

# 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



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## Key points

The Commerce Commission has prepared a draft report to Ministers concluding that that “information disclosure regulation has been effective in limiting Auckland Airport’s ability to extract excessive profits over time”.

The Commission is being overly generous with its assessment. The Airport’s ability to extract excessive profits is much greater than the Commission concludes. As a result, the Commission’s self-assessment of the information disclosure regime is too rosy.

The Commission’s analysis and analytical frameworks (IMs) point to a range of possible outcomes for the Airport’s profitability over time. Across that range:

- there is only one scenario in which the Airport is not projected to achieve excess returns
- this is the sole scenario the Commission uses to make its conclusions
- all other outcomes are assigned zero probability yet
  - the most likely outcome is \$44 million in excess returns; and
  - if the Airport does not keep to non-binding assurances around asset revaluation excess returns could be in the order of \$150 million.

The Commission has drawn conclusions about the Airport’s profitability while also concluding that it has insufficient information to determine whether investment and operating expenditure are efficient.

We do not believe it is reasonable to draw conclusions on one without the others – particularly when the balance of other evidence points to excess returns.

A high level assessment of Auckland Airport’s performance and past profitability suggests it is in the company of some of the best performing Airport’s in the world, in financial terms. Aeronautical revenues appear healthy as does the Airport’s asset base.

We do not know if this reflects excess profits to the long term detriment of consumers but it should raise some flags for the Commission and warrants further investigation.

The Commission has relied rather too much on the assurances and forecasts of the Airport itself in drawing its conclusions. The Commission should conduct further analysis of costs and the efficiency of past and future investment.

Information disclosure regimes shouldn’t be run on optimism. Unsubstantiated conclusions about the regime’s effectiveness are likely to undermine the effectiveness of the regime.

A more balanced assessment of Auckland Airport’s performance is needed.

# Contents

1.	Issues.....	1
2.	Profitability: a generous assessment.....	3
	2.1. Singular focus on 75 <sup>th</sup> percentile is misplaced .....	3
	2.2. What is the right percentile? .....	3
	2.3. The mid-point is the most likely outcome.....	3
	2.4. Expected values indicate excess returns .....	5
	2.5. Sensitivities largely ignored .....	7
3.	Conclusions rely too much on assurances and incomplete information.....	9
	3.1. Prior profit performance has been strong.....	9
	3.2. Healthy aeronautical revenues.....	11
	3.3. A robust asset base.....	13
4.	Is generosity appropriate under information disclosure? .....	15

## Figures

Figure 1	Probability of excess returns given WACC distribution .....	5
Figure 2	Expected value of excess returns .....	6
Figure 3	Expected value of excess returns due to revaluation .....	8
Figure 4	Auckland EBITDA margins over time .....	10
Figure 5	AIAL & Sydney EBITDA margins .....	11
Figure 6	Aeronautical revenue per passenger, 2008 — PPP adjusted .....	12
Figure 7	Growth in revenue per passenger .....	12
Figure 8	Regulated assets per passenger .....	13
Figure 9	Chain of events in the functioning of information disclosure .....	16

## Tables

Table 1	EBITDA margins.....	10
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# 1. Issues

The Commerce Commission has recently released a “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” (hereafter referred to as the Draft Report). The Draft Report was positive in its assessment of the effects of information disclosure (ID) regulation.

This review of that assessment focuses on the reasonableness of one particular draft conclusion:

*Our draft conclusion is that information disclosure regulation has been effective in limiting Auckland Airport’s ability to extract excessive profits over time (s 52A(1)(d)). In particular, for PSE2 Auckland Airport targeted returns within an appropriate range, based on a reasonable assessment of how, at that time, it could have considered the Commission might assess its performance. (paragraph X3, Draft Report).*

There are two pieces to this conclusion:

- the Commission’s expectation that Auckland Airport is, on the balance of evidence, unlikely to earn excessive profits over time and
- the Airport is not targeting excessive profits because it knew its performance would be assessed by the Commission.

The Draft Report’s findings about expectations for excess profits are the most important element in the overall Draft conclusion that the ID regime is working effectively.

We have serious misgivings about the reasonableness of the conclusions drawn by the Commission based on its analysis of Auckland Airport’s profitability. The Commission has been selective in the analytical findings it uses to draw its conclusions. By the standards of its own input methodologies (IMs) the Commission has been very generous in its assessment. Our reasoning for this view is outlined in Section 2 below.

Our review in Section 2 is of the judgements of the Commission given the frameworks that the Commission is working with. The analysis uses the Commission’s analytical approaches and the Commission’s IMs. We do not cover the on-going debates around, for example, reasonable WACC values and other IMs. Consequently, the results of this analysis should not be interpreted as a standalone assessment of the behaviour or performance of Auckland Airport. They are an assessment of the reasonableness of the Commission’s conclusions in its Draft Report.

We are also conscious that the Commission judged it did not have sufficient information to draw conclusions on Auckland Airport’s investment and operational efficiency which relate directly to profitability. Rather than say there was insufficient information to draw conclusions the Commission relied on information and assurances from Auckland Airport. We believe this is overly generous. This is discussed in Section 3 where we consider some alternative metrics of Airport profitability. These are somewhat outside the scope of the Commission’s IMs but

they are useful data points for assessing whether the purpose of Part 4 of the Commerce Act is being promoted under the current regime.

Under some circumstances there may be good reasons for regulators to err on the side of generosity in their assessment of the performance of regulated entities. An ID regime is not one of those circumstances, as discussed in Section 3.

Any assessment of the ID regime needs to be as balanced as possible and not overly generous in its assessment of Auckland Airport's performance. Any other approach is counterproductive and risks undermining the credibility of the regime.

## 2. Profitability: a generous assessment

### 2.1. Singular focus on 75th percentile is misplaced

The Commission's assessment of the expected profitability of Auckland Airport is not reasonable given the terms of its own IMs.

The Commerce Commission's IMs lay out a range of possible outcomes that are consistent with workable competition and a limitation on the ability to achieve excess profits. This includes rates of return somewhere between 6.08% and 8.04% – the 25<sup>th</sup> and 75<sup>th</sup> percentiles of post-tax weighted average cost of capital (WACC).

The Commission's conclusion about Auckland Airport's profitability is based on its own analysis showing that the Airport's forecast revenue will deliver an 8.0% rate of return and that 8.0% is smaller than 8.04% – the largest (75<sup>th</sup> percentile) value considered appropriate under the Commission's IMs.

The Commission's analysis shows that the Airport will achieve excess returns of around \$44 million (present value) if the Airport's 'true' WACC is at the mid-point of the Commission's range.

Our analysis suggests that all values of WACC within the Commission's range would lead to the conclusion that Auckland Airport is targeting excess returns *except* the 75<sup>th</sup> percentile.

### 2.2. What is the right percentile?

Is the 75<sup>th</sup> percentile of WACC the right percentile? Is it any less right than other percentiles?

Behind these questions is a more general question: are all percentiles within the WACC range created equal? There are two ways to consider this question:

- expected outcomes on the balance of probabilities
- expected outcomes on the balance of consequences.

Both of these lead to the conclusion that focussing on the 75<sup>th</sup> percentile is not reasonable and the Commission's conclusion does not follow from its own IMs.

### 2.3. The mid-point is the most likely outcome

*In assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (mid-point) on the range. (Reasons Paper, E.11.2)*

One way to consider whether all percentiles in the WACC range are created equal is to consider whether the 75<sup>th</sup> percentile in the Commission's WACC range is just as



likely to be the true value of WACC as any other value, on the balance of probabilities.

The idea that a 75<sup>th</sup> percentile might be as likely as any other value is illogical. The mid-point of the range is the most likely 'true' value. The 75<sup>th</sup> percentile is by definition 25% less likely than the midpoint. This means that the likelihood of the Airport achieving excess returns of \$44 million is 25% more likely than under-recovery of \$1 million (Table 3.2, Draft Report).

The mid-point of the range must be the Commission's assessment of the most likely 'true' rate of return (WACC) that would promote the objectives of the Act. If it was not then some other mid-point should have been chosen.

The Commission's IMs do, however, accommodate a range of possible values for WACC and this begs the question of how the Airport's profitability should have been assessed, given that framework.

The most logical approach would have been to ask: What is the probability of excess returns given that WACC lies within the probability-weighted range set out in the IMs? Mathematically, given uncertainty, this means finding the solution to:

$$p(R > R^* | W) \\ W \sim N(0.0706, 0.015)$$

That is, finding the probability that revenue ( $R$ ) is greater than required revenue ( $R^*$ ) given that WACC ( $W$ ) is normally distributed<sup>1</sup> with mean 7.06%<sup>2</sup> and standard error 0.15%. If we admit all possible WACC values from the Commission's specified probability distribution the answer turns out to be 0.74 or 74% (see Figure 1).

That is, there is a 74% probability that the Airport's forecast revenue will deliver excess returns.<sup>3</sup>

The Commission has specified that a reasonable return lies somewhere within the 25<sup>th</sup> and 75<sup>th</sup> percentiles of its specified distribution. If we adjust our calculation to consider only values within this range then the probability of excess returns rises to 0.98 or 98%.

In short, we can't be certain of excess returns but on the balance of probabilities it is more likely than not.

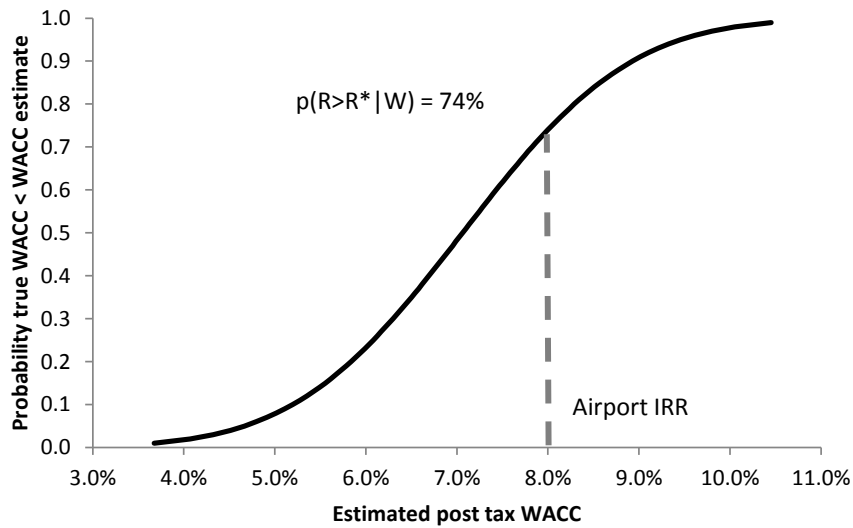
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<sup>1</sup> The use of a Normal distribution is specified in paragraph E11.19 of the "Input Methodologies (Airport Services) Reasons Paper", December 2010. We note that the use of some other reasonable distribution (e.g. a gamma distribution) would imply a lower 75<sup>th</sup> percentile WACC value than the one evaluated here. See e.g. Lally, M., The weighted average cost of capital for gas pipeline businesses, 28 October 2008, Appendix 7.

<sup>2</sup> The value for the mean and standard error of the distribution are from the Commerce Commission's "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.

<sup>3</sup> Assuming that true value of WACC comes from the distribution specified in the Commission's IMs.

**Figure 1 Probability of excess returns given WACC distribution**



Source: NZIER

## 2.4. Expected values indicate excess returns

Different points on the WACC distribution are not created equal as they are associated with quite different impacts. For example, the Commerce Commission’s draft report provides estimates of excess returns ranging from -\$1 million, at the 75<sup>th</sup> percentile of WACC, to \$44.9 million at the 50<sup>th</sup> percentile or mid-point.<sup>4</sup> Thus, in terms of consequence, these two estimates are not created equal.

If one assumed that the 75<sup>th</sup> percentile was as likely as the 50<sup>th</sup> percentile and compared only these two possible outcomes, the implication would be an expectation of excess returns in the order of \$43.9 million (present value over 5 years).

A reasonable approach to the evaluation of the Airport’s returns should take this asymmetry of impacts into account. The orthodox way of doing this would be to evaluate the expected present value of returns given the assumption of an underlying range or distribution for the true value of WACC. This means finding the solution to:

$$E[R - R^*] = \sum_i^I p_i(W_i) \cdot (R(W_i) - R^*(W_i))$$

$$W \sim N(0.0706, 0.015)$$

This equation for the expected value is simply the sum of the probability ( $p_i$ )<sup>5</sup> weighted excess returns ( $R - R^*$ ) between a range of percentiles ( $i$  through  $l$ ) given the probability distribution for WACC ( $W$ ) specified in the Commission’s IMs.<sup>6</sup>

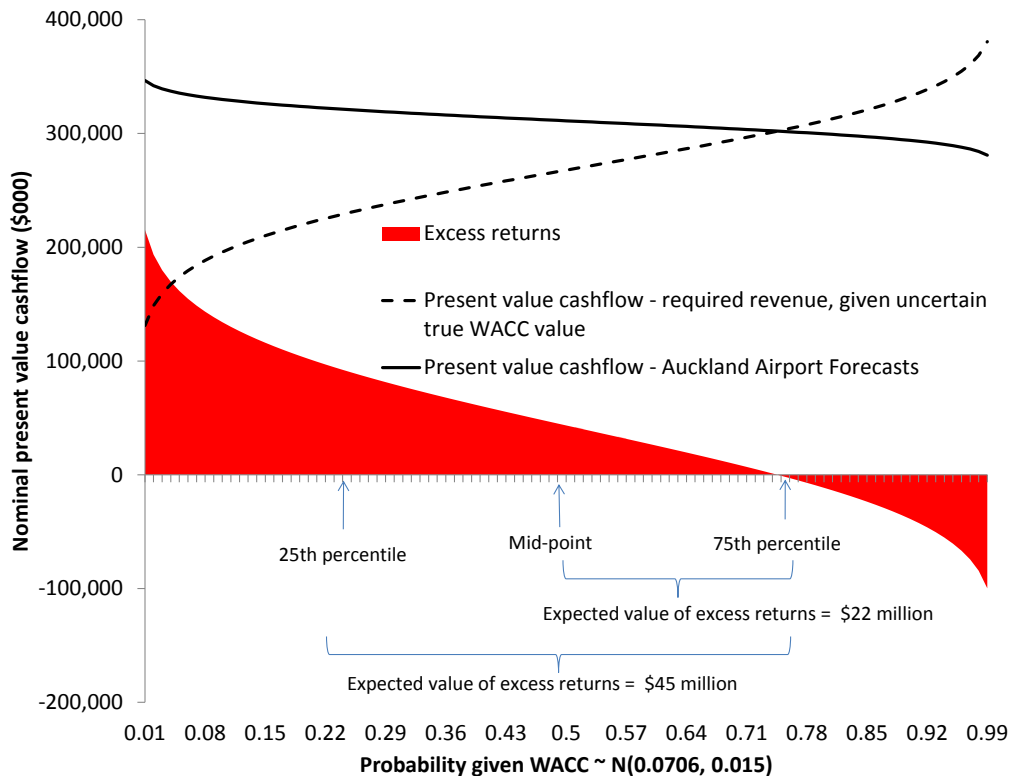
<sup>4</sup> Plus an assumption that cashflows are received mid-year as opposed to end-year under the ‘low’ end estimate.

<sup>5</sup> Adjusted for the range over which the probabilities are assessed.

The expected value for the Airport’s excess returns is \$22 million (present value) over PSE2, evaluating returns between the 50<sup>th</sup> and 75<sup>th</sup> percentiles.

Widening the range of evaluation to include the 25<sup>th</sup> to 75<sup>th</sup> percentiles increases this expected value of excess returns to \$44 million (see Figure 2).

**Figure 2 Expected value of excess returns**



Source: NZIER

This analysis demonstrates that the Commission has been generous in its assessment that “Auckland Airport’s expected return does not exceed the Commission’s estimate of the cost of capital” (p.80 of the Draft Report).

On the basis of this analysis **the Commerce Commission’s draft conclusions are not reasonable, when evaluated within the terms of the IMs for WACC.**

There may be reasons we are unaware of for drawing conclusions solely on the basis of expected returns at the 75<sup>th</sup> percentile of WACC. However, ours was a very conservative analysis which excluded consideration of a range of sensitivities which the Commission conducted.

<sup>6</sup> The calculations of excess returns used in our analysis follow the input data and methods in the spreadsheet accompanying the Commission’s Draft Report (‘Auckland Airport Draft s56G Report Profitability Calculations 30 April 2013.xlsx’)

## 2.5. Sensitivities largely ignored

All of the sensitivities conducted by the Commission raise the likelihood of excess returns beyond what we described above and would eliminate the slim analytical basis the Commission has for concluding that the Airport is targeting reasonable returns.

The Commission assumed that these sensitivities were not consequential. We believe this is inappropriate.

For example, one of the most important sensitivities which was disregarded by the Commission was the impact on Auckland Airport's returns if the Airport was to revalue its assets when setting prices for PSE2 and beyond. For example:

*E43.1 If Auckland Airport were to apply IMs from PSE2, recognise the revaluation of assets between 2009 and 2017 due to inflation but not treating revaluations as income, its expected return for PSE2 and beyond could be as high as 10.7% to 11.3% (depending on assumptions about the timing of the cash flows).*

*E43.2 If Auckland Airport were to recognise the revaluation of specialised assets between 2009 and 2017 due to inflation, value its land using a market value existing use (MVEU) approach in 2017 and not treat revaluations as income, its expected return for PSE2 and beyond could be as high as 11.5% to 12.1% (depending on assumptions about the timing of the cash flows).*

It is reasonable for the Commission to partially discount the possibility of revaluations. But, given the potential impact of a revaluation, it is not reasonable to assign zero probability to this outcome when assessing the effectiveness of information disclosure.

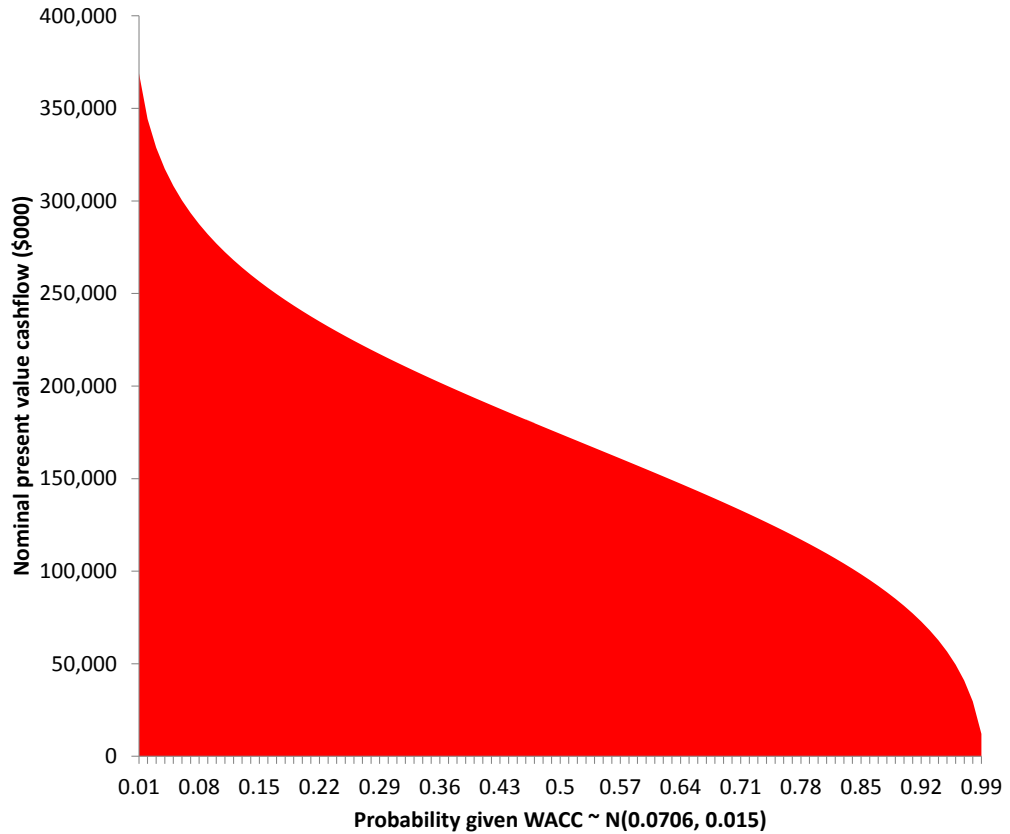
By way of example (see Figure 3) we have evaluated the expected value of excess returns based on the smaller of the impacts evaluated by the Commission (the revaluation which yields a 10.7% expected return). Excess returns evaluated at the 75<sup>th</sup> percentile of WACC are \$124 million (present value). The expected value of excess returns (evaluated over the 50<sup>th</sup> to 75<sup>th</sup> percentiles) is \$150 million. Even at the 99<sup>th</sup> percentile, outside the Commission's range of appropriate returns, excess returns are \$12 million.

If it were the case that Auckland Airport's returns were well within the bounds of what the Commission has deemed appropriate in its IMs then it may be reasonable to ignore entirely the impact of a revaluation. Given that this is not the case, and the Commission's findings are extremely sensitive to this assumption, a non-zero probability of revaluation should have been taken into account in the Commission's conclusions around the likelihood of excess returns.

If the Commission were, for example, to assign a 1% probability to the likelihood of this revaluation scenario, it implies an additional (probability weighted) \$15 million in excess returns which needs to be taken into account. This number clearly swamps the \$1 million under-recovery of returns found by the Commission in its 'base scenario' evaluated at the 75<sup>th</sup> percentile of WACC.

### Figure 3 Expected value of excess returns due to revaluation

Comparison of no revaluation versus a closing asset base value of \$1,285,922,000



Source: NZIER

We note also that a very minor change in profitability calculations, shifting the assumed timing of cashflows from year end to mid-year, eliminates any possibility of returns falling within the Commission's prescribed WACC range. This outcome is the downplayed in the Commission's conclusions despite the fact that mid-year cashflows are a much better approximation to reality than an assumption that cashflows appear at year end.

The Commission's arguments against giving weight to some of the sensitivities are reasonable, such as disregarding demand scenarios on the grounds that these have been considered at some length by Auckland Airport and taken into account in their price setting process.

Nonetheless, on the face of it, the Commission has chosen to make its judgements based on the only scenario that delivers a rate of return within the prescribed WACC range. In effect, the Commission is assigning this outcome a probability of 1 and declaring all other sensitivities as having a probability of 0. This is an extreme approach and begs the question of what the point is of conducting the sensitivities in the first place.

## 3. Conclusions rely too much on assurances and incomplete information

Our view is that the Commission places too much reliance on assurances and incomplete<sup>7</sup> information provided by Auckland Airport, for example:

- the Commission's financial analysis is dependent on forecast information and assurances regarding future performance supplied by AIAL
- the presumption that AIAL is not targeting excess profits in PSE2 because of the partial the use of IMs in price setting consultations
- assurances that the Airport will not revalue assets through the PSE2 period other than by way of a basic additions and deletions approach.

Reliance on the Airport's assurances and forecasts is problematic primarily given that the Commission has said it is not in a position to draw conclusions about the efficiency of the Airport's investments or operating expenditure. This means that two of the main drivers of the Airport's measured profitability have not been fully assessed but have been taken as given from Auckland Airport's forecasts.

We do not understand how conclusions can be drawn regarding the expected profitability of the Airport if conclusions cannot be drawn about the efficiency of its investment and operating expenditure. Both of these measures are a key part of determining whether profits are being targeted within an appropriate range.

An important question in this regard is whether there are any indications that the Commission needed to look more closely at efficiency of investment and operating expenditure. Our analysis suggests that there is.

### 3.1. Prior profit performance has been strong

In the absence of a full assessment of the efficiency of investment and operational expenditure it can be useful to draw on insights from alternative measures of profitability instead of focussing on return on investment.

One useful performance measure is EBITDA and EBITDA margins. On this measure, Auckland Airport's profitability was very healthy (see Table 1). EBITDA performance has remained strong since this 2010 snapshot (see Figure 4 and Figure 5).

These figures could be reflective of very strong operational efficiencies. However they may not be.

The Commission has taken the AIAL operational expenditure forecasts largely at face value. It is unclear, but important, whether this forecast of expenses represents efficient performance. In the forecast provided to the Commission these expenses average 2% growth over the period revenue, which is less than the 5% average

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<sup>7</sup> In this context we mean incomplete in terms of the judgements being made or needing to be made. We have not conducted a review of the Airport's compliance with formal information disclosure obligations.

revenue growth that is forecast. EBITDA, which is already up there with the best performers, should grow further, all things being equal.

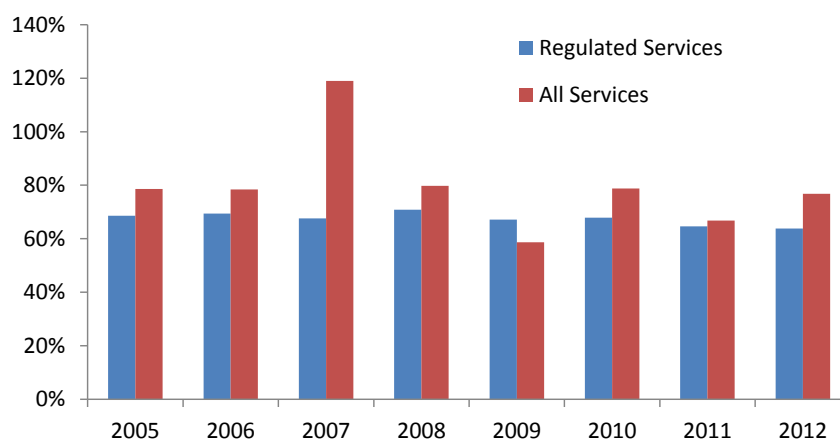
**Table 1 EBITDA margins**

A selection of high performing airports

Airport/Operator	EBITDA margin (%)
Sydney	83%
MAp Airports (Sydney +)	80%
Auckland	76%
Hong Kong	67%
Wellington	65%
Brussels	61%
Australia (IF airports)	61%
GAP Mexico	57%
Copenhagen	55%
ACSA South Africa	53%
BAA	52%
Rome	52%
Venice	50%

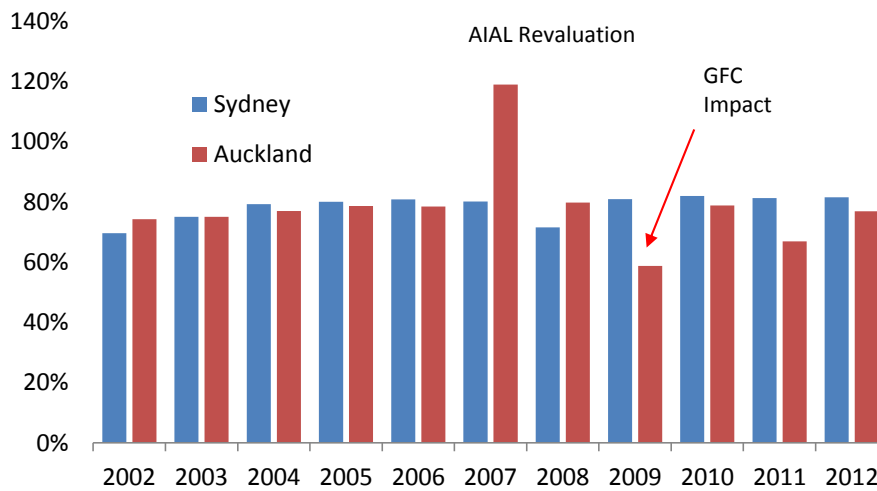
Source: CAPA Aviation Analysis 2010

**Figure 4 Auckland EBITDA margins over time**



Source: AIAL disclosures

**Figure 5 AIAL & Sydney EBITDA margins**



Source: AIAL and Sydney regulatory disclosures

Sydney airport is a useful “global” comparator for a number of reasons, the main one being that Sydney is regarded as one of, if not the, top performing airports globally. This strong and sustained performance over the last 10 years has resulted in a number of calls for its “performance monitoring” regulation to be strengthened to full price control.

### 3.2. Healthy aeronautical revenues

Auckland Airport has higher (price-standardised) revenue per passenger than both Wellington (recently assessed as earning excessive profits) and Sydney (the subject of on-going calls for price regulation).<sup>8</sup>

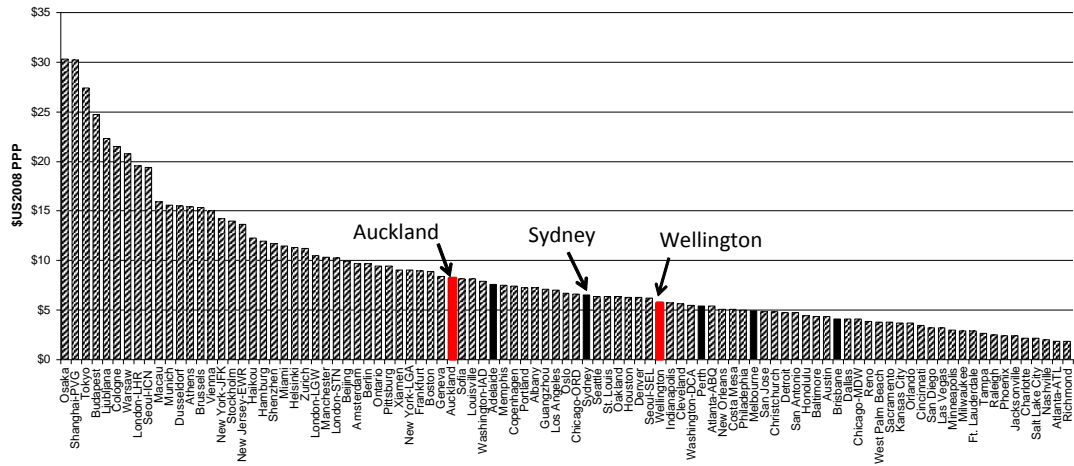
Revenue per passenger is widely used as an alternative measure for average prices. The ACCC uses it in the performance monitoring of Australia’s main airports. Figure 6 shows revenue per passenger for a large selection of major airports, including Auckland, Wellington and Sydney. This measure, from the Australian Productivity Commission’s 2012 inquiry report on “Economic Regulation of Airport Services” uses a standardised measure of prices across countries (a ‘purchasing-power-parity’ or PPP basis).

<sup>8</sup> Airports excessive profits have been of concern for some time and across a number of countries. In the UK the CAA forced the privatised BAA to divest two of its airports based on their assessment that the group’s behaviour was having an adverse effect on competition. This was after BAA plc had a windfall profits tax imposed because it simply made too much money. The most recent divestiture was Stanstead whose new owners, along with the remaining BAA airports, are required by the CAA to provide quite detailed disclosures of their financial performance on top of specific undertakings regarding future conduct.



**Figure 6 Aeronautical revenue per passenger, 2008 — PPP adjusted**

Airport charges in \$US 2008, adjusted for purchasing power parity (PPP).

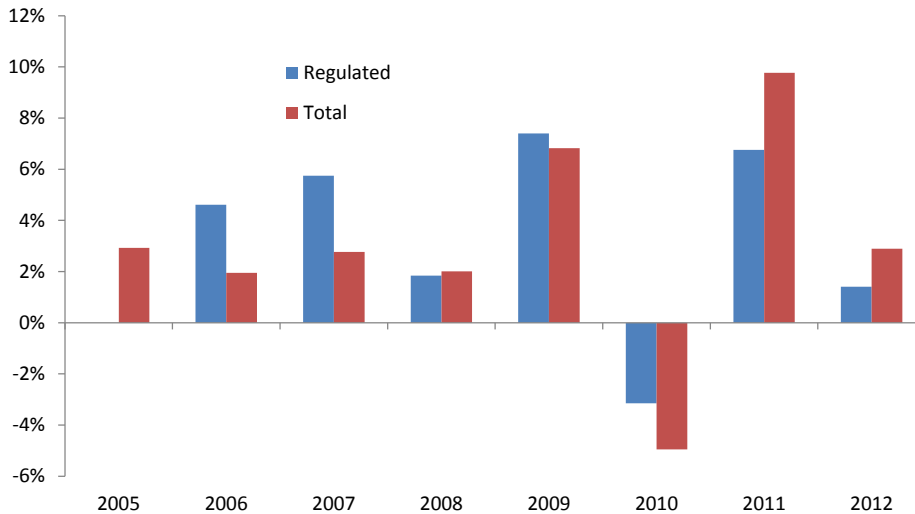


Source: Figure 4.5 from the Australian Productivity Commission Inquiry report 2012

Up to the point of this 2008 snapshot growth in revenue per passenger for regulated services had outpaced growth in total revenue per passenger. This trend has reversed since the global economic slowdown with unregulated revenue helping to provide a buffer against slower growth in aeronautical and other regulated activities.

**Figure 7 Growth in revenue per passenger**

Annual percentage change



Source: Auckland Airport Disclosures

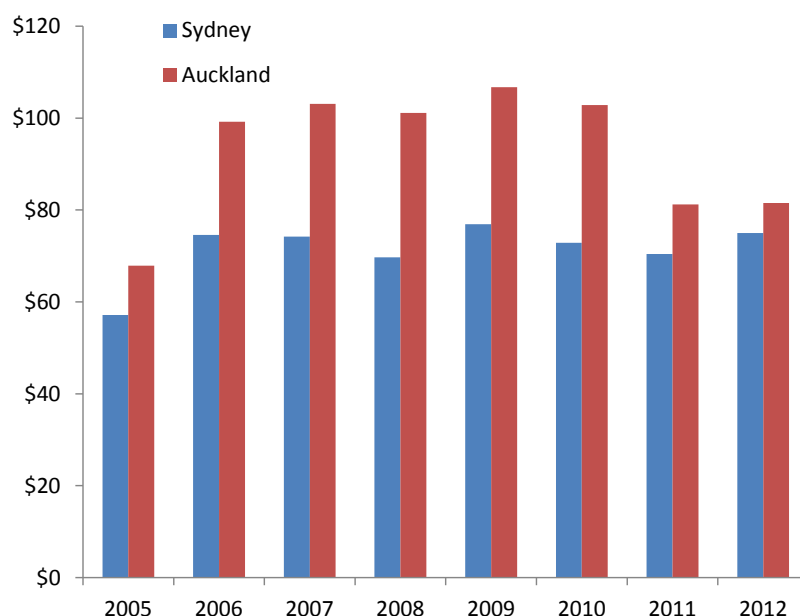
### 3.3. A robust asset base

Auckland Airport's regulated revenue and strong profitability performance is partly explained by an asset base which justifies reasonably good revenue on a per passenger basis.

Figure 8, for example, shows that Auckland's asset base is larger than Sydney's when measured on a per passenger basis.

On its own, the data in Figure 8 tells us little which is definitive. However, it does raise questions about investment efficiency and the efficiency of the Airport's asset base as it is currently valued – let alone the impacts on consumers from a revaluation in the future.

**Figure 8 Regulated assets per passenger**



**Source: AIAL disclosures & ACCC monitoring reports**

The key point is that investment plans and the efficiency of the asset base are key determinants of 'reasonable returns'. This includes assets that are not immediately necessary for operations (e.g. land) but are included in the price setting assets and are paid for by captive customers.<sup>9</sup>

The Commission should be very clear that its profitability assessment depends crucially on subjective factors relating to the size of Auckland's asset base including the assurances of Auckland Airport that it will maintain a moratorium on revaluation.

<sup>9</sup> We note also that depending on the regulatory conditions the opposite can also be true with airports withholding investments that would reduce their profitability given regulated prices. There were several submissions regarding Sydney airport strategic behaviour during the 2000's that included elements of this issue and other behaviour.

We tend to the view that this subjectivity, in and of itself, should cause the Commission to be extremely cautious in its pronouncements about Auckland Airport's profitability.<sup>10</sup>

In its Draft Report the Commission should have been clear about the limitations of its assessment methodologies and, in the absence of sufficient information on investment and operational efficiency, be willing to consider information from outside its 'model' (that is, the IMs).

Indeed return on investment has a number of material downsides that have limited its use as a performance measure of airports around the world.<sup>11</sup> ICAO, ACI and others have published extensive work on the performance measures for airports in the US and Europe (and other airports around the world) that do not include return on investment as a performance metric.<sup>12</sup> Furthermore many of these airports could be thought of as operating in more (workably) competitive markets because they are in close proximity to each other and offer consumers some ability to choose which airports to fly from and to. In this sense they offer a useful benchmark for comparison.

The Commission's determination to stick solely to its IMs and not to consider information from outside those IMs seems very generous given that insufficient information has been made available to make a full assessment of all relevant issues.

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<sup>10</sup> The value of the asset base is especially influential in the ROI outcome, to a much greater extent than is the airports operating profit, which is more observable.

<sup>11</sup> The main issue with ROI is that it is in conflict with efficiency objectives and dis-incentivises airports to improve operating performance that would take their ROI metric outside of the regulatory WACC envelope. Price monitoring is cost based and the lens is on the operating performance of the airport where its performance "controls" reside.

<sup>12</sup> ICAO's Airports Economics Manual (Doc. 9562) and ACI I 'Guide to Airport performance measures' February, 2012.

## 4. Is generosity appropriate under information disclosure?

The conclusions of the Draft Report suggest to us an inclination to find in favour of the effectiveness of the ID regime based primarily on the assessment that the regime is limiting the Airport's ability to extract excess returns. This inclination is out of place in an information disclosure regime.

Assessing the effectiveness of a regulatory regime is not an exact science. There will often need to be a degree of flexibility shown in interpreting the performance of the regime. With this flexibility comes the choice over whether to err on the side of positive or negative pronouncements.

Quite aside from the evidence cited above that the Airport is likely to achieve excess returns, it seems to us that it is inappropriate to err on the side of positive pronouncements when the form of regulation is ID.

As discussed by the Commission (Draft Report),

*2.8 Information disclosure can directly promote the Part 4 purpose. ID provides incentives to achieve outcomes consistent with those found in workably competitive markets in two main ways:*

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

*2.8.2 through the threat of further regulation.*

These incentives only work if there is decisiveness on the part of the regulator; decisiveness around the data to be disclosed, the ways in which that data will be assessed (IMs) and the way that resulting information is interpreted for its implications.

Information disclosure is a much longer chain of events than other forms of regulation with, in many cases, much less obvious implications (see Figure 9). There is a lengthy chain of information, interpretation and deliberation before there is any implication or signal for improved performance on the part of the regulated entity. In this context, indecisive or poorly evidenced judgements will diminish the efficacy of the regime.

The incentive for improved performance that comes through the threat of further regulation is likely to be undermined if the Commission errs on the side of positive pronouncements as to the effectiveness of the ID regime and the likelihood of reasonable returns. By being too generous in its assessments the Commission sends a signal to the Airport that it has room to manoeuvre.

The Airport already appears to have afforded itself flexibility in how it interprets and applies the Commission's existing determinations. The case in point being that the Airport has used and reported WACC methodologies and values which are different to those set out in the Commission's IMs. The Airport may well have forecast revenues that could (with a small probability) fall within the range of appropriate

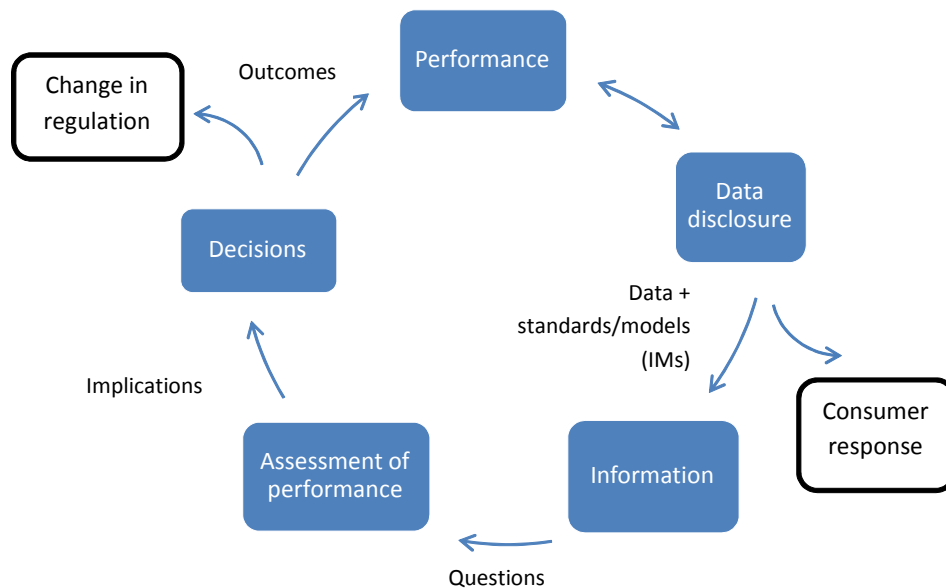
returns but this is only through ad hoc adjustment to pricing. This is not very transparent.

The Airport’s claims around the rates of return it needs have been undermined by its ad hoc pricing adjustment. As cited in paragraph F69 of the Draft Report Auckland Airport has claimed "there is a real risk that the theoretical position on WACC is diverging from business reality" and that "this will have a significant impact on whether Auckland Airport has the right incentives to invest and is able to attract the necessary capital to do so".

If, for example, WACC of 8.88% or more is as ‘mission critical’ as the Airport has claimed, how is it that they have accepted (through ad hoc adjustment) a forecast rate of return which is below that figure?

This demonstrates that reasonable rates of return are lower than the Airport would have people believe. In our view, unless the Airport has some other (not ad hoc) evidence justifying its assessed rate of return its returns should be based on the mid-point of the WACC range specified by the IMs. A decision by Auckland Airport to use other WACC values is obfuscatory.<sup>13</sup>

**Figure 9 Chain of events in the functioning of information disclosure**



Source: NZIER

Our comments mainly go to pointing out that the Commission needs to take steps to ensure the regime that works over time. In that context, there is no need to sugar coat the performance of the regime by making out that excess profitability is not a

<sup>13</sup> Focussing on WACC is of course rhetorical. A lower ‘true’ WACC is only one reason why the Airport could have accepted the rate of return that it appears to have accepted. It may be that Auckland Airport in fact does believe it requires a return in excess of 8.88% but believes it has sufficient flexibility to lower operational expenditure or defer investment (amongst other strategies) to ensure that it achieves its desired rate of return. It may also be that the ‘true’ value of its regulated asset base is lower than it suggests.

problem. It clearly is. If the Commission was to point to this fact then there would hardly be dramatic implications for either Auckland Airport or for the future of the ID regime. It would be a proverbial 'slap with a wet bus ticket'.

Noting that the Airport is likely to achieve excess returns and that this is a problem would, at least, send a signal that based on the evidence the performance of the Airport has not been as positive to date as it might have been given the Commission's expectations and application of its IMs. This would provide a clear and credible regulatory threat and would ensure that the ID regime functions as effectively as it can do in limiting the ability of the Airport to achieve excess returns.