29 May 2018

INTRODUCTION

1. This is the New Zealand Airports Association ("**NZ Airports**") submission on the Commerce Commission's ("**Commission"**) draft report "Review of Auckland International Airport Limited's pricing decisions and expected performance (July 2017 – June 2022)" ("**Draft Report**").

2. The NZ Airports contact for this submission is:

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3. As with our previous submissions as part of this review process, NZ Airports has focussed its comments on regulatory framework issues raised by the Draft Report.

EXECUTIVE SUMMARY

Approach to the review

4. The section 53B summary and analysis ("**review**") is an important part of ensuring that the Information Disclosure Regime ("**ID Regime**") continues to be effective. This is the first time the review has been done following the IM Review, so there is a material element of learning for all parties. The topics of focus in the Draft Report are consistent with how we understood the Commission would approach the review. However, it is important to keep in mind that all four limbs of the Part 4 purpose statement are important to assessing the long-term benefit of consumers, and that reviews over time (including of annual disclosures) build a more balanced and complete picture of performance.

5. In that context, NZ Airports appreciates that the Commission has:

   (a) sought to provide guidance on the types of further evidence that it would find persuasive to alleviate identified concerns;

   (b) not sought to "second-guess" consultation outcomes on complex matters such as capital expenditure, where airports and airlines have an information advantage; and

   (c) to some extent considered evidence from historical information disclosures to help inform views on reasonableness of current forecasts.

The bigger picture is positive for consumers

6. NZ Airports believes that the Draft Report is a positive endorsement of Auckland Airport's effective and efficient investment in response to significant growth challenges – for the long-term benefit of consumers. The Commission's views on investment and pricing efficiency are relevant to all airports. However, it remains the case that each airport is different, so what has worked well for Auckland Airport is not necessarily an approach that will work well for other airports, and vice versa. Ongoing flexibility remains important. For example, the extent of consultation required for capital expenditure programmes will depend on the scale and timing of investment.

Targeted profitability

7. The Commission is not yet convinced that Auckland Airport's target return is justified. This view is based on its requirement for extensive empirical justification of individual WACC IM parameter adjustments (particularly asset beta).

8. It appears to NZ Airports that the Commission's concerns on target returns mostly arise from the Commission's technical assessment approach being different to the way Auckland Airport approached price setting, and not a deliberate decision by Auckland Airport to operate outside the Part 4 purpose statement. NZ Airports emphasises that all airports seek to ensure that their performance promotes the long-term benefit of consumers. NZ Airports believes that looking at the broader picture and airport-specific context as set out in airport pricing disclosures should provide interested parties with comfort that airports are doing so, including because they are limited in their ability to extract excessive profits.

A different assessment approach is required

9. The new approach to profitability assessment determined in the IM Review was welcomed by NZ Airports. It was understood that airports would need to justify any departure from the WACC IM mid-point, but flexibility and full consideration of airport-specific contextual factors would be important features of the Commission's assessment of the airport's reasons. The Commission was clear that the WACC IM mid-point would not become a new bright line benchmark for acceptable returns.

10. While the Commission says that this remains the case, NZ Airports is very concerned that the extensive evidence required to justify individual adjustments to individual WACC IM parameters means that the flexibility and contextual assessment intended by the Commission will not be achieved in practice. There is a serious risk of a new bright line emerging, which does not reflect that a significant degree of judgement is required when estimating WACC and target returns – and when assessing airport performance. This is not assisted by the Commissions publication of headline numbers on the difference between an airport's target returns and the WACC IM mid-point.

11. Accordingly, NZ Airports believes the draft assessment framework for target returns should include a further step of considering a broader range of factors that are relevant to an assessment of the long-term benefit of consumers. For example:

    (a) Although this review is focussed on particular aspects of price setting, there should still be greater consideration of the full range of practical consumer benefits that are relevant to assessment of performance under the Part 4 purpose statement over time. Significant benefits of investment include improved quality, less congestion, and more airline competition that benefits passengers (including types of service, routes and lower prices). Such benefits should be weighed against estimates of excess returns.

(b) The Commission has found in the Part 4 price setting context that, to promote the long-term interests of consumers, avoiding the risk of underinvestment is more important than the risk of allowing excess returns. The Commission has found that Auckland Airport is proposing to invest efficiently, but has not addressed whether inferring that Auckland Airport should reduce its target return could have an adverse impact on its investment intentions, and reduce the types of benefits to consumers mentioned above.

(c) For assessing whether performance will promote the long-term benefit of consumers, evidence that airports have sought to conduct themselves with regard to the Part 4 purpose and the Commission's guidance is important.

(d) Care is required when assessing and presenting benefits or costs for passengers. For example, the Commission states that aeronautical charges consistent with the WACC IM mid-point would result in savings of up to 61 cents per passenger, per flight – but this does not take into account the dynamics of revenue management and airline pricing, and assumes airlines would pass on the full saving to passengers. Assuming current airline prices are set to optimise airline revenue, a reduction in airport charges would be unlikely to impact airline pricing. The perceived cost is not weighed against the substantial direct benefits for passengers that will arise from the investment programme – that is, even if the number were correct, 61 cents per passenger seems a small premium to pay to ensure a high quality of service is delivered. However, ultimately this is a matter for consumers (and interested persons) to consider.

(e) How prices are set is important. Property leases outside aeronautical pricing consultation are heavily negotiated based on market evidence at that time, and are priced according to the level of service required by the customer. They are likely to be a mix of short-term and long-term exclusive leases that are very unlikely to align with a five year pricing period. It is therefore inappropriate to apply a building blocks approach (including the current WACC IM) to estimate excess returns over the pricing period. Put simply, there is a timing mismatch, meaning the Commission will give a misleading impression of airport conduct and performance for PSE3 if its summary and analysis does not recognise the full underlying context for the property leases and/or place less emphasis on their impact on profitability for PSE3. On the other hand, if the Commission's analysis means to imply that airports should price consistently with the WACC IM across all regulated services for each pricing period, then it suggests airports would need to cross-subsidise across activities, which would likely raise pricing efficiency concerns.

The ID Regime remains effective

12. NZ Airports emphasises that airports do not seek an undue degree of freedom when setting target returns. Each airport is still required to carefully justify the rationale for their decisions, and the Commission retains the ability to decide whether to accept those justifications on a case-by-case basis. This dynamic places effective limits on airport profitability. However, we do seek an assessment approach that more proportionately, and realistically, reflects the inherent uncertainty in estimating WACC, and more directly engages with the reasons airports provide to support the exercise of reasonable judgement when determining a fair airport-specific WACC and target return.

13. Each airport is doing their best to work within the ID Regime. Airports seek to understand and apply the evolving guidance provided by the Commission. Where a mismatch of views arises under this review NZ Airports believes that the starting assumption should be that this is a genuine difference in understanding, rather than a sign that airports are seeking to operate outside the ID Regime.

APPROACH TO THE REVIEW

Overview

14. In this section, NZ Airports explains why:

(a) it is broadly comfortable that the general approach to the review will assist to maintain an effective ID regime (subject to our concerns on points of detail); and

(b) it believes that there remains scope for the review to provide a fuller picture of how, over time, airports are promoting the long-term benefit of consumers.

Focus of the Review

15. The Commission has focussed on the following aspects of performance in the Draft Report:

(a) expected profitability;

(b) investment efficiency; and

(c) pricing efficiency.

16. Subject to its understanding that a contextual analysis should be undertaken, NZ Airports is comfortable with this as a matter of detailed focus for this review, and agrees with the Commission that it reflects the nature of the information provided in pricing disclosures. We believe that the Commission's approach is consistent with ensuring that the ID Regime is effective, as it will help to ensure attention is directed toward the most relevant issues at each review.

17. However, NZ Airports reiterates its previously expressed views that assessing whether airports are promoting the long-term benefit of consumers requires consideration of performance under each limb of the Part 4 purpose statement, and overall performance, which is an ongoing task. Snapshots of performance will not provide the full picture. Trends are important. The Commission therefore has an important role to play in helping to promote understanding of how its summary and analysis under this review fits within the broader picture of performance under an ongoing ID Regime. On that note:

(a) Compared to the section 56G review for PSE2, the Commission appears generally more comfortable that Auckland Airport is transparently explaining its decision-making in a way that allows its performance to be readily assessed under the ID framework.

(b) This reflects that over time, airports are gaining a deeper understanding of the Commission's expectations, and are seeking to adjust their approaches accordingly.

(c) As discussed further below, the Commission should be reflecting this evolution in its summary and analysis, in addition to taking the additional step of considering how its views on target profitability should fit within a broader "in the round" assessment of the significant practical benefits being delivered by airports for the long-term benefit of consumers.

18. For this review, the Commission has sought to apply an assessment approach that is consistent with the section 56G review approach, unless there is good reason for departure – such as to reflect changes to the IMs.[1] NZ Airports agrees with that approach.

19. There has also been some productive use of historical information to assess PSE3 outcomes. For example, the Commission was able to conclude that:

(a) Auckland Airport's capital expenditure outcomes from PSE2 reflected a collaborative effort between the airport and the airlines;

(b) there was no indication that Auckland Airport had managed either its capital or operating expenditure to enhance its short term return on capital in PSE2; and

(c) Auckland Airport's approach to managing demand and development cost risk for PSE2 reflected an appropriate risk share arrangement, albeit that a different approach has been implemented for PSE3.

20. However, as discussed below in the context of target returns, NZ Airports believes that a change in the Commission's assessment approach for PSE3 does not mean that historical performance should be excluded from an assessment of performance over time. Historical information can still provide valuable information on how airports have sought to adjust their performance, in response to evolving guidance from the Commission.

21. The Commission has also noted that it will consider all relevant information provided as part of the review, and will not limit itself to information before the airports at the time they set prices. However, it notes that when assessing the reasonableness of pricing decisions, the Commission has given consideration to the information that was available to airports at that time.[2] NZ Airports is comfortable with the Commission's approach, as it addresses our key concern from previous submissions – namely, that airport conduct is important to the overall assessment of performance, and adverse findings should not be made if the airport could not have reasonably anticipated an issue (or assessment approach) that was raised after prices were set.

Long-term benefit of consumers

22. The Commission states that it has assessed whether Auckland Airport's expected performance is consistent with outcomes that are in the long-term benefit of consumers (ie the Part 4 purpose).[3] If an airport's forecasts do not align with the IMs, the Commission does not assume the Part 4 purpose is not being promoted – "ultimately, we establish whether a departure from our benchmark value is promoting the long-term benefit of consumers".[4] As noted by the Commission, departure from the WACC IM is the focus of this review.

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[1] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [40].

[2] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [47] to [48].

[3] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [29].

[4] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [35]. In this context, we take the 'consumer' to be the passenger, although it is not always clear in the draft report whether 'consumer' refers to substantial airline customers or passengers.

23. Assessing the long-term benefit of consumers is a complex exercise, which makes it difficult to provide an accurate picture of performance using mechanical methods. Although airlines and passengers are both consumers under Part 4, costs and benefits accrue to them in ways that are different and difficult to quantify, which should feature in the Commission's qualitative analysis. For example, there is an indirect relationship between passengers and aeronautical charges, which means the assumptions underlying a per passenger indication of pricing above the WACC IM mid-point (ie 61 cents per passenger) are very unlikely to hold in practice – ultimately, prices paid by passengers will depend on airline pricing models. On the other hand, passengers directly benefit from airport investment that a pricing WACC supports, while airlines may have mixed views on the benefits arising from capacity-enhancing investment and their willingness to pay for it.

24. It is therefore notable that the Draft Report is silent on the long-term benefit of consumers in the sections that analyse whether Auckland Airport's expected profitability is justified. Instead, the analysis focuses on whether there is empirical evidence to support adjustments to certain WACC IM parameters.

25. The result is that, ultimately, the Commission does not qualitatively consider all of the factors that are important to understanding whether Auckland Airport's expected profitability will promote the long-term benefit of consumers (passengers and airlines) over time. Although the Commission does not believe sufficient evidence has been provided to justify departures from the WACC IM parameters, it does not:

(a) place the WACC IM mid-point in proper context – ie it should not be treated as a bright line benchmark or a 100% accurate indicator of returns that will promote the long-term benefit of consumers (passengers and airlines) in Auckland Airport's specific circumstances;

(b) consider disclosed information where Auckland Airport has explained why it believes its decisions promote the long-term benefit of consumers; or

(c) consider the long-term consumer benefits that will be promoted by Auckland Airport setting a target return that it considers sufficient to support its extensive investment programme.

26. It appears that the Commission's view on the impact of the dual till is a key reason why the Commission is reluctant to consider whether a WACC higher than its mid-point can provide long-term benefits for consumers – including passengers. That is, it believes that the incentives arising from the non-regulated business mean that it does not need to be concerned about whether its WACC IM mid-point underestimates the true WACC for each airport, such that investment that benefits passengers in the long-term could be put at risk.[5]

27. NZ Airports has previously expressed why it strongly disagrees with this position.[6] For this review, we submit that the Commission has not presented sufficient empirical evidence to support its assumption regarding the impact of the dual till. Accordingly, the Commission should consider whether any risk that airport-specific target returns above the Commission's WACC IM mid-point are "excessive" are mitigated by benefits to consumers arising from airport investment.

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[5] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [A138].
[6] NZ Airports, *Submission on IM review draft decision*, 4 August 2016 at 27.

EXPECTED PROFITABILITY

Overview

28. The Commission's draft conclusion is that Auckland Airport has not sufficiently justified its target return above the Commission's benchmark WACC IM, and therefore the Commission is not yet confident that Auckland Airport will be limited in its ability to extract excessive profits over PSE3.

29. The Commission acknowledges that some of Auckland Airport's expected profit may not represent excessive profits, because the Commission agrees that Auckland Airport's significant capital expenditure programme will increase its operating leverage, and could justify an uplift from the WACC IM mid-point.

30. The Commission states that it has applied the assessment framework established at the conclusion of the IM Review.

31. In this section, NZ Airports explains that:

    (a) We supported the new assessment approach, which de-emphasised the past focus on WACC values in favour of considering broader airport-specific factors. It was clear that airports would be required to justify any departure from the WACC IM mid-point, but it was left open as to what reasons would be relevant and what evidence would be sufficient in any given case.

    (b) We are concerned that the assessment framework now set out in the Draft Report does not implement the Commission's intent from the IM Review, as it will materially limit flexibility and requires an evidential standard that does not allow full consideration of commercial reality and airport-specific circumstances. There is a serious risk that the WACC IM mid-point will become the new bright line benchmark. We ask the Commission to consider whether it would be better for new guidance to be established under a process separate from consideration of pricing decisions – as was the case with the assessment framework established under the IM Review.

    (c) If the Commission maintains its draft approach, then to fulfil the statutory purpose of promoting greater understanding of airport performance over time, and to be more consistent with the IM assessment framework, the Commission's final report should include more information to place the WACC IM analysis in its proper context when assessing the long-term benefit of consumers. This includes:

        (i) noting any evidence that airports have changed their approach to target returns in response to the updated IM and Commission guidance – eg there has not been a "backward step" in performance over time;

        (ii) acknowledging that any estimation of WACC and asset beta, including by the Commission, lacks precision and relevant empirical data is difficult to obtain and/or is unreliable. There should be more focus on considering and assessing the judgement that airports must exercise when estimating a reasonable airport-specific WACC and target return;

(iii) consideration of broader evidence of airport conduct and performance that demonstrates airports are seeking to promote the long-term interests of consumers; and

(iv) the extent to which the Commission's assessment puts downwards pressure on target returns, which could have an adverse impact on the timing and nature of investment.

Performance over time

32. NZ Airports is concerned that because the Commission changed its expected profitability assessment framework following the IM Review, it has decided not to consider Auckland Airport's historical profitability performance. NZ Airports submits that performance trends are important as they help interested parties to understand how, over time, the ID Regime is effectively promoting the long-term benefit of consumers.

33. Further, it is unrealistic under an ID Regime to expect that an airport's target return for PSE3 will precisely align with the Commission's assessment benchmarks, especially when significant elements call for informed judgement, and the new framework involves a material element of learning. Views will reasonably differ. It is more realistic to consider, in comparison to their historical approach, how airports have moved towards the new benchmark and had regard to available Commission guidance.

34. Section 53B(2)(b) of the Commerce Act 1986 ("**Act**") provides that the Commission must:

> … publish a summary and analysis of that [disclosed] information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.

35. There is clear evidence that, since the ID Regime was introduced, airports have sought to adjust their performance to align with the Commission's expectations of conduct that is consistent with the Part 4 purpose statement. Although not binding in pricing, the IMs heavily influence each airport's approach to price setting.

36. The WACC IM is different to other IMs. Parliament's clear intent is that the Commission should not establish an expectation that the WACC IM must be applied in pricing. Section 53F of the Act provides that airports do not have to apply the WACC IM in their information disclosures. Clearly, if Parliament included this statutory exception in an effort to distinguish light-handed information disclosure from other forms of regulation, it could never have intended that airports would be pressured to apply a bright line WACC IM without any commercial overlay in their pricing decisions.

37. Nevertheless, the Commission's WACC IM benchmark, and the Commission's guidance on how it will be applied in assessment, materially guides each airport's determination of target returns.

38. To illustrate, in the Draft Report the Commission notes that: [7]

[7] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [D14].

> Auckland Airport's target WACC percentile has decreased in PSE3 compared to PSE2. In PSE2, Auckland Airport's expected returns were at the 75th percentile of our WACC range; this has reduced to the 67th percentile for PSE3.

39. The Commission found that Auckland Airport's target return for PSE2 was within an acceptable range, as its view for the section 56G reports to Ministers was that the 75th percentile was the upper bound of an acceptable range. Although many commercial and regulatory factors have informed Auckland Airport's target return for PSE3, given that Auckland Airport chose to target a return well below its assessed Auckland Airport specific WACC estimate, it appears clear that the Commission's guidance that the 75th percentile should not be targeted as an acceptable return was taken into account.

40. NZ Airports believes that this is important contextual information for the Commission to include in its assessment of profitability, to help ensure that Auckland Airport's performance over time is properly understood. In the Draft Report, the information on PSE2 profitability is included at Attachment D, which considers whether amendments as part of the IM Review have improved transparency. Elsewhere, the Commission expressly states that it has not considered PSE1 and PSE2 performance when assessing profitability.[8]

41. Historical performance is relevant to understanding whether information disclosure is effective at limiting the ability of airports to earn excess profits over time. In particular, it would help interested parties to understand that there has not been a "backward step" in airport performance since the ID Regime was introduced. Instead, as further discussed below, it is evident that Auckland Airport sought to take a comprehensive approach to determining an appropriate target return for PSE 3, including developing detailed evidence, based on its assessment of the Commission's performance expectations.

42. The historical performance of each airport will be different, but the same principle should apply to each review. That is, the Commission should provide more information on how performance has changed over time, and whether there is evidence that the ID Regime is maintaining its effectiveness over time.

Less focus on WACC IM values is required – context remains key

43. During the IM Review, NZ Airport was concerned that the WACC IM mid-point could inappropriately becoming a new "bright line" benchmark for target returns. The Commission sought to provide comfort by stating that:

> We agree that care needs to be taken when using the WACC to assess profitability and our emerging views paper outlined how we are attempting to reduce the focus on specific WACC values.[9]

44. Our concern now is that the Commission's assessment framework in fact increases the focus on WACC IM values (particularly the WACC IM mid-point), as discussed below. NZ Airports submits that to avoid this risk, instead of primarily focussing on technical parameter adjustments, the Commission's assessment of expected profitability must more carefully consider and assess the judgement that airports must reasonably exercise when estimating an airport-specific WACC and target return.

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[8] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [77].

[9] Commerce Commission, *Input Methodologies Review Decisions - Topic Paper 6 – WACC percentile for airports*, 20 December 2016 at [58].

45. When it first determined the WACC IM for airports, the Commission noted the following challenges it had faced:

> The cost of capital, in particular the cost of equity, cannot be observed directly. Rather it must be estimated from the available data using a number of tools and techniques. This is not a simple task. The available tools are imperfect, the data can be hard to obtain or unreliable, and can change over time. Older data can be re-interpreted in new ways; newer data may call into question previous assumptions. The cost of capital is forward-looking. That is, it reflects expectations of the returns required in the future, which cannot be observed in advance.
>
> In estimating the cost of capital, there are also choices around the analytical models to be used, over the level of each parameter, and around the estimate of the cost of capital to be applied under the different regulatory instruments. The estimation of cost of capital is not a mechanical task. To determine the methodology for estimating the cost of capital, and to assure itself that the estimate is reasonable and meets the Part 4 Purpose and the purpose statement of information disclosure regulation, the Commission has had to exercise a degree of judgement over these matters. The Commission has carefully considered the effect of a number of choices individually and in combination. The Commission has used its IM to estimate the cost of capital based on current market conditions. It has then tested the resulting estimate of the cost of capital against a range of market information to ensure the IM is reasonable and commercially realistic, in the context of how the cost of capital is to be applied in regulation under Part 4.[10]

46. The challenges airports face when estimating an airport-specific WACC and target return are similar to the challenges the Commission faced when estimating the industry-wide WACC IM.

47. Given that all of these challenges lead to imprecision and likely estimation error, the Commission noted that "it is usual practice to estimate a range for the WACC".[11]

48. As part of the IM Review, the Commission removed the WACC range for airports. Accordingly, it has removed the usual mechanism by which it allows for potential error in its WACC estimate. However, the Commission summarised the outcomes of this change as follows:

> We consider that our change will contribute to an ID framework that is best able to allow interested parties to assess whether airports are extracting excessive profits or not. As a result, this approach promotes the long-term benefit of consumers.
>
> This change enables flexibility in assessing the acceptability of airport returns and will reduce the focus of any assessment on the upper limit of the WACC percentile range.

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[10] Commerce Commission, *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [6.1.4] – [6.1.5].
[11] Commerce Commission, *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [6.7.3].

> It will also provide flexibility to enable any assessment to take into account different contextual factors affecting an airport's required return expectations, or the expectations of a particular project.[12]

49. NZ Airports understood that by removing the WACC IM range, the Commission was seeking to achieve a balance. Removing the WACC IM range would reduce focus on its upper limit as being the limit of acceptable returns (which would encourage airports to carefully justify their position), while retaining the standard error continued to recognise the estimation uncertainty and that a range of target return outcomes could be consistent with the Part 4 purpose statement. As the Commission put it:

> We consider that a precisely defined WACC percentile range applied to all airports in all situations is not appropriate for the IMs. Airport-specific factors should be considered when undertaking an assessment of whether individual airports are meeting the purpose of Part 4.[13]

50. The Commission also explained that for airports it did not wish to allow an "uplift" from the WACC IM mid-point in recognition of asymmetric social consequences in the same way as it did for entities subject to price control. That was because:

> Logically, an airport would use the same approach to WACC for [estimating a WACC use to set prices and that determines whether investment will proceed], thereby ensuring the prices charged for airport services reflect the returns required by the airport to cover all its costs, including its cost of capital, on its investment to provide those services. As a result of using its own estimate of WACC to set its prices, it is not apparent why an airport would defer investment because the WACC (which it sets for itself) is too low.
>
> We acknowledge that the airport, like us, does not know the true but unobservable WACC. The airport's estimate of WACC might be an under – or over – estimate of the true WACC, but the investment ought not to be deferred because the airport considers the WACC is too low. If the airport has mis-estimated the true WACC, it may experience returns that are different from the return actually required by the market, until it can reset it prices to reflect its revised estimate of WACC.[14]

51. NZ Airports agrees that airports attempt to set a target return that they consider is sufficient to cover all of their forecast costs of investment, including the airport-specific cost of capital. NZ Airport's concern is that downward pressure on an airport's target return (through regulatory uncertainty or otherwise) may have an adverse impact on an airport's investment programme. Professor Yarrow explained the risk within his report:[15]

> To illustrate the sort of thing that can happen, consider an investment project under contemplation which is at the high risk end of the investment opportunities spectrum. If the project is added to the business plan, the spread of the returns distribution of the business as a whole will be increased.

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[12] Commerce Commission, *Input Methodologies Review Decisions - Topic Paper 6 – WACC percentile for airports*, 20 December 2016 at 3.

[13] Commerce Commission, *Input Methodologies Review Decisions - Topic Paper 6 – WACC percentile for airports*, 20 December 2016 at [78].

[14] Commerce Commission, *Input Methodologies Review Decisions - Topic Paper 6 – WACC percentile for airports*, 20 December 2016 at [63] – [64].

[15] Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector*, February 2016 at 7.

> However, if regulatory policy is targeted simply at the upper end of the profitability spectrum, addition of the project will tend to increase the risk of regulatory intervention. The result could be a bias against more risky, possibly more innovative projects: policy intended to target market power succeeds in reducing the mean rate of return, but may do so by creating unintended distortions in investment.
>
> Similar points apply when the relevant cost of capital estimate (for the business as a whole) turns out, inadvertently, to be an underestimate: investment in low risk projects may still be profitable, but higher risk investments may become unprofitable.

52. Accordingly, NZ Airports believed that, at the conclusion of the IM Review, the Commission had established that:

    (a) the mid-point WACC IM estimate remains subject to estimation error, and is not a "bright line" benchmark of acceptable returns for each airport. NZ Airports believes this is a material factor that should expressly qualify the way the Commission presents its expected profitability analysis in accordance with section 53B (eg the Commission will need to continue to acknowledge that there is uncertainty about the quantum of returns above the WACC IM mid-point that might be "excessive"); and

    (b) airports must exercise reasonable judgement when estimating an airport-specific WACC and target return to support investment, and empirical evidence will not provide a full answer to every issue.

53. NZ Airports understands that the WACC IM mid-point represents the Commission's best estimate of a benchmark that will promote the purpose of Part 4, and that the Commission wishes to promote consistency and certainty in assessment of returns. Nevertheless, consistent with the maturing of the ID Regime and the ongoing learning by all parties, it must be possible to adopt an assessment approach that achieves a better balance between:

    (a) providing interested parties with comfort that the assessment of target profitability influences airports to set their target returns in accordance with the Part 4 purpose statement; and

    (b) allowing airports to exercise reasonable judgement, based on evidence, that takes into account all relevant airport-specific factors and context.

54. Ultimately, the balance can be achieved by the Commission's exercise of independent judgement, in a similar manner to the way it exercised judgement when establishing the WACC IM. That is, it will always retain the ability to conclude that airports have not adequately justified their target return as being in the long-term interests of consumers, and the IM benchmark will materially inform that assessment. However, it is important for the Commission's judgement to be primarily based on direct engagement with the airport's reasoning and judgements as set out in their information disclosure, instead of being primarily based on a technical analysis that does not feature in, or accurately represent, the way airports have made decisions and exercised judgement. We expand on this point below.

The Commission's assessment framework

The new assessment framework

55. NZ Airports accepts that under the IM Review, the Commission followed a process to establish new guidance on how it would assess target profitability. In particular, it was clear to NZ Airports that:

    (a) it should no longer be assumed that target returns up to the 75th percentile of the WACC IM range would be automatically found to be within an acceptable range;

    (b) there could be a range of legitimate reasons for airports to target returns higher than the mid-point of the WACC IM, depending on airport-specific circumstances and context; and

    (c) if airports were targeting returns above the mid-point of the WACC IM, then the onus was on airports to explain and justify their position.

56. It was less clear what reasons would be considered legitimate for targeting returns above the WACC IM mid-point, and what evidence would be sufficient. Although this presented challenges and uncertainty for airports, it was consistent with the spirit and intent of the ID Regime.

57. Airports have demonstrated over time that they endeavour to understand and apply the guidance provided by the Commission, so where a mismatch of views arises under this review, NZ Airports believes that the starting assumption should be that this is a genuine difference in understanding, rather than a sign that airports are seeking to operate outside the ID Regime.

58. In the Draft Report, the Commission has provided additional guidance on how Auckland Airport (and other airports) might justify target returns above the mid-point of the WACC IM. As discussed below, the detailed application of this assessment framework differs from the understanding NZ Airports had formed at the conclusion of the IM Review.

59. A benefit of establishing new guidance as part of the IM Review was that it allowed interested parties to constructively engage on the relevant principles independently of any specific airport decision-making under review. NZ Airports submits that if the Commission wishes to develop further guidance, a similar process should be adopted – and it should not take place as part of a review of price setting.

Flexibility in assessment and consideration of full context – an additional assessment step is required

60. There is common ground that flexibility is a material new feature of the assessment framework. As discussed above, the Commission also stated that consideration of the full context of airport-specific circumstances would be a feature of assessment. In the Draft Report, the Commission states that it remains open to a return above the mid-point being justified. The Commission accepts that determining a pricing WACC is a judgement exercise and the IM WACC mid-point estimate is not a bright line benchmark. To summarise, it intends for its approach to:

    (a) enable flexibility in assessing the acceptability of airport returns, and to reduce the focus of any assessment on the upper limit of the range; and

(b) provide flexibility to enable any assessment to take into account different contextual factors affecting an airport's required return expectations, or the expectations of a particular project.[16]

61. NZ Airports asks the Commission to reconsider whether its new assessment framework fully aligns with the Commission's intent to provide flexibility and to fully consider airport-specific context. NZ Airport's concern is that the Commission's requirement for airports to provide extensive empirical evidence to justify the reason for, and size of, each deviation from individual WACC IM parameters means that, in practice, little or no flexibility is provided to consider airport specific context.

62. Again, this practical lack of flexibility in the assessment approach is inconsistent with NZ Airport's understanding of the Commission's intent at the conclusion of the IM review. In particular NZ Airports did not anticipate that:

(a) the WACC IM would be the only acceptable model for estimating an airport-specific WACC. The Commission had noted that using a different methodological approach could be one reason that an airport is targeting a return that differs from the WACC IM midpoint;[17]

(b) an airport-specific WACC could only be justified on a parameter by parameter basis;

(c) broader contextual factors would only be relevant to assessing whether a parameter adjustment was unjustified for other reasons;[18] and

(d) broader contextual factors and the commercial considerations contemplated by Professor Yarrow would not be a feature for consideration if raised by airports.

63. It is therefore disappointing that the Commission is now of the view that Auckland Airport's approach lacks transparency because it has not provided alternative estimates of each WACC IM parameter (which required the Commission to back-solve the value). It appears to NZ Airports that Auckland Airport expended a great deal of time and effort to carefully justify its approach in a manner that transparently complied with the framework as it was understood at the time of price setting.

64. If the Commission adheres to the assessment framework set out in the Draft Report, NZ Airports believes that, to better implement its intent as expressed at the conclusion of the IM Review, the Commission should take a further step of considering all contextual factors that could support a finding that airports are promoting the long-term benefit of consumers, including because they are limited in their ability to extract excessive profits.

65. NZ Airports believes that assessing the extent to which airports are limited in their ability to extract excessive profits should not be an "all or nothing" assessment dependant on whether or not the Commission is satisfied departures from the WACC IM mid-point estimate are technically or mathematically justified. As with other aspects of performance that the Commission is called on to assess (eg quality, efficiency, innovation), performance or

[16] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [95]

[17] Commerce Commission, *Input Methodologies Review Decisions - Topic Paper 6 – WACC percentile for airports*, 20 December 2016 at [131].

[18] Our understanding of the final step in the Commission's assessment framework is that it will consider whether there are any additional factors relevant to the airport's overall target return, but only for the purpose of determining whether otherwise legitimate parameter adjustment are offset.

achievement can fall within a range, and is usually a question of degree (as opposed to a binary assessment).

66. The final step of the assessment should therefore involve a qualitative analysis of airport conduct and performance. For example, is there evidence that:

(a) supports a finding that an airport believed it was exercising reasonable judgement in accordance with the Part 4 purpose statement (ie was it seeking to promote the long-term benefit of consumers);

(b) shows an airport was materially influenced by the assessment framework; or

(c) demonstrates that any mathematical estimate of "excess" returns should not be regarded as "excessive" when weighed against the consumer benefits that are likely to accrue (as discussed above, understanding how direct benefits to passengers compares to direct benefits for airlines is important)?

67. If so, then this is evidence that airports are promoting the long-term benefit of consumers, including because they are limited in their ability to extract excessive profits. This remains the case even if the Commission may hold the view that not all of the target return has been completely justified on a WACC IM parameter adjustment basis.

68. NZ Airports also considers that the underlying reason for Auckland Airport's departure from the mid-point should receive greater prominence in the Commission's analysis of target returns. As noted by the Commission:[19]

> In the context of the current review, we consider that if the capital expenditure forecast is credible, the investment is in the long term benefit of consumers, and is material enough to significantly impact operating leverage, then an asset beta adjustment should be considered.

69. That is, the Commission has acknowledged that the once in a generation investment Auckland Airport is undertaking for the long-term benefit of consumers is a legitimate reason to consider higher target returns.

70. The Commission should feel comfortable that taking into account this wider context is consistent with what it stated at the end of the IM review. It is also in line with its view that empirical evidence is ultimately limited when estimating WACC and that judgement is required when determining an airport specific WACC. We believe that such qualitative judgement is something that interested persons would find useful to complement the technical analysis.

71. Equally, as discussed above, it would not represent a relaxation of the assessment. Rather, it would represent a more rounded assessment of performance and conduct that more directly engages with an airport's reasoning and judgement at the time it set prices – which will always seek to avoid an adverse assessment by the Commission.

72. Overall, NZ Airports believes that the Commission should not provide an immediate "black mark" or finding of failure in this section 53B review based on an assessment framework that was developed after prices were set. Rather, consistent with how the ID Regime has

[19] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [A116].

effectively worked to this point, it should allow airports to consider appropriate adjustments, going forward, that do not have a detrimental impact on other aspects of performance.

Consistency in airport rationales

73. The Commission states that it expects consistency in reasoning between airports' justifications for their target returns. This could mean, for example, that factors that lead to a positive adjustment at one airport could lead to a reduction at another airport:[20]

> We agree that it is important to consider consistency between airports' rationale for their target returns. As indicated in our framework above, we intend to consider whether each airport has applied consistent logic over time, and whether there are any off-setting considerations which would reduce airports' target returns. This includes considering arguments other airports have made when setting their target returns.

74. NZ Airports accepts that the rationale behind the Commission's summary and analysis should be consistent across airports – including the application of its benchmarks and guidance. Each airport will need to be conscious of this when making their price setting decisions.

75. However, requiring airports to ensure across airport consistency in rationales for price setting contradicts the Commission's previous statements that its approach will provide flexibility in assessment, and allow for full consideration of airport-specific context (as discussed above).

76. The Commission's previous statements better reflect the complexity of pricing, and the nature of light-handed information disclosure regulation. We therefore do not understand the Commission to be suggesting that airports should coordinate their price setting decisions in advance of them being made, or that in justifying their airport-specific target returns, they must undertake an analysis of all of the differences and similarities between each airport. We ask the Commission to confirm that our understanding is correct.

Asset beta

77. Under the Commission's proposed assessment framework, it appears that airports will need to justify an airport-specific asset beta to justify an airport-specific WACC.[21]

78. In summary, NZ Airports:

(a) believes that an estimate of airport-specific asset beta should be arrived at using reasonable judgement informed by all relevant evidence; and

(b) is concerned that a requirement for extensive evidence to justify the size of an adjustment from the WACC IM to determine an airport-specific asset beta gives the impression that the same level of rigour has produced the WACC IM asset beta, which is incorrect.

79. Conceptually, asset beta is specific to each airport, whereas the WACC IM asset beta is an industry-wide estimate for regulatory purposes. NZ Airports struggles with the Commission's

[20] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at [A28] – [A29].

[21] Unless the variance is due to a different cost of debt, which has materially less impact on the overall WACC. As discussed below, the Commission has also accepted that an airport's actual cost of debt could differ from the WACC IM cost of debt.

baseline view that the three New Zealand airports, which are themselves significantly different from each other, have the same systematic risk as the average outcome from the Commission's international sample. It was NZ Airport's understanding that contextual factors which demonstrated specific business characteristics and systematic risk of each individual airport would be considered.

80. NZ Airports appreciates that, from the Commission's perspective, it has carefully developed its IM for estimating asset beta, which has been tested in Court. It is therefore necessary for airports to demonstrate why their airport-specific circumstances justify an adjustment to the asset beta estimate.

81. Nevertheless, NZ Airports believes that the Commission's request for extensive evidence to justify the size of adjustments from the WACC IM asset beta is inconsistent with the inherent nature of a WACC IM parameter that is subject to estimation error, and which cannot be empirically justified. Ultimately, reasonable judgement is required.

82. The Commission has based its conclusion that target returns are not justified on its view that (implied) adjustments from the WACC IM asset beta are not justified. In order to help interested parties understand performance, it should explicitly acknowledge that its conclusion involves a material degree of judgement on a WACC IM parameter that is not directly observable.

83. In NZ Airport's view, such an acknowledgement would reflect the High Court's and Commission's previous views that the WACC IM asset beta was inherently difficult to estimate:

   (a) The High Court stated that asset beta is "notoriously difficult to estimate".[22]

   (b) In submissions to the High Court, the Commission summarised its position on asset beta as follows:[23]

   > In summary, the Commission says the estimation of beta, both asset and equity, is very much a matter of judgement and not science. Neither is directly observable. As noted earlier, the Commission is estimating a forward-looking cost of capital – one to apply in the future. Beta is notoriously difficult to estimate.
   >
   > …..
   >
   > Due to the uncertainty associated with beta estimates, the Commission estimates the standard error for the asset beta from the portfolio of comparable firms. The different estimates of asset beta advanced by the appellants all fall within that standard error.
   >
   > The Commission made an explicit allowance for potential error in a number of parameters, the most significant of which is asset beta, by using the 75th percentile estimate of WACC in the IMs for setting prices.

   (c) The Commission's submissions to the High Court were consistent with statements in the IM Reasons Papers to the effect that calculating asset beta is not a mechanical task and that it is subject to estimation error:

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[22] *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 at [1102].

[23] Commerce Commission, S*ubmissions to the High Court on Cost of Capital*, 2013 at 515 – 517.

(i) In its IM Reasons Paper for Airports, the Commission noted that:[24]

> …estimating asset betas for an industry (or specific service) is inherently imprecise and involves a significant degree of judgement. Estimating supplier-specific equity betas would require an even greater degree of judgement than estimating service-specific equity betas.

(ii) In its IM Reasons Paper for Electricity Distribution and Gas Pipeline Services, it was similarly noted that:[25]

> While the Commission uses empirical methods wherever possible, the Commission's approach is not mechanical. Rather the Commission weighs the empirical results against other considerations, and exercises its judgement to best estimate the cost of capital and satisfy the Part 4 Purpose.

84. In that context, NZ Airports encourages the Commission to consider whether its requirement for extensive evidential justification of the size of an adjustment to the WACC IM asset beta is a fair reflection of how the WACC IM asset beta is estimated in the first place:

(a) The Commission uses the largest possible international comparator set to reduce the statistical probability of the estimate being wrong. Although it aims to ensure that the systematic risk of the comparator set is broadly comparable to airports in New Zealand, the Commission did not seek to understand the underlying systematic risk factors for each airport in the sample, and compare those to airports in New Zealand. This creates the very real risk that a simple average of the comparator sample is not a reliable indicator of asset beta for New Zealand airports.

(b) The Commission also did not seek to eliminate airports for which data may not be sufficiently reliable – eg due to insufficient liquidity. As an illustration of our concern that that comparator sample's reliability as a measure of systematic risk for airports in New Zealand is being overstated by the Commission, we do not understand why the Commission believes that, due to its concern that a single company is subject to estimation error, Auckland Airport should not have considered its own asset beta. The Commission has no apparent basis to conclude that other companies in the comparator sample (individually or combined) are a more reliable and/or a better indicator of Auckland Airport's systematic risk. Its view that the average from the comparator sample is a more reliable indicator is only true if it has established that the airports in the sample are subject to substantially similar systematic risk factors as Auckland Airport.

(c) The Commission did not seek to rigorously quantify the downward adjustment from the mid-point of the comparator sample to account for the companies in the sample being multi-divisional businesses. Instead, it exercised judgement on the appropriate adjustment. This is similar to the judgement it exercised when adjusting upward from the energy sample for gas businesses.

[24] Commerce Commission, *Input Methodologies (Airports) Reasons Paper*, 22 December 2010 at [E8.10]

[25] Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010 at [6.529].

(d) The Commission's unadjusted asset beta estimate from its 26 airport company sample set of 0.65 is only 3 basis points below the asset beta implied by Auckland Airport's PSE3 target return.

Cost of Debt

85. NZ Airports welcomes the Commission's draft conclusion that it is reasonable for airports to estimate their cost of debt by reflecting their actual debt portfolios.

Prices set by commercial agreement are a distinct category

86. The Commission has observed that Auckland Airport's target return for regulated services outside the pricing consultation (eg. property leases) are higher than target returns for aeronautical pricing services, and that Auckland Airport has not provided sufficient information to justify those returns.

87. The Commission notes that it is open to receiving further evidence to explain the difference, such as whether other services face greater exposure to systematic risk or returns should be considered over a longer period.[26]

88. NZ Airports does not believe that it will help interested persons to understand airport performance over time if the Commission seeks to apply, or requires airports to apply, its IM building blocks to leased assets. That is because, unlike aeronautical pricing assets, building blocks bear are inconsistent with how competitive markets for property (leased) assets determine prices.

89. Each airport can better explain how prices under property leases are set, but NZ Airports understands that, in general:

(a) The prices for leased properties are not set using a building block approach, consistent with the general approach to leases in workably competitive markets.

(b) The price setting between airports and counterparties matches what would occur in a competitive marketplace. This is because price setting occurs with counterparties that are well-resourced and do not suffer a power imbalance.

(c) Counterparties pay for what they value – for example, aircraft and freight leases are exclusive and often long-term which provides them stability in strategic planning for their business.

90. These factors are why BARNZ has previously accepted that returns on leased assets are a better indicator of returns in a competitive market:[27]

> It is BARNZ's experience that returns on the pricing asset base are the most relevant to the question of whether an airport is misusing its right to set charges as it sees fit under the AAA. Returns on leased assets are invariably influenced by market rate provisions contained in the lease agreement which link the rate for leasing the space to market rates charged for comparable space either in the proximity of the airport or in the nearest commercial centre.

[26] Commerce Commission, *Draft report – review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022)*, 26 April 2018 at 121.
[27] BARNZ, *BARNZ – IM Review draft decisions cross submission,* 18 August 2016 at 7.

…

> For the airlines, it is the return on the pricing assets which is most relevant to assessing whether an airport is targeting the extraction of excessive profits.

91. NZ Airports submits that these factors should materially influence how returns are assessed, consistent with Professor Yarrow's advice that the degree of market power held by an entity should influence how its returns are assessed:[28]

> Within each of three broad categories of policy approach – competition law, information disclosure and full price-quality regulation – there can also be significant variations in the risks of AEEMP. Thus: the stringency of the enforcement of competition law may vary with the assessed level of market power in a particular case; the scope of information disclosure requirements and the likely regulatory responses to the results of the relevant exercises may vary depending on context; and the scope and stringency of the controls imposed in a full regulatory regime may likewise vary to reflect the factual circumstances of an individual case.

92. Further, if the Commission was to maintain its draft conclusion, it is not clear how it expects airports to respond in practice, given that:

    (a) Price setting events for leases are spread over time and do not occur at a uniform price setting event in the same way as for aeronautical charges. To achieve a return aligned to the WACC IM for all regulated assets for each aeronautical consultation pricing period, airports would effectively need to cross-subsidise, which we expect would raise pricing efficiency concerns.

    (b) Assumptions in a WACC IM determination will be inconsistent with the time at which lease pricing is set, and provide a misleading indicator of performance.

    (c) Customers pay for what they value – eg short or long term leases, rights of renewal, terms for rent reviews, proximity to the airport facilities.

    (d) Over time the collective outcome from aircraft and freight, or other property leases, may be above or below a WACC IM, which reflects the above factors.

93. In that context, the better question for the Commission to consider, in accordance with Professor Yarrow's advice, is whether there is evidence that airports are exercising market power against the long-term interest of consumers. NZ Airports is confident that evidence that airports provide on how terms of leases are set will demonstrate that the Commission should have no concerns in that respect.

94. Accordingly, the Commission should remove leased assets from its headline comparators of target profitability against the WACC IM mid-point, as it provides a misleading picture of airport performance for PSE3. In particular, it is inappropriate for the revenues or return expectations from non-pricing consultation assets to be ascribed to passengers as calculated and published by the Commission. Passengers do not meet the cost of the leases and consequently any change in leased asset returns will have no impact on passengers.

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[28] Professor George Yarrow, *Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector*, February 2016 at 2 – 3.

95. Instead, the Commission should better contextualise, or de-emphasise, the impact of property leases on PSE3 profitability.

INVESTMENT EFFICIENCY AND CONSULTATION PROCESS

96. The Commission's draft conclusion is that there are no significant concerns that Auckland Airport will not invest appropriately, and its forecasts do not raise concerns that it would be expected to earn excessive profits.

97. The Commission also noted that stakeholders have commented favourably on Auckland Airport's approach to consultation and engagement on its planned investment, and outcomes have generally been acceptable to participants.

98. These are positive findings, which are supported by NZ Airports, and which feed into our views on promoting the long-term benefit of consumers above. We simply note here that each airport is different, so it should not be expected that they will adopt the same engagement process. Consultation, for example, may look different for smaller capital expenditure programmes.

99. NZ Airports also notes that the Commission has accepted that the size of Auckland Airport's capex programme is not a reason to require risk allocation adjustments – particularly simple and/or asymmetric wash-ups as proposed by airlines. This approach is consistent with the expectations established during the IM Review. Each airport will consider risk allocation adjustments on a case-by-case basis, but the underlying presumption is that they are best placed to manage risk.

PRICING EFFICIENCY

100. The Commission's discussion of pricing efficiency will provide guidance for other airports. Again, however, it should be noted that each will need to address specific circumstances, so Auckland Airport's approach does not necessarily provide a template for all.

101. NZ Airports is particularly pleased that the Commission is comfortable with Auckland Airport's Runway Land Charge. It is an excellent example of where the Commission has constructively worked with interested parties to develop an appropriate information disclosure framework, which has now been transparently applied by Auckland Airport.