

SECTION 56G REVIEW OF AUCKLAND AIRPORT: POST CONFERENCE SUBMISSION

15 March 2013

1. The Commerce Commission ("**Commission**") held its conference on Auckland Airport on 26 February 2013 ("**Auckland Conference**"), as part of its review of the information disclosure regime ("**ID regime**"). The New Zealand Airports Association ("**NZ Airports**") makes this post-conference submission on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch International Airport Limited (together, "**Airports**").
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INTRODUCTION AND EXECUTIVE SUMMARY

3. NZ Airports believes that an assessment of the ID regime should reflect a balanced and fully-contextualised approach to evaluating the effectiveness of the ID regime against all limbs of the Part 4 purpose statement in the Commerce Act 1986 ("**Commerce Act**"). By this we mean that:
 - (a) All relevant evidence regarding the impact of ID on conduct and performance must be factored into the analysis, and models and formula should not be unduly relied upon. By way of example, there is ample evidence that ID is limiting and constraining pricing decisions, even though forecast returns may not precisely align with the Commission's rigid and formulaic approach to assessing profitability (which in itself is problematic).
 - (b) All findings in relation to each limb of the Part 4 purpose statement are treated equally, as part of the overall question of how effectively ID is achieving the purpose of Part 4. By way of example, a negative finding in relation to profitability should not be given more weight and prominence than positive findings regarding innovation and quality.
 - (c) The limitations on ID's ability to achieve particular outcomes for PSE2 are fully recognised. For example, at the time prices were set, it was not known how returns would be assessed or what the relevant benchmarks were, given that merits review proceedings were yet to be resolved, and limited guidance from the Commission was

available. Such matters will be clarified during PSE2, meaning that ID will provide much sharper and clearer incentives and guidance for PSE3.

4. NZ Airports submits that adopting this approach for assessing airport performance demonstrates a healthy and well-performing airport sector, characterised by quality airport services at a level reflecting passenger and airline demands, efficient and innovative airports, and reasonable charges that benchmark well by international standards. In other words, ID is effectively meeting the purpose of Part 4, and should become more effective over time.
5. In our view, the weight given to conclusions from the Commission's analytical model in the final report for Wellington Airport ("**WIAL Report**") does not represent the balanced and fully contextualised analysis that the Commission should undertake to properly assess whether information disclosure is effectively promoting the purpose of Part 4.
6. The Commission has advised that it intends to follow a consistent analytical framework for each airport. However, it is apparent from the Auckland Conference that the different circumstances of Auckland Airport are presenting challenges to the Commission's modelling process.
7. In NZ Airports' view, the challenges associated with the Commission's proposed modelling for Auckland Airport indicate the difficulties that arise from the Commission's analytical approach, rather than signalling issues with the effectiveness of the ID regime itself or Auckland Airport's performance. Accordingly, NZ Airports encourages the Commission to recognise that modelling cannot produce definitive conclusions.
8. NZ Airports continues to have some reservations and concerns with the Commission's approach (discussed in more depth below). We encourage the Commission to reflect on these concerns with an open mind, and to consider how they may be taken into account in the review processes for Auckland and Christchurch Airports going forward.

THE APPROACH TO ANALYSING PROFITABILITY

9. It is apparent from the WIAL Report and the Auckland Conference that the main area of discussion is the Commission's analysis of profitability. In light of this, NZ Airports considers it is extremely important that the Commission's profitability analysis:
 - (a) receives appropriate weight in the Commission's overall conclusions;
 - (b) reflects the ID framework and follows the more balanced and moderate approach the Commission appears to be taking when assessing other areas of the Part 4 purpose statement;
 - (c) is properly contextualised in light of the available evidence;
 - (d) reflects the guidance available to airports at the time of price setting;
 - (e) acknowledges where the Commission's analytical model depends on an assumption about future pricing behaviour.

The ID framework sets the tone for the profitability analysis

10. After reviewing the final WIAL Report, NZ Airports is concerned that the overall conclusion appears to be that ID is not effective because it is not achieving the same outcomes as would be achieved if price control was imposed.

11. In the foreword to the WIAL Report, the Commission cites the Regulatory Impact Statement for the Commerce Amendment Bill 2008, noting that the main area of concern with the Airport Authorities Act 1966 ("**AAA**") information disclosure regime was that it failed to constrain the exercise of substantial market power in setting airport charges.
12. However, it is equally important to recognise the Regulatory Impact Statement notes that heavier-handed regulation (such as negotiate-arbitrate regulation or price control) was not considered to be a desirable outcome. This was primarily due to the costs involved and the impact that heavier-handed regulation may have on the incentives for airports and airlines to attempt to reach commercial agreements. ID regulation was adopted to provide a stronger and more transparent information base to allow these commercial arrangements to foster.
13. Although we recognise that ID regulation under Part 4 of the Commerce Act was seeking to introduce change, and was seeking to address the potential exercise of market power in setting charges, it is important to be clear how that change was expected to be achieved. The ID regime was intended to incentivise behaviour change through:
 - (a) improving the relevance and value of the information that would be disclosed;
 - (b) giving better information and greater guidance on acceptable approaches to assist commercial consultations between airlines and airports, including reducing the scope for dispute and allowing greater incentives to improve commercial relationships;
 - (c) providing guidance on desired regulatory outcomes; and
 - (d) creating a more credible threat of further regulation to encourage acceptable outcomes (including through closer monitoring and analysis by the Commission).
14. Ultimately, the ID framework was to provide more transparent information to interested parties (including the Commission) to improve the ability to assess and understand airport performance and profitability.
15. Properly reflecting these conclusions in the profitability analysis undertaken in the section 56G review would involve:
 - (a) acknowledging and emphasising the positive impact of ID regulation on the airports' consultation processes as a key part of the Commission's profitability analysis; and
 - (b) recognising that a balanced and moderate approach to profitability analysis involves more than a simple modelling assessment of returns compared to an "absolute standard" considered acceptable to the Commission.
16. Further, NZ Airports encourages the Commission to reflect on its description and use of the WACC IM as an "absolute standard",¹ in light of:
 - (a) the lack of clear guidance that existed at the time of price setting; and
 - (b) the judgements and uncertainty inherent in WACC estimates.

The guidance that existed at the time of price setting

17. NZ Airports is concerned that the Commission's approach is that:

¹ WIAL Report at paragraph 2.27 and E22.

- (a) the IM benchmarks were clear, and the airports knew what the Commission would consider to be an appropriate return when the ID framework was applied;
 - (b) any forecast return above the WACC IM is evidence that an airport set prices knowing that it would exceed an appropriate economic return; and
 - (c) taken together, these two considerations demonstrate that ID is not effective in limiting excessive profits.
18. NZ Airports considers it is important to recognise that the clear guidance anticipated by the Commission did not exist at the time of price setting, and has still not been achieved. The section 56G review process, the completion of the merits review appeals, and the ongoing monitoring and analysis contemplated by the ID framework will all assist in establishing clear guidance moving forward.
19. The Commission has acknowledged that it may need to revisit its findings if the High Court changes the IMs. However, what it has not acknowledged is that this will involve more than simply plugging new numbers into its models. The fact that scope exists for material changes to be made to the IMs exposes the Commission's error in drawing negative conclusions about pricing conduct on the basis that airports "knew" that their targeted returns were higher than the "clear" benchmark set by the Commission. We strongly encourage the Commission to acknowledge now that significant uncertainty regarding "acceptable" benchmarks existed at the time prices were set.
20. We also note that various technical (and somewhat unclear) questions regarding how the profitability analysis should be carried out were asked during the conference. We anticipate that the answers to those questions could materially impact the Commission's profitability analysis. Accordingly, it is not credible to suggest that airports had clear guidance, when they set prices, as to how their profitability would be assessed. Auckland Airport and Christchurch Airport still do not know how their profitability will be assessed.
21. Finally, it is concerning that the Commission's view on the effectiveness of ID materially turns on the vagaries and uncertainties of modelling approaches that it is deciding long after pricing decisions were made, and which could not be anticipated by airports at the time of price setting.

The WACC IM must be considered in context

22. In addition, the guidance that did exist at the time of price setting was that:
- (a) the ID framework was interested in the pricing and investment decisions the Airports actually made;
 - (b) the Commission (and airlines) had been clear that ID regulation was not intended to be price control; and
 - (c) the Commission had acknowledged the judgement, discretion and uncertainty inherent in the process of developing a WACC estimate.
23. Accordingly, NZ Airports understood that the Commission would consider a range of information when assessing profitability, rather than simply its cost of capital IM. As such, we continue to stress the importance of considering the WACC IM in context in the Commission's profitability analysis.

24. However, NZ Airports is concerned the Commission may have misunderstood its submissions (and those of the Airports) so far in this respect. In particular, NZ Airports is not:
- (a) suggesting the Commission should not apply its WACC IM; or
 - (b) using the section 56G process as an opportunity to further submit on the parameters that make up the WACC IM.
25. The key question for the section 56G review is the **application** of the WACC IM, not its **content**. Submissions to date about the importance of analysing the pricing decisions taken by the Airports have not been directed at persuading the Commission to amend the substance of the WACC IM. Instead, submissions to date have discussed these factors to encourage the Commission to focus on the application and role of the estimate produced by that IM in assessing profitability and drawing its overall conclusions.
26. In this regard, NZ Airports emphasises that:
- (a) The Commission has a wide range of information available to it when considering airport profitability:
 - (i) Quantitative and qualitative features are equally important in evaluating that range of information.
 - (ii) Modelling is one feature to be considered alongside evidence of consultation behaviour, commercial circumstances, changes in conduct and incentives, and the interaction between returns and the other elements of the Part 4 purpose statement in a real and meaningful manner.
 - (iii) The fact that such considerations may not be able to be captured by a formula does not mean they should be put to one side when assessing profitability.
 - (b) The full range of contextual information should be considered when the Commission is applying its WACC IM and considering the weight to place on the outcome of its modelling processes. This consideration should include:
 - (i) evidence that pricing decisions taken by airports were in fact constrained by ID, including whether those decisions have been rationally and transparently justified by the airports and/or whether the approaches adopted were more conservative than those advised by experts; and
 - (ii) acknowledging that these factors form an important part of the context when assessing whether ID has been effective at limiting the exercise of market power and limiting the ability of airports to extract excess profits.
 - (c) Focussing on a simple comparison of returns to the WACC IM does not fully acknowledge what "success" means for ID regulation:
 - (i) Effective ID regulation is about providing information and incentivising changes in conduct and outcomes over time.
 - (ii) A simplistic comparison of returns to the Commission's WACC estimate risks sidelining the evidence that ID regulation has provided transparency, required airports to justify the decisions they have taken in pricing

(including thoroughly justifying the reasons behind those decisions), and influenced behaviour and outcomes.

- (iii) Accordingly, NZ Airports considers that any changes in behaviour between PSE1 and PSE2 are highly relevant to the Commission's analysis, and to whether ID has been effective at limiting excess profits. We encourage the Commission to consider whether performance in this area is moving closer to the Part 4 purpose statement over time, as it has done for the other limbs of the purpose statement.

27. The discussion at the Auckland Conference regarding the potential asset valuation options for PSE3 illustrates a key concern previously raised by NZ Airports. NZ Airports notes that:

- (a) We are concerned the Commission appears to be asking the Airports to pre-determine the outcome of pricing consultations which will occur in 2017. NZ Airports does not consider this is appropriate.
- (b) We are concerned the Commission's approach biases an assessment of current performance by making assumptions about future performance. If the Commission's model depends on an assumption about future pricing behaviour, the effect of that assumption must be explicitly acknowledged as part of the Commission's overall conclusion on profitability.
- (c) Further, it is not a failure of ID that future pricing decisions are not currently known. The ID framework (and the Commission's analysis) clearly contemplates that more information will become available over time as future decisions are made and can be analysed. Decisions that are made in the future about pricing (in PSE3 and in subsequent pricing periods) will add to this pool of information once those decisions have been made. A long-term analysis requires long-term data, rather than assumptions about future behaviour.

ALTERNATIVE ASSET VALUATIONS

28. NZ Airports is also concerned that the Commission has used an alternative asset valuation put forward by BARNZ in its analysis for Wellington Airport, and has invited BARNZ to give its view of the appropriate asset valuation for Auckland Airport. In our view, this approach raises a number of issues:

- (a) Airport valuations were prepared by professional advisers, and adopted by airports for ID purposes after a due diligence process to satisfy the Airports that these valuations complied with the IMs.
- (b) The nature of the land valuation exercise under schedule A means that it is possible for valuers to have different opinions about some aspects of the valuations (as has been shown through the section 56G review process). The valuation exercise requires expert judgment based on a hypothetical task involving a number of inter-related assumptions about what may happen in the future.
- (c) However, the ability for different valuers to reach different opinions does not mean that the valuations prepared by the airports are "wrong" in any way. In NZ Airports' view, the Commission should be hesitant to use an alternative asset valuation in its assessments that has not been subject to the same due diligence process as the airport IM valuations and which have not been tested against the IM requirements. Doing so would undermine the certainty that IMs were meant to bring and provide ongoing uncertainty for the airports when adopting expert valuations going forward.

CONCLUSION

29. In conclusion, NZ Airports continues to consider that ID is effectively promoting the purpose of Part 4 of the Commerce Act. We encourage the Commission to give full recognition to the positive performance areas at each airport, and to contextualise any areas for improvement as part of an overall assessment of behaviour, conduct and outcomes.