The starting point: Principles that inform profitability assessment under Information Disclosure

NZ AIRPORTS ASSOCIATION

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Introduction

- We welcome the Commission's approach to engagement in the IM Review and this opportunity to outline what we see as the fundamental principles that underline profitability assessment under ID.

- The draft worked examples supplied by the Commission provide helpful detail on the mechanics of a possible forward-looking profitability indicator. Our engagement on them is within the broader context of how we think profitability assessment should operate.

- For NZ Airports, it is important that assessments of profitability under ID:

    - recognise that airports seek to take efficient commercial approaches in consultation with their airline customers, and that these approaches may differ from the existing IMs;
    - provide transparency, while maintaining flexibility – airports being able to effectively explain decisions and performance; and
    - incorporate broader contextual analysis – numerical comparisons ought not to be afforded undue prominence.

- These principles drive outcomes that are consistent with the benefits delivered in workably competitive markets.

ID and forward looking profitability

- ID influences the pricing consultation process and outcomes.
- However, ID should not seek to dictate specific approaches to consulted outcomes, as it is beneficial to consumers for airports to take efficient commercial approaches, suited to their circumstances.
- Rather, the main focus should be on ID providing transparent explanations of consulted outcomes.
- The forward looking profitability indicator has the potential to assist interested parties to understand the expected impact of consulted outcomes – if established and applied in the right way.

Important to avoid prescription and lack of flexibility in ID

- To be workable, there needs to be sufficient flexibility for disclosure of a forward looking IRR, which is supported by explanations of consulted outcomes.

- Prescription can introduce greater complexity, which inevitably:

    - increases the risk of mis-alignment between the true impact of pricing decisions and how they are assessed under the ID framework;
    - requires greater explanation; and
    - therefore makes it harder for an interested party to fully understand what has been disclosed.

- ID should provide an accurate assessment of airport decision-making and performance. It should not put airports at risk of adverse conclusions by the Commission simply because their approaches do not align with the ID templates. Airport specific explanations will always be required.

- This appears to be recognised in the Commission's worked examples, which is welcomed by NZ Airports.

IRR and WACC

- Professor Yarrow has raised important questions about the role of regulatory WACC in profitability assessment.

- An undue focus on numerical comparisons between IRR and WACC will be unhelpful because:

  - the IRR in itself does not provide a full and meaningful picture of airport performance;
  - there is no basis to assume that a reasonable rate of return should always align with the regulatory WACC; and
  - even if that wasn't the case, WACC estimates inherently involve a high risk of regulatory error (and so comparisons risk a quest for false precision).

- That all means that the regulatory WACC is limited in its ability to provide a useful measure of acceptable returns or exercise of market power.

IRR and WACC

- That being the case, it is inevitable that an ex ante assessment, which involves rigid numerical comparison between the WACC (and in particular any point estimate of WACC) and the IRR, does not provide a meaningful indication of whether targeted returns are reasonable (and is contrary to Professor Yarrow's advice).

- It also poses a threat to the objective of transparency and the ability of interested parties to assess all objectives under Part 4 of the Commerce Act.

- And that is why contextual analysis is so important... Any assessment of performance should include a broader contextual assessment including airport-specific factors, such as the airport investment cycle, the level of airport investment, efficiency and quality of performance and external market factors.

Broader contextual analysis is key

- Contextual analysis is an essential component of ID and should not be given less prominence in favour of numerical mechanisms (for both ex ante and ex post assessments).

- ID is designed to facilitate explanations of what airports have done, and what their intentions were. That can only be properly disclosed, and understood, through contextual analysis.

- ID is underpinned by flexibility...

    - the Commission's proposal to provide flexibility for airports to decide how to disclose the impact of their pricing decisions across pricing periods is welcome; and
    - no matter how the specific disclosure schedules are formulated to provide a forward looking profitability indicator (IRR), this will always need to be reviewed alongside airport explanations.

...meaning contextual analysis is crucial.