

**Air NZ Limited**  
**Submission to the Commerce Commission on**

Commerce Act 1986, Part 4

Draft report to the Ministers of Commerce and Transport on how  
effectively information disclosure regulation is promoting the  
purpose of Part 4 for Auckland Airport



**31 May 2013**

## Summary

1. The Commerce Commission (“Commission”) on 2 April 2013 released its draft report (“Draft report”) to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport. This submission responds to the Draft report.
2. Air NZ’s contact person for this submission is:

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3. The Commission’s draft findings and Air New Zealand’s (“Air NZ”) views on those draft findings are:

Part 4 Purpose	Commission’s Draft Finding	Air NZ Response
Incentives to innovate	Information disclosure is effectively promoting incentives to innovate.	Information disclosure does not in itself promote innovation.  As the Commission notes “information disclosure does not appear to have an additional impact on incentives to innovate, but has not negatively affected existing incentives to innovate” <sup>1</sup>
Incentives to invest	The Commission is unable to conclude whether information disclosure is effectively promoting efficient investment.	Auckland Airport has demonstrated a willingness to engage constructively on future investment. Air NZ considers this outcome to be independent from information disclosure itself.
Incentives to improve efficiency	Prices based on the pricing methodology for PSE 2 are more likely to promote efficiency than those previously in place. However, the Commission is unable to conclude whether information disclosure is effectively promoting improvements in operating expenditure efficiency.	Air NZ agrees that the new pricing structure is more likely to promote efficiency.  Air NZ agrees that information disclosure under Part 4 has not enabled conclusions to be reached on this area of performance.
Incentives to provide services at a quality that reflects consumer demands	Information disclosure is effectively promoting incentives to provide services at a quality that reflects consumer demands	Drivers for the provision of quality services are embedded in the relationship between airlines and Auckland

<sup>1</sup> Commerce Commission, *Draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, (Draft Report), April 2013, para. B3, p. 44

		<p>Airport. Information disclosure does not in itself promote such incentives.</p> <p>As the Commission notes “Information disclosure regulation does not appear to have had a significant impact on the quality of service provided at Auckland Airport...Furthermore, there is limited evidence through the information disclosed at this time that quality has improved as a result of the introduction of information disclosure.”<sup>2</sup></p>
Sharing efficiency gains, including through lower prices	The Commission is unable to conclude whether Auckland Airport is sharing the benefits of operating and investment efficiency gains.	Air NZ agrees that information disclosure under Part 4 has not enabled conclusions to be reached on this area of performance.
Limiting the ability to extract excessive profits over time	Information disclosure has been effective at limiting Auckland Airport’s ability to extract excessive profits.	Air NZ is mystified as to how the Commission has reached this draft conclusion given its own “conservative” analysis demonstrates that Auckland Airport will be extracting excessive revenues of \$78 million at the “best estimate” IM-compliant cost of capital.

4. The Commission considers that:

“Information disclosure under Part 4 should be particularly effective at highlighting concerns about excessive profits (and therefore prices), which heightens the credible threat of further regulation.”<sup>3</sup>

Given the Commission’s own analysis identifies that Auckland Airport will be extracting excessive profits at the “best-estimate” cost of capital<sup>4</sup>, Air NZ submits that the Commission can only conclude that information disclosure has been ineffective in promoting the purpose of Part 4.

<sup>2</sup> Ibid, para. C4.5, p. 49

<sup>3</sup> Draft report, 2.19, p. 14

<sup>4</sup> And as highlighted in the NZIER Report at every point on the WACC range below the 75<sup>th</sup> percentile which the Commission has inappropriately focussed on.

## **Air NZ's Position and NZIER Report**

5. Air NZ has significant concerns with the Commission's draft conclusion on profitability and considers that this draft conclusion is inconsistent with the Commission's own analysis in the draft report.
6. As a result of these concerns Air NZ commissioned a review of the Commission's draft report from the NZ Institute of Economic Research (NZIER). Our reasoning for engaging NZIER was to seek and provide independent expert economic opinion, to test our own understanding of the issues at Auckland Airport. The independent expert report is attached at Annex 1.
7. The analysis put forward by NZIER is compelling, and must form part of the Commission's analysis as it finalises its position on Auckland Airport's ability to extract excessive profits under the information disclosure regulatory regime.
8. NZIER's independent expert report provides evidence that demonstrates that Auckland Airport has the potential to earn \$150 million in excessive returns. These excessive returns will be borne by consumers, who receive no additional benefit for the higher price they must pay because the extra cost is, by definition, excessive. It is difficult to understand how the Commission can conclude that the information disclosure regime is working effectively in light of this evidence.
9. The NZIER report highlights several issues in the Commission's draft findings notably concluding that while excessive profits cannot be a certainty, "on the balance of probabilities it is more likely than not".<sup>5</sup>
10. The report focuses on profitability in the context of the 75<sup>th</sup> percentile assessment used by the Commission and raises concern about the appropriateness of the approach in this regulatory setting.
11. NZIER question the validity of placing too much reliance on non-binding assurances and incomplete information. Noteworthy in their assessment is the concern that the Commission has found it is able to assess profitability based on Auckland Airport's forecast information but has been unable to assess the drivers of that profit - investment and operating expenditure.
12. Air NZ contends and international experience shows that, when it comes to the assessment of airports, benchmarking is a pointless exercise given the variables that exist between each airport. Nonetheless, given the NZ Airports continue to claim benchmarking as justification for their pricing behaviour we find the comments from NZIER about Sydney Airport's performance and how Auckland Airport compares insightful.
13. Lastly, NZIER provide independent expert opinion on regulatory responsibility under an Information Disclosure regime. While only focusing on the draft report relating to Auckland Airport, NZIER raise significant concerns with the Commission's approach and the current regulatory framework.
14. Air NZ makes its own comments in response to the Commission's draft report on Auckland Airport below.

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<sup>5</sup> NZIER, *Assessing the effectiveness of information disclosure – A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, NZIER Report to Air New Zealand, (NZIER Report) May 2013, p. 4

## **Excessive Profits – WACC Range**

15. The Commission's draft conclusion is that "... information disclosure regulation has been effective in limiting Auckland Airport's ability to extract excessive profits over time...".<sup>6</sup> This draft conclusion is based on the Commission's "estimated range of appropriate returns of 7.1% to 8.0%."<sup>7</sup>
16. Air NZ is surprised at the Commission's use of a range of 7.1% - 8.0%, being the mid-point and 75<sup>th</sup> percentile respectively of the range as at 1 April 2012 calculated in accordance with the WACC IM, and more specifically with the Commission's focus on the 75<sup>th</sup> percentile WACC estimate. This focus is inconsistent with the Commission's approach in its draft report on Wellington Airport
17. The IM defines the WACC range as "... the values falling between the 25<sup>th</sup> percentile and 75<sup>th</sup> percentile inclusive of the mid-point estimate of WACC."<sup>8</sup> By focussing on a range from the mid-point to the 75<sup>th</sup> percentile and ignoring the 25<sup>th</sup> percentile, the Commission's analysis in the draft report is inconsistent with the IM and results in a draft conclusion which is incorrect.
18. Furthermore, the Commission's draft finding is based entirely on assessing returns at the 75<sup>th</sup> percentile and takes no account of returns at the mid-point. The mid-point is the appropriate starting point because it is the best estimate of the cost of capital that would be reflected in a competitive market. The Commission identifies that Auckland Airport will be earning revenues \$78 million above those which could be earned in a competitive market based on the mid-point of the WACC range. This \$78 million is by definition excessive because it represents an amount over and above the best available estimate of a competitive standard. How the Commission can then conclude that information disclosure is limiting Auckland Airport's ability to extract excessive profits is a mystery.
19. The Commission states in its report that:

"The IRR is compared to the Commission's estimate of the midpoint and 75<sup>th</sup> percentile cost of capital, as defined in the input methodologies. We consider the midpoint cost of capital to be [the] appropriate starting point for any assessment of profitability for Auckland Airport while the 75<sup>th</sup> percentile cost of capital allows for the uncertainty of estimating the true cost of capital and in light of the direct consequence of estimation error on pricing and investment."<sup>9</sup>
20. Air NZ considers the Commission's approach to the WACC range in this draft report is inherently at odds with the approach it indicated it would adopt when it made the Determination in December 2010:

"For the purposes of information disclosure, these (mid-point) WACC estimates will enable interested parties to assess the profitability of a regulated service. The Commission will also estimate the WACC at the 25<sup>th</sup> and 75<sup>th</sup> percentiles."<sup>10</sup>

In the case of Airports, for information disclosure, the Commission considers it appropriate to take a range between the 25<sup>th</sup> to 75<sup>th</sup> percentiles. In assessing profitability for the Airports an appropriate starting point for any assessment is the 50<sup>th</sup> percentile (mid-point) on the range."<sup>11</sup>

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<sup>6</sup> Ibid, para X3, p. 3

<sup>7</sup> Ibid, para. X4, p. 3

<sup>8</sup> Commerce Commission, *Commerce Act (Specified Airport Services Input Methodologies) Determination 2010*, Decision No. 709, 22 December 2010, 5.7(2), p.30

<sup>9</sup> Draft Report, para. E 40, p.80

<sup>10</sup> Commerce Commission, *Input Methodologies (Airport Services) Reasons Paper*, (IM Reasons Paper) 22 December 2010, para. 6.7.9, p. 137

“Airports are subject to information disclosure regulation. It is a matter of judgement as to what is the appropriate range of the cost of capital to be applied in assessing excess profits. The Commission considers that it needs to balance all of the considerations above and recognises that returns in competitive markets often fall below or exceed the mid-point of the cost of capital. In assessing profitability for the Airports an appropriate starting point for any assessment is the 50<sup>th</sup> percentile (mid-point) on the range.”<sup>12</sup>

21. Air NZ has supported the Commission’s stated cost of capital approach during the Merits Review process, including its use of a range where the “logical starting point in assessing profitability is the actual cost of capital estimate resulting from application of the IM (i.e. the mid-point of the range, which is intended to be the best estimate)”.<sup>13</sup> Air NZ relied on the Commission’s stated approach prior to and during the Input Methodologies review, currently proceeding in the High Court. It is of significant concern that the Commission appears now to be resiling from that approach. We do not believe that this inconsistency in approach is appropriate for a body exercising statutory authority.
22. The mid-point must be assumed to be the best available estimate. It balances the statistical risk between over- and under-estimation, and is derived from a methodology which the Commission concedes is already geared in the Airport’s favour.<sup>14</sup> On this basis, it is incumbent on the Commission to provide strong reasons to justify any move upwards from the starting point to the 75<sup>th</sup> percentile. In the absence of such reasons the Commission’s decision is open to challenge as being arbitrary and ill-suited to the purpose of reviewing the effectiveness of information disclosure regulation. Factors such as appropriately targeted new investment or superior efficiency that *might* justify a higher return than the mid-point (and which would have to be extremely compelling to justify use of the 75<sup>th</sup> percentile) are simply not able to be demonstrated on the Commission’s own analysis.
23. Further, the precedent value of the Commission taking the 75<sup>th</sup> percentile in the absence of careful justification is significant and likely to be detrimental to the entire information disclosure regime. It sends the signal to all regulated suppliers that, despite the mid-point providing the best evidence of a competitive market outcome, the 75<sup>th</sup> percentile is the *de facto* “business as usual” target. The result will be to incentivise all regulated airports to price up to at least the 75<sup>th</sup> percentile, and then seek to advance reasons to try and support an even higher return. Auckland Airport’s unsupported claims of superior performance show the types of spurious attempts to raise excessive profits to even higher levels that will become commonplace if the Commission’s current approach is not amended.
24. The result of this lack of reasons to support an upwards movement and the detrimental precedential effect of any such move is that the burden of proof on the Commission to justify the selection of any point above the 50<sup>th</sup> percentile is likely to be insurmountably high in these circumstances. It simply cannot be a reasonable or justifiable exercise of the Commission’s discretion to select a higher point as the basis of its assessment. If it were to do so in any event, its decision is unlikely to withstand further scrutiny.
25. In fact, give that the IM is already significantly in favour of the regulated Airport, a departure from the mid-point towards the 25<sup>th</sup> percentile would be justifiable, as it would balance the greater likelihood of over-compensation under the IM.

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<sup>11</sup> Ibid, para. E11.2, p. 326

<sup>12</sup> Ibid, para. E11.58, p. 337

<sup>13</sup> Commerce Commission, Respondents Submissions, Volume 2, 6 August 2012, para. 755, pp.318-9

<sup>14</sup> See, for example, IM Reasons Paper at E5.43 and E5.98.

Applying the 25<sup>th</sup> percentile – which the Commission has failed to do – sees excessive revenues balloon out to \$153 million. This is simply too high a price for consumers to pay.

26. The range of excessive revenues identified by the Commission that Auckland Airport will be extracting is therefore between \$153 million and \$2.9 million. As the Commission notes, given that its analysis assumes year-end cash flows – consistent with returns calculated under information disclosure – this understates the actual excess revenue which will be generated. Given the size of Auckland Airport’s regulated asset base, the 0.5% delta between returns calculated using year-end cash flows and those using mid-year cash flows is significant in revenue terms – some \$5 million per annum. For the Commission to acknowledge this yet still find that Auckland Airport is limited in its ability to extract excessive profits is extraordinary.

27. The inconsistency in the Commission’s approach is highlighted when considering its own comments:

“We do not agree that we can conclude that information disclosure is effective providing it places some constraints on profit levels, and as a result prices are lower than they would otherwise be. This is because the airport might still be targeting an excessive level of profits.”<sup>15</sup>

28. Air NZ notes also that the Commission’s analysis further underestimates the forecast excess revenues/returns due to its use of the April 2012 cost of capital determination rather than a value calculated at the time Auckland Airport made its decision – the latter approach being consistent with Auckland Airport’s actual approach. This is despite both Auckland Airport and the Commission commenting that timely information should be used:

“...our intentions and conduct in setting prices should be measured against information available to Auckland Airport at the time of pricing”.<sup>16</sup>

“We agree that information available at the time of Auckland Airport’s pricing decision should be used when estimating the WACC for assessing its profitability in this section 56G review.”<sup>17</sup>

29. Given the Commission has done this calculation<sup>18</sup>, this is a significant omission.

30. Use of the timely (21 May 2012) WACC estimate would result in a significantly different conclusion as to the effectiveness of information disclosure at limiting Auckland Airport’s ability to extract excessive profits – excess revenues at the 75<sup>th</sup> percentile are \$34 million and at the “appropriate starting point” (the mid-point) a staggering \$107 million. At the 25<sup>th</sup> percentile, excess revenues amount to \$178 million.

31. Air NZ considers it highly irregular that in two instances – the timing of cash flows and the timing of the WACC determination – the Commission has acknowledged its approach favours Auckland Airport yet has proceeded to issue the airport with an unequivocal clean bill of health based on returns generated at the top of the WACC range for the five year period of the pricing determination. The WACC estimate intended to be the best estimate of a normal return over time is the midpoint 50<sup>th</sup> percentile. While variations over and under this point can be expected throughout a period of analysis, achieving an average return above this “best estimate” can be characterised as nothing other than exercise of monopoly

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<sup>15</sup> Draft Report, para. E26, p. 77

<sup>16</sup> Auckland Airport, *Post Conference Submission*, 15 March 2013, para. 74, p.20

<sup>17</sup> Draft Report, para. 2.44, p. 19

<sup>18</sup> *Ibid*, Table F1, p.102

power to extract excessive returns – inconsistent with a competitive market and therefore inconsistent with the Part 4 Purpose.

32. The Commission also shows a lack of consistency in its own approach to its assessment of Auckland Airport's performance. The Commission states that:

"Finding some evidence of progress in a particular performance area does not necessarily mean that the intended performance outcome has been achieved"<sup>19</sup>

And

"To the extent that profitability remains clearly excessive, placing some constraints on profitability is unlikely to be sufficient in and of itself for satisfaction of the outcome sought under s 52A(1)(d)."<sup>20</sup>

33. Notwithstanding this, the Commission later states:

"...we might be more concerned about Auckland Airport's expected returns extending beyond the appropriate range if there appeared to be problems with Auckland Airport's performance with regards to quality, innovation, pricing efficiency, operational expenditure and investment. This is not the case. Most significantly, Auckland Airport has made some positive changes to its price setting approach for PSE2 which have brought its own targets within an appropriate range."<sup>21</sup>

34. Given that the Commission has highlighted that the IM approach will inevitably mark down the expected return an airport will achieve, and that its own analysis indicates that Auckland Airport just achieves an appropriate return at the extreme top of the range, it is difficult to see how information disclosure can be characterised as a "constraint on profitability" "sufficient in and of itself for satisfaction of the outcome sought under s 52A(1)(d)."<sup>22</sup>

35. The Commission's draft conclusion on this point is also surprising in light of its correct and relevant acknowledgement that "... 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."<sup>23</sup> Notwithstanding the outcome of any particular pricing consultation airports retain the **ability** to set whatever prices they wish, including with an eye to extracting excessive profits, as evident with Wellington Airport. The notion that information disclosure can limit that **ability** is therefore inherently false.

### Non-binding Assurances

36. The Commission also notes:

"Our draft conclusion is based on accepting the guidance Auckland Airport has provided during this review about its likely pricing behaviour after PSE2. Given this guidance cannot be seen as a binding commitment, we intend closely monitoring whether Auckland Airport acts consistently with the guidance it has given during this review at the next price setting event."<sup>24</sup>

37. It is clear from this statement that the Commission accepts that Auckland Airport may adopt a different approach in 2017 than the one current management have indicated is "distinctly possible", including one Auckland Airport currently claims

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<sup>19</sup> Ibid, para. A20.2, p.38

<sup>20</sup> Ibid, footnote 55, p. 38

<sup>21</sup> Ibid, para. E9, p. 72

<sup>22</sup> Ibid, footnote 55, p. 38

<sup>23</sup> Ibid, para. A24, p. 39

<sup>24</sup> Ibid, para. E47, p. 82



to be “highly unlikely”. There is a distinct lack of logic in accepting that this may be the case yet going on to conclude that Auckland Airport’s **ability** to extract excessive profits has been limited by information disclosure. Auckland Airport’s price setting authority remains subject to the Airport Authorities Act which New Zealand Courts have repeatedly found does nothing to prevent airports from monopoly pricing.

38. The Commission’s reliance on the (‘non-binding’) assurances of Auckland Airport is surprising. It seems on the face of the Commission’s reasoning as though this is a key element in determining Auckland Airport to be acting reasonably in its pricing behaviour. However, if this is a requirement to reach this conclusion, then surely more enforceable measures should be part of the regulatory regime in order to confidently assure this outcome.
39. It is therefore worth noting that, if Auckland Airport was genuine in its commitment, a binding and enforceable option is available. Auckland Airport has the ability to issue a legally binding deed of undertaking in favour of the Commission which clearly sets out its intentions. There is precedent for this approach in New Zealand, with privately initiated undertakings being used in the telecommunications sector to provide confidence in the future behaviour of regulated parties to the Commission, the government and the wider industry.<sup>25</sup>
40. Auckland Airport has chosen not to provide a meaningful commitment to the Commission or the wider air transport sector at this time. In the absence of a meaningful commitment from Auckland Airport, the non-binding, contingent assurances it has given can only carry very limited (if any) weight in the Commission’s considerations. Further, the Commission’s naïve conclusion that Auckland Airport’s assurances are the “best” evidence available to it regarding Auckland Airport’s future conduct does nothing to establish whether this “evidence” meets a minimum threshold of probity or relevance. The failure to use a more credible commitment mechanism, and the limited supporting information available concerning Auckland Airport’s performance under the information disclosure regime mean that Auckland Airport’s assurances should not carry any meaningful weight in the Commission’s decision making.
41. We would like to be able to accept Auckland Airport’s non-binding assurances as a genuine commercial commitment. However, the private sector is commercially intensive and forever changing. Wellington Airport and Christchurch Airport have indicated that to make commitments such as the one relied on by the Commission in Auckland Airport’s case is not appropriate and that there is no restraint on Airport behaviour:

“CIAL is required to consult on prices every 5 years. The Airport Authorities Act requires CIAL to approach each consultation with an open mind. Hence, while CIAL can consult on a preferred proposal at the next price re-set, it cannot close its mind to options.

As a result, the regulatory environment for the airport price setting makes it impossible for the CIAL to give a “commitment” now that purports to take something off the table in 5 years’ time.”<sup>26</sup>

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<sup>25</sup> <http://web.archive.org/web/20081016195841/http://www.med.govt.nz/upload/45929/vodafone-deed.pdf>;  
<http://web.archive.org/web/20081016195830/http://www.med.govt.nz/upload/45931/telecom-deed.pdf>.

<sup>26</sup> Responses from Christchurch Airport to questions asked by airlines at a briefing on 23 August 2012, p. 5

“Wellington Airport did take into account the Commerce Commission’s Input Methodologies (IMs) during its consultation process; however Wellington Airport is under no obligation to use the IM parameters as a basis for setting charges”<sup>27</sup>

42. On this basis we find it astonishing that the Commission would choose to rely on such a “commitment”, highlight this inherently unknown element as a key part of its draft conclusions and still proceed to reach such a definitive position in respect of Auckland Airport’s profitability.

### **Conclusion - The behavioural link between the regulated airports**

43. The Commission has indicated that there are no further Section 56G reports after it has reported on Christchurch Airport and consequently there will not be a chance to assess the influence of ID on the airports in this wider, industry context again. The Commission has publicly made clear that it considers it has a monitoring function only with regards to future price setting events of airports. As such, the time to reach definitive conclusions on the effectiveness of regulation and to make appropriate changes to the regime is now.
44. ID is ineffective and any perceived influence of non-binding self restraint in Auckland Airport’s behaviour can only be due to not wanting to “kill the golden goose” before the Commission’s final outcome. However, this outcome is temporary and loses its teeth of the threat of more appropriate legislative action as soon as the Section 56G report process concludes.
45. It is important to note that Auckland Airport is one of three regulated airports and the purpose of the Section 56G reports is to assess legislative effectiveness. While we would agree that the commercial relationship between Air NZ and Auckland Airport is healthier than that with Wellington Airport for example, we cannot agree that legislation is effective. The Commission’s own analysis has demonstrated that Auckland Airport will make excessive profits at the best estimate of a commercially reasonable “benchmark” return. It should also be noted that Wellington Airport has proven, unequivocally, that the legislative regime is not working.
46. In a wider comparative context, Auckland Airport should not be seen as reasonable simply because its pricing behaviour is not as blatantly extreme as Wellington Airport’s. Wellington Airport is not a benchmark against which the other airports should be measured. It is the current, working example of a monopoly enterprise exercising an antiquated piece of legislative power, designed for a time when airport infrastructure was owned by the State.
47. This statutory anomaly has the effect of passing onto private enterprise the ability to make excessive profits at the cost of the total NZ economy. Auckland Airport follows that excessive path and as a private company, responsible to its Board and shareholders, it is incentivised to do so under the current regime, both now and in the future.
48. Air NZ cannot help but draw parallels between this assessment process and the 2002 Airports Inquiry. In that Inquiry the Commission found that regulation of services at Auckland Airport was warranted and regulation at Wellington Airport would likely be justified if Wellington Airport proceeded with its proposed price increases at the time. Wellington Airport proceeded to increase its prices yet the Minister concluded that regulation was not warranted. A decade later the Commission again finds that Wellington Airport is extracting excessive profits. Auckland Airport is, on the Commission’s analysis, sitting on the upper cusp of

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<sup>27</sup> Letter from WIAL CEO to Air NZ, June 2012

what might be considered a competitive market outcome (although we remain of the view that this threshold has already been well and truly breached). It would be extremely unfortunate if history were to repeat itself in this regard, with consumers continuing to pay the price over an extended period for a lack of regulatory rigour and application of the credible threat that is crucial to effective regulation.

## **Annex 1**

Assessing the effectiveness of information disclosure  
A review of the Commerce Commission's draft report on the effectiveness of information  
disclosure regulation of Auckland Airport

NZIER report to Air New Zealand

May 2013