

## SECTION 56G REVIEW OF CHRISTCHURCH AIRPORT: SUBMISSION ON PROCESS AND ISSUES PAPER

22 March 2013

### INTRODUCTION

1. The Commerce Commission ("**Commission**") published its Process and Issues Paper on Christchurch International Airport Limited ("**Christchurch Airport**") on 8 February 2013, as part of its review of the Information Disclosure ("**ID**") regime under section 56G of the Commerce Act 1986 ("**Act**"). The New Zealand Airports Association ("**NZ Airports**") makes this submission on that Process and Issues Paper on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch Airport (together, "**Airports**").
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### OVERVIEW

3. The Commission's review of Wellington and Auckland Airports has highlighted many positive aspects of airport performance. In our view, consumers are benefitting from 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.
4. Despite airlines' efforts to portray those positive outcomes as having been achieved independently of ID (such that ID is in their view ineffectual),<sup>1</sup> the Commission has properly recognised that ID is effective if it has not dampened or constrained such positive outcomes. We encourage the Commission to continue this approach under the Christchurch Airport review.
5. In that context, NZ Airports anticipates that the Commission's review of Christchurch Airport will also find high quality performance across a number of areas of the Part 4 purpose statement.
6. We also anticipate that submissions from airlines will seek to argue that excess returns are being earned, and that there will be a considerable degree of debate on how the Commission should calculate the level of returns forecast to be earned by Christchurch Airport.

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<sup>1</sup> See, for example: BARNZ, Post Auckland Airport Section 56G Conference Submission, 15 March 2013, at pages 1-2.

7. NZ Airports remains deeply concerned that focussing on contentious matters of theoretical modelling (that may bear little resemblance to how prices were in fact set at the time) tells interested parties little or nothing about how effectively ID is promoting the purpose of Part 4 in practice. In relation to airport returns, properly addressing those questions requires the Commission to consider **all evidence** relevant to the essential question of how effectively ID is *promoting* the objective of airports being *limited* in their ability to extract excess profits.
8. NZ Airports anticipates that Christchurch Airport will provide considerable evidence to demonstrate that its ability to extract excess profits has been limited by ID, including:
  - (a) the pressure to align pricing decisions with ID and input methodologies, and the requirement to explain any departures from IMs in a transparent, rigorous and disciplined way;
  - (b) the knowledge that its forecast returns would be closely examined under the section 56G review (albeit with considerable uncertainty at the time of pricing as to how that analysis would be undertaken); and
  - (c) the careful justification of forecast returns that are reasonable (particularly given the limited ability of theoretical WACC models to provide accuracy and the need to accommodate airport specific circumstances).
9. This evidence must be taken into account in the Commission's analysis. Further, when the Commission is analysing the detailed information that has been disclosed by Christchurch Airport, NZ Airports encourages the Commission to:
  - (a) take a balanced approach which acknowledges that all areas of performance and conduct are equally relevant when assessing the effectiveness of ID regulation; and
  - (b) draw its analysis and conclusions from the extensive current evidence that has been disclosed, and not allow assumptions about future decisions to unduly affect an assessment of current behaviour and performance (particularly in relation to returns).
10. In the remainder of this submission, NZ Airports expands on:
  - (a) Our views on how the effectiveness of ID regulation should be properly assessed, including the role of ID in understanding airport performance, the role of ID in pricing consultations, and the need to consider all areas of performance and conduct as equally relevant; and
  - (b) Our concerns with the way the Commission is assessing the effectiveness of ID regulation in relation to profitability and returns, including our concerns about specific areas of the Commission's Process and Issues Paper for Christchurch Airport.

#### **ASSESSING THE EFFECTIVENESS OF ID REGULATION**

11. At this stage of the review process, it is useful to step back and consider the key overarching questions the Commission has posed under its review:<sup>2</sup>
  - (a) Has information disclosure had any impact on Christchurch Airport's performance and/or in understanding Christchurch Airport's performance relative to the first price setting event (PSE1), and why?

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<sup>2</sup> Christchurch Airport Process and Issues Paper, 8 February 2013, at questions 16.1 - 16.3.

- (b) Has information disclosure had any impact on the effectiveness and scope of consultation as part of Christchurch Airport's second price setting event (PSE2) relative to PSE1, and why?
  - (c) What aspects of performance and conduct should we focus our efforts on for this review of Christchurch Airport?
12. These questions are appropriate, and accurately reflect the key issues the Commission should have in mind in its review. However, NZ Airports is concerned that the approach followed by the Commission in its final report on Wellington Airport ("**WIAL Report**") appears to overlook these questions, instead jumping directly to an analysis of the information which has been disclosed and the outcomes of the consultation process.
13. NZ Airports acknowledges that the Commission is interested in, and focussing on, responses provided by submitters to a number of specific questions. However, the three overarching questions remain crucially important and relevant to the Commission's task when assessing the effectiveness of ID regulation. This is because, in essence, they require consideration of evidence demonstrating that airport performance and decision-making is transparent and fully understood, such that ID can influence behaviour and conduct and therefore effectively promote the Part 4 purpose statement.
14. We therefore encourage the Commission to:
- (a) reflect on the weight that it has given to these overarching questions about the effectiveness of ID in the section 56G review so far;
  - (b) consider how it is reflecting its overarching questions in its overall conclusions and its conclusions for each performance area; and
  - (c) appropriately factor this information into its assessment of the effectiveness of ID regulation in the review process going forward.
15. Our views on each of the Commission's overarching questions are provided below.

#### **The role of ID in understanding airport performance**

16. NZ Airports remains strongly of the view that the core of an effective ID regime is to allow a robust evaluation of airport performance. The resulting transparency provides incentives to align performance with the Part 4 purpose statement.
17. In this respect, and in accordance with the purpose of ID regulation, an effective ID regime should ensure sufficient information is available to interested parties to assess whether the Part 4 purpose statement is being promoted, including sufficient information to allow the Commission to undertake its monitoring and analysis obligations.
18. It follows, therefore, that a fundamental aspect of assessing the effectiveness of ID is assessing its impact on the ability of interested parties to understand and evaluate airport performance.
19. Accordingly, the quality and availability of information to the Commission, airlines and other interested parties must be fully recognised by the Commission when drawing its conclusions. The fact that the Commission, the Airports and airlines can have robust discussions on matters of investment, quality, innovation, operating costs, asset valuation, cost of capital and pricing efficiency is a sign that information disclosure is working as it should to promote transparency, encourage debate, and allow informed assessments of airport performance to take place.

20. NZ Airports encourages the Commission to fully reflect the positive impact of ID regulation in promoting the understanding of airport performance in its draft and final conclusions for the remainder of the section 56G review process. In our view, an assessment of the effectiveness of ID is not complete without this recognition.

**The role of ID in pricing consultations**

21. A similarly important objective behind the introduction of ID regulation was to provide information to guide commercial negotiations and pricing consultations between the Airports and airlines. In doing so, ID regulation was intended to preserve and enhance the incentives for airlines and Airports to reach mutually beneficial commercial arrangements.
22. Accordingly, the role of ID in providing information to guide and facilitate effective consultation between Airports and airlines is fundamental to any assessment of the effectiveness of ID regulation.
23. Each of the Airports has or will provide information to the Commission in relation to the positive role that ID regulation played in the pricing consultation processes for PSE2. NZ Airports understands that ID regulation, including the Part 4 consultation process, has provided airlines and the Airports with a common language to approach pricing consultations.
24. In addition, NZ Airports understands that consultation matters such as cost allocation, quality measures and pricing efficiency have benefitted from the IM process. Further, more informed consultation discussion can take place on matters such as asset valuation as the information in the IMs provides a reference point for airlines to consider and engage with the pricing approaches proposed by the Airports during consultation.
25. NZ Airports considers the positive impact of ID in these respects must be fully recognised by the Commission when assessing the impact and effectiveness of ID regulation.

**All areas of performance and conduct are equally relevant**

26. The Commission has also asked what aspects of performance and conduct it should focus its efforts on for the review of Christchurch Airport. NZ Airports repeats its comments, set out in earlier submissions, that:
- (a) 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.
  - (b) 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 formulaic and price control benchmark approach to assessing profitability (which in itself is problematic).
  - (c) All findings in relation to each limb of the Part 4 purpose statement should be 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.
  - (d) The limitations on ID's ability to achieve particular outcomes for PSE2 must be fully recognised. For example, at the time prices were set, it was not known how returns

would be assessed or that the Commission would apply bright line benchmarks, 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 (although, for the avoidance of doubt, we consider that it will remain important to assess performance in context going forward and to avoid a formulaic or bright line approach to assessing behaviour and outcomes).

27. Analysing the information disclosed by Airports (both in relation to forecast and actual performance) should not equate to a calculation exercise for the purpose of assessing returns. Instead, an assessment of the full range of incentives and outcomes sought under the purpose statement must be made.

28. We comment further on the approach to assessing returns below.

### **RETURNS, PROFITABILITY AND ASSESSING THE EFFECTIVENESS OF ID REGULATION**

29. NZ Airports continues to have concerns with the way the Commission is undertaking its assessment of profitability and returns.

#### **The starting point for assessing returns**

30. NZ Airports is concerned that the Commission's approach in the WIAL Report has coloured the questions it is asking about the appropriate economic return for Christchurch Airport. In particular, the questions asked by the Commission appear to be heavily influenced by its view that the cost of capital IM provides an "absolute standard"<sup>3</sup> which represents the only appropriate economic return for an individual airport.

31. For example, in the review of Auckland Airport, the Commission asked:<sup>4</sup>

What is an appropriate level of target return for AIAL, and why is the level appropriate?

What is an appropriate level to reflect normal performance, and why?

What is an appropriate level to reflect superior performance, and why?

32. This can be contrasted to the questions in the Christchurch Airport Process and Issues Paper where the Commission asks:<sup>5</sup>

Is Christchurch Airport targeting an appropriate return, and why?

Are there any indicators of superior performance that would justify Christchurch Airport earning higher than normal profits?

33. NZ Airports considers that this approach risks starting the review of Christchurch Airport from the wrong starting point. We have previously submitted that the review should not start by asking whether the "right" inputs have been applied in pricing. Similarly, the review of Christchurch Airport should not start by asking whether the "right" or "appropriate" return is being targeted. Instead, it should start by considering the evidence that demonstrates returns have been limited by ID (regardless of what the actual forecast return is).

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<sup>3</sup> WIAL Report at paragraph 2.27.

<sup>4</sup> Auckland Airport Process and Issues Paper, 6 September 2012, at question 3.1 - 3.3.

<sup>5</sup> Christchurch Airport Process and Issues Paper, 8 February 2013, at question 17.1 - 17.2.

34. The point is that the Commission must not begin its review from the starting point that there is only one appropriate return for Christchurch Airport. Questions such as "is Christchurch Airport targeting an appropriate return", which imply that there is only one number that will be considered appropriate by the Commission, do not properly reflect the nature of the ID framework, the Commission's task in the section 56G review process, or the inherent uncertainty in estimating returns.
35. Our concerns in this area are not simply about ensuring that ID is properly applied and does not resemble an approach that is more akin to price control. In our view, the key issue is ensuring the Commission is considering the right questions and fully considering all relevant evidence when answering those questions.
36. In other words, the question to be answered in relation to airport returns is as follows:
- When all relevant information is taken into account, how effectively is ID **promoting** the objective of airports being **limited** in their ability to extract excess profits over time?

#### **Conclusions should be drawn from current evidence**

37. Much of the Commission's analysis of returns tries to figure out if excess profits will in fact be earned over time. This is a fraught and contentious exercise in itself, and cannot produce certain conclusions given that actual results are necessary before those conclusions can be drawn.
38. Actual performance over time is critical, with the annual and price setting event disclosures published by each of the Airports being the key means to assess that performance. That information comprehensively covers all aspects of the purpose statement, and should allow a full assessment of conduct and performance. The Commission should focus on a full and robust analysis of this evidence in its review, rather than adopting an approach which is heavily influenced by assumptions about decisions that will occur in five years' time.
39. Accordingly, NZ Airports is concerned that Commission is expressly asking Christchurch Airport and interested parties to provide submissions on what they consider to be the most likely basis of asset valuation used to set prices after 2017.
40. It will be readily apparent to the Commission that NZ Airports has grave concerns about the use of potential future behaviour in this way to influence the assessment of current behaviour and current performance. We continue to urge the Commission to consider:
- (a) The impact that assumptions about future pricing behaviour are having on its analysis and on the conclusions that it is drawing on the effectiveness of ID regulation.
  - (b) The actual evidence which does exist at this time. The annual and price setting disclosures provide considerable current evidence that the Airports have been limited in their ability to extract excess profits, and, therefore, that ID is effective at promoting this outcome over time. For example, evidence supporting the current effectiveness of ID can be seen where Airports have:
    - (i) rigorously and transparently explained their WACC estimates, including through reference to expert advice;
    - (ii) been influenced by the WACC IM and consultation feedback from airlines in setting prices; and

- (iii) lowered their returns expectations between PSE1 and PSE2.

### **Assets held for future use and efficient pricing**

41. NZ Airports is also concerned about the phrasing of the Commission's question in relation to assets held for future use. In previous Process and Issues Papers, the Commission has invited submissions on the appropriate treatment for pricing purposes of assets held for future use.<sup>6</sup>
42. In its paper for Christchurch Airport, the Commission now asks:<sup>7</sup>
- Has Christchurch Airport appropriately excluded assets held for future use?
43. This is not a question of semantics. The question now indicates the Commission considers that assets held for future use must be excluded in pricing, and that no other pricing treatment of these assets may be appropriate. NZ Airports is concerned that the Commission appears to be conflating the disclosure requirements about future use assets with the appropriate pricing treatment of these assets.
44. NZ Airports accepts that the IMs require assets held for future use to be disclosed outside the RAB for **disclosure** purposes. However, the treatment of these assets for **pricing** purposes (including the timing of returns on assets held for future use and how the costs involved in developing additional capacity are recovered from airlines) is a business decision to be made by Airports following consultation with substantial customers. For example, in order to implement a sensible and efficient pricing structure, a smoothed approach over a number of years may be required.
45. Within the ID framework, it is for the Airports (with appropriate regard to the consultation views expressed by airlines) to determine the appropriate pricing treatment for assets held for future use.
46. Accordingly, NZ Airports strongly encourages the Commission to reconsider its approach to the questions asked about future use assets and the treatment of these assets in pricing.
47. More generally, we are concerned that the Commission's approach to future use assets continues to blur the interaction between ID regulation and aeronautical pricing. We consider that:
- (a) The ID framework provides information to create transparency around airport performance pricing decisions, and to guide consultation processes. It does not imply a single "correct" or "efficient" approach to pricing.
  - (b) Efficient and sensible pricing is a complex concept. This is particularly the case in an industry characterised by long-term investment and the constructing and commissioning of major infrastructure developments.
  - (c) Care must be taken to ensure that the ID framework is applied in a way that preserves incentives for Airports to engage in long-term efficient pricing for the long-term benefit of consumers.

### **CONCLUSION**

48. In conclusion, NZ Airports continues to advocate for a full and balanced analysis of all available evidence to assess the effectiveness of ID regulation. We continue to consider that this

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<sup>6</sup> Auckland Airport Process and Issues Paper, 6 September 2012, at question 3.11.

<sup>7</sup> Christchurch Airport Process and Issues Paper, 8 February 2013, at question 17.9.

approach will reveal ID is effectively promoting the purpose statement (and that this effectiveness will improve over time).

49. In addition, it is clear that the Airports have carefully and thoroughly disclosed extensive information which has enabled interested parties, including the Commission, to gain a full and comprehensive understanding of airport performance. Further, ID regulation has resulted in a sound framework to inform pricing consultations between the Airports and airlines, and to guide the scope, content, and effectiveness of those consultations.