 While the airlines tend to highlight the narrow fact that the airports retain decision rights, the broader picture is one of robust engagement and the provision of significant levels of information supporting the need for the level of capital expenditure. Airlines and airports do have different perspectives on the appropriate level, and nature, of investment. An airline will be rightly focused on the level of investment that best fits with its commercial objectives. An airport will have a broader focus on the level of investment that is right for the likely demands across all airlines which have service outcomes ranging from premium personal service to minimal cost at reflective service levels (both incumbent and entrant) and the travelling public.

36 CIAL's experience is that both the AAA process and the price consultation process result in changes to capex proposals from that initially proposed, influencing the outcomes supporting the final pricing decision.

37 Efficient investment is a dynamic efficiency consideration, which puts the emphasis on the processes used by the industry to identify efficient investment levels. In CIAL's view, the processes in place do give good levels of comfort that over time the efficient level of investment will be identified.

IS WELLINGTON AIRPORT INNOVATING APPROPRIATELY? (ATTACHMENT D)

Innovation should be assessed broadly, having regard to inherent commercial risks and associated rates of return

38 We agree that the Commission needs to take a broader view when considering innovation. The question is not limited to whether the airports are innovating themselves, but whether the airports are enabling their users to implement their innovations.

39 One example of this is the switch from the use of staffed check-in counters to self-check-in kiosks. Such innovations by the airlines reduce airline operating costs and potentially significantly reduce the required airport infrastructure. However, such innovation can create the risk of stranded investment by airports that have invested in large check-in halls. In theory, an airport could have an incentive to prevent such innovation, but the willingness of airports to accommodate innovations by airlines and

other service providers—and to take the associated commercial risk—needs to be weighed by the Commission, particularly in considering the appropriate rate of return.

40 For example, where the airports work with the airlines to help airlines cut costs through innovative technologies and work practices (such as reducing airplane turnaround times, by loading and unloading passengers through improved passenger facilitation process; and provision of infrastructure – for example, loading facilities for both front and rear aircraft exits), it would seem entirely appropriate for the efficiency benefits to be shared between the airlines and the airports, at least for a period of time. This would result in additional returns to the airport, which should not be regarded as "extraordinary returns".

41 Further, we believe that commercial innovation should be taken into account. For example, the introduction of fixed charges by WIAL, which will incentivise better utilisation of the airway through reduced runway congestion, is an important innovation that will increase consumer benefits.

IS WELLINGTON AIRPORT SHARING EFFICIENCY GAINS WITH CONSUMERS? (ATTACHMENT F)

Efficiency gains achieved in one pricing period flow through to the next pricing period

42 The Commission concluded that since it could not identify either way whether efficiency gains were being achieved, this largely determined the question of whether efficiency gains are being shared.

43 While there is obviously some logic in that observation, the Commission can take account of the fact that, when setting prices, the airports put their best estimates of forecast opex into the building blocks model. This means that at each reset, any efficiencies created in the previous period would be passed in full through to consumers and forecast changes in operating efficiency per passenger are anticipated and passed through in the prices set.

44 This also means that while the Commission may not be able to reach a definitive view on whether efficiency gains are being achieved, it can conclude that any efficiency gains that are achieved in a pricing period are being passed through to consumers in the next period.

45 As we noted earlier, the Commission also needs to consider whether the efficiency gains achieved by WIAL are shared with consumers (the airlines) by enabling them to implement their own efficiencies.

IS WELLINGTON AIRPORT EARNING AN APPROPRIATE ECONOMIC RETURN OVER TIME? (ATTACHMENTS H AND I)

Estimating investment internal rates of return has limitations

46 CIAL believes that the Commission's approach to estimating investment IRR is a useful innovation. It allows the Commission to overcome the difficulty of dealing with revaluations as well as the inevitable problems associated with looking at returns at a point of time. However, we believe the Commission does not give due attention to the limitations of this analysis, and hence is at risk of being too quick to the draw in concluding that it has identified excess returns - particularly when only two discrete historic disclosures have been made under the information disclosure regime.

Period prior to 2012

47 As noted above, it is not clear to us why the Commission has included in its analysis pricing and returns for the years prior to the most recent price resets (which occurred in 2012). The outcomes in these years reflect decisions made prior to the implementation of the IMs, and the Commission cannot expect the returns to have been influenced by information disclosure.

Using the correct WACC and drawing conclusions from any difference in IRR

48 We believe that the Commission has not adequately considered what would constitute “extraordinary returns”. While the Commission estimates that WIAL’s returns over the 7 year period exceed the Commission’s WACC by a significant margin, we question whether it makes sense to compare spot estimates of WACC—derived from the most recent parameters—with a 7 year IRR.

49 A 7 year IRR is essentially an estimate of the returns that would have been available to an investor contemplating the investment at the start of the period. To make any comparison, the Commission should consider what its WACC estimate would have been at the same time that the investor would have been contemplating the investment. In other words, abstracting for the moment from the issue of whether the Commission’s input methodologies for estimating WACC are correct—a subject currently being examined through the merits review—the timing of the estimate matters.

50 Using the Commission’s input methodologies, the WACC estimate at the start of the 7 year period would have been considerably higher. For example, as of December 2009, the WACC using the Commission’s input methodologies (75th percentile) would have been 9.18%. Hence, the gap between the Commission’s estimate of the 7 year IRR (10.18%) and the appropriate WACC is only 100 basis points. Given the margin of error in estimating the 7 year IRR (particularly due to a wide range of assumptions possible about the terminal value), it is important for the Commission to consider whether such gap is indeed likely to signal “extraordinary returns”.

The IM WACC is industry-wide

51 CIAL would have preferred to see more of recognition that the WACC IM is industry-wide. When it comes to assessing the performance of a particular airport, it is relevant that the WACC for a particular airport will differ from an industry-wide estimate.

52 For example, Futures Consulting (advising BARNZ) accepted CIAL’s argument for a higher asset beta than the Commission’s industry-wide estimate, owing to the relative risk difference in passenger profiles when compared with the other major airports.

Sensitivity to assumed closing asset value

53 We are concerned that the Commission does not explore the error range in its estimate of the IRR. The IRR calculation is critically dependent on assumptions about the closing asset value, which is in turn driven by assumptions about pricing beyond the current pricing period.

54 There is a logical circularity in this approach: the Commission is seeking to make an assessment of whether WIAL is using its market position to earn an “extraordinary return” by assuming that it will seek to make “extraordinary returns” in the future. This significantly weakens the quality of the assessment made by the Commission, since the conclusions are not robust to small changes in assumptions about future behaviour.

55 For example, a 10% reduction in the terminal value—which is well within the plausible range of outcomes for future price periods—would change the IRR from 10.18% to

9.18%. That is, it would completely eliminate any gap between the appropriate WACC and the IRR.

Calculations of internal rates of return need to be consistent

56 Further, the Commission needs to be logically consistent in its use of the IRR calculation. An investment IRR is essentially an assessment of the cashflows that can be generated as an outcome of all possible actions by the investor. The ability to raise prices would be one of such possible actions. However, an ability to achieve efficiency gains would be another. Even with price control in place, an airport that does not earn an IRR which is higher than the regulated WACC, is an airport that does not respond to incentives deliberately built into the regulatory system.

57 In other words, when combining ex ante and ex post analysis, the Commission can no longer assume that its WACC is the appropriate benchmark for returns. It would be a disappointment to all concerned—including the Commission—if ex post returns did not exceed the ex ante WACC.

58 Before concluding it has identified an "extraordinary" return, the Commission needs to consider what would be a reasonable uplift on WACC from the airport achieving efficiency gains, as well as the influence of assumptions about future behaviour on the IRR calculation.

59 CIAL believes that a reasonable gap between the calculated IRR and the appropriately timed WACC can be quite significant. This is particularly so during the period of rapid change in airline and airport technologies and work practices, when all sides are taking risks and should be compensated for that risk taking.

60 Overall, we believe that the Commission's conclusion that WIAL earned extraordinary returns is driven by unjustified assumptions and a logical inconsistency in the Commission's model, and hence the Commission's conclusion not robust or supported by evidence.