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# 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

## Section 56G of the Commerce Act 1986

Date: 2 November 2012

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# Contents

# Executive Summary

X1 This report contains our draft conclusions as to how effectively information disclosure regulation is promoting the Part 4 purpose for Wellington Airport.[1]

X2 You are invited to provide your views.

X2.1 Submissions are due by **30 November 2012**.

X2.2 Cross submissions are due by **12 December 2012**.

X3 After considering your views, we plan to finalise our conclusions and report to the Ministers of Commerce and Transport by 21 December 2012.

## How we assess the effectiveness of information disclosure for this review

X4 Our task under s 56G of the Commerce Act 1986 is to report on how effectively information disclosure regulation is promoting the Part 4 purpose. The report must be made 'as soon as practicable' after any new price for airport services is set in or after 2012.

X5 We consider it is appropriate to make this draft report now because Wellington Airport set new prices on 1 March 2012 for the 2013-17 pricing period (PSE2), and has made two disclosures of information under Part 4 information disclosure and a specific price-setting event disclosure containing detailed financial information.

X6 The scope of our review only considers how effectively information disclosure regulation is promoting the Part 4 purpose. We are not extending our report to include considering and recommending to the Ministers whether regulation other than information disclosure should apply to the airports, nor whether information disclosure should no longer apply.

X7 To assess how effectively information disclosure is promoting the Part 4 purpose we have:

X7.1 examined the performance (historical and projected) and conduct of Wellington Airport, both before and after the Part 4 information disclosure came into effect; and

X7.2 assessed the extent to which this information disclosure has had an impact on Wellington Airport's performance and conduct.

[1] Auckland Airport and Christchurch Airport will be considered in separate reports.

X8 We determined input methodologies for regulated airport services on 22 December 2010. It is the combination of disclosures based on input methodologies, and of other historic and forecast information that the Commission uses in the assessment against the Part 4 purpose.

X9 Airports are not required to apply the input methodologies in setting their prices, although they must disclose information consistent with the input methodologies for information disclosure purposes. They thus form an important benchmark in enabling interested persons to assess whether the Part 4 purpose is being met.

X10 Our assessment has considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance.

## Draft conclusions from our section 56G review

X11 Our draft conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our s 56G review for Wellington Airport has found that information disclosure is effective in some areas, it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas. Of the three areas that we are unable to conclude on, only operating efficiency is an area of concern at this time.

X12 Information disclosure regulation is effectively promoting the Part 4 purpose in the following areas:

X12.1 Innovation (s 52A(1)(a)). Our review has found that information disclosure has had limited impact on Wellington Airport's incentives to innovate, but this is not problematic because innovation levels appear to be appropriate.

X12.2 Quality (s 52A(1)(b)). Our review has found that Wellington Airport appears to be providing quality of services at a level that reflects consumers' demands. Information disclosure has had a positive impact on Wellington Airport's performance and conduct in this area.

X12.3 Pricing efficiency (s 52A(1)( b)). Our review has found that prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. Information disclosure has had a positive impact on this outcome.

X13 Information disclosure regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits (s 52A(1)(d)). We consider that Wellington Airport is earning an excessive return over time. We consider the excessive profits are attributable to:

X13.1 Wellington Airport's use of its own asset valuation methodologies to revalue assets without fully accounting for the resulting revaluation gains in determining its revenue requirements; and

X13.2 Wellington Airport having targeted the recovery of a cost of capital that exceeds the estimate provided by the input methodologies of the cost of capital that could be expected if it was subject to workable competition.

X14 We are unable to conclude on the effectiveness of information disclosure in the following areas:

X14.1 Operational expenditure (s 52A(1)(b)). We are unable to conclude on the effectiveness of information disclosure regulation in this area because the evidence of whether Wellington Airport is operating efficiently, or improving its operating efficiency, is mixed.

X14.2 Investment (s 52A(1)(a)-(b)). It is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Information on actual investment over PSE2 is necessary before we can form a conclusion.

X14.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). We are unable to conclude whether Wellington Airport is sharing the benefits of efficiency gains with consumers because it is too early to conclude whether there are any operational expenditure and capital expenditure efficiency gains that could be shared.

X15 As a general matter, we consider that information disclosure has had a positive impact on the transparency of the recent consultation process on setting prices. Although Wellington Airport would have had to disclose price-setting information under information disclosure regulation once prices had been set, it opted to do so early on during consultation on new prices.

# 1. Introduction

## Purpose of this report

1.1 This report contains our draft conclusions as to how effectively information disclosure regulation is promoting the purpose of Part 4 of the Commerce Act 1986 (the Act) for Wellington International Airport Limited (Wellington Airport).

1.2 We invite you to provide your views on our draft conclusions and supporting analysis in this report by 30 November 2012. Cross submissions are due by 12 December 2012.

1.3 After considering your views, we intend to finalise our conclusions and report to the Ministers of Commerce and Transport (the Ministers) by 21 December 2012.

## Our task under section 56G

### We must review how effectively information disclosure is promoting the Part 4 purpose

1.4 Information disclosure regulation was put in place with effect from 1 January 2011 for airport services provided by Wellington Airport, Auckland International Airport (Auckland Airport) and Christchurch International Airport (Christchurch Airport).[2]

1.5 Our task under section 56G of the Act is to report on how effectively information disclosure regulation is promoting the Part 4 purpose. The report must be made 'as soon as practicable' after any new price for airport services is set in or after 2012.

### It is appropriate to carry out this review for Wellington Airport now

1.6 We consider it is appropriate to make this draft report now because Wellington Airport set new prices on 1 March 2012 for the 2013-17 pricing period, and has made two disclosures of information under information disclosure regulation and a specific price-setting event disclosure containing detailed financial information.[3]

1.7 We do not consider it would be consistent with reporting 'as soon as practicable' to delay the review in order to wait for:

1.7.1 other information disclosures to be made in the future;

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[2] The regulated airport services are set out in section 56A(1) of the Act as 'specified airport services', and consist of aircraft and freight activities, airfield activities, specified passenger terminal activities.

[3] A price setting event occurs when an airport fixes or alters the price it charges for its regulated services following consultation. Airports are required to consult on their prices at least once every five years. Following the price-setting event, Airports must publicly disclose information on their forecast expenditures, assets, expected return and associated required revenues for the pricing period, as well as a ten year demand forecast. Airports are also required to provide information on their pricing methodology and the quality of service provided.

1.7.2 current court appeals on input methodologies to be resolved;

1.7.3 summary and analysis reports to be published under section 53B(2).

1.8 To wait for these events would likely result in the report being delayed for at least 2-3 years. Parliament clearly envisaged that the review would be made relatively soon after price-setting, and did not require that we publish a summary and analysis report prior to carrying out the section 56G review.

1.9 We consider that the price-setting event disclosure and other views and evidence relating to the price-setting event provide sufficient information to carry out the section 56G review. Any limitations in our analysis or to the conclusions that we have drawn are explained in the relevant parts of this report.

## How we are carrying out our task under section 56G

1.10 We consulted on our process and approach for the section 56G reviews for the three airports with all interested parties in May 2012. Submitters raised a range of issues which we responded to in a Process Update Paper on 27 July 2012.[4]

### We will report separately to the Ministers for each airport

1.11 We consider that preparing a separate report to the Minister for each airport is the most appropriate interpretation of the s 56G task. This is because each airport's price setting decisions are occurring at different times, and information disclosure regulation may be having a different impact across the three airports.[5]

### We will follow the same assessment approach and process for each airport

1.12 Although we will report separately, we are using the same assessment approach for each airport. This draft report only applies to Wellington Airport as it set its prices first, however the framework for our review that we describe in Chapter 2 and Attachment A is relevant to the review of all three airports.

1.13 We also intend to follow the same process for all three airports, which includes consulting with interested parties on the issues arising for each airport's review and holding a conference for each airport before publishing our draft report. The process we have followed for Wellington Airport is summarised in Attachment A.

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4 These reports and submissions are available on our website at http://www.comcom.govt.nz/section-56g-reports/

5 Auckland Airport set new prices on 7 June 2012 and Christchurch Airport set new prices on 24 October 2012. The effectiveness of information disclosure regulation for Auckland Airport and Christchurch Airport will be considered in separate reports.

### We have not considered whether other forms of regulation should apply

1.14 The scope of our review considers how effectively information disclosure regulation is promoting the Part 4 purpose only. We are not extending our report to include considering and recommending to the Ministers whether regulation other than information disclosure should apply to the airports, nor whether information disclosure should no longer apply.[6]

### We have not considered whether the definition of regulated services should be changed

1.15 Some submitters to this process raised the issue of including recommendations to regulate additional services not currently regulated as specified airport services.[7] We do not consider that extending the definition of specified airport services under section 56A(1) is within the scope of our section 56G review, therefore we have not considered this issue within this review.

## How we have set out our analysis and draft conclusions in this report

1.16 Our draft conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. Our s 56G review for Wellington Airport has found that information disclosure is effective in some areas, it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas.

1.17 The remainder of this draft report outlines how we have reached these draft conclusions and provides the necessary explanations:

1.17.1 Chapter 2 sets out the key elements of our approach to assessing how effectively information disclosure regulation is promoting the Part 4 purpose. Attachment A expands on this approach and issues raised in submissions on our interpretation of the relevant statutory provisions.

1.17.2 Chapter 3 then summarises our draft conclusions and the reasons why we have reached them. These conclusions are supported by further detailed analysis in Attachments B to I.

6 Air New Zealand submitted that parallel reviews (eg, Commission inquiry, Ministry of Economic Development review) should be undertaken alongside the s 56G review to consider other types of regulation: Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 134. BARNZ submitted that s 56G gives the Commission scope to consider other types of regulation: BARNZ "BARNZ responses to Commerce Commission questions relating to process" 28 June 2012, pages 4-5.

7 BARNZ "BARNZ responses to Commerce Commission questions relating to process" 28 June 2012, pages 4- 5; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraphs 117-119.

1.17.3 Chapter 4 describes our next steps in completing our report to the Ministers by 21 December 2012. It explains how you can provide your views to the Commission, including the dates for submissions and cross-submissions.

# 2. How we assess the effectiveness of information disclosure regulation for this review

## Purpose of this chapter

2.1 In this chapter we explain our approach to assessing how effectively information disclosure regulation is promoting the Part 4 purpose for Wellington Airport. To assess how effectively information disclosure is promoting this purpose we have:

2.1.1 examined the performance (historical and projected) and conduct of Wellington Airport, both before and after the Part 4 information disclosure came into effect; and

2.1.2 assessed the extent to which this information disclosure has had an impact on Wellington Airport's performance and conduct.

2.2 We begin by explaining what outcomes are sought in the Part 4 purpose and how information disclosure under Part 4 can promote those outcomes. We then explain how we have undertaken our assessment, including the role that input methodologies have played. Further detail is included in Attachment A.

## Information disclosure and the Part 4 purpose

### The Part 4 purpose sets our approach to the s 56G review

2.3 The purpose of Part 4 as set out in s 52A(1) of the Act is to:

> Promote the long-term benefit of consumers in [regulated markets] by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services:
>
> (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
>
> (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
>
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
>
> (d) are limited in their ability to extract excessive profits.

2.4 The outcomes produced in workably competitive markets that are relevant to regulated markets under Part 4 are those reflected in the regulatory objectives in (a)-(d) of the purpose. The focus of our s 56G review is therefore on considering how effectively information disclosure is promoting the outcomes reflected in the Part 4 purpose statement. We do this by considering the key performance questions in Table 2.1.

**Table 2.1: Key performance questions to assess if the Part 4 purpose is being met**

| Key performance questions | Relevance to the Part 4 purpose (s 52A(1)) |
|---|---|
| Is Wellington Airport operating and investing in its assets efficiently? | (a) and (b) |
| Is Wellington Airport innovating where appropriate? | (a) |
| Is Wellington Airport providing services at a quality that reflects consumer demands? | (b) |
| Is Wellington Airport sharing the benefits of efficiency gains with consumers, including through lower prices? | (c) |
| Do the prices set by Wellington Airport promote efficiency? | (a) and (b) |
| Is Wellington Airport earning an appropriate economic return over time? | (d) |

### How information disclosure regulation can promote the Part 4 purpose

2.5 As well as enabling interested persons to assess whether the Part 4 purpose is being met, information disclosure can directly promote the purpose.[8] It provides incentives to achieve outcomes consistent with those found in workably competitive markets in two main ways:

2.5.1 by providing transparency about how well a supplier is performing relative to other suppliers and over time; and

2.5.2 through the threat of further regulation.[9]

2.6 Greater transparency enhances consumers' countervailing power, provides owners with better information to help them govern their business more effectively, and incentivises management of regulated suppliers to improve their performance. Better information can facilitate comparisons with other regulated suppliers that may identify sources of best practice, or innovations that should be adopted. Requirements to disclose information may also generate useful information that would not have been collected in the absence of the disclosure requirements.[10]

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8 We note that the question of how well information disclosure is promoting the Part 4 purpose is different from how well the information disclosure requirements we have set are meeting the purpose of information disclosure regulation under s 53A. The purpose of ID is that sufficient information is readily available to assess whether the purpose of Part 4 is being met.

9 Including, for example, the incentives created by this s 56G review.

10 An example of this for airports is the new requirement to undertake customer surveys on quality. That has provided Wellington Airport with better information on quality that it would otherwise not have had.

2.7 The threat of further regulation incentivises suppliers to ensure their performance is consistent with the desired outcomes from workably competitive markets to avoid any direct limitations on their behaviour.

**Suppliers have incentives other than those provided by information disclosure**

2.8 Information disclosure regulation by itself is not expected to provide all the necessary incentives to promote the Part 4 purpose. Other features of Wellington Airport's operating environment create additional incentives and external pressures to improve performance in these areas. For example, Wellington Airport:

2.8.1 operates as a profit maximising entity. It therefore has an incentive to improve its efficiency and to innovate in order to maximise profits;

2.8.2 is subject to other regulatory requirements. For example, the Airport Authorities Act 1966 (AAA)[11] requires Wellington Airport to consult on large capex programmes with its major customers, and therefore encourages Wellington Airport to provide services at the quality consumers demand. Wellington Airport is also subject to minimum safety and security requirements that impact on quality; and

2.8.3 uses a building blocks model to set its revenue requirement. This creates incentives for Wellington Airport to achieve efficiency gains and outperform its expenditure forecast to earn higher profits.

**The effect of information disclosure regulation will vary for the different outcomes**

2.9 We expect the potential impact of information disclosure will vary between the different outcomes sought under Part 4. We also expect the time it takes for information disclosure regulation to have an effect on each of the Part 4 outcomes to vary.[12]

2.10 Information disclosure regulation is likely to have the greatest impact on Wellington Airport's incentives to earn excessive profits, and to share efficiency gains with its consumers. This is because of the relatively weak incentives on Wellington Airport in this area without regulation, and because information disclosure under Part 4 is particularly effective at highlighting issues in this area, which heightens the credible threat of further regulation.[13] It is also the area of performance that is most likely to

11 Refer s 4C of the AAA.

12 Attachments B to H outline our views on these matters for each area of performance.

13 This is particularly the case with information disclosure under Part 4 (compared to information disclosure under the AAA) 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.

There are several examples of industries which have responded to the threat of regulation through price cuts, for example see Glazer and McMillan, Pricing by the Firm under Regulatory Threat, Quarterly Journal lead to more heavy-handed regulation if the desired outcomes are not being achieved. Incentives from the threat of further regulation are therefore likely to be strongest in this area.[14]

2.11 In contrast, for example, information disclosure regulation is likely to have a relatively weak impact on incentives to innovate at Wellington Airport. This is because other incentives play a more important role in driving innovation, for example, incentives to maximise profits.

2.12 It is not a concern if information disclosure has a relatively weak effect on incentives in some areas as long as there are other incentives on Wellington Airport to promote the outcomes sought under Part 4, or Wellington Airport is already performing well in these areas. In these circumstances, the benefit of information disclosure is in allowing interested persons to assess whether these outcomes are being promoted. It is also important that information disclosure regulation does not provide disincentives in these areas.

2.13 We may therefore conclude that information disclosure is effectively promoting the purpose of Part 4 with respect to a particular area of performance, even if information disclosure regulation is having a limited impact on that outcome, on the basis that information disclosure is having as much of an impact as we reasonably expect it could have.

2.14 We expect the length of time it will take for information disclosure regulation to promote the different outcomes sought under the Part 4 purpose will also vary. In areas such as efficiency of expenditure and quality, information disclosure will have the greatest effect over time, as trends and comparative information become available to interested persons.[15] The effectiveness of information disclosure at limiting excessive profits can be seen more immediately. This is because:

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

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

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of Economics, August 1992 and Stango, Strategic Responses to Regulatory Threat in the Credit Card Market, Journal of Law and Economics, University of Chicago Press, vol. 46(2), pages 427-52, October 2003.

14 Price-quality regulation is typically applied for the purpose of limiting excessive profits. It is unlikely that, for example, price control would be considered as a solution to improve innovation or quality of service if profits were not considered excessive.

15 Trends are important because there is not necessarily an immediate benchmark available to assess performance.

## How we have assessed the impact of information disclosure regulation

### Is the Part 4 purpose being promoted by information disclosure regulation?

2.15 To understand how effectively information disclosure regulation is promoting the Part 4 purpose, we have assessed whether performance and conduct (behaviour) at Wellington Airport has moved closer to the outcomes sought by the Part 4 purpose and, if so, whether changes are likely to be attributable to information disclosure regulation.

2.16 In assessing performance we have asked ourselves the questions outlined in Table 2.1 above. The focus of some of the objectives in the Part 4 purpose is on suppliers having incentives. We consider the practical test of whether incentives are working to promote the long-term benefit of consumers is to consider actual performance in that area.[16]

2.17 We have also considered whether information disclosure has had an impact on Wellington Airport's conduct. The recent price-setting event is the most important element here. Other areas of conduct are also of relevance, for example ongoing conduct in relation to collaboration with airlines. This assessment has given insights into the likelihood of further performance improvement in relation to a specific outcome.

2.18 To assess how effectively information disclosure is promoting the Part 4 purpose we have therefore:

2.18.1 examined the performance (historical and projected) and conduct of Wellington Airport, both before and after the Part 4 information disclosure came into effect; and

2.18.2 assessed the extent to which this information disclosure has had an impact on Wellington Airport's performance and conduct.

### The role of input methodologies in our assessment

*Input methodologies provide a benchmark for assessing profitability*

2.19 The input methodologies we developed for airports in December 2010 in relation to cost allocation, asset valuation, the treatment of taxation, and the cost of capital are intended to promote certainty as to the rules, requirements, and processes applying to information disclosure regulation.

2.20 Airports are not required to apply the input methodologies in setting their prices although they must disclose information consistent with the input methodologies for

16 Where information disclosed by Wellington Airport relates to its forecast activities then the questions above have been considered in relation to whether performance is forecast to be achieved.

information disclosure purposes.[17] They thus form an important benchmark in enabling interested persons to assess whether the purpose of Part 4 is being met.[18]

2.21 We have found the input methodologies to be most relevant to the profitability assessment aspect of our review. This is because the input methodologies for asset valuation, taxation and cost allocation are inputs to the calculation of the return on investment that airports must disclose.

2.22 The cost of capital input methodology, which airports are not required to apply, then provides a basis for comparing what airports are earning against our view of the level of return that is appropriate for this type of business.

2.23 If an airport has not applied the input methodologies in setting its prices, we do not simply assume that this means that the Part 4 purpose is not being promoted. For example, a combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

2.24 Our assessment has therefore considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance.

*Where input methodologies are not available we have considered what would be expected in a workably competitive market*

2.25 In some areas of performance it is more difficult to assess the impact information disclosure regulation has had on the actual performance of airports as there are no relevant input methodologies (for example, for pricing efficiency or quality) and changes in performance or conduct may be attributable to external factors.

2.26 For those aspects of performance we have assessed Wellington Airport's performance based on what we might expect to find in a workably competitive market. We have been largely reliant on submissions received from interested parties as part of this review to assess whether information disclosure regulation has had an impact on these areas.

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17 Under s 4A of the AAA, airports may set charges (prices) as they see fit.

18 In their cross submissions on the Wellington Airport conference all parties acknowledged the relevance of the input methodologies in the s 56G review. Christchurch Airport "CIAL Cross Submission following Wellington Airport Conference" 17 August 2012, paragraph 9; Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, paragraphs 38-45; BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, pages 4-5; NZAA "Cross Submission on the Commerce Commission's Wellington Airport Conference held on 7 August 2012" 17 August 2012, paragraphs 18-32; Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraphs 48-57.

**Information used to examine performance**

2.27 We have relied on the information disclosed by Wellington Airport under Part 4 and the material provided by the parties during the s 56G consultation process to date to examine performance. Where relevant, we have also had regard to information disclosed under the regulatory regime in the AAA, and documentation shared between Wellington Airport and airlines during consultation on the recent price-setting event.

2.28 As we acknowledged in Chapter 1, information disclosure regulation under Part 4 has only been in place with effect since 1 January 2011 and the time-series of disclosed data is relatively short in some areas. Where we consider that more time is required in order to tell whether information disclosure is effective, or likely to be effective, in promoting an aspect of the purpose, we highlight that in this draft report.

# 3. Draft conclusions from our section 56G review

## Purpose of this chapter

3.1 This chapter sets out our draft conclusions on how effectively information disclosure regulation is promoting the Part 4 purpose for Wellington Airport and the key reasons why we have reached those conclusions.

## Summary of our draft conclusions

3.2 Our draft conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our s 56G review for Wellington Airport has found that information disclosure is effective in some areas, it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas. Of the three areas that we are unable to conclude on, only operating efficiency is an area of concern at this time.

3.3 We consider that, if it is effective, information disclosure should have its greatest impact in promoting the profitability based objectives in s 52A(1) and so its ineffectiveness at limiting excessive profits is of significant concern.

3.4 As a general matter, we consider that information disclosure has had a generally positive impact on the transparency of the recent consultation process on setting prices. Although Wellington Airport would have had to disclose price-setting information under information disclosure regulation once prices had been set, it opted to do so early on during consultation on new prices.

### Summary of draft conclusions in respect of each performance area

3.5 Information disclosure regulation is effectively promoting the Part 4 purpose in the following areas.

3.5.1 Innovation (s 52A(1)(a)). Our review has found that information disclosure has had limited impact on Wellington Airport's incentives to innovate, but this is not problematic because innovation levels appear to be appropriate.

3.5.2 Quality (s 52A(1)(b)). Our review has found that Wellington Airport appears to be providing quality at a level that reflects consumers' demands. Information disclosure has had a positive impact on Wellington Airport's performance and conduct in this area.

3.5.3 Pricing efficiency (s 52A(1)(b)). Our review has found that prices based on the pricing methodology for PSE2 are more likely promote efficiency than those previously in place. Information disclosure has had a positive impact on this outcome.

3.6 Information disclosure regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits (s 52A(1)(d)). We consider that Wellington Airport is earning an excessive return over time. We consider the excessive profits are attributable to:

3.6.1 Wellington Airport's use of its own asset valuation methodologies to revalue assets without fully accounting for the resulting revaluation gains in determining its revenue requirements; and

3.6.2 Wellington Airport having targeted the recovery of a cost of capital that exceeds the estimate provided by the input methodologies of the cost of capital that could be expected if it was subject to workable competition.

3.7 We are unable to conclude on the effectiveness of information disclosure in the following areas.

3.7.1 Operational expenditure (s 52A(1)(b)). We are unable to conclude on the effectiveness of information disclosure regulation in this area because the evidence of whether Wellington Airport is operating efficiently, or improving its operating efficiency, is mixed.

3.7.2 Investment (s 52A(1)(a)-(b)). It is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Information on actual investment over PSE2 is necessary before we can form a conclusion.

3.7.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). We are unable to conclude whether Wellington Airport is sharing the benefits of efficiency gains with consumers because it is too early to conclude whether there are any operating expenditure (opex) and capital expenditure (capex) efficiency gains that could be shared.

## How effectively is information disclosure regulation promoting the Part 4 purpose?

3.8 In the remainder of this chapter we set out how we have reached these draft conclusions. Further detail on our reasons and supporting analysis is provided in the attachments listed in Table 3.1.

**Table 3.1: Attachments to this report**

| | |
|---|---|
| Operational expenditure | B |
| Investment | C |
| Innovation | D |
| Quality | E |
| Sharing the benefits of efficiency gains | F |
| Pricing efficiency | G |
| Profitability | H and I |

3.9 The order of the attachments reflects the way we approached our analysis. We are unable to assess the effectiveness of information disclosure in promoting particular outcomes observed in workably competitive markets without first assessing outcomes in other areas. For example, we were not able to reach a draft conclusion on profitability without considering each of the other analytical areas.

**We are unable to conclude whether information disclosure is effectively promoting operating efficiency**

3.10 We are unable to conclude whether information disclosure regulation is effectively promoting the purpose of Part 4 in relation to improvements in Wellington Airport's operating efficiency as it is too early to assess meaningful trends in operational expenditure (opex) at Wellington Airport. The evidence of whether Wellington Airport is improving its operating efficiency is mixed.

3.11 Submissions to this s 56G review indicate that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's operating efficiency to date.[19] This limited impact may not be a concern because we would expect information disclosure to be as effective as it can be in this area over time, and Wellington Airport has incentives to operate efficiently to increase its profits.

3.12 However, increases in Wellington Airport's opex in recent years have raised concerns amongst some airlines that Wellington Airport may not be operating efficiently, or improving its operating efficiency. Our key findings on Wellington Airport's operating efficiency are mixed.

3.12.1 Unit opex (opex per passenger and per aircraft movement) increased during PSE1, and total opex was higher than forecast. This may indicate increasing inefficiency. However, Wellington Airport submitted that these increases in costs were largely outside its control and were unforeseen at the time opex was forecast. Excluding these unforeseen costs, Wellington Airport's opex was 1% lower than forecast over the previous 2008-12 pricing period (PSE1). However, it is not clear that this is an appropriate comparison.

3.12.2 Unit opex has increased at a faster rate at Wellington Airport than at Auckland and Christchurch Airports since 2006. This may indicate increasing inefficiency at Wellington Airport relative to these airports historically.

3.12.3 Unit opex is forecast to decline over PSE2, which could be a result of improvements in efficiency and/or economies of scale.

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[19] See for example, Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 181; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 20; Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 87.

3.12.4 Airlines have expressed concerns that Wellington Airport's recent and forecast opex is not efficient, and that its efficiency in PSE2 should be assessed relative to Wellington Airport's 2007 unit opex.

3.12.5 Wellington Airport is forecasting a similar decline in unit opex during PSE2 as Auckland Airport, which may indicate that these are reasonable levels of opex efficiencies to be made in the industry given the current operating environment.

3.12.6 Benchmarking data indicates that Wellington Airport has low unit opex relative to other airports in New Zealand and Australia. This suggests that Wellington Airport's opex may be efficient, but it is not clear to what extent this is due to differences in its operational circumstances, for example, differences in the number of international passengers processed.

**It is too early to tell whether information disclosure is effectively promoting efficient investment**

3.13 Our draft conclusion is that it is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Based on the available evidence on forecast investment for PSE2, information disclosure may be effectively promoting efficient investment at Wellington Airport. However, it is too early to conclude whether it is effective until we know whether the issue of timing of investment raised by airlines for PSE1 continues to raise concerns.

3.14 Submissions to this s 56G review indicate that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's investment efficiency to date.[20] We do not consider this to be a significant concern for the following reasons:

3.14.1 We expect information disclosure to become as effective as it can be at providing incentives to invest efficiently over time, when information on actual capex becomes available and interested persons can assess trends in forecast and actual expenditure.

3.14.2 Based on submissions from airlines to this review, the forecast levels of capital expenditure over the next pricing period appear prudent given current information. Few concerns were raised by airlines, particularly compared to PSE1.

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[20] See for example Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 181; Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 87.

3.14.3 Wellington Airport has some incentives to make investments efficiently once prices have been set for the five year pricing period, though there may also be incentives to over-invest and to delay investment inefficiently. Wellington Airport also has some incentives to invest efficiently as a result of the requirement under the AAA to consult on large capex projects, and the use of wash-up mechanisms for specific delayed capex projects.[21]

3.14.4 There is no evidence in submissions to this review that Wellington Airport is not undertaking necessary investments.

3.14.5 Wellington Airport submitted that its conduct suggests that it seeks to invest efficiently.

3.15 There have been significant concerns raised about investments that were planned for PSE1, before information disclosure under Part 4 took effect. These concerns were about the level of quality and timing of some investments. Airlines considered that the new international terminal development "The Rock" and the Runway End Safety Areas (RESAs) were at a quality that exceeded their needs. It is not clear whether passengers are willing to pay for this quality. Airlines have also expressed concerns that the timing of capex was not efficient. Given that these concerns relate to investment prior to information disclosure, we have not undertaken a detailed review of these investments to take a view on whether these concerns were justified.

3.16 It is possible that issues of this nature could recur in future and information disclosure under the AAA does not appear to have been effective at resolving such issues when they arise. At this time, it is unclear if information disclosure regulation under Part 4 will assist in resolving these issues.

**Information disclosure is effectively promoting innovation**

3.17 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Information disclosure is having a limited impact on incentives to innovate at Wellington Airport to date, but this is not a concern for the following reasons:

3.17.1 We expect that information disclosure regulation would have had a limited impact on innovation because other incentives play a more important role in driving innovation.

3.17.2 Wellington Airport has incentives to innovate so as to increase its profits and information disclosure does not appear to have negatively impacted on those incentives.

[21] The wash-up arrangement provides a pricing credit in the next pricing period if the project is delayed.

3.17.3 It appears that innovation at Wellington Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4. This view is based on the fact that submissions have not raised any substantive concerns as part of this s 56G review.

3.17.4 Innovation itself is not focused around the price setting events and collaboration on airline-led innovation appears most important to the airlines. Few concerns were raised by airlines about Wellington Airport's facilitation of airline-led innovation.

**Information disclosure is effectively promoting the provision of quality at a level that reflects consumers' demands**

3.18 Our draft conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Wellington Airport providing services at a quality that reflects consumers' demands. The key reasons for this are as follows:

3.18.1 Quality of service at Wellington Airport compares well against other airports. Our analysis of passenger satisfaction surveys indicates that the level of quality experienced by passengers at Wellington Airport is similar or better than at other airports in New Zealand and Australia. Similarly, our analysis of the level and duration of service interruptions suggests Wellington Airport is comparable with other airports.

3.18.2 Airlines appear to be generally satisfied with the quality of service provided at Wellington Airport - both before and after information disclosure under Part 4 was introduced. This is based on submissions from Wellington Airport and airlines to this s 56G review. Service quality at Wellington Airport is comparable with the quality of service provided at Christchurch and Auckland Airports.

3.18.3 The concerns that were raised relate to the price-quality trade off airlines wish to make. This was raised in respect of the air-bridges charge and in respect of investment into the new international terminal "The Rock" and the Runways End Safety Areas (RESAs). The main concern and perceived risk by airlines was Wellington Airport investing in too high quality.

3.18.4 Information disclosure has had a positive impact on Wellington Airport's performance and conduct in relation to quality. Wellington Airport has attributed the introduction of information disclosure under Part 4 to being partially responsible for improvements to customer surveys. In turn, feedback from the surveys has focused investment in improving customer experience. Passenger satisfaction levels have improved slightly since the introduction of information disclosure under Part 4.

**We are unable to conclude whether information disclosure is effectively promoting the sharing of efficiency gains with consumers**

3.19 Our draft conclusion is that we are unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers. This is because it is too early to conclude whether there are any opex and capex efficiency gains at Wellington Airport that could be shared with consumers.

3.20 Our key findings are:

3.20.1 there is limited evidence of historic and forecast efficiency gains at Wellington Airport that could be shared with consumers;

3.20.2 Wellington Airport's prices for PSE1 and PSE2 include any efficiency gains that are included in their expenditure forecasts and, all things being equal, will result in lower prices. However, it is not clear to what extent efficiency gains have been included in these forecasts, and therefore to what extent efficiency gains have been shared;

3.20.3 we have no evidence to suggest that Wellington Airport is sharing efficiency gains through re-investment in assets, increased output, or improved quality at no additional cost to consumers; and

3.20.4 as we cannot measure where Wellington Airport is achieving opex and capex efficiency gains at this time, we cannot assess the effectiveness of information disclosure in promoting the sharing of opex and capex efficiency gains with consumers.

**Information disclosure is effectively promoting pricing efficiency**

3.21 Our draft conclusion is that information disclosure is effectively promoting efficiency of pricing (referred to as 'efficient pricing'). Prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place.

3.22 Our analysis indicates that little consideration had been given to pricing efficiency in PSE1. For PSE2, Wellington Airport took greater consideration of pricing efficiency. For example, there was greater consideration of:

3.22.1 how pricing can ensure the optimal use of scarce facilities at Wellington Airport with the introduction of new charges to manage congestion; and

3.22.2 the price sensitivity of customers in designing price structures with prices being modified to reflect this.

3.23 Information disclosure has had a positive impact on this outcome. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure. This is consistent with the apparent changes between PSE1 and PSE2.

3.24 Airlines have raised concerns about the extent to which the revised pricing structure will promote efficiency and about Wellington Airport's volume growth incentive scheme. These concerns indicate that further improvements to promote efficiency could occur, in particular, in relation to price-quality trade-offs.

**Information disclosure is not limiting Wellington Airport's ability to earn excessive profits**

3.25 Our draft conclusion is that Wellington Airport is earning an excessive return over time and that information disclosure regulation is not effectively promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits.

3.26 The key reasons for this conclusion are as follows:

3.26.1 There has been no material change in Wellington Airport's approach to profitability targets since Part 4 information disclosure was introduced. Similar rates of return were targeted through prices in PSE1 and in PSE2 despite the estimates of the required cost of capital under the input methodologies falling between those periods.

3.26.2 Our analysis of historical and expected profitability suggests that Wellington Airport has extracted excessive profits in PSE1 and, on the basis of the prices set by Wellington Airport for PSE2, that excessive profits are expected to be extracted for the future.

3.26.3 There is no evidence of superior performance or other external conditions that would justify the existence of excessive profits. We consider the excessive profits are attributable to Wellington Airport's use of its own asset valuation methodologies to revalue assets without accounting appropriately for the resulting revaluation gains. Wellington Airport has also targeted the recovery of a cost of capital that exceeds the estimate of normal levels of returns provided by the cost of capital input methodology.

3.26.4 In our view, Wellington Airport is targeting returns in PSE2 that are well above a normal level. In light of this approach, and in the absence of adequate reasons for the level of excessive returns from Wellington Airport, the conclusion we draw is that information disclosure regulation has not affected the outcomes observed in respect of its profitability.

3.26.5 Finally, significant disagreement exists between Wellington Airport and its customers over the financial inputs to its price-setting decisions. While there has been increased transparency, the existence of Part 4 information disclosure regulation has not appeared to reduce the extent of disagreement as to price-setting outcomes. Against this background we are not confident that there is a likelihood of Wellington Airport's excessive profits being limited at PSE3 or beyond.

# 4. Next steps

## Purpose of this chapter

4.1 This chapter outlines the steps that we envisage will be involved in finalising our conclusions and reporting to the Ministers of Commerce and Transport.

## How you can provide your views

### We will hold a technical Q&A session on 14 November 2012

4.2 A spreadsheet containing the calculations and assumptions used for our profitability analysis contained in Attachment H has been released with this draft report. We will hold a session on 14 November 2012 to explain the calculations and assumptions contained in the spreadsheet and respond to questions from interested parties. We will advise parties of the arrangements for this session shortly.

### We welcome submissions from any interested parties by 30 November 2012

4.3 You are invited to provide your views on any aspect of this report, or any other issue that you think should be before us in reaching our final conclusions.

4.4 To allow sufficient time for us to consider your views before we finalise the report, all submissions should be provided to us by no later than 30 November 2012.

### We will provide an opportunity for cross submissions by 12 December 2012

4.5 We will provide an opportunity to cross submit once we have published submissions on our website. We expect cross-submissions will be due by 12 December 2012.

4.6 The purpose of cross-submissions is to identify where there are areas of disagreement between submitters and we ask that you focus your cross-submissions in this way. Where there is disagreement, it should be supported by evidence if possible.

### Address for providing your submissions and cross-submissions

4.7 We request all submissions be provided electronically in a format suitable for word processing. You should address your responses to:

> Dr Ruth Nichols (Project Manager, Section 56G Review)
> c/o regulation.branch@comcom.govt.nz

4.8 We intend to publish all submissions and cross-submissions on our website. If you wish for the published electronic copy to be 'locked' then we ask that you provide multiple versions of your submission. At least one version should be provided in a file format suitable for word processing, rather than a locked PDF file format.

**Guidance for parties that wish to provide confidential information**

4.9 While we discourage requests for non-disclosure of submissions, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We offer the following guidance.[22]

4.9.1 If it is necessary to include confidential material in a submission, the information should be clearly marked.

4.9.2 Both a clearly labelled confidential and public version of the submission should be provided.

4.9.3 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

22 Parties can also request that we make orders under s 100 of the Act in respect of information that should not be made public. Any request for a s 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

# Attachment A: Regulatory Framework

## Purpose

A1 This attachment sets out more detail on some of the matters covered in chapters 1 and 2 of this draft report, including responding to relevant submissions. In particular, it sets out the:

A1.1 key statutory provisions applicable to the three regulated airports;

A1.2 application of input methodologies to a s 56G review;

A1.3 relationship between information disclosure regulation under Part 4 and s 4A of the AAA; and

A1.4 scope, timing and process for the s 56G review.

## Key statutory provisions relevant to airports

A2 Specified airport services supplied by Auckland Airport, Wellington Airport and Christchurch Airport are subject to information disclosure regulation under subpart 11 of Part 4 of the Act. The subpart came into force on 14 October 2008 and prescribes:

A2.1 the scope of regulated services and the definition of “specified airport services” (s 56A), which are defined as:

A2.1.1 aircraft and freight activities (s 56A(1)(a));

A2.1.2 airfield activities (s 56A(1)(b));

A2.1.3 specified passenger terminal activities(s 56A(1)(c)); and

A2.1.4 any other services that are determined by the Governor-General, by Order in Council made on the recommendation of the Minister, to be specified airport services (s 56A(1)(d));

A2.2 arrangements for transition from the previous regulatory regime, namely the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 to the new regulatory provisions under the Act (s 56F);

A2.3 when the provisions take effect and the statutory timeframes for making section 52P determination specifying how information disclosure regulation applies to the regulated airports (s 56E); and

A2.4 monitoring responsibilities for the Commission, including a requirement to provide a one-off report to the Ministers of Commerce and Transport (s 56G).

A3 Each of the “specified airport services” set out in clause A2.1 above is defined in detail in section 2 of the AAA. These definitions are quite broad and include nonexhaustive lists of the types of activity that are considered to fall within each of these categories.

A4 In accordance with s 56E of subpart 11 and subpart 4 of the Act the Commission determined the “Commerce Act (Specified Airport Services Information Disclosure) Determination 2010” on 22 December 2010 (ID determination). The ID determination sets out the information disclosure requirements applying to the regulated airports.

A5 Section 56G states that the Commission must review the information disclosed under the information disclosure requirements that are in place under the Act and report to the Ministers on the effectiveness of information disclosure regulation. We must do this as soon as practicable after a supplier sets any new price for a specified airport service in or after 2012. Under s 56G(1) the Commission must:

> (a) review the information that has been disclosed by suppliers of specified airport services under subpart 4; and
>
> (b) consult (without necessarily holding an inquiry) with interested parties; and
>
> (c) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services.

## Application of input methodologies to the s 56G review

### Overview

A6 The input methodologies for regulated airport services provide a benchmark for assessing how effectively information disclosure regulation is promoting the purpose of Part 4 in a number of key performance areas, notably historic and forecast revenues and profits, and expenditure efficiency.

A7 As discussed in chapter 2, while it is accepted that there may be other avenues for promoting the purpose of Part 4 other than input methodologies, the purpose of setting the input methodologies is to provide certainty to regulated suppliers as to the tool the Commission will use in assessing the impact of information disclosure on the promotion of outcomes consistent with outcomes produced in workably competitive markets such that s 52A(1)(a) to (d) occur. We set out our detailed views below.

### Application of input methodologies to information disclosure

A8 We determined input methodologies for the regulated airport services on 22 December 2010. The Commission applied those input methodologies in making its information disclosure determination for airports. The information required to be disclosed includes a wide range of historic and forecast information and performance measures, covering both financial and non-financial matters.[23]

A9 Wellington Airport is required to apply all of those input methodologies, except the cost of capital input methodology when disclosing information under Part 4.[24] The Information Disclosure (Airport Services) Reasons Paper sets out when and how the Airports are required to apply the input methodologies, in particular:[25]

> When disclosing historical financial information, Airports are required to apply input methodologies for the valuation of assets (including depreciation and treatment of revaluations), the allocation of common costs, and the treatment of taxation. The Commission has also set an input methodology for Airports in relation to deriving the cost of capital. Airports do not, however, have to apply this input methodology when disclosing information, but the Commission may use the methodology in its summary and analysis reporting.[26]

A10 As is explained in the Airport Input Methodologies Reasons Paper, the matters covered by input methodologies in s 52T(1)(a) are most relevant to the disclosure of financial performance measures, as well as the financial statements and other information that supports those measures. The key historic financial performance measure airports must disclose is annual return on investment (ROI), which measures the supplier's regulatory profit relative to the regulatory investment on which that profit has been earned. (The ROI is discussed further in Attachments H and I.)

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23 Section s 53C(2) sets out the types of information that the Commission may require airports to disclose.

24 Section 53F(1).

25 Commerce Commission "Information Disclosure (Airport Services) Final Reasons Paper" 22 December 2010, paragraph X9.

26 The Commission's approach to applying the cost of capital input methodology reflects section 53F –

> 53F Limited exception to obligation to apply input methodologies
> (1) Despite section 52S, suppliers that are subject only to information disclosure regulation do not have to apply the following input methodologies in accordance with that section:
> (a) pricing methodologies:
> (b) methodologies for evaluating or determining the cost of capital.
> (2) However, to avoid doubt, subsection (1) does not affect anything else in this subpart, and in particular does not affect—
> (a) section 53B(2) (which means the Commission may use the input methodologies referred to in subsection (1) to monitor and analyse information); and
> (b) section 53C(2) (which means that suppliers may still be required to disclose information about the pricing methodologies, and methodologies for evaluation or determining the cost of capital, that they do in fact use).

## Application of input methodologies to the s 56G review

A11 Wellington Airport is not required to apply the input methodologies when undertaking any task other than disclosing information under Part 4. For example, it does not have to apply the input methodologies when setting prices. However, Wellington Airport is required to disclose its forecast revenues and prices, and the actual methodologies it used in determining those revenues and prices.

A12 It is the combination of disclosures of information based on input methodologies, and disclosures of actual and forecast information that the Commission uses in any assessment against the Part 4 purpose.

A13 In their cross-submissions on the Wellington Airport conference most parties acknowledged the relevance of the input methodologies in the s 56G review.[27] Further, Auckland Airport stated in its reply submissions to the High Court in the appeal under section 52Z on input methodologies, at page 2, para 2.4:[28]

> IMs are of distinct importance. In respect of airports, subject only to information disclosure, IMs determine whether information disclosure functions as intended (to ensure that sufficient information is readily available to interested persons) or applies with undue weight (akin to de facto price control). In at least the context of information disclosure the IMs, in substance, do the heavy lifting. They determine the key information required to be disclosed and the evaluative benchmark against which airports' returns, and the effectiveness of the regime, will be assessed.

A14 However, New Zealand Airports Association (NZAA) considers that:[29]

> ...whether or not IMs have been applied in pricing decisions is not a valid basis on which to assess the effectiveness of the ID Regime.

A15 Moreover, NZAA sets out how it considered input methodologies ought to be used in this review:[30]

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27 Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, paragraph 39; BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, paragraph 2; Christchurch Airport "CIAL Cross Submission following Wellington Airport Conference" 17 August 2012, paragraph 9; NZAA "Cross Submission on the Commerce Commission's Wellington Airport conference held on 7 August 2012" 17 August 2012, paragraph 8; Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 6.

28 *Auckland International Airport Limited v Commerce* Commission HC Wellington CIV 2011-404-000820, 3 September 2012, Reply Submissions for Auckland Airport in response to the Commerce Commission's Submissions dated 6 August 2012, 20 August 2012, paragraph 2.4.

29 NZAA "Cross Submission on the Commerce Commission's Wellington Airport conference held on 7 August 2012" 17 August 2012, paragraph 19.

> NZ Airports acknowledges that the IMs could have broader relevance to the Review. For example, the process and reasoning around an Airport's decision to apply or depart from an IM in pricing could provide good evidence of the influence that the ID Regime is having in practice. For example, the evidence would show that Airports are being rigorous and careful in explaining and justifying their approaches and assessing whether they are consistent with the Part 4 purpose statement. An important countervailing consideration is that the Commission must be open to considering expert advice as to why approaches adopted by Airports that are different to the IMs have been taken, and why those different approaches are appropriate in light of the Part 4 Purpose statement.
>
> ...
>
> ultimately, however, the focus for assessing the effectiveness of the ID Regime should be on the outcomes from airport decisions, not inputs...

A16 NZAA argued during the consultation that the assessment of the effectiveness of the ID Regime must be focussed on the outputs (ie, information disclosed), and that:[31]

> This is because what is important to an effective ID Regime is ensuring *transparency* so that the outcomes produced by Airports are fully scrutinised. Airports must also be transparent about the inputs they have in fact used. ...This approach best aligns with the purpose of the ID Regime, to ensure transparency of Airports' decisions and decision-making processes, together with the potential threat of further regulation.

A17 The purpose of input methodologies is set out in s 52R:

> to promote certainty for suppliers and consumers in relation to rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under [Part 4].

A18 We agree with NZAA in that the focus is on the outcomes. Indeed that focus informed the various questions on which we based our analytical framework, as discussed in chapter 2. What we are interested in is assessing whether those outcomes are evident, or at the very least that the opposite of those outcomes is not evident, in Wellington Airport's performance or conduct. We are also interested in assessing whether information disclosure regulation has had any impact on

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30 NZAA "Cross Submission on the Commerce Commission's Wellington Airport conference held on 7 August 2012" 17 August 2012, paragraphs 22 and 23(b).

31 NZAA "Cross Submission on the Commerce Commission's Wellington Airport conference held on 7 August 2012" 17 August 2012, paragraphs 25-26. This is supported by Wellington Airport's position in its "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, where they stated in paragraph 50: "As commented above the Commission agrees that the IMs are not required to be applied in pricing established under the AAA. This means that: The Commission should not seek to establish its own calculation of required revenue by substituting pricing inputs derived from the IMs for those applied by the airports. The Commission must recognise that if it were to take this approach it would be effectively applying a de facto price control calculation and the commercial arrangements or concessions applied by the airport would need to be excluded."

promoting such outcomes, acknowledging that we would expect information disclosure regulation to have more impact on some areas of performance than others, as discussed in chapter 2.

A19 We acknowledge that airports are not required to apply the input methodologies to their pricing. Rather, the input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks (eg asset valuation) should be specified to promote the Part 4 purpose. As such, the input methodologies are a tool the Commission can use in its analysis of both historic and forecast performance.

A20 This approach is reflected in s 53F, which explicitly allows us to use input methodologies for our s 53B summary and analysis reports. As much of the analysis and assessment required to be carried out by the Commission under ss 53B and 56G overlaps, it is therefore also logical to use the input methodologies in the assessment required under s 56G.

A21 As an example of the benchmark process, in assessing whether outcomes are being promoted such that airports are limited in their ability to earn excessive profits we need to form a view on what excessive profits would look like for the individual airport. To do this we apply our relevant input methodologies to get an estimate of a normal return and then consider whether such a return has been, and is likely to be, achieved (refer discussion in Attachment H). That normal return may have been (or may be forecast to be) achieved using or not using our input methodologies.

A22 As discussed above, airports are free to choose whatever methodology they like in undertaking their operations. What we are ultimately interested in is the outcome - whether airports are limited in their ability to extract excessive profits. For example, if an airport has not applied the input methodologies in setting its prices, we do not simply assume that this means that the Part 4 purpose is not being promoted. For example, a combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

A23 Our assessment has therefore considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance.

A24 We then take the results of that analysis and consider what, if any, impact information disclosure has had on that outcome.

A25 In summary, we agree with the views of submitters that each input methodology is not itself definitive. We do not agree, however, with any suggestion that input methodologies should not be applied to establish an overall performance benchmark or that such a benchmark is in any way contrary to the purpose the airports information disclosure regime is intended to achieve.

## The relationship between ID regulation under Part 4 and s 4A of the Airports Authorities Act 1996

A26 Section 4A(1) of the AAA provides that an airport subject to that statute may:

> set such charges as it from time to time thinks fit for the use of the airport operated or managed by it, or the services or facilities associated therewith.

A27 However this right needs to co-exist with the new Part 4 regime, evidenced by the inclusion of s 4A(4) which provides:

> This section does not limit the application of regulation under Part 4 of the Commerce Act 1986.

A28 The AAA provisions relating to charges are primarily concerned with ensuring that the decision making process for airport pricing is clear. In that context section 4A clarifies that, while airports are required to consult with their major customers in accordance with the AAA, the final decision as to charges rests with the airports, and the consultation process does not have the ability to prevent airports setting charges as they think fit.

A29 However, information disclosure regulation, while being light-handed, is still intended to promote the overall Part 4 purpose as set out in s 52A. Parliament's intention behind the adoption of this regime was to introduce regulation that would, among other functions, have an impact on airport's prices. That is clear from the structure of Part 4 – all forms of Part 4 regulation including ID, are intended to promote the Part 4 purpose, which includes promoting outcomes such that suppliers are limited in their ability to extract excessive profits. Further, when referring to the s 56G Review in its report on the Commerce Amendment Bill, the then Ministry of Economic Development (MED) stated:[32]

> It is expected that the knowledge of an impending review (combined with robust information disclosure) will influence the price setting by airports

A30 MED's response to issues raised by the Commerce Committee on the Bill also went on to state:[33]

> Officials remain of the view that the major airports should be covered in the Commerce Act. Considerations are: ...The major airports have strong natural monopoly characteristics. Absent effective regulation, airports are able to set prices as they see fit...

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32 Ministry of Economic Development "Commerce Amendment Bill: Report of the Ministry of Economic Development", 4 July 2008, page 52.

33 Ministry of Economic Development "Commerce Amendment Bill: Response to issues raised by the Commerce Committee", 23 July 2008, pages 5 and 50.

> ...Note however, that information disclosure, combined with annual analysis by the Commission and the requirements for a review, will impose some disciplines on pricing behaviour.

A31 So while airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. As such, we do not consider that s 4A of the AAA is incompatible with the ID regime as the two operate for distinct purposes, or that the Part 4 purpose is subordinate to s 4A.

## Scope, timing and process for the s 56G review[34]

### Scope of the review

A32 Under s 56G(1) the Commission must:

> (1) As soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service, the Commission must-
>
> (a) review the information that has been disclosed by suppliers of specified airport services under subpart 4; and
>
> (b) consult (without necessarily holding an inquiry) with interested parties; and
>
> (c) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services.

A33 The substantive part of the Commission's task under s 56G is to assess "how effectively information disclosure regulation under this Part is promoting the purpose in s 52A in respect of the specified airport services". This report is therefore an evaluation carried out by the Commission in accordance with s 56G.

A34 We have not carried out an assessment as to how effectively ID is promoting the purpose of Part 4 relative to other types of regulation provided for under Part 4. In our view the wording of s 56G(1)(c) is clear: the scope of this s 56G review does not extend to considering and recommending to the Ministers whether regulation other than ID should apply to the regulated airports. Consequently this report does not make any recommendations concerning changes to the current regulatory framework for Wellington Airport.[35]

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[34] We note that we have already responded to a number of submissions on the scope, timing and process of the review in our "Airports s 56G Update on Process and Scope" dated 27 July 2012. We have included this current section in our draft s56G report to confirm our position. As noted in our July paper parties are welcome to make further submissions on scope, timing and process at this point, including if they believe that anything material has changed since their previous submissions.

[35] Air New Zealand submitted that parallel reviews (eg, Commission inquiry, Ministry of Economic Development review) should be undertaken alongside the s 56G review to consider other types of regulation: Air New Zealand "Submission to the Commerce Commission; Commerce Act 1986, Part 4 –

A35 We note that parties have also raised the issue of including recommendations to regulate additional services, not currently regulated as specified airport services, in their submissions and during the Wellington Airport conference.[36] We do not consider that extending the definition of "specified airport services" under s 56A(1) is within the scope of the s 56G review. Section 56G is confined to the assessment of the ID regime as it currently stands. Therefore we have not considered this issue within this review.

**Timing of the review**

*The trigger for undertaking the s 56G review has been met*

A36 Section 56G provides that the trigger for the review is the setting of any new price “in or after 2012”:

> as soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service.

A37 This is further confirmed by the wording of s 56(1)(c) which is a guide to the overall aim of subpart 11, namely (emphasis added):

> for a review of the new regime **as soon as** any new price is set in 2012 for specified airport services.

A38 We therefore consider that the trigger for reporting to the Ministers has already been met, as Wellington Airport, Auckland Airport and Christchurch Airport have reset their prices in 2012.

A39 NZAA and the regulated airports submitted that it is too early to commence the s 56G reviews[37] for several reasons, proposing that the review be delayed:

A39.1 until further information from annual disclosures is available and there is sufficient time series data information;[38]

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Section 56G Review” 29 June 2012, paragraph 134. BARNZ submitted that s 56G gives the Commission scope to consider other types of regulation: BARNZ “BARNZ responses to Commerce Commission questions relating to process” 28 June 2012, pages 4-5.

36 BARNZ “BARNZ responses to Commerce Commission questions relating to process” 28 June 2012, pages 4- 5; Air New Zealand “Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review” 29 June 2012, paragraphs 117-119.

37 AIAL “Submission on the Commerce Commission’s Process and Issues Paper (Airport Services – Section 56G Reports)” 29 June 2012, paragraph 5; Christchurch Airport “Airport Services – Section 56G Reports: Process and Issues” 29 June 2012, paragraphs 3- 4; Wellington Airport “Initial submission to the Commerce Commission: Section 56G Process and Issues Paper” 29 June 2012, paragraph 8; NZAA “Submission on the Commerce Commission’s Process and Issues Paper: Airport Services – Section 56G Reports” 29 June 2012, paragraph 4.

A39.2 until summary and analysis reports are completed and published by the Commission in accordance with s 53B;[39] and

A39.3 until the completion of the merits appeals under s 52Z of the input methodologies published in January 2011.[40]

A40 We consider that the language in s 56G is not consistent with these reasons for delay. Each of these reasons is addressed in turn below.

*Data is available*

A41 Parties have raised in their submissions the difficulty in assessing the effectiveness of the ID regime given the lack of time series data[41] and the summary and analysis reports.[42] We acknowledge that the timing requirement of the s 56G review carries

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38 Airports submitted that the information required to make an assessment is not available at this time, and in particular the submissions note that there is insufficient time series data from annual disclosures and that any conclusions drawn about historical performance will be limited: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 4 and 19(b); AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph 6; Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 4.1; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraph 20.

39 Airports submitted that s 53B reports would provide valuable evidence for the review and improve the information available. Airports also submitted that s 53B could influence Airports' behaviour, even after the price setting event, and that they are an important part of the ID regime. Wellington Airport requested that the Commission expressly acknowledge in its reports the absence of s 53B(2) report and "the lack of opportunity for airports to engage in self-initiated behaviour change (if required)" in response to such a report: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 8(b)-(c), 17(a) and 18-24; AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 10(a) and 19(a); Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 7.3; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraphs 8-15.

40 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraph 17(b); AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph 19(c); AIAL "Section 56G Cross Submission" 20 July 2012, paragraph 42; Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 11.

41 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 4-6 and 19(b); AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph 6; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraph 20.

42 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 8(b)-(c), 17(a) and 18-24; AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 10(a) and 19(a); Christchurch Airport "Airport Services – Section 56G Reports: Process and

with it certain limitations as to the assessment being carried out. For example, the availability of a greater amount of time series data would enable a more robust assessment of some of the outcomes expected from the regime over a longer period of time.

A42 While we are not persuaded that the benefit of more data overrides the wording of s 56G, we acknowledge that a potential outcome of conducting the s 56G review now could be that it is too early to draw firm conclusions about the effectiveness of the information disclosure regime in relation to some of the intended Part 4 outcomes. Accordingly the conclusions drawn in this review reflect the level of data available.

*Relevance of Commission's s 53B summary and analysis reports to the s 56G Review*

A43 Parties have argued in their submissions and at the Wellington Airport conference that the availability of summary and analysis reports would have an impact on the effectiveness of the ID regime, and therefore the review should be delayed until such reports are completed and, as seems to follow, have been available long enough to have an impact on the conduct of airports.[43]

A44 As set out below, we acknowledge parties' submissions concerning the potential impact of the summary and analysis reports on airport conduct. However, we do not consider that availability of s 53B(2) reports is a prerequisite of the s 56G review.

A45 We noted in our Update Process Paper that while in the current circumstances the timing of the completion of the summary and analysis reports and the s 56G review overlaps, there is no requirement in the Act that sets out a chronological order for the two tasks, or that prescribes their interdependence, chronological or otherwise. As set out in the Process Update Paper: [44]

> Summary and analysis is intended to aid interested persons in understanding the performance of suppliers. The purpose of the s 56G report is to provide an *assessment* to the Minister *of the effectiveness* of information disclosure regulation in promoting the Part 4 purpose. Section 56G therefore goes beyond summary and analysis as it requires an assessment of not only the information disclosed but the effectiveness of the information disclosure regime on the promotion of the purpose in s52A(1).

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Issues" 29 June 2012, paragraph 7.3; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraphs 8-15.

43 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 8(b)-(c), 17(a) and 18-24; AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 10(a) and 19(a); Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 7.3; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraphs 8-15. Also see Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, pages 126-134.

44 Commerce Commission "Airports s 56G Update on Process and Scope" 27 July 2012, paragraph 28.

A46 We are therefore proceeding with the s 56G reviews now. It is not clear to us what impact the s 53B reports would in fact have on airport performance. As an example it is difficult to see any likely impact from our summary and analysis on pricing given that the price setting event for Wellington Airport has already occurred, and that Wellington Airport was aware of the input methodology benchmarks we would be applying at the time of setting prices. However, we welcome any further submissions on this point.

*Input methodologies merits appeals*

A47 We consider that waiting for the outcome of the input methodologies merits appeals could delay this review considerably, which would be contrary to Parliament's intention as to the timing requirement in s 56G. In particular, appeals are potentially available to parties through to the Supreme Court so the delay could be for some years. Moreover, s 53(2) is clear in stating that input methodologies currently in effect are applicable irrespective of any ongoing merits appeals:

> Section 52S continues to apply with respect to every input methodology published under section 52W until any appeal against the input methodology is finally determined.

A48 In our view this framework supports our approach to applying the current input methodologies as a benchmark in the s 56G review. We remain open to submissions from parties as to the particular impact the ongoing merits appeals have had on airports' conduct and the effectiveness of the information disclosure regime.

**Process for the review**

A49 The statutory process we must follow in undertaking this review is set out in paragraph A5 above. We have exceeded these minimum requirements and included various additional consultation steps. The following process has been adopted:

A49.1 review the information disclosed under Part 4 and the price setting consultation documentation;

A49.2 review the information disclosed in consultation during this review process and in response to any requests for information under our information-gathering powers under the Act;

A49.3 publish a Process and Issues paper and seek submissions and cross-submissions on the proposed process and scope of the review;

A49.4 publish an Updated Process paper responding to issues raised in submissions and cross-submissions;

A49.5 publish a preliminary issues paper for the Wellington Airport conference;

A49.6 hold a conference for Wellington Airport prior to preparing a draft report to ensure that we have all the relevant information, and to test the issues and ensure we understand any differences of opinion;

A49.7 seek cross-submissions on material discussed at the Wellington Airport conference;

A49.8 issue a draft report for Wellington Airport;

A49.9 seek submissions and cross-submissions on the Wellington Airport draft report. Once we receive submissions on the Wellington Airport draft report, we will also consider whether a further process steps and consultation is necessary before finalising our report to the Ministers; and

A49.10 prepare a final report for the Ministers.

*Separate reports for each airport*

A50 We consider that preparing a separate report to the Minister for each airport is the most appropriate interpretation of the s 56G task. This view takes into account that each airport's price setting decisions are occurring at different times, and that information disclosure regulation may be having a different impact across the three airports. This interpretation is also consistent with the trigger wording of s 56G which provides (emphasis added):

> As soon as practicable after any new price for a specified service is set in or after 2012 by a supplier of the service, the Commission must…

A51 We acknowledge that some parties have submitted in support of the Commission producing a single report to the Minister that covers all specified airport services.[45] We do not, however, accept that producing a single report is mandatory or that it would be more effective.

*Information the Commission may consider in undertaking the s 56G review*

A52 As discussed in our Process Update Paper the Act does not contain any explicit limitations on information that we may take into consideration when conducting our analysis of the effectiveness with which the purpose of Part 4 is, or is not, being promoted.[46] We note that the s 56G goes beyond a mere review of information disclosed, namely:

A52.1 it requires a review of the information disclosed (s 56G(1)(a)); and

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[45] Airports submitted that the appropriate approach is for the Commission to produce one report which assesses the effectiveness of the information disclosure regime in relation to all airports, and that all three airports should be reviewed at the same time: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 11 and 45-48; AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 21-23; Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 7.2.

[46] Commerce Commission "Airports s 56G Update on Process and Scope" 27 July 2012, paragraph 32.

A52.2 a report to the Minister comprising an assessment of how effectively the information disclosure regulation is promoting the purpose in section 52A (s 56G(1)(c)).

A53 The trigger for the review is the price setting event. To assess the effectiveness of information disclosure in promoting the purpose in that context, and also in the context of the wider airport sector performance, for example in terms of quality, the review explores a wider range of information than just the Part 4 disclosures.

A54 We have therefore reviewed the information disclosed by Wellington Airport, and have also sought further information in order to make a meaningful assessment of whether, and to what extent, information disclosure is promoting the Part 4 purpose.

A55 Parties raised concerns in their submissions that seeking additional information may pre-judge the outcomes of the review by pre-supposing that information disclosure is not effective.[47] We do not consider that the additional information sought in any way pre-judged the outcomes of the review; rather it clarified the disclosed material necessary to undertake this review and allowed the information disclosure regime to be assessed against an appropriate context.

47 NZAA submitted that, while Airports don't consider that the Commission is precluded from seeking and considering further information under s 56G, the information disclosed under the information disclosure regime should be sufficient for the review: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraph 12. Moreover, Airports have expressed a concern that seeking further information may pre-judge the outcomes of the review as this may signal that the information disclosure regime is not effective: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraph 50; AIAL "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph 43.

# Attachment B: Is Wellington Airport operating efficiently?

## Purpose

B1 This attachment summarises the analysis undertaken for this s 56G review to assess the effectiveness of information disclosure in promoting outcomes consistent with workably competitive markets such that Wellington Airport has incentives to improve operating efficiency (refer s 52A(1)(b) of the Act).

B2 Improvements in operating efficiency result from reductions in operational expenditure (opex), while still maintaining or increasing the quality and quantity of service provided. Opex efficiency gains may also result from an increase in quantity or quality for no additional opex. Opex is efficient when a supplier is operating with the lowest opex possible, while providing the quality and quantity of service demanded by consumers.

## Summary of draft conclusion

B3 We are unable to conclude whether information disclosure regulation is effectively promoting the purpose of Part 4 in relation to improvements in Wellington Airport's operating efficiency as it is too early to assess meaningful trends in opex at Wellington Airport. The evidence of whether Wellington Airport is improving its operating efficiency is mixed.

B4 Submissions to this s 56G review indicate that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's operating efficiency to date.[48] This limited impact may not be a concern because we would expect information disclosure to be as effective as it can be in this area over time, and Wellington Airport has incentives to operate efficiently to increase its profits.

B5 However, increases in Wellington Airport's opex in recent years have raised concerns amongst some airlines that Wellington Airport may not be operating efficiently, or improving its operating efficiency. Our key findings on Wellington Airport's operating efficiency are mixed:

B5.1 Unit opex (opex per passenger and per aircraft movement) increased during PSE1, and total opex was higher than forecast. This may indicate increasing inefficiency. However, Wellington Airport submitted that these increases in costs were largely outside its control and were unforeseen at the time opex was forecast. Excluding these unforeseen costs, Wellington Airport's opex

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48 See for example, Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 181; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 20; Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 87.

was 1% lower than forecast over PSE1. However, it is not clear that this is an appropriate comparison.

B5.2 Unit opex has increased at a faster rate at Wellington Airport than at Auckland and Christchurch Airports since 2006. This may indicate increasing inefficiency at Wellington Airport relative to these airports historically.

B5.3 Unit opex is forecast to decline over PSE2, which could be a result of improvements in efficiency and/or economies of scale.

B5.4 Airlines have expressed concerns that Wellington Airport's recent and forecast opex is not efficient, and that its efficiency in PSE2 should be assessed relative to Wellington Airport's 2007 unit opex.

B5.5 Wellington Airport is forecasting a similar decline in unit opex during PSE2 as Auckland Airport, which may indicate that these are reasonable levels of opex efficiencies to be made in the industry given the current operating environment.

B5.6 Benchmarking data indicates that Wellington Airport has low unit opex relative to other airports in New Zealand and Australia. This suggests that Wellington Airport's opex may be efficient, but it is not clear to what extent this is due to differences in its operational circumstances, for example, differences in the number of international passengers processed.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to improve its opex efficiency

B6 Wellington Airport has an incentive to operate efficiently to increase its profits. This incentive is strengthened by Wellington Airport fixing its prices for a five-year pricing period. This gives Wellington Airport an incentive to improve efficiency so as to outperform the opex forecast in its building blocks model (ie, have lower actual expenditure than forecast) and earn higher profits.

B7 These incentives to operate efficiently are weakened because of Wellington Airport's market power. For example, Wellington Airport sets its prices, in part, based on its forecast of opex. Wellington Airport has an incentive to set this forecast above an efficient level so as to earn higher profits by outperforming this opex forecast without necessarily being efficient.

### How information disclosure can provide incentives to improve operating efficiency

B8 Information disclosure may strengthen Wellington Airport's incentives to operate efficiently. The public disclosure of information on historic and forecast opex provides transparency about how well Wellington Airport is performing relative to other suppliers and over time. Over time it can highlight if Wellington Airport has over-forecast opex for the purpose of price-setting.

**We expect that information disclosure would have had a relatively limited impact at this stage**

B9 We expect that it will take a number of years for information disclosure regulation to be fully effective at promoting operating efficiency. That is because the effectiveness of information disclosure in this area is dependent on the availability of data to assess trends in expenditure, as well as to make comparisons with other airports. This information was not available at the time of consultation for PSE2.

**How we have assessed operating efficiency for the purpose of this review**

B10 We have analysed whether information disclosure regulation is effectively promoting operating efficiency at Wellington Airport by examining:

B10.1 whether Wellington Airport has outperformed its opex forecast for PSE1, and the reasons for any over or under performance;

B10.2 the efficiency of Wellington Airport's historic opex expenditure. As part of this, we have examined historic trends in Wellington Airport's unit opex for the period 2003-2012 and its unit opex relative to other airports;

B10.3 evidence of forecast improvements in opex efficiency in PSE2, and Wellington Airport's conduct in establishing this forecast.

B11 Our analysis considers Wellington Airport's performance and conduct both before and after the introduction of information disclosure regulation to gain an insight into the impact of information disclosure regulation on promoting incentives to improve opex efficiency.

B12 To help understand the efficiency of Wellington Airport's opex, we have explored two unit opex measures: opex per passenger and opex per aircraft movement. We consider these are appropriate measures of Wellington Airport's opex efficiency as they are likely to reflect some of the drivers of Wellington Airport's variable costs.[49] Wellington Airport also sets a number of its prices on a per passenger or per movement basis.

B13 A more detailed assessment of the reasons for the recent opex increases would be necessary at this time to conclude whether Wellington Airport's opex for PSE2 is at an efficient level. This includes a more disaggregated review of the different

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[49] The Australian Productivity Commission's assessment of the opex efficiency of Australian airports also considered opex per passenger, see Productivity Commission (Australia) "Economic Regulation of Airport Services" (Productivity Commission Inquiry Report, No. 57, 14 December 2011), page 45. Wellington Airport and BARNZ have submitted that opex per passenger is an appropriate measure of opex efficiency, for example see Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to Wellington Airport" 6 July 2012, paragraph 181; and BARNZ "BARNZ responses to Commerce Commission questions relating to Wellington Airport" 28 June 2012, page 15.

components of opex. Given that the specific concerns raised by the airlines will not have a significant impact on Wellington Airport's opex, we did not consider the costs of undertaking such a review were appropriate.

**Information used to assess opex efficiency at Wellington Airport**

B14 Our analysis uses quantitative and qualitative data from the following sources:

B14.1 information disclosed under Part 4 and the AAA;

B14.2 information published by the Australian Competition and Consumer Commission (ACCC);

B14.3 submissions received as part of this s 56G review; and

B14.4 the detailed opex forecasts provided in Wellington Airport's building blocks model for PSE2. This provides information on individual components of Wellington Airport's forecast expenditure at a more disaggregated level than is available in information disclosure.

B15 All currency values in this attachment are expressed in real 2012 terms unless otherwise stated.[50]

## Analysis of Wellington Airport's opex efficiency performance and conduct

### Did Wellington Airport outperform its opex forecast during the first pricing period?

B16 Wellington Airport's actual opex was higher than forecast during PSE1, including following the introduction of information disclosure regulation in 2011. Wellington Airport has attributed this to unforeseen costs. Excluding all of these costs would have resulted in actual opex 1% lower than forecast over the period 2007/08-2010/11, and may indicate it marginally outperformed its own opex efficiency assumption. However, it is not clear that this is an appropriate comparison.

B17 Actual opex exceeded forecasts in PSE1 by 16%. Wellington Airport has attributed much of the discrepancy to unforeseen costs.[51] These unforeseen costs include:[52]

B17.1 building utility expenditures which increased due to the reallocation of expenditures from its non-aeronautical to the regulated part of business;

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50 We have calculated real values using the Statistics New Zealand consumer price index (CPI).

51 Wellington Airport "Specified Airport Services Information Disclosure Requirements Information Templates for year ending 31 March 2011" 31 March 2012, pages 13-14.

52 Wellington Airport "Specified Airport Services Information Disclosure Requirements Information Templates for year ending 31 March 2011" 31 August 2011; Wellington Airport "Specified Airport Services Information Disclosure Requirements Information Templates for year ending 31 March 2012" 31 August 2012.

B17.2 increased remuneration costs as a result of one-off costs from restructuring within the company and the additional staff needed to provide extra aeronautical functions;

B17.3 new costs as a result of the implementation of ID regulation;

B17.4 increases in insurance premiums; and

B17.5 increases in local council rates.

B18 Together, these costs accounted for much of the variance between actual and forecast opex in PSE1.[53] It is likely that some of these cost increases were within the control of Wellington Airport, for example, the increased remuneration costs. Other costs are not wholly within Wellington Airport's control. For example, increases in local council rates and insurance premiums have been observed in other sectors. Airlines have expressed concern about the appropriateness of Wellington Airport's historic regulation costs, which include litigation costs associated with the input methodologies applicable to information disclosure regulation.[54]

**Was Wellington Airport's opex efficient in the first pricing period?**

B19 We have insufficient detailed information on Wellington Airport's opex and the drivers of its opex to conclude whether Wellington Airport's opex was efficient historically. However, we observed:

B19.1 Wellington Airport's unit opex increased over PSE1. This may indicate increasing inefficiency at Wellington Airport, although it may also be a result of increases in costs that are outside Wellington Airport's control, potentially including the unforeseen costs discussed above. Unit opex was forecast to increase over PSE1, although not to the same extent as occurred; and

B19.2 Wellington Airport has low unit costs relative to other airports, but the reasons for this are unclear.

B20 To understand whether Wellington Airport's opex was efficient during PSE1 we have examined historic trends in unit opex at Wellington Airport, as well as its unit opex relative to other airports.

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53 Wellington Airport has not provided detailed information on the difference between actual and forecast opex for the 2012 disclosure year.

54 See for example, Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 78.

*Historic trends in unit opex*

B21 Figure B1 and Figure B2 shows that unit opex increased over PSE1, including following the introduction of ID regulation in 2011. It also shows that unit opex has increased by more than was forecast during PSE1.

**Figure B1: Opex per passenger (2003-12)**

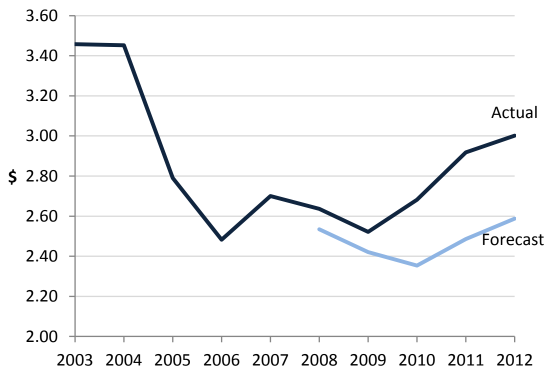
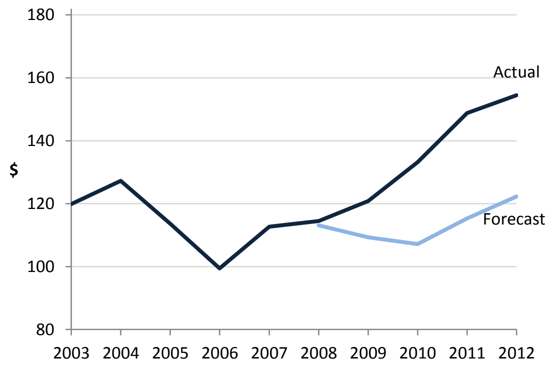



**Figure B2: Opex per aircraft movement (2003-12)**




Notes: Our analysis uses information disclosed by Wellington Airport as part of the AAA regime for the period 2003-2010. We have adjusted this opex to exclude subvention payments (payments relating to the transfer of profits from a profitable company to a loss-making company) and consider this data to be approximately comparable with opex reported under ID. Dollars shown in real (2012) value.

Sources: Wellington Airport “Identified Airport Activities Disclosure Financial Statements” 2004-2010; Wellington Airport “Specified Airport Services Annual Information Disclosure” 2011-2012.

*Comparisons of unit opex*

B22 In comparison with seven other New Zealand and Australian airports, Wellington Airport’s operating expenditure is lower on both per passenger and per movement measures, as shown in Figure B3 and Figure B4. Opex per passenger and per aircraft movement at Wellington Airport has been lower than at Auckland and Christchurch Airport throughout PSE1. This may indicate that Wellington Airport is relatively efficient. It may also be due to the differences in its operational circumstances, for example, differences in the international passenger ratio, which means Wellington Airport could have lower expenditure without being more efficient. At this stage, due to limited understanding and data on these differences, we cannot provide more detailed comparisons. Submissions have not provided insight as to the reasons why opex measures at Wellington Airport are lower than that of other major airports.

**Figure B3: Opex per passenger (2011)**

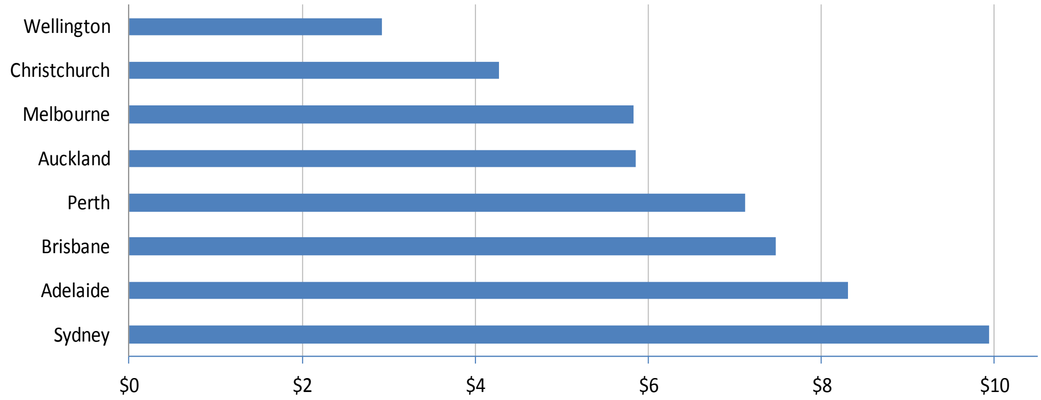
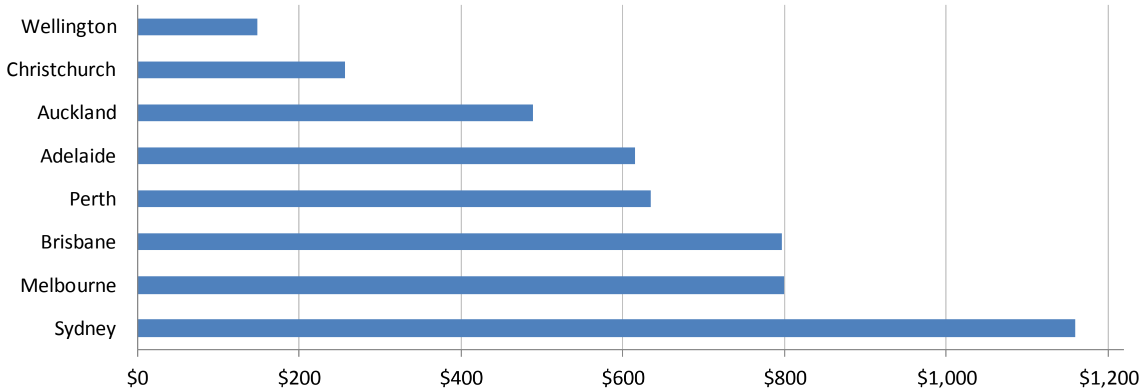



**Figure B4: Opex per aircraft movement (2011)**




Notes: 2011 data is the most recent we have available for all the airports. Australian currency converted to New Zealand currency based on a rate of $NZ1 = $A0.775.

Sources: Wellington Airport “Specified Airport Services Annual Information Disclosure for year ending 31 March 2011”, 31 March 2012; Christchurch Airport “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011, 31 May 2012; Auckland Airport, “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011”, 17 May 2012; ACCC “Airport Monitoring Report 2010-11: Price, Financial Performance and Quality of Service Monitoring”, March 2012.

B23 As shown in Figure B5 and Figure B6, unit opex at Wellington Airport has increased historically at a slightly faster rate than at Auckland Airport, while unit opex at Christchurch Airport has declined. Between 2006 and 2010, opex per passenger increased by 8% at Wellington Airport, 4% at Auckland Airport, and decreased by 24% at Christchurch Airport. Meanwhile, opex per aircraft movement increased by 34% at Wellington Airport and 21% at Auckland Airport, and fell by 7% at Christchurch Airport. This analysis excludes the impact of the Canterbury earthquakes.[55] Between 2006 and 2011, opex per passenger increased by 18% at Wellington Airport and 17% at Auckland Airport, while opex per aircraft movement

[55] Based on analysis of information provided in the AAA and Part 4 information disclosures.

increased by 50% and 40% respectively.[56] This may indicate increasing inefficiency at Wellington Airport relative to these airports historically.

**Figure B5: Opex per passenger at Wellington, Auckland and Christchurch Airports (2006-11)**

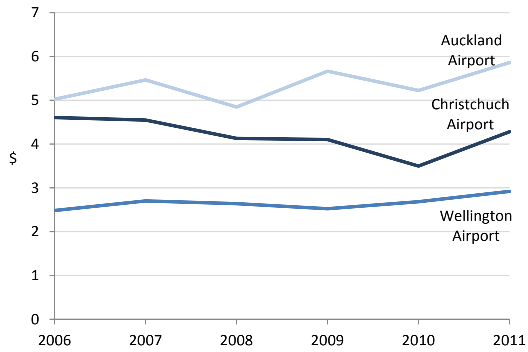
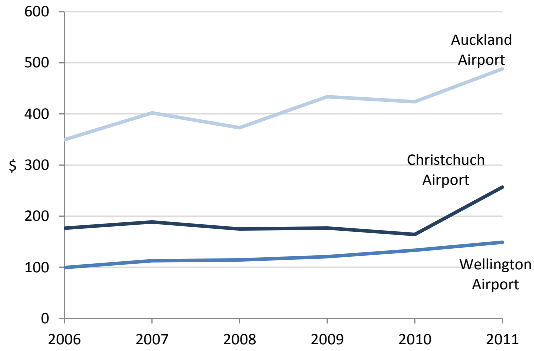



**Figure B6: Opex per aircraft movement at Wellington, Auckland and Christchurch Airports (2006-11)**




Notes: 2012 data not available for Auckland and Christchurch Airport at the time of publication. Dollars shown in real (2012) value.

Sources: Wellington Airport “Identified Airport Activities Disclosure Financial Statements” 2004-2010; Christchurch Airport “Identified Airport Activities Disclosure Financial Statements” 2004-2010; Auckland Airport “Identified Airport Activities Disclosure Financial Statements” 2004-2010; Wellington Airport “Specified Airport Services Annual Information Disclosure for year ending 31 March 2011”, 31 March 2012; Christchurch Airport “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011, 31 May 2012; Auckland Airport, “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011”, 17 May 2012.

### Did Wellington Airport's opex forecast for the second price setting event indicate reasonable future efficiency gains?

B24 Wellington Airport has forecast a decrease in the unit opex over PSE2. This appears to be partly due to forecast decreases in expenditure on overheads, and the presence of economies of scale at Wellington Airport.[57] It may also be a result of improving efficiencies at Wellington Airport, although unit opex is forecast to remain at a higher level than observed historically. We are unable to separately identify the impact of these different factors.

B25 The presence of economies of scale may be partly attributed to efforts by Wellington Airport to increase passenger volumes through the volume growth incentive scheme, as well as organic growth and efforts by airlines to increase passenger volumes.

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[56] 2011 data for Christchurch Airport is not comparable due to the impact of the Canterbury earthquakes.

[57] Economies of scale are the result of a decrease in average costs resulting from an increase in total volumes. This reflects the recovery of fixed costs from a greater number of consumers.

There is disagreement from airlines about the extent to which the forecast increased volumes are a result of this scheme. [58]

B26 To assess whether Wellington Airport's opex forecast for PSE2 indicates reasonable future efficiency gains, we have:

B26.1 considered forecast trends in unit opex at Wellington Airport, including relative to unit opex in PSE1;

B26.2 benchmarked Wellington Airport's forecast unit opex in PSE2 relative to Auckland Airport's forecast expenditure in the same period;[59]

B26.3 examined Wellington Airport total opex forecast, and the drivers of any increases in this expenditure.

*Forecast trends in unit opex*

B27 Figure B7 and Figure B8 show that opex per passenger and opex per aircraft movement is forecast to decline over the pricing period to below the 2012 level.[60] However, unit opex is forecast to remain at a higher level than actual unit opex in PSE1 prior to 2011, and forecast unit opex throughout PSE1. Unit opex is also forecast to start at a higher level than observed in 2012.

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58 BARNZ “BARNZ Post Conference Submission on Wellington Airport Section 56G Review” 17 August 2012, page 19.

59 At the time of publication, equivalent data for Christchurch Airport was not available.

60 Analysis of unit opex for the three categories of opex disclosed in ID (asset maintenance, asset management and operations, and overheads) indicates that unit opex is forecast to increase for asset maintenance and asset management and operations, but to decrease for overheads expenditure.

**Figure B7: Opex per passenger (2008-2017)**

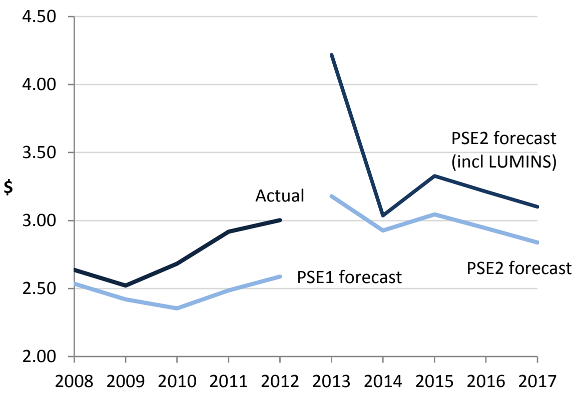
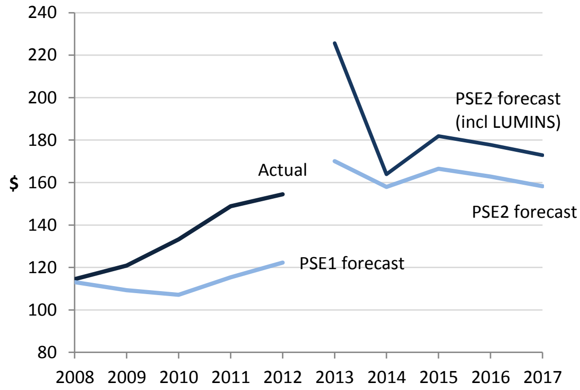



**Figure B8: Opex per aircraft movement (2008-2017)**




Notes: Forecast unit opex shown including and excluding noise mitigation expenditure for comparability with PSE1, as this is an additional cost for PSE2. Dollars shown in real (2012) value.

Sources: Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2006-2010; Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011-2012; Wellington Airport "Wellington International Airport Limited: Price setting event disclosure", 30 April 2012.

B28 BARNZ submitted that it considered an efficient level of opex for PSE2 would be equivalent to opex per passenger in 2007. This level appears to be based on the information available at the time of consultation, rather than a detailed consideration of what an efficient level of opex is.[61] This equates to approximately a 10% reduction relative to forecast opex over PSE2. This would result in an average decrease in opex of $1.6m per year over the pricing period, or $7.9m over PSE2.

*Comparison of forecast opex with Auckland Airport*

B29 Auckland Airport and Wellington Airport are both forecasting similar reductions in opex per passenger (11%) and opex per movement over the pricing period (1%).[62] This may indicate that Wellington Airport's forecast reductions in unit costs are reasonable. Furthermore, opex per passenger is forecast to be lower at Wellington Airport relative to Auckland Airport throughout the pricing period. However, as discussed in paragraph B22, these differences in the level of unit costs may be due to differences in operational circumstances, and it is therefore not clear whether the forecast efficiencies are reasonable.

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61 BARNZ clarified at the Wellington Airport Conference that 2007 was chosen as an appropriate year as this was the last year they had actual opex per passenger for the airport pricing models. See Commerce Commission, *Transcript of Wellington Airport Section 56G Conference,* held on 7 August 2012, page 77.

62 Information for Christchurch Airport was not available at the time of publication.

*Total forecast opex*

B30 Wellington Airport's total opex is forecast to increase by 19% ($13m) (excluding noise mitigation costs) over PSE2, relative to opex in PSE1. Despite this increase, as discussed above, unit opex is forecast to decrease.

B31 The forecast decline in unit costs appears, in part, to be attributable to the high fixed costs at Wellington Airport and the forecast increase in passenger and aircraft volumes. This has resulted in Wellington Airport operating at a level that means there are economies of scale.[63] The extent to which economies of scale have arisen from efforts by Wellington Airport to increase volumes while managing costs is unclear. However, BARNZ disagree with Wellington Airport about the extent to which the forecast growth in volumes is a result of Wellington Airport's volume growth incentive scheme.[64] Economies of scale may also arise from organic growth or efforts by airlines to increase passenger volumes.

B32 Airlines have submitted that aspects of Wellington Airport's forecast opex do not represent efficient costs. We note that neither of these specific areas of concern raised will have a significant impact on Wellington Airport's opex.

B32.1 Wellington Airport has forecast an increase in remuneration costs arising from the employment of additional staff to provide gate allocation services. The airlines submitted that the increased opex as a result of the three additional employees to provide gate allocation services is not appropriate.[65] This accounts for around 1% of Wellington Airport's total forecast opex; and

B32.2 Wellington Airport is forecasting a reduction in airport overheads. Airlines do not consider this reduction to be sufficient as it includes the litigation costs associated with information disclosure regulation and the associated input methodologies.[66] Total "consultation and regulatory expenditures", under which litigation costs are classified, will comprise 3% of Wellington Airport's total forecast opex over PSE2, and it is therefore unlikely that litigation expenditures on their own will have a significant impact on prices at Wellington Airport.

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63 This means that average opex declines as passenger and aircraft volumes increase.

64 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 19.

65 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference,* held on 7 August 2012, pages 80-81.

66 They submitted that this is a discretionary cost to Wellington Airport . See BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 14.

**Does Wellington Airport's conduct indicate that it seeks to improve efficiency?**

B33 Submissions have suggested that Wellington Airport's conduct does not indicate that it seeks to improve its efficiency. BARNZ submitted that they consider operational expenditure prior to 2007 and forecast operational expenditure for PSE1 showed commendable restraint, however, they suggest that opex efficiency is no longer a priority at Wellington Airport.[67] Air New Zealand agreed with this statement.[68] BARNZ also did not consider there was effective consultation on opex, stating that "if we ever try and get into specifics [of the opex forecast] we get into the argument, are you trying to micro manage our airport...".[69]

B34 Wellington Airport submitted that it has provided customers with detailed expenditure forecasts for the last several pricing periods, and made changes to its forecasts following feedback from airlines. They also submitted that the airlines did not identify any specific cost areas where they considered Wellington Airport was not exhibiting inefficient behaviour. [70]

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67 BARNZ “BARNZ responses to Commerce Commission questions relating to WIAL” 28 June 2012, pages 14-15.

68 Air New Zealand “Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review” 29 June 2012, paragraph 219.

69 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 79.

70 Wellington Airport “Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to Wellington Airport” 6 July 2012, paragraphs 181 - 184.

# Attachment C: Is Wellington Airport investing efficiently?

## Purpose

C1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport has incentives to invest and improve the efficiency of its investment (refer s 52A (1)(a) and (b)).

C2 Efficient investment is the investment in assets at the lowest possible cost over the lifetime of the assets, while delivering the required level of quality or output which is valued by consumers.

## Summary of draft conclusion

C3 Our draft conclusion is that it is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Based on the available evidence on forecast investment for PSE2, information disclosure may be effectively promoting efficient investment at Wellington Airport. However, it is too early to conclude whether it is effective until we know whether the issue of timing of investment raised by airlines for PSE1 continues to raise concerns.

C4 Submissions to this s 56G review indicate that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's investment efficiency to date.[71] We do not consider this to be a significant concern for the following reasons.

C4.1 We expect information disclosure to become as effective as it can be at providing incentives to invest efficiently over time, when information on actual capex becomes available and interested persons can assess trends in forecast and actual expenditure.

C4.2 Based on submissions from airlines to this review, the forecast levels of capital expenditure over the next pricing period appear prudent given current information. Few concerns were raised by airlines, particularly compared to PSE1.

C4.3 Wellington Airport has some incentives to make investments efficiently once prices have been set for the five year pricing period, though as we note

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71 See for example Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 181; Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 87.

below, there may also be incentives to over-invest and to delay investment inefficiently. Wellington Airport also has some incentives to invest efficiently as a result of the requirement under the AAA to consult on large capex projects, and the use of wash-up mechanisms for specific delayed capex projects.[72]

C4.4 There is no evidence in submissions to this review that Wellington Airport is not undertaking necessary investments.

C4.5 Wellington Airport submitted that its conduct suggests that it seeks to invest efficiently.

C5 There have been significant concerns raised about investments that were planned for PSE1, before information disclosure under Part 4 took effect. These concerns were about the level of quality and timing of some investments. Airlines considered that the new international terminal development "The Rock" and the Runway End Safety Areas (RESAs) were at a quality that exceeded their needs. It is not clear that whether passengers are willing to pay for this quality. Airlines have also expressed concerns that the timing of capex was not efficient. Given that these concerns relate to investment prior to information disclosure, we have not undertaken a detailed review of these investments to take a view on whether these concerns were justified.

C6 It is possible that concerns of this nature could recur in future and information disclosure under the AAA does not appear to have been fully effective at resolving such issues when they arise. At this time, it is unclear if information disclosure regulation under Part 4 will better resolve these issues.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to invest efficiently

C7 Wellington Airport has some incentives to invest efficiently. Wellington Airport fixes its prices for a five-year pricing period. Fixing its prices provides Wellington Airport with an incentive to invest efficiently so as to outperform the capex forecast in its building blocks model (ie, have lower actual expenditure than forecast), and therefore earn higher profits. Under s 4C of the AAA Wellington Airport is also required to consult on large capex programmes with its substantial consumers.

C8 Some of these incentives to invest efficiently are weakened because of Wellington Airport's market power. For example:

C8.1 Wellington Airport has an incentive to set its capex forecast above an efficient level, to justify higher prices through its building blocks approach,

72 The wash-up arrangement provides a pricing credit in the next pricing period if the project is delayed.

allowing it to then earn higher profits by outperforming this forecast without necessarily being efficient.

C8.2 Wellington Airport may choose to defer investment beyond the point at which it is efficient to invest so as to reduce its costs within the pricing period. Wellington Airport may also choose to forecast investment earlier in the pricing period than would likely occur. Where the timing of investment differs from the forecast used to set prices, Wellington Airport may earn higher profits.

C8.3 Under the building blocks model that it uses to set prices, Wellington Airport's prices are based on the size of its asset base. If it is targeting the recovery of an excessive cost of capital on its asset base, it has an incentive to over-invest to increase the size of its asset base. This is because it would earn higher profits if the targeted cost of capital on that investment exceeds the economic cost of financing the investment.

**How information disclosure can provide incentives to improve investment efficiency**

C9 Information disclosure strengthens Wellington Airport's incentives to invest efficiently. The public disclosure of information on historic and forecast capex provides transparency about how well Wellington Airport is performing relative to other suppliers and over time. Over time it can highlight if Wellington Airport over-forecasts capex or forecasts capex to occur too early in the pricing period for the purpose of price-setting.

*We expect that information disclosure will be most effective over time*

C10 We expect information disclosure regulation to become as effective as it can be in promoting efficient investment over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends, and the opportunity for suppliers and consumers to react to the information disclosed. At the time of consultation for PSE2, only limited information on Wellington Airport's capex was available in ID.

**How we have assessed whether Wellington Airport is investing efficiently**

C11 Our approach to assessing investment for this review is to consider Wellington Airport's performance and conduct regarding investment. We have looked for evidence of:

C11.1 the delivery of capex at lowest possible cost, without compromising quality or outputs and delivering the desired outcome. As part of this we have reviewed the actual and forecast capex of Wellington Airport in PSE1;

C11.2 planned under-investment and over-investment; and

C11.3 planned and actual investment occurring at an appropriate time.

C12 We have also considered the conduct of Wellington Airport when planning and delivering capital projects.

C13 We consider that the efficiency of forecast investments should be judged based, in part, on the information available at the time the decision was made to invest. An analysis of actual capital expenditure can also assist with an assessment of the efficiency of investment.

C14 Given the relatively low level of concern from the airlines about Wellington Airport's capex forecast for PSE2, we have not undertaken a detailed review of their capex forecasts and supporting business case. We did not consider the costs of undertaking such a review were appropriate to address relatively minor concerns with Wellington Airport's capex forecast. Our analysis therefore relies on submissions received as part of this s 56G review.

### Information used to assess whether Wellington Airport is investing efficiently

C15 Our analysis uses quantitative and qualitative data from the following sources:

C15.1 information disclosed under Part 4; and

C15.2 submissions and other material generated as part of this s 56G review.

## Analysis of Wellington Airport's investment performance and conduct

### Is Wellington Airport investing efficiently?

C16 Wellington Airport's capex was higher than forecast in PSE1. This appears to be attributable largely to the impact of asset transfers (included in 'other' capex) and the unplanned construction of the Western Hangar, rather than inefficiencies.[73] As discussed further below, airlines have expressed concerns that capex on 'The Rock' and the RESAs was inefficient as it reflected over-investment. Table C1 shows that these projects also exceeded their forecast. At this time, we do not have actual expenditure information for PSE2 to assess the effectiveness of information disclosure in promoting the efficient delivery of capex.

**Table C1: Forecast and actual capex at Wellington Airport (2007-12) ($m)**

| Capex program | 2008 | 2009 | 2010 | 2011 | 2012 | Total difference from forecast (2008-12) |
|---|---|---|---|---|---|---|
| **South RESA** | | | | | | **-0.9** |
| Forecast | 2.6 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Actual | 1.7 | 0.4 | -0.6 | 0.3 | 0.0 | |
| **North RESA** | | | | | | **2.1** |

73 Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012" 31 August 2012, Schedule 6.

| | | | | | | |
|---|---|---|---|---|---|---|
| Forecast | 5.7 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Actual | 2.6 | 4.0 | 0.6 | 0.5 | 0.0 | |
| **Northern pier (eastern gate)** | | | | | | **1.2** |
| Forecast | 4.5 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Actual | 5.7 | 0.0 | 0.0 | 0.0 | 0.0 | |
| **Northern pier (terminal and western gate, including 'The Rock')** | | | | | | **1.9** |
| Forecast | 14.6 | 19.1 | 0.0 | 0.0 | 0.0 | |
| Actual | 4.6 | 2.7 | 9.8 | 17.7 | 0.8 | |
| **Airfield pavement maintenance** | | | | | | **2.8** |
| Forecast | 1.9 | 1.7 | 7.3 | 2.1 | 0.9 | |
| Actual | 1.1 | 4.9 | 7.2 | 2.1 | 1.5 | |
| **Western hangar** | | | | | | **7.7** |
| Forecast | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Actual | 0.0 | 0.0 | 0.0 | 0.0 | 7.7 | |
| **Other capex** | | | | | | **24.2** |
| Forecast | 1.7 | 1.9 | 3.7 | 4.2 | 2.4 | |
| Actual | 3.0 | -5.2 | 33.4 | 0.4 | 6.4 | |
| **Total** | | | | | | **39.0** |
| Forecast | 31.0 | 22.7 | 11.0 | 6.3 | 3.3 | |
| Actual | 18.6 | 6.8 | 50.4 | 21.0 | 16.4 | |

Note: Figures reported in $m (nominal values). Negative capex values indicate a transfer of assets out of the regulated asset base in that year.

Sources: Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2011" 31 March 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012" 31 August 2012; Wellington Airport "WIAL response (25 July 2012) to Commerce Commission queries on price setting event disclosure for the pricing period 1 April 2012 to 31 March 2017", 25 July 2012.

C17 Airlines have raised concerns that Wellington Airport forecasts have included some over-investment, but otherwise consider its forecast capex for PSE1 and PSE2 to be reasonable.[74] Their key concerns are as follows.

[74] Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 45.

C17.1 Airlines submitted that the specification of 'The Rock' international terminal is higher quality than is necessary for an airport terminal.[75] Wellington Airport has responded that actual capex for 'The Rock' was $28.3m, within BARNZ's suggested range of $24m to $29m.[76]

C17.2 BARNZ submitted that the tunnels forming part of RESAs have been constructed to accommodate aircraft that are not likely to operate at Wellington Airport.[77] BARNZ submitted that this led to an additional $5m of capex on the RESAs.[78] This accounts for around 7% of the forecast capex over PSE1. Wellington Airport has submitted that this investment was necessary as a result of changes in CAA regulatory requirements.[79]

C17.3 BARNZ submitted that the forecast taxiway works are above the level required given the type of aircraft that generally use the runway.[80] Wellington Airport responded that the forecast taxiway works during PSE2 are required to meet minimum standards set by the International Civil Aviation Organisation (ICAO).[81] The taxiway accounts for around 15% of forecast capex in PSE2, and 14% of forecast capex for the period 2013-2022.

C18 The airlines have not indicated any concerns about under-investment by Wellington Airport. They are more concerned with the risk of over-investment as a result of the profit-maximising incentives at Wellington Airport (combined with the building blocks methodology).[82]

C19 Airlines have raised concerns that Wellington Airport forecasts capital expenditure earlier in the regulatory period than the investment is likely to occur so as to earn

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75 Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, page 28.

76 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page24.

77 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 6.

78 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 18.

79 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 174.

80 BARNZ "BARNZ responses to Commerce Commission questions relating to Wellington Airport" 28 June 2012, page 13.

81 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, pages 29-30.

82 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 13; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 45.

higher profits.[83] Table C2 shows that there is evidence that capital expenditure was incurred later than forecast during PSE1. The reasons for this are unclear and can be attributed in part to higher capex than forecast. It is not clear whether the forecast timing of capex was inefficient, or whether the apparent deferral of capex was efficient.

**Table C2: Variance between forecast and actual capex for PSE1**

| **Key capex programmes** | **Year ending 2008** $m | % | **2009** $m | % | **2010** $m | % | **2011** $m | % | **2012** $m | % |
|---|---|---|---|---|---|---|---|---|---|---|
| South RESA | -1.0 | -37 | 0.4 | | -0.6 | | 0.3 | | 0.0 | |
| North RESA | -3.1 | -55 | 4.0 | | 0.6 | | 0.5 | | 0.0 | |
| Northern pier (eastern gate) | 1.2 | 26 | 0.0 | | 0.0 | | 0.0 | | 0.0 | |
| Northern pier (terminal and western gate, including 'The Rock') | -10.0 | -68 | -16.4 | -86 | 9.8 | | 17.7 | | 0.8 | |
| Airfield pavement maintenance | -0.8 | -43 | 3.2 | 185 | -0.1 | -2 | 0.0 | -2 | 0.6 | 67 |

Notes: The negative values in 2009 arise from transfers out of the regulated asset base in that year. The negative value in the South RESA in 2010 arose from a review of outstanding work in progress and reclassification of capital expenditure from the South to North RESA Project. Variance (%) not shown where forecast expenditure was zero.

Sources: Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2011" 31 March 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012" 31 August 2012.

C20 During PSE2, around half of the capex forecast for Year 1 and Year 2 is for the 'Building works' programme, which consists of projects subject to wash-up arrangements.[84] We expect that wash-up arrangements will provide some mitigation against deferring this investment, but that incentives to defer other

83 Wellington Airport has set prices based, in part, on forecasts of annual capex. Once prices are fixed, Wellington Airport may earn a higher profit if it delays capex later than forecast, by recovering revenue for an asset while not incurring a cost for the asset as it has not been built. See BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 16.

84 Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 April 2012 to 31 March 2017" 30 April 2012, Appendix G.

investment will still remain.[85] At this time, we do not have actual expenditure information for PSE2 to assess the effectiveness of ID in mitigating incentives to inefficiently delay capex.

**Does Wellington Airport's conduct reflect that they seek to invest efficiently?**

C21 Submissions from Wellington Airport regarding their conduct suggest it seeks to invest efficiently. For example:

C21.1 Wellington Airport submitted that they consulted with airlines about its capex projects significantly more than is required by the AAA regime;[86]

C21.2 Wellington Airport submitted that they deferred some investment in response to feedback from customers that did not support this component of their forecast;[87] and

C21.3 Wellington Airport agreed to airlines' proposals for wash-up arrangements for major capex projects in both PSE1 and PSE2.[88]

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85 The wash-up arrangement provides a pricing credit in the next pricing period if the project is delayed by 12 months or more from forecast completion dates. The wash-up is equivalent to the forecast expenditure, adjusted for the WACC, deprecation and tax. We note that the wash-up mechanism may create adverse incentives not to delay investment later than forecast when it may be more efficient to defer this investment.

86 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 158.

87 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 160.

88 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 161.

# Attachment D: Is Wellington Airport innovating appropriately?

## Purpose

D1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport has incentives to innovate (refer s 52A(1)(a) of the Act).

D2 Innovation is about the discovery and use of new information, leading to the development of new goods or services, and/or more efficient production techniques.[89] Innovation is driven by the prospect of earning higher profits and a greater than normal return.

## Summary of draft conclusion

D3 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Information disclosure is having a limited impact on incentives to innovate at Wellington Airport to date, but this is not a concern for the following reasons.

D3.1 We expect that information disclosure regulation would have had a limited impact on innovation because other incentives play a more important role in driving innovation.

D3.2 Wellington Airport has incentives to innovate so as to increase its profits and information disclosure does not appear to have negatively impacted on those incentives.

D3.3 It appears that innovation at Wellington Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4. This view is based on the fact that submissions have not raised any substantive concerns as part of this s 56G review.

D3.4 Innovation itself is not focused around the price setting events and collaboration on airline-led innovation appears most important to the airlines. Few concerns were raised by airlines about Wellington Airport's facilitation of airline-led innovation.

[89] Innovation is not the same as the adoption of industry best practice from New Zealand or overseas.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to innovate appropriately

D4 Wellington Airport has incentives to maximise its profits through improved performance, including through innovation.

### How information disclosure can provide incentives to innovate

D5 Information disclosure regulation places relatively weak incentives on Wellington Airport to innovate appropriately due to the unique and unpredictable nature of innovation. Information disclosure regulation is likely to be most effective over time when combined with analysis of operational and capital expenditure, as this will highlight where innovation may assist in achieving efficiency gains.[90]

### How we have assessed whether Wellington Airport is innovating appropriately

D6 Our approach to assessing innovation for this review was to consider Wellington Airport's performance and conduct regarding innovation. We have looked for evidence of:

D6.1 innovation occurring at Wellington Airport, comparisons with innovation at other airports, and awards for innovation; and

D6.2 Wellington Airport enabling or facilitating innovation through collaboration.

D7 We have considered this both before and after the introduction of information disclosure regulation to gain insight into the impact of information disclosure regulation on incentives to innovate.

### Information used to assess whether Wellington Airport is innovating appropriately

D8 Our analysis is based on qualitative information from two main sources:

D8.1 information disclosed under Part 4; and

D8.2 submissions and other material generated as part of this s 56G review.

## Analysis of innovation performance and conduct

### Is Wellington Airport innovating appropriately?

D9 The available evidence suggests that Wellington Airport innovates appropriately. Both Air New Zealand and BARNZ agree that the level of innovation at Wellington Airport is comparable to other airports, both domestically and internationally.[91]

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[90] It may also highlight where innovations or best practice may be appropriate to adopt by an airport to improve operation and capital efficiency.

[91] Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 89.

Wellington Airport has also provided examples of its innovation. For example, Wellington Airport has developed an integrated terminal and multi-use 'swing gates' to optimise the use of its relatively small land area.[92] These gates allow domestic and international services to use the same facilities.

D10 Air New Zealand raised one concern on pricing. It submitted that Wellington Airport has ignored suggested pricing innovations that would enable separate charging for passengers using the baggage handling system.[93] Wellington Airport's response to this criticism is that they invited airlines and BARNZ to provide a technological solution for this innovation, but no advice was provided.[94]

**Does Wellington Airport's conduct demonstrate that it has facilitated innovation?**

D11 Overall, we consider that Wellington Airport facilitated innovation. There has been little concern about Wellington Airport's facilitation of airline-led innovation in the consultation process for this review to date.[95]

D12 Wellington Airport's view is that the key to innovation is collaboration with its customers and other stakeholders.[96] Air New Zealand commented that there is good collaboration about regular operational issues and putting in place sensible solutions.[97] This suggests that Wellington Airport and airlines agree that its collaboration promotes innovation, at least on a day-to-day basis.

D13 Ongoing conduct in facilitating innovation appears to be more important than conduct during the price-setting consultation process. This is because innovation is

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92 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, page 4.

93 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 15.

94 Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 160.

95 Whilst Air New Zealand did criticise Wellington Airport for not seeking and being slow to adopt self service kiosk innovation for passenger check-in, Air New Zealand does not consider that Wellington Airport's overall support for airline-led innovation is an issue that they would highlight. Refer: Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 47. Wellington Airport believes the issue on self-service kiosk innovation was due to its relatively small footprint and common user terminal, rather than a specific reluctance to innovate. Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, pages 90-91.

96 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 89.

97 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 90.

not explicitly covered in these processes.[98] This is different to the other areas we have examined in this draft report, where the price-setting process is more important.

98 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, page 34.

# Attachment E: Is Wellington Airport providing services at the quality consumers demand?

## Purpose

E1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport provides services at a quality that reflects consumer demands (refer s 52A(1)(b) of the Act).

E2 We consider that quality is about consumers' experiences of airport services, including comfort, timeliness and the availability of the service.

## Summary of draft conclusion

E3 Our draft conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Wellington Airport providing services at a quality that reflects consumer demands. The key reasons for this are as follows.

E3.1 Quality of service at Wellington Airport compares well against other airports. Our analysis of passenger satisfaction surveys indicates that the level of quality experienced by passengers at Wellington Airport is similar or better than at other airports in New Zealand and Australia. Similarly, our analysis of the level and duration of interruptions suggests Wellington Airport is comparable with other airports.

E3.2 Airlines appear to be generally satisfied with the quality of service provided at Wellington Airport - both before and after information disclosure under Part 4 was introduced. This is based on submissions from Wellington Airport and airlines to this s 56G review. Service quality at Wellington Airport is comparable with the quality of service provided at Christchurch and Auckland Airports.

E3.3 The concerns that were raised relate to the price-quality trade off airlines wish to make. This was raised in respect of the air-bridges charge and in respect of investment into the new international terminal "The Rock" and the Runways End Safety Areas (RESAs). The main concern and perceived risk by airlines was Wellington Airport investing in too high quality. This is discussed further in attachment C.

E3.4 Information disclosure has had a positive impact on Wellington Airport's performance and conduct in relation to quality. Wellington Airport has attributed the introduction of information disclosure under Part 4 to being partially responsible for improvements to customer surveys. In turn, feedback from the surveys has focused investment in improving customer experience. Passenger satisfaction levels have improved slightly since the introduction of information disclosure under Part 4.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to provide services at a quality that reflects consumer demands

E4 Wellington Airport has some incentives to provide quality that reflects consumers' demand. Wellington Airport provides unregulated services (eg retail, parking) that are complementary to its regulated services. This means that it has some incentives to increase passenger numbers to increase demand for these services to earn higher profits. Quality of passenger experience is likely to have an impact on this demand.

E5 It is also subject to other regulatory requirements. For example, the AAA requires Wellington Airport to consult on material capex programmes with its major customers. This creates incentives to understand the level of quality consumers demand, and therefore may encourage Wellington Airport to provide services at the quality consumers demand. Wellington Airport is also obliged to meet safety requirements in some areas, which requires a minimum level of quality.

E6 Wellington Airport's incentive to maximise its profits may weaken its incentives to provide quality at the level consumers demand. For example, once prices are set for the pricing period, Wellington Airport may earn higher profits by reducing quality as it may reduce its expenditure. As discussed in paragraph C8.3, a regulated supplier that is targeting an excessive return also has an adverse incentive to over-invest in quality where it will result in higher capital expenditure, so as to earn higher profits.

### How information disclosure can provide incentives to provide the quality consumers demand

E7 The public disclosure of information through information disclosure regulation can strengthen the incentives, and mitigate the disincentives, to provide services at a quality that reflects consumer demand discussed in paragraph E6.

E8 It can also provide additional incentives to provide services at quality that reflects consumer demand, for example by requiring Wellington Airport to improve its understanding of what level of quality consumers demand through passenger surveys.

E9 We expect information disclosure regulation to be as effective as it can be in promoting the provision of services at a quality that reflects consumer demands over time. Any significant quality improvements highlighted as necessary by consumers through information disclosure regulation may require a long lead time to implement if investment is required.

### How we have assessed whether Wellington Airport is providing quality at the level consumers demand

E10 There are usually many dimensions to the quality of a service and a single indicator will provide only an approximation to the overall quality of the service or services to which it relates. Different types of consumers may also demand different levels of quality. We have therefore examined a number of aspects of service quality at Wellington Airport experienced by different types of consumers.

E11 Our approach considers whether historic or forecast improvements to quality at Wellington Airport reflect consumer demands. We have considered evidence of:

E11.1 whether the quality of service being received by passengers at Wellington Airport reflects their demand;

E11.2 whether the aspects of service quality that are important to airlines reflects their demand; and

E11.3 changes to Wellington Airport's processes and service quality following the introduction of information disclosure regulation.

E12 An assessment of whether quality reflects consumer demands implicitly includes an assessment of whether consumers are willing to pay for higher quality, or would prefer to pay less and receive a lower quality. Specific price-quality trade-offs are discussed in Attachment G.

**Information used to assess whether Wellington Airport is providing services at the level of quality consumers demand**

E13 Our analysis is based on qualitative and quantitative information from:

E13.1 information disclosed under Part 4 and the AAA; and

E13.2 submissions and other material generated as part of this s 56G review.

E14 The information generated as part of this s 56G review has been most helpful to understanding whether quality reflects consumer demands because we also have received the views of some of Wellington Airport's consumers directly. Information disclosure provides information on the steps Wellington Airport has taken to elicit feedback from consumers on the quality they expect, but does not provide information on whether consumers are willing to pay for higher quality, or whether they consider quality at Wellington Airport is too high. These price-quality trade-offs are largely addressed through consultation at the price setting events.

## Analysis of Wellington's Airport's quality performance and conduct

### Is Wellington Airport providing services at a quality that reflects passenger demands?

E15 Passenger satisfaction at Wellington Airport since information disclosure regulation took effect are similar to other New Zealand airports.[99] Passenger satisfaction at Wellington Airport has improved since the first quarter of 2011.

E16 Table E1 shows that overall, Wellington Airport had a similar level of passenger satisfaction to Auckland and Christchurch airports in 2011, following the introduction of information disclosure regulation.[100]

**Table E1: Annual passenger satisfaction survey results for Wellington, Auckland and Christchurch airports (2011)**

| Airport | Domestic | International |
|---|---|---|
| Wellington | 4.1 | 4.0 |
| Auckland | 4.0 | 4.1 |
| Christchurch | 3.9 | 4.1 |

Sources: Wellington Airport “Specified Airport Services Annual Information Disclosure for year ending 31 March 2011”, 31 March 2012; Christchurch Airport “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011, 31 May 2012; Auckland Airport, “Specified Airport Services Annual Information Disclosure for year ending 30 June 2011”, 17 May 2012.

E17 Passenger satisfaction has improved or remained constant at Wellington Airport since information disclosure regulation was introduced. Table E2 shows that the average score from the international passenger survey has increased, from 3.7 (out of 5) in the first quarter of 2011 to 4.1 in 2012. At the same time, the average quarterly score from the domestic passenger survey also increased from 4.0 to 4.1.

**Table E2: Quarterly passenger satisfaction survey results at Wellington Airport (2011-12)**

| | 2011 | | 2012 | |
|---|---|---|---|---|
| | Domestic | International | Domestic | International |
| 1st quarter | 4.0 | 3.7 | 4.0 | 4.1 |

99 We have not received any submission from passengers as part of this s 56G review to be able to consider passenger views on whether WIAL is providing services at a quality that reflects passenger demands. We have therefore been reliant on evidence provided in ID, as well as submissions on this issue by airports and by airlines.

100 Our analysis uses measures of passenger satisfaction from the Airport Service Quality (ASQ) quarterly survey programme run by the Airports Council International (ACI). 2012 disclosure data for Auckland Airport or Christchurch Airport was not available at the time of publication.

| | | | | |
|---|---|---|---|---|
| 2nd quarter | 4.0 | 4.0 | 4.1 | 4.1 |
| 3rd quarter | 4.1 | 4.1 | 4.1 | 4.1 |
| 4th quarter | 4.1 | 4.3 | 4.1 | 4.1 |
| Annual average | 4.1 | 4.0 | 4.1 | 4.1 |

Notes: Table shows average survey score in each quarter.

Sources: Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011-12.

E18 Wellington Airport did not participate in the Airport Service Quality (ASQ) passenger satisfaction survey prior to information disclosure regulation, and we do not therefore have comparable information to assess performance in this area prior to information disclosure regulation.[101] Wellington Airport's participation in a passenger survey is required under information disclosure regulation. We have no reason to believe there was significant passenger dissatisfaction before the introduction of information disclosure.[102]

**Does service reliability at Wellington Airport reflect consumer demands?**

E19 An analysis of service reliability at Wellington Airport provides information about continuity of supply. We have not received any submissions to suggest that reliability at Wellington Airport does not reflect consumer demands. Our analysis also shows that Wellington Airport has a level and duration of interruptions within the range for Auckland and Christchurch airports, and in some cases it has the lowest number or duration of interruption.[103]

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101 Wellington Airport did use other passenger surveys prior to ID. See Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 203.

102 Air New Zealand has also submitted that their own surveys of passengers found WIAL within one point of the average for baggage collection and airport departure lounge satisfaction. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 50.

103 An interruption occurs if a service is withdrawn for 15 minutes or longer. 2012 data for Auckland Airport and Christchurch Airport was not available at the time of publication. 2012 data for Wellington Airport indicates that there has been little change from their performance in 2011.

**Table E3: Number and average duration of interruptions at Wellington, Auckland and Christchurch Airports (2011)**

| | Number of interruptions | | | Average duration (hours) | | |
|---|---|---|---|---|---|---|
| | Wellington | Auckland | Christchurch | Wellington | Auckland | Christchurch |
| Runway | 0.2 | 0.1 | 1.0 | 0.2 | 1.0 | 8.3 |
| Taxiway | 0 | 0.1 | 0 | 0 | 0.1 | 0 |
| Stand and air bridge | 3.6 | 12.1 | 1.5 | 10.9 | 32.4 | 2.7 |
| Outbound baggage sortation system | 2.7 | 2.4 | 6.2 | 9.3 | 3.6 | 13.0 |
| Baggage reclaim | 0 | 0.3 | 1.4 | 0 | 0.1 | 2.8 |

Notes: Runway, taxiway, and stand and air bridge data reported per 10,000 landings. Outbound baggage sortation system data reported per million departing passengers. Baggage reclaim data reported per million arriving passengers.

Sources: Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2011", 31 March 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure for year ending 30 June 2011, 31 May 2012; Auckland Airport, "Specified Airport Services Annual Information Disclosure for year ending 30 June 2011", 17 May 2012.

**Does the utilisation of capacity at Wellington Airport reflect consumer demands?**

E20 Utilisation of capacity is relevant to our assessment of quality because it can identify potential service constraints, indicating that a service is not available when required.[104]

E21 Our draft conclusion is that overall Wellington Airport appears to have provided capacity at a level that reflected consumer demands. Submissions received as part of this 56G review have not indicated any aspects of service quality at Wellington Airport where they considered service was constrained, and where they required additional capacity. Submissions have not indicated that they consider capacity will be inefficiently constrained in the future.

[104] However, a service may be constrained as consumers may not be willing to pay for additional capacity. In this case, increasing capacity may not reflect consumer demands. Where capacity is constrained, a more efficient outcome may be to introduce congestion charging than to increase capacity. For example, Wellington Airport has introduced new charges to manage congestion. These are discussed further in Attachment G.

**Does Wellington Airport's conduct indicate that it seeks to ensure quality reflects consumer demands?**

E22 Overall, Wellington Airport's conduct indicates that it seeks to ensure quality reflects consumer demands. However, airlines have expressed some concerns with aspects of Wellington Airport's conduct.

E23 To assess whether Wellington Airport's conduct is consistent with providing quality that reflects consumer demands, we have reviewed whether there have been:

E23.1 improvements to operational processes to address concerns about quality;

E23.2 additional investment and operational expenditure to address concerns about quality, where demanded; and

E23.3 consultation by Wellington Airport about quality for PSE1 and PSE2, as well as in the intervening period.

E24 Wellington Airport has indicated some changes to operational processes since the introduction of information disclosure regulation. For example:

E24.1 the establishment of a forum with airlines to discuss service reliability, service performance, and to review ASQ results;[105] and

E24.2 it has taken over the role of gate allocation from Air New Zealand to improve efficiency. However, Air New Zealand disputes whether this is required, or cost efficient.[106]

E25 There are several examples of quality enhancements made during PSE1, and forecast for PSE2. With the exception of the extent of investment in quality at 'The Rock' and in the RESAs, we have no evidence to suggest these enhancements were not demanded by consumers.[107] Air New Zealand submitted that improvements in quality for regional airline customers are necessary.[108] We are not aware of any other areas where further investment is required to improve quality.

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105 Wellington Airport "Wellington International Airport Limited: Annual Disclosure for year ended 31 March 2012" 31 March 2012, page 33.

106 See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 51; Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, page 39.

107 Airlines have expressed concern quality for 'The Rock' was higher than demanded by consumers. This issue is discussed further in Attachment C.

108 This includes the bypass of jet screened areas. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 227.

E26 Wellington Airport's consultation on quality appears to be appropriate. Wellington Airport consults on quality through monthly meetings with its main stakeholders (including airlines) as a way of regularly discussing and resolving quality issues that may arise.[109] Quality was not a focus of consultation for either PSE1 or PSE2, although it was implicitly considered in discussions about capex and the pricing methodology.[110] Submissions received as part of this project do not suggest the amount of consideration given to the views of consumers about service quality during the price setting consultations was inappropriate.

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[109] Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 12.

[110] See Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, page 39; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, page 48; BARNZ "BARNZ Cross-submission on Wellington Airport Issues Paper submission" 20 July 2012, page 7.

# Attachment F: Is Wellington Airport sharing efficiency gains with consumers?

## Purpose

F1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Wellington Airport shares the benefits of efficiency gains with consumers, including through lower prices (refer s 52A(1)(c) of the Act.

F2 Efficiency gains result from a reduction in expenditure while maintaining the same quantity and quality of service, or an increase in the quantity or quality of service for a given level of expenditure, where these occur as a result of improvements in managerial efficiency.

F3 Our focus is on sharing efficiency gains made in the supply of regulated services. Some of these efficiency gains arise as a result of providing regulated and unregulated services in combination.

## Summary of draft conclusion

F4 Our draft conclusion is that we are unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers. This is because it is too early to conclude whether there are any opex and capex efficiency gains at Wellington Airport that could be shared with consumers.

F5 Our key findings are:

F5.1 there is limited evidence of historic and forecast efficiency gains at Wellington Airport that could be shared with consumers;

F5.2 Wellington Airport's prices for PSE1 and PSE2 include any efficiency gains that are included in their expenditure forecasts and, all things being equal, will result in lower prices. However, it is not clear to what extent efficiency gains have been included in these forecasts, and therefore to what extent efficiency gains have been shared;

F5.3 we have no evidence to suggest that Wellington Airport is sharing efficiency gains through re-investment in assets, increased output, or improved quality at no additional cost to consumers; and

F5.4 as we cannot measure where Wellington Airport is achieving opex and capex efficiency gains at this time, we cannot assess the effectiveness of information disclosure in promoting the sharing of opex and capex efficiency gains with consumers.

F6 Although not necessarily an efficiency gain, cost savings resulting from reductions in financing costs have not been shared with consumers. Similar rates of return were targeted through prices in PSE1 and in PSE2 despite our estimates of the required cost of capital falling between those periods. This is discussed further in Attachment H.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to share efficiency gains with consumers

F7 Wellington Airport has weak incentives to share efficiency gains with consumers, including through lower prices. Setting prices using a building blocks model provides some incentive to share efficiencies by making it more transparent whether efficiency gains have been made and shared. However, although Wellington Airport is required to consult with its customers on pricing, its ability to set charges as it sees fit means it is unlikely to have strong incentives to promote the sharing of efficiency gains outcomes sought under Part 4.

### How information disclosure can provide incentives to share efficiency gains

F8 Information disclosure can strengthen incentives to share efficiency gains, by increasing transparency of whether efficiency gains have been made, and allowing interested persons to assess whether these have been shared with consumers. If efficiency gains are not shared with consumers over time, then this can indicate that excessive profits are being earned, which may increase the likelihood of further regulation. The ability of information disclosure regulation to be effective in this area relies on Wellington Airport making or forecasting efficiency gains in the first instance.

F9 Information disclosure may also strengthen incentives to share efficiency gains resulting from economies of scope through the cost allocation input methodology.[111] This sets rules on how common costs should be allocated between Wellington Airport's regulated aeronautical services, and its non-aeronautical services. The input methodology may help efficiency gains in common costs that are achieved in non-aeronautical services to be shared with consumers of aeronautical services.

### We expect that information disclosure would have had a relatively limited impact at this stage

F10 We expect information disclosure regulation to become as effective as it can be in this area over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends in expenditure relative to forecasts to see whether gains are being made or forecast, and to see what if any impact they have on prices. As discussed in Attachments B and C, we are unable to conclude at this time whether Wellington Airport has achieved, or is forecasting to achieve, efficiency gains.

[111] Economies of scope arise when it is less expensive to produce different types of goods or services together rather than separately.

F11 At this stage we consider that information disclosure regulation has not provided any disincentives for making efficiency gains or sharing them with consumers.[112]

**How we have assessed whether Wellington Airport is sharing efficiency gains for the purpose of this review**

F12 Our approach considers whether any historic or forecast efficiency gains are being passed on through lower prices. As part of this, we examined whether Wellington Airport has any mechanisms in place that explicitly pass on efficiency gains that they have achieved, or are forecast to achieve.

F13 We also considered whether efficiency gains have been passed on in improvements to service quality at Wellington Airport or investment in aeronautical assets, at no cost to consumers.[113] This would mean that these investments or improvements are not funded through the prices set by Wellington Airport during the price setting event.

F14 We have considered whether Wellington Airport is sharing efficiency gains with consumers both before and after the introduction of information disclosure regulation. This provides insight into the effectiveness of information disclosure regulation in promoting the sharing of efficiency gains.

**Information used to assess whether Wellington Airport is sharing efficiency gains**

F15 Our analysis relies on qualitative information provided by Wellington Airport in its disclosures for PSE1 and PSE2, and our assessment of the efficiency of Wellington Airport's operational and capital expenditure discussed in Attachments B and C. We have also considered submissions received as part of this s 56G review on whether Wellington Airport has shared efficiency gains.

## Analysis of Wellington's Airports performance and conduct

F16 The approach and mechanisms used by Wellington Airport to set prices has resulted in any forecast efficiency gains being shared with consumers through lower prices, all things being equal. The extent to which efficiency gains are shared is dependent on the extent to which Wellington Airport's expenditure forecast reflects historic or forecast efficiency gains. This is because the building block model used by Wellington Airport to determine the revenue requirement includes forecasts of operational and capital expenditure. Forecast efficiency gains that are included in these expenditure forecasts will therefore automatically be reflected in lower prices through the revenue requirement.

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[112] Our future summary and analysis reports on the information disclosed under Part 4 will likely consider the treatment of efficiency gains in considering profitability and may therefore have incentive effects in this area.

[113] For example, an airport may choose to share efficiency gains through investment in new lounge facilities without these being funded through the prices it charges for its services.

F17 As discussed in the Attachments B and C, it is too soon to conclude whether Wellington Airport is forecasting efficiency gains and there is no evidence of historic efficiency gains. At this time, we have insufficient information to assess the extent of economies of scale at Wellington Airport, and to what extent these have resulted in lower unit opex in PSE2.

F18 Prices for PSE2 are higher relative to PSE1.[114] This indicates than any efficiency gains are outweighed by increases in the other factors that determine the price set, for example, the regulatory asset base.

F19 We are not aware of any actual or planned improvements in quality or investment at Wellington Airport's regulated business that was not funded through prices set for aeronautical activities for PSE1 and PSE2.

[114] Average revenue for the first price setting event was $10.41 per passenger compared to $12.73 per passenger for the second price setting event (excluding noise mitigation costs). Figures are in 2012 real dollars.

# Attachment G: Do the prices set by Wellington Airport promote efficiency?

## Purpose

G1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Wellington Airport has incentives to set prices that promote efficiency (refer s 52A1(b) of the Act).[115]

G2 References to prices in this attachment relate to the pricing structure at Wellington Airport and how the total revenue requirement is collected from different services and consumers. This is set out in Wellington Airport's pricing methodology disclosed in information disclosure. This attachment does not consider whether Wellington Airport's target total revenue is appropriate. That is considered in the other attachments. Our analysis does not assess whether Wellington Airport's prices are fully efficient. Consistent with s 52A(b), we have assessed whether the pricing methodology used by Wellington Airport results in prices that *improve* efficiency.

## Summary of draft conclusion

G3 Our draft conclusion is that information disclosure is effectively promoting efficiency of pricing (referred to as 'efficient pricing'). Prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place.

G4 Our analysis indicates that little consideration had been given to pricing efficiency in PSE1. For PSE2, Wellington Airport took greater consideration of pricing efficiency. For example, there was greater consideration of:

G4.1 how pricing can ensure the optimal use of scarce facilities at Wellington Airport with the introduction of new charges to manage congestion; and

G4.2 the price sensitivity of customers in designing price structures with prices being modified to reflect this.

G5 Information disclosure has had a positive impact on this outcome. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure. This is consistent with the apparent changes between PSE1 and PSE2.

G6 Airlines have raised concerns about the extent to which the revised pricing structure will promote efficiency and about Wellington Airport's volume growth incentive

[115] S 52A1(b) states that the Part 4 purpose is to promote outcomes such that regulated suppliers "have incentives to improve efficiency".

scheme. These concerns indicate that further improvements to promote efficiency could occur. In particular, in relation to price-quality trade-offs.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to set prices that promote efficiency

G7 Wellington Airport has an incentive to set prices that will result in higher demand and higher profits. However, this profit maximising objective also creates adverse incentives to earn excessive profits through the pricing methodology. For example, Wellington Airport may use an unrealistically low demand forecast when setting its pricing methodology so as to set higher average prices, and increase the potential to earn additional profits from higher demand than forecast.

### How information disclosure can provide incentives to improve operating efficiency

G8 The increased transparency of Wellington Airport's pricing methodology and the outcomes of its methodology generated by information disclosure regulation may mitigate the incentive to under-forecast demand, and strengthen incentives to set prices that promote efficiency. Information disclosure regulation under Part 4 allows interested persons to understand the reasons for the pricing methodology adopted, and to assess the outcomes resulting from the methodology. This greater transparency also enhances consumers' countervailing power. The disclosure of pricing methodologies can also provide examples of best practice from other regulated airports.

### How we have assessed whether Wellington Airport's prices promote efficiency for the purpose of this review

G9 Section 52A(1)(b) states that the Part 4 purpose is to promote outcomes consistent with outcomes in workably competitive markets such that regulated suppliers "have incentives to improve efficiency". This includes productive, dynamic and allocative efficiencies.[116]

G10 The prices set by Wellington Airport through its pricing methodology have an important role to play in improving efficiency. Consistent with outcomes observed in workably competitive markets, the prices set by Wellington Airport for each charged service should help ensure the efficient allocation of its aeronautical services and therefore its resources (allocative efficiency) and provide signals of where innovation

[116] Productive efficiency relates to the supply of goods or services at the lowest cost possible, while maintaining (or increasing) the quantity and quality of the good or service produced. Dynamic efficiency relates to decisions made over time, including investment and innovation, which improve productive efficiency. Allocative efficiency occurs when resources, goods or services are allocated to their use in which they have their highest value.

and investment is needed at Wellington Airport to meet consumer demands (dynamic efficiencies).[117] Prices that achieve these outcomes are efficient.[118]

G11 To assess whether Wellington Airport's prices promote efficiency, we have reviewed its pricing methodology and subsequent prices for PSE1 and PSE2 against efficient pricing principles. This will allow us to understand whether information disclosure regulation has had any impact on its performance in this area.

### Information used to assess whether Wellington Airport is sharing efficiency gains

G12 Our analysis uses quantitative and qualitative data from the following sources:

G12.1 information disclosed under Part 4 and AAA; and

G12.2 submissions and other material generated as part of this s 56G review.

## Analysis of whether Wellington Airport's performance and conduct on pricing resulted in prices that promote efficiency

G13 The remainder of this document considers:

G13.1 the appropriate efficient pricing principles to assess Wellington Airport's pricing methodology against;

G13.2 the extent to which Wellington Airport's methodology addresses each of these principles; and

G13.3 Wellington Airport's conduct in setting its pricing methodology during PSE2.

### Efficient pricing principles

G14 We have assessed Wellington Airport's pricing methodology and subsequent prices against a number of established principles that reflect the objectives of efficient prices.[119] These principles are discussed in more detail in the following section.

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117 For example, if there is constrained capacity at an airport, higher charges in busy periods may promote allocative and dynamic efficiency. Peak charges would likely help ensure that these constrained services are consumed only by those who would benefit most from using them, as only these customers would be willing to pay the peak charge. The higher prices will also provide a signal that additional investment may be necessary to increase capacity at peak times.

118 We acknowledge that in workably competitive markets, the efficiency of prices is limited by factors such as information asymmetry and transaction costs. Our assessment of the efficiency of WIAL's prices takes this into account.

119 These principles are consistent with the pricing methodology IM applicable to gas distribution and transmission businesses. See Commerce Commission "Input methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, Table 7.2. Similar principles are discussed in reports commissioned by the airlines and Wellington Airport during consultation for the second pricing period. See for example, LeighFisher "Pricing review of aeronautical services at Wellington Airport" 14 July

G14.1 Prices should signal the efficient incremental economic cost of providing the service to individual or groups of consumers.

G14.2 Where a good or service is scarce, the price should ensure that the good or service is consumed by those that value it the most.

G14.3 Prices should have regard to consumers' demand responsiveness.

G14.4 Prices should enable consumers to make price-quality trade-offs or non-standard arrangements for services, where practical, to reflect the value they place on services.

G14.5 The development of prices should be transparent, and promote price stability and certainty for consumers, where demanded.

G15 The pricing methodology should also ensure that suppliers are not able to earn excessive profits as a result of their pricing structure. For example, it should use appropriate demand forecasts. Excessive profits may however result from other factors, such as the cost of capital used. This is considered in Attachment H.

**Prices should signal efficient incremental economic costs**

G16 Prices that signal the efficient incremental economic cost of services are subsidy free. To be subsidy free, prices should therefore be equal to or greater than marginal costs, and less than or equal to standalone costs.[120] However, there may be instances where it is not efficient for these criteria to be met.[121] Given the long-term nature of many of Wellington Airport's investments and costs, we consider that an assessment of Wellington Airport's prices should consider their long run, rather than short-run incremental costs.

G17 Given the low marginal costs of airport services, we consider there is unlikely to be cross-subsidisation at Wellington Airport during PSE2, with the exception of cross-subsidisation of smaller aircraft in peak periods. However, we have insufficient

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2011, NZIER, "Wellington airport congestion charging. Issues of congestion pricing and possible effects on airline network connectivity", 1 June 2011.

120 The marginal cost is the additional cost of producing another service. The standalone cost is the cost that would have occurred if the supplier solely undertook that activity. For prices to be efficient, these costs should reflect the lowest financial cost of producing the service (both in the short and the long run), and the opportunity cost from consumption of the service (for example, prices should have regard to capacity constraints). See Commerce Commission "Input methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, paragraph 7.2.5 for further discussion on this issues.

121 For example, due to transaction costs.

information to fully assess whether any cross-subsidisation has occurred and note airlines concerns regarding cross-subsidisation.[122]

G18 Wellington Airport has stated that it does not consider that the prices set for each charged service for PSE1 and PSE2 were below its short-run marginal cost as marginal costs are considered to be low.[123] However, this analysis does not take account of all costs.

G19 As discussed in paragraph G16, we consider than an assessment of long-run marginal costs is more appropriate, and may indicate some cross-subsidisation. Wellington Airport acknowledges that cross-subsidisation of 19-seat aircraft by other aircrafts at peak period may result if long-run incremental costs and externalities are considered. These aircraft pay a lower charge than larger aircraft but use scarce capacity that could be utilised by these larger aircraft.[124]

G20 Airlines have however highlighted a number of areas where they consider cross-subsidisation may occur in PSE2. Wellington Airport's consultants also recommended a cost-reflective charging structure that was not fully adopted by Wellington Airport. Given these concerns, further refinements to Wellington Airport's prices could be made to ensure they promote efficiency.

G20.1 Air New Zealand and BARNZ submitted that domestic passengers will cross-subsidise international passengers as a result of the common charge for terminal facilities.[125] Wellington Airport's consultants also recommended that Wellington Airport differentiate its passenger terminal charge for domestic and international services to reflect the different costs of these passengers.

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[122] We do not consider that this is necessarily a weakness of information disclosure regulation under Part 4, as the provision of information to fully assess whether any cross-subsidisation has occurred may be costly.

[123] Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011, page 23; Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 230.

[124] Commerce Commission, *Transcript of Wellington Airport Section 56G Conference,* held on 7 August 2012, page 100.

[125] BARNZ argues that a common charge is not appropriate as facilities for domestic passengers take up less terminal space than facilities for international passengers and domestic passengers do not use 'The Rock' development in the international terminal. They also submit that while gates 25 to 29 of the international terminal can be used for domestic operations, this only occurs on rare occasions and that international operations have priority. Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 287; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, pages 25-26.

[126] Wellington Airport has stated that they do not consider passengers are charged less than their marginal cost.[127]

G20.2 Air New Zealand submitted that domestic passengers who transfer from one aircraft to another en route to their final destination may cross-subsidise non-transfer passengers.[128] Wellington Airport's consultants also suggested that an appropriate discount be allowed for transfer passengers as they impose a lower overall cost burden.[129]

G20.3 BARNZ considers the differential between international and domestic airfield prices results in cross-subsidisation, as airfield facilities for domestic and international aircraft of the same size are largely the same.[130] Wellington Airport responded that the difference in prices is an anomaly of the previous pricing approach and that they are aligning the prices over the pricing period to reflect the use of facilities at Wellington Airport.[131]

G20.4 BARNZ also considers that the lower MCTOW[132] rate for aircraft above 100 tonnes relative to smaller aircraft is cross-subsidisation as larger aircraft require increased facilities and services.[133] Wellington Airport responded that larger aircraft still pay a higher total charge than smaller aircraft to reflect any additional costs incurred.[134]

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126 LeighFisher "Pricing review of aeronautical services at Wellington Airport" 14 July 2011, page 25.

127 Wellington Airport also highlight that they expect domestic usage of the North (international) Pier will intensify as there is limited gate lounge space available and a growing number of domestic passengers. See Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraphs 163-165.

128 Air New Zealand argue that transfer passengers do not use much of the terminal infrastructure but are charged the same amount as passengers who use all facilities. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 285.

129 LeighFisher "Pricing review of aeronautical services at Wellington Airport" 14 July 2011, page 25.

130 International aircraft pay a higher tariff for airfield services than domestic aircraft of the same type. BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, pages 25-27.

131 Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 169.

132 MCTOW is the Maximum Certified Take-Off Weight of an aircraft.

133 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 25.

134 For example, they explain that a 777-300 aircraft exceeding 100 tonnes will pay $4,876 per movement at 75% load compared to a smaller B1900 aircraft which although paying a higher charge per tonne, has a movement cost of $95. See Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 167.

**Price should ensure the optimal use of scarce resources**

G21 Scarcity at airports may arise through congestion at facilities, and a lack of capacity where required. [135] To understand whether Wellington Airport's prices promote the optimal use of scarce resources, we have examined whether Wellington Airport's prices are likely to allocate congested or scarce services efficiently to manage competing demands for limited capacity and resources.

G22 Our draft conclusion is that Wellington Airport's prices for PSE2 are likely to promote the optimal use of scarce resources at Wellington Airport. A number of new charges have been introduced with the purpose of allocating scarce resources optimally. Airlines have diverging views on whether scarcity pricing is necessary at Wellington Airport.

G23 While there is evidence of congestion at Wellington Airport in PSE1,[136] prices do not appear to have been set with the intention of managing this scarcity efficiently. It is possible that congestion was managed without the need to signal this through prices, for example, through working groups.

G24 For PSE2, Wellington Airport introduced a number of new charges to manage congestion and scarcity at Wellington Airport. These include:

G24.1 an additional charge for airfield services at peak times. The charge is supported by BARNZ.[137] However, Air New Zealand states that they do not consider the runway at Wellington to be congested yet; [138]

G24.2 a mandatory charge for aircraft parking at gates. BARNZ support this move.[139] However, Air New Zealand do not consider there to be capacity constraints for aircraft parking, and submit that a parking charge is not necessary;[140] and

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135 A service is scarce if there is little or no scope to increase the output on that service due to the finite resources used to produce that service. Where a service is scarce and demand for the service exceeds supply, prices can promote allocative efficiency by reflecting the opportunity cost of consuming the service. This will likely result in higher prices for those scarce services and will help ensure that only those who benefit most from consuming the service will do so.

136 Wellington Airport submits that it invested in additional aircraft gates and North Pier terminal area during the first pricing period to address current and future congestion of aircraft gates, passenger processing facilities and lounge space in the North Pier. See Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011, page 32.

137 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 27.

138 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 260.

139 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 27.

G24.3 an hourly charge for check-in counter use.

**Prices should have regard to consumers' demand responsiveness**

G25 In an industry with high fixed costs, such as airports, prices based on the efficient incremental costs would under-recover the required revenues. Where this occurs, a likely efficient outcome would be to make-up any shortfall by setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable (ie, Ramsey pricing).[141]

G26 Our draft conclusion is that Wellington Airport has considered consumers' demand responsiveness in its pricing methodology for PSE2, and that pricing efficiency in respect of this principle has improved relative to PSE1. The appropriateness of Wellington Airport's assumed demand responsiveness has, however, been challenged by airlines.

G27 Wellington Airport does not appear to have explicitly considered consumers' demand responsiveness when establishing its pricing methodology for PSE1. While we observe some variation in charges for different passenger groups, these differences do not appear to be driven by different price sensitivities.[142]

G28 Wellington Airport's pricing methodology and evidence provided in submissions indicates that they have considered consumers' demand responsiveness in its pricing methodology for PSE2. For example, Wellington Airport has indicated that part of the purpose of the peak charge for airfield services is to recover a greater proportion of fixed costs from less price sensitive services.

**Prices should enable price-quality trade-offs**

G29 Consumers may demand different levels of quality or quantity of service, for which they are willing to pay different prices. Where practical, consumers should therefore be able to make price-quality trade-offs. This may include the use of non-standard contracts or commercial agreements for individual consumers.

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140 Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, paragraph 109.

141 This means that if the cost of serving each consumer group is the same, those consumers that are less responsive to prices are set higher prices than more price-sensitive consumers. For this to be efficient, Ramsey pricing should increase output relative to a common price for all consumers. In practice, this type of pricing is difficult to apply perfectly as it requires significant amounts of information on individual consumer demand responsiveness and may have high transaction costs. Our analysis takes this into account.

142 For example, international passengers were charged more than domestic passengers for terminal services. This difference is due to the assumption that international and domestic passengers use different terminals, and the differences in the cost of these facilities, rather than any difference in their responsiveness to higher charges. See Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011, page 17.

G30 We consider that further refinements to the pricing methodology may be required to address airlines concerns that they have not been able to make appropriate price-quality trade-offs. [143] However, there is some evidence that Wellington Airport has enabled consumers to make some price-quality trade-offs. For example, Wellington Airport report that it has agreed to work with Air New Zealand in good faith to investigate a commercial agreement for use of check in counters that meets their needs.[144]

G31 Airlines have raised several instances in which they consider Wellington Airport does not enable them to make appropriate price-quality trade-offs in PSE2.

G31.1 Wellington Airport has not provided a discrete charge for baggage handling for PSE2 despite proposals from airlines to only be charged for bags that use the baggage sortation system. Air New Zealand submits that a discrete baggage handling charge would reflect their airfare structure which allows customers to make a choice about the value of their baggage.[145] Wellington Airport has explained that a discrete baggage handling charge was not introduced for PSE2 as there were technical complexities to doing so.[146]

G31.2 Wellington Airport abandoned the separate charge for air bridge use levied in PSE1, although both Air New Zealand and BARNZ requested the continuation of this discrete charge. Wellington Airport has explained that a separate air bridge could not be justified economically as it may discourage customers from using existing infrastructure.[147]

G31.3 The airlines suggest that the cost of the investment in the Runway End Safety Areas (RESAs) required to accommodate larger aircraft should be borne by operators who require this specification.[148]

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143 We are unable to conclude whether these trade-offs are appropriate without additional information on the likely costs and outcomes of enabling these price-quality trade-offs.

144 This is in response to a submission from Air New Zealand that the pricing decision results in significantly higher costs than anticipated as a result of additional counter hours. See Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 183.

145 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 279.

146 Wellington Airport explain that although they invited airlines and BARNZ to provide a technological solution, no advice was provided. See Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 160.

147 Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 160.

148 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 27; Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce

G31.4 The airlines submitted that domestic passengers should not bear the cost of 'The Rock' international terminal, as they do not benefit from it and it does not reflect their demands.[149]

**The development of prices should be transparent, promote price stability and certainty for stakeholders, where demanded**

G32 Wellington Airport appears to have considered the impact of any price shocks on consumers during PSE1 and PSE2.

G32.1 For PSE1, Wellington Airport implemented an annual change in charges, rather than a single increase at the starts of the pricing period in response to comments from substantial customers.

G32.2 Wellington Airport applied a uniform increase to all charges from PSE1, rather than setting charges to ensure that revenues would be sufficient to recover costs for each individual activity. It states that this was to avoid any unnecessary volatility in the forecast prices.[150]

G32.3 Wellington Airport's disclosure for PSE2 highlights that congestion charging will be implemented gradually from 2013 to provide airlines with an opportunity to consider their operational responses to the new pricing structure.[151]

**The pricing methodology should ensure Wellington Airport is not able to earn excessive profits**

G33 Our analysis focuses on the impact of the pricing methodology on Wellington Airport's ability to earn excessive profits. Other factors that drive profitability are discussed in the other attachments.

G34 Based on submissions, we consider that Wellington Airport's overall demand forecast for PSE2 is unlikely be too low. Airlines have raised concerns that the volume growth incentive scheme in Wellington Airport's pricing methodology may lead to excessive profits during PSE2. We consider that excessive profits may be

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Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, paragraph 112.

149 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 283; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 26.

150 Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011, page 17.

151 Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 April 2012 to 31 March 2017" 30 April 2012, page 46.

earned if efficiency gains resulting from economies of scale are not shared with consumers.[152]

*Appropriateness of Wellington Airport's demand forecast*

G35 Wellington Airport has an incentive to under-forecast the demand used to derive its pricing methodology so as to earn higher profits. Prices are set through the pricing methodology by assuming a volume forecast for each charged service. If volumes are then higher than assumed in the pricing methodology, Wellington Airport will receive a higher total revenue than required and likely higher returns.

G36 Based on submissions, we consider that, all other things being equal, Wellington Airport's overall demand forecasts for PSE2 are unlikely to result in excessive profits.[153] Air New Zealand and BARNZ submitted that the overall domestic passenger and aircraft movement forecasts for PSE2 were reasonable, and BARNZ also considers the international forecasts to be reasonable.[154] In contrast, BARNZ and Air New Zealand did not consider the demand forecasts for passenger forecasts for PSE1 to be reasonable.[155] As shown in Table G1 and Figure G1, Wellington Airport's demand exceeded its forecast in PSE1, leading to higher revenue than forecast. However, the higher volumes may also be a result of factors outside Wellington Airport's control, or due to superior performance in attracting additional passengers and aircraft over the regulatory period.

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152 This does not imply such sharing occurs immediately.

153 We consider that airlines are in a better position to comment on the appropriateness of Wellington Airport's volume forecasts than us.

154 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 211; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 19.

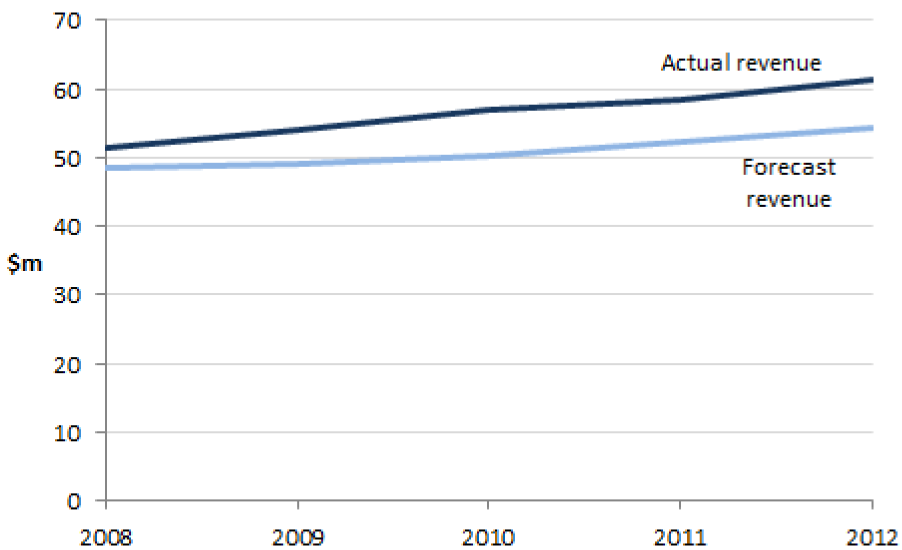
155 BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, pages 19-20; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 216.

**Table G1: Comparison of forecast and actual passenger volumes**

| | Domestic passengers (m) | | | International passengers (m) | | |
|---|---|---|---|---|---|---|
| Year | Forecast | Actual | Difference | Forecast | Actual | Difference |
| 2008 | 4.1 | 4.2 | 4% | 0.59 | 0.59 | 1% |
| 2009 | 4.1 | 4.6 | 12% | 0.60 | 0.61 | 1% |
| 2010 | 4.2 | 4.5 | 6% | 0.62 | 0.63 | 1% |
| 2011 | 4.3 | 4.5 | 3% | 0.65 | 0.65 | 1% |
| 2012 | 4.5 | 4.5 | 0% | 0.68 | 0.72 | 5% |
| Total | 21.3 | 22.3 | 5% | 3.1 | 3.2 | 2% |

Sources: Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2011" 31 March 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012" 31 August 2012; Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2004-2010.

**Figure G1: Comparison of forecast and actual revenue**




Notes: Real (2012) dollars. Actual revenue prior to 2011 taken from AAA disclosures.

Sources: Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2011" 31 March 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012" 31 August 2012; Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2004-2010.

*Impact of the volume growth incentive scheme on Wellington Airport's profits*

G37 If the discounts provided for in the volume growth incentive scheme are not triggered, Wellington Airport may earn excessive profits beyond those discussed in Attachment H. We are not currently able to take a view on whether the incentive scheme is likely to be triggered.

G38 Wellington Airport has introduced a volume growth incentive scheme for PSE2. The incentive scheme provides short-term discounts on some aeronautical charges to airlines that increase capacity beyond defined thresholds.[156] The expected cost of these discounts is funded by airlines through the pricing methodology set for PSE2, and equate to $11m over the pricing period.[157]

G39 Air New Zealand submitted that individual airlines will not meet the threshold to qualify for the discount, resulting in Wellington Airport retaining the funded cost of the incentive scheme, equivalent to around $11m. [158] We have tested the impact on Wellington Airport's revenue and return of increases in volumes similar to those expected by the incentive scheme, but without the incentive scheme being triggered by an individual airline. If the volumes forecast as a result of the incentive scheme were achieved without the incentive scheme being triggered by an individual airline, Wellington Airport would earn a return of 9.46% compared to 9.14% over PSE2 if the incentive scheme was triggered. This is above the Commission's 75th percentile estimate of the cost of capital, and higher than the return target specified by Wellington Airport in its building block model.

G40 Air New Zealand and BARNZ expressed concern that the incentive scheme is funded by aeronautical activities, but will likely result in increased revenues for non-aeronautical activities as increased capacity on routes would increase demand for non-aeronautical services such as car parking and retail.[159] This may not necessarily lead to excessive profits, unless there is cross-subsidisation (as defined in paragraph

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[156] For more information, see Wellington Airport "Airline Pricing Consultation – for pricing to apply from 1 April 2012: Final Pricing Document" 1 March 2012, page 155.

[157] Calculated based on Wellington Airport's pricing structure model for the second pricing period.

[158] Air New Zealand has expressed concern that while overall volumes may increase in response to the incentive scheme, individual airlines are unlikely to meet the defined threshold to trigger the application of the discounts. They submit that this will allow Wellington Airport to retain the funded cost of the incentive scheme, and will therefore result in excessive profits. Wellington Airport anticipates that the thresholds will be met by individual airlines. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 271; Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 157.

[159] Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 270; BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 20.

G16) or efficiency gains resulting from any economies of scale as passenger volumes increase are not shared with consumers. Wellington Airport notes that lower volumes, and therefore higher charges, would occur in the absence of the incentive scheme, and that economies of scale are being shared.[160] We note that the airlines disagree with Wellington Airport about the extent to which the forecast increased volumes are a result of this scheme, and challenge whether the cost of the incentive scheme is therefore justified.[161]

**Does Wellington Airport's conduct indicate that it seeks to improve the efficiency of its pricing?**

G41 Overall, we consider that Wellington Airport's conduct in setting the pricing methodology for PSE2 shows that it seeks to improve the efficiency of its prices. Wellington Airport's pricing methodology for PSE2 shows greater consideration of efficient pricing principles than previously. Wellington Airport also commissioned economic experts to advise them on efficient pricing principles during consultation for PSE2 and adopted many, although not all, of their recommendations. However, submissions received as part of this s 56G review and discussed above indicate that the airlines have expressed a number of concerns with Wellington Airport's pricing methodology during consultation, and that these concerns have not been addressed.

160 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 248.

161 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 19.

# Attachment H: Is Wellington Airport earning an appropriate economic return over time?

## Purpose of this attachment

H1 This attachment contains our analysis and draft conclusion on how effectively information disclosure regulation is promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits (as required by s 52A(1)(d) of the Act).

H2 For the purpose of this s 56G review we consider profitability to be the measure of the profits achieved or expected by a supplier from its operations over time relative to the value of the assets employed in those operations. A supplier's profitability can be compared against indicators of normal levels of economic return to assess whether its return is appropriate or whether its profits are excessive.[162]

## Summary of draft conclusion

H3 We examined the performance and conduct of Wellington Airport in relation to its profitability, both before and after Part 4 information disclosure to assess the extent to which information disclosure has had an impact. As noted in paragraph 3.9, our draft conclusion on profitability was reached only after considering the other analytical areas relevant to the Part 4 purpose, such as efficiency of operational expenditure.

H4 Our draft conclusion is that Wellington Airport is earning an excessive return over time and that information disclosure regulation is not effectively promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits.

H5 The key reasons for this conclusion are as follows:

H5.1 There has been no material change in Wellington Airport's approach to profitability targets since Part 4 information disclosure was introduced. Similar rates of return were targeted through prices in PSE1 and in PSE2 despite the estimates of the required cost of capital under the input methodologies falling between those periods.

H5.2 Our analysis of historical and expected profitability suggests that Wellington Airport has extracted excessive profits in PSE1 and, on the basis of the prices set by Wellington Airport for PSE2, that excessive profits are expected to be extracted for the future.

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162 This report uses post tax nominal measures of economic returns and the cost of capital unless otherwise stated.

H5.3 There is no evidence of superior performance or other external conditions that would justify the existence of excessive profits. We consider the excessive profits are attributable to Wellington Airport's use of its own asset valuation methodologies to revalue assets without accounting appropriately for the resulting revaluation gains. Wellington Airport has also targeted the recovery of a cost of capital that exceeds the estimate of normal levels of returns provided by the cost of capital input methodology.

H5.4 In our view, Wellington Airport is targeting returns in PSE2 that are well above a normal level. In light of this approach, and in the absence of adequate reasons for the level of excessive returns from Wellington Airport, the conclusion we draw is that information disclosure regulation has not affected the outcomes observed in respect of its profitability.

H5.5 Finally, significant disagreement exists between Wellington Airport and its customers over the financial inputs to its price-setting decisions. While there has been increased transparency, the existence of Part 4 information disclosure regulation has not appeared to reduce the extent of disagreement as to price-setting outcomes. Against this background we are not confident that there is a likelihood of Wellington Airport's excessive profits being limited at PSE3 or beyond.

## Summary of analysis

H6 A summary of our analysis is included in Table H1 and the following discussion.

**Table H1: Summary of Wellington Airport profitability analysis**

| | |
|---|---|
| Approach used | We compared changes in Wellington Airport's price-setting profitability targets with changes in the cost of capital estimates under input methodologies. We then examined historical and projected profitability for the periods before and after Part 4 information disclosure regulation was introduced. Lastly, we considered the submissions received from interested parties on other aspects of Wellington Airport's price-setting conduct. |
| Wellington Airport's target profitability | There was no material change in Wellington Airport's targeted return (approximately 9.5%) between PSE1 and PSE2 since Part 4 information disclosure was introduced, despite our estimates of the cost of capital falling between those periods. |
| Pre-ID profitability | Wellington Airport is likely to have achieved a return for PSE1 prior to the introduction of Part 4 information disclosure in excess of both its stated target of 9.50% and our estimates of the cost of capital. |
| Post-ID profitability | Our IRR assessment shows an expected return of 10.18% for the period after the introduction of Part 4 information disclosure. This is significantly in excess of both Wellington Airport's stated target of 9.51% and our estimates of the cost of capital under input methodologies for the majority of this period (ie, PSE2) of 7.06% (midpoint) and 8.04% (75$^{th}$ percentile). |
| Other conduct | Submissions from customers indicate no material change in approach for price-setting inputs or in consultation behaviour. |

H7 In our analysis we first considered whether any changes occurred in Wellington Airport's target profitability used in its price-setting for PSE1 and PSE2, and compared these with changes in the levels of cost of capital estimated under input methodologies. The key observation is that Wellington Airport's target rates of return set for PSE1 and PSE2 (ie, prior to and after Part 4 information disclosure) remained virtually identical (9.50% and 9.51%) despite midpoint estimates of the cost of capital under input methodologies having fallen between those periods (from 8.19% to 7.06%).

H8 Secondly, we calculated the profitability achieved and expected by Wellington Airport for periods prior to and after the introduction of information disclosure. However, we could not simply rely on Wellington Airport's profitability targets used for price-setting in making a comparison with levels of normal returns because Wellington Airport has not used the input methodologies in determining its price-setting outcomes and our benchmark calculation of profitability is based on input methodologies. We needed to recalculate its returns in order to make a 'like-for-like' comparison. Specifically, we analysed profitability based on approaches which differed to those used by Wellington Airport in:

H8.1 measuring operating revenues and profits (especially the quantification and inclusion of revaluations);[163] and

H8.2 valuing assets (using either input methodology compliant methodologies or Wellington Airport's own price-setting valuations).

H9 Our calculations of the data relevant to calculating profitability for 2011 and 2012 (the last two years of PSE1) are shown in Table H2.

**Table H2: Wellington Airport profitability analysis: PSE1 (2011-12)**

| **Scenario** | **Year** | **Asset values** *($000)* | **Revenues** *($000)* | **Profit** *($000)* |
|---|---|---|---|---|
| Use IM compliant asset valuations and revenues as assessed under information disclosure | 2011 | 398,873 | 50,686 | 24,351 |
| | 2012 | 412,211 | 54,737 | 28,093 |
| Includes revaluation gains in year of valuation using Wellington Airport's forecast pricing asset values | 2011 | 341,351 | 51,107 | 20,799 |
| | 2012 | 336,174 | 123,897[1] | 91,483 |
| Includes revaluation gains | 2011 | 398,873 | 78,767[1] | 47,444 |

[163] The effect of revaluations attributable to CPI indexing on profitability measures are taken into account consistently with the treatment under input methodologies.

| | | | | |
|---|---|---|---|---|
| smoothed over 2008-12 using IM compliant asset valuations | 2012 | 412,211 | 82,818[1] | 51,186 |

Notes: [1]Revenues are presented inclusive of revaluation gains allocated as income under our assessment scenario.

H10 The calculations of profitability for PSE1 are presented in Table H3 as rates of return, and the asset base values used as the denominator in the calculations are indicated. We also present comparable calculations for the PSE2 period (2013-17). Lastly, we present a calculation of the IRR for the 7 year period from 2011-17 which represents the whole of the period after the introduction of Part 4 information disclosure for which prices have been set by Wellington Airport. Table H4 presents the estimates of the cost of capital under input methodologies which allows us to make suitable comparisons with our calculations of Wellington Airport's returns.

**Table H3: Wellington Airport rates of return: post ID (2011-17)**

| Scenarios | Asset base values | | Rates of Return | | |
|---|---|---|---|---|---|
| | PSE1 | PSE2 | PSE1 | | PSE2 |
| | (Historic) | (Forecast) | 2011 | 2012 | 2013-17 |
| Information disclosure ROI formula | IM compliant | IM compliant | 5.75% | 6.51% | 9.14% |
| Include revaluation gains in year of valuation | Wellington pricing | Wellington pricing | 6.09% | 34.50 % | 8.69% |
| Include revaluation gains smoothed over 2008-12 | IM compliant | - | 11.54% | 12.12 % | - |
| IRR post information disclosure (2011-17) | IM compliant opening value 2011 | Wellington pricing closing value 2017 | 10.18% | | |

**Table H4: Wellington Airport profitability comparators: post ID (2011-17)**

| | PSE1 | | PSE2 |
|---|---|---|---|
| | 2011 | 2012 | 2013-17 |
| IM cost of capital estimate (midpoint) | 8.19% | 7.75% | 7.06% |
| IM cost of capital estimate (75th percentile)[1] | - | - | 8.04% |
| Wellington Airport stated target | 9.50% | 9.50% | 9.51% |

Notes: [1]A cost of capital estimate above the midpoint has been included because in considering the trade-offs between assessing outcomes that promote dynamic efficiency (eg, incentives to invest) and static allocative efficiency (ie, higher short-term pricing) under Part 4, we generally favour outcomes that promote dynamic efficiency. This consideration is not relevant in an ex post analysis of profits and returns, therefore for PSE1 we have used only the midpoint as a benchmark of normal returns.

H11 The key findings emerging from Tables H3 and H4 are:

H11.1 The returns of 5.75% and 6.51% calculated for the last two years of PSE1 using the information disclosure Return on Investment (ROI) measure are less than the midpoint estimates of the cost of capital under input methodologies of 8.19% and 7.75% respectively. However, the ROI calculations are annual, single period profitability indicators and in Wellington Airport's case are likely to understate the economic returns achieved as the effect of revaluations arising from Wellington Airport's use of its own asset valuation methodology for price-setting purposes are not taken into account in that calculation.

H11.2 The alternative approaches ('Include revaluation gains in year of valuation' and 'Include revaluation gains smoothed over 2008-12') which *do* take into account revaluations suggest that Wellington Airport's profitability has in fact exceeded both the midpoint estimates of the cost of capital under input methodologies (7.75% and 8.19%) and Wellington Airport's stated target return used in PSE1 price-setting of 9.50%.

H11.3 Prices for PSE1 were applied consistently by Wellington Airport from when they were set for that period with effect from 2008. The calculations of profitability for the last two years of PSE1 suggest that excessive profits were also likely to have been generated for the initial years of PSE1 before Part 4 information disclosure regulation was introduced once revaluations are taken into account. We do not have direct evidence of the profitability for these initial years of PSE1 as that period pre-dated Part 4 information disclosure regulation. Our conclusion is therefore inferred from the last two years of PSE1 for which we do have information under Part 4.

H11.4 The estimate of the returns expected to be disclosed for each year of PSE2 which should approximate the weighted average of the annual ROIs under information disclosure is 9.14%. This exceeds both the midpoint (7.06%) and 75$^{th}$ percentile (8.04%) estimates of the cost of capital under input methodologies. Our estimates of these returns are based on information available under Part 4 information disclosure and on forecast information from Wellington Airport's PSE2 price-setting documentation.

H11.5 We consider that the best estimate of the economic return being earned over time by Wellington Airport after the introduction of Part 4 information disclosure is provided by the Internal Rate of Return (IRR) for the period 2011 to 2017.[164] This shows an annual expected return of 10.18% which exceeds both of the midpoint (7.06%) and 75 percentile (8.04%) estimates of the cost of capital under input methodologies for the majority of this period (ie, PSE2). It also exceeds both of Wellington Airport's stated target returns of 9.50% (PSE1) and 9.51% (PSE2). Our calculation of the IRR is based on information

164 As explained in paragraph H89, we have used an opening asset value based on an IM compliant asset value and a closing asset value based on Wellington Airport's pricing closing asset base value.

available under Part 4 information disclosure and on forecast information from Wellington Airport's PSE2 price-setting documentation.

H12 Our overall finding, on the information before us, is that Wellington Airport expects to extract profits in excess of its cost of capital for the period for which prices have been set after Part 4 information disclosure came into force. Given the significant margin by which Wellington Airport's expected profits exceed the comparable estimates of the cost of capital under input methodologies for the period 2011-17 we have concluded that, in the absence of adequate justification in terms of the outcomes sought under Part 4, the expected profits for the period after Part 4 information disclosure came into force are excessive within the meaning of s 52A(1)(d) of the Act. As noted above, we also have inferred that Wellington Airport is likely to have extracted profits in excess of its cost of capital in PSE1 prior to the introduction of Part 4 information disclosure.

H13 To provide an indication of the magnitude of Wellington Airport's profits, our estimate of the present value of net cash flows expected to be generated by Wellington Airport for PSE2 is presented in Table H5.[165]

**Table H5: Wellington Airport profitability analysis: PSE2 (2013-17)**

| **Scenario** | **Compare using midpoint cost of capital** ***($000)*** | **Compare using 75th percentile cost of capital** ***($000)*** |
|---|---|---|
| Present value of Wellington Airport's estimated net cash flows over PSE2 | 140,062 | 140,062 |
| Present value of estimated net cash flows if IM cost of capital estimate were to be achieved over PSE2 | 101,285 | 119,422 |
| Difference | 38,776 | 20,640 |

H14 In Table H5, the present value of expected net cash flows can be compared against that arising if the estimate of either the midpoint or 75th percentile estimate of the cost of capital under input methodologies were to be achieved through prices set by Wellington Airport. We consider the 'Difference' row in Table H5 to provide an indication of the magnitude of the excessive profits expected to be earned by Wellington Airport in PSE2.

H15 Wellington Airport has submitted that its application of "commercial concessions" in setting prices for PSE2 offsets the net impact of the outcomes produced by not applying input methodologies in determining its price-setting profitability outcomes.

165 For the purposes of this s 56G review asset valuations can be conceived of as representing expectations of the net present value of future cash flows: refer paragraph I15.

Our finding as to existence of excessive profits for PSE2 demonstrates that Wellington Airport's claim is incorrect.[166]

H16 No other explanation for the excessive profits has been offered by Wellington Airport and we have found no evidence of superior performance or other external conditions that would adequately justify the level of its profits beyond the reasonable benchmark provided by the estimate of the cost of capital under the input methodologies.

H17 In these circumstances, we have attributed the excessive profits to:

H17.1 Wellington Airport choosing to use its own asset valuation methodologies to value assets without fully accounting for the resulting revaluation gains in determining revenues through the prices set for PSE2;[167] and

H17.2 Wellington Airport targeting the recovery of a cost of capital which is significantly higher than our expectation of normal returns over time.

H18 Although Part 4 information disclosure regulation provides a number of incentives which could be expected to have a significant impact on limiting Wellington Airport's ability to extract excessive profits, our draft conclusion is that they have not been effective in the case of the historical or projected profitability for Wellington Airport.

H19 If Wellington Airport's approach to setting charges persists in future price-setting periods, profitability assessments such as the one carried out in this s 56G review will continue to show excessive profits expected to be earned by Wellington Airport over the longer run.

H20 Lastly, the submissions received from airlines indicated that more information was made available in PSE2 for price-setting purposes but suggested there had been little reduction in the level of disagreement with Wellington Airport over the financial inputs to its price-setting such as the cost of capital, valuation of assets and the treatment of revaluations. Submitters suggested that resolution in these areas was ultimately governed by Wellington Airport's right to set charges as it thinks fit and whilst there has been increased transparency, the existence of Part 4 information disclosure regulation has not appeared to reduce the extent of disagreement.

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166 Our analysis of cash flows has adopted the lower level of revenue associated with the commercial concessions for the revaluation wash up and the final cost of capital used by Wellington Airport for pricing. We have however, added back the terminal wash up. Refer to paragraph H97.

167 Paragraphs I18 to I19 explain why revaluations are treated as income. With respect to asset values, Wellington Airport is entitled to adopt the approach it has taken in setting charges under the AAA but the consequence is that asset values disclosed under information disclosure are disconnected from the asset values used by Wellington Airport for price-setting purposes. It is possible that revaluation gains in excess of those forecast and recognised as income in PSE2 may occur during that period. We cannot predict the extent (if any) of such revaluations and have not attempted to account for them in our analysis.

## How we have structured the analysis in this attachment

H21 The analysis in this attachment is structured around the following questions:

H21.1 What is the role of profitability analysis in information disclosure regulation? (paragraphs H24 to H26)

H21.2 How have we analysed profitability for this report? (paragraphs H27 to H40)

H21.3 What were Wellington Airport's stated profitability objectives in price-setting? (paragraphs H41 to H45)

H21.4 Were profits excessive prior to the introduction of information disclosure regulation? (paragraphs H46 to H71)

H21.5 Is Wellington Airport expecting to extract excessive profits after the introduction of information disclosure regulation? (paragraphs H72 to H90)

H21.6 What change in the level of profitability has occurred? (paragraphs H91 to H94)

H21.7 What are the reasons for excessive profits? (paragraphs H95 to H102)

H21.8 How else has information disclosure regulation influenced profitability performance and conduct? (paragraphs H103 to H122)

H21.9 What is our draft conclusion on profitability? (paragraphs H123 to H128)

H22 A spreadsheet containing the calculations and assumptions used for our profitability analysis referred to in this attachment has been released with this draft report. We intend to hold a workshop (scheduled for 14 November 2012) to explain the calculations and assumptions contained in the spreadsheet. As noted in Chapter 4, we would be interested in views on how our analysis could be improved for the purposes of this s 56G review, including the appropriateness of using more detailed information on Wellington Airport's profitability (if available).

H23 Additional material outlining detail of our technical approach and key issues arising in relation to the analysis of information collected is contained in Attachment I.

## How we have assessed the effectiveness of information disclosure

### Incentives on Wellington Airport to limit excessive profits

H24 Wellington Airport has weak incentives to limit excessive profits in the absence of competition. Setting prices using a building blocks model provides some incentive to limit the extraction of excessive profits by making it more transparent whether excessive profits are being made. However, although Wellington Airport is required to consult with its customers on pricing, its ability to set charges as it sees fit means that it may not have sufficient incentives to promote the outcomes sought under Part 4.

### How information disclosure can provide incentives to limit excessive profits

H25 We consider that information disclosure under Part 4 could have a significant impact on limiting Wellington Airport's ability to extract excessive profits because information disclosure is particularly effective in highlighting issues in this area by increasing transparency and allowing interested persons to assess whether excessive profits have been made. It is the area that is arguably most likely to lead to more heavy-handed regulation if the desired outcomes under Part 4 are not being achieved. Incentives from the threat of further regulation are therefore likely to be strongest in this area.

### We expect that information disclosure should have had an impact at this stage

H26 The effectiveness of information disclosure in limiting Wellington Airport's ability to extract excessive profits should be able to be seen at this stage. This is because:

H26.1 Wellington Airport has set its revenue requirement, and therefore its expected profits, for the next five years (PSE2);

H26.2 the input methodologies applicable to information disclosure under Part 4 of the Act provide key benchmark inputs for assessing the levels of profitability that could be expected in a workably competitive market;[168] and

H26.3 the input methodologies were available at the time Wellington Airport set its revenue requirement for PSE2.

### We have adopted a number of analytical approaches

H27 Regulated airports set charges in advance 'as they see fit' under the Airports Authorities Act 1966 for periods of up to five years. Part 4 information disclosure regulation was introduced with effect from 2011[169] and was therefore in force for the last two years of Wellington Airport's 2008-12 pricing period (PSE1), and at the time that Wellington Airport set its prices for the 2013-17 pricing period (PSE2).

H28 These circumstances suggest that the different approaches discussed below can be used to assess how effective information disclosure regulation has been in promoting outcomes consistent with those produced in competitive markets such

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[168] Input methodologies for information disclosure under Part 4 of the Act allow profitability to be measured on a consistent basis across suppliers and over time. A primary indicator of a benchmark level of normal profits achieved in a competitive market is provided by the cost of capital input methodology which estimates a supplier's weighted average cost of capital (WACC). A level of profitability that exceeds the estimate of WACC indicates that the supplier is achieving or will expect to achieve profits in excess of that which is required to meet the supplier's costs of debt and equity. Unless otherwise specified our analysis has allowed for estimates of the Term Credit Spread Differential (TCSD) in calculations of returns.

[169] The first year for which disclosure was required under information disclosure regulation in Part 4 of the Act was the year ended 31 March 2011.

that Wellington Airport is limited in its ability to extract excessive profits. We have examined:

H28.1 Wellington Airport's target profitability for PSE1 and PSE2;

H28.2 Measures of profitability (historical and expected) prior to and following the introduction of Part 4 information disclosure regulation; and

H28.3 Other matters relating to price-setting conduct.

**Target profitability for PSE1 and PSE2**

H29 A comparison of Wellington Airport's target profitability used for its price-setting processes for PSE1 and PSE2 against expectations of levels of normal returns in workably competitive markets can indicate the effect that information disclosure regulation has had for Wellington Airport. Our focus is on changes in target profitability compared to changes in expectations of normal returns.

H30 PSE1 (2008-12) represents a period that spans both pre information disclosure regulation and post information disclosure regulation. However, as prices (and thus targets for expected profitability) are set in advance then PSE1 is representative of the pre information disclosure situation for the purposes of assessing the implications of changes in Wellington Airport's profitability targets. Analysis for the price-setting undertaken for PSE2 (2013-17) and beyond addresses Wellington Airport's profitability situation post information disclosure regulation.

**Measures of historical and expected profitability**

H31 A calculation of the profitability achieved and expected for the periods prior to and following the introduction of Part 4 information disclosure regulation has been undertaken. This profitability has been compared to the level of returns that could be expected in workably competitive markets.

H32 We undertook a calculation of profitability instead of simply relying on the profitability targets stated by Wellington Airport under its price-setting consultation. This is because the input methodologies for information disclosure for the valuation of assets have not been applied by Wellington Airport as part of its price-setting processes[170] and we needed to recalculate its returns to ensure we are making a 'like-for-like' comparison with our benchmark calculation of profitability based on input methodologies.[171]

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[170] Although airports have typically used a 'building blocks' approach in consulting on and setting charges under the AAA, they are not required to apply input methodologies for information disclosure regulation to determine the building block inputs.

[171] A 75$^{th}$ percentile estimate of the cost of capital has been considered as a benchmark in addition to the midpoint estimate because in trade-offs between assessing outcomes that promote dynamic efficiency

H33 Our analysis of the period prior to Part 4 information disclosure starts with the calculation of historic profitability for PSE1 as detailed in paragraphs H46 to H71. Our analysis calculates the returns reported under Part 4 information disclosure regulation for 2011 and 2012 by using asset values set under input methodologies and reported under information disclosure as opening and closing values, and compares this with the returns calculated using the asset values used by Wellington Airport for price-setting as the closing values.

H34 This allows us to assess to what extent the ROI calculation provided through information disclosure regulation reflects historic performance in PSE1 and to consider what alternative bases of measurement might be required, for example, by adjusting the disclosed PSE1 returns to reflect the impact of the terminal wash up, or revaluation wash ups implied by the use of a revalued asset base for pricing purposes.[172]

H35 This data allows us to draw inferences about the profitability levels of Wellington Airport for PSE1 prior to the introduction of Part 4 information disclosure regulation.

H36 Our analysis of profitability for the period after information disclosure was introduced is informed by the expected returns for PSE2 as detailed in paragraphs H72 to H84. We used Wellington Airport's 2011 input methodology compliant information disclosure information to inform an opening asset value which is then rolled forward over the PSE2 period to derive an input methodology compliant closing value.[173] In calculating profitability, we have removed the impact of the terminal wash up (which has been accounted for in the PSE1 analysis). We then performed sensitivity testing on this input methodology compliant return assessment.

H37 Our profitability assessment for the period after the introduction of the Part 4 information disclosure regulation is for the 7 year period for which prices have been set by Wellington Airport. This includes the last two years of PSE1 and all of the forthcoming 5 year PSE2 period. As discussed at paragraph H78, this has involved using the input methodology compliant asset values as the appropriate starting point and the asset values from Wellington Airport's own asset valuation methodologies as the best estimate of future expected returns over the remaining economic life of the

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(eg, incentives to invest) and static allocative efficiency (ie, higher short-term pricing) under Part 4, we generally favour outcomes that promote dynamic efficiency. This consideration is not relevant in an ex post analysis of profits and returns, therefore for profitability analysis for PSE1 we have considered only the midpoint as a benchmark of normal returns.

172 Wash ups are financial adjustments that seek to correct for the fact that actual performance or circumstances can differ to those forecast. Treatment of terminal wash ups and revaluation wash ups are discussed in greater detail in paragraphs I89 to I102.

173 The 2012 regulatory asset base values have since become available under Part 4 information disclosures. These are consistent with the 2011 rolled forward values we have used.

assets. We computed the IRR for this period which allows us to draw comparisons with the costs of capital estimated for a workably competitive market under input methodologies.

H38 The results of this analysis are summarised in paragraphs H87 to H90 of this attachment. However, as part of undertaking this analysis:

H38.1 We acknowledge that regulatory asset values may not, and do not have to, be used as the basis for an airport's price-setting. Therefore the closing regulatory value determined under input methodologies may not necessarily reflect future returns. In Wellington Airport's case we know it does not use this value for pricing purposes; and

H38.2 We do not know what asset value Wellington Airport will use as the basis for setting prices in PSE3, or whether there will be any wash ups associated with any revaluations. However, we believe it is reasonable to assume that, at the very least, Wellington Airport expects to price off its current forecast of the closing asset value for PSE2.

H39 Lastly, to provide an indication of the magnitude of Wellington Airport's profits, we estimated the present value of net cash flows expected to be generated by Wellington Airport for PSE2. We also estimated the cash flows arising if the midpoint and 75$^{th}$ percentile estimates of the cost of capital set under input methodologies were to be achieved over this period. This analysis is detailed from paragraph H85.

**Other matters relating to price-setting conduct**

H40 Other matters relating to the conduct of Wellington Airport in its interaction with customers as part of price-setting processes were considered. These matters are indicative of the effect information disclosure regulation has had on conduct relevant to profitability. These are discussed at paragraphs H103 to H122.

## Wellington Airport's stated profitability objectives in price-setting

H41 To assess whether a change in the level of target profitability has occurred before and after the introduction of information disclosure regulation we have examined Wellington Airport's stated profitability targets for PSE1 and PSE2, and compared those against our estimates of the cost of capital for regulated airports as comparators for the levels of profitability normally expected in a workably competitive market.

H42 Table H6 summarises the relevant analysis:

**Table H6: Wellington Airport target profitability analysis**

| Profitability indicators | PSE1 | PSE1 | PSE2 |
|---|---|---|---|
| | 2011 | 2012 | 2013-17 |
| Wellington Airport target | 9.50% | 9.50% | 9.51% |

| | | | |
|---|---|---|---|
| IM cost of capital estimate (midpoint) | 8.19% | 7.75% | 7.06% |
| IM cost of capital estimate (75th percentile) | N/A | N/A | 8.04% |

H43 Wellington Airport's target profitability has not changed materially between PSE1 and PSE2, with it targeting the recovery of a post tax cost of capital of approximately 9.5% in both periods.[174] However, in light of the trends in the risk free rate used to generate the estimates of the cost of capital under input methodologies shown in Table H6, we would expect that the target profitability for Wellington Airport would have decreased over the period from PSE1 to PSE2.[175]

H44 We consider that Wellington Airport's cost of capital has not reduced over this period because Wellington Airport has increased the value of certain other parameters in its estimates. In particular, its estimate of asset beta has increased from 0.60 to 0.75 between these periods. As discussed in Attachment I, the asset beta of 0.75 used by Wellington Airport in PSE2 is higher than the asset beta used under input methodologies, and the beta estimated by other expert advisors including expert advisers to New Zealand Airports. As a result of this high estimate of beta, and adoption of a value of TAMRP (of 8%) that is above that used by New Zealand experts and practitioners (generally 7% or 7.5%), Wellington Airport's targeted cost of capital for PSE2 is 246 basis points (2.46%) higher than the Commission's estimate of the cost of capital at around the same time. Wellington Airport is currently appealing our cost of capital input methodology to the High Court under the merits review provisions of the Act. We note that its approach and parameter values in PSE2 are not consistent with its merits appeal position.

H45 The fact that Wellington Airport's target rates of return for PSE1 and PSE2 remained virtually identical despite them exceeding the falling level of our estimated cost of capital between those periods indicates that Wellington Airport's conduct is departing from what might normally be expected if outcomes consistent with those in workably competitive markets were occurring.

## Were profits excessive prior to the introduction of information disclosure?

H46 As noted in paragraph H32, we cannot simply use Wellington Airport's profitability targets to assess profitability prior to the introduction of Part 4 information disclosure because input methodologies for information disclosure were not applied by Wellington Airport for price-setting. Consequently, we consider that its

174 For PSE2, the rate of 9.51% applied was lower than that suggested by external advice received from Wellington Airport and the reduction was termed by it to be a commercial concession to keep target profitability consistent between PSE1 and PSE2. The 'concessionary' nature of this is disputed by airlines. Refer to paragraph I64 for further details.

175 If WIAL had simply updated its WACC from PSE1 for the risk-free rate prevailing as at PSE2, it would have estimated a post-tax WACC of 7.95% for PSE2.

profitability targets are unlikely to provide an appropriate basis for comparisons with normal levels of returns expected in a workably competitive market.

H47 Instead, we have assessed profitability for Wellington Airport for the years in PSE1 for which we have information disclosed under Part 4 regulation (ie, 2011 and 2012), and have then drawn an inference about the profitability levels prior to the introduction of information disclosure from that data.

H48 The profitability calculations for 2011 and 2012 were undertaken in various ways, based on different approaches to:

H48.1 measuring operating revenues and profits (especially the quantification and inclusion of revaluation gains); and

H48.2 valuing assets (using either input methodology compliant valuations or Wellington Airport's own price-setting valuations).

H49 The profitability formula which is used is that prescribed as the 'Return on Investment' measure under Part 4 information disclosure. In applying this formula for 2011 and 2012 we have had regard to asset values set under input methodologies as opening and closing values, compared with Wellington Airport's calculation of required returns which uses the pricing asset base as a closing value.

H50 Table H7 summarises the alternative regulatory investment values (RIVs) available to use as asset values to assess PSE1 returns on an input methodology compliant basis. The table also includes the RIV calculated on an input methodology compliant basis adjusted for an alternative land valuation submitted by BARNZ,[176] which we have used for sensitivity testing of the returns calculated under information disclosure regulation.

**Table H7: Regulatory investment value: PSE1 (2011-12)**

| | **2011 ($000)** | **2012 ($000)** |
|---|---|---|
| IM compliant information disclosure RIV value | 398,873[1] | 412,211[1] |
| Wellington Airport pricing asset base | 341,351[2] | 336,174[2] |
| Alternative IM compliant RIV value (BARNZ) | N/A | 375,211 |

Notes: [1] RIV value provided under Part 4 information disclosure regulation is higher than the Wellington Airport pricing asset base value because it includes lease, rental and concession assets

[176] The valuation was on the basis of a Market Value Alternative Use (MVAU). BARNZ has submitted that the MVAU valuation undertaken by Telfer Young for Wellington Airport overstates the land valuation by not using a feasible alternative land use plan. BARNZ supplied an alternative MVAU valuation undertaken by Property Advisory Limited as at 1 July 2011 which has been used in sensitivity testing: refer paragraph H81.

excluded from the price-setting event. It also includes the impact of a revaluation in 2009 of approximately $30 – 40m (also included in the pricing asset base) and a devaluation in 2011 of $1.7m due to the difference between the 2011 and 2009 MVAU valuations. The BARNZ alternative RIV value adjusts the IM compliant RIV by its estimation of land value in its highest and best alternative use.
[2] Wellington Airport has calculated the asset value used to determine return in each period as being the average of the opening and closing pricing asset base.

H51 For PSE1, Wellington Airport targeted a post-tax return of 9.50%. The PSE1 pricing model assumed that all asset revaluations over the pricing period were accumulated until the final year when they were recognised as income. This meant that the 9.50% return incorporated 4 years of low returns from 2008-2011 with a large spike in the return achieved in 2012.

H52 Our analysis indicates that Wellington Airport achieved its forecast revenues and operating profits over the PSE1 period and that the actual revaluation that occurred over PSE1 was substantially greater than forecast for pricing purposes, indicating the total return for the period, when assessed using the ROI formula, was greater than 9.50%.

H53 If returns for 2011 and 2012 were assessed using the ROI formula but using Wellington Airport's pricing asset base and recognising the actual revaluations over the period as revenue then the returns for 2011 and 2012 would be 11.54% and 12.12% respectively. This assumes the impact of revaluation was smoothed over the 5 years of the pricing period so as not to generate as a spike in returns under the ROI measure in the final year. These returns can be compared to the estimate of the post-tax cost of capital under input methodologies of 8.19% for 2011 and 7.75% for 2012.

H54 Table H8 summarises the returns achieved by Wellington Airport for 2011 and 2012 using both the input methodology compliant asset base and the pricing asset base.

**Table H8: Assessment of historic returns: PSE1 (2011-12)**

| Basis of Assessment | Quantification of revaluation gains | Asset base used as denominator for ROI | Return 2011 | Return 2012 |
|---|---|---|---|---|
| ID compliant ROI | Indexed revaluation on IM compliant asset base | ID RIV | 6.16% | 6.91% |
| ID compliant ROI adjusted for terminal wash up | Indexed revaluation on IM compliant asset base | ID RIV | 5.75% | 6.51% |
| Include revaluation gains in year of valuation | Revaluations implied by difference between PSE1 and PSE2 pricing opening asset bases | Wellington pricing asset base | 6.09% | 34.50% |

| | | | | |
|---|---|---|---|---|
| Include revaluation gains smoothed over 2008-12[1] | Revaluations implied by difference between PSE1 and PSE2 pricing opening asset bases | ID RIV | 11.54% | 12.12% |
| IM cost of capital estimate (midpoint) | | | 8.19% | 7.75% |

Notes: [1] One fifth of actual revaluations for the 5 year PSE1 period is allocated to each of 2011 and 2012.

H55 Tables H9 shows the underlying amounts supporting the calculations in Table H8.

**Table H9: Supporting data for assessment of historic returns: PSE1 (2011-12)**

| Scenario | Year | Asset values ($000) | Revenues ($000) | Profit ($000) |
|---|---|---|---|---|
| Use IM compliant asset valuations and revenues as assessed under information disclosure with terminal wash up | 2011 | 398,873 | 50,686 | 24,351 |
| | 2012 | 412,211 | 54,737 | 28,093 |
| Includes revaluation gains in year of valuation using Wellington Airport's pricing asset base | 2011 | 341,351 | 51,107 | 20,799 |
| | 2012 | 336,174 | 54,184 | 91,483 |
| Include revaluation gains smoothed over 2008-12 using IM compliant asset valuations | 2011 | 398,873 | 78,767 | 47,444 |
| | 2012 | 412,211 | 82,818 | 51,186 |

H56 When returns are assessed on an input methodology compliant basis Wellington Airport achieved returns of 6.19% and 6.91%. These would be reported under Part 4 information disclosure. If the impact of the terminal wash up is included in PSE1, Wellington Airport achieved returns of 5.75% and 6.51% in 2011 and 2012 respectively. These latter figures are preferred for our analysis and have been included in Table H8 and Table H9 above.

H57 Wellington Airport has stated that its returns are "well below the Commission's cost of capital and has resulted in significant shortfalls in revenue of $17.2m in 2011 and $10.4m in 2012."[177]

177 Wellington Airport "WIAL Cross Submission Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page 13.

H58 Disclosed returns achieved by Wellington Airport do appear to be below the estimate of the cost of capital under input methodologies of 8.19% for 2011 and 7.75% for 2012. However, the ROI measure used to calculate these returns is an annual, single period profitability indicator. As noted in the Airports Reasons Paper, costs can vary from year to year, income can be profiled to reflect customer requirements, while short-term profits above the cost of capital may simply reflect superior efficiency or innovation. Ideally, in order to obtain a more appropriate picture over time, returns for Wellington Airport would be assessed using longer term assessments of ROI (eg, trends in ROI or an average ROI over several years).[178]

H59 Wellington Airport's assertion that its disclosed ROI returns represent a shortfall in revenue in each of the last two years (and the calculation of the quantum of those shortfalls) therefore needs to be more closely examined. We consider that there is sufficient information available from Part 4 information disclosure and through AAA pricing documentation to carry out such an assessment.

H60 When performance for 2011 and 2012 is compared to the forecast performance for the same period as shown in Wellington Airport's original PSE1 building blocks price-setting model, we can see that the aeronautical revenue received was greater than forecast in 2012 and close to forecast in 2011. Wellington Airport's operating surplus and regulatory profit (excluding revaluations) also appear to be greater than forecast. Analysis at this level is complicated by the fact that information disclosure data includes revenue and costs associated with leased assets, whilst the building blocks model does not. We do not, however, consider the impact of leased assets to have a material impact.[179]

H61 Our conclusion is that it is not a failure to achieve its forecasts that has caused Wellington Airport's returns to appear to be low. It is that Wellington Airport's revaluation gains on asset values used for pricing purposes were not required to be treated as income in the ROI measure under the information disclosures, as is discussed below.

H62 Tables H10 and Table H11 show the comparison of Wellington Airport's performance as disclosed under information disclosure regulation and its forecast performance in Wellington Airport's PSE1 pricing model for 2011 and 2012.

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[178] Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 3.23 and 3.25.

[179] Aeronautical revenue presented in this analysis excludes income from leased assets but associated costs are not able to be separately identified and removed from the calculation of disclosed regulatory profit. Revenues and costs from leased assets are therefore included in Regulatory Profit. We have assumed that this does not materially affect the analysis on the basis that income from leased asset accounts for less than 7% of total regulatory income and the profitability targeted in relation to leased asset activities is comparable to that of other services provided.

**Table H10: Comparison of Forecast vs Actual Performance 2011**

| | Forecast 2011 | ID 2011 | ID 2011 including terminal wash up | ID 2011 alternative MVAU (BARNZ) |
|---|---|---|---|---|
| | ($000) | ($000) | ($000) | ($000) |
| Aeronautical revenue | 51,107 | 52,955 | 50,686 | N/A |
| Regulatory profit | 20,799 | 25,985[1,2] | 24,351[1,2,3] | N/A |
| Asset investment value | 341,351 | 398,873 | 398,873 | N/A |
| Target return/ROI – comparable to post-tax cost of capital | 6.09% | 6.16% | 5.75% | N/A |
| IM cost of capital estimate (midpoint, March 2011) | | 8.19% | 8.19% | 8.19% |

**Table H11: Comparison of Forecast vs Actual Performance 2012**

| | Forecast 2012 (consistent with ID) | ID 2012 | ID 2012 including terminal wash up | ID 2012 alternative MVAU (BARNZ) |
|---|---|---|---|---|
| | ($000) | ($000) | ($000) | ($000) |
| Aeronautical revenue | 54,184 | 57,006 | 54,737 | 54,737 |
| Regulatory profit | 21,770[4] | 29,727[1] | 28,093[1] | 28,093[1,3] |
| Asset investment value | 336,174 | 412,211 | 412,211 | 375,211 |
| Target return/ROI – comparable to post-tax cost of capital | 6.48% | 6.91% | 6.51% | 7.16% |
| IM cost of capital estimate (midpoint, April 2011 | | 7.75% | 7.75% | 7.75% |

Notes: [1] Regulatory profit calculated under information disclosure includes the impact of lease, rental and concession income.
[2] The regulatory profit in 2011 includes the impact of an asset devaluation loss of $1.7m due to the difference between the 2011 and 2009 valuations.
[3] The terminal wash up adjustment has been based on Wellington Airport's estimate of a total $11.345m impact from delayed capital expenditure spread evenly over the 5 year period of PSE1.
[4] Forecast regulatory profit excludes forecast revaluation income.

H63 The returns shown under information disclosure for 2011 and 2012 are lower than Wellington Airport's targeted post tax returns over the 5 year PSE1 period of 9.50%.

H64 In the relevant pricing model the returns for the first 4 years of PSE1 were forecast to be between 5.6% - 6.1%, with one large return being generated in 2012 through a $70m revaluation being taken to income and giving rise to a forecast return in the final year of approximately 27.2%.[180] If the revaluation gain had not been included in the revenue forecast the return would have been approximately 6.48% as shown in Table H11.

H65 Wellington Airport undertook a valuation of all of its assets for the purposes of Part 4 information disclosure in 2009. In 2011, Wellington Airport revalued its assets, this time using a land valuation approach that was not input methodology compliant. Therefore, the asset base disclosed in 2011 and 2012 is higher than originally forecast, but the impact of the revaluation gain has not been disclosed under information disclosure because it either occurred in a period that pre-dated Part 4 information disclosure or it was not required to be recognised as a revaluation gain as it did not relate to an input methodology compliant asset base.[181] Over time, the impact of the revaluations will become apparent under information disclosure as elevated profit levels to the extent that the revaluations flow through into the revenues collected from customers by Wellington Airport (as our analysis for PSE2 and beyond demonstrates later in this attachment).

H66 In order to determine whether Wellington Airport actually achieved its target return of 9.50% including revaluations for PSE1, we have treated all asset valuations as occurring in 2012, consistent with Wellington Airport's original forecasts.

H67 If we were to assess Wellington Airport's return in 2012 including the actual revaluation experienced by Wellington Airport for the PSE1 period, by estimating the total revaluation as being the forecast revaluation for PSE1 plus the difference attributable to revaluation between the PSE1 closing asset base and the PSE2 opening asset base, then Wellington Airport's forecast profit including revaluation would increase by $56m ($53m after the terminal wash up), as shown in Table H12. Because we are including the total revaluation experienced by Wellington Airport over PSE1, we have also recognised the revaluation wash up conceded by Wellington Airport of $14.5m (which equates to $10.4m post tax impact on profit).

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180 It was Wellington Airport's intention that the revaluation gain be treated as income, hence the lower return if it is excluded. The impact of this revaluation was subsequently smoothed back across the whole PSE1 period to give the annual required revenue in the Final Pricing Document.

181 We have not sought to reconcile the actual valuations and the associated gain on revaluation in 2009 and 2011 for specified airport services because land valuations have been undertaken on the total airport land including land not used for specified airport services, and also because of ongoing transfers between the regulated and unregulated asset base.

**Table H12: Comparison of Forecast vs Actual Performance 2012 Adjusted for Revaluations**

| | Forecast 2012 *($000)* | Actual 2012 *($000)* | Actual 2012 including terminal wash up *($000)* |
|---|---|---|---|
| Pricing profit (excluding revaluation) | 21,770 | 29,727[1] | 28,093[1,2] |
| Revaluation income | 69,713 | 125,903[3] | 125,903[3] |
| Pricing profit (including revaluation) | 91,483 | 155,630 | 153,996 |
| Tax adjusted impact of revaluation wash up | N/A | 10,440[4] | 10,440[4] |
| Adjusted pricing profit (including revaluation) | 91,483 | 145,200 | 143,556 |
| Pricing asset investment value | 336,174 | 412,211 | 412,211 |
| Target Return/ROI including revaluation | 27.2% | 34.9% | 34.5% |

Notes: [1] Regulatory profit under ID includes the impact of lease, rental and concession income. [2] The terminal wash up adjustment has been based on Wellington Airport's estimate of a total $11.345m impact from delayed capital expenditure spread evenly over the 5 year period of PSE1. [3] The Commission's estimate of actual revaluation is based the forecast revaluation plus the difference between the PSE1 2012 forecast asset base and the PSE2 2012 forecast asset base attributable to revaluations. The PSE2 forecast asset base reflects valuations undertaken in 2011 which were not forecast in PSE1. [4] When using Wellington Airport's pricing profit including revaluations, the impact of the revaluation wash up must be considered. The revaluation wash up is valued at $14.5m and occurs at the time the revaluation gains are recognised, The adjusted pricing profit recognises the tax adjusted impact of the revaluation wash up of $10.4m.

H68 Therefore, it would appear that Wellington Airport's revaluation gain over the PSE1 period[182] is higher than that forecast in the PSE1 pricing disclosure and would result in a higher ROI for 2012 than forecast, even after the impact of the revaluation wash up is considered. It would also indicate that assuming there was no substantial under-performance in the years 2008-2010,[183] Wellington Airport would have made a higher return than the 9.50% post tax return targeted over the total period. We consider this conclusion would be evident to Wellington Airport at the time the Part 4 information disclosure was introduced on the basis of information known to it at the time and a methodological approach consistent with the one set out in this attachment.

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182 Actual revaluation measured as being the closing 2012 pricing asset base from the PSE1 pricing model less the opening 2008 pricing asset base from the PSE1 pricing model adjusted for the impact of depreciation and capital expenditure.

183 Disclosures made by Wellington Airport under the AAA information disclosure requirements suggest there was no underperformance in these years.

H69 Table H13 restates the 2011 and 2012 returns (after terminal and revaluation wash up) to allow for the actual revaluation to be attributed evenly across the 5 years of the PSE1 pricing period.[184] This removes the spike in returns shown in 2012 when the revaluation gain is included and smoothes the impact across each of the years in PSE1. As discussed in paragraph H58, we consider this to be a more appropriate reflection of returns achieved in each year and representative of returns over the PSE1 period when using the ROI formula.

**Table H13: Assessment of ROI in 2011 and 2012 including revaluation/terminal wash up**

| | 2011 ($000) | 2012 ($000) |
|---|---|---|
| Aeronautical revenue | 50,686 | 54,737 |
| Regulatory profit | 24,351 | 28,093 |
| Revaluation | 25,181 | 25,181 |
| Tax adjusted impact of revaluation wash up | 2,088 | 2,088 |
| Adjusted regulatory profit (including revaluation) | 47,444 | 51,186 |
| Asset investment value | 398,873 | 412,211 |
| Target Return/ROI including revaluation | 11.54% | 12.12% |

H70 We note that BARNZ has attempted to calculate a 5 year returns analysis across the 5 years of PSE1. Its assessment of returns on regulated airport activities indicates annual returns of 8.15%. This analysis includes the revaluation of $32.5m which occurred in 2009 but not the 2011 revaluation which would have had a significant impact on the overall return. This means that the BARNZ analysis understates the total return over PSE1 and we do not consider that this method therefore allows an assessment of returns which is applicable to our review.

H71 The average return estimated by BARNZ is further complicated by the difficulty in calculating the input methodology compliant RIV against which returns are assessed. BARNZ has stated that it estimated the RIV for each of the years from 2008 – 2011 using an average of the closing asset base for the current and previous year as it did not know the proportionate investment value that would have been used to calculate an input methodology compliant RIV. BARNZ has used the information provided by Wellington Airport in Appendix 7 of its Initial Pricing Proposal to determine the value of the asset base.[185]

[184] We have not taken into account the time value of money when allocating this gain on the assumption that the impact would not be material.

[185] We note that these values do not match the information disclosed by Wellington Airport under the prior AAA disclosure regime and we have not sought to reconcile these differences.

## Are excessive profits expected to be achieved after information disclosure?

H72 Our analysis of profitability for the period after information disclosure was introduced is informed by Wellington Airport's expected returns for PSE2. These are used to calculate the expected profitability for the 7 year period for which prices have been set by Wellington Airport (2011-2017) following the introduction of Part 4 information disclosure regulation. Our assessment uses the IRR approach.

H73 As discussed in paragraph H36, we have assessed returns against both an input methodology compliant base and Wellington Airport's pricing asset base. We have also looked at what the returns would be if we used the input methodology compliant asset base as a starting point and the pricing asset base as a closing value. Sensitivity testing has then been performed on the input methodology compliant return assessment and we have tested the impact on the revenue required by Wellington Airport of targeting an input methodology compliant cost of capital.

H74 Table H14 summarises the various regulatory investment values that are used to assess forecast returns on an input methodology compliant basis[186] as well as the asset base values used by Wellington Airport in its pricing model. The table also includes the RIV under an input methodology compliant basis adjusted for an alternative MVAU valuation submitted by BARNZ,[187] which we used as a sensitivity test against the input methodology compliant estimate of returns.

**Table H14: Assessment of forecast regulatory investment value for PSE2**

| ($000s) | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| IM compliant RIV value | 427,740 | 442,898 | 460,263 | 465,269 | 463,901 |
| Wellington Airport pricing asset base | 506,757 | 524,267 | 544,052 | 551,532 | 552,702 |
| IM compliant using adjusted ID RIV value (BARNZ)[1] | 389,486 | 403,688 | 420,072 | 424,074 | 421,676 |

Notes: [1] The calculation of ID RIV using the adjusted MVAU value supplied by BARNZ is discussed at paragraph I84.

H75 Table H15 summarises the returns expected by Wellington Airport for PSE2.

[186] We have used Wellington Airport's 2011 information disclosure information to establish the opening asset value which is then rolled forward over the PSE2 period to derive an IM compliant closing value for our analysis of profitability for PSE2. Refer footnote 173.

[187] Refer footnote 176.

**Table H15: Assessment of expected returns for PSE2**

| Basis of Assessment | Opening Asset Base[1] | Closing Asset Base | PSE2 return |
|---|---|---|---|
| IRR on IM compliant assets | ID RAB | ID RAB rolled forward | 9.14% |
| IRR on pricing assets[2] | Pricing MVAU + land conversion costs | Pricing MVAU + land conversion costs rolled forward | 8.69% |
| IM cost of capital estimate (midpoint) | | | 7.06% |
| IM cost of capital estimate (75th percentile) | | | 8.04% |

Notes :[1] Opening PSE2 asset value is equal to the closing PSE1 asset value used in the determination of the comparable 2012 post-tax ROI.[2] Return adjusted for the revaluation wash up. Targeted return for PSE2 9.51%.

H76 The table shows that if returns are assessed using an input methodology compliant MVAU land valuation methodology, Wellington Airport's forecast post-tax IRR for PSE2 would be 9.14%[188] compared to the estimate of the cost of capital under input methodologies (midpoint) of 7.06%. Wellington Airport's forecast post-tax IRR for PSE2, for all regulated activities, using its own forecast value of assets employed and including revenue adjusted for the revaluation wash up is 8.69%.

H77 Assessing returns based on input methodology compliant opening and closing asset values provides a reasonable estimate of returns for the period to which they apply provided the closing asset value continues to be applied in future periods to determine revenues and profits. However, we know the input methodology compliant closing RAB does not provide a good reflection of the revenues and profits expected after that date because Wellington Airport does not use this asset value for pricing purposes. Therefore, the IRRs presented above do not appear to provide a good estimate of the returns expected to be earned on the post information disclosure opening RAB over a longer time frame.

H78 We do not know what asset value Wellington Airport will use as the basis for setting prices beyond PSE2, or whether there will be any wash ups associated with any revaluations. However, at this point in time we consider it is reasonable to assume

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188 Wellington Airport has stated that using an IM compliant valuation approach to land, the forecast return for PSE2 under this scenario would be 8.92%: refer Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page 12. We note that this assessment of returns excludes the impact of noise mitigation activities and lease, rental and concession income. It also reduces revenue by the value of the terminal wash up, which in our calculations has reduced revenue in PSE1 not PSE2. Further discussion of our treatment of the terminal wash up is provided in paragraphs I25 to I36.

that, at the very least, Wellington Airport expects to set prices for PSE3 and beyond by pricing off its current forecast of the closing asset value for PSE2. We therefore consider the closing pricing asset base for PSE2 provides a better estimate of the discounted net cash flows beyond PSE2 than the rolled forward input methodology compliant RAB.

H79 The returns assessed using an input methodology compliant MVAU land valuation methodology are subject to sensitivity testing as discussed in the following section, and are then used to calculate the 7 year IRR for the period 2011-17 which we consider provides the best measure of post information disclosure profitability.

**Sensitivity analysis on input methodology compliant returns for PSE2**

*Alternative MVAU land valuation*

H80 The calculations we employed to assess returns for PSE2 were designed to calculate returns on an input methodology compliant basis and are not suitable for rolling forward two distinct asset bases so as to include results for the last 2 years of PSE1. Therefore we have performed our sensitivity analysis on the input methodology compliant return of 9.14% relating only to PSE2.

H81 We have tested the impact of assessing Wellington Airport's return using the alternate MVAU based land valuation supplied by BARNZ.[189] The reduction in the regulatory investment value under this scenario, leads to a forecast post tax IRR of 9.78% compared to our input methodology compliant post-tax IRR of 9.14%.

*Incentive scheme is not triggered*

H82 As discussed in Attachment G, we have explored the impact of the proposed volume growth incentive scheme on Wellington Airport's forecast revenues and return. If volumes increase as a result of the incentive scheme but no individual airline meets the required threshold as submitted by Air New Zealand, we estimate that Wellington Airport's revenue would increase by approximately $21.7m over the pricing period, resulting in a forecast return of 9.46%.

*Impact of cost of capital estimates on Wellington Airport target pricing revenue*

H83 We have also tested the impact on revenue of targeting an input methodology compliant return based on the midpoint, 75th percentile and 25th percentile estimates of the cost of capital.

H84 The impact on the required revenue calculated to achieve a target return of either the midpoint, 75th percentile or 25th percentile cost of capital is outlined in Table H16.

[189] For further details see paragraph I84.

**Table H16: WACC sensitivities: revenue required to achieve a target return**

| (All $000 unless specified) | 2013 | 2014 | 2015 | 2016 | 2017 | Total |
|---|---|---|---|---|---|---|
| Wellington Airport Forecast Total Revenue | 64,341 | 75,193 | 82,099 | 89,189 | 96,835 | 407,658 |
| Midpoint post-tax cost of capital – 7.06% | 61,952 | 63,325 | 69,053 | 71,489 | 72,685 | 338,504 |
| % Change from Wellington Airport Forecast | -3.71% | -15.78% | -15.89% | -19.85% | -24.94% | -16.96% |
| 75th Percentile post-tax cost of capital – 8.04% | 67,787 | 69,370 | 75,339 | 77,845 | 79,025 | 369,365 |
| % Change from Wellington Airport Forecast | 5.36% | -7.74% | -8.23% | -12.72% | -18.39% | -9.39% |
| 25th Percentile post-tax cost of capital – 6.08% | 56,135 | 57,298 | 62,787 | 65,152 | 66,364 | 307,735 |
| % Change from Wellington Airport Forecast | -12.75% | -23.80% | -23.52% | -26.95% | -31.47% | -24.51% |

### Magnitude of PSE2 profits

H85 To provide an indication of the magnitude of Wellington Airport's profits for the PSE2 period, our estimate of the present value of net cash flows expected to be generated by Wellington Airport for PSE2 is presented in Table H17.[190]

**Table H17: Wellington Airport profitability analysis: PSE2 (2013-17)**

| Scenario | Compare using midpoint cost of capital *($000)* | Compare using 75th percentile cost of capital *($000)* |
|---|---|---|
| Present value of Wellington Airport's estimated net cash flows over PSE2[1] | 140,062 | 140,062 |
| Present value of estimated net cash flows if IM cost of capital estimate were to be achieved over PSE2 | 101,285 | 119,422 |
| Difference | 38,776 | 20,640 |

Notes: [1] The estimated net cash flows include the revaluation wash ups implied by the use of a revalued asset base for pricing purposes, but does not include the terminal wash up as we have attributed that to PSE1.

[190] The cash flow inputs for the calculation of net cash flows for Wellington Airport are forecast revenue (excluding gain/loss on sale) less opex less value of commissioned assets plus cash received from disposals less tax less term credit spread adjustment. The present value of this are compared to the present value of the same cash flow inputs generated from an IM compliant regulatory investment value using the Commission's cost of capital estimate.

H86 In Table H17, the present value of expected net cash flows can be compared against that arising if the estimate of either the midpoint or 75th percentile estimate of the cost of capital under input methodologies were to be achieved through prices set by Wellington Airport. We consider the 'Differences' row in Table H5 to indicate the range of excessive profits expected to be earned by Wellington Airport in PSE2.

**Assessment of 7 year returns using pricing asset base as best estimate of future returns**

H87 The analysis of profitability above relates to expected returns for PSE2, however we consider that the best estimate of expected profitability for the period after which information disclosure has been introduced is for the 7 years for which prices have been set over 2011-2017. This includes the last 2 years of PSE1.

H88 Wellington Airport in their post conference submission provided additional analysis regarding the expected 7 year returns following the commencement of the information disclosure regime. Wellington Airport states that the return over the 7 year period (comprising 2 years of historic returns and 5 years of forecast returns) is 6.88% based on an MVEU asset base and 8.21% based on an MVAU asset base.[191] We have not seen the details of the analysis undertaken by Wellington Airport.

H89 We consider that in constructing a 7 year IRR analysis, the opening asset value should be based on an input methodology compliant asset base as discussed further in paragraph I37. However, we also consider that the closing asset value, which represents the net future cash flows of the assets, should be based on Wellington Airport's closing pricing asset base as this is the best currently available estimate of the value of the asset base likely to be used for pricing into PSE3 and beyond. The reasons for this were outlined in paragraph H78.

H90 Calculating the 7 year IRR using the opening input methodology compliant asset base but the PSE2 pricing closing asset value results in post-tax return of 10.18% based on Wellington Airport's opening MVAU. Analytically, we consider this provides a reasonable reflection of the returns presently expected to be earned on the input methodology compliant 2011 opening RAB over the remaining lifetime of the assets.[192]

## What change has there been in the level of profitability?

H91 PSE1 represents a period that incorporates both pre IMs disclosures, under AAA, and post-IMs disclosures. In assessing changes in the level of profitability prior to and

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[191] Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 65.

[192] As noted in Attachment I, our IRR analysis has not made any adjustments to reflect the actual timing of cash flows but has used end of period discounting (except in the case of capital expenditure). This gives rise to a conservative estimate of the IRR in favour of Wellington Airport, when compared to using assumptions which attempt to approximate the actual timing of cash flows.

after the introduction of information disclosure regulation we have used returns in PSE1 as representative of returns achieved by Wellington Airport prior to the introduction of ID, with historic returns for the last 2 years of PSE1 and expected returns for PSE2 and beyond representing Wellington Airport's profitability post information disclosure regulation.

H92 Wellington Airport targeted a post-tax return of 9.50% in PSE1. Our analysis indicates that Wellington Airport's performance for the 5 year period was in excess of its target return if all revaluation gains on its pricing asset base are taken into account.[193] Considering that the input methodology compliant midpoint estimate of the cost of capital determined by the Commission for 2011/2012 was in the range of 7.75% - 8.19% this suggests that the profits earned by Wellington Airport prior to the introduction of information disclosure regulation were in excess of its cost of capital.

H93 Wellington Airport is targeting a post-tax return of 9.51% in PSE2. Our analysis of the returns that are likely to be disclosed under information disclosure for PSE2 gives a post-tax return of 9.14%, however Wellington Airport's returns over the life of the assets as assessed at the end of PSE2 are 10.18%. A comparison of this figure with the midpoint cost of capital estimated under input methodologies of 7.06% and a 75th percentile cost of capital of 8.04% indicates that its expected profits exceed its cost of capital for that period.

H94 Given the significant margin by which Wellington Airport's expected profits exceed the comparable estimates of the cost of capital under input methodologies we consider that, in the absence of an adequate justification, the expected profits for the period for which prices have been set after Part 4 information disclosure came into force are excessive within the meaning of s 52A(1)(d) of the Act.

## What are the reasons for excessive profits?

H95 As discussed in paragraph 2.23, if an airport has not applied the input methodologies in setting its prices, we do not simply assume that this means that the Part 4 purpose is not being promoted. For example, a combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

H96 This point was raised by Wellington Airport in its cross submission on the Commission's Conference of August 2012[194] where it submitted that its use of "commercial concessions" in setting prices for PSE2 offsets the net impact of not applying input methodologies in determining its profitability outcomes. Wellington

193 The returns are below its target return if only compliant revaluations are taken into account. This effect is discussed from paragraph H57.

194 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Airports Conference" 17 August 2012, paragraph 46.

explained that it provided "considerable comment in its consultation material, the price setting event disclosure and earlier substantive and cross submissions on how it gave consideration to the IMs in consultation", noted specifically that:

> "WIAL applied, through consultation, a number of commercial concessions to its price setting that materially offset the net impact of variations from the application of IMs – demonstrating that net outputs need to be considered and not selective inputs".

H97 However, our analysis indicates that Wellington Airport's claim is not correct and that the net outcome of its price-setting is that it expects to earn a greater than normal return over time. Our analysis of cash flows for these purposes has adopted the lower level of revenue associated with the commercial concessions for the revaluation wash up and the final cost of capital used by Wellington Airport for pricing. We have however, added back the terminal wash up. A discussion of our treatment of the terminal wash up is included at paragraph I102.

H98 Given the significant margin by which Wellington Airport's expected profits exceed the comparable estimates of the cost of capital under input methodologies for the period 2011-17 we have concluded that, in the absence of adequate justification in terms of the outcomes sought under Part 4, the expected profits for the period after Part 4 information disclosure came into force are excessive within the meaning of s 52A(1)(d) of the Act.

H99 We have considered whether there is any other reason that would justify this level of excessive profitability. No evidence or explanation of superior performance or for the existence of external conditions outside the control of Wellington Airport has been presented to us during the course of our s 56G review to justify the existence of excessive profits. Further, our analysis in this draft report of the areas of economic efficiency relevant to the Part 4 purpose for Wellington Airport has not indicated that the forecast levels of expenditure underlying Wellington Airport's PSE2 pricing model represents levels of expenditure associated with superior performance.

H100 We have therefore concluded that based on our analysis:

H100.1 A major driver of excessive levels of profitability is Wellington Airport's choice of its asset base valuation used for price-setting purposes (relative to that calculated under input methodologies) without fully accounting for the revaluation gains inherent in the using revaluation. The asset base used for pricing purposes is an estimate of the future discounted cash flows over the remaining lifetime of those assets. Hence Wellington Airport's closing asset valuation contains its expectations of the remaining profits that can be extracted from regulated activities.

H100.2 A second significant driver of excessive profits is the cost of capital targeted by Wellington Airport in forecasting revenue and setting prices. As discussed in the analysis above, Wellington Airport has targeted a 9.51% return after the introduction of Part 4 information disclosure. This level is significantly higher than the estimate of an appropriate cost of capital under input methodologies.

H101 Wellington Airport's aeronautical revenue will increase by approximately 9% per annum during the five year PSE2 pricing period from $56m in FY12 to $86m in FY17, a 54% increase over five years. There has been a marked increase in the level of returns as a result of the decision to revalue the land on an MVAU plus land conversion costs basis for PSE2 pricing purposes. The inclusion of some $56m of revaluations in excess of those forecast at the end of PSE1 implies a significant consequent increase in profitability with no relaxation of the targeted cost of capital or reduction of forecast costs.

H102 With respect to asset valuation, Wellington Airport is entitled to adopt the approach it has taken in setting charges under the AAA but the consequence is that asset values disclosed under information disclosure are disconnected from the asset values used by Wellington Airport for price-setting purposes. If Wellington Airport's approach persists for future price-setting, profitability assessments will show excessive profits being earned by Wellington Airport over the longer run.

## How else has information disclosure regulation influenced profitability performance and conduct?

### Key areas of change in Wellington Airport conduct

H103 We have also considered the conduct of Wellington Airport in its interaction with customers as part of price-setting processes. In summary, we have concluded:

H103.1 Wellington Airport's approach to asset valuation methodologies adopted for pricing purposes has made more explicit the significant value difference from the valuation approach we use to assess outcomes expected in a workably competitive market;

H103.2 The feedback from airlines suggested that, while more information was made available in PSE2, there had been little reduction in the level of disagreement between the airlines and Wellington Airport in pricing consultations, with resolution being governed by Wellington Airport's reliance upon its right to make the final decision on price-setting matters.

*Asset Valuation*

H104 Wellington Airport has indicated that it has changed its approach to land asset valuation from a zonal MVEU approach to a MVAU plus land conversion costs.[195] BARNZ has suggested this represents no real change in approach to land asset valuation as a MVAU plus airport conversion costs approach was also undertaken in the previous land valuations and that Wellington Airport is continuing to use a non

[195] Wellington Airport "Initial pricing proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 42.

IM-compliant valuation. BARNZ[196] states that "a discounted cash-flow alternative use subdivision was undertaken in every one of those valuations. The only difference between the present valuation and those past valuations is that greater effort has been put into determining the composition of the alternative use, and expert planning and civil engineering advice has been sought. A change to the inputs, or volume of experts consulted, does not constitute a change in methodology."

H105 We consider that regardless of whether the approach to land asset valuation has changed or not since PSE1, the approach used to value land assets for the Wellington Airport building blocks model is not input methodology compliant (but we acknowledge that under the AAA approach to setting charges it is not required to be). In the absence of an adequate explanation of how the outcome of Wellington Airport's building blocks approach is consistent with the purpose of Part 4 the implication is that airports still have the ability to target and achieve excessive profits under the Airports Authorities Act charging regime, which we consider has occurred for Wellington Airport.

H106 We also recognise that the valuations used in PSE2 for other asset categories are not input methodology compliant. Buildings and civil works have been revalued in 2011 using an ODRC based valuation approach. The IMs state that the value of buildings and civil works should determined by rolling forward the 2009 ODRC valuation. We consider that the impact of this difference in approach is not material.

H107 Wellington Airport has assumed for PSE2 that all assets are revalued annually at the airport's CPI assumption, and has accounted for these revaluations as income consistent with the requirement under input methodologies that indexed asset revaluations are treated as income.

H108 Wellington Airport has stated that "it has amended its treatment of the timing of the forecast valuation uplift. In past consultations, the forecast valuation uplift was recognised at the end of the pricing period. For the next pricing period Wellington Airport proposes to recognise the valuation uplift annually. This will achieve consistency with the approach required by the Commission for the information disclosure regime and ensure that comparison of pricing forecasts and Commission information disclosures can be undertaken on a consistent basis."[197]

H109 While these changes represent a change on behalf of Wellington Airport to be more consistent with IMs, the impact of these changes are insignificant when compared to the more significant issue of the overall approach to the land valuation.

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196 BARNZ "BARNZ Assessment of WIAL Initial Pricing Proposal for Charges to Apply from 1 April 2012 – 31 March 2017" 10 October 2011, page 21.

197 Wellington Airport "Initial pricing proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 50.

H110 While BARNZ considers that forecast CPI represents an appropriate interim allowance for revaluations for the purposes of setting prices now, it notes that CPI is effectively only a place-holder, and once actual revaluations are known, then the difference between the forecast revaluations and the actual revaluations (be it a higher or lower revaluations) needs to be reflected in charges for the next price setting period.[198] No wash up mechanism for revaluations in excess of forecast indexed revaluations has been provided for by Wellington Airport for PSE2 price-setting.

*Consultation Process*

H111 The Commerce Commission's conference highlighted that there were strongly opposing views of Wellington Airport's conduct during the PSE2 consultation. Representatives for Air New Zealand indicated that there has been no substantial change in Wellington Airport's behaviour as the result of ID stating "there is no aspect we would characterise as negotiation. It is consultation under the AAA with the AAA being used to set prices as the airport see fit and that has not changed since prior to ID." [199]

H112 BARNZ (who is a representative body for airlines) similarly commented that "certainly you discuss things, the material put in front of us has been professionally prepared but you feel at the end of each meeting you've been ignored." [200]

H113 In response Wellington Airport submitted: "Wellington Airport negotiates and has got negotiated agreements with substantial customers. Air New Zealand is not willing to negotiate." [201]

H114 During the Wellington Airport Conference, Wellington Airport stated that it sees the benefit of the Information Disclosure regime as being in the quality of the consultation process and discussions between the airports and the airlines on important issues.[202]

H115 However, BARNZ has stated while Wellington Airport is no longer placing confidentiality restrictions around its consultation information and has made it

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198 BARNZ "BARNZ Assessment of WIAL Revised Pricing Proposal for Charges to Apply from 1 April 2012 – 31 March 2017" 23 December 2011, page 7.

199 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 72.

200 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 73.

201 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 73.

202 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 71.

available for all interested parties, the level of dispute or disagreement between the parties has not diminished with key issues remaining unresolved or in dispute.[203] BARNZ also states that Wellington Airport has continued to rely heavily upon the right to set charges as it thinks fit under the AAA, with the outcome of consultation appearing to be a foregone conclusion.

H116 This feedback suggests that, while more information was made available in PSE2, there has been little reduction in the level of disagreement between the airlines and Wellington Airport in relation to pricing outcomes, with resolution being governed by Wellington Airport's reliance upon its right to make the final decision on price-setting matters. There is no evidence that this level of disagreement will abate for future price-setting periods, and if it does persist then we cannot be confident that Wellington Airport's excessive profits will be limited at PSE3 or beyond.

*Other changes in conduct*

H117 Wellington Airport has made a number of alterations to the model used to calculate the revenue required to generate its targeted return since PSE1. We are unable to conclude for all amendments whether the changes made to model were made because of ID or were part of the ongoing update and maintenance of the pricing model.

H118 The cost allocation methodology has changed since PSE1 from an expenditure line allocation approach to an activity-based cost allocation approach which is input methodology compliant. This may not result in a significant change in the value of costs being allocated. However, we note another change in treatment with regards to the inclusion of the terminal hall within the aeronautical asset base. This is discussed further in paragraphs I103 to I104.

**What is information disclosure's likely impact going forward?**

H119 The cost allocation methodology used by Wellington Airport appears to have changed due to the introduction of Part 4 information disclosure; however, this may not have had a material impact on profitability bearing in mind the considerable discretion that Wellington Airport continues to have in setting prices.

H120 Although the assumptions surrounding the 'highest and best alternative use' of land have been modified, the land valuation methodology has not otherwise changed significantly between PSE1 and PSE2 and information disclosure appears to have had little impact. Considering that Wellington Airport continues to argue against the prescribed methodology for valuing land under input methodologies, information disclosure, in its current form, may not have any significant impact looking forward.

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[203] BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 35.

H121 Information disclosure has had no impact on the valuation of other specified assets. The methodology used for valuing other specified assets is consistent with IMs; however, this methodology was in place prior to the introduction of IMs. The ongoing revaluation of these assets is not consistent with IMs (and neither does it have to be under Part 4) and we see no evidence that Wellington Airport will not continue this treatment in future. While this has had no material impact to date, BARNZ[204] has suggested that the variance between the value under ID and the value forecast by Wellington Airport will continue to diverge over time.

H122 Information disclosure has had no impact on Wellington Airport's targeted cost of capital. Wellington Airport continues to use a cost of capital above that determined by the Commission under the cost of capital input methodology. Considering that Wellington Airport continues to take a different view to the Commission over the key assumptions used in determining an estimate of the cost of capital for the airport, it is unlikely that information disclosure will have any impact looking forward.

## Draft conclusion on profitability

H123 Wellington Airport stated at the conference that it believes information disclosure regulation is working and that it is adding value by providing for consistency of information.[205] It also stated that the input methodologies have "very materially" influenced its consideration of asset valuation.

H124 On the other hand, BARNZ states that it "has not seen any evidence of behavioural change on the part of Wellington Airport as a result of ID regulation" and notes that there has been no behavioural change in relation to asset valuation methodology, treatment of revaluations, or estimation of cost of capital.[206]

H125 We have concluded that there has been little apparent change in the behaviour of Wellington Airport with respect to profitability since information disclosure regulation was introduced. Similar rates of return were targeted by Wellington Airport through prices in PSE1 and PSE2 despite the level of our cost of capital estimates falling between those periods.

H126 To the extent that Wellington Airport is able to set its prices using an asset base in excess of that calculated under information disclosure regulation, then the ROI under information disclosure regulation will understate the returns achieved.

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[204] BARNZ "BARNZ response to WIAL Section 56G Issues paper" 28 June 2012, page 12.

[205] Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, pages 55-56.

[206] BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue" 17 August 2012, page 22.

H127 Our analysis suggests that Wellington Airport has extracted excessive profits prior to the introduction of information disclosure regulation in PSE1, and that it expects to extract excessive profits in PSE2 and possibly beyond. Significant disagreement with customers exists over the valuation of assets and the treatment of revaluation gains and the associated wash ups which has led to disagreement over pricing outcomes.

H128 Information disclosure regulation therefore does not appear to have been effective in promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits.

# Attachment I: Supplementary material on profitability

### Purpose of this attachment

I1 This attachment contains further detail on our approach to assessing profitability in Attachment H and the information we collected and analysed for our assessment. We also discuss the key issues identified in submissions received from interested parties in relation to profitability.

### Structure of this attachment

I2 The following discussion addresses some of the challenges associated with performing investment profitability assessments for periods shorter than the expected lives of the relevant assets, in particular the choice of opening and closing asset values, the selection of the period of analysis, and the choice of the appropriate returns measure. We also discuss the timing of revenue recognition in relation to wash-ups, which span more than one period of analysis.

I3 This forms the background for the description of our analytical approach in Attachment H.

I4 We then describe the information on which our assessment has been based and discuss the limitations of that information.

I5 Lastly, we explain how we have dealt with the key issues that arose at the conference and in submissions that bear directly upon our assessment of profitability.

I6 For ease of reference we have structured the section headings as follows:

- I6.1 Relationship between asset values and profits (paragraphs I7 to I9)
- I6.2 Assessing returns using disclosed return on investment (ROI) (paragraphs I10 to I13)
- I6.3 Assessing returns using an internal rate of return (IRR) (paragraphs I14 to I17)
- I6.4 Treatment of asset revaluations (paragraphs I18 to I19)
- I6.5 Assessing Wellington Airport's returns in PSE1 and PSE2 (paragraphs I20 to I24)
- I6.6 Treatment of cash and non-cash wash ups (paragraphs I25 to I41)
- I6.7 Key information used in our analysis
  - I6.7.1 Summary of information used (paragraphs I42 to I43)
  - I6.7.2 Limitations of information used (paragraphs I44 to I46)
- I6.8 Revenue assessment (paragraphs I47 to I55)

I6.9 Treatment of key issues

I6.9.1 Cost of capital (paragraphs I57 to I74)

I6.9.2 Asset values (paragraphs I75 to I88)

I6.9.3 Impact of revaluation wash up (paragraphs I89 to I96)

I6.9.4 Impact of terminal wash up (paragraphs I97 to I102)

I6.9.5 Allocation of food court space (paragraphs I103 to I104)

**Relationship between asset values and profits**

I7 As is discussed in our input methodologies reasons papers,[207] in a workably competitive market, the value of an asset depends on expected profits in the future, and those profits are based on expected prices that are constrained by competition. In markets regulated under Part 4 however, there is little or no competition and little or no likelihood of a substantial increase in competition. The unconstrained profits of a supplier that does not face competition (such as Wellington Airport) would therefore be an inappropriate reference point for establishing a regulatory asset value used for assessing returns (or for setting regulated prices). Such an asset value would be based on, and could lead to, future monopoly pricing.

I8 Consequently, the link between a regulated Airport's asset values and its profits (and therefore its prices) is reversed when compared to a competitive market. Rather than reflecting the profits that an Airport expects to earn, an Airport's regulatory asset value is intended to provide an appropriate baseline against which profits can be assessed. We have set an input methodology[208] (IM) for establishing the regulatory asset value of Airports regulated under Part 4, including for Wellington Airport.

I9 Having established a regulatory asset value, determining an appropriate approach for assessing returns for regulated suppliers like Airports, which invest in long-lived

[207] Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 4.1.3-4.1.4; also refer Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, paragraphs 4.1.3-4.1.4. Airlines can be expected to have some degree of countervailing market power over the Airports regulated under Part 4. However, Airports are only subject to information disclosure regulation, and that does not affect the right of Airports under the AAA to charge for specified airport services as they think fit.

[208] IMs set out the rules, requirements and processes applying to the regulation of specified airport services. The purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of goods and services under Part 4. Key IMs include the setting of the initial regulatory asset values and how the value of the regulatory asset base (RAB) is rolled forward, the treatment of asset revaluations and the determination of the cost of capital.

infrastructure assets, is still a challenge. This is because the analysis will almost always be over a time period much shorter than the lifetimes of the assets involved.[209]

**Assessing returns using disclosed return on investment (ROI)**

I10 The Information Disclosure Determination requires Airports to disclose return on investment (ROI). The ROI is an annual, single period profitability indicator which, in simple terms, measures net income against regulatory asset values. The ROI is intended to be comparable to the weighted average cost of capital (WACC).

I11 Ideally, in order to obtain an accurate picture over time, returns for Wellington Airport would be assessed over as long a period for which information is readily available. In our final reasons paper on the information disclosure requirements for Airports, we stated that meaningful economic assessment should include longer term assessments of ROI (eg, trends in ROI or an average ROI over several years). An ROI in excess of the WACC is, on its own, not indicative of excessive profits. Costs can vary from year to year, income can be profiled to reflect customer requirements, while short-term profits above the WACC may simply reflect superior efficiency or innovation.[210]

I12 Revaluing assets complicates the assessment of returns. The ROI reflects a revaluation gain (or loss) in the year prior to the change in asset value. This can result in a 'spike' in the ROI which simply signals an expectation of higher (or lower) profits in the future.[211] However, whether the reported returns actually eventuate (and any gains or losses associated with them) depends on the extent to which the change in the asset value flows through into prices and revenues.[212]

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209 For example: Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd Decisions Paper" 30 October 2008, paragraph 207.

210 Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 3.23 and 3.25.

211 A 'spike' in the ROI above the WACC indicates an expectation of higher profits in the future—but those higher profits have not yet occurred Such a spike would also indicate that consumers have not yet received any compensation, through lower prices, to offset those expected higher profits. However, that expected level of profits will only fully eventuate if prices rise to the level implied by receiving a normal return on the revalued asset base (eg Commerce Commission, Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd Decisions Paper" 30 October 2008, paragraph F.9). For example, during consultation on the asset valuation input methodology, Professor George Yarrow observed that a revaluation corresponds to a capitalisation of *future* cash flows (G. Yarrow, M. Cave, M. Pollitt and J. Small, *Review of Submissions on Asset Valuation in Workably Competitive Markets, a Report to the New Zealand Commission, Annex 2: George Yarrow – Response to Submissions on Individual Expert Reviews*, November 2010, paragraph 2.11).

212 If prices following the revaluation do not rise to the level implied by the revalued assets, the ROI measured at the point of revaluation may give a misleading view of returns. Refer: Commerce

I13 The potential spike in ROI is avoided if revaluation gains are recognised as income in each period. This is the approach proposed by the information disclosure regime which allows for indexed inflation in each year. However, information disclosure does allow for the revaluation of land and therefore periodic adjustments to the market values of land might still result in some unusual movements.

**Assessing returns using an internal rate of return (IRR)**

I14 An internal rate of return (IRR) assessment across the entire lifetime of the assets used to supply regulated services would resolve any problems associated with the revaluation of assets under an ROI calculation.[213] This is because, unlike an ROI calculation, an internal rate of return calculation does not rely on asset values. Only the initial capital outlay, and the net cash flows associated with that investment, is required.

I15 However, if the IRR calculation cannot be undertaken over the lifetimes of all assets, then both an opening and closing asset value are required, in addition to the net cash flows associated with the opening asset value (which is the deemed capital outlay at that time). Ideally, the closing asset value should represent the value of future net cash flows at that time (discounted by the WACC).[214] If the closing asset value is a good estimate of the present value of subsequent net cash flows, then the IRR will provide a good estimate of the returns on the opening asset value over the entire remaining lifetime of the assets, rather than just being an estimate of returns earned between the opening and closing asset value dates.

I16 Analytically, in our IRR analysis we have not made any adjustments to reflect the actual timing of cash flows but have used end of period discounting except in the case of capital expenditure, where we have assumed that half of the capex forecast for each year of the regulatory period occurs at the beginning of that year, with the remaining half occurring at the end of the year. This approximates the proportionate value treatment specified for the regulatory investment value under information disclosure.

I17 We note that this gives rise to a conservative estimate of the IRR which is in favour of Wellington Airport, when compared to using assumptions which attempt to

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Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, Appendix F.

213 The IRR is the discount rate that results in the sum of net cash flows, discounted using that IRR, equalling the initial capital outlay.

214 Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, paragraphs 190-193. The ROI, and the way it treats revaluations, is effectively a close approximation to an IRR calculated over only one year, with the revaluation reflected in the closing asset value.

approximate the real timing of cash flows, such as those specified in the proposed amendments for cash flow timing for Customised Price Paths for EDBs/GPBs.[215]

**Treatment of asset revaluations**

I18 Normal returns need to be assessed over a period of time, so that singular events do not bias the results. However, assessing returns over time can be a difficult issue. A particular problem with assessing returns over time is the treatment of revaluation gains/losses on assets.[216] Over the life of an asset it is possible to apply a principle such that the returns discounted by an appropriate WACC earned on the asset over its life should equal the initial investment amount. This is referred to as the NPV=0 principle.

I19 The asset valuation input methodology allows land to be revalued using MVAU. In years between revaluations, land is revalued for CPI-indexation, like specialised assets. Because a nominal estimate of the cost of capital is used the input methodology requires that revaluations due to new MVAU valuations as well as due to CPI-indexation must be treated as income consistent with the NPV=0 principle.[217]

**Assessing Wellington Airport's returns in PSE1 and PSE2**

I20 In assessing Wellington Airport's returns, the longest feasible period for analysis would be the 10 years relating to both the first price setting event, covering the period from 2008-12 (PSE1), and the current pricing period covering the period 2013-17 (PSE2). Correspondingly, a long term cash flow measure of performance such as an IRR is preferable to a short-term (annual performance measure such as ROI. [218]

I21 A 10 year analysis of Wellington Airport's returns is further complicated because PSE1 and PSE2 relate to historic and prospective performance. As noted above, a return in excess of the cost of capital is not, on its own, indicative of excessive profits. In the short term, profit levels higher than the cost of capital may actually reflect temporarily superior performance in terms of improvements in productive and/or dynamic efficiency. However, in a workably competitive market such profits would be only temporary, because other firms will attempt to quickly catch up with market leaders.

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215 Commerce Commission "Consultation on Electricity and Gas Input Methodologies: Cash flow timing for customised price-quality paths"10 August 2012.

216 The treatment of revaluation gains has been previously addressed in the Commerce Commission "Gas Control Inquiry Final Report" 29 November 2004, paragraphs 5.28-5.36.

217 Commerce Commission "Airports Input Methodologies Reasons Paper" December 2010, paragraphs 2.8.13-2.8.17.

218 The use of accounting profits in measures such as the ROI rather than cash flows is another reason why the reported return may diverge from the true rate of return.

I22 Identifying superior performance as compared to excess returns in assessing historic performance involves reviewing actual performance against forecasts and determining to what extent excess profits have arisen from efficiency gains which are higher than expected.

I23 On the other hand, in assessing forecast performance it is important that any potential efficiency gains are taken into consideration. If potential efficiency gains have been included in the forecast assumptions for operational and capital expenditure, then there is some margin for superior performance which is appropriately taken into account comparing expected returns to measures that are indicative of a normal level of returns.

I24 As the key purpose of our analysis is looking at whether returns have changed prior to and after the introduction of Part 4 information disclosure, this would suggest it is appropriate to focus our analysis on the 7 year period comprising of the last two years of PSE1 and the 5 years of PSE2 rather than attempting to make an assessment of the return over the entire 10 year period.

**Treatment of cash and non-cash wash ups**

I25 In looking at the pricing periods separately it becomes important to ensure that income is recognised in the period in which it relates. This is of particular concern with the issue of the wash ups included in the Wellington Airport pricing disclosure, as these wash ups, which are NPV neutral over the 10 year period of the two pricing periods, can have a significant impact on the return attributed to an individual pricing period.

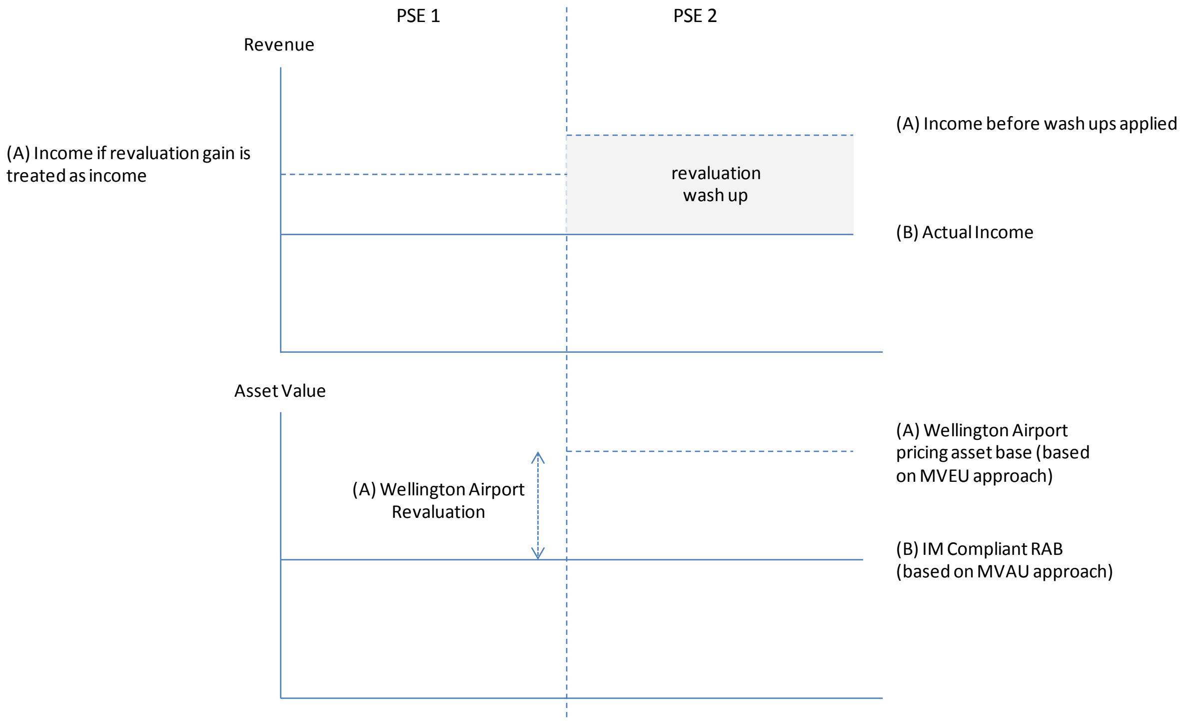
I26 Wellington Airport has included two types of wash up. The first wash up relates to the delay in spending of capital expenditure in PSE1 (the terminal wash up). This arises from a direct saving of cash expenditure. The second wash up relates to the revaluation of assets at the end of PSE1 being higher than forecast, and this is a non-cash wash up in that Wellington Airport does not receive the benefit of the revaluation gain, achieved through higher revenues, until PSE2.

I27 The terminal wash up recognises that the revenue collected by Wellington Airport through pricing in PSE1 was based on the expectation that the capital expenditure on the international terminal would occur sooner than it actually occurred. The time value of money saving that this wash up represents is effectively being refunded to airlines in respect of the same period and, although occurring in PSE2, should be attributed back to PSE1, as a reduction in revenue. Consequently the recognised revenue in PSE2 should be grossed up by the same amounts, with the regulatory profit grossed up by the tax adjusted value of the wash up allocation.

I28 In dealing with the revaluation wash up, which is a non-cash item, it is important that there is a consistent treatment of the revalued asset base and the revenue recognised on that revalued asset base in anticipation of higher future cash flows. To preserve the relationship between the two, the closing revalued RAB at the end of PSE1 must be the same as the opening RAB of PSE2, and the returns for PSE2 measured using the corresponding uplifted revenue and asset base.

I29 Figure 1 below is used to discuss the various approaches to the assessment of returns forwarded by BARNZ and Wellington Airport.

**Figure I1: Treatment of asset valuation and the revaluation wash up**




I30 The analysis of PSE1 provided by BARNZ[219] has recognised the revaluation of the Wellington Airport RAB in 2011 as income in the PSE1 period, leading to a higher return than that recognised by Wellington Airport ie, revenue (A) in the above highly simplified diagram.[220] However BARNZ also argue that the prices set in PSE2 should be based on an input methodology compliant MVAU valuation,[221] which would have generated no increase in valuation in the 2011 valuation ie, asset value (B). Therefore the two approaches appear inconsistent. If BARNZ recognise the MVEU revaluation as income in PSE1, then they should also recognise the higher asset value in PSE2, and should attribute the value of the revaluation wash up in PSE2 back to PSE1 which would reduce the PSE1 return, while increasing PSE2 revenue.

I31 We consider the most appropriate valuation treatment of the RAB is under a MVAU basis consistent with its IM. Using this value, the significant revaluation gains that

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219 BARNZ “BARNZ Post-Conference Submission on Wellington Airport Section 56G Review” 17 August 2012, Attachment 2.

220 For simplicity, Figure I1 takes into consideration only the movements in the asset base due to asset revaluation (original forecast to occur at the end of PSE1). It ignores the impact of capital expenditure and depreciation and also ignores a small devaluation of the asset base that was recognised in 2011.

221 BARNZ “BARNZ Assessment of WIAL Initial Pricing Proposal for charges to apply from 1 April 20012 to 31 march 2017” 10 October 2011, page 1.

occurred in 2011 under the MVEU based valuation would no longer be relevant and the impact of the wash up on PSE1 resulting from the higher MVEU value could be ignored. For PSE2 the actual revenue forecast to be generated by the current pricing would be assessed against the input methodology compliant MVAU based valuation. This would match the regulatory asset base (B) with the appropriate corresponding revenue stream (B).

I32 It should be noted, however, that moving from the Wellington Airport MVAU land valuation assumption of highest and best alternative use (on which the input methodology compliant MVAU value is based) to the BARNZ MVAU valuation assumption would shift the asset value (B) line down and could lead to significant differences in the assessment of returns for both PSE1 and PSE2. Both values are claimed to be IM-compliant, but differ significantly.

I33 PSE1 represents a period that incorporates both pre IMs disclosures, under AAA, and post-IMs disclosures. Information disclosure regulation under Part 4 did not apply to part of the pricing period, and prices were set before the regime came into force. Nevertheless, for the purposes of this s 56G review, an analysis of targeted and actual profits prior to the Part 4 regime is still of interest, as it is relevant to the considering the effectiveness of information disclosure regulation. However, a complication exists in trying to move from one framework to another. While an IRR analysis could potentially be undertaken over the 5 year period for PSE1, this would involve recasting data disclosed under AAA for the years 2008 – 2010 in order to present it on an IM-consistent basis.

I34 Given the difficulties in undertaking a reconciliation of information disclosed under AAA and Part 4 information disclosure within the timeframes of this review, particularly with regards to reconstructing appropriate IM-consistent opening RAB values, we have focused on the 2011 and 2012 disclosure years, for which information disclosure compliant with the IMs was available, rather than the full 5 years of the pricing period. For our analysis we have used an input methodology compliant ROI analysis.

I35 This approach is not ideal as it involves cutting the analysis period into smaller slices, which risks introducing misleading volatility when looking at each year in isolation or even the two years together, as the returns in 2011 and 2012 may not be reflective of returns across the whole of PSE1. There is also the additional complication that in 2011 there is an un-indexed devaluation of the airport land which depresses the return for that period as compared with 2012, given the devaluation is recognised as a loss[222] in the ROI calculation.

I36 As noted in paragraph I30, BARNZ in its post conference submission has provided its own analysis of returns over the whole PSE1 period. We have reviewed BARNZ's

[222] It is offset against the indexed revaluation income recognised on other asset classes.

analysis and provided comment in paragraphs H70 to H71. We note that other interested parties including Wellington Airport have not had an opportunity to submit on the BARNZ analysis and would invite submissions now on the approach, assumptions and values that BARNZ has used.

I37 We also calculate the return over the 7 years since the introduction of information disclosure. In order to calculate the 7 year IRR, we have adopted the IM-compliant opening regulatory investment value as at 1 April 2011. We have done this as we consider the IM land valuation approach to be most clearly consistent with promoting outcomes consistent with outcomes produced in a workably competitive market.[223]

I38 Our 7 year analysis also uses actual revenue and cost numbers from information disclosures as proxies for cash flows for the years 2011 to 2012 (adjusting for the effect of the terminal wash-up). We have then used the cash flows associated with Wellington Airport's forecast revenues and costs (after remittance of the revaluation wash-up) for the period 2012 to 2017, adopting the closing rolled-forward pricing asset base, including all specified airport services assets, for 2017 as the best measure of asset values (i.e. the present value of future expected cash flows) at that point

I39 The roll-forward of the pricing asset base that gives us the 2017 value which is based on Wellington Airports own building blocks model proceeds from an estimate of the capital expenditure and depreciation for 2012 (the actual values not being known at the time pricing was set) and so we have adjusted for the actual values.

I40 The IRR calculated on these cash flows is compared to the IRR generated from cash flows using an input methodology compliant opening and closing regulatory investment value and the 75th percentile of the Commission's cost of capital estimate.

I41 In order to roll-forward the input methodology compliant asset base, in the absence of detailed information about the depreciation rates applying to each asset class, we have proportionately adjusted the forecast depreciation on Wellington Airport's pricing asset base from 2012 by the opening difference between the pricing asset base and the input methodology compliant asset base. We have not adjusted the forecast capital expenditure as we have assumed this will hold regardless of the valuation assigned to existing assets.

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223 Commerce Commission, "Input Methodologies (Airport Services) Reasons Paper", December 2010, para 4.3.2.

## Key information used in our analysis

*Summary of information*

I42 Table I1 outlines the key information we have relied on in undertaking our analysis of revenue and profitability.

**Table I1: Key Information Sources Used**

| Key information sources in the revenue and profitability analysis |
|---|
| ID disclosures 2011, 2012 |
| Pricing Disclosures PSE1 and PSE2 |
| Supporting models for PSE1 and PSE2 |
| 2009 valuations for land on MVAU basis provided by Wellington Airport |
| Supplementary land valuation reconciliation provided by Wellington Airport |
| Submissions and cross submission made by parties throughout Wellington Airport's pricing consultation and the Commission's s56G review process. |
| Responses from Wellington Airport on specific queries by the Commission |

I43 We have relied on data from Wellington Airport's building block models for PSE2 to inform our profitability calculations. In particular, operating expenditure, capital expenditure, revaluation rates, the depreciation of existing assets and the tax book values[224] have been taken unadjusted from Wellington Airport's building block model.

*Limitations on information used*

I44 The main limitations on our analysis of the information we used related to the lack of transparency in some of the information disclosed for price-setting and in the reconciliation of information disclosed for price setting to the information reported in the historical information disclosure schedules, in particular:

I44.1 We were unable to reconcile the forecast revenue for services applicable to price setting event value of $62.5m disclosed on page 12 of the Price Setting Event Disclosure to the building block required revenue of $60.3m disclosed on page 45. Our own building block analysis has used the latter.

I44.2 We were not able to fully reconcile the land value from Wellington Airport's 31 March 2011 MVAU valuation ($141m) to the value in the asset base for the price-setting event disclosed in the price-setting disclosures ($85.4m). An unreconciled difference of $38.2m appeared to be related to asset allocation

[224] We have not adjusted Wellington Airport's modelled tax asset values even though there is an approx $8m difference between these and the tax values disclosed in the 2011 ID schedules.

adjustments. We have not sought to verify this difference but have used the disclosed value.

I44.3 There was no reconciliation between Wellington Airport's MVAU land valuation value ($141m), a copy of which was provided in support of the required disclosures for 2011, and the closing land value disclosed ($119m). This was later provided to us upon request.

I45 We have identified some errors in the models provided by Wellington Airport to support the PSE2 disclosure and provided feedback to Wellington Airport:

I45.1 The calculation of tax payable was linked to accounting depreciation rather than tax depreciation. This error would have resulted in a slight increase in the revenue required to achieve Wellington Airport's target return. We have not adjusted forecast revenue to reflect the impact of this error.

I45.2 We identified a number of small errors in the LUMINS model[225] related to the movements in the asset base. Wellington Airport provided us with a revised version of the LUMINS[226] model and we have relied on this version for the asset and revenue assumptions in our profitability calculations.

I46 We note that Wellington Airport's method for calculating forecast tax is consistent with the IMs. We have used Wellington Airport's forecasts of tax depreciation. Where we have made adjustments to forecast asset values we have adjusted tax assets proportionately so as to preserve the opening relationship between regulatory depreciation and tax depreciation.

**Revenue assessment**

I47 Wellington Airport's forecast revenues used in our assessment for PSE2 involve a number of components and calculations which we explain below for the information of interested parties.

I48 Wellington Airport's PSE2 pricing event encompasses the period from 2013 – 2017. The pricing event disclosure includes only aeronautical services and excludes the asset values and revenues from leased assets and the costs associated with Wellington Airport's noise mitigation obligations, even though these activities are included in the definition of specified airport services for the purpose of information disclosure regulation.

I49 For the purposes of assessing the forecast return on an input methodology compliant basis, we have considered the combined asset values and results for

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225 Wellington Airport's model which reflects the forecast cash flows associated with noise mitigation activities.

226 This model was provided in response to the Commission's queries about errors in the original model.

Wellington Airport (ie, including leased assets and noise mitigation). We have sourced the relevant noise mitigation data from Wellington Airport's LUMINS model, and information relating to the leased assets has been taken from the pricing event disclosures.

I50 Table I2 shows Wellington Airport's total forecast revenue for the period which has been used in our returns assessment. Revaluations are reflected as income through the closing asset base in the IRR calculation.

**Figure I2: Wellington Airport Combined Forecast Revenue**

| | 2013 ($000) | 2014 ($000) | 2015 ($000) | 2016 ($000) | 2017 ($000) |
|---|---|---|---|---|---|
| Airport activity charges | 60,303 | 65,686 | 71,918 | 78,706 | 85,850 |
| Terminal wash up removal | 2,485 | 2,721 | 2,980 | 3,263 | 3,574 |
| Lease, rental and concession income | 4,645 | 4,733 | 4,837 | 4,856 | 4,977 |
| Gain or loss on sale of assets | (5,477) | (411) | (843) | (864) | (886) |
| Noise mitigation | 2,179 | 2,255 | 2,992 | 3,008 | 3,094 |
| Other revenue | 205 | 210 | 215 | 221 | 226 |
| Total revenue | 64,341 | 75,193 | 82,099 | 89,189 | 96,835 |

I51 The revenue above is based on the assumption that the asset base used to estimate the returns generated by this revenue will be an input methodology compliant regulatory investment value.[227] The impact of using Wellington Airport's pricing asset base is discussed in greater detail in paragraphs 0 to H76.[228]

I52 For the calculations above, the noise mitigation cash flows were excluded from the building blocks model used by Wellington Airport for PSE2. A separate "LUMINS" model was used to estimate costs associated with noise mitigation obligations and the per passenger charge that would be required to cover these costs. The costs associated with noise mitigation were included in the pricing event as adjustments

227 Using an IM compliant regulatory investment value means that the revaluation gains which occurred due to the 2011 land revaluation are taken out of the RIV and the revaluation wash up can be ignored.

228 We note that Wellington Airport has disclosed that the valuations for buildings and civil works for pricing are not IM compliant as they consist of 2011 ODRC values rather than the 2009 ODRC valuation rolled forward, a point that BARNZ has emphasised in its submissions. While we recognise that the valuations for buildings and civil works are not IM compliant, the values are not sufficiently different to have a material impact on our assessment of Wellington Airport's profitability. Therefore we have used Wellington Airport's values to avoid having to make necessary depreciation adjustments, for which we have do not have detailed asset information.

made to required revenue as per the table in the PSE2 Final Pricing document under Clause 2.5(1)(a)(i) Disclosure of Forecast Total Revenue Requirements.

I53 The LUMINS model targets the same 9.5% post tax return as the building blocks model and we have incorporated the forecast revenues, costs and asset base into our own profitability calculations for the purpose of assessing Wellington Airport's total return across all regulated services.

I54 Leased assets and the associated lease, rental and commercial revenue were excluded from the building blocks model used by Wellington Airport for PSE2. The revenues associated with leased assets were included in the pricing event as adjustments made to required revenue as per the table in the PSE2 disclosure document under Clause 2.5(1)(a)(i) Disclosure of Forecast Total Revenue Requirements.

I55 We have incorporated the leased assets and their associated forecast revenues and costs for the purpose of assessing Wellington Airport's total return across all regulated services.

**Treatment of key issues**

I56 The key areas of disagreement between parties on the measurement of inputs for the assessment of returns were the value of the WACC, the valuation of assets, in particular airport land, the treatment of wash-ups, the allocation of the food-court space, and the inclusion of incentive scheme costs.

*Cost of capital*

I57 We consider that the most appropriate WACC to use in assessing Wellington Airport's forecast returns is the cost of capital closest to the time at which prices were set, and therefore have used as the basis for our assessment of returns for PSE2 the cost of capital determination dated 27 April 2012.

I58 Under Part 4, the Commission has published an input methodology for the estimation of the cost of capital for the purposes of monitoring and analysing information disclosed by the Airports. The Commission considered a range of analyses used by capital market practitioners to estimate the cost of capital.

I59 The cost of capital, as set out in the input methodologies, is the Weighted Average Cost of Capital (WACC), which is an estimation of the percentage return on capital that is consistent with a return that may be achieved in a workably competitive market over time. [229]

[229] Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraph 3.23.

I60 The input methodology for the cost of capital requires that a vanilla nominal cost of capital and post-tax nominal cost of capital will be estimated for Airport services for the purpose of information disclosure.

I61 The vanilla cost of capital is specified as the expected post-tax cost of equity capital and the expected pre-tax cost of debt capital, weighted by the respective proportion each represents of the total capital. The post-tax cost of capital is determined as the expected post-tax cost of equity capital and the post-tax expected cost of debt capital weighted by the respective proportion each represents of the total capital.

I62 In the case of a vanilla WACC, the interest tax shield provided by debt capital is ignored in the cost of capital estimation, and firms are remunerated for their levered tax liabilities through a cash flow allowance in the vanilla ROI or vanilla IRR calculation. In the case of a post-tax WACC, the cost of debt is adjusted down by an interest tax deduction (the ‘interest tax shield’) and no cash flow allowance is made for the interest tax deduction in the post-tax ROI or post-tax IRR calculation. Therefore when assessing a company’s actual performance against a post-tax WACC, the profit needs to be reduced by the value of the interest tax shield to give a like for like comparison.

I63 In this report we have stated all returns on a post tax basis as this is consistent with analysis provided by both Wellington Airport and BARNZ.

I64 Wellington Airport notes in its price setting event disclosure document[230] that they commissioned economic advisors Sapere to provide a recommendation on the appropriate post-tax WACC for application by Wellington Airport in its building block model. During the consultation Wellington Airport, on receipt of further advice recalculated its WACC to 10.85%. Wellington Airport decided to apply a post-tax WACC of 9.51%.

I65 On April 27 2012, the Commission published its most recent cost of capital determination. The determination[231] set a mid-point estimate of post-tax WACC of 7.06% for the five year period commencing on the first day of disclosure year 2013 (ie 1 April 2012). The Commission has also determined a 75th percentile post-tax WACC of 8.04%.

I66 Table I2 below summaries the key parameters used by Wellington Airport in setting the cost of capital for PSE1 and PSE2. We note that some of the parameters used by Wellington Airport, including the asset beta and TAMRP are more aggressive than

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230 Wellington Airport “WIAL Price Setting Event Disclosure for the Pricing Period 1 April 2012 to 31 March 2017” 30 April 2012, page 28.

231 Commerce Commission “Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10” 27 April 2012, page 2.

those sought from the High Court in its merits review appeal. The most material of these assumptions is the asset beta which also represents a change in assumption from PSE1. Table I2 also shows that adjusted PSE2 cost of capital if the asset beta used to set the PSE2 cost of capital had remained the same as the PSE1 assumption.

**Table I2: Estimated WACC parameters for Wellington Airport**

| Parameters | Wellington Airport PSE1 Pricing | Wellington Airport PSE2 Pricing | PSE2 scenario no change to asset beta |
|---|---|---|---|
| Risk free rate | 6.16% | 3.90% | 3.90% |
| Debt premium | 1.50% | 1.89% | 1.89% |
| Debt issuance costs | 0.00% | 0.54% | 0.54% |
| **Cost of debt** | **7.66%** | **6.33%** | **6.33%** |
| TAMRP | 8.00% | 8.00% | 8.00% |
| Asset beta | 0.60 | 0.75 | 0.6 |
| Equity Beta | 1.00 | 1.25 | 1.00 |
| **Cost of equity** | **12.31%** | **12.81%** | **10.80%** |
| Leverage | 40% | 40% | 40% |
| **Post tax WACC** | **9.50%** | **9.51%** | **8.30%** |

I67 WIAL's WACC for PSE2 is 246 basis points (2.46%) higher than the Commission's estimate of midpoint WACC. It is also higher than the estimates of WACC considered by the Commission in estimating a commercially realistic WACC for New Zealand airports.[232]

I68 Wellington Airport states in its cross submission on the Section 56G process and issues review[233] that current Commission WACC was not published until 27 April 2012, which was after consultation for the current pricing period was completed. Wellington Airport states that "the most recent Commission WACC publication available to Wellington Airport prior to the completion of consultation advised a [post-tax] WACC of 7.75% (midpoint) to 8.73% (75th percentile)."

232 Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, Figure E2 and paragraphs E13.42-E13.45.

233 Wellington Airport "WIAL Cross Submission to the Commerce Commission Section 56G Process and Issues Review" 20 July 2012, page 13.

I69 Alternatively BARNZ have stated in its post conference submission[234] that "the Commission's methodology has been specified sufficiently clearly in its Input Methodologies that interested parties (with access to sufficient expertise) are themselves able to update the WACC estimate." BARNZ also notes that its own experts provided advice prior to the end of the pricing consultation which estimated WACC to within 0.04% of the Commission's WACC published in April 2012.

I70 Auckland Airport, in noting that the Wellington Airport pricing decision was made on 1 March 2012 stated that it would be "inappropriate to use a WACC estimate of March 2011 for pricing."[235]

I71 We consider that the most appropriate WACC to use in assessing Wellington Airport's forecast returns is the cost of capital closest to the time at which prices were set. This is the cost of capital determination dated 27 April 2012.[236]

I72 We have also considered what range of WACC would be appropriate when determining the 'normal' return for Wellington Airport. In its post conference submission, Christchurch Airport states that "the uncertainty associated with an ex-ante assessment justifies the use of a higher point estimate than the midpoint estimate the Commission would typically use when conducting an ex-post assessment."[237] Similarly, Auckland Airport consider the WACC range of "75th – 85th percentile would be a sensible point range for ex-ante assessment of profitability."[238] Wellington Airport themselves have stated that a range should be established but "the range should not commence at the 50th percentile."[239]

I73 Alternatively BARNZ have stated that "the long term interests of consumers would be better served if returns are measured ex ante relative to the mid-point WACC estimate (ie the 50th percentile) with a judgement being made ex post as to whether

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234 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue" 17 August 2012, page 21.

235 Auckland Airport "Auckland Airport Section 56G Cross Submission" 17 August 2012, page 21.

236 Wellington Airport set its prices as at January 2012. At that time it would not have known the risk-free rate and debt premium that would be used by us in setting our estimate of WACC we would use in this report (as these parameters and our WACC was estimated as at 1 April 2012). However, relative to the risk-free rate and debt premium prevailing in January when Wellington Airport finalised its prices, the April risk-free rate and debt premium produced a higher WACC than would have been estimated in January 2012. This higher WACC results in a lower estimate of excess profits than we would have estimated if we had made our WACC estimate as at January 2012.

237 Christchurch Airport "CIAL Cross Submission following Wellington Airport Conference" 17 August 2012, page 5.

238 Auckland Airport "Auckland Airport Section 56G Cross Submission" 17 August 2012, page 21.

239 Wellington Airport "WIAL Cross Submission Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page 3.

returns have been on average excessive, or have fallen short."[240] While Air New Zealand state that "they consider that returns consistent with the WACC mid-point are an appropriate level of target return" and that "this represents a balance between the objectives of s 52A(1)(a) and (d)."[241]

I74 Typically the Commission would use a 75th percentile WACC as an upper boundary of the range in contexts where it is administering price control. The 75th percentile WACC is used in these contexts to allow for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment.

*Asset values*

I75 We have assessed Wellington Airport's return using the input methodology compliant asset values disclosed under information disclosure in 2011 as the opening regulatory asset base which has been rolled forward to provide an estimate of the closing input methodology compliant asset base. We have also assessed Wellington Airport's return using the airport's pricing asset base.

I76 Finally, we have used the input methodology compliant asset values as the starting point for assessing excess returns, with pricing asset values being used as the best estimates of the returns on the opening asset value over the entire remaining lifetime of the assets as assessed at the end of PSE2.

I77 The asset values used for pricing purposes may differ from the asset values used to assess performance under ID. Provided, however, that the corresponding values used for information disclosure are as specified in the IMs, this does not give rise to compliance issues, albeit that the pricing asset values and the information disclosure asset values are not consistent. This means that the returns shown by using information disclosure compliant closing values will differ from those using pricing asset closing values.

I78 For pricing purposes the asset values that have been used by Wellington Airport differ from those specified under the asset valuation IM. This has given rise to strongly diverging views between BARNZ, Air New Zealand and Wellington Airport about the level of returns achieved by Wellington Airport during PSE1 and the appropriate treatment of revaluation wash ups.

I79 The asset values in the PSE1 pricing model were based on valuations undertaken as at 31 March 2006 using an optimised depreciated replacement cost (ODRC) approach for building and civil works assets and a zonal MVEU approach for land. The MVEU land valuation approach that Wellington Airport adopted for pricing

[240] BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue" 17 August 2012, page 21.

[241] Air New Zealand "Air NZ Submission to the Commerce Commission S56G Review" 29 June 2012, page 37.

purposes is not consistent with the MVAU land valuation approach now required by the input methodology for information disclosure, which was not in place at the time of the prices were set for PSE1. This difference necessarily implies that returns forecast in the PSE1 pricing model and calculated off the pricing asset base would not be expected to be the same as returns calculated under information disclosure for the same five year period, if information disclosure were to have applied for all of that period.

I80 For pricing purposes Wellington Airport revalued its specialised assets (other than plant and equipment) using ODRC as at 31 March 2011. Again, this pricing valuation approach is not consistent with the IMs, which require the ODRC valuations as at 31 March 2009 to be rolled forward and indexed at CPI. BARNZ has estimated the rolled forward values to be $4.1m less than the pricing values for civil works ($131.5m) and $5.3m higher than the pricing value for buildings ($112.3m). The combined difference is $1.2m.

I81 Under ID, ROI is assessed against the regulatory investment value (RIV). RIV is determined as being the opening regulated asset base[242] plus the proportionate investment in the RAB in each period.

I82 For historic analysis we have relied on the input methodology compliant MVAU and ODRC based RIV values disclosed in 2011 and 2012 under information disclosure for our examination of returns under ID. In assessing Wellington Airport's return using the airport's pricing asset base we have used the total asset base forecast by the Wellington Airport pricing model used for the PSE1 pricing period as Wellington Airport's estimate of RIV.

I83 The 2011 and 2012 disclosures include an MVAU land valuation, which assumes a highest and best alternative that includes the development of a large scale retail precinct. However, BARNZ has submitted that the MVAU valuation, undertaken by Telfer Young on behalf of Wellington Airport, overstates the land valuation by not using a feasible alternative land use plan.

I84 In its assessment of Wellington Airport's revised pricing proposal,[243] BARNZ provided its own estimate of an MVAU land valuation for Wellington Airport of $98m for the 103.2 ha of operational airport land owned by Wellington Airport. This translates to a value of $949,645 per ha. Wellington Airport indicated in its response to queries from the Commission,[244] that the actual land area used for specified airport services is 86.3 ha. Using the revised land area estimate and BARNZ's value per hectare results in a revised BARNZ land valuation of approximately $82m. This can be

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[242] The opening regulated asset base includes indexed revaluations to date.

[243] BARNZ "BARNZ Assessment of WIAL Revised Pricing Proposal for Charges to Apply from 1 April 2012 – 31 March 2017" 23 December 2011, page 9.

[244] Wellington Airport "WIAL response to Commerce Commission queries" 15 August 2012, page 2.

compared to Wellington Airport's 2011 disclosure of a MVAU land value of $119m. The difference of $37m has been applied to the disclosed regulatory investment for 2011 and 2012 to provide an estimate of the RIV under an alternative MVAU valuation.

I85 A summary of the alternative regulatory investment values that are used to assess historic returns on an input methodology compliant basis through information disclosure, to determine Wellington Airport's target returns for pricing, and the returns under an input methodology compliant basis adjusted for an alternative MVAU valuation has been previously provided in Table H7.

I86 While there was a significant uplift in the land valuation carried out at 31 March 2011 for PSE2 pricing purposes, this was on an MVEU (MVAU + land conversion costs) basis which is not recognised under IMs and information disclosure. The land conversion costs component of the revaluation is therefore not recognised in the disclosed 2011 ROI calculation.

I87 For our forward looking analysis we have also estimated the impact of adopting as a starting point the alternative MVAU land valuation based on BARNZ's highest and best alternative use assumption.

I88 A summary of the alternative regulatory investment values that are used to assess forecasts returns on an input methodology compliant basis through information disclosure, to determine Wellington Airport's target returns for pricing, and the returns under an input methodology compliant basis adjusted for an alternative MVAU valuation has been previously provided in Table H14.

*Impact of revaluation wash up*

I89 We have not made any adjustment to the disclosed revenue under Part 4 information disclosure regulation for 2011 and 2012 revenue as no revaluation wash up would be recognised under an input methodology compliant MVAU land valuation.

I90 Wellington Airport has classified the terminal and revaluation wash up arrangements incorporated into the current pricing event as "one way risk sharing arrangements for specific events. That is, [Wellington Airport] gave away upside risk while retaining downside risk."[245]

I91 In respect of the revaluation wash up Wellington Airport has explained in its revised pricing document[246] that its position as land-owner "is no different to the situation in competitive markets where a landlord earns income from tenants and also owns the

[245] Wellington Airport "WIAL Cross Submission Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page 3.

[246] Wellington Airport "WIAL Revised Pricing Proposal" 22 November 2011, page 44.

risk and reward of movements in capital value." Wellington Airport goes on to explain that "it sees the proposition of sharing in all revaluation gains and losses to be a challenge and in reality will pose an asymmetric risk to [Wellington Airport]" due to fact that airlines will be willing to receive the benefit of any unforecast revaluation gains but that the issue of unforecast losses is likely to pose a challenge in practice.

I92 In the Final Pricing Proposal for PSE1, the agreement for any potential wash ups in future period was worded as follows:

> "[Wellington Airport] will provide the airlines with a pricing credit in the next pricing period (2013-17) in the event that its forecasts differ from revaluation outcomes (in accordance with asset valuations undertaken by [Wellington Airport]'s valuers using the same valuation methodologies as in the 2006 Valuation), working as follows:
>
> If the compounding growth rate (CGR) in actual valuation movements between 30 June 2007 and the date of the valuation used for the next pricing period is more than 2.5% p.a. but less than 6.4% p.a., [Wellington Airport] will credit the airlines in the next pricing period the difference between its forecast and the actual outcome.
>
> [Wellington Airport] assumes valuation risk if actual revaluations are less than 2.5% p.a. compounding – i.e. [Wellington Airport] takes the downside risk.
>
> If actual valuation movement is greater than 6.4% p.a. compounding, [Wellington Airport] retains the net gains over 6.4% p.a. - i.e. [Wellington Airport] takes the marginal upside benefit beyond that forecast by BARNZ.
>
> [Wellington Airport] offers the same procedure with civil works/buildings valuations; albeit with 5.0% p.a. and 5.5% p.a. bands (reflecting [Wellington Airport]'s assumption in the pricing model and BARNZ proposed growth rate). Albeit, the wash up calculation would reflect the total outcome from all asset categories."[247]

I93 Wellington Airport stated in its PSE2 Final Pricing Document[248] that the revaluation wash up arrangement outlined above was not applicable. The reason for this, given in its Revised Pricing Proposal[249], was that there had been a change in land valuation approach, as Wellington Airport had moved from a zonal MVEU approach to an approach based on MVAU plus airport conversion costs. The applicability of the wash up relies upon "using the same valuation methodologies as in the 2006 Valuation." Wellington Airport nonetheless included the value of the wash up as calculated above as a "commercial concession" in the PSE2 pricing period.

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247 Wellington Airport "WIAL Initial Pricing Proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 50.

248 Wellington Airport "WIAL Final Pricing Document for the pricing period commencing 1 April 2012" March 2012, page 8.

249 Wellington Airport "WIAL Revised Pricing Proposal"22 November 2011, page 42.

I94 The extent to which this calculation was actually agreed is not clear. Nor is it clear about how the calculation should be applied in determining the total wash up value. Wellington Airport have treated the wash up as the combined total of all three asset categories giving a wash up value of $14.5m, which includes offsetting the shortfall in the actual value of buildings and civil works compared to forecast against the land valuation increment (which reflects the difference between forecasts). While the agreement states that the wash up would reflect the total outcome from all asset categories, it also states that Wellington Airport assumes the 'downside' valuation risk if actual revaluations are less than 2.5% compounding. BARNZ therefore argues[250] that the offset should not be applied and that the value of the wash up should be the $29.1m increase in the land valuation over forecast.

I95 The IMs and information disclosure requirements give no guidance as to how wash ups or other commercial concessions across pricing periods should be treated. However, as discussed above, it is conceptually important that the treatment of the revaluation wash up is consistent with the asset base used to assess returns. If returns were to be assessed against an asset base using Wellington Airport's MVEU based land valuation, then the actual revenue received by Wellington Airport during the PSE1 pricing period should reflect the actual revaluation gain net of the revaluation wash up adjusted for the time value of money as per Wellington Airport's calculation.

I96 We consider that the most appropriate treatment of the revaluation wash up under an input methodology compliant ROI calculation is to make no adjustment to revenue as no wash up would be recognised under an input methodology compliant MVAU land valuation.

*Impact of terminal wash up*

I97 We have added back the value of the wash up to PSE2 in order to appropriately reflect the forecast returns for that pricing period, consistent with the assessment of returns in PSE1.

I98 During the PSE1 consultation, BARNZ noted in its written response that Wellington Airport had front loaded its forecast capital expenditure profile when it set charges in 2007. The most significant capital project as noted by BARNZ was the international departure terminal. As part of the 2006 consultation, Wellington Airport agreed to put in place a wash up mechanism if completion of the capital project was delayed by more than 12 months.[251]

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250 BARNZ "BARNZ Assessment of WIAL Initial Pricing Proposal for charges to apply from 1 April 20012 to 31 march 2017" 10 October 2011, page 22.

251 Wellington Airport "WIAL Initial Pricing Proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 55.

I99 Wellington Airport forecast capital expenditure for the "Rock" Northern Pier terminal expansion to be completed by March 2009. Under the terms of the wash up, if the project completion was delayed by more than 12 months, Wellington Airport would provide compensation to the airlines in the subsequent pricing period. The development was not commissioned until the end of October 2010 and was therefore delayed by more than 12 months.

I100 We consider that the most appropriate treatment of the terminal wash up is to reduce the revenue received during PSE1 by the value of the terminal wash up, since this represents a repayment to airlines in respect of that period, despite airlines receiving the cash benefit of that repayment in PSE2. As the revenue for PSE1 was smoothed, it is difficult to attribute the value of the terminal wash up back to the specific 18 month period from which it arose, therefore we have assumed that the value of the terminal wash up is attributed evenly across the 5 years of the PSE1 pricing period.

I101 The value of the wash up was determined by Wellington Airport to be $11.345m at 1 April 2012. Therefore we have adjusted the revenue by $2.27m each period.[252]

I102 Because we treat the value of the wash up as being recognised in PSE1, we consequently have to add back the value of the wash up to PSE2 in order to appropriately reflect the forecast returns for that pricing period, consistent with the assessment of returns in PSE1. We have used Wellington Airport's estimate of the value over the 5 years of PSE2, which accounted for the time value of money, and attributed the value of the wash up over the 5 years of the pricing period to revenue.

*Allocation of food court space*

I103 For PSE2 Wellington Airport changed its approach to the allocation of the food court space within the main terminal building. This gave rise to an additional $2.25m being added to the pricing asset base. BARNZ argues that this has reversed a 15 year pattern of the airport treating this space as commercial and that it will give rise to a significant over-recovery of the costs of this space.[253] Wellington Airport has stated that "in the past pricing period a substantial commercial concession was made that allocated areas to commercial areas only that very obviously are used by passengers" and that it believes "the 2012 approach to cost allocation is accurate."[254]

I104 Given its immaterial effect on returns we have not formed a view of this issue, and have not included any adjustments in our analysis.

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252 We have not incorporated allowance for the time value of money for this adjustment as we do not believe it to have a material impact.

253 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 22.

254 Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 69.