NZ AIRPORTS

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

5 April 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**") ("**Review**"). This cross-submission is made by the New Zealand Airports Association ("**NZ Airports**") on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch Airport (together, "**Airports**"), and responds to submissions made to the Commission by BARNZ, Air New Zealand and Qantas/Jetstar (together, "**airlines**").

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OVERVIEW

3. In general, the airlines' submissions on the review of Christchurch Airport closely follow the pattern that has been established in the section 56G review process to date. Positive performance is mentioned, but put swiftly to one side in an effort to present ID regulation as ineffectual.

4. NZ Airports is disappointed that the airlines continue to adopt a tactical position that ID regulation is not and cannot be effective in any circumstances. In particular, the airlines:

   (a) continue to take a narrow and unhelpful view of the effectiveness of ID regulation and how that effectiveness should be assessed; and

   (b) invite the Commission to draw negative and inappropriate inferences from the interaction between the ID regime and the statutory consultation process under the Airport Authorities Act 1966 ("**AAA**").

5. In addition, the airlines' submissions demonstrate that:

(a) The Commission's approach to modelling returns invites ill-informed, speculative and opportunistic comments about potential future approaches to asset valuation. The airlines' suggestions for the "likely" asset valuation to be used by Christchurch Airport in 2017 reinforce the importance of the Commission basing its analysis and conclusions on robust factual evidence.

(b) Airport-specific factors play an important role in airport pricing, and can and should be factored into the Commission's analysis of airport performance (including where assessments have been made about the appropriate adjustments to the WACC IM when establishing the WACC estimate to use in setting prices for an airport).

THE AIRLINES TAKE A NARROW AND INAPPROPRIATE APPROACH TO ID REGULATION

6. The airlines continue to seek to distort the assessment of the effectiveness of ID regulation. We summarise and respond to their arguments as follows:

(a) Both BARNZ and Air New Zealand acknowledge the positive performance of Christchurch Airport in a number of key areas but maintain that such performance is irrelevant to assessing the effectiveness of ID regulation (because those positive outcomes would be achieved in the absence of ID). As such, the airlines' submissions continue to assert that ID has had no impact on the effectiveness and scope of pricing consultations or on performance outcomes. In response, NZ Airports notes that:

(i) The Commission has appropriately acknowledged that ID is effective where it does not dampen or constrain positive outcomes or the incentives of airports to engage in positive behaviour (regardless of whether those outcomes were achieved before the introduction of ID or independently of ID). We encourage the Commission to continue this approach.

(ii) The fact that positive outcomes are being achieved independently of ID strongly evidences that light-handed regulation is the appropriate form of regulation for airports. ID should be considered effective in that respect.

(iii) That said, ID regulation has clearly provided a significant change to the regulatory landscape for the Airports, and has played a key role in interactions with airlines since its introduction. It is disingenuous for airlines to argue that ID regulation has been ignored by the Airports.

(iv) In particular, the Airports have provided considerable evidence of the ways in which ID regulation has impacted positively on the most recent pricing consultations and has affected performance and behavioural outcomes. This evidence should be fully reflected in the conclusions drawn from the section 56G review.

(v) ID will, over time, inform interested parties whether the current positive performance (which includes aspects that are of vital interest to airlines and other interested parties) is being maintained, and will influence future airport behaviour in relation to those areas of performance.

(b) The airlines continue to focus on attacking the level of forecast returns and the perceived ineffectiveness of ID regulation in limiting the ability of the Airports to earn excessive profits. From this narrow focal point, the airlines continue to advocate that ID is not and cannot be effective. In reply, we note that:

(i) It is very clear that all limbs of the Part 4 purpose statement are important to an analysis of the effectiveness of ID regulation. We have previously submitted, extensively, that each aspect of the purpose statement must be given appropriate weight and prominence.

(ii) Areas of concern to airlines (which appear to be almost entirely limited to profitability) must be considered in light of the positive comments made by airlines about a number of the other limbs of the purpose statement, and given appropriate weight and balance in that context.

(iii) In any event, for the reasons provided by each airport in their submissions, forecast returns are not excessive, and are appropriately in balance with the other limbs of the purpose statement.

(c) Air New Zealand, in particular, continues to repeat arguments that the current ID requirements will be ineffective unless a single till approach, negotiate/arbitrate regulation, and a pricing methodology are introduced. In NZ Airports' view:

(i) The Commission has appropriately recognised that these considerations are outside the scope of the section 56G review process.

(ii) The airlines' assertions amount to an argument that light-handed regulation is not effective because it is not the heavy-handed regulation they sought prior to the enactment of Part 4 of the Commerce Act. This is not an appropriate or helpful approach to assessing the effectiveness of the light-handed ID regime that Parliament has chosen to implement.

(iii) In particular, this approach fails to recognise that light-handed regulation was a key element of the regulatory toolbox introduced by Part 4 of the Commerce Act, and has the characteristics to promote appropriate regulatory outcomes. The Airports have provided extensive evidence which demonstrates that ID regulation is working effectively to promote those appropriate outcomes.

(d) Air New Zealand argues that ID regulation is ineffective without a regulatory response to Christchurch Airport's pricing disclosure. Although it is not clear, Air New Zealand appears to consider that the only appropriate regulatory response would be further regulation. Air New Zealand appears to consider that, as it currently stands, ID regulation will produce no benefit to airlines and other consumers of Christchurch Airport's services.[1] In response, NZ Airports notes that:

(i) Overall, the effectiveness of ID lies in its ability to provide transparent performance information to the Commission and interested parties. In this way, and through the resulting Commission, ministerial and media attention, ID creates powerful incentives for airports to engage in appropriate behaviour for the long-term benefit consumers of airport services.

(ii) The Airports accept and understand that ID regulation will become more effective over time as disputes over input methodologies are resolved, a clear feedback process is established as the Commission reports on annual

[1] Air New Zealand Submission to the Commerce Commission on the section 56G review of Christchurch International Airport, 22 March 2013, at paragraph 69.

information disclosures, and as performance and behavioural trends (as well as areas for potential improvement) are identified.

(iii) Any areas for improvement (in both airport performance and how ID measures and incentivises that performance) identified during the section 56G review are a sign that ID regulation is working as it should.

(e) The airlines consider that Christchurch Airport's pricing decision needs to be considered in light of factors before the introduction of ID regulation, such as the treatment of pre-2007 asset revaluations. The airlines are, in effect, stating that ID regulation is ineffective because it has failed to provide redress for past perceived grievances which took place before the introduction of ID. In NZ Airports' view:

(i) The Commission has established a forward-looking process for the way in which assets are to be valued for disclosure purposes, and the way in which asset revaluations are to be treated in annual information disclosures going forward.

(ii) The airlines suggest a selective approach which focuses on one area of perceived over-recovery that occurred prior to the introduction of ID regulation, without regard for any areas of under-recovery that may have taken place. This approach is not constructive.

(iii) In any event, a backwards-looking approach is not appropriate. The correct and appropriate measure of the effectiveness of ID regulation is how effective it has been from its introduction, looking forward. The impact of ID in reducing historic areas of dispute between airports and airlines is a relevant part of that analysis, but the effectiveness of ID in incentivising behaviour and outcomes must be assessed on a forward-looking basis.

(iv) ID regulation was designed to be a forward-looking mechanism and to provide certainty for regulated suppliers and consumers of regulated services. These elements are clear requirements in order to promote investment. Effective regulation does not have a retrospective effect.

(v) Accordingly, the effectiveness of ID cannot be measured by whether it provides a retrospective remedy for perceived under or over-recovery that took place before ID was introduced.

7. NZ Airports acknowledges that airline feedback is an important part of reviewing the effectiveness of the ID framework and ensuring that framework can be improved where appropriate to better meet the needs of all regulatory participants. However, continuing to state that ID has had no discernible impact and will have no impact in the future is an unhelpful approach in the current context.

8. Accordingly, we are disappointed that the airlines continue to argue that ID is inherently broken, and to push for heavier and more restrictive regulation, in the context of a section 56G review which was intended to be a transitional "check up" on the implementation and early progress of ID regulation under the Commerce Act.

DRAWING INFERENCES FROM THE AIRPORT AUTHORITIES ACT 1966

9. Air New Zealand claims that Christchurch Airport is justifying higher prices on the basis that the AAA allows the Airports to set prices "as they see fit". Air New Zealand argues that, in doing so,

Christchurch Airport has ignored ID benchmarks and expectations. Similar comments were made in the context of the reviews of Wellington and Auckland Airports.

10. However, the evidence demonstrates that Airports have never sought to use the AAA in this manner. The evidence before the Commission, including in the pricing disclosures for each of the three Airports, clearly illustrates that the Airports have appropriately considered ID benchmarks and expectations when setting prices. In particular, the ID framework and the Airports' recognition of the Commission's review and monitoring role formed an important element of the price setting process, along with other important factors such as the views of substantial customers expressed through consultation, advice from expert advisors, and airport-specific circumstances.

11. Overall, when this evidence is taken into account, it is clear that Airports are limited in their ability to set prices. In addition, it is clear that the constraints on Airport price setting have been strengthened since ID regulation has been introduced. Assertions that Airports have complete freedom to set prices are grossly oversimplified and misleading when viewed against the reality of lengthy and complicated consultation processes with well-informed and well-resourced airline customers.

12. In addition, BARNZ attempts to argue that ID is ineffective because Airports re-consult on pricing every five years under the AAA regime. BARNZ argue this means there can be no certainty about long-term pricing approaches and that ID is destined for failure in these circumstances. However, NZ Airports notes that:

    (a) The requirement to consult on charges every five years was introduced to protect consumers. In particular, the consultation requirements were changed to put pressure on Airports to review their charges, allow Airports to respond to changing market conditions and changing consumer demands, and to allow airlines to contest aeronautical charges through regular consultation.[2]

    (b) No negative inferences can be drawn from the fact that Airports cannot make commitments now about what will happen in pricing decisions that will take place in five years' time. In any event, the evidence that has been submitted by Airports throughout the section 56G review demonstrates that Airports have provided indications of likely future approaches, to the extent that doing so does not pre-determine future outcomes in breach of consultation requirements.

13. In general, all airlines continue to refer to the AAA as evidence that the Airports are somehow exploiting a loophole that Government and officials are unaware of when setting charges, and continue to argue that the AAA prevents outcomes consistent with the Part 4 purpose statement. This ignores the fact that Parliament deliberately retained the AAA as part of reviewing the regulatory regime for Airports and bringing the ID regime under the umbrella of the Commerce Act.

14. Essentially, the airlines continue to revisit concerns regarding the statutory framework that the Commission has properly determined are well outside the bounds of the review directed by section 56G of the Act.

15. As explained in previous submissions, the AAA and ID can and are intended to work together effectively. Parliament clearly and expressly intended to retain the AAA pricing and consultation processes, and the charge setting and consultation processes under the AAA were intended to be complemented by ID regulation under Part 4 of the Commerce Act. Arguments

[2] Ministry of Transport, Review of New Zealand Airport Regulation: Proposals for Consultation, April 1995 at paragraphs 4.3.1 to 4.3.4.

that Airports are somehow using the AAA inappropriately and/or that ID cannot be effective because of the AAA are misguided and ignore that Parliamentary intention.

AIRLINE SUBMISSIONS DEMONSTRATE THE FLAWS IN MAKING ASSUMPTIONS ABOUT PSE3

16. In its Process and Issues Paper on Christchurch Airport, the Commission invited interested parties to provide an indication of what they considered to be the most likely basis of asset valuation used to set prices after 2017.

17. The airlines' responses to the Commission's question demonstrate that such an approach is inherently flawed and encourages some parties to make ill-informed and speculative assumptions about potential future decisions. Such comments cannot form the basis of a robust and evidence-based approach to assessing airport performance and the effectiveness of ID regulation.

18. In response to the specific comments raised in the airlines' submissions, NZ Airports notes that:

    (a) BARNZ continues to attempt to draw inferences about future asset valuations in an aeronautical pricing context based on current financial reporting by the Airports. Airports' financial reporting must be prepared in accordance with relevant financial reporting standards and, as such, uses valuation methods which comply with those standards. Accordingly, financial reporting is not a reliable evidence source for future aeronautical pricing behaviour or future asset valuations for pricing purposes.

    (b) The fact that Airports may choose to adopt valuation approaches which differ from the Commission's input methodologies is not evidence that ID is ineffective, or that Airports are unconstrained in setting prices. Similarly, it is not evidence that Airports have adopted, or will adopt, approaches which may lead to excess profits in the future.

        As the Commission has appropriately recognised, it is the combination of pricing outputs and behaviour which provide evidence of the profitability outcomes sought by the Airports. Additionally, the Airports have provided considerable evidence that ID has been a key constraining factor in pricing decisions.

    (c) Air New Zealand argues that, in the absence of Government intervention following the Commission's section 56G review of Wellington Airport, it can be expected that the other airports will move to adopt new ODRC and MVEU valuation approaches in the future to increase revenues and profits. Air New Zealand therefore considers the Commission should include an assessment of Christchurch Airport's performance on the basis of a new MVEU and ODRC valuation in 2017 in its analysis.[3] This is clearly opportunistic and speculative. Assumptions about one airport's future pricing behaviour (which are inappropriate in any event) cannot form any kind of credible evidence about the future pricing behaviour for a different airport.

    (d) The clear evidence is that Christchurch Airport has adopted an asset valuation approach consistent with the input methodologies, and has treated actual revaluations as income in its pricing decision. There is simply no evidence to support inferences that it will adopt materially different approaches in 2017.

19. NZ Airports continues to encourage the Commission to focus its analysis on robust factual evidence, and to avoid an approach which relies on assumptions about future pricing decisions.

[3] Air New Zealand, Submission Christchurch Airport Process and Issues Paper, 22 March 2013, at [30].

20. More generally, airline submissions in this area serve to illustrate a wider issue of concern with the airlines' approach to the section 56G review. NZ Airports is concerned that airline submissions are heavily coloured by the implication that Airports can and will do whatever they can to increase profits, regardless of the views of airlines, other customers, consumers, and the Commission's oversight.

21. This is clearly not the case, and ignores the substantial evidence which demonstrates that Airports:

(a) are constrained in their pricing decisions;

(b) fully recognise the importance of strong relationships with their substantial customers, including the need for pricing decisions to be commercially acceptable to all stakeholders;

(c) engage in positive, robust and constructive consultation processes when setting prices and consulting on capital expenditure;

(d) are working to foster competitive aviation markets in New Zealand to the benefit of consumers;

(e) set charges that benchmark favourably compared to international standards (on the basis of comparable market pricing information which has been provided to the Commission previously), demonstrating that the AAA regime imposes suitable constraints on airport pricing; and

(f) have instigated changes in approaches as a result of the countervailing power of airlines and due to the presence of the ID framework, including the IMs and the threat of further regulation (as evidenced in the Airports' pricing disclosures and in submissions from the Airports through the section 56G review).

AIRPORT-SPECIFIC FACTORS PLAY AN IMPORTANT ROLE IN AIRPORT PRICING

22. BARNZ has submitted, in reliance on advice from Futures Consultants Limited, that it is appropriate for Christchurch Airport to adopt a different WACC estimate in pricing to the industry-wide WACC estimate for information disclosure purposes.

23. NZ Airports is pleased that BARNZ now endorses the Airports' submissions that it is appropriate for the airports to depart from the industry-wide WACC IM in pricing where that is appropriate in light of airport-specific circumstances.

24. We encourage the Commission to reflect this in its analytical approach, and to expressly acknowledge that the WACC IM does not represent a fixed benchmark that is automatically appropriate for use in aeronautical pricing by each airport.

25. Further, we continue to encourage the Commission to give appropriate recognition to airport-specific circumstances, as well as financial market evidence, when undertaking its monitoring and analysis obligations (including in the section 56G review).