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

Section 56G of the Commerce Act 1986

Date: 8 February 2013

Foreword

To the Ministers of Commerce and Transport

This report presents our conclusions on how effectively information disclosure regulation under Part 4 of the Commerce Act 1986 (Act) is promoting the purpose of Part 4. Part 4 is designed to ensure that suppliers of regulated goods and services have similar incentives and pressures to suppliers operating in competitive markets.

This report fulfils our obligations under s 56G of the Act in relation to regulated airport services provided by Wellington International Airport Limited (Wellington Airport). We will provide you with our reports in relation to Auckland and Christchurch International Airports later this year.

Although each of the three airports have been subject to information disclosure regulation under the Airports Authorities Act 1966 (AAA) for many years, airports only became subject to information disclosure regulation under Part 4 of the Commerce Act on 14 October 2008, with the passing of the Commerce Amendment Act 2008. The Regulatory Impact Statement to the Commerce Amendment Bill 2008 indicated that the main area of concern with the information disclosure regime under the AAA was that it failed to constrain the exercise of substantial market power in setting airport charges. A key objective of the Part 4 information disclosure regime was to address this.

Our review has been able to conclude how effectively information disclosure regulation is promoting the purpose of Part 4 to date in some areas, even though the Part 4 information disclosure requirements (and the 'input methodologies' which underpin them) have only been in place a short time (since January 2011). This is because Wellington Airport has been required to provide both historic and forecast data, including the information used to set its charges last year. Submissions received as part of our review have also been informative.

Based on the charges that Wellington Airport set last year, our conclusion is that information disclosure regulation is not limiting excessive profits, as Wellington Airport is expected to over-recover at least $38 million from airport users over the current five-year pricing period.

On the positive side, information disclosure regulation has improved some aspects of Wellington Airport's performance, most notably its service quality and the way it structures its prices. Innovation is also considered to be appropriate at Wellington Airport. This supports the views of some submitters that noted the airport sector in New Zealand is 'in good heart'.

The input methodologies we set, which are particularly relevant to our conclusion on Wellington Airport's expected profits, are under review by the High Court. When the Court's judgment is released, we will update you on whether or not that judgment causes us to change any conclusion in this report.

Dr Mark Berry
Chair

Sue Begg
Deputy Chair

Pat Duignan
Commission Member

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Executive Summary

X1 This report contains our conclusions on how effectively information disclosure regulation is promoting the Part 4 purpose for Wellington Airport. Auckland Airport and Christchurch Airport will be considered in separate reports.

How we assess the effectiveness of information disclosure for this review

X2 Our task under s 56G of the Commerce Act 1986 is to report on how effectively information disclosure regulation is promoting the Part 4 purpose. The report must be made 'as soon as practicable' after any new price for regulated airport services is set in or after 2012.

X3 We consider it is appropriate to make this report now because Wellington Airport set new prices on 1 March 2012 for the 2013–17 pricing period (PSE2). Wellington Airport has made two annual disclosures of information under Part 4 information disclosure as well as specific price-setting event disclosures for PSE2 and the 2008–2012 pricing period (PSE1).

X4 The scope of our review only considers how effectively information disclosure regulation is promoting the Part 4 purpose. We are not extending our report to include considering and recommending whether regulation other than information disclosure should apply to the airports, nor whether information disclosure should no longer apply.

X5 To assess how effectively information disclosure is promoting the Part 4 purpose we have:

X5.1 examined the performance (historical and expected) and conduct (ie, behaviour) of Wellington Airport, both before and after the Part 4 information disclosure came into effect; and

X5.2 assessed the extent to which this information disclosure has had an impact on Wellington Airport's performance and conduct.

X6 Input methodologies have informed our assessment of whether Wellington Airport is limited in its ability to extract excessive profits. We determined input methodologies for regulated airport services on 22 December 2010. Airports are not required to apply the input methodologies in setting their prices, although they must disclose information consistent with the input methodologies for information disclosure purposes. Our assessment of whether Wellington Airport is limited in its ability to earn excessive profits has considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance.

Conclusions from our section 56G review

X7 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our s 56G review for

Wellington Airport has found that information disclosure is effective in some areas (innovation, quality, pricing efficiency), it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas (operational expenditure efficiency, efficient investment, sharing the benefits of efficiency gains).

X8 Information disclosure regulation is effectively promoting the Part 4 purpose in the following areas:

X8.1 Innovation (s 52A(1)(a)). Our review has found that information disclosure has not negatively affected incentives to innovate at Wellington Airport and innovation levels appear to be appropriate.

X8.2 Quality (s 52A(1)(b)). Information disclosure has had a positive impact in this area. Our review has found that Wellington Airport appears to be providing quality at a level that reflects consumers' demands. Wellington Airport has attributed some of its improvements in quality to information disclosure regulation.

X8.3 Pricing efficiency (s 52A(1)(b)). Information disclosure has had a positive impact on this outcome. Our review has found that prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure.

X9 At the time of this s 56G report, information disclosure regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits (s 52A(1)(d)). Based on Wellington Airport's own forecasts, Wellington Airport is targeting an excessive return over time. In particular, Wellington Airport has set prices for PSE2 with the knowledge that this would result in a return which exceeds the Commission's estimate of the appropriate level, and has not demonstrated that doing so might be justified because of superior performance.

X10 Based on our analysis, Wellington Airport is likely to earn a return of 12.3% to 15.2% for PSE2 and beyond, which is significantly higher than the Commission's estimate of the appropriate level (7.1% to 8.0%). In present value terms, our estimated returns range of 12.3% and 15.2% is equivalent to excess returns of between $81 million and $139 million for PSE2 and beyond. In dollar terms, from 2013 to 2017 we expect Wellington Airport to recover at least $38 million to $69 million more from consumers through prices than it needs to make a reasonable return.

X11 Excessive profits are largely attributable to two factors. In setting its prices for PSE2:

X11.1 Wellington Airport has valued its land higher than expected in a workably competitive market; and

X11.2 Wellington Airport is targeting a return higher than appropriate for a business with a similar level of risk in the market conditions that were expected when prices were set.

X12 There are a number of performance areas where we cannot conclude on the effectiveness of information disclosure regulation under Part 4 at this time.

X12.1 Operational expenditure efficiency (s 52A(1)(b)). The evidence that Wellington Airport is seeking to improve its operating efficiency for PSE2 is mixed and our analysis therefore inconclusive. Further, information on actual expenditure during PSE2 will assist in drawing conclusions on Wellington Airport's efficiency.

X12.2 Efficient investment (s 52A(1)(a)–(b)). Information on actual investment over a longer period of time is necessary before we can form a conclusion.

X12.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). It is too early to conclude whether there are any operational expenditure (opex) and capital expenditure (capex) efficiency gains that could be shared.

X13 While we are not able to conclude whether information disclosure is effective in these performance areas, we do not consider this precludes us from concluding that Wellington Airport is expected to earn excessive profits. This is because Wellington Airport has not been able to provide us with evidence of superior performance in PSE1 to justify an expected return in PSE2 that exceeds our cost of capital. Wellington Airport has access to more information than us and, had their performance been superior, we would have expected Wellington Airport to provide evidence of this superior performance.

X14 As a general matter, although Wellington Airport would have had to disclose price-setting information under information disclosure regulation once prices had been set, it opted to do so early on during consultation on new prices. This is a positive change as it increases overall transparency for stakeholders.

1. Introduction

Purpose of this report

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

1.2 We have prepared our report after considering all of the submissions and cross-submissions received as part of our s 56G review, including on our draft report published on 2 November 2012.

Our task under section 56G

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

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

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

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

1.5 We consider it is appropriate to make this report now because Wellington Airport set new prices on 1 March 2012 for the 2013–17 pricing period (referred to as 'PSE2').[2] Wellington Airport has made two disclosures of annual information under information disclosure regulation as well as specific price-setting event disclosures for PSE1 and PSE2.[3]

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

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

2 PSE2 relates to the price-setting event which set out Wellington Airport's revenue requirements and prices from 1 April 2012 to 31 March 2017. PSE2 is also referred to as the '2013-17 pricing period' where '2013' means the disclosure year ending on the 31 March 2013, and '2017' means the disclosure year ending on the 31 March 2017. PSE1 relates to the price-setting event which set out Wellington Airport's revenue requirements and prices from 1 April 2007 to 31 March 2012 (ie, the 2008-12 pricing period).

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

1.6.1 other information disclosures to be made in the future;

1.6.2 current Court appeals on input methodologies to be resolved; or

1.6.3 summary and analysis reports to be published under s 53B(2).

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

1.8 The materiality of price-setting is clearly evident in the Explanatory Note to the Commerce Amendment Bill. The Explanatory Note indicates that the main area of concern with the information disclosure regime prior to Part 4 (ie, under the Airport Authorities Act 1966 (AAA)), was that it failed to constrain the exercise of substantial market power in setting airport charges. A key objective of the Part 4 information disclosure regime was to address this by protecting consumers from prices that would not be consistent with those in a workably competitive market.[4] Our review has enabled us to conclude on how effectively this has been achieved to date.

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

1.10 If the airports' input methodology (IM) merits appeals relevant to our conclusions in this s 56G review succeed to a material degree, we will provide further advice to the Minister regarding how such outcomes impact on our s 56G reports.

How we are carrying out our task under section 56G

1.11 We consulted on our process and approach for the s 56G reviews for the three airports with all interested parties in May 2012. Submitters raised a range of issues which we responded to in a Process Update Paper on 27 July 2012.[5]

We are reporting separately for each airport

1.12 We consider that preparing a separate report for each airport is the most appropriate interpretation of the s 56G task. This is because each airport's price-

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4 Refer to the discussion about the provisions in the Bill relevant to airports: Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 1.2.15 to 1.2.16 and paragraphs 1.2.19 to 1.2.23.

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

setting decisions have occurred at different times, and information disclosure regulation may be having a different impact across the three airports.[6]

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

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

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

We have not considered whether other forms of regulation should apply

1.15 The scope of our review considers how effectively information disclosure regulation is promoting the Part 4 purpose only. We are not extending our report to include considering and recommending whether regulation other than information disclosure should apply to the airports, nor whether information disclosure should no longer apply.[7]

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

1.16 Some submitters to this process raised the issue of including recommendations to regulate additional services not currently regulated as specified airport services.[8] We do not consider that extending the definition of specified airport services under s 56A(1) is within the scope of our s 56G review, therefore we have not considered that issue within this review.

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

1.17 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. Our s 56G review for Wellington Airport has

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

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

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

found that information disclosure is effective in some areas, it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas.

1.18 The remainder of this report outlines how we have reached these conclusions and provides the reasons for our views.

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

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

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

Purpose of this chapter

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

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

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

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

Information disclosure and the Part 4 purpose

The Part 4 purpose sets out our approach to the section 56G review

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

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

2.4 The outcomes produced in workably competitive markets that are relevant to regulated markets under Part 4 are those reflected in the regulatory objectives in (a)–(d) of the purpose. The focus of our s 56G review is therefore on considering how effectively information disclosure is promoting the outcomes reflected in the Part 4 purpose statement. We do this by considering the key performance questions in Table 2.1.[9]

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

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

2.5 These performance areas are interrelated. In order to assess the effectiveness of information disclosure in promoting particular outcomes observed in workably competitive markets, it is appropriate to consider relevant outcomes in other areas. For example, in order to reach our conclusion on profitability we first considered some of the other areas of performance. This is because the appropriateness of an economic return may vary depending on whether there is evidence that a supplier's performance is superior (or inferior) in other areas. Likewise, in order to assess whether the supplier is sharing the benefits of its efficiency gains we first assessed whether it had achieved any efficiency gains.

2.6 While it is appropriate for us to consider the interrelated outcomes, this does not mean we must reach conclusions in one area to draw conclusions in another. We are satisfied that the information available at the time of this review has been sufficient for us to reach the conclusions set out in Chapter 3. We consider we are able to

[9] Our analysis of Wellington Airport's performance and prices for PSE2 does not include an assessment of its prices relative to prices at other airports. Submissions from Wellington Airport have suggested we should consider its prices relative to prices at Australian and New Zealand airports when assessing its performance (see for example Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraphs 256 to 260). We do not consider such a comparison is appropriate without a better understanding of the differences between airports. This is because prices may differ across airports for a number of reasons, other than differences in performance. For example, airports have different asset bases and may experience varying degrees of economies of scale. These differences need to be accounted for in order to make meaningful comparisons.

reach conclusions on the effectiveness of information disclosure in limiting Wellington Airport's ability to earn excessive profits based on forecast information, but are not able to do so in the areas of operational expenditure efficiency and efficient investment.[10]

2.6.1 The effectiveness of information disclosure in limiting excessive profits can be assessed based on whether we consider Wellington Airport is targeting excessive profits when setting prices. This analysis uses Wellington Airport's own forecast information for PSE2.

2.6.2 In the area of operational expenditure efficiency, we consider an analysis of actual opex in PSE2 is required to form a conclusion on the effectiveness of information disclosure regulation. This is because Wellington Airport's forecast of its opex for PSE2 is unlikely to include all its expected future efficiency gains.

2.6.3 As discussed in Attachment H, information on forecast capex for PSE2 at Wellington Airport does not provide the full picture needed to understand whether Wellington Airport is investing efficiently and whether information disclosure will be effective in addressing the key concerns with capex raised by airlines previously. Information on actual capex in PSE2 is required for us to make this assessment.

How information disclosure regulation can promote the Part 4 purpose

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

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

2.7.2 through the threat of further regulation.[11]

2.8 Greater transparency enhances consumers' countervailing power, provides owners with better information to help them govern their business more effectively, and incentivises management of regulated suppliers to improve their performance.

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[10] Our information disclosure reasons paper explains that forecast disclosures are intended to assist interested persons assess whether expected profits are excessive, and whether airports are planning to meet forecast demand and quality expectations of consumers in their investment decisions. Forecast disclosures also enhance the assessment of airports' historical performance, because actual outcomes can be reconciled with forecast information. This informs the assessment of whether airports have incentives to improve efficiency (refer: Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 5.4 to 5.7. Currently, such reconciliation cannot be undertaken for PSE2 given that no actual expenditure information for PSE2 has yet been disclosed.

[11] Including, for example, the incentives created by airports recognising that the Commission would be undertaking this section 56G review.

Better information can facilitate comparisons with other regulated suppliers that may identify sources of best practice, or innovations that should be adopted. Requirements to disclose information may also generate useful information that would not have been collected in the absence of the disclosure requirements.[12]

2.9 The threat of further regulation incentivises suppliers to ensure their performance is consistent with the desired outcomes from workably competitive markets. Part 4 requires the Commission to monitor and analyse the information that is disclosed by all regulated suppliers, including airports. Such analysis can help policymakers to identify whether regulation should be removed, or strengthened.

2.10 In this review we refer to the way that an airport responds to the incentives provided by information disclosure regulation under Part 4 (or by the information disclosure regime under the AAA prior to Part 4) as the airport's 'conduct'.

Relevance of information disclosure purpose (s 53A) to Part 4 purpose (s 52A)

2.11 Information disclosure regulation has its own specific purpose (s 53A). The purpose of information disclosure regulation is for sufficient information to be readily available to interested persons to assess whether the purpose of Part 4 is being met.

2.12 The task of the s 56G review, namely assessing how well information disclosure is promoting the Part 4 purpose, is different from assessing how well the information disclosure requirements we have set are meeting the purpose of information disclosure regulation under s 53A.

2.13 Nevertheless, the extent to which information disclosure requirements are meeting the s 53A purpose is relevant to our s 56G assessment. The more effectively the disclosure requirements are in meeting the s 53A purpose of information disclosure regulation, the more likely it is that information disclosure is promoting the overall Part 4 purpose.

2.14 For instance, if the indicators disclosed in accordance with the information disclosure requirements are not providing a good measure of a particular area of performance, there might be relatively weak incentives for suppliers to change their conduct so that their performance becomes more consistent with the Part 4 purpose. Indicators of performance that are more effective in allowing interested persons to assess whether the Part 4 purpose is being met are also likely to provide stronger incentives on suppliers to act consistently with that purpose.

Suppliers have incentives other than those provided by information disclosure

2.15 Information disclosure regulation by itself is not expected to be the sole source of all the necessary incentives to promote the Part 4 purpose. Other features of

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

Wellington Airport's operating environment also create incentives and external pressures to improve performance. For example, Wellington Airport:

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

2.15.2 is subject to other regulatory requirements. For example, the AAA requires Wellington Airport to consult on large capex programmes with its major customers, and therefore encourages Wellington Airport to provide services at the quality consumers demand.[13] Wellington Airport is also subject to minimum safety and security requirements that impact on quality; and

2.15.3 sets its revenue requirement and prices for five-year periods in advance, using a 'building blocks' model.[14] This creates some incentives for Wellington Airport to achieve efficiency gains and outperform its expenditure forecast to earn higher profits.

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

2.16 We expect the potential impact of information disclosure will vary between the different outcomes sought under Part 4. We also expect the time it takes for information disclosure regulation to have an effect on each of the Part 4 outcomes to vary.[15]

2.17 Given the incentives already in place, the most obvious additional incentives provided by information disclosure regulation are on Wellington Airport's ability to earn excessive profits, and on its sharing of efficiency gains with its consumers. This is because of the relatively weak incentives on Wellington Airport in these areas of performance without regulation. Information disclosure under Part 4 should be particularly effective at highlighting concerns about excessive profits (and therefore prices), which heightens the credible threat of further regulation.[16] It is also the area

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13 Refer s 4C of the AAA.

14 Economic regulators often employ 'building blocks' models to assist in setting regulated price caps or revenue caps when implementing price-quality regulation. Each building block relates to a different type of cost facing a regulated supplier, and regulators aim to provide firms with an opportunity to recover an efficient level of these costs, including the cost of capital, over the forthcoming regulatory period. We use a building blocks approach to set regulated prices for regulated electricity and gas suppliers under Part 4. By choosing to use a building blocks model to set its revenue requirements for each price-setting period, Wellington Airport is replicating this kind of approach although, as this review demonstrates, we consider some of the key inputs to that model to be inconsistent with the purpose of Part 4.

15 Attachments B to I outline our views on these matters for each area of performance.

16 This is particularly the case with information disclosure under Part 4 (compared to information disclosure under the AAA) because there are input methodologies that allow profitability to be assessed on a consistent basis across suppliers and over time, as well as providing a benchmark for assessing returns through the cost of capital input methodology.

of performance that is most likely to lead to more heavy-handed regulation if the desired outcomes are not being achieved. Incentives from the threat of further regulation are therefore likely to be strongest in this area.[17]

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

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

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

2.21 We expect the length of time it will take for information disclosure regulation to promote the different outcomes sought under the Part 4 purpose will also vary. In areas such as efficiency of expenditure and quality, information disclosure will have the greatest effect over time, as trends and comparative information become available to interested persons.[18] The effectiveness of information disclosure at limiting excessive profits can be seen more immediately. This is because:

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

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

2.22 The conclusions we are able to draw in this report are based on the information available to the Commission at this point in time – ie, "as soon as practicable after any new prices are set for airport services in or after 2012". We have acknowledged in this report those areas of performance where information disclosure will be as

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

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

effective as it can be over time and as such it is not possible to reach a firm conclusion at this stage (for example, in the case of operating efficiency). Even in those areas where we can draw conclusions at the time of this review, we expect such conclusions may be re-tested through our summary and analysis process as more information become available over time.

How we have assessed the impact of information disclosure regulation

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

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

2.24 In assessing performance we have asked ourselves the questions outlined in Table 2.1 above. The focus of some of the objectives in the Part 4 purpose is on suppliers having incentives. We consider the practical test of whether incentives are working to promote the long-term benefit of consumers is to consider actual performance in that area.[19]

2.25 In assessing whether information disclosure is effectively promoting the Part 4 purpose we have also assessed whether it has impacted on Wellington Airport's conduct. The choices and decisions made by Wellington Airport for its recent price-setting event are the obvious example. Other areas of conduct are also of some relevance, for example, collaboration with airlines.

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

2.26.1 examined the performance and conduct of Wellington Airport, both before and after the Part 4 information disclosure came into effect; and

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

2.27 The one area where we have not undertaken a relative comparison of conduct and performance before and after the introduction of Part 4 information disclosure is profitability. The cost of capital set out in the input methodologies provides an absolute standard (or benchmark) against which to measure profits. Therefore we do not need to examine in any detail Wellington Airport's revenue requirements for the price-setting period beginning prior to Part 4 (ie, PSE1). We explain how we have used the input methodologies below.

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

The role of input methodologies in our assessment

Input methodologies provide a benchmark for assessing profitability

2.28 The input methodologies we developed for airports in December 2010 in relation to cost allocation, asset valuation, the treatment of taxation, and the cost of capital are intended to promote certainty as to the rules, requirements, and processes applying to information disclosure regulation. The input methodologies represent our best assessment of how certain building blocks should be specified to promote the Part 4 purpose in these areas.

2.29 Airports are not required to apply the input methodologies in setting their prices although they must disclose information consistent with the input methodologies for information disclosure purposes.[20] The input methodologies then provide an important tool which assists interested persons in assessing whether the purpose of Part 4 is being met.[21]

2.30 We have found the input methodologies to be most relevant to the profitability assessment aspect of our review. This is because the input methodologies for asset valuation, taxation and cost allocation are inputs into profitability measures (including the calculation of the return on investment that airports must disclose for past years). Therefore, although the airports are not required to apply the cost of capital IM, it provides a basis for comparing what airports are earning against our view of the level of return that is appropriate for this type of business.

2.31 Airports are not required to apply our input methodologies in setting their prices. If the airport's prices are not fully aligned with our input methodologies we do not simply assume that this means that the Part 4 purpose is not being promoted. Our assessment considers the extent to which the airport has departed from our input methodologies and how other factors shape such a departure. For example, we examined whether there is evidence of superior performance or whether supplier's performance with respect to other Part 4 outcomes (contained in s 52A (a)–(c)) reflects outcomes in workably competitive markets that justify such a departure.

2.32 Moreover, a combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

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

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

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

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

2.34 In some areas of performance it is more difficult to assess the impact information disclosure regulation has had on the actual performance of airports as there are no relevant input methodologies (for example, for pricing efficiency or quality) and changes in performance or conduct may be attributable to external factors. For those aspects of performance, our analysis takes into account events (for example, PSE2) and what we might expect to find in a workably competitive market. We have been largely reliant on submissions received from interested parties as part of this review to assess whether information disclosure regulation has had an impact on these areas of performance.

Information used to examine performance

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

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

3. Conclusions from our section 56G review

Purpose of this chapter

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

Summary of our conclusions

3.2 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our s 56G review for Wellington Airport has found that information disclosure is effective in some areas (innovation, quality, pricing efficiency), it is not effective at limiting excessive profits, and we are unable to conclude whether it is effective in other areas (operational expenditure efficiency, efficient investment, sharing the benefits of efficiency gains).[22]

3.3 We consider that, if it is effective, information disclosure should have its greatest impact in promoting the profitability based objectives in s 52A(1) and so its ineffectiveness to date at limiting excessive profits is of significant concern.[23]

3.4 As a general matter, although Wellington Airport would have had to disclose price-setting information under information disclosure regulation once prices had been set, it opted to do so early on during consultation on new prices. This is a positive change as it increases overall transparency for stakeholders.

Summary of conclusions in each performance area

3.5 At the time of this s 56G report, we can conclude that information disclosure regulation is effectively promoting the Part 4 purpose in some areas. Information disclosure is considered effective if it promotes outcomes consistent with those found in workably competitive markets.

3.5.1 Innovation (s 52A(1)(a)). Our analysis has found that information disclosure has not negatively affected incentives to innovate at Wellington Airport and innovation levels appear to be appropriate.

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

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22 We have considered how the outcomes in s 52A(1)(a)–(d) are interrelated and how conclusions in one area may be relevant to conclusions in another. We have discussed this in Chapter 2 as well as in Attachment A.

23 For further discussion on why we consider information disclosure will have the greatest effect on Wellington Airport's incentive to earn excessive profits see paragraphs 2.16 to 2.22.

attributed some of this improvement in quality to information disclosure regulation.

3.5.3 Pricing efficiency (s 52A(1)(b)). Information disclosure appears to have had a positive impact on this outcome. Our review has found that prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure.

3.6 At the time of this s 56G report, information disclosure regulation has not been effective in limiting Wellington Airport's ability to extract excessive profits (s 52A(1)(d)). Based on Wellington Airport's own forecasts, Wellington Airport is targeting an excessive return over time. In particular, Wellington has set prices for PSE2 with the knowledge that this would result in a return which exceeds the Commission's estimate of the appropriate level, and has not demonstrated that doing so might be justified because of superior performance.

3.7 Based on our analysis, Wellington Airport is likely to earn a return of 12.3% to 15.2% for PSE2 and beyond (ie, from 1 April 2012 over the remaining life of the assets), which is significantly higher than the Commission's estimate of the appropriate level (7.1% to 8.0%). In present value terms, our estimated returns range of 12.3% and 15.2% is equivalent to excess returns of between $81 million and $139 million for PSE2 and beyond. In dollar terms, from 2013 to 2017 we expect Wellington Airport to recover at least $38 million to $69 million more from consumers than it needs to make a reasonable return.

3.8 Excessive profits are largely attributable to two factors. In setting its prices for PSE2:

3.8.1 Wellington Airport has valued its land higher than expected in a workably competitive market; and

3.8.2 Wellington Airport is targeting a return higher than appropriate for a business with a similar level of risk in the market conditions that were expected when prices were set.

3.9 There are a number of performance areas where we cannot conclude on the effectiveness of information disclosure regulation under Part 4 at this time.

3.9.1 Operational expenditure efficiency (s 52A(1)(b)). The evidence that Wellington Airport is seeking to improve its operating efficiency for PSE2 is mixed and our analysis therefore inconclusive. Further, information on actual expenditure during PSE2 will assist in drawing conclusions on Wellington Airport's efficiency.

3.9.2 Efficient investment (s 52A(1)(a)–(b)). Information on actual investment over a longer period of time is necessary before we can form a conclusion.

3.9.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). It is too early to conclude whether there are any operational expenditure (opex) and capital expenditure (capex) efficiency gains that could be shared.

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

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

Table 3.1: Attachments to this report

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

Information disclosure is effectively promoting innovation

3.11 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Wellington Airport facilitates airline-led innovation, and the level of innovation at Wellington Airport appears to be appropriate. At this time, information disclosure does not appear to have had an incremental impact on incentives to innovate at Wellington Airport, but has not negatively affected existing incentives to innovate at Wellington Airport. Where a supplier is already innovating appropriately, we would not expect information disclosure to have any material incremental impact on innovation and therefore consider that it is effectively promoting incentives to innovate at Wellington Airport.

3.12 The key reasons for our conclusion are as follows.

3.12.1 Collaboration on airline-led innovation appears most important to the airlines. Airlines generally consider that Wellington Airport does facilitate airline-led innovation.

3.12.2 It appears that innovation at Wellington Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4. This view is based on the fact that submissions have not raised any substantive concerns as part of this s 56G review. Innovation at Wellington Airport is considered comparable with other airports in New Zealand and overseas.

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

3.13 Our conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Wellington Airport providing services at a quality that reflects consumer demands. Wellington Airport has sought improvements in their service quality and has a level of quality comparable with other airports. Wellington Airport has attributed some of this improvement in quality to information disclosure regulation.

3.14 The key reasons for our conclusion are as follows.

3.14.1 Quality at Wellington Airport is comparable with other airports. Passenger satisfaction survey results at Wellington Airport compare well against other airports. Our analysis of passenger satisfaction surveys indicates that the level of quality experienced by passengers at Wellington Airport is similar or better than at other airports in New Zealand and Australia. The level and duration of interruptions suggests Wellington Airport is comparable with other airports.

3.14.2 Airlines appear to be generally satisfied with the quality of service provided at Wellington Airport—both before and after information disclosure under Part 4 was introduced. This is based on submissions from Wellington Airport and airlines to this s 56G review. Our analysis supports this indicator.

3.14.3 Information disclosure has had a positive impact on quality at Wellington Airport. Wellington Airport has attributed the introduction of information disclosure under Part 4 to being partially responsible for improvements to passenger satisfaction surveys, and the consequent improvement in passenger satisfaction levels since the introduction of information disclosure under Part 4.

3.14.4 The concerns that were raised relate to the price-quality trade-offs airlines wish to make. The main concerns and perceived risks by airlines were Wellington Airport investing in too high quality and that consumers who did not benefit from or demand higher quality should not bear the cost of these investments. This issue is addressed in relation to the efficiency of Wellington Airport's prices.

Information disclosure is effectively promoting pricing efficiency

3.15 Our conclusion is that information disclosure is effectively promoting efficiency of pricing (referred to as 'efficient pricing'). Wellington Airport has given greater consideration to pricing efficiency in PSE2 relative to PSE1. Consequently, prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure.

3.16 Our analysis indicates that greater consideration had been given to pricing efficiency in PSE2 relative to PSE1. For example, there was greater consideration of:

3.16.1 how pricing can ensure the optimal use of scarce facilities at Wellington Airport with the introduction of new charges for aircraft parking and check-in desks, as well as for runway use at peak times; and

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

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

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

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

3.19 Our conclusion is that information disclosure regulation at this time has not been effective in limiting Wellington Airport's ability to extract excessive profits over time. This is because Wellington Airport has set prices with knowledge that the resulting return when the information disclosure framework is applied (estimated by Wellington Airport to be 8.9%[24]) is expected to exceed the Commission's estimate of an appropriate return of 7.1% to 8.0%.[25]

3.20 Our analysis of Wellington Airport's expected performance indicates that expected returns from 1 April 2012 over the remaining life of the assets (ie, for PSE2 and beyond) are likely to be 12.3% and could be as high as 15.2%, which is substantially higher than our estimates of an appropriate return in a competitive market (7.1% to 8.0%). Wellington Airport has not provided evidence of superior performance to justify this level of expected returns in PSE2.

3.21 Excessive profits are largely attributable to a combination of two factors. In setting its prices for PSE2:

3.21.1 Wellington Airport has valued its land assets higher than expected in a workably competitive market; and

24 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 59. The methodology used by Wellington Airport to calculate this return is not intended to estimate the return over the lifetime of the assets. However, the return generated using this methodology is equivalent to an IRR, which is the return over the lifetime of the assets.

25 We use returns as the measure of Wellington Airport's profits.

3.21.2 Wellington Airport is targeting a return higher than appropriate for an airport business with a similar level of risk in the market conditions that prevailed when PSE2 occurred.

3.22 In present value terms, our estimated returns range of 12.3% and 15.2% is equivalent to excess returns of between $81.2 million and $138.5 million for PSE2 and beyond. These are returns in excess of what would likely be expected by Wellington Airport if it received a return that reflects outcomes in workably competitive markets.[26]

3.23 Table 3.2 shows the range of excess returns we consider Wellington Airport will earn, broken down by the excess returns they will earn for PSE2 and over the remaining life of the assets.

Table 3.2: Present value of excess returns earned by Wellington Airport

	Lower estimate	Higher estimate
Excess returns over PSE2 (2013–17)	$19.7m	$46.1m
Excess returns from 2017 over remaining life of assets	$61.5m	$92.4m
Total excess returns from 2013 over remaining life of assets	$81.2m	$138.5m

Note: The excess returns for PSE2 are based on Wellington Airport's announced prices for PSE2. The excess returns over the remaining life of the assets (ie, from the beginning of the next pricing period) are based on an assumption that Wellington Airport will continue to price in a similar manner to PSE2.

3.24 Our estimate of the range of excess returns earned by Wellington Airport has been determined by assumptions about:

3.24.1 whether the more appropriate land valuation is that disclosed by Wellington Airport, or the alternative provided by BARNZ's valuers;

3.24.2 whether cash flows occur at the end or middle of the year; and

3.24.3 whether Wellington Airport's returns are assessed relative to the 75th percentile or midpoint of the Commission's estimated cost of capital.

3.25 To understand the impact of Wellington Airport's pricing decision on consumers, we also quantified the 'excess revenues' Wellington Airport would expect to earn over the five-year period of PSE2. This helps to understand the impact on consumers

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26 Excess returns have been presented in present value terms. This reflects the dollar value as at the start of PSE2 discounted to reflect the time value of money. In workably competitive markets, firms expect to earn their cost of capital over time and would only expect to earn higher than this as a result of superior performance. The estimate of excess returns earned by Wellington Airport is based on the cash flows expected to be generated by Wellington Airport as a result of the prices they set for PSE2, assuming that they continue to value their assets higher than expected in a workably competitive market.

because excess revenues represent the extent to which consumers are over-charged. We estimate that Wellington Airport will earn at least $38.3 million to $68.9 million of excess revenue in PSE2, which is 10.4% to 20.3% higher than the revenues considered appropriate.[27] The calculation of excess revenues differs from that of excess returns in that unlike returns, the revenues are a pre-tax measure and we have not discounted them to a present value.

3.26 Our analysis of Wellington Airport's conduct indicates that they set prices with the knowledge that this would result in a return which exceeds the Commission's estimate of the appropriate level. Wellington Airport's understanding of how information disclosure rules would be applied suggests that that they considered their expected return based on PSE2 prices would be 8.9%.[28] This is higher than our published estimates of an appropriate return in a competitive market (7.1% to 8.0%). Wellington Airport has not provided evidence of superior performance which might justify targeting these higher returns.

3.27 Incentives for airports to price consistent with the Part 4 purpose could be strengthened if each airport were required to disclose an indicator of its expected returns comparable to its cost of capital, along with the other information disclosed following a price-setting event. Under the current disclosure requirements, after each price-setting event airports must disclose information about how they have set their current and future prices. However, airports are not required to disclose an indicator of their expected returns for the relevant pricing period. This indicator could be derived in the same way we have estimated expected returns in this s 56G review (ie, an internal rate of return calculation that uses the IM compliant asset value as the opening asset value, and for the closing asset value uses an estimate of the asset base expected to provide the basis for setting prices in the subsequent pricing period).

3.28 Wellington Airport, in its submission on the draft report, identified four arguments against our conclusion that it has not been limited in its ability to earn excessive profits. The arguments and our responses to those arguments are outlined below.

3.28.1 Wellington Airport considers that a land valuation approach of market value alternative use (MVAU) plus airport conversion costs is more reflective of a

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27 The range is based on the revenues required to generate a return based on the Commission's 75th percentile and midpoint of the cost of capital respectively, and uses Wellington Airport's land valuation. Higher excess revenues would be earned if the BARNZ alternative land valuation was used.

28 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 59. The methodology used by Wellington Airport to calculate this return is not intended to estimate the return over the lifetime of the assets. However, the return generated using this methodology is equivalent to an IRR, which is the return over the lifetime of the assets, using the rolled forward 2012 disclosed RAB as the closing asset base.

competitive market. We consider an MVAU valuation is most consistent with the value of land in a workably competitive market.[29]

3.28.2 Wellington Airport considers that it should be assessed using its own cost of capital which reflects company specific risks. We consider our estimated cost of capital, as specified in the input methodologies, to be the best approach.

3.28.3 Wellington Airport considers that the terminal wash-up should be recognised as reducing revenues in PSE2 and not be adjusted for. We consider that adjusting for the terminal wash-up, so its effect on reducing revenue is accounted for in PSE1, represents the most appropriate matching of cash flows to investment.

3.28.4 Wellington Airport considers the use of the forecast pricing asset base as the closing asset base in the IRR calculation is inappropriate. We consider that using the forecast pricing asset base as the closing pricing asset base provides the best estimate of Wellington Airport's expected future cash flows if it were to continue its current pricing behaviour with regards to asset valuation.

It is too early to tell whether information disclosure is effectively promoting improvements in operating efficiency

3.29 We are unable to conclude whether information disclosure regulation is effectively promoting the purpose of Part 4 in relation to improvements in Wellington Airport's operating efficiency. This is because the evidence that Wellington Airport sought to improve its operating efficiency in PSE2 is mixed (ie, our analysis of Wellington Airport's conduct is inconclusive), and it is too early to assess meaningful trends in opex at Wellington Airport since information disclosure regulation under Part 4 was implemented.

3.30 The key reasons for our conclusion are as follows.

3.30.1 The evidence of historic improvements in opex efficiency at Wellington Airport since information disclosure under Part 4 was implemented is inconclusive. It is unclear whether forecast reductions in unit opex for PSE2 are a result of efficiency improvements, or can be attributed to economies

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29 Many past investments in the conversion of land for use as an airport will have already contributed to the market value of land in an alternative use. These costs will therefore already be reflected in a higher MVAU valuation than would otherwise have been the case (eg, levelled land is typically more valuable than unlevelled land). However, recognition of past investments relating to land conversion is appropriate in the regulatory asset base where the expenditure has been incurred relatively recently and would not be expected to affect the value of land in an alternative use. The IM compliant asset base includes such investments, but they are recognised as specialised assets rather than land (eg, the Runway End Safety Area at Wellington Airport).

of scale resulting from organic growth or airline efforts to increase passenger volumes.

3.30.2 We do not yet have actual expenditure information for PSE2 to assess whether Wellington Airport has been able to achieve its forecast reduction in unit costs, whether Wellington Airport has been able to achieve lower opex than forecast for PSE2, and the reasons for any differences. This will be an important indicator of whether Wellington Airport is improving its efficiency and whether information disclosure under Part 4 is effective in this area. Submissions from Wellington Airport and the airlines to this s 56G review suggest that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's operating efficiency to date.[30]

3.30.3 s 56GParties have mixed views on whether Wellington Airport's conduct indicates that it seeks to improve its efficiency.

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

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

3.31 Our conclusion is that it is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Submissions to this review indicate that Wellington Airport has sought to invest efficiently for PSE2 and that forecast capital expenditure for PSE2 is prudent, particularly relative to PSE1. However, it is too early to conclude whether information disclosure regulation under Part 4 is effective until we know whether the issues of timing and level of investment raised by airlines for PSE1 continue to raise concerns in PSE2 and beyond.

3.32 The key reasons for our conclusion are as follows.

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

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30 See, for example, BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 20; Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 213; Commerce Commission, Transcript of Wellington Airport Section 56G Conference, held on 7 August 2012, page 87.

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

3.32.3 Wellington Airport submitted that its conduct suggests that it seeks to invest efficiently.[31] We have not received submissions from airlines to suggest that this statement is incorrect.

3.32.4 There have been significant concerns raised about investments that were planned for PSE1 (eg, in relation to “The Rock“), before information disclosure under Part 4 took effect. It is possible that concerns of this nature could recur in future. At this time, it is unclear if information disclosure regulation under Part 4 will result in fewer concerns from airlines about the level and timing of investment.

3.32.5 We expect information disclosure to become as effective as it can be at providing incentives to invest efficiently over time, when information on actual capex becomes available and interested persons can assess trends in forecast and actual expenditure. Information on actual capex relative to forecast, and the supporting explanation required for information disclosure, will be an important indicator of whether Wellington Airport is investing efficiently, and whether information disclosure regulation under Part 4 is effective in this area.

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

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

3.34 The key reasons for our conclusion are as follows.

3.34.1 There is limited evidence of historic efficiency gains at Wellington Airport that could be shared with consumers when resetting prices in PSE2.

3.34.2 There is limited evidence of forecast efficiency gains at Wellington Airport than could be shared with consumers during PSE2.

3.34.3 There are no mechanisms to ensure that Wellington Airport shares any efficiency gains within the pricing period that were not forecast.

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31 Wellington Airport “Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL” 6 July 2012, paragraph 158 to 160.

Attachment A: Regulatory Framework

Purpose

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

A1.1 the key statutory provisions applicable to the three regulated airports, and explains how these apply in the context of this current review. The key provisions relevant to this review are sections 52A, 53A and 56G set out in Part 4 of the Commerce Act 1986;

A1.2 the application of input methodologies to a s 56G review. The input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks should be specified to promote the Part 4 purpose. The input methodologies are a tool the Commission can use in its analysis of Wellington Airport's historic and expected performance;

A1.3 the relationship between information disclosure regulation under Part 4 and s 4A of the AAA. While airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. We do not consider that s 4A of the AAA is incompatible with the information disclosure regime as the two operate for distinct purposes. We also do not consider that Part 4 is subordinate to s 4A; and

A1.4 the scope, timing and process for the s 56G review. The substantive part of the Commission's task under s 56G is to assess "how effectively information disclosure regulation under this Part is promoting the purpose in s 52A in respect of the specified airport services". Section 56G provides that the trigger for the review is the setting of any new price "in or after 2012". This report is therefore an evaluation carried out by the Commission in accordance with s 56G. We consider that we are able to draw conclusions as summarised in chapter 3 in this report at this point in time (that point in time being "as soon as practicable after any new prices are set …in or after 2012") based on the information available to us.

Key statutory provisions relevant to airports

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

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

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

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

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

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

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

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

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

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

A4 In accordance with s 56E of subpart 11 and subpart 4 of the Act, the Commission determined the "Commerce Act (Specified Airport Services Information Disclosure) Determination 2010" on 22 December 2010 (ID determination). The information disclosure determination sets out the information disclosure requirements applying to the regulated airports from 1 January 2011.

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

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

Application of input methodologies to the section 56G review

Overview

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

A7 As discussed in chapter 2, it is accepted that there may be other avenues for promoting the purpose of Part 4 other than input methodologies. The purpose of setting the input methodologies is to promote certainty to regulated suppliers as to the tools the Commission will use in assessing the impact of information disclosure, such that s 52A(1)(a) to (d) occur. We set out our detailed views below.

Application of input methodologies to information disclosure

A8 We determined input methodologies for the regulated airport services on 22 December 2010. We applied those input methodologies in making our information disclosure determination for airports. The information required to be disclosed includes a wide range of historic and forecast information and performance measures, covering both financial and non-financial matters.[32]

A9 Wellington Airport is required to apply all of those input methodologies, except the cost of capital IM, when disclosing information under Part 4.[33]

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

Application of input methodologies to the section 56G review

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

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

A13 In their cross-submissions on the Wellington Airport conference most parties acknowledged the relevance of the input methodologies in the s 56G review.[34] The

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32 Section 53C(2) sets out the types of information that we may require airports to disclose.

33 Section 53F(1).

use and relevance of input methodologies was debated in the parties' submissions on the Process and Issues Paper as well as in the post-conference submissions. These previous discussions and our response are fully set out in paragraphs A13 – A18 of our Draft Report.

A14 In summary, we agreed with submitters in that the focus of the s 56G review is on the outcomes in s 52A(1). That focus informed the various questions on which we based our analytical framework, as discussed in chapter 2. What we are interested in is assessing whether those outcomes are evident in Wellington Airport's performance or conduct.

A15 The input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks (for example, asset valuation) should be specified to promote the Part 4 purpose. As such, the input methodologies are a tool we can use in our analysis of Wellington Airport's historic and forecast performance.

A16 This approach is reflected in s 53F, which explicitly allows us to use input methodologies for our s 53B summary and analysis reports. As much of the analysis and assessment required to be carried out by the Commission under ss 53B and 56G overlaps, it is therefore also logical to use the input methodologies in the assessment required under s 56G.

A17 In their submissions on the Draft Report, airports generally agreed with our view that the IMs are an appropriate basis for analysing Wellington Airport's financial performance.[35] Auckland Airport, however in its submission on the Draft Report expressed the following concerns:

> Although Auckland Airport has always considered the IMs for ID relevant and important to pricing, it did not consider that the IMs are the only view that is consistent with workably

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

[35] Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, page 20, paragraphs 95 to 96; Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, page 19, paragraph 59; NZ Airports Association "Submission on the Commerce Commission draft report on the section 56G review of Wellington Airport" 30 November 2012, page 10, paragraph 40; Christchurch Airport "Submission on draft report assessing how effectively information disclosure is promoting the purpose of Part 4 for Wellington Airport" 30 November 2012, page 5, paragraph 16.

competitive markets or that it would be at risk of adverse findings simply because its pricing decision did not precisely align with the IMs.[36]

A18 Given that airports are not required to apply our input methodologies in setting their prices, where the airport is not fully aligned with our input methodologies we do not simply assume that this means that the Part 4 purpose is not being promoted. Our assessment considers the extent to which the airport has departed from our input methodologies, and how other factors shape such a departure—for example, whether there is evidence of superior performance or whether the supplier's performance with respect to other Part 4 outcomes (contained in s 52A (a)–(c)) reflects outcomes in workably competitive markets that justify such a departure.

A19 As discussed above, airports are free to choose whatever methodology they like in undertaking their operations. What we are ultimately interested in is the outcome—for example, whether airports are limited in their ability to extract excessive profits. A combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

A20 Specifically, this point was raised by Wellington Airport in its cross submission on the Commission's Conference of August 2012 where it submitted that its use of 'commercial concessions' in setting prices for PSE2 offsets the net impact of not applying input methodologies in determining its profitability outcomes.[37] Wellington Airport explained that it provided "considerable comment in its consultation material, the price-setting event disclosure and earlier substantive and cross submissions on how it gave consideration to the IMs in consultation", noting specifically that:

> WIAL applied, through consultation, a number of commercial concessions to its price setting that materially offset the net impact of variations from the application of IMs – demonstrating that net outputs need to be considered and not selective inputs.[38]

A21 We have taken into account commercial concessions in assessing Wellington Airport's conduct, but this does not affect our conclusion that Wellington Airport is expecting to earn excessive profits over time. The 'commercial concessions' do not fully offset the excessive returns expected to be earned by Wellington Airport.

A22 Our assessment has considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the

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36 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, pages 5 to 6, paragraph 6(c)(i).

37 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Airports Conference" 17 August 2012, paragraph 46.

38 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Airports Conference" 17 August 2012, paragraph 46.

impact this has had on performance or expected performance. We then took the results of that analysis and considered what, if any, impact information disclosure has had on the s 52A(1) outcomes.

A23 In summary, we agree with the views of submitters that whether the input methodologies were applied to the pricing decisions is not itself definitive. We do not agree, however, with any suggestion that input methodologies should not be applied to establish an overall performance benchmark or that such a benchmark is in any way contrary to the purpose the airports information disclosure regime is intended to achieve.

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

A24 Section 4A(1) of the AAA provides that an airport subject to that statute may:

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

A25 However this right needs to co-exist with the new Part 4 regime, evidenced by the inclusion of s 4A(4) which provides:

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

A26 The AAA provisions relating to charges are primarily concerned with ensuring that the decision making process for airport pricing is clear. In that context s 4A clarifies that, while airports are required to consult with their major customers in accordance with the AAA, the final decision as to charges rests with the airports, and the consultation process does not have the ability to prevent airports setting charges as they think fit.

A27 However, information disclosure regulation, while being light-handed, is still intended to promote the overall Part 4 purpose as set out in s 52A. Parliament's intention behind the adoption of this regime was to introduce regulation that would, among other functions, have an impact on airport's prices. That is clear from the structure of Part 4 – all forms of Part 4 regulation including information disclosure regulation, are intended to promote the Part 4 purpose, which includes promoting outcomes such that suppliers are limited in their ability to extract excessive profits. Further, when referring to the s 56G review in its report on the Commerce Amendment Bill, the then Ministry of Economic Development (MED) stated:

> It is expected that the knowledge of an impending review (combined with robust information disclosure) will influence the price setting by airports.[39]

A28 MED's response to issues raised by the Commerce Committee on the Bill also went on to state:

> Officials remain of the view that the major airports should be covered in the Commerce Act. Considerations are: ...The major airports have strong natural monopoly characteristics. Absent effective regulation, airports are able to set prices as they see fit...
>
> ...Note however, that information disclosure, combined with annual analysis by the Commission and the requirements for a review, will impose some disciplines on pricing behaviour.[40]

A29 So while airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. As such, we do not consider that s 4A of the AAA is incompatible with the information disclosure regime as the two operate for distinct purposes, or that the Part 4 purpose is subordinate to s 4A.

Scope, timing and process for the section 56G review[41]

Scope of the review

A30 Under s 56G(1) the Commission must:

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

A31 The substantive part of the Commission's task under s 56G is to assess "how effectively information disclosure regulation under this Part is promoting the

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

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

[41] We note that we have already responded to a number of submissions on the scope, timing and process of the review in our "Airports s 56G Update on Process and Scope" dated 27 July 2012. We have included this current section in our s 56G report to confirm our position.

purpose in s 52A in respect of the specified airport services". This report is therefore an evaluation carried out by the Commission in accordance with s 56G.

A32 We have not carried out an assessment as to how effectively information disclosure is promoting the purpose of Part 4 relative to other types of regulation provided for under Part 4. In our view the wording of s 56G(1)(c) is clear: the scope of this s 56G review does not extend to considering and recommending to the Ministers whether regulation other than information disclosure should apply to the regulated airports. Consequently this report does not make any recommendations concerning changes to the current regulatory framework for Wellington Airport.[42]

A33 We note that parties have also raised the issue of including recommendations to regulate additional services, not currently regulated as specified airport services, in their submissions and during the Wellington Airport conference.[43] We do not consider that extending the definition of 'specified airport services' under s 56A(1) is within the scope of the s 56G review. Section 56G is confined to the assessment of the information disclosure regime as it currently stands. Therefore we have not considered this issue within this review.

Timing of the review

The trigger for undertaking the section 56G review has been met

A34 Section 56G provides that the trigger for the review is the setting of any new price "in or after 2012":

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

A35 This is further confirmed by the wording of s 56(1)(c) which is a guide to the overall aim of subpart 11, namely:

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

A36 We therefore consider that the trigger for reporting to the Ministers has already been met, as Wellington Airport, Auckland Airport and Christchurch Airport have reset their prices in 2012.

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

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

A37 NZAA and the regulated airports submitted that it is too early to commence the s 56G reviews for several reasons,[44] proposing that the review be delayed:

A37.1 until further information from annual disclosures is available and there is sufficient time series data information;[45]

A37.2 until summary and analysis reports are completed and published by the Commission in accordance with s 53B;[46] and

A37.3 until the completion of the merits appeals under s 52Z of the input methodologies published in January 2011.[47]

A38 We consider that the language in s 56G is not consistent with these reasons for delay. Each of these reasons is addressed in turn below.

Sufficient information is available at the time of this review to draw conclusions

A39 Parties have raised in their submissions the difficulty in assessing the effectiveness of the information disclosure regime given the lack of time series data.[48] Auckland

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44 Auckland Airport "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph 5; Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraphs 3 to 4; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraph 8; NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraph 4.

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

46 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 8(b)–(c), 17(a) and 18 to 24; Auckland Airport "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 10(a) and 19(a); Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 7.3; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraphs 8 to 15.

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

48 NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 4 to 6 and 19(b); Auckland Airport "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraph

Airport further argued in their submission on the Draft Report that the Commission ought to recognise it is "too early to draw definitive conclusions about the effectiveness of ID" and that we "couch [our] conclusions on the effectiveness of the ID regime (in respect of the limbs of the purpose statement) in a less definitive manner".[49]

A40 The conclusions drawn in this review reflect the level of data available. We consider that we are able to draw conclusions as summarised in Chapter 3 in this report at this point in time (that point in time being "as soon as practicable after any new prices are set …in or after 2012") based on the available data.

A41 However, we also acknowledge that the timing requirement of the s 56G review carries with it certain limitations as to the assessment being carried out. For example, the availability of a greater amount of time series data would enable a more robust assessment of some of the outcomes expected from the regime.

A42 While we are not persuaded that the benefit of more data overrides the wording of s 56G, we acknowledge that an outcome of conducting the s 56G review now is that it is too early to draw conclusions about the effectiveness of the information disclosure regime in relation to some of the intended Part 4 outcomes. We have acknowledged in this report those areas where the impact of information disclosure may only be assessed over a longer period of time, for example in relation to operational efficiency.

A43 In their submissions on the Draft Report the parties have raised a related issue, namely that the Commission did not appropriately and explicitly reflect the interdependence of the limbs of the purpose statement.[50] For example Auckland Airport specifically argued that "it will be difficult for the Commission to establish a robust evidential foundation to conclude that excess profits are being earned when it is too early to make any findings on efficiency".[51]

A44 As discussed in Chapter 2, while we consider that the performance areas are interrelated, this does not preclude us reaching a conclusion on performance in one area without reaching a conclusion on performance in another. For example based on the evidence we were presented with, it is not necessary to conclude whether

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6; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraph 20.

49 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, page 39, paragraph 128.

50 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, page 4, paragraph 6; NZ Airports Association "Submission on the Commerce Commission draft report on the section 56G review of Wellington Airport" 30 November 2012, page 7, paragraph 25(c); WIAL Submission on Draft Report, page 5, paragraph 8, bullet 7.

51 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012

information disclosure is effective in the areas of operational expenditure efficiency, efficient investment and the sharing of efficiency gains in order to conclude that Wellington Airport is expected to earn excessive profits. This is because Wellington Airport has not been able to provide us with any evidence of superior performance relating to opex or capex efficiency in the last period (PSE1).

A45 As discussed above, the Act requires us to undertake this review "as soon as practicable after any new prices are set…in or after 2012" (which rules out postponing the report until prices are set again in 2017). We consider that there is sufficient information available to draw conclusions in certain areas, while not others.[52] We will continue to analyse and draw conclusions on Wellington Airport's performance over time in our s 53B reports.

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

A46 Airports have argued in their submissions and at the Wellington Airport conference that the availability of summary and analysis reports would have an impact on the effectiveness of the information disclosure regime, and therefore the review should be delayed until such reports are completed and, as seems to follow, have been available long enough to have an impact on the conduct of airports.[53]

A47 As set out below, we acknowledge parties' submissions concerning the potential impact of the summary and analysis reports on airport conduct. However, we do not consider that availability of s 53B(2) reports is a prerequisite of the s 56G review.

A48 We note that in their submissions on the Draft Report, while restating their position on the importance of the s 53B reports to this review, NZ Airports agreed with the

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52 We note that Auckland Airport agreed with this overall view in its Auckland Airport "Auckland Airport's cross-submission on the section 56G review draft WIAL report" 29 November 2012, page 17, paragraphs 76 to 66: "Nowhere in Part 4, and certainly not in the language used under section 56G, is it suggested that the Part 4 purpose statement is something that is achieved (or not) in the short term. ...As correctly articulated by the Commission, regulation under Part 4 promotes outcomes consistent with the purpose statement, on an ongoing basis. ..In our view, ID is most certainly achieving the purpose of Part 4 in some areas, and in others may be characterised as establishing the foundation for continued improvement."

53 Airports submitted that s 53B reports would provide valuable evidence for the review and improve the information available. Airports also submitted that s 53B could influence Airports' behaviour, even after the price setting event, and that they are an important part of the information disclosure regime. Wellington Airport requested that the Commission expressly acknowledge in its reports the absence of s 53B(2) report and "the lack of opportunity for airports to engage in self-initiated behaviour change (if required)" in response to such a report: NZAA "Submission on the Commerce Commission's Process and Issues Paper: Airport Services – Section 56G Reports" 29 June 2012, paragraphs 8(b)–(c), 17(a) and 18to 24; Auckland Airport "Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports)" 29 June 2012, paragraphs 10(a) and 19(a); Christchurch Airport "Airport Services – Section 56G Reports: Process and Issues" 29 June 2012, paragraph 7.3; Wellington Airport "Initial submission to the Commerce Commission: Section 56G Process and Issues Paper" 29 June 2012, paragraphs 8to 15. Also see Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, pages 126 to 134.

Commission's view that s 53B(2) reports "are not a legal prerequisite for the section 56G review".[54]

A49 We noted in our Update Process Paper that while in the current circumstances the timing of the completion of the summary and analysis reports and the s 56G review overlaps, there is no requirement in the Act that sets out a chronological order for the two tasks, or that prescribes their interdependence, chronological or otherwise. As set out in the Process Update Paper:[55]

> Summary and analysis is intended to aid interested persons in understanding the performance of suppliers. The purpose of the s 56G report is to provide an assessment to the Minister of the effectiveness of information disclosure regulation in promoting the Part 4 purpose. Section 56G therefore goes beyond summary and analysis as it requires an assessment of not only the information disclosed but the effectiveness of the information disclosure regime on the promotion of the purpose in s 52A(1).

A50 We are therefore proceeding with the s 56G reviews now. It is not clear to us what impact the s 53B reports would in fact have on airport performance. As an example it is difficult to see any likely impact from our summary and analysis on pricing given that the price-setting event for Wellington Airport has already occurred, and that Wellington Airport was aware of the IM benchmarks we would be applying at the time of setting prices.

Input methodologies merits appeals

A51 We consider that waiting for the outcome of the input methodologies merits appeals could delay this review considerably, which would be contrary to Parliament's intention as to the timing requirement in s 56G.[56] In particular, appeals are potentially available to parties through to the Supreme Court so the delay could be

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54 NZAA Submission on Draft Report, page 5, paragraph 18. Wellington Airport also restated their arguments on the importance of s 53B in their submissions on the Draft Report in terms of importance to the review: "…WIAL's view that the Section 56G review and Section 53B reports are an important tool for the Commission to provide guidance on matters of concern. These are an important part of the process (which includes resolution of the merits review proceedings) to develop a mature ID regime, where clear expectations for performance are established and the right incentives are provided over time." Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, page 13, paragraph 65.

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

56 Wellington Airport, in its submission on the Draft Report reiterated its concern that "the Commission must recognise in its evaluation of the regime that the IMs remain subject to merits appeal. The fact that the prospect for change of the methodologies remains should lead the Commission to be less definitive in its conclusions and recognize several different future pathways are possible." See Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, page 20, paragraph 97.

for some years. Moreover, s 53(2) is clear in stating that input methodologies currently in effect are applicable irrespective of any on-going merits appeals.

A52 Section 52S continues to apply with respect to every IM published under s 52W until any appeal against the IM is finally determined.

A53 In our view this framework supports our approach to applying the current input methodologies as a benchmark in the s 56G review.

A54 If the airports' merits appeals as to a number of input methodologies' parameters that impact our conclusions in this s 56G review are successful to a material degree, we will provide further advice to the Minister regarding how that impacts on our s 56G reports.

Process for the review

A55 The statutory process we must follow in undertaking this review is set out in paragraph A5 above. We have exceeded these minimum requirements and included various additional consultation steps. The process below has been adopted. We have:

A55.1 reviewed the information disclosed under Part 4 and the price-setting consultation documentation;

A55.2 reviewed the information disclosed in consultation during this review process and in response to any requests for information under our information-gathering powers under the Act;

A55.3 published a Process and Issues paper and seek submissions and cross-submissions on the proposed process and scope of the review;

A55.4 published an Updated Process paper responding to issues raised in submissions and cross-submissions;

A55.5 published a preliminary issues paper for the Wellington Airport conference;

A55.6 held a conference for Wellington Airport prior to preparing a draft report to ensure that we have all the relevant information, and to test the issues and ensure we understand any differences of opinion;

A55.7 sought cross-submissions on material discussed at the Wellington Airport conference;

A55.8 issued a draft report for Wellington Airport;

A55.9 sought submissions and cross-submissions on the Wellington Airport draft report. Once we received submissions on the Wellington Airport draft report, we considered whether further process steps and consultation were necessary before finalising our report to the Ministers; and

A55.10 prepared this final report for the Ministers.

Separate reports for each airport

A56 We consider that preparing a separate report for each airport is the most appropriate interpretation of the s 56G task. This view takes into account that each airport's price-setting decisions are occurring at different times, and that information disclosure regulation may be having a different impact across the three airports. This interpretation is also consistent with the trigger wording of s 56G which provides (emphasis added):

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

A57 We acknowledge that some parties have submitted in support of the Commission producing a single report that covers all specified airport services.[57] We do not, however, accept that producing a single report is mandatory or that it would be more effective.

Information the Commission may consider in undertaking the section 56G review

A58 As discussed in our Process Update Paper the Act does not contain any explicit limitations on information that we may take into consideration when conducting our analysis of the effectiveness with which the purpose of Part 4 is, or is not, being promoted.[58] We note that the s 56G goes beyond a mere review of information disclosed, namely:

A58.1 it requires a review of the information disclosed (s 56G(1)(a)); and

A58.2 a report to the Minister comprising an assessment of how effectively the information disclosure regulation is promoting the purpose in s 52A (s 56G(1)(c)).

A59 The trigger for the review is the price-setting event. To assess the effectiveness of information disclosure in promoting the purpose in that context, and also in the context of the wider airport sector performance, for example in terms of quality, the review explores a wider range of information than just the Part 4 disclosures.

A60 We have therefore reviewed the information disclosed by Wellington Airport, and have also sought further information in order to make a meaningful assessment of

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

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

whether, and to what extent, information disclosure is promoting the Part 4 purpose.

A61 Parties raised concerns in their submissions that seeking additional information may pre-judge the outcomes of the review by pre-supposing that information disclosure is not effective.[59] We do not consider that the additional information sought in any way pre-judged the outcomes of the review; rather it clarified the disclosed material necessary to undertake this review and allowed the information disclosure regime to be assessed against an appropriate context.

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

Attachment B: Is information disclosure promoting appropriate innovation at Wellington Airport?

Purpose

B1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport has incentives to innovate (s 52A(1)(a) of the Act).

B2 Innovation is about the discovery and use of new information, leading to the development of new goods or services, and/or more efficient production techniques.[60] Innovation is driven by the prospect of earning higher profits and a greater than normal return.

Conclusion

B3 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Wellington Airport facilitates airline-led innovation, and the level of innovation at Wellington Airport appears to be appropriate. At this time, information disclosure does not appear to have had an incremental impact on incentives to innovate at Wellington Airport, but has not negatively affected existing incentives to innovate at Wellington Airport. Where a supplier is already innovating appropriately, we would not expect information disclosure to have any material incremental impact on innovation and therefore consider that it is effectively promoting incentives to innovate at Wellington Airport.

B4 The key reasons for our conclusion are as follows.

B4.1 Collaboration on airline-led innovation appears most important to the airlines. Airlines generally consider that Wellington Airport does facilitate airline-led innovation.

B4.2 It appears that innovation at Wellington Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4. This view is based on the fact that submissions have not raised any substantive concerns as part of this s 56G review. Innovation at Wellington Airport is considered comparable with other airports in New Zealand and overseas.

B5 We expect that information disclosure regulation would have a limited impact on innovation because other incentives play a more important role in driving innovation. Wellington Airport has incentives to innovate so as to increase its profits

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

and information disclosure does not appear to have negatively impacted on those incentives.

B6 Wellington Airport has not provided evidence to suggest their performance with regard to innovation was superior in PSE1 to justify earning a return that exceeds our estimated cost of capital in PSE2.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to innovate appropriately

B7 Wellington Airport has incentives to maximise its profits through improved performance, including through innovation.

How information disclosure can provide incentives to innovate

B8 Information disclosure regulation places relatively weak incentives on Wellington Airport to innovate appropriately due to the unique and unpredictable nature of innovation. Information disclosure regulation is likely to be most effective over time when combined with analysis of operational and capital expenditure, as this will highlight where innovation may assist in achieving efficiency gains.[61]

How we have assessed whether Wellington Airport is innovating appropriately

B9 Our approach to assessing innovation for this review was to consider Wellington Airport's performance and conduct regarding innovation. We have looked for evidence of:

B9.1 innovation occurring at Wellington Airport, comparisons with innovation at other airports, and awards for innovation; and

B9.2 Wellington Airport enabling or facilitating innovation through collaboration.

B10 We have considered this both before and after the introduction of information disclosure regulation to gain insights into the impact of information disclosure regulation on incentives to innovate.

Information used to assess whether Wellington Airport is innovating appropriately

B11 Our analysis is based on qualitative information from two main sources:

B11.1 information disclosed under Part 4; and

B11.2 submissions and other material generated as part of this s 56G review.

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

Analysis of innovation performance and conduct

Is Wellington Airport innovating appropriately?

B12 The available evidence suggests that Wellington Airport innovates appropriately. Both Air New Zealand and BARNZ agree that the level of innovation at Wellington Airport is comparable to other airports, both domestically and internationally.[62] Wellington Airport has also provided examples of its innovation. For example, Wellington Airport has developed an integrated terminal and multi-use 'swing gates' to optimise the use of its relatively small land area.[63] These gates allow domestic and international services to use the same facilities.

B13 Air New Zealand raised one concern with innovation by Wellington Airport. It submitted that Wellington Airport has ignored suggested pricing innovations that would enable separate charging for passengers using the baggage handling system.[64] Wellington Airport's response to this criticism is that they invited airlines and BARNZ to provide a technological solution for this innovation, but no advice was provided.[65]

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

B14 Overall, we consider that Wellington Airport has facilitated innovation. There has been little concern about Wellington Airport's facilitation of airline-led innovation in the consultation process for this review to date.[66]

B15 Wellington Airport's view is that the key to innovation is collaboration with its customers and other stakeholders.[67] Air New Zealand commented that there is good collaboration about regular operational issues and putting in place sensible

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

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

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

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

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

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

solutions.[68] This suggests that Wellington Airport and airlines agree that its collaboration promotes innovation, at least on a day-to-day basis.

B16 On-going conduct in facilitating innovation appears to be more important than conduct during the price-setting consultation process. This is because innovation is not explicitly covered in these processes.[69] This is different to the other areas we have examined in this report, where the price-setting process is more important.

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

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

Attachment C: Is information disclosure promoting services at the quality consumers demand at Wellington Airport?

Purpose

C1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport provides services at a quality that reflects consumer demands (s 52A(1)(b) of the Act).

C2 We consider that quality is about consumers' experiences of regulated airport services, including comfort, timeliness and the availability of the service. Consumers include airlines, air cargo handlers, passengers and other users of Wellington Airport's aeronautical services.

Conclusion

C3 Our conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Wellington Airport providing services at a quality that reflects consumer demands. Wellington Airport has sought improvements in their service quality and has a level of quality comparable with other airports. Wellington Airport has attributed some of this improvement in quality to information disclosure regulation.

C4 The key reasons for our conclusion are as follows.

C4.1 Quality at Wellington Airport is comparable with other airports. Passenger satisfaction survey results at Wellington Airport compare well against other airports. Our analysis of passenger satisfaction surveys indicates that the level of quality experienced by passengers at Wellington Airport is similar or better than at other airports in New Zealand and Australia. The level and duration of interruptions suggests Wellington Airport is comparable with other airports.

C4.2 Airlines appear to be generally satisfied with the quality of service provided at Wellington Airport—both before and after information disclosure under Part 4 was introduced. This is based on submissions from Wellington Airport and airlines to this s 56G review. Our analysis supports this indicator.

C4.3 Information disclosure has had a positive impact on quality at Wellington Airport. Wellington Airport has attributed the introduction of information disclosure under Part 4 to being partially responsible for improvements to passenger satisfaction surveys, and the consequent improvement in passenger satisfaction levels since the introduction of information disclosure under Part 4.

C4.4 The concerns that were raised relate to the price-quality trade-offs airlines wish to make. The main concerns and perceived risks by airlines was

Wellington Airport investing in too high quality and consumers who did not benefit from or demand higher quality should not bear the cost of these investments. This is discussed further in Attachment D.

C5 Wellington Airport has not provided evidence to suggest their performance with regard to quality was superior in PSE1 to justify earning a return that exceeds our estimated cost of capital in PSE2.

How we have assessed the effectiveness of information disclosure

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

C6 Wellington Airport has some incentives to provide quality that reflects consumers' demand, aside from those provided by information disclosure regulation under Part 4 (discussed below). As a commercial operator, Wellington Airport has incentives to provide quality at a level that consumers are willing to pay for to maximise profits. Wellington Airport is subject to other regulatory requirements, which also creates incentives in this area. The AAA requires Wellington Airport to consult on material capex programmes with its major customers. This creates some incentives to understand the level of quality consumers demand, and therefore may encourage Wellington Airport to provide services at the quality consumers demand. Wellington Airport is also obliged to meet safety requirements set by the Civil Aviation Authority (CAA), which requires a minimum level of quality.

C7 However, Wellington Airport's approach to setting prices, along with its incentive to maximise its profits may weaken its incentives to provide quality at the level consumers demand. For example, once prices are set for the pricing period, Wellington Airport may earn higher profits by reducing quality as it may reduce its expenditure. As discussed in paragraph H8.3, a regulated supplier that is targeting an excessive return also has an adverse incentive to over-invest in quality where it will result in higher capital expenditure, so as to earn higher profits.

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

C8 The public disclosure of information through information disclosure regulation can strengthen the incentives, and mitigate the disincentives, to provide services at a quality that reflects consumer demand, as discussed in paragraphs C6 and C7.

C9 It can also provide additional incentives to provide services at a quality that reflects consumer demand, for example by requiring Wellington Airport to improve its understanding of what level of quality consumers demand through passenger surveys.

C10 We expect information disclosure regulation to be as effective as it can be in promoting the provision of services at a quality that reflects consumer demands over time. Any significant quality improvements highlighted as necessary by consumers through information disclosure regulation may require a long lead time to implement if investment is required.

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

C11 There are usually many dimensions to the quality of a service and a single indicator will provide only an approximation to the overall quality of the service or services to which it relates. Different types of consumers may also demand different levels of quality. We have therefore examined a number of aspects of service quality at Wellington Airport experienced by different types of consumers.

C12 Our approach considers whether historic or forecast improvements to quality at Wellington Airport reflect consumer demands. We have considered evidence of:

C12.1 whether the quality of service being received by passengers at Wellington Airport reflects their demand;

C12.2 whether the aspects of service quality that are important to airlines reflects their demand; and

C12.3 changes to Wellington Airport's processes and service quality following the introduction of information disclosure regulation.

C13 An assessment of whether quality reflects consumer demands implicitly includes an assessment of whether consumers are willing to pay for higher quality, or would prefer to pay less and receive a lower quality. Specific price-quality trade-offs are discussed in Attachment D.

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

C14 Our analysis is based on qualitative and quantitative information from:

C14.1 information disclosed under Part 4 and the AAA; and

C14.2 submissions and other material generated as part of this s 56G review.

C15 The information generated as part of this s 56G review has been most helpful to understanding whether quality reflects consumer demands because we also have received the views of some of Wellington Airport's consumers directly. Information disclosure provides information on the steps Wellington Airport has taken to elicit feedback from consumers on the quality they expect, but does not provide information on whether consumers are willing to pay for higher quality, or whether they consider quality at Wellington Airport is too high. These price-quality trade-offs are largely addressed through consultation at the price-setting events.

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

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

C16 Passenger satisfaction at Wellington Airport since information disclosure regulation took effect is similar to other New Zealand airports.[70] Passenger satisfaction at Wellington Airport has improved since the first quarter of the 2011 disclosure year.

C17 Table C1 shows that overall, Wellington Airport had a similar level of passenger satisfaction to Auckland and Christchurch airports in 2011 and 2012, following the introduction of information disclosure regulation.[71]

Table C1: Annual passenger satisfaction survey results for Wellington, Auckland and Christchurch airports (2011–12)

	2011		2012	
	Domestic	**International**	**Domestic**	**International**
Wellington	4.1	4.0	4.1	4.1
Auckland	4.0	4.1	4.1	4.2
Christchurch	3.9	4.1	4.1	4.2

Sources: Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Auckland Airport, "Specified Airport Services Annual Information Disclosure" 2011 to 2012 .

C18 Passenger satisfaction has improved or remained constant at Wellington Airport since information disclosure regulation was introduced. Figure C1 shows that the average score from the international passenger survey has increased, from 3.7 (out of 5) in the first quarter of 2011 to 4.1 in 2012. At the same time, the average quarterly score from the domestic passenger survey also increased from 4.0 to 4.1.

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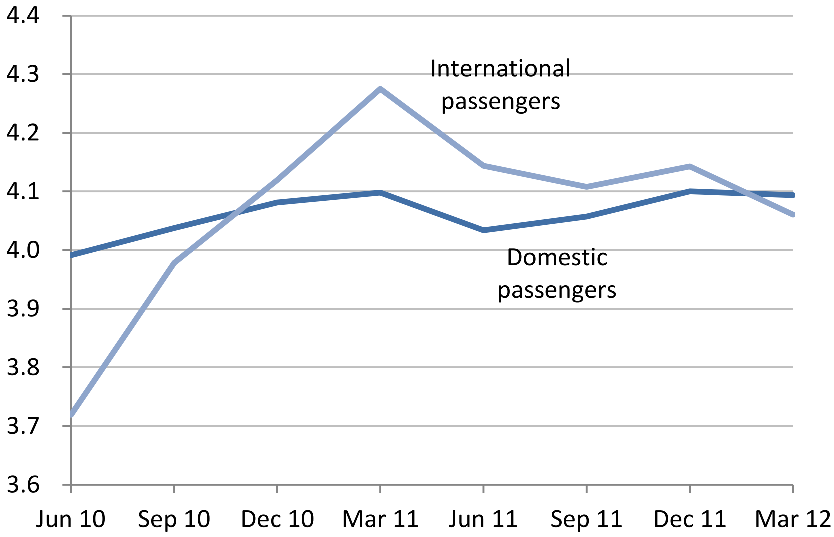
70 We have not received any submission from passengers as part of this section 56G review to be able to consider passenger views on whether Wellington Airport is providing services at a quality that reflects passenger demands. We have therefore been reliant on evidence provided in information disclosure,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

71 Our analysis uses measures of passenger satisfaction from the Airport Service Quality (ASQ) quarterly survey programme run by the Airports Council International (ACI).

Figure C1: Quarterly passenger satisfaction survey results at Wellington Airport (2011–12)



Notes: Graph shows average survey score in each quarter. Graph does not start at 0 for readability.
Sources: Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

C19 Wellington Airport did not participate in the Airport Service Quality (ASQ) passenger satisfaction survey prior to information disclosure regulation, and we do not therefore have comparable information to assess performance in this area prior to information disclosure regulation.[72] Wellington Airport's participation in a passenger survey is required under information disclosure regulation. We have no reason to believe there was significant passenger dissatisfaction before the introduction of information disclosure.[73]

Does service reliability at Wellington Airport reflect consumer demands?

C20 An analysis of service reliability at Wellington Airport provides information about continuity of supply. We have not received any submissions to suggest that reliability at Wellington Airport does not reflect consumer demands. Our analysis also shows that Wellington Airport generally has a level and duration of interruptions within the range for Auckland and Christchurch airports, and in some cases it has the lowest number or duration of interruption (see Table C2 and Table C3).[74] We consider it too

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72 Wellington Airport did use other passenger surveys prior to information disclosure regulation under Part 4. Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 203.

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

74 An interruption occurs if a service is withdrawn for 15 minutes or longer.

early to be able to assess meaningful trends in service reliability at Wellington Airport.

Table C2: Number of interruptions at Wellington, Auckland and Christchurch Airports (2011–12)

	2011			2012		
	Wellington	**Auckland**	**Christchurch**	**Wellington**	**Auckland**	**Christchurch**
Runway	0	0	1	0	0	0
Taxiway	0	0	0	0	0	0
Remote stands/ means of (dis)embarkation	0	0	0	0	0	0
Contact stands and air bridges	4	12	1	0	18	2
Baggage sortation system on departures	3	2	6	1	2	2
Baggage reclaim belts	0	0	1	0	1	1
On-time departure delay	0	0	0	1	2	N/A

Table C3: Duration of interruptions (minutes) at Wellington, Auckland and Christchurch Airports (2011–12)

	2011			2012		
	Wellington	**Auckland**	**Christchurch**	**Wellington**	**Auckland**	**Christchurch**
Runway	8	62	505	0	0	21
Taxiway	0	7	0	0	0	0
Remote stands/ means of (dis)embarkation	0	0	0	0	0	0
Contact stands and air bridges	661	1,943	165	8	1,732	198
Baggage sortation system on departures	555	218	787	393	20	107
Baggage reclaim belts	0	9	168	0	97	209
On-time departure delay	0	0	0	2	88	N/A

Notes: Runway, taxiway, and stand and air bridge data reported per 10,000 landings. Outbound baggage sortation system data reported per million departing passengers. Baggage reclaim data reported per million arriving passengers. 2011 interruptions data shown here are interruptions caused by all parties. 2012 interruptions shown include only interruptions where the primary cause is the airport. Differences in interruptions may also be due to varying approaches to recording interruptions at airports.

Sources: Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Auckland Airport, "Specified Airport Services Annual Information Disclosure"2011 to 2012.

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

C21 Utilisation of capacity is relevant to our assessment of quality because it can identify potential service constraints, indicating that a service is not available when required.[75]

C22 Our conclusion is that overall Wellington Airport appears to have provided capacity at a level that reflected consumer demands. Submissions received as part of this s 56G review have not indicated any aspects of service quality at Wellington Airport where they considered any service constraints were not being addressed. Submissions have not indicated that they consider capacity will be inefficiently constrained in the future.

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

C23 Overall, Wellington Airport's conduct indicates that it seeks to ensure quality reflects consumer demands. However, airlines have expressed some concerns with aspects of Wellington Airport's conduct.

C24 To assess whether Wellington Airport's conduct is consistent with providing quality that reflects consumer demands, we have reviewed whether there have been:

C24.1 improvements to operational processes to address concerns about quality;

C24.2 additional investment and operational expenditure to address concerns about quality, where requested; and

C24.3 consultation by Wellington Airport about quality for PSE1 and PSE2, as well as in the intervening period.

C25 Wellington Airport has indicated some changes to operational processes since the introduction of information disclosure regulation. For example:

C25.1 the establishment of a forum with airlines to discuss service reliability, service performance, and to review ASQ results;[76] and

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

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

C25.2 it has taken over the role of gate allocation from Air New Zealand to improve efficiency. However, Air New Zealand disputes whether this is required, or cost efficient.[77]

C26 There are several examples of quality enhancements made during PSE1, and forecast for PSE2. With the exception of the extent of investment in quality at "The Rock" and in the Runway End Safety Areas (RESAs), we have no evidence to suggest these enhancements were not demanded by consumers. Air New Zealand submitted that improvements in quality for regional airline customers are necessary.[78] We are not aware of any other areas where further investment is required to improve quality.

C27 Wellington Airport's consultation on quality appears to be appropriate. Wellington Airport consults on quality through monthly meetings with its main stakeholders (including airlines) as a way of regularly discussing and resolving quality issues that may arise.[79] Quality was not a focus of consultation for either PSE1 or PSE2, although it was implicitly considered in discussions about capex and the pricing methodology.[80] Submissions received as part of this project do not suggest the amount of consideration given to the views of consumers about service quality during the price-setting consultations was inappropriate.

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

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

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

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

Attachment D: Is information disclosure promoting prices that are efficient at Wellington Airport?

Purpose

D1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Wellington Airport has incentives to set prices that promote efficiency (s 52A1(b) of the Act).[81]

D2 References to prices in this attachment relate to the charging structure at Wellington Airport and how Wellington Airport's total revenue requirement is collected from different services and consumers. This is set out in Wellington Airport's pricing methodology disclosed in information disclosure. This attachment does not consider whether Wellington Airport's target total revenue is appropriate. That is considered in Attachment E.

D3 Consistent with s 52A(b), we have assessed whether the pricing methodology used by Wellington Airport is likely to result in prices that *improve* efficiency. We have therefore assessed Wellington Airport's pricing methodology for PSE2 relative to their PSE1 pricing methodology. Our analysis does not assess whether Wellington Airport's prices are fully efficient.

Conclusion

D4 Our conclusion is that information disclosure is effectively promoting efficiency of pricing (referred to as 'efficient pricing'). Wellington Airport has given greater consideration to pricing efficiency in PSE2 relative to PSE1. Consequently, prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure.

D5 Our analysis indicates that greater consideration had been given to pricing efficiency in PSE2 relative to PSE1. For example, there was greater consideration of:

D5.1 how pricing can ensure the optimal use of scarce facilities at Wellington Airport with the introduction of new charges for aircraft parking and check-in desks, as well as for runway use at peak times; and

D5.2 the price sensitivity of customers in designing price structures with prices being modified to reflect this.

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

D6 Information disclosure has had a positive impact on this outcome. Wellington Airport has indicated that one of the reasons it changed its pricing methodology was due to information disclosure. This is consistent with the apparent changes between PSE1 and PSE2.

D7 Airlines have raised concerns including the extent to which the revised pricing structure will promote efficiency and about Wellington Airport's volume growth incentive scheme. These concerns may indicate that further improvements to promote pricing efficiency could occur, in particular in relation to price-quality trade-offs.

D8 Wellington Airport has not provided evidence to suggest their performance with regard to pricing efficiency was superior in PSE1 to justify earning a return that exceeds our estimated cost of capital in PSE2.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to set prices that promote efficiency

D9 Wellington Airport has an incentive to set prices that will result in higher demand and therefore higher profits. It therefore has incentives to set prices that promote efficiency. However, this profit maximising objective also creates adverse incentives to earn excessive profits through the pricing methodology. For example, Wellington Airport may use an unrealistically low demand forecast when setting its pricing methodology so as to set higher average prices, and increase the potential to earn additional profits from higher demand than forecast.

How information disclosure can provide incentives to improve operating efficiency

D10 The increased transparency of Wellington Airport's pricing methodology generated by information disclosure regulation may mitigate the incentive to under-forecast demand, and strengthen incentives to set prices that promote efficiency. Information disclosure regulation under Part 4 allows interested persons to understand the reasons for the pricing methodology adopted, and to assess the outcomes resulting from the methodology. This greater transparency may enhance consumers' countervailing power. The disclosure of pricing methodologies can also provide examples of best practice from other regulated airports.

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

D11 Section 52A(1)(b) states that the Part 4 purpose is to promote outcomes consistent with outcomes in workably competitive markets such that regulated suppliers "have incentives to improve efficiency". This includes productive, dynamic and allocative efficiencies.[82]

D12 The prices set by Wellington Airport through its pricing methodology have an important role to play in improving efficiency. Consistent with outcomes observed in workably competitive markets, the prices set by Wellington Airport for each charged service should help ensure the efficient allocation of its aeronautical services and therefore its resources (allocative efficiency) and provide signals of where innovation and investment is needed at Wellington Airport to meet consumer demands (dynamic efficiencies).

D13 To assess whether Wellington Airport's prices promote efficiency, we have reviewed its pricing methodology for PSE1 and PSE2 against efficient pricing principles. This will allow us to understand whether information disclosure regulation has had any impact on its performance in this area.

Information used to assess whether Wellington Airport is sharing efficiency gains

D14 Our analysis uses quantitative and qualitative data from the following sources:

D14.1 information disclosed under Part 4 and AAA; and

D14.2 submissions and other material generated as part of this s 56G review.

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

D15 The remainder of this document considers:

D15.1 the appropriate efficient pricing principles to assess Wellington Airport's pricing methodology against;

D15.2 the extent to which Wellington Airport's methodology for PSE2 addresses each of these principles relative to PSE1; and

D15.3 Wellington Airport's conduct in setting its pricing methodology during PSE2.

Efficient pricing principles

D16 We have assessed Wellington Airport's pricing methodology and subsequent prices against a number of principles that reflect the objectives of efficient prices.[83] These principles are discussed in more detail in the following section.

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

D16.1 Prices should be subsidy free.

D16.2 As part of this, where a good or service is scarce, the price should ensure that the good or service is consumed by those that value it the most.

D16.3 Prices should have regard to consumers' demand responsiveness.

D16.4 Prices should enable consumers to make price-quality trade-offs or non-standard arrangements for services, where practical, to reflect the value they place on services.

D16.5 The development of prices should be transparent, and promote price stability and certainty for consumers, where demanded.

D17 The pricing methodology should also ensure that suppliers are not able to earn excessive profits as a result of their pricing structure and assumptions. For example, it should use appropriate demand forecasts. Excessive profits may however result from other factors as discussed in Attachment E.

Prices should be subsidy free

D18 To be subsidy free, prices should therefore be equal to or greater than incremental costs, and less than or equal to standalone costs.[84] However, there may be instances where it is not efficient for these criteria to be met.[85] Given the long-term nature of many of Wellington Airport's investments and costs, we consider that an assessment of Wellington Airport's prices should consider their long-run, rather than short-run incremental costs.

D19 Our conclusion is that Wellington Airport's pricing methodology for PSE2 is likely to better reflect the principle of being subsidy free than the methodology adopted for PSE1. This is because Wellington Airport is limiting previous cross-subsidisation by

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83 These principles are consistent with the pricing methodology IM applicable to gas distribution and transmission businesses. See Commerce Commission "Input methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, Table 7.2. Similar principles are discussed in reports commissioned by the airlines and Wellington Airport during consultation for the second pricing period. See for example, Leigh Fisher "Pricing review of aeronautical services at Wellington Airport" 14 July 2011, NZIER, "Wellington airport congestion charging. Issues of congestion pricing and possible effects on airline network connectivity", 1 June 2011.

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

85 For example, due to transaction costs.

aligning the prices for domestic and international airfield charges where appropriate, and introducing additional charges for runway use at peak times.

D20 Given the low incremental costs of airport services, we consider it is unlikely that prices will be less than incremental costs at Wellington Airport during PSE2, with the exception of cross-subsidisation of smaller aircraft in peak periods. However, we have insufficient information to fully assess whether any cross-subsidisation has occurred and it is not clear whether charges are less than or equal to standalone costs, where efficient. Airlines have expressed concerns regarding cross-subsidisation.[86]

D21 Wellington Airport has stated that it does not consider that the prices set for each charged service for PSE1 and PSE2 were below its short-run incremental cost as marginal costs are considered to be low.[87] However, this analysis does not take account of all costs.

D22 As discussed in paragraph D18, we consider that an assessment of long-run incremental costs is more appropriate, and may indicate some cross-subsidisation. Wellington Airport acknowledges that cross-subsidisation of 19-seat aircraft by other aircrafts at peak period may result if long-run incremental costs and the opportunity costs of this peak use are considered. These aircraft pay a lower charge than larger aircraft but use scarce capacity that could be utilised by these larger aircraft.[88] However, the introduction of a charge for runway use at peak times may result in a reduction in this cross-subsidisation between other aircraft relative to PSE1.

D23 Airlines have however highlighted a number of areas where they consider cross-subsidisation may occur in PSE2. Wellington Airport's consultants also recommended a cost-reflective charging structure that was not fully adopted by Wellington Airport. These concerns may indicate that further refinements to Wellington Airport's prices could be made to ensure they continue to promote efficiency.

D23.1 Air New Zealand and BARNZ submitted that domestic passengers will cross-subsidise international passengers as a result of the common charge for terminal facilities.[89] Wellington Airport's consultants also recommended

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

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

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

89 BARNZ argues that a common charge is not appropriate as facilities for domestic passengers take up less terminal space than facilities for international passengers and domestic passengers do not use 'The Rock'

that Wellington Airport differentiate its passenger terminal charge for domestic and international services to reflect the different costs of these passengers.[90] Wellington Airport has stated that they do not consider passengers are charged less than their marginal cost.[91] They also submitted that they expect domestic passengers to make increasing use of assets that were previously exclusively used by international passengers, although it is not clear to what extent this will occur.[92]

D23.2 Air New Zealand submitted that domestic passengers who transfer from one aircraft to another en route to their final destination may cross-subsidise non-transfer passengers.[93] Wellington Airport's consultants also suggested that an appropriate discount be allowed for transfer passengers as they impose a lower overall cost burden.[94] Wellington Airport has submitted that there is no efficient or transparent means for it to identify transfer passengers.[95]

D23.3 BARNZ considers the differential between international and domestic airfield prices results in cross-subsidisation, as airfield facilities for domestic and international aircraft of the same size are largely the same.[96] Wellington Airport responded that the difference in prices is an anomaly of the

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development in the international terminal. They also submit that while gates 25 to 29 of the international terminal can be used for domestic operations, this only occurs on rare occasions and that international operations have priority. Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 287; BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, pages 25to 26.

90 Leigh Fisher "Pricing review of aeronautical services at Wellington Airport" 14 July 2011, page 25.

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

92 Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, paragraph 212.

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

94 Leigh Fisher "Pricing review of aeronautical services at Wellington Airport" 14 July 2011, page 25.

95 Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, page 44.

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

previous pricing approach and that they are aligning the prices over the pricing period to reflect the use of facilities at Wellington Airport.[97]

D23.4 BARNZ also considers that the lower MCTOW[98] rate for aircraft above 100 tonnes relative to smaller aircraft is cross-subsidisation as larger aircraft require increased facilities and services.[99] Wellington Airport responded that larger aircraft still pay a higher total charge than smaller aircraft to reflect any additional costs incurred.[100]

Price should ensure the optimal use of scarce resources

D24 Scarcity at airports may arise through congestion at facilities, and a lack of capacity where required. To understand whether Wellington Airport's prices promote the optimal use of scarce resources, we have examined whether Wellington Airport's prices are likely to allocate congested or scarce services efficiently to manage competing demands for limited capacity and resources.[101]

D25 Our conclusion is that Wellington Airport's prices for PSE2 are likely to better promote the optimal use of scarce resources at Wellington Airport relative to PSE1. We therefore conclude that there has been an improvement in the efficiency of Wellington Airport's prices. A number of new charges have been introduced with the purpose of allocating scarce resources optimally. However, airlines have diverging views on whether scarcity pricing is necessary at Wellington Airport.

D26 While there is evidence of congestion at Wellington Airport in PSE1,[102] prices do not appear to have been set with the intention of managing this scarcity efficiently. It is possible that congestion was managed without the need to signal this through prices, for example, through working groups.

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

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

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

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

101 Where a service is scarce and demand for the service exceeds supply, prices can promote allocative efficiency by reflecting the opportunity cost of consuming the service. This will likely result in higher prices for those scarce services and will help ensure that only those who benefit most from consuming the service will do so.

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

D27 For PSE2, Wellington Airport introduced a number of new charges to manage congestion and scarcity at Wellington Airport. These include:

D27.1 an additional charge for airfield services at peak times. BARNZ acknowledge that this should provide improved pricing signals.[103] However, Air New Zealand states that they do not consider the runway at Wellington to be congested yet; [104]

D27.2 a mandatory charge for aircraft parking at gates. BARNZ acknowledge that this charge should also provide improved pricing signals.[105] However, Air New Zealand do not consider there to be capacity constraints for aircraft parking, and submit that a parking charge is not necessary;[106] and

D27.3 an hourly charge for check-in counter use.

Prices should have regard to consumers' demand responsiveness

D28 In an industry with high fixed costs, such as airports, prices based on the efficient incremental costs would under-recover the required revenues. Where this occurs, a likely efficient outcome would be to make up any shortfall by setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable (ie, Ramsey pricing).[107]

D29 Our conclusion is that Wellington Airport has considered consumers' demand responsiveness in its pricing methodology for PSE2, and that pricing efficiency in respect of this principle has improved relative to PSE1. The appropriateness of Wellington Airport's assumed demand responsiveness has, however, been challenged by airlines.

D30 Wellington Airport does not appear to have explicitly considered consumers' demand responsiveness when establishing its pricing methodology for PSE1. While we observe some variation in charges for different passenger groups, these differences do not appear to be driven by different price sensitivities.[108]

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

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

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

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

107 This means that if the cost of serving each consumer group is the same, those consumers that are less responsive to prices are set higher prices than more price-sensitive consumers. For this to be efficient, Ramsey pricing should increase output relative to a common price for all consumers.

108 For example, international passengers were charged more than domestic passengers for terminal services. This difference is due to the assumption that international and domestic passengers use

D31 Wellington Airport's pricing methodology and evidence provided in submissions indicates that it has considered consumers' demand responsiveness in its pricing methodology for PSE2. For example, Wellington Airport has indicated that part of the purpose of the peak charge for airfield services is to recover a greater proportion of fixed costs from less price sensitive services.

Prices should enable price-quality trade-offs

D32 Consumers may demand different levels of quality or quantity of service, for which they are willing to pay different prices. Where practical, consumers should therefore be able to make price-quality trade-offs. This may include the use of non-standard contracts or commercial agreements for individual consumers.

D33 We conclude that there is no evidence at this time that Wellington Airport's pricing methodology for PSE2 better enables price-quality trade-offs than the PSE1 pricing methodology. This is not necessarily a concern if airlines and passengers are able to make appropriate price-quality trade-offs. There is some evidence that Wellington Airport has enabled consumers to make some price-quality trade-offs. For example, Wellington Airport reports that it has agreed to work with Air New Zealand in good faith to investigate a commercial agreement for use of check-in counters that meets their needs.[109] However, airlines have raised concerns that they have not been able to make appropriate price-quality trade-offs for PSE2 for some services. [110]

D33.1 Wellington Airport has not provided a discrete charge for baggage handling for PSE2 despite proposals from airlines to only be charged for bags that use the baggage sortation system. Air New Zealand submits that a discrete baggage handling charge would reflect their airfare structure which allows customers to make a choice about the value of their baggage.[111] Wellington Airport has explained that a discrete baggage handling charge was not introduced for PSE2 as there were technical complexities to doing so.[112]

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different terminals, and the differences in the cost of these facilities, rather than any difference in their responsiveness to higher charges. See Wellington Airport "Wellington International Airport Limited: Price setting event disclosure for the pricing period 1 July 2007 to 31 March 2012" 31 October 2011, page 17.

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

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

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

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

D33.2 Wellington Airport abandoned the separate charge for air bridge use levied in PSE1, although both Air New Zealand and BARNZ requested the continuation of this discrete charge. Wellington Airport has explained that a separate air bridge could not be justified economically as it may discourage customers from using existing infrastructure.[113] They also submitted that they are unable to provide alternative gate facilities for jet aircraft if the air bridge is not used.[114]

D33.3 The airlines suggest that the cost of the investment in the Runway End Safety Areas (RESAs) required to accommodate larger aircraft should be borne by operators who require this specification.[115]

D33.4 The airlines submitted that domestic passengers should not bear the cost of 'The Rock' international terminal, as they do not benefit from it and it does not reflect their demands.[116]

D34 Disagreement between the airlines and Wellington Airport does not necessarily indicate that Wellington Airport's prices do not enable price-quality trade-offs. However, it may indicate that further refinements to the pricing methodology are possible and would incorporate best practice from other airports where these airlines operate.

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

D35 Wellington Airport appears to have considered the impact of any price shocks on consumers during PSE1 and PSE2. While there is no discernible improvement in Wellington Airport's pricing methodology for PSE2 in respect of transparency, price stability and certainty, this does not appear to be a concern. This is because submissions have not indicated that improvements to the PSE1 pricing methodology were required in this area.

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

114 Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, paragraph 216.

115 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 27; Air New Zealand "Post-conference Cross Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Wellington International Airport Limited" 17 August 2012, paragraph 112.

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

D35.1 For PSE1, Wellington Airport implemented an annual change in charges, rather than a single increase at the start of the pricing period in response to comments from substantial customers.

D35.2 Wellington Airport applied a uniform increase to all charges from PSE1, rather than setting charges to ensure that revenues would be sufficient to recover costs for each individual activity. It states that this was to avoid any unnecessary volatility in the forecast prices.[117]

D35.3 Wellington Airport's disclosure for PSE2 highlights that congestion charging will be implemented gradually from 2013 to provide airlines with an opportunity to consider their operational responses to the new pricing structure.[118]

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

D36 Our analysis focuses on the impact of the pricing methodology on Wellington Airport's ability to earn excessive profits. Other factors that drive profitability are discussed in the Attachment E.

D37 Based on submissions and information available at this time, we do not consider Wellington Airport is likely to earn excessive profits as a result of their pricing methodology. Wellington Airport's overall demand forecast for PSE2 is considered by the airlines to be more appropriate than the PSE1 demand forecast, and is therefore unlikely to result in excessive profits. However, we consider that excessive profits may be earned if the discounts provided for in the volume growth incentive scheme are not triggered. Airlines have raised a number of concerns about the introduction of this incentive scheme, which are discussed below. An assessment of actual performance in this area is required before we can fully conclude whether Wellington Airport's pricing methodology is likely to lead to excessive profits.

Appropriateness of Wellington Airport's demand forecast

D38 Wellington Airport has an incentive to under-forecast the demand used to derive its pricing methodology so as to earn higher profits. Prices are set through the pricing methodology by assuming a volume forecast for each charged service. If volumes are then higher than assumed in the pricing methodology, Wellington Airport will receive higher total revenue than required and likely higher returns. However, higher volumes may also be a result of factors outside Wellington Airport's control, or due

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

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

to superior performance in attracting additional passengers and aircraft over the regulatory period.

D39 Based on submissions, we consider that Wellington Airport's overall demand forecasts for PSE2 are unlikely to result in excessive profits and are more realistic than the demand forecasts used to determine the pricing methodology at PSE1.[119] Air New Zealand and BARNZ submitted that the overall domestic passenger and aircraft movement forecasts for PSE2 were reasonable, and BARNZ also considers the international forecasts to be reasonable.[120] In contrast, BARNZ and Air New Zealand did not consider the demand forecasts for passenger forecasts for PSE1 to be reasonable.[121] Wellington Airport's actual domestic passenger volumes were 5% higher than forecast during PSE1 while international passenger volumes were 2% higher. Partly as a result, total revenue over the period was 11% higher than forecast.

Impact of the volume growth incentive scheme on Wellington Airport's profits

D40 Wellington Airport has introduced a volume growth incentive scheme for PSE2. The incentive scheme provides short-term discounts on some aeronautical charges to airlines that increase capacity beyond defined thresholds.[122] The expected cost of these discounts is effectively funded by airlines through the pricing methodology set for PSE2.[123] Wellington Airport submitted that the increased passenger volumes resulting from this incentive scheme will benefit passengers as it will reduce the average aeronautical price per passenger relative to the removal of the scheme.[124]

D41 If the discounts provided for in the volume growth incentive scheme are not triggered, Wellington Airport may earn excessive profits beyond those discussed in Attachment E. However, we are not sufficiently expert in this area to take a view on whether the incentive scheme is likely to be triggered.

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

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

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

122 For more information, see Wellington Airport "Airline Pricing Consultation – for pricing to apply from 1 April 2012: Final Pricing Document" 1 March 2012, page 155.

123 Calculated based on Wellington Airport's pricing structure model for the second pricing period.

124 Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 152.

D42 Air New Zealand submitted that individual airlines will not meet the threshold to qualify for the discount, resulting in Wellington Airport retaining the funded cost of the incentive scheme, equivalent to around $11 million.[125] We have tested the impact on Wellington Airport's revenue and return of increases in volumes similar to those expected by the incentive scheme, but without the incentive scheme being triggered by an individual airline. If the volumes forecast as a result of the incentive scheme were achieved without the incentive scheme being triggered, Wellington Airport would earn a return of 12.6% compared to our lower estimate of a 12.3% return over PSE2 and beyond if the incentive scheme was triggered.[126] This is above the Commission's estimate of an appropriate cost of capital, and higher than the return target specified by Wellington Airport in its building block model.

D43 Air New Zealand and BARNZ expressed concern that the incentive scheme is funded by aeronautical activities, but will likely result in increased revenues for non-aeronautical activities as increased capacity on routes would increase demand for non-aeronautical services such as car parking and retail.[127] This may not necessarily lead to excessive profits, unless there is cross-subsidisation (as defined in paragraph D18) or efficiency gains resulting from any economies of scale as passenger volumes increase are not shared with consumers. Wellington Airport notes that economies of scale are being shared as charges are lower as a result of the increased volumes resulting from the incentive scheme.[128]

Does Wellington Airport's conduct indicate that it seeks to improve the efficiency of its pricing?

D44 Overall, we consider that Wellington Airport's conduct in setting the pricing methodology for PSE2 shows that it seeks to improve the efficiency of its prices. Wellington Airport's pricing methodology for PSE2 shows greater consideration of efficient pricing principles than previously. Wellington Airport also commissioned economic experts to advise them on efficient pricing principles during consultation for PSE2 and adopted many, although not all, of their recommendations. However,

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125 Air New Zealand has expressed concern that while overall volumes may increase in response to the incentive scheme, individual airlines are unlikely to meet the defined threshold to trigger the application of the discounts. They submit that this will allow Wellington Airport to retain the funded cost of the incentive scheme, and will therefore result in excessive profits. Wellington Airport anticipates that the thresholds will be met by individual airlines. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 271; Wellington Airport "Cross submission to the Commerce Commission: Section 56G Process and Issues Paper" 20 July 2012, paragraph 157.

126 For more information on how the 12.3% estimate is derived, see Attachment E.

127 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 270; BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 20.

128 Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 248.

submissions received as part of this s 56G review and discussed above indicate that the airlines have expressed a number of concerns with Wellington Airport’s pricing methodology.

Attachment E: Is information disclosure limiting Wellington Airport's ability to extract excessive profits?

Purpose

E1 This attachment contains our analysis and conclusions on how effectively information disclosure regulation is promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits (s 52A(1)(d) of the Act).

E2 For the purpose of this s 56G review, profitability is measured as the returns achieved or expected by a supplier from its operations over time relative to the value of the assets employed in those operations. A supplier's profitability can be compared against the cost of capital to assess whether it is earning a reasonable economic return over time, or whether its profits are excessive.[129] Further discussion of our approach to assessing Wellington Airport's profits is provided in Attachment F.

Conclusion

E3 Our conclusion is that information disclosure regulation at this time has not been effective in limiting Wellington Airport's ability to extract excessive profits over time. This is because Wellington Airport has set prices with knowledge that the resulting return when the information disclosure framework is applied (estimated by Wellington Airport to be 8.9%[130]) is expected to exceed the Commission's estimate of an appropriate return of 7.1% to 8.0%.[131]

E4 Our analysis of Wellington Airport's expected performance indicates that expected returns from 1 April 2012 over the remaining life of the assets (ie, PSE2 and beyond) are likely to be 12.3% and could be as high as 15.2%, which is substantially higher than our estimates of an appropriate return in a competitive market (7.1% to 8.0%). Wellington Airport has not provided evidence of superior performance to justify this level of expected returns in PSE2.

E5 Excessive profits are largely attributable to a combination of two factors. In setting its prices for PSE2:

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129 This report uses post tax nominal measures of economic returns and the cost of capital unless otherwise stated.

130 Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 59. The methodology used by Wellington Airport to calculate this return is not intended to estimate the return over the lifetime of the assets. However, the return generated using this methodology is equivalent to an IRR, which is the return over the lifetime of the assets, using the rolled forward 2012 disclosed RAB as the closing asset base.

131 We use returns as the measure of Wellington Airport's profits.

E5.1 Wellington Airport has valued its land assets higher than expected in a workably competitive market; and

E5.2 Wellington Airport is targeting a return higher than appropriate for an airport business with a similar level of risk in the market conditions that prevailed when PSE2 occurred.

E6 In present value terms, our estimated returns range of 12.3% and 15.2% is equivalent to excess returns of between $81.2 million and $138.5 million for PSE2 and beyond.[132] These are returns in excess of what would likely be expected by Wellington Airport if it received a return that reflects outcomes in workably competitive markets.[133]

E7 Table E1 shows the range of excess returns we consider Wellington Airport will earn, broken down by the excess returns they will earn for PSE2 and over the remaining life of the assets.

Table E1: Present value of excess returns earned by Wellington Airport

	Lower estimate	Higher estimate
Excess returns over PSE2 (2013–2017)	$19.7m	$46.1m
Excess returns from 2017 over remaining life of assets	$61.5m	$92.4m
Total excess returns from 2013 over remaining life of assets	$81.2m	$138.5m

Note: The excess returns for PSE2 are based on Wellington Airport's announced prices for PSE2. The excess returns over the remaining life of the assets (ie, from the beginning of the next pricing period) are based on an assumption that Wellington Airport will continue to price in a similar manner to PSE2.

E8 Our estimate of the range of the excess returns earned by Wellington Airport has been determined by assumptions about:

E8.1 whether the more appropriate land valuation is that disclosed by Wellington Airport, or the alternative provided by BARNZ's valuers;

E8.2 whether cash flows occur at the end or middle of the year; and

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132 We define returns as the measure of Wellington Airport's profits. Excess profits have been presented in present value terms. This reflects the dollar value as at the start of PSE2 discounted to reflect the time value of money.

133 In workably competitive markets, firms expect to earn their cost of capital over time and would only expect to earn higher than this as a result of superior performance. The estimate of excess returns earned by Wellington Airport is based on the cash flows expected to be generated by Wellington Airport as a result of the prices they set for PSE2 and assuming that they continue to value their assets higher than expected in a workably competitive market.

E8.3 whether Wellington Airport's returns are assessed relative to the 75th percentile or midpoint of the Commission's estimated cost of capital.

E9 To understand the impact of Wellington Airport's pricing decision on consumers, we also quantified the 'excess revenues' Wellington Airport would expect to earn over the five-year period of PSE2. This helps to understand the impact on consumers because excess revenues represent the extent to which consumers are over-charged. We estimate that Wellington Airport will earn at least $38.3 million to $68.9 million of excess revenue in PSE2, which is 10.4% to 20.3% higher than the revenues considered appropriate.[134] The calculation of excess revenues differs from that of excess returns in that unlike returns, the revenues are a pre-tax measure and we have not discounted them to a present value.

E10 Our analysis of Wellington Airport's conduct indicates that they set prices with the knowledge that this would result in a return which exceeds the Commission's estimate of the appropriate level. Wellington Airport's understanding of how information disclosure rules would be applied suggests that that they considered their expected return based on PSE2 prices would be 8.9%. This is higher than our estimates of an appropriate return in a competitive market (7.1% to 8.0%). Wellington Airport has not provided evidence of superior performance which might justify targeting these higher returns.

E11 Incentives for airports to price consistent with the Part 4 purpose could be strengthened if each airport were required to disclose an indicator of its expected returns comparable to its cost of capital, along with the other information disclosed following a price-setting event. Under the current disclosure requirements, after each price-setting event airports must disclose information about how they have set their current and future prices. However, airports are not required to disclose an indicator of their expected returns for the relevant pricing period. This indicator could be derived in the same way we have estimated expected returns in this s 56G review (ie, an IRR calculation that uses the IM compliant asset value as the opening asset value, and for the closing asset value uses an estimate of the asset base expected to provide the basis for setting prices in the subsequent pricing period).

E12 Wellington Airport, in its submission on the draft report, identified four arguments against our conclusion that it has not been limited in its ability to earn excessive profits. The arguments and our responses to those arguments are outlined below.

E12.1 Wellington Airport considers that a land valuation approach of market value alternative use (MVAU) plus airport conversion costs is more reflective of a competitive market. As discussed in paragraph F20.1, we consider an MVAU

134 The range is based on the revenues required to generate a return based on the Commission's 75th percentile and midpoint of the cost of capital respectively, and uses Wellington Airport's land valuation. Higher excess revenues would be earned if the BARNZ alternative land valuation was used.

valuation is most consistent with the value of assets in a workably competitive market.[135]

E12.2 Wellington Airport considers that it should be assessed using its own weighted average cost of capital (WACC) which reflects company specific risks. As discussed in paragraphs F45 to F50, we consider our estimated cost of capital, as specified in the input methodologies, to be the best approach.

E12.3 Wellington Airport considers that the terminal wash-up should be recognised as reducing revenues in PSE2 and not be adjusted for. As discussed in paragraphs F55 to F59, we consider that adjusting for the terminal wash-up, so its effect on reducing revenue is accounted for in PSE1, represents the most appropriate matching of cash flows to investment.

E12.4 Wellington Airport considers the use of the forecast pricing asset base as the closing asset base in the IRR calculation is inappropriate. As discussed in paragraphs F20, we consider that using the forecast pricing asset base as the closing pricing asset base provides the best estimate of Wellington Airport's expected future cash flows if it were to continue its current pricing behaviour with regards to asset valuation.

How we have structured the analysis in this attachment

E13 The analysis in this attachment outlines:

E13.1 how we have assessed the effectiveness of information disclosure;

E13.2 Wellington Airport's expected profitability, and why we consider this is excessive; and

E13.3 whether Wellington Airport's conduct indicates that they seek to earn a reasonable economic return over time.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to limit excessive profits

E14 Without information disclosure regulation, Wellington Airport has weak incentives to limit excessive profits. Wellington Airport has market power and may therefore

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[135] Many past investments in the conversion of land for use as an airport will have already contributed to the market value of land in an alternative use. These costs will therefore already be reflected in a higher MVAU valuation than would otherwise have been the case (eg, levelled land is typically more valuable than unlevelled land). However, recognition of past investments relating to land conversion is appropriate in the regulatory asset base where the expenditure has been incurred relatively recently and would not be expected to affect the value of land in an alternative use. The IM-compliant asset base includes such investments, but they are recognised as specialised assets rather than land (eg, the Runway End Safety Area at Wellington Airport).

choose to set prices that result in excessive profits. The potential countervailing power of airlines and competition between airports for some routes may provide some incentives to constrain profits, but are not expected to significantly constrain Wellington Airport's market power.

How information disclosure can provide incentives to limit excessive profits

E15 As discussed in Chapter 2, information disclosure under Part 4 is intended to provide incentives for Wellington Airport not to extract excessive profits. The public disclosure of information on Wellington Airport's returns provides transparency about whether Wellington Airport is earning, or is expected to earn, a return that exceeds the Commission's estimate of returns earned in workably competitive markets (ie, the IM compliant cost of capital estimate). This transparency, combined with the threat of further regulation, is expected to deter the regulated airports from setting prices that result in excessive profits.

We expect that any impact from information disclosure should be able to be identified at this stage

E16 The effectiveness of information disclosure in limiting Wellington Airport's ability to extract excessive profits should be able to be identified at this stage as discussed in paragraphs A34 to A54. This is because the input methodologies (IMs) applicable to information disclosure under Part 4 provide benchmarks against which to assess whether Wellington Airport's profits reflect the levels of profitability that could be expected in a workably competitive market.[136] The input methodologies were available to Wellington Airport at the time it set its prices for PSE2, and could therefore have influenced their conduct and performance at the time.

How we have assessed whether Wellington Airport is earning excessive profits

E17 We have assessed whether information disclosure regulation is effectively limiting Wellington Airport's ability to extract excessive profits by examining the performance and conduct of Wellington Airport in relation to its expected returns.

E18 In assessing Wellington Airport's performance, we have calculated the return we expect Wellington Airport will earn based on the prices it set for PSE2 and forecast traffic. We compare this expected return to the Commission's estimates of the cost

[136] Input methodologies for information disclosure under Part 4 of the Act allow profitability to be measured on a consistent basis across suppliers and over time. A primary indicator of a benchmark level of normal profits achieved in a competitive market is provided by the cost of capital input methodology which estimates a supplier's weighted average cost of capital (WACC). A level of profitability that exceeds the estimate of WACC indicates that the supplier is achieving or will expect to achieve profits in excess of that which is required to meet the supplier's costs of debt and equity. Unless otherwise specified our analysis has allowed for estimates of the Term Credit Spread Differential (TCSD) in calculations of returns.

of capital that would be expected for businesses with similar risk at the time prices were set.

E19 We have measured Wellington Airport's return using an internal rate of return (IRR) approach.[137] The IRR allows an assessment of returns across the remaining lifetime of the assets.

E20 In assessing Wellington Airport's conduct, we have considered the return that Wellington Airport might have expected the Commission to estimate based on information disclosed in accordance with the Part 4 information disclosure regime. This analysis helps us to understand whether Wellington Airport set prices knowing that the resulting profits would be excessive considering the Commission's published framework for analysis (the IMs).

E21 Our conclusion on profitability was reached only after considering the other areas of performance relevant to this aspect of the Part 4 purpose, such as improvements to the efficiency of their operational expenditure. Superior performance in these other performance areas may result in a return higher than the Commission's estimate of the cost of capital, but which is not considered excessive.

E22 Unlike many of the other aspects of performance set out in chapter 2, our conclusion on whether Wellington Airport has been able to extract excessive profits does not require detailed comparison of performance prior to and subsequent to the introduction of information disclosure under Part 4. Instead, the cost of capital set out in the IMs provides an absolute standard (or benchmark) against which to measure performance. As such, our conclusions on the effectiveness of information disclosure regulation under Part 4 are not based on the returns achieved by Wellington Airport over PSE1.

Information used to assess whether Wellington Airport is earning excessive profits

E23 Our analysis relies on:

E23.1 historic and forecast data provided in the Part 4 information disclosures;

E23.2 information provided by Wellington Airport and other parties to the Commission as part of this s 56G review. This includes expert advice provided to the Commission on airport land valuation;[138] and

E23.3 information made publically available by Wellington Airport as part of its consultation process for PSE2. This information is not required to be disclosed as part of information disclosure regulation under Part 4.

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137 A discussion of why we have used an IRR methodology is provided in Attachment F.

138 We have consulted with Wellington Airport on the advice received from our airport land valuation expert and have consider Wellington Airport's responses in drawing our conclusions.

Analysis of Wellington Airport's profitability performance and conduct

Has Wellington Airport set prices to earn an appropriate economic return over time?

E24 Using the IRR approach, our estimate of the range of the returns expected by Wellington Airport for PSE2 and beyond is 12.3% to 15.2%. Our estimate of the returns that would be earned in a workably competitive market by businesses with similar risk, found by applying the cost of capital input methodologies is 7.1% to 8.0%.

E25 Given the significant margin by which Wellington Airport's expected profits exceed the comparable estimates of the cost of capital under input methodologies, we have concluded that, in the absence of adequate justification in terms of the other outcomes sought under Part 4, the expected profits are excessive within the meaning of s 52A(1)(d) of the Act.

E26 Analytically, our estimate of the returns presently expected to be earned by Wellington Airport from 1 April 2012 over the remaining life of the assets is 12.3%. Further details on the assumptions used and approach taken to estimate and assess this return are provided below, along with sensitivity analysis.

Value of assets used to estimate the return

E27 Wellington Airport's return is assessed relative to the value of its assets over time. Our estimate of the IRR therefore requires assumptions on the value of Wellington Airport's assets for regulated activities at the beginning of our period of analysis (the opening asset base) and at the end of the analysis period (the closing asset base).

E27.1 Our analysis uses the value of assets disclosed in the information disclosure by Wellington Airport at the beginning of PSE2 as the opening regulatory asset base.[139]

E27.2 Our analysis uses the value of assets used by Wellington Airport to set prices for PSE2 as the estimate of the closing regulatory asset base (closing pricing asset base).[140] This valuation is not consistent with the input methodologies, as discussed in paragraph F19, and results in a significantly higher asset base against which to set prices than defined in the input methodologies. At this point in time and based on the available evidence, we consider it is reasonable to assume that, at the very least, Wellington Airport expects to

[139] Potential compliance issues have been raised regarding the land valuation provided by Wellington Airport through information disclosure. This is discussed further in Attachment F. As such we cannot describe the asset values provided under information disclosure as IM compliant. When discussing our estimation of Wellington Airport's return we refer to the 2012 disclosed RAB as the opening asset value.

[140] The asset base has been rolled forward. This means that we have taken the opening asset value and used forecast estimates of capital expenditure, depreciation and indexed revaluations to estimate the changing value of the asset base over the pricing period.

set prices for PSE3 and beyond based on the pricing asset base for PSE2, ie, that Wellington Airport will continue its current behaviour with regards to asset valuation. We recognise that if Wellington Airport were not to use their pricing asset base to set prices beyond PSE2 then the expected future return would differ from that estimated in this report.

Treatment of terminal wash-up

E28 The terminal wash-up is an arrangement entered into by Wellington Airport in PSE1 which compensates airlines for a delay in capital expenditure in PSE1 by reducing charges in PSE2. This arrangement was triggered by the delay in the construction of "The Rock" in PSE1. For the purpose of setting prices in PSE2, Wellington Airport has recognised this triggered wash-up as a reduction in PSE2 revenues to offset the over-recovered revenues in PSE1. Therefore, the wash-up is not treated by Wellington Airport as a liability for the PSE1 period.

E29 We do not consider this reflects an appropriate matching of cash flows to investment. Analytically, we consider this returned revenue should be treated as a reduction in overall PSE1 revenues received and that PSE2 revenues should be increased accordingly. Our approach increases Wellington Airport's total forecast revenue for PSE2 by the value of the terminal wash-up. For further discussion see paragraphs F56 to F58.

Cash flows assumed to occur at the year-end

E30 Our analysis assumes that cash flows (eg, staff wages, revenues received) occur at Wellington Airport at the end of the year. This is a conservative assumption, and does not reflect actual cash flows at Wellington Airport. As a result, our estimated return is a lower bound.

Wellington Airport's expected return significantly exceeds the Commission's estimate of the cost of capital

E31 The IRR is compared to the Commission's estimate of the midpoint and 75th percentile cost of capital, as defined in the input methodologies. We consider the midpoint cost of capital to be appropriate starting point for any assessment of profitability for Wellington Airport while the 75th percentile cost of capital allows for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment.

E32 We have considered whether there is any other reason that would justify this level of return beyond our estimate of the cost of capital. No evidence or explanation of superior performance or for the existence of external conditions outside the control of Wellington Airport has been presented to us during the course of our s 56G review to justify the existence of this return. Further, our analysis in this report of the other aspects of performance relevant to the Part 4 purpose for Wellington Airport has not indicated superior performance.

Sensitivity analysis

E33 Our estimate of the expected return for PSE2 and beyond is subject to sensitivity testing in order to test the impact on performance of key assumptions.

E33.1 We have tested the impact of assessing Wellington Airport's return using the alternate valuation of Wellington Airport's land assets supplied by BARNZ.[141] This results in a lower regulatory asset base than provided by Wellington Airport in information disclosure. Using BARNZ's valuation for the land component of the opening asset base results in an expected post-tax return for PSE2 and beyond of 14.4%.[142]

E33.2 We have tested the impact of assuming cash flows will occur mid period rather than at the end of the period (as is assumed to obtain the 12.3% estimate).[143] This results in an expected post tax return for PSE2 and beyond of 12.9%. This represents the least conservative reasonable cash flow timing assumption.

E33.3 We have tested the impact of using the alternative BARNZ land valuation in conjunction with mid period cash flows. This would lead to an expected post-tax return for PSE2 and beyond of 15.2%.

E33.4 We have tested the potential impact on Wellington Airport's return of increases in volumes similar to those expected by the incentive scheme, but without the incentive scheme being triggered by an individual airline. This issue is discussed further in paragraphs D40 to D43. This would lead to an expected post tax return for PSE2 and beyond of 12.6% compared to our lower estimate of 12.3%.

Magnitude of excess returns earned by Wellington Airport

E34 We have estimated the present value of excess returns, based on our estimated range of returns, likely to be earned at Wellington Airport is between $81.2 million

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141 For further discussion of the alternative land valuation provided by BARNZ refer paragraph F23.

142 Our estimate of the impact of using BARNZ's alternative land valuations differs from that published in the draft report. This is because in the draft report, we were unable to test sensitivity analysis on our preferred measure of the seven year IRR as it included two years of actual data that could not be sensitised. Therefore, in the draft report sensitivity analysis was conducted on the five year IRR using the rolled-forward 2012 disclosed RAB as the closing asset base which generated a more conservative estimate of the impact of using the BARNZ alternative land valuation.

143 Consistent with return on investment values disclosed for part years under the information disclosure requirements, the expected post tax return has been calculated using an assumption of end of period cash flows (except in the case of capital expenditure, which is assumed to occur mid period). This is a conservative assumption as it is most likely that cash flows are likely to be spread over the period and will therefore occur on average earlier than the end of the period.

and $138.5 million for PSE2 and beyond.[144] This is our estimate of the present value of excess cash flows expected to be generated by Wellington Airport for PSE2 relative to the equivalent cash flows expected to be generated to recover the IM compliant cost of capital. [145]

E35 Table E2 provides the range of excess returns for the PSE2 period and the period beyond that makes up this total. The value of returns flows is dependent on whether it is compared to the midpoint or 75th percentile of our estimated cost of capital, the opening regulatory asset base, and the assumed timing of cash flows.

Table E2: Estimated present value of excess returns at Wellington Airport

Scenario	**2012 disclosed RAB as opening asset base** **End of period cash flows**	**BARNZ adjusted opening asset base** **Mid period cash flows**
Cost of capital comparator	**75th percentile**	**Midpoint**
Excess returns over PSE2 period (2013–17)	$19.7m	$46.1m
Excess returns from 2017 over remaining life of assets	$61.5m	$92.4m
Total excess returns from 2013 over remaining life of assets	$81.2m	$138.5m

Notes: The estimated net cash flows include the revaluation wash-ups implied by the use of a revalued asset base for pricing purposes, but do not include the terminal wash-up as we have attributed that to PSE1.

E36 The present value of the excess revenues presented above for the period beyond 2017 is likely to be understated if Wellington Airport continues to price using its pricing asset base because the calculation implicitly assumes no capital expenditure and a normal level of returns being earned over the remaining life of the assets.

144 We have quantified the excess returns as being any amount above returns expected in recovering the IM compliant cost of capital. A return in excess of an IM compliant cost of capital is not on its own indicative of excessive profits. A determination of whether excessive profits are expected to be earned can only be drawn after consideration of other factors including superior performance.

145 The cash flow inputs for the calculation of excess returns for Wellington Airport are forecast revenue (excluding gain/loss on sale) less opex less value of commissioned assets plus cash received from disposals less tax less term credit spread adjustment. The present value of this is compared to the present value of the same cash flow inputs generated from the use of the 2012 disclosed regulatory asset base (RAB) and the Commission’s cost of capital estimate.

Impact of excess returns on consumers

E37 We estimate that Wellington Airport will earn at least $38.3 million to $68.9 million excess revenues over the five-year period of PSE2 (without discounting).[146] This is 10.4% to 20.3% higher than we consider appropriate. Unlike the estimation of excess returns, excess revenues are calculated on a pre-tax basis. The quantification of excess revenues helps to understand the impact on consumers because excess revenues represent the extent to which consumers are over-charged. Therefore, we have also calculated the excess revenues expected to be earned by Wellington Airport over PSE2.

E38 Table E3 provides the range of excess revenues expected to be received from consumers for the PSE2 period. These values have not been adjusted to reflect the present value of this revenue, as the appropriate discount rate for consumers is not readily quantifiable. This analysis also uses the land valuation provided under information disclosure by Wellington Airport as the opening asset value. Higher excess revenues would be expected to be earned if the alternative land valuation provided by BARNZ had been used. As such, the excess revenues could be higher than shown here.

Table E3: Excess revenues received by Wellington Airport over PSE2

	($000)
Forecast revenue based on PSE2 prices	407,672
Forecast revenue required to achieve 75th percentile of Commission’s cost of capital	369,409
Forecast revenue required to achieve midpoint of Commission’s cost of capital	338,750

Source: Commerce Commission’s final s56G review technical calculations for Wellington Airport

Does Wellington Airport’s conduct indicate that it seeks to earn an appropriate economic return over time?

E39 We have considered whether Wellington Airport’s conduct is likely to limit its expected excessive profits. We have concluded:

E39.1 Wellington Airport has set prices for PSE2 with the knowledge that this exceeded the Commission’s estimate of the cost of capital, and therefore an appropriate economic return;

146 The range is based on the revenues required to generate a return based on the Commission’s 75th percentile and midpoint of the cost of capital respectively, and uses Wellington Airport's land valuation. Higher excess revenues would be earned if the BARNZ alternative land valuation was used.

E39.2 Wellington Airport's approach to asset valuation methodologies adopted for pricing purposes for PSE2 results in land values higher than those consistent with those found in workably competitive markets; and

E39.3 Wellington Airport has changed its approach to asset revaluations and their cost allocation methodology from PSE1 to PSE2 in line with input methodologies. However, this will not have a material impact on estimates of profitability.

E40 Attachment A provides a discussion of why we think the IMs are a relevant basis for assessing whether Wellington Airport is earning excessive profits.

Wellington Airport has set prices with the knowledge that this exceeded the Commission's estimate of the cost of capital

E41 No forward-looking indicator of returns is currently required to be disclosed under information disclosure regulation. However, we have considered the forecast return that Wellington Airport might have expected the Commission to estimate from the start of the PSE2 period, given Wellington Airport's knowledge of the information disclosure requirements and the relevant IMs underpinning those requirements.

E42 In Wellington Airport's post-conference submission, Wellington Airport stated that its expected return estimated using Wellington Airport's assessment of an IM consistent asset base would be 8.9%.[147] This does not include the impact of leased assets and noise mitigation activities and therefore does not precisely match the information disclosure requirements. We estimate that had Wellington Airport included all specified airport services, the return for PSE2 and beyond would be 8.7%. However, we consider that Wellington Airport's estimate of 8.9% return represents the level of return that the airport might have expected to achieve consistent with information disclosure for the PSE2 period and is equivalent to using the rolled forward 2012 disclosed RAB as the closing asset value.

E43 We consider Wellington Airport's estimate of returns to be conservative. Wellington Airport's estimate of returns treats the terminal wash-up as a reduction in revenue in PSE2. As discussed in paragraph F55 to F59, our treatment of the terminal wash-up is to attribute the reduction in revenue to PSE1. Had the impact of the terminal wash-up been removed from PSE2, the expected return for all specified services would be 9.1% for PSE2 and beyond. This is based on using the 2012 disclosed RAB as the opening asset value and rolling this forward for the closing asset value.

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[147] Wellington Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, paragraph 59. This return reflects Wellington Airport's forecast revenues (treating the terminal wash-up as a commercial concession which reduces revenues over the PSE2 period) and an MVAU based land valuation. The terminal wash-up is an arrangement entered into by Wellington Airport in PSE1 which compensates airlines for a delay in capital expenditure in PSE1 by reducing charges in PSE2.

E44 Wellington Airport's estimate of returns under information disclosure is 1.8 percentage points higher than the Commission's midpoint cost of capital estimate of 7.1%, and 0.9 percentage points higher than the 75th percentile cost of capital estimate of 8.0%. Wellington Airport has not provided evidence of superior performance which might justify these higher returns.

Asset valuation

E45 Wellington Airport's conduct when valuing assets for PSE2, combined with their targeted cost of capital, does not result in outcomes consistent with those found in workably competitive markets. The IMs outline that such an outcome would mean that land is valued based on its market value alternative use (MVAU) only.[148] Wellington Airport has chosen an approach resulting in a significantly higher land value. They have valued land based on the MVAU and include the value of converting land to use as an airport[149] resulting in a market value equivalent use (MVEU) value.[150] Table E4 highlights the differences between the value of the rolled forward 2012 disclosed RAB and the pricing asset base for each year of PSE2. [151]

Table E4: Assessment of forecast regulatory investment value for PSE2

($000s)	2013	2014	2015	2016	2017
Rolled forward disclosed asset base	423,906	437,588	455,404	460,868	459,971
Pricing asset base	502,220	518,219	538,419	546,547	544,740

Source: The roll forward of the 2012 disclosed RAB and the pricing asset base are based on calculations provided in the Commerce Commission's final s56G review technical calculations for Wellington Airport.

Changes in approach to asset revaluations and cost allocation

E46 Our analysis of Wellington Airport's conduct has focussed on PSE2 because, as stated in paragraph E22, we have an absolute standard against which to measure expected performance. However, we have noted some changes from PSE1 to PSE2 in response to the introduction of information disclosure.

E47 Wellington Airport has adopted an approach to treating asset revaluations that would result in outcomes in this area consistent with the IMs. They have assumed that assets are revalued annually based on assumed CPI, and has accounted for

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148 Commerce Commission, "Input Methodologies (Airport Services) Reasons Paper", December 2010, paragraph 4.3.2.

149 See footnote 137.

150 Wellington Airport "Initial pricing proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 42.

151 Input methodologies require the asset value used for returns assessment to be the regulatory investment value or RIV, which is defined as being the opening regulated asset base plus the proportionate annual investment in capital expenditure.

these revaluations as income. This is consistent with the input methodologies. Wellington Airport has signalled that this approach was adopted to ensure consistency with the information disclosure regime. [152]

E48 The cost allocation methodology has changed since PSE1 from an expenditure line allocation approach to an activity-based cost allocation approach. This latter approach is consistent with the IM and provides another example of Wellington Airport aligning its conduct with the input methodologies. However, we also note another change in treatment with regards to the inclusion of the terminal hall within the aeronautical asset base. This is discussed further in paragraphs F65 to F66.

E49 While we have noted these changes to Wellington Airport's approach since the introduction of information disclosure, we do not consider these to have a material impact on the expected returns for PSE2.

Enhancements to the information disclosure requirements may provide stronger incentives to limit excessive profits

E50 Incentives for airports to price consistent with the Part 4 purpose could be strengthened if each airport were required to disclose an indicator of its expected returns comparable to its cost of capital, along with the other information disclosed following a price-setting event. Under the current disclosure requirements, after each price-setting event airports must disclose information about how they have set their current and future prices. However, airports are not required to disclose an indicator of their expected returns for the relevant pricing period. This indicator could be derived in the same way we have estimated expected returns in this s 56G review (ie, an IRR calculation that uses the IM compliant asset value as the opening asset value, and for the closing asset value uses an estimate of the asset base expected to provide the basis for setting prices in the subsequent pricing period). This would better serve the aim of increasing transparency and allowing interested persons to assess whether excessive profits have been made.

E51 The inclusion of such an indicator would require additional information requirements than currently provided for under information disclosure, particularly information about the asset base expected to be used to set prices on an on-going basis which is not currently provided through information disclosure.

E52 This recommendation does not change our conclusion. Wellington Airport targeted returns well above what it knew would be considered appropriate under the Commission's information disclosure framework. Rather the recommendation seeks to close the gap between the returns measured under the information disclosure

[152] Wellington Airport "Initial pricing proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 50.

framework and a returns measurement that accounts for Wellington Airport’s approach to asset valuation.

Attachment F: Supplementary material on our analysis of Wellington Airport's returns

Purpose

F1 This attachment contains further detail on our approach to assessing whether Wellington Airport is earning excessive profits discussed in Attachment E. It also addresses key issues raised in submissions on our approach to assessing Wellington Airport's profitability.

Structure of this attachment

F2 The remainder of this attachment is structured as follows:

F2.1 paragraphs F3 to F17 discuss why we assess returns using the internal rate of return (IRR) approach, why we considered a five-year IRR assessment was appropriate, and our assumptions on cash flow timings for the IRR;

F2.2 the key areas of disagreement between parties, and our decisions in these areas are discussed in paragraph F18 to paragraph F66. These areas are:

F2.2.1 the approach to valuing assets, in particular airport land;

F2.2.2 the cost of capital and the assumptions underlying this cost of capital;

F2.2.3 the treatment of wash-ups; and

F2.2.4 the allocation of food court space.

F2.3 information on the activities included in our analysis of returns is provided in paragraphs F67 to F68;

F2.4 paragraph F69 to paragraph F71 discuss the limitations of the information used in our analysis, including information relating to the issues discussed above.

Use of the internal rate of return to assess profitability[153]

The IRR estimates a return relative to the value of Wellington Airport's assets

F3 The regulatory asset value provides an appropriate baseline against which profits can be assessed. In a workably competitive market, the value of a supplier's assets depends on their expected profits in the future which are themselves dependent on

[153] The internal rate of return (IRR) is the discount rate that results in the sum of net cash flows, discounted using that IRR, equalling the initial capital outlay.

expected prices that are constrained by competition.[154] A monopoly service provider such as Wellington Airport is not subject to the same constraints on their prices and therefore their profits. Consequently, their unconstrained profits would not be an appropriate reference point for establishing an asset value against which to assess returns (or for setting regulated prices). Such an asset value would be based on, and could lead to, future monopoly pricing. We have set an IM for establishing the regulatory asset value of Airports regulated under Part 4, including for Wellington Airport.[155]

We consider the IRR is a more appropriate measure than the return on investment

F4 Our analysis of Wellington Airport's returns is based on its internal rate of return (IRR). We have used the IRR, rather than estimating its return on investment (ROI) which would be consistent with information disclosure, as it avoids problems associated with the short-term variability in returns.

F5 Information Disclosure regulation under Part 4 requires airports to disclose an ROI. The ROI is an annual, single period profitability indicator which measures the airport's net income against its regulatory asset values at the end of each prior disclosure year. The ROI is intended to be comparable to the Commission's estimated weighted average cost of capital (WACC).

F6 Analysis of returns using the ROI for Wellington Airport could be distorted by the revaluation of assets at Wellington Airport. The ROI reflects any revaluation gain (or loss) that occurs in the year prior to the change in the asset value. This can result in a 'spike' in the ROI, which signals an expectation of higher (or lower) profits in the future.[156] However, whether the reported returns actually eventuate depends on the

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154 For further discussion of this issue, see Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 4.1.3 to 4.1.4; also refer Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, paragraphs 4.1.3 to 4.1.4. Airlines can be expected to have some degree of countervailing market power over the Airports regulated under Part 4. However, Airports are only subject to information disclosure regulation, and that does not affect the right of Airports under the AAA to charge for specified airport services as they think fit.

155 IMs set out the rules, requirements and processes applying to the regulation of specified airport services. The purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of goods and services under Part 4. Key IMs include the setting of the initial regulatory asset values and how the value of the regulatory asset base (RAB) is rolled forward, the treatment of asset revaluations and the determination of the cost of capital.

156 A 'spike' in the ROI above the cost of capital as a result of a revaluation of assets indicates an expectation of higher profits in the future—but those higher profits have not yet occurred. Such a spike would also indicate that consumers have not yet received any compensation, through lower prices, to offset those expected higher profits. However, that expected level of profits will only fully eventuate if prices rise to the level implied by receiving a normal return on the revalued asset base (eg, Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd Decisions Paper" 30 October 2008, paragraph F.9). For example, during consultation on the asset

extent to which the change in the asset value flows through into prices and revenues.[157]

F7 Unlike an ROI calculation, an IRR calculation does not rely on asset values in each year. Instead, it is based on the initial capital outlay, and the net cash flows associated with that investment. It therefore avoids the 'spikes' that can occur in the ROI.

Our analysis of the IRR uses an opening and closing asset value

F8 Information was not available at the time of this report to calculate the IRR over the lifetimes of all assets. Therefore, it uses an opening and closing asset value, in addition to the net cash flows associated with the opening asset value (which is the deemed capital outlay at that time). Ideally, the closing asset value should represent the value of future net cash flows at that time (discounted by the WACC).[158] If the closing asset value is a good estimate of the present value of subsequent net cash flows, then the IRR will provide a good estimate of the returns on the opening asset value over the entire remaining lifetime of the assets, rather than just being an estimate of returns earned between the opening and closing asset value dates.

Our IRR is based on the five-year period of PSE2

F9 A meaningful assessment of Wellington Airport's return should include a long-term assessment of returns (for example, an assessment of trends in returns or an average return over several years). We consider it important to examine returns over a number of years as a return in excess of the cost of capital is, on its own, not indicative of excessive profits because costs can vary from year to year and income can be smoothed to reflect customer requirements. Furthermore, a short-term return that exceeds the cost of capital may simply reflect superior efficiency or innovation.[159]

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valuation input methodology, Professor George Yarrow observed that a revaluation corresponds to a capitalisation of *future* cash flows (G. Yarrow, M. Cave, M. Pollitt and J. Small, *Review of Submissions on Asset Valuation in Workably Competitive Markets, a Report to the New Zealand Commission, Annex 2: George Yarrow – Response to Submissions on Individual Expert Reviews*, November 2010, paragraph 2.11).

157 If prices following the revaluation do not rise to the level implied by the revalued assets, the ROI measured at the point of revaluation may give a misleading view of returns. See Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, Appendix F.

158 Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, paragraphs 190 to 193. The ROI, and the way it treats revaluations, is effectively a close approximation to an IRR calculated over only one year, with the revaluation reflected in the closing asset value.

159 For further discussion of this issue, see Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 3.23 and 3.25.

F10 In response to submissions on our draft report, in this report we use the five-year IRR from 1 April 2012 as our preferred measure of expected returns for Wellington Airport.

F11 In our draft report, we presented the results of our profitability analysis for the seven year period following the introduction of information disclosure (ie, 2011–17). We placed significant weight on this value in our draft report. Submissions indicated some concerns with this approach. Auckland Airport submitted that the use of a seven year IRR conflates the assessment of PSE1 and PSE2 outcomes and that any assessment using PSE1 should acknowledge that the pricing for this period pre-dated information disclosure regulation under Part 4.[160] NZ Airports Association also argues that because outcomes in PSE1 are a product of decisions made prior to the introduction of information disclosure, any analysis of post information disclosure profitability must exclude the data from PSE1.[161]

F12 Having taken into account submissions from interested parties on that draft report, we have concluded that the five-year IRR does provide a more useful indicator of Wellington Airport's conduct and performance in response to information disclosure regulation than the seven year IRR. This is because the returns achieved in 2011 and 2012 reflect pricing decisions made prior to the introduction of information disclosure. Even had Wellington Airport been making excessive returns at that point, it would have been highly unlikely for Wellington Airport to have changed in its pricing in PSE1 to account for the introduction of information disclosure.

F13 For reference, the results of the seven year IRR analysis are provided below.

IRR based on the seven year period following the introduction of information disclosure

F14 We tested the impact of calculating the IRR using 2011 as the starting point rather than the first year of PSE2, resulting in a seven year IRR analysis. This results in a forecast post tax return of 10.1%. The seven year IRR analysis estimates Wellington Airport's return since the first year information disclosure regulation under Part 4 came into effect. It therefore includes the last two years of PSE1.

F15 The seven year IRR analysis results in a lower expected post tax return than the five-year IRR results because Wellington Airport achieved lower returns in 2011 and 2012 than those forecast for PSE2. In 2011 and 2012, Wellington Airport achieved returns of 6.2% and 6.9% respectively. These returns are comparable to the Commission's estimate of the cost of capital of 8.2% and 7.8% for 2011 and 2012 respectively. If the impact of the terminal wash-up were to be included in PSE1, Wellington Airport's

160 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, paragraphs 99(a) and 102.

161 NZ Airports Association "Submission on the Commerce Commission draft report on the section 56G review of Wellington Airport" 30 November 2012, paragraph 63.

historic returns would have been reduced further to 5.8% and 6.5% in 2011 and 2012.

Our treatment of the timing of cash flows for the IRR is consistent with information disclosure

F16 Analytically, in our IRR analysis we have not made any adjustments to reflect the actual timing of cash flows. Instead, we have assumed cash flows occur at the end of the period, with the exception of capital expenditure. We have assumed that half of the capital expenditure forecast for each year of the regulatory period occurs at the beginning of that year, with the remaining half occurring at the end of the year. This is most consistent with the treatment of cash flow timing in the annual performance measure under information disclosure.

F17 This gives rise to a conservative estimate of the IRR which is in favour of Wellington Airport, when compared to using assumptions which attempt to better approximate the real timing of cash flows.[162]

Consideration of key areas of disagreement

F18 The key areas of disagreement between parties, and our decisions in these areas, are discussed in more detail below. These areas are:

F18.1 the approach to valuing assets, in particular airport land;

F18.2 the cost of capital and the assumptions underlying this cost of capital;

F18.3 the treatment of wash-ups; and

F18.4 the allocation of food court space.

Approach to valuing assets

F19 The IM for asset valuation allows land to be revalued based on the market value alternative use (MVAU). In years where there are no land revaluations, the IM specifies that it is revalued based on CPI (CPI indexation).[163] Both types of revaluations are treated as income in the IM. This is to ensure that the returns earned on these assets over their lifetime (discounted by an appropriate WACC) equate to the initial investment amount.[164] The asset values that have been used by Wellington Airport to set prices for PSE2 differ from those specified under the asset

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162 For example, see those specified in the recent information disclosure requirements for Electricity Distribution and Gas Pipeline Businesses. See Commerce Commission "Information Disclosure for Electricity and Gas Pipeline Businesses Final Reasons Paper" 1 October 2012, paragraphs E10 to E13.

163 The same treatment applies to specialised assets.

164 For more discussion on this issue, see Commerce Commission "Airports Input Methodologies Reasons Paper" December 2010, paragraphs 2.8.13 to 2.8.17.

valuation IM. Wellington Airport uses a MVAU plus land conversion costs approach (or market value equivalent use (MVEU) approach). Land conversion costs are valued at $69 million in 2011.

F20 Our estimate of the IRR requires assumptions on the value of Wellington Airport's assets for regulated activities at the beginning of our period of analysis (the opening asset base) and at the end of the analysis period (the closing asset base). The IRR calculation represents expected returns over the remaining lifetime of the assets. Therefore, the closing asset value for the analysis period should represent the expected future cash flows from the assets over their remaining life from the end of that period.

F20.1 We have assessed Wellington Airport's return using the asset valuation approach specified in the IM as the opening regulatory asset base. This is disclosed by Wellington Airport under information disclosure in 2011. We consider the IM asset valuation approach to be consistent with the value of the assets in a workably competitive market.

F20.2 We have used the closing pricing asset values expected by Wellington Airport at the end of the PSE2 pricing period to provide our estimate of the returns. This is the MVAU plus land conversion costs. Since Wellington Airport does not use an IM compliant asset valuation for setting prices, we do not consider the IM compliant asset base (rolled forward to the end of PSE2) provides a reasonable estimation of the expected future cash flows. We have assumed that Wellington Airport will continue valuing assets as they have done for PSE2.

F21 Auckland Airport has submitted that it is inappropriate that an assumption about future behaviour should influence an assessment of current behaviour.[165] However, in this instance, even the most conservative assumption of the closing asset base (ie, using the rolled forward 2012 disclosed RAB as the closing asset base) results in excessive profits.[166] Using the pricing asset base also allows us to quantify the return Wellington Airport could expect if its current behaviour was to continue.

F22 We have received advice from our expert valuer that identifies a number of areas where Wellington Airport's MVAU land valuation provided under information disclosure is not compliant with input methodologies.[167] It is not clear what, if any,

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165 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report", 30 November 2012, paragraph 99 (c).

166 As discussed in paragraph E44, the expected return for Wellington Airport using the rolled forward 2012 disclosed RAB as the forecast closing asset base is 9.1%.

167 The relevant reports provided by Darroch Limited are: "Review of Land Valuation Methodology Wellington International Airport Limited Final Report 1 February 2013" [2009], "Review of Land Valuation Methodology Wellington International Airport Limited Final Report 1 February 2013" [2011]. These

impact such non-compliance, if confirmed by the Commission, would have on the value of land disclosed by Wellington Airport.[168] We consider that any adjustment to the land valuation as a result of the compliance issues raised would not result in an increase in the land valuation disclosed but could result in a decrease.

F23 BARNZ has provided its own estimate of an MVAU land valuation for Wellington Airport. It suggests that the 103.2 hectares of operational airport land owned by Wellington Airport should be valued at $98 million. This translates to a value of $949,645 per hectare (ha).[169] Wellington Airport indicated in its response to queries from the Commission that the actual land area used for specified airport services is 86.3 ha.[170] Using the revised land area estimate and BARNZ's value per hectare results in a revised BARNZ land valuation of approximately $82 million. This can be compared to Wellington Airport's 2011 disclosure of a MVAU land value of $119 million.

F24 We have tested the impact of BARNZ's alternative MVAU valuation on our estimate of Wellington Airport's expected returns. The results are provided in paragraph E33 of this report.

F25 Wellington Airport's prices for PSE2 are based on revalued specialised assets (with the exception of plant and equipment). Specialised assets were revalued using optimised depreciated replacement cost (ODRC) as at 31 March 2011. Again, this pricing valuation approach is not consistent with the IMs, which require the ODRC valuations as at 31 March 2009 to be rolled forward and indexed at CPI. BARNZ has estimated the rolled forward values to be $4.1 million less than values for civil works used to set prices ($131.5 million) and $5.3 million higher than the value for buildings used to set prices ($112.3 million). The combined difference is $1.2 million, and we consider that the impact is not material to our returns assessment.

Cost of capital and underlying assumptions

F26 The following discussion on the cost of capital used in our analysis to assess Wellington Airport's return explains:

F26.1 how we estimate an appropriate cost of capital;

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reports can be found on our website. The Commission has not yet formed its own view on the compliance issues raised in these reports. A letter of advice dated 1 February 2013, provided by Darroch Limited for our s 56G review, can also be found on our website.

168 We cannot describe the asset values provided under information disclosure as IM compliant. When discussing our estimation of Wellington Airport's return we refer to the 2012 disclosed RAB as the opening asset value.

169 BARNZ, "BARNZ Assessment of WIAL Revised Pricing Proposal for Charges to Apply from 1 April 2012 – 31 March 2017" 23 December 2011, page 9.

170 Wellington Airport "WIAL response to Commerce Commission queries" 15 August 2012, page 2.

F26.2 why we consider that the most appropriate cost of capital to use in assessing Wellington Airport's forecast returns is the cost of capital closest to the time at which prices were set (ie, the cost of capital determination dated 27 April 2012);

F26.3 why we have compared Wellington Airport's returns to both the midpoint and the 75th percentile estimate of the cost of capital;

F26.4 why our estimated cost of capital differs from that estimated by Wellington Airport;

F26.5 why we consider our cost of capital is commercially realistic; and

F26.6 why our estimated cost of capital does not include company specific factors.

How we estimate an appropriate cost of capital

F27 Under Part 4, we have published an IM for the estimation of the cost of capital for the purposes of monitoring and analysing information disclosed by the Airports. We considered a range of analyses used by capital market practitioners to estimate the cost of capital.

F28 The cost of capital, as set out in the input methodologies, is the Weighted Average Cost of Capital (WACC), which is an estimation of the percentage return on capital that is consistent with a return that may be achieved in a workably competitive market over time in the absence of superior performance.[171] The IM for the cost of capital requires a vanilla nominal cost of capital and post-tax nominal cost of capital to be estimated and published for airport services for the purpose of information disclosure.

F29 The vanilla cost of capital is specified as the expected post-tax cost of equity capital and the expected pre-tax cost of debt capital, weighted by the respective proportion each represents of the total capital. The post-tax cost of capital is determined as the expected post-tax cost of equity capital and the post-tax expected cost of debt capital weighted by the respective proportion each represents of the total capital.

F30 In this report we have stated all returns on a post-tax basis as this is consistent with analysis provided by both Wellington Airport and BARNZ and is the basis likely to be most familiar to most interested persons.

Our analysis uses the cost of capital closest to the time at which prices were set

F31 We consider that the most appropriate cost of capital to use in assessing Wellington Airport's forecast returns is the cost of capital closest to the time at which prices

[171] Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraph 3.23.

were finalised. For our assessment, this is the cost of capital determination dated 27 April 2012.[172] The use of this determination does not disadvantage Wellington Airport compared to an estimate of WACC made at the time Wellington Airport set its prices.

F32 Wellington Airport states in its cross submission on the s 56G process and issues review that the current Commission cost of capital was not published until 27 April 2012, which was after consultation for the current pricing period was completed.[173] Wellington Airport states that “the most recent Commission WACC publication available to Wellington Airport prior to the completion of consultation advised a [post-tax] WACC of 7.8% (midpoint) to 8.7% (75th percentile).” The post-tax cost of capital referred to by Wellington Airport was based on the Commission’s determination dated 27 April 2011.

F33 Alternatively BARNZ has stated in its post conference submission that “the Commission’s methodology has been specified sufficiently clearly in its Input Methodologies that interested parties (with access to sufficient expertise) are themselves able to update the WACC estimate”.[174] BARNZ also notes that its own experts provided advice prior to the end of the pricing consultation which estimated WACC to within 0.04% of the Commission’s WACC published in April 2012.

F34 Auckland Airport, in noting that the Wellington Airport pricing decision was made on 1 March 2012 stated that it would be “inappropriate to use a WACC estimate of March 2011 for pricing”.[175]

F35 A reasonable estimation of the Commission’s IM based cost of capital could be determined at the date that Wellington Airport finalised its prices. Had Wellington Airport attempted to estimate the Commission’s cost of capital in January 2012, when it finalised its prices, it is likely its calculation would have been lower than the Commission’s determination dated 27 April 2012 due to changes in the risk free rate. Therefore the use of the Commission’s 27 April 2012 determination does not disadvantage Wellington Airport.

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172 Wellington Airport set its prices as at January 2012. At that time it would not have known the risk-free rate and debt premium that would be used by us in setting our estimate of the WACC we would use in this report (as these parameters and our WACC were estimated as at 1 April 2012). However, relative to the risk-free rate and debt premium prevailing in January when Wellington Airport finalised its prices, the April risk-free rate and debt premium produced a higher WACC than would have been estimated in January 2012. This higher WACC results in a lower estimate of excess profits than we would have estimated if we had made our WACC estimate as at January 2012.

173 Wellington Airport “WIAL Cross Submission to the Commerce Commission Section 56G Process and Issues Review” 20 July 2012, page 13.

174 BARNZ “BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue” 17 August 2012, page 21.

175 Auckland Airport “Auckland Airport Section 56G Cross Submission” 17 August 2012, page 21.

We have assessed Wellington Airport's returns relative to the midpoint and the 75th percentile estimate of the cost of capital

F36 We consider the midpoint cost of capital to be appropriate starting point for any assessment of profitability for Wellington Airport. The 75th percentile cost of capital allows for the uncertainty of estimating the true cost of capital and in light of the potential asymmetric consequences of estimation error on pricing and investment.

F37 The Airport IM reasons paper states that "in assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (midpoint) on the range".[176] The use of a midpoint is supported by the airlines. However, the airports have submitted that a higher percentile should be used to assess returns as part of this s 56G review. Typically, we would use a 75th percentile in contexts where we are administering price control. The 75th percentile cost of capital is used in these contexts to allow for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment. In its post-conference submission, Christchurch Airport states that "the uncertainty associated with an ex-ante assessment justifies the use of a higher point estimate than the midpoint estimate the Commission would typically use when conducting an ex-post assessment".[177] Similarly, Auckland Airport considers the WACC range of "75th – 85th percentile would be a sensible point range for ex-ante assessment of profitability".[178] Wellington Airport themselves have stated that a range should be established but "the range should not commence at the 50th percentile".[179]

F38 Alternatively BARNZ has stated that "the long term interests of consumers would be better served if returns are measured ex-ante relative to the midpoint WACC estimate (ie, the 50th percentile) with a judgement being made ex post as to whether returns have been on average excessive, or have fallen short".[180] Air New Zealand states that they "consider that returns consistent with the WACC midpoint are an appropriate level of target return" and that "this represents a balance between the objectives of s 52A(1)(a) and (d)".[181] The parameters used to calculate Wellington Airport's cost of capital differ from those applied by the Commission.

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176 Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraph E11.2.

177 Christchurch Airport "CIAL Cross Submission following Wellington Airport Conference" 17 August 2012, page 5.

178 Auckland Airport "Auckland Airport Section 56G Cross Submission" 17 August 2012, page 21.

179 Wellington Airport "WIAL Cross Submission Following the Commerce Commission Section 56G Review Airports Conference" 17 August 2012, page 3.

180 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue" 17 August 2012, page 21.

181 Air New Zealand "Air NZ Submission to the Commerce Commission S56G Review" 29 June 2012, page 37.

F39 Wellington Airport's cost of capital for PSE2 is 246 basis points higher than the Commission's estimate of midpoint cost of capital. This is due to a number of differing assumptions about the parameters that make up the cost of capital.

F40 On 27 April 2012, we published our most recent cost of capital determination. The determination set a midpoint estimate of post-tax weighted average cost of capital of 7.1% for the five-year period commencing on the first day of disclosure year 2013, ie, 1 April 2012.[182] We also determined a 75th percentile post-tax weighted average cost of capital of 8.0%.

F41 Wellington Airport commissioned economic advisors Sapere Research Group to provide a recommendation on the appropriate post-tax WACC for application by Wellington Airport in its building block model.[183] On receipt of further advice during consultation on PSE2, Wellington Airport recalculated its cost of capital as 10.9% and decided to apply a post-tax cost of capital of 9.5%.

F42 Table F1 below summaries the key parameters used by Wellington Airport in setting the cost of capital for PSE1 and PSE2 and the parameters used by the Commission to set its cost of capital determination for Wellington Airport as at 27 April 2012. We note that some of the parameters used by Wellington Airport, including the asset beta and tax-adjusted market risk premium (TAMRP) are more aggressive than those sought by Wellington Airport in its merits review appeal to the High Court on the cost of capital IM. The most material of these assumptions is the asset beta, which also represents a change in assumption from PSE1. We know of no basis for Wellington Airport's claim that its systematic risk is at this increased level.

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182 Commerce Commission "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10" 27 April 2012, page 2.

183 Wellington Airport "WIAL Price Setting Event Disclosure for the Pricing Period 1 April 2012 to 31 March 2017" 30 April 2012, page 28.

Table F1: Cost of capital parameters for Wellington Airport

Parameters	Wellington Airport cost of capital PSE1	Wellington Airport cost of capital PSE2	Commission's estimate of cost of capital 27 April 2012	Commission's estimate of cost of capital 27 April 2011
Risk free rate (%)	6.16	3.90[184]	3.61	4.66
Debt premium (%)	1.50	1.89	1.94	1.39
Debt issuance costs (%)	0.00	0.54	0.35	0.35
Cost of debt (%)	7.66	6.33	5.90	6.40
TAMRP (%)	8.00	8.00	7.00	7.0
Asset beta	0.60	0.75	0.60	0.60
Equity Beta	1.00	1.25	0.72	0.72
Cost of equity (%)	12.31	12.81	7.46	8.40
Leverage (%)	40	40	17	17
Post tax WACC (%)	9.50	9.51	7.06	7.75

Sources: Wellington Airport building block model for PSE1; Wellington Airport building block model for PSE2; Commerce Commission, "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10" 27 April 2012; Commerce Commission, "Determination of the Cost of Capital for Information Disclosure Year 2012 for Airport Services (March year-end) and Electricity Distribution Services under Part 4 of the Commerce Act 1986, pursuant to Decisions 709 and 710" 27 April 2011.

We consider our estimated cost of capital is commercially realistic

F43 In its submission to the draft s 56G report, Auckland Airport states that the cost of capital is well below the estimates used in our reasonableness tests (provided in our IM reasons paper) and is not commercially realistic.[185] It argues that we should undertake new reasonableness tests as our current estimate of WACC now sits outside the majority of the reasonableness checks used in the 2010 reasons paper.

F44 We do not consider that additional reasonableness tests are required for this review. We undertook extensive reasonableness testing in 2010 and our subsequent cost of capital estimates reflect changes in the risk free rate and debt premium since that time.

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184 Wellington Airport has used a risk free rate based on a ten year term rather than the five year term specified in the input methodologies. Had Wellington Airport used a risk free rate with a five year term at the time they determined prices for PSE2, this rate would have been approximately 3.22%.

185 Auckland Airport "Auckland Airport's submission on the section 56G review draft WIAL report" 30 November 2012, paragraphs 84 to 90.

Consistent with the input methodologies, our estimated cost of capital does not include company specific factors

F45 Wellington Airport has identified three differences in the assumptions used to estimate its cost of capital from those used by the Commission in its analysis.[186] It argues that the Commission should take these into account in determining an appropriate return. Those factors are:

F45.1 Wellington Airport's own credit rating (BBB+ as compared to the Commission's benchmark of A–);

F45.2 Wellington Airport's preferred estimate of asset beta (0.75 as compared to the Commission's benchmark of 0.60); and

F45.3 Wellington Airport's preferred estimate of TAMRP (8.0% as compared to the Commission's benchmark of 7.0%).

F46 In setting the IMs, we considered the use of firm specific factors. For reasons set out in the IM reasons paper,[187] we determined that a supplier which sets prices based on a higher estimate of its cost of capital than the actual cost at which capital is available in an industry cannot expect consumers to pay these higher prices. Parties have had extensive opportunities to submit on IMs, and the final IM was our view of the best approach.

F47 The purpose of the IMs is to promote certainty in the rules and assumptions used to assess performance. Such certainty would be undermined if we make ad hoc adjustments to our published cost of capital estimates derived from IMs. We note, however, that while Wellington Airport is subject to company-specific risks, investors can diversify away such risks. The cost of capital reflects risk which investors cannot diversify away.

F48 Our estimate of an asset beta of 0.60 is the best estimate of the systematic risk which cannot be diversified away, and Wellington Airport has presented no reliable evidence that its asset beta is 0.75 and not 0.60.

F49 The TAMRP is a market-wide parameter and not a company-specific parameter.

F50 Wellington Airport's credit rating reflects features and choices made by Wellington Airport and its shareholders, including the overall level of leverage. There is no

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186 Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, paragraph 34.

187 Commerce Commission, "Input Methodologies (Airports) Reasons Paper, December 2010, paragraphs 6.2.2 to 6.2.7.

evidence before us that it is not practically feasible for Wellington Airport to secure an A– credit rating, given different choices by the airport and its shareholders. Both Auckland Airport and Christchurch Airport have A– ratings.

Treatment of wash-ups

F51 Our analysis recognises income resulting from wash-ups in the period to which it relates. These wash-ups are NPV neutral over the 10 year period of the combined PSE and PSE2 pricing periods but have a significant impact on the return attributed to an individual pricing period.

F52 Wellington Airport has applied two types of wash-ups:

F52.1 a wash-up for the delay in capital expenditure in PSE1 (the terminal wash-up). This arises from a direct saving of cash expenditure; and

F52.2 a wash-up due to the revaluation of assets at the end of PSE1 being higher than forecast. This is a non-cash wash-up. This is because Wellington Airport does not receive the benefit of the revaluation gain, achieved through higher revenues, until PSE2 and beyond.

F53 Our analysis of Wellington Airport's profitability reduces the revenues recognised in PSE1 by the value of the terminal wash-up arrangement. The revenues in PSE2, which are used to estimate our preferred measure of returns, are similarly increased.

F54 Our preferred measure of returns uses the 2012 disclosed RAB as the opening asset value. As a result, the revaluation wash-up is treated as a commercial concession in our determination of Wellington Airport's expected future returns.

Treatment of the terminal wash-up

F55 The terminal wash-up recognises that the revenue collected by Wellington Airport through pricing in PSE1 was based on the expectation that the capital expenditure on the international terminal would occur sooner than it actually occurred. During the PSE1 consultation, BARNZ noted that Wellington Airport had front-loaded its forecast capital expenditure profile when it set charges in 2007. The most significant capital project as noted by BARNZ was the international departure terminal. As part of the 2006 consultation, Wellington Airport agreed to put in place a wash-up mechanism if completion of the capital project was delayed by more than 12 months.[188] The development was not commissioned until the end of October 2010 and was therefore delayed by more than 12 months.

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[188] Wellington Airport "WIAL Initial Pricing Proposal for the pricing period commencing 1 April 2012" 18 August 2011, page 55.

F56 Wellington Airport has not recognised the liability for the terminal wash-up in PSE1 on the basis that the amount will not be offset against charges until PSE2. Wellington Airport has explained that, in its view,

> while it may seem that a past event has triggered an obligation... there remains an ongoing future event. This is the future traffic (and hence revenue) that needs to occur by a third party airline before the discount is provided in the form of the reduced charges.[189]

F57 We do not consider this reflects an appropriate matching of cash flows to the investment made in PSE1.

F58 We consider that the most appropriate treatment of the terminal wash-up is to reduce the revenue received during PSE1 by the value of the terminal wash-up. This is because the wash-up represents a repayment to airlines in respect of that period, despite airlines receiving the cash benefit of that repayment through lower charges in PSE2.

F59 Because we treat the value of the wash-up as being recognised in PSE1, we have to add back the value of the wash-up to PSE2 in order to appropriately reflect the forecast returns for that pricing period, consistent with the assessment of returns in PSE1. We have used Wellington Airport's estimate of the value over the five years of PSE2, which accounted for the time value of money, and attributed the value of the wash-up over the five years of the pricing period to revenue.

Treatment of the revaluation wash-up

F60 Unlike our treatment of the terminal wash-up discussed above, we recognise the revenue from the revaluation wash-up in PSE2.

F61 Our analysis includes the reduction in revenue in PSE2 forecast by Wellington Airport as a result of the revaluation wash-up. We use the revenue forecast by Wellington Airport as it is the revenue that determines the prices paid for commercial services at Wellington Airport.

F62 We have not made any adjustment to Wellington Airport's forecast revenues in respect of the revaluation wash-up. Our estimate of IRR uses the MVAU asset valuation provided by Wellington Airport under information disclosure as the opening asset value, and the revalued MVEU pricing asset values as the closing asset value. This implicitly recognises the revaluation gains associated with the MVEU valuation. Therefore the attendant revaluation wash-up has also been recognised as a reduction in revenues.[190]

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[189] Wellington Airport, Email from Martin Harrington, Follow up questions re terminal wash up, 21 December 2012.

[190] Further discussion of the revaluation wash up was provided in the draft report in paragraphs I91 to I99.

F63 Under the IMs, revaluation gains are treated as income to reflect the expectation that a higher asset valuation would result in higher future cash flows. The revaluation wash-up was created by Wellington Airport recognising that the revaluation realised during PSE1 on its pricing asset base were significantly higher than those forecast. The revaluation wash-up serves to offset some of the associated revaluation gains to consumers through a reduction in charges in PSE2.

F64 Wellington Airport has argued in its submission to the draft report that the Commission included unforecast revaluation gains in PSE1 and apportioned these to 2011 and 2012 without appropriately evaluating the contribution of the unforecast gains to the Commission's assessment of the returns for these years.[191] Neither the five-year nor the seven year IRR analysis apportions any revaluation gains to PSE1.

Our analysis does not include an adjustment for the costs associated with the food court space area

F65 Wellington Airport has changed its approach to allocating the costs associated with the food court space between its regulated and unregulated activities for PSE2. Given its immaterial effect on returns we have not formed a view on how the food court space area should be allocated, and have not included any adjustments in our analysis.

F66 The reallocation resulted in a $2.25 million increase in the value of the asset base used to set prices. BARNZ argues that this has reversed a 15 year pattern of the airport treating this space as commercial and that it will give rise to a significant over-recovery of the costs of this space.[192] Wellington Airport has stated that "in the past pricing period a substantial commercial concession was made that allocated areas to commercial areas only that very obviously are used by passengers" and that it believes "the 2012 approach to cost allocation is accurate".[193]

Activities included in our assessment of Wellington Airport's returns

F67 Our assessment of Wellington Airport's expected returns in PSE2 uses Wellington Airport's forecast revenues (and costs) for all of Wellington Airport's regulated activities. This is consistent with the input methodologies. Table F2 shows Wellington Airport's total forecast revenue for the period which has been used in our returns assessment.

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191 Wellington Airport "Wellington International Airport Limited's substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited" 30 November 2012, paragraph 8.

192 BARNZ "BARNZ Post Conference Submission on Wellington Airport Section 56G Review" 17 August 2012, page 22.

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

Table F2: Wellington Airport combined forecast revenue ($000)

	2013	2014	2015	2016	2017
Airport activity charges	60,303	65,686	71,918	78,706	85,850
Terminal wash-up removal	2,485	2,721	2,980	3,263	3,574
Lease, rental and concession income	4,645	4,733	4,837	4,856	4,977
Gain or loss on sale of assets	(5,439)	(414)	(850)	(871)	(893)
Noise mitigation	2,179	2,255	2,992	3,008	3,094
Other revenue	205	210	215	221	226
Total revenue	64,378	75,190	82,093	89,183	96,828

Note: The revenue from airport activity charges is not the same as that provided in Wellington Airport's pricing disclosure for PSE2. Instead, our analysis uses the revenue provided in the model used by Wellington Airport to set prices for PSE2.

Sources: Commerce Commission analysis of Wellington Airport "Wellington International Airport Limited: Price setting event disclosure", 30 April 2012; Wellington Airport LUMINS pricing model; Wellington Airport building block model for PSE2.

F68 These forecast revenues differ from those reported by Wellington Airport in the pricing event disclosure in the following areas:

F68.1 our analysis removes revenue associated with the terminal wash-up for PSE2. This is discussed further in paragraphs F53 to F59;

F68.2 Wellington Airport's disclosure excludes the costs and revenues associated with Wellington Airport's noise mitigation obligations. This activity is however included in the definition of specified airport services for the purpose of information disclosure regulation and has therefore been included in our analysis of Wellington Airport's returns. Our analysis of revenues from Wellington Airport's noise mitigation obligation uses information on revenues, costs and assets provided in the LUMINS model;[194] and

F68.3 Wellington Airport's pricing disclosure excludes the asset values and revenues from leased assets. This activity is however included in the definition of specified airport services for the purpose of information disclosure regulation and has therefore been included in our analysis. [195]

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[194] The costs associated with noise mitigation were included in the pricing event as adjustments made to required revenue as per the table in the PSE2 Final Pricing document under Clause 2.5(1)(a)(i) Disclosure of Forecast Total Revenue Requirements.

[195] As shown in the table in the PSE2 disclosure document under Clause 2.5(1)(a)(i) Disclosure of Forecast Total Revenue Requirements.

Limitations of the information used in our analysis

F69 Our assessment of whether Wellington Airport is earning excessive profits uses information from the following sources:

F69.1 Wellington Airport's annual information disclosures under Part 4 for 2011 and 2012, and its price-setting information disclosures under Part 4 for PSE1 and PSE2;

F69.2 Wellington Airport's models used to set prices for PSE1 and PSE2, including its building block model. In particular, operational expenditure, capital expenditure, revaluation rates, the depreciation of existing assets and the tax book values have been taken unadjusted from Wellington Airport's building block model for PSE2;[196]

F69.3 advice from our airport land valuation expert;

F69.4 responses from Wellington Airport on specific queries by the Commission. This includes information on their 2009 land valuation on an MVAU basis and supplementary land valuation reconciliation information; and

F69.5 submissions and cross-submissions made by parties throughout Wellington Airport's pricing consultation and the Commission's s56G review process.

F70 Our analysis has been limited by a lack of transparency in some of the information disclosed for price-setting and errors in the models provided by Wellington Airport. In particular:

F70.1 we were unable to verify the reconciliation amounts between the forecast revenue for services applicable to price-setting event value of $62.5 million (disclosed on page 12 of the information disclosure for PSE2) and the building block required revenue of $60.3 million (disclosed on page 45). Our own building block analysis has used the latter;

F70.2 there was no reconciliation between Wellington Airport's MVAU land valuation value ($141 million), a copy of which was provided in support of the required disclosures for 2011, and the closing land value disclosed ($119 million). This was later provided to us upon request;

F70.3 the calculation of tax payable was linked to accounting depreciation rather than tax depreciation. This error would have resulted in a slight increase in

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[196] We have not adjusted Wellington Airport's modelled tax asset values even though there is an approximate $8 million difference between these and the tax values disclosed in the 2011 information disclosure schedules.

the revenue required to achieve Wellington Airport's target return. We have not adjusted forecast revenue to reflect the impact of this error; and

F70.4 we identified a number of small errors in the LUMINS model related to the movements in the asset base.[197] Wellington Airport provided us with a revised version of the LUMINS model and we have relied on this version for the asset and revenue assumptions in our profitability calculations.[198]

F71 Wellington Airport's method for calculating forecast tax is consistent with the IMs. We have used Wellington Airport's forecasts of tax depreciation. Where we have made adjustments to forecast asset values we have adjusted tax assets proportionately so as to preserve the opening relationship between regulatory depreciation and tax depreciation.

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197 Wellington Airport's model, which reflects the forecast cash flows associated with noise mitigation activities.

198 This model was provided in response to the Commission's queries about errors in the original model.

Attachment G: Is information disclosure promoting improvements in operating efficiency at Wellington Airport?

Purpose

G1 This attachment summarises the analysis undertaken for this s 56G review to assess the effectiveness of information disclosure in promoting outcomes consistent with workably competitive markets such that Wellington Airport has incentives to improve operating efficiency (s 52A(1)(b) of the Act).

G2 Consistent with s 52A(b), we have assessed whether Wellington Airport is *improving* its operating efficiency. Our analysis does not assess whether Wellington Airport's operational expenditure is efficient.

G3 Improvements in operating efficiency result from reductions in operational expenditure (opex) while maintaining (or even increasing) the quality and quantity of service provided as a result of improvements in managerial efficiency. Opex efficiency gains may also result from an increase in quantity or quality for no additional opex.

Conclusion

G4 We are unable to conclude whether information disclosure regulation is effectively promoting the purpose of Part 4 in relation to improvements in Wellington Airport's operating efficiency. This is because the evidence that Wellington Airport sought to improve its operating efficiency in PSE2 is mixed (ie, our analysis of Wellington Airport's conduct is inconclusive), and it is too early to assess meaningful trends in opex at Wellington Airport since information disclosure regulation under Part 4 was implemented. Further, information on actual expenditure during PSE2 will assist in drawing conclusions on Wellington Airport's operating efficiency.

G5 The key reasons for our conclusion are as follows.

G5.1 The evidence of historic improvements in opex efficiency at Wellington Airport since information disclosure under Part 4 was implemented is inconclusive. It is unclear whether forecast reductions in unit opex for PSE2 are a result of efficiency improvements, or can be attributed to economies of scale resulting from organic growth or airline efforts to increase passenger volumes.

G5.2 We do not yet have actual expenditure information for PSE2 to assess whether Wellington Airport has been able to achieve its forecast reduction in unit costs, whether Wellington Airport has been able to achieve lower opex than forecast for PSE2, and the reasons for any differences. This will be an important indicator of whether Wellington Airport is improving its efficiency and whether information disclosure under Part 4 is effective in this area. Submissions from Wellington Airport and the airlines to this s 56G review suggest that information disclosure regulation under Part 4 has had a limited impact on Wellington Airport's operating efficiency to date.[199]

G5.3 Parties have mixed views on whether Wellington Airport's conduct indicates that it seeks to improve its efficiency.

G5.4 We expect that it will take a number of years for information disclosure regulation to be as effective as it can be at promoting operating efficiency. That is because the effectiveness of information disclosure in this area is dependent on the availability of data to assess trends in expenditure, as well as to make comparisons with other airports. This information was not available at the time of consultation for PSE2.

G6 Wellington Airport has not provided any evidence of superior performance with respect to improvements in operating efficiency over PSE1 to justify earning a return that exceeds our estimated cost of capital in PSE2. We have insufficient information on opex during PSE1 to assess ourselves whether Wellington Airport achieved efficiency gains beyond those expected of an average performer, and therefore whether a return higher than our estimated cost of capital is justified. Information disclosure was not implemented until the latter part of PSE1, and therefore there is limited information available on historic opex. Wellington Airport has access to more information than us and, had it achieved superior performance, we would expect Wellington Airport to provide evidence of this, which they have not done.[200]

G7 The nature of opex efficiency means that an assessment of the effectiveness of information disclosure in this area relies largely on an analysis of historical performance, rather than expected performance. We would expect forecast opex used to set prices to reflect some, but not necessarily all, expected future efficiency gains. Furthermore, the evidence we do have based on Wellington Airport's forecast opex is mixed. An ex-post assessment of historic opex will be more informative, for example, revealing whether Wellington Airport has been able to achieve its forecast reductions in unit costs and whether it has been able to outperform its forecasts due to further efficiency improvements. Information disclosure regulation under Part 4 was implemented in 2011 and Wellington Airport set prices for the first time under Part 4 information disclosure regulation in 2012. We therefore have very limited historical information on performance under Part 4 information disclosure

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[199] See, for example, BARNZ "BARNZ responses to Commerce Commission questions relating to WIAL" 28 June 2012, page 20; Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 213; Commerce Commission, Transcript of Wellington Airport Section 56G Conference, held on 7 August 2012, page 87.

[200] As an indication of the magnitude of efficiency gains Wellington Airport would have had to achieve to attribute their excess return fully to past improvements in opex efficiency, the excess returns of $19.7 million to $46.1 million in PSE2 can be compared to actual opex of $70 million in PSE1.

regulation, and no information on actual performance since prices were set for PSE2, against which to assess the effectiveness of information disclosure regulation on Wellington Airport's operating efficiency.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to improve its opex efficiency

G8 Wellington Airport has an incentive to operate efficiently to increase its profits. This incentive is strengthened by Wellington Airport fixing its prices for a five-year pricing period. This gives Wellington Airport an incentive to improve efficiency so as to outperform the opex forecast in its building blocks model (ie, have lower actual expenditure than forecast) and earn higher profits.

G9 These incentives to operate efficiently are weakened because of Wellington Airport's market power. For example, Wellington Airport sets its prices, in part, based on its forecast of opex. Wellington Airport has an incentive to set this forecast above an efficient level so as to earn higher profits by outperforming this opex forecast without necessarily being efficient. Wellington Airport may also have an incentive not to achieve efficiency gains in the last year of the pricing period. This results in a higher starting point than otherwise from which to forecast opex for the subsequent starting period.

How information disclosure can provide incentives to improve operating efficiency

G10 Information disclosure may strengthen Wellington Airport's incentives to operate efficiently. The public disclosure of information on historic and forecast opex provides transparency about how well Wellington Airport is performing relative to other suppliers and over time. Over time it can highlight if Wellington Airport has over-forecast opex for the purpose of price-setting.

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

G11 We expect that it will take a number of years for information disclosure regulation to be fully effective at promoting operating efficiency. That is because the effectiveness of information disclosure in this area is dependent on the availability of data to assess trends in expenditure, as well as to make comparisons with other airports. The availability of this information potentially increases the countervailing power of consumers at Wellington Airport. This information was not available at the time of consultation for PSE2.

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

G12 We have analysed whether information disclosure regulation is effectively promoting operating efficiency at Wellington Airport by examining:

G12.1 whether Wellington Airport has outperformed its opex forecast for PSE1, and the reasons for any over or under performance;

G12.2 the efficiency trend of Wellington Airport's historic opex expenditure. As part of this, we have examined historic trends in Wellington Airport's unit opex for the period 2003–12 and its unit opex relative to other airports;

G12.3 evidence of forecast improvements in opex efficiency in PSE2, and Wellington Airport's conduct in establishing this forecast.

G13 Our analysis considers Wellington Airport's performance and conduct both before and after the introduction of information disclosure regulation, to gain an insight into the impact of information disclosure regulation on promoting incentives to improve opex efficiency.

G14 To help understand the efficiency of Wellington Airport's opex, we have explored two unit opex measures: opex per passenger and opex per aircraft movement. We consider these are appropriate measures of Wellington Airport's unit opex as they are likely to reflect some of the drivers of Wellington Airport's variable costs.[201] Wellington Airport also sets a number of its prices on a per passenger or per movement basis.

G15 We have insufficient trends in opex data at Wellington Airport to conclude whether information disclosure regulation under Part 4 is effective in promoting improvements in operating efficiency. A disaggregated review of the different components of opex would be necessary at this time to conclude whether Wellington Airport's opex for PSE2 reflects improvements in efficiency. This level of information can be costly to provide and is therefore not required to be disclosed in information disclosure under Part 4. Given that the specific concerns raised by airlines (discussed in paragraph G34) will not have a significant impact on Wellington Airport's opex, we do not consider the costs of requiring this information for the purpose of this review were appropriate.

G16 We expect that the availability of longer trends in opex for Wellington Airport and comparator airports in PSE2 through information disclosure, as well as information to assess differences between actual and forecast opex for PSE2 will better allow interested persons to assess whether Wellington Airport is improving its opex efficiency in PSE2.

Information used to assess opex efficiency at Wellington Airport

G17 Our analysis uses quantitative and qualitative data from the following sources:

G17.1 information disclosed under Part 4 and the AAA;

[201] Changes in opex per aircraft movement may however also reflect changes in the size and capacity of aircraft.

G17.2 information published by the Australian Competition and Consumer Commission (ACCC);

G17.3 submissions received as part of this s 56G review; and

G17.4 the detailed opex forecasts provided in Wellington Airport's building blocks model for PSE2. This provides information on individual components of Wellington Airport's forecast expenditure at a more disaggregated level than is available in information disclosure. Further refinements to the information disclosure requirements may therefore be necessary to ensure this useful information is available in the future.

G18 All currency values in this attachment are expressed in real 2012 terms unless otherwise stated.[202]

Analysis of Wellington Airport's opex efficiency performance and conduct

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

G19 Wellington Airport's actual opex was higher than forecast during PSE1, including following the introduction of information disclosure regulation in 2011. Wellington Airport has attributed this to unforeseen costs which were largely outside their control. Excluding these costs would have resulted in actual opex 1% lower than forecast over the period 2007/08–2010/11, and may indicate Wellington Airport marginally outperformed its own opex efficiency assumption. However, it is not clear that this is an appropriate comparison.

G20 Actual opex exceeded forecasts in PSE1 by 16%. Wellington Airport has attributed much of the discrepancy to unforeseen costs.[203] These unforeseen costs include:

G20.1 building utility expenditures which increased due to the reallocation of expenditures from its non-aeronautical to the regulated part of business;

G20.2 increased remuneration costs as a result of one-off costs from restructuring within the company and the additional staff needed to provide extra aeronautical functions;

G20.3 increases in insurance premiums;

G20.4 increases in local council rates; and

G20.5 new costs as a result of the implementation of information disclosure regulation.[204]

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

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

G21 Together, these costs accounted for much of the variance between actual and forecast opex in PSE1. It is likely that some of these cost increases were to some extent within the control of Wellington Airport, for example, the increased remuneration costs. Other costs are not wholly within Wellington Airport's control. For example, increases in local council rates and insurance premiums have been observed in other sectors. Airlines have expressed concern about the appropriateness of Wellington Airport's historic regulation costs, which include litigation costs associated with the input methodologies applicable to information disclosure regulation.[205]

Did Wellington Airport improve its operating efficiency in the first pricing period?

G22 There is no evidence of improving efficiency at Wellington Airport in PSE1. Wellington Airport's unit opex increased over PSE1, and as discussed above, exceeded forecast opex. Furthermore, unit opex at Wellington Airport increased in PSE1 at a faster rate than for Auckland and Christchurch Airport.

G23 Wellington Airport has low unit opex relative to other airports, but the reasons for this are unclear. We are unable to make appropriate comparisons without first better understanding the operational circumstances of these airports. These operational circumstances are likely to explain some of the difference in unit opex. Furthermore, we consider a comparison of trends in unit opex at airports is more informative when assessing whether Wellington Airport has improved its efficiency. However we recognise that comparisons of trends may still not reflect differences in operational circumstances.

G24 To understand whether Wellington Airport improved its operating efficiency during PSE1 we have examined historic trends in unit opex at Wellington Airport, as well as its unit opex relative to other airports.

Historic trends in unit opex

G25 Figure G1 and Figure G2 shows that unit opex increased over PSE1 (2007–12), including following the introduction of information disclosure regulation in 2011. This increase occurred after a period of declining opex in the period prior to PSE1. Figure G1 and Figure G2 also shows that unit opex has increased by more than was forecast during PSE1.

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

[205] Commerce Commission, *Transcript of Wellington Airport Section 56G Conference*, held on 7 August 2012, page 78.

Figure G1: Opex per passenger (2003–12)

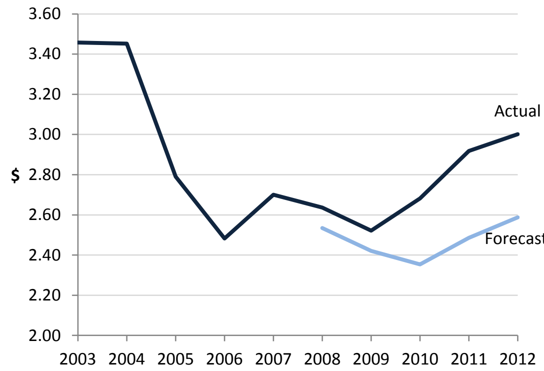
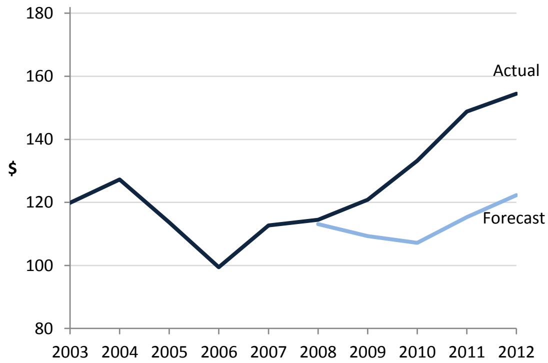


Figure G2: Opex per aircraft movement (2003–12)



Notes: Our analysis uses information disclosed by Wellington Airport as part of the AAA regime for the period 2003–10. We have adjusted this opex to exclude subvention payments (payments relating to the transfer of profits from a profitable company to a loss-making company) and consider this data to be approximately comparable with opex reported under information disclosure. Dollars shown are in real (2012) value.
Sources: Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2004 to 2010; Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

Comparisons of unit opex

G26 As shown in Figure G3 and Figure G4, unit opex at Wellington Airport has increased historically at a slightly faster rate than at Auckland Airport, while unit opex prior to 2010 at Christchurch Airport has declined. This may indicate increasing inefficiency at Wellington Airport relative to these airports historically.

Figure G3: Indexed opex per passenger at Wellington, Auckland and Christchurch Airports (2006–12)

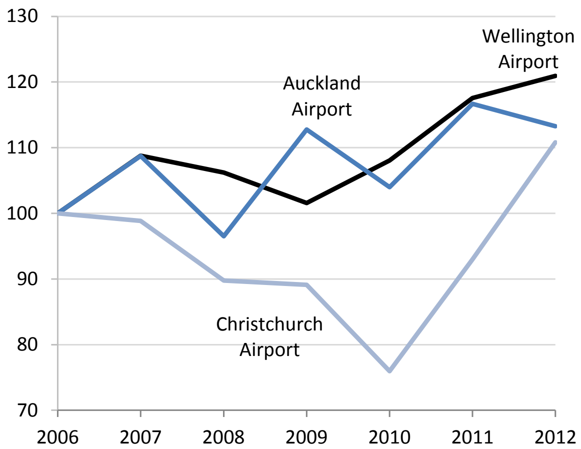
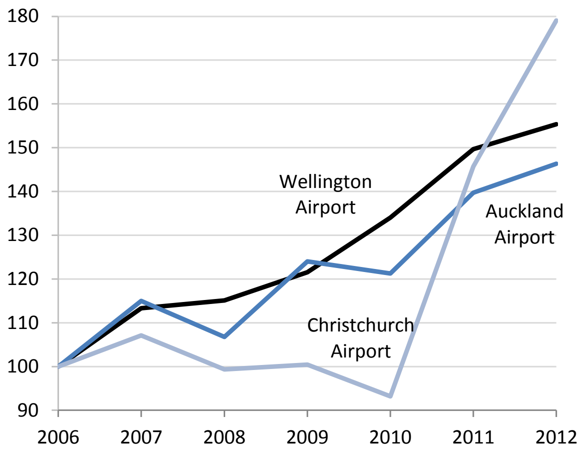


Figure G4: Indexed opex per aircraft movement at Wellington, Auckland and Christchurch Airports (2006–12)



Note: Dollars shown in real (2012) value.
Sources: Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2004–10; Christchurch Airport "Identified Airport Activities Disclosure Financial Statements" 2004 to 2010; Auckland Airport "Identified Airport Activities Disclosure Financial Statements" 2004 to 2010; Wellington Airport "Specified Airport Services

Annual Information Disclosure, 2011 to 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure"2011 to 2012; Auckland Airport, "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

G27 Wellington Airport has lower unit opex relative to other airports, but it is not clear if this is because Wellington Airport is relatively efficient. As shown in Figure G5 and Figure G6, relative to seven other New Zealand and Australian airports Wellington Airport's operational expenditure is lower on both per passenger and per movement measures. This may be due to the differences in its operational circumstances which mean Wellington Airport could have lower expenditure without being more efficient, for example, differing mixes of international and domestic passengers. At this stage, due to limited understanding and data on these differences, we cannot provide more detailed comparisons.

Figure G5: Opex per passenger (2011)

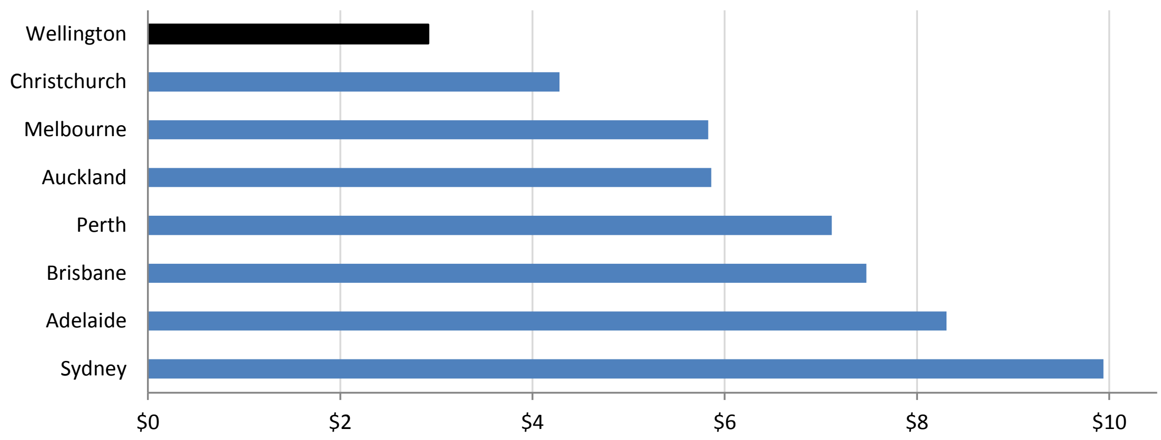
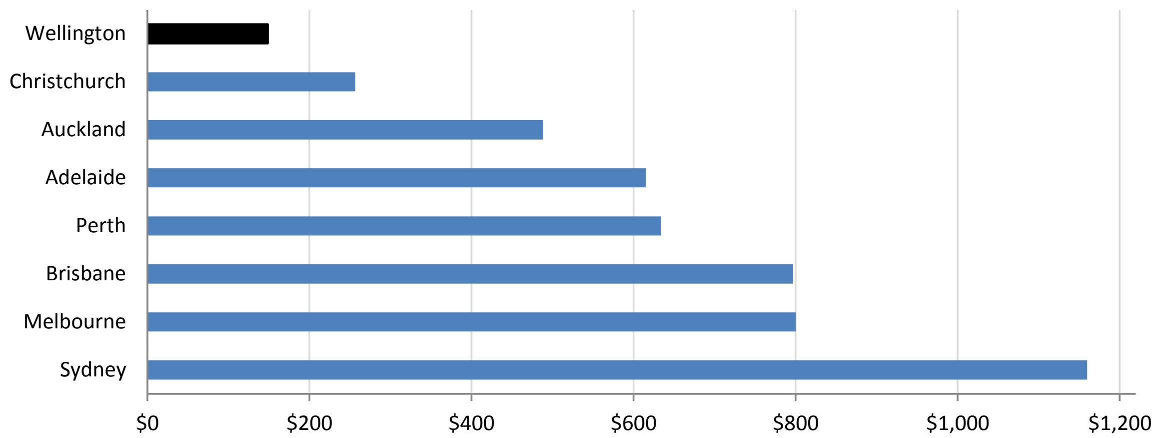


Figure G6: Opex per aircraft movement (2011)



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

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

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

G28 Wellington Airport has forecast a decrease in the unit opex over PSE2 but it is not clear if this is a result of improvements in managerial efficiency. It may instead be due to economies of scale which have resulted from an increase in passenger volumes outside the control of Wellington Airport. We also note that unit opex is forecast to remain at a higher level than observed historically.

G29 To assess whether Wellington Airport's opex forecast for PSE2 indicates reasonable future efficiency gains, we have:

G29.1 considered forecast trends in unit opex at Wellington Airport, including relative to unit opex in PSE1. We would expect forecast opex to reflect some, but not necessarily all, expected future efficiency gains;

G29.2 benchmarked Wellington Airport's forecast unit opex in PSE2 relative to Auckland and Christchurch Airports' forecast expenditure in the same period. This provides an indication of whether any forecast efficiencies by Wellington Airport are appropriate;

G29.3 assessed whether any reduction in unit opex are due to economies of scale, and whether these economies are attributable to improvements in Wellington Airport's efficiency; and

G29.4 considered the views raised in submissions on this s 56G review.

Forecast trends in unit opex

G30 Figure G7 and Figure G8 show that opex per passenger and opex per aircraft movement is forecast to decline over the pricing period to below the 2012 level.[206] However it is unclear if this is an improvement in operating efficiency. Unit opex is forecast to remain at a higher level than forecast and actual unit opex for much of PSE1. Unit opex is also forecast to start at a higher level than observed in 2012.

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

Figure G7: Opex per passenger (2008–17)

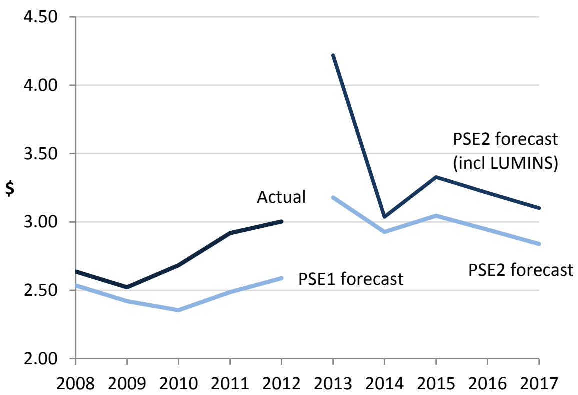
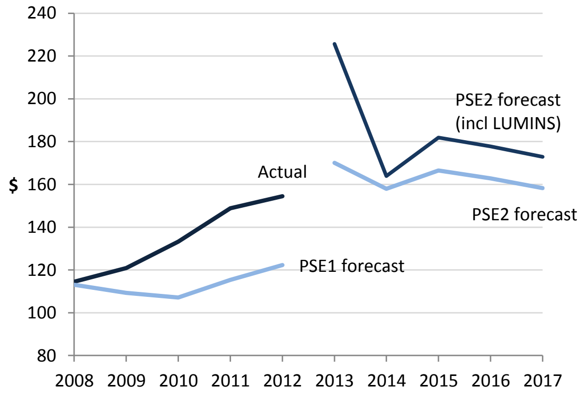


Figure G8: Opex per aircraft movement (2008–17)



Notes: Forecast unit opex shown including and excluding noise mitigation expenditure (LUMINS) for comparability with PSE1, as this is an additional cost for PSE2. Dollars shown are in real (2012) value.
Sources: Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2006 to 2010; Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Wellington Airport "Wellington International Airport Limited: Price setting event disclosure", 30 April 2012.

Comparison of forecast trends in unit opex

G31 As shown in Figure G9 and Figure G10, Wellington Airport has forecast similar or larger decreases in unit opex over PSE2 relative to Auckland and Christchurch Airports. Unit opex is also forecast to be at a lower level than at Auckland Airport over the period. This may indicate that Wellington Airport's forecast reductions are reasonable, although as discussed in paragraph G27, it is not clear such comparisons are appropriate.

Figure G9: Indexed opex per passenger at Wellington, Auckland and Christchurch Airports (2013-17)

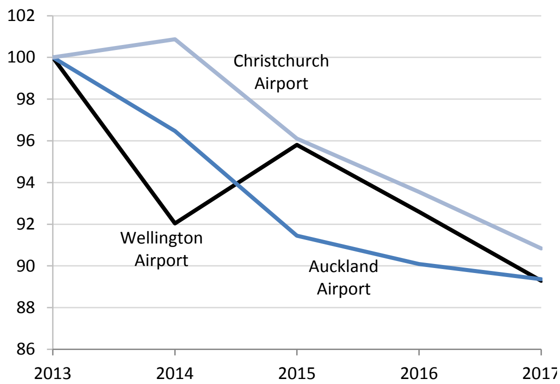
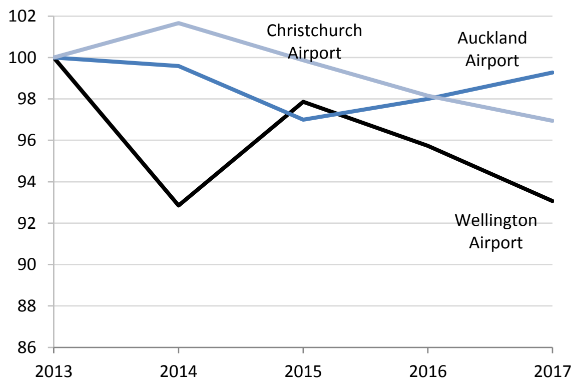


Figure G10: Indexed opex per aircraft movement at Wellington, Auckland and Christchurch Airports (2013-17)



Sources: Wellington Airport "Wellington International Airport Limited: Price setting event disclosure" 30 April 2012; Christchurch Airport "Christchurch International Airport Limited: Price setting event disclosure" 19 December 2012; Auckland Airport "Auckland International Airport Limited: Price setting event disclosure" 2 August 2012.

Economies of scale at Wellington Airport

G32 The forecast reduction in unit opex at Wellington Airport appears, in part, to be attributable to the presence of economies of scale. Wellington Airport's total opex is forecast to increase by 19% ($13 million) (excluding noise mitigation costs) over PSE2, relative to opex in PSE1. Despite this increase, as discussed above, unit opex is forecast to decrease. This indicates economies of scale.

G33 It is not clear if these economies of scale have resulted from forecast efforts by Wellington Airport to increase passenger volumes and exploit their economies of scale (which results in improvements in operating efficiency), organic growth, or efforts by airlines to increase passenger volumes. Reductions in unit costs resulting from these latter factors would not be relevant efficiency improvements as they do not result from Wellington Airport's managerial efforts. BARNZ disagree with Wellington Airport about the extent to which the forecast growth in volumes is a result of Wellington Airport's volume growth incentive scheme.[207]

Concerns raised in submissions

G34 Airlines have submitted that aspects of Wellington Airport's forecast opex do not represent efficient costs. We note that neither of these specific areas of concern will have a significant impact on Wellington Airport's opex.

G34.1 Wellington Airport has forecast an increase in remuneration costs arising from the employment of additional staff to provide gate allocation services. The airlines submitted that the increased opex as a result of the three additional employees to provide gate allocation services is not appropriate.[208] This accounts for around 1% of Wellington Airport's total forecast opex over PSE2.

G34.2 Wellington Airport is forecasting a reduction in airport overheads. Airlines do not consider this reduction to be sufficient as it includes the litigation costs associated with the input methodologies applicable to Airports' information disclosure regulation.[209] Total 'consultation and regulatory expenditures', which includes litigation costs amongst other expenditure items, will comprise 3% of Wellington Airport's total forecast opex over PSE2. It is therefore unlikely that litigation expenditures on their own will have a significant impact on prices at Wellington Airport.

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

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

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

G35 BARNZ submitted that it considered an efficient level of opex for PSE2 would be equivalent to opex per passenger in 2007. This level appears to be based on the information available at the time of consultation, rather than a detailed consideration of what an efficient level of opex is. [210] This equates to approximately a 10% reduction relative to forecast opex over PSE2. This would result in an average decrease in opex of $1.6 million per year over the pricing period, or $7.9 million over PSE2.

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

G36 We are unable to conclude whether Wellington Airport's conduct indicates that it seeks to improve efficiency. Parties have mixed views on whether Wellington Airport's conduct indicates that it seeks to improve its efficiency. We note however that Wellington Airport did provide airlines with more detailed expenditure forecasts than required under information disclosure.

G37 BARNZ did not consider there was effective consultation on opex, stating that "if we ever try and get into specifics [of the opex forecast] we get into the argument, are you trying to micro manage our airport...".[211] Wellington Airport submitted that it has provided customers with detailed expenditure forecasts for the last several pricing periods, and made changes to its forecasts following feedback from airlines. They also submitted that the airlines did not identify any specific cost areas where they considered Wellington Airport was exhibiting inefficient behaviour.[212]

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

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

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

Attachment H: Is information disclosure promoting incentives to invest efficiently at Wellington Airport?

Purpose

H1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Wellington Airport has incentives to invest and improve the efficiency of its investment (s 52A (1)(a) and (b)).

H2 Efficient investment is the investment in assets at the lowest possible cost over the lifetime of the assets, while delivering the required level of quality or output which is valued by consumers. The efficiency of an investment is assessed based on the information available at the time the decision to invest was made.

Conclusion

H3 Our conclusion is that it is too early to tell whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Wellington Airport. Submissions to this review indicate that Wellington Airport has sought to invest efficiently for PSE2 and that forecast capital expenditure for PSE2 is prudent, particularly relative to PSE1. However, it is too early to conclude whether information disclosure regulation under Part 4 is effective until we know whether the issues of timing and level of investment raised by airlines for PSE1 continues to raise concerns in PSE2 and beyond.

H4 The key reasons for our conclusion are provided below.

H4.1 Based on submissions from airlines to this review, the forecast levels of capital expenditure over the next pricing period appear prudent given current information. Few concerns were raised by airlines, particularly compared to PSE1.

H4.2 There is no evidence in submissions to this review that Wellington Airport is not undertaking necessary investments.

H4.3 Wellington Airport submitted that its conduct suggests that it seeks to invest efficiently.[213] We have not received submissions from airlines to suggest that this statement is incorrect.

[213] Wellington Airport "Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL" 6 July 2012, paragraph 158 to 161.

H4.4 There have been significant concerns raised about investments that were planned for PSE1 (eg, in relation to “The Rock”), before information disclosure under Part 4 took effect. It is possible that concerns of this nature could recur in future. At this time, it is unclear if information disclosure regulation under Part 4 will result in fewer concerns from airlines about the level and timing of investment.

H4.5 We expect information disclosure to become as effective as it can be at providing incentives to invest efficiently over time, when information on actual capex becomes available and interested persons can assess trends in forecast and actual expenditure. Information on actual capex relative to forecast, and the supporting explanation required by information disclosure, will be an important indicator of whether Wellington Airport is investing efficiently, and whether information disclosure regulation under Part 4 is effective in this area.

H5 Similar to the discussion in paragraph G6, Wellington Airport has not provided any evidence of superior performance with respect to improvements in the efficiency of its investments over PSE1 to justify earning a return that exceeds our estimated cost of capital in PSE2.

H6 The nature of capex means that an assessment of the effectiveness of information disclosure in providing incentives for efficient investment at Wellington Airport relies largely on an analysis of historical performance, rather than expected performance. Forecast capex does not inform us whether information disclosure regulation under Part 4 is effective in addressing past concerns with the level and timing of Wellington Airport’s capex. As discussed in paragraph G7, we have no information on actual performance since prices were set for PSE2. PSE2 is the earliest we would expect information disclosure to have an impact against which to assess the effectiveness of information disclosure regulation on Wellington Airport’s efficient investment.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to invest efficiently

H7 Wellington Airport has some incentives to invest efficiently. Wellington Airport sets its prices for a five-year pricing period. Setting its prices for a fixed period provides Wellington Airport with an incentive to invest efficiently so as to outperform the capex forecast in its building blocks model (ie, have lower actual expenditure than forecast), and therefore earn higher profits. Under s 4C of the AAA Wellington Airport is also required to consult on large capex programmes with its substantial consumers.

H8 Some of these incentives to invest efficiently are weakened because of Wellington Airport’s market power. For example:

H8.1 Wellington Airport has an incentive to set its capex forecast above an efficient level, to justify higher prices through its building blocks approach.

This allows it to then earn higher profits by outperforming this forecast without necessarily being efficient;

H8.2 Wellington Airport may choose to defer investment beyond the point at which it is efficient to invest so as to reduce its costs within the pricing period. Wellington Airport may also choose to forecast investment earlier in the pricing period than would likely occur. Where the timing of investment differs from the forecast used to set prices, Wellington Airport may earn higher profits;[214] and

H8.3 under the building blocks model that it uses to set prices, Wellington Airport's prices are based on the size of its asset base. If it is targeting the recovery of an excessive cost of capital on its asset base, it has an incentive to over-invest to increase the size of its asset base. This is because it would earn higher profits if the targeted cost of capital on that investment exceeds the economic cost of financing the investment.

How information disclosure can provide incentives to improve investment efficiency

H9 Information disclosure may strengthen Wellington Airport's incentives to invest efficiently. The public disclosure of information on historic and forecast capex can provide transparency about how well Wellington Airport is performing relative to other suppliers and over time. Over time, it can highlight if Wellington Airport over-forecasts capex or forecasts capex to occur too early in the pricing period for the purpose of price-setting.

H10 We expect information disclosure regulation to become as effective as it can be in promoting efficient investment over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends, and the opportunity for suppliers and consumers to react to the information disclosed. At the time of consultation for PSE2, only limited information on Wellington Airport's capex was available in information disclosure.

How we have assessed whether Wellington Airport is investing efficiently

H11 Our approach to assessing investment for this review is to consider Wellington Airport's performance and conduct regarding investment. We have looked for evidence of:

H11.1 the delivery of investment at lowest possible cost, without compromising quality or outputs and delivering the desired outcome. As part of this we have reviewed the actual and forecast capex of Wellington Airport in PSE1;

H11.2 planned under-investment and over-investment; and

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214 The use of wash-up mechanisms by Wellington Airport for delayed capex may mitigate the incentives to defer investment inefficiently for those projects subject to such an arrangement.

H11.3 planned and actual investment occurring at an appropriate time.

H12 We have also considered the conduct of Wellington Airport when planning, consulting on and delivering capital projects.

H13 Given the relatively low level of concern from the airlines about Wellington Airport's capex forecast for PSE2, we have not undertaken a detailed review of their capex forecasts and supporting business case. We did not consider the costs of undertaking such a review were appropriate to address relatively minor concerns with Wellington Airport's capex forecast for PSE2. Our analysis of the efficiency of Wellington Airport's capex therefore relies to a large extent on submissions received as part of this s 56G review.

Information used to assess whether Wellington Airport is investing efficiently

H14 Our analysis uses quantitative and qualitative data from the following sources:

H14.1 information disclosed under Part 4; and

H14.2 submissions and other material generated as part of this s 56G review.

Analysis of Wellington Airport's investment performance and conduct

Is Wellington Airport investing efficiently?

Does Wellington Airport deliver investment for an efficient cost?

H15 At this time, we do not have actual expenditure information for PSE2 to assess the effectiveness of information disclosure in promoting the efficient delivery of capex.

H16 Wellington Airport's capex was higher than forecast in PSE1. Table H1 shows that many of the individual projects exceeded their forecast. However, much of the total difference between actual and forecast capex appears to be attributable to the impact of asset transfers (included in 'other' capex) and the unplanned construction of the Western Hangar.[215] No concerns have been raised in submissions about the construction of the Western Hangar.

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

Table H1: Forecast and actual capex at Wellington Airport (2008–12)

Program	Forecast ($m)	Actual ($m)	Difference from forecast ($m)	Difference from forecast (%)
South RESA	2.6	1.8	-0.9	-33
North RESA	5.7	7.7	2.0	36
Northern pier (eastern gate)	4.5	5.7	1.2	26
Northern pier (terminal and western gate, including 'The Rock')	33.7	35.6	1.9	6
Airfield pavement maintenance	13.9	16.8	2.8	20
Western hangar	0	7.7	7.7	–
Other capex	13.9	38.0	24.2	174
Total	74.3	113.2	39.0	52

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

Is there evidence of planned under or over-investment at Wellington Airport?

H17 Airlines have raised concerns that Wellington Airport forecasts have included some over-investment, but have not indicated any concerns about under-investment.[216] They otherwise consider Wellington Airport's forecast capex for PSE1 and PSE2 to be reasonable.[217] Their key concerns are as follows.

H17.1 Airlines submitted that the specification of 'The Rock' international terminal built in PSE1 is higher quality than is necessary for an airport terminal.[218] Wellington Airport has responded that actual capex for 'The Rock' was $28.3 million, within BARNZ's suggested range of $24 million to $29 million.[219]

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

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

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

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

H17.2 BARNZ submitted that the tunnels forming part of RESAs have been constructed to accommodate aircraft that are not likely to operate at Wellington Airport.[220] BARNZ submitted that this led to an additional $5 million of capex on the RESAs.[221] This accounts for around 7% of the forecast capex over PSE1. Wellington Airport has submitted that this investment was necessary as a result of changes in CAA regulatory requirements and to ensure efficient use of the runway.[222]

H17.3 BARNZ submitted that the forecast taxiway works for PSE2 and PSE3 are above the level required given the type of aircraft that generally use the runway.[223] Wellington Airport responded that the forecast taxiway works during PSE2 are required to meet minimum standards set by the International Civil Aviation Organisation (ICAO).[224] The disputed taxiway works accounts for around 8% of forecast capex in PSE2, and 14% of forecast capex for the period 2013–22.

Is investment planned and undertaken at an appropriate time?

H18 Airlines have raised concerns that Wellington Airport forecasts capital expenditure earlier in the regulatory period than the investment is likely to occur so as to earn higher profits.[225] Figure H1 to Figure H5 show that there is evidence that capital expenditure was incurred later than forecast during PSE1. The reasons for this are unclear and can be attributed in part to higher capex than forecast. It is not clear whether the forecast timing of capex was inefficient, or whether the apparent deferral of capex was efficient. We note that a wash-up mechanism applied to the delayed commissioning of the terminal project.[226]

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220 BARNZ “BARNZ Post Conference Submission on Wellington Airport Section 56G Review” 17 August 2012, page 6.

221 BARNZ “BARNZ responses to Commerce Commission questions relating to WIAL” 28 June 2012, page 18.

222 Wellington Airport “Submission to the Commerce Commission: Section 56G Process and Issues Paper: Substantive Submission - responses to questions relating to WIAL” 6 July 2012, paragraph 174; Wellington Airport “Wellington International Airport Limited’s substantive submission to the Commerce Commission in relation to its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington International Airport Limited” 30 November 2012, paragraph 159.

223 BARNZ “BARNZ responses to Commerce Commission questions relating to Wellington Airport” 28 June 2012, page 13.

224 Wellington Airport “Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference” 17 August 2012, pages 29 to 30.

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

226 This is discussed in more detail in paragraph E28.

Figure H1: Variance between forecast and actual capex on South RESA

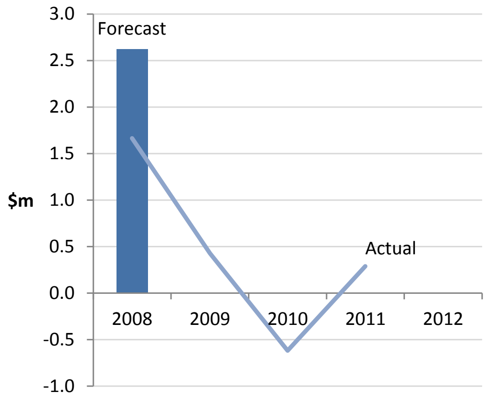
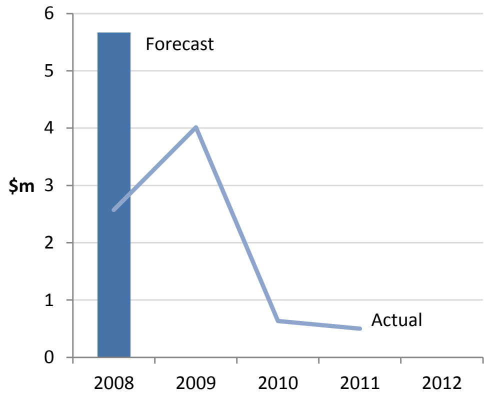


Figure H2: Variance between forecast and actual capex on North RESA



Note: The negative value in the South RESA in 2010 arose from a review of outstanding work in progress and reclassification of capital expenditure from the South to North RESA Project.

Figure H3: Variance between forecast and actual capex on Northern pier (eastern gate)

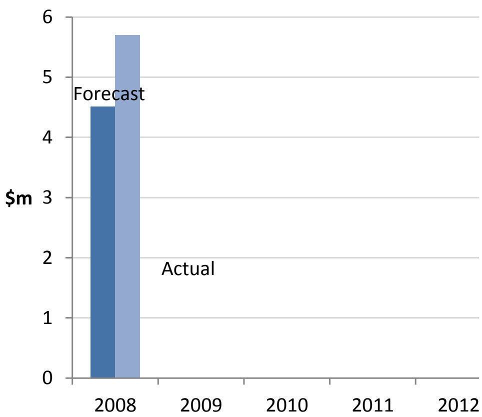


Figure H4: Variance between forecast and actual capex on Northern pier (terminal and western gate including 'The Rock')

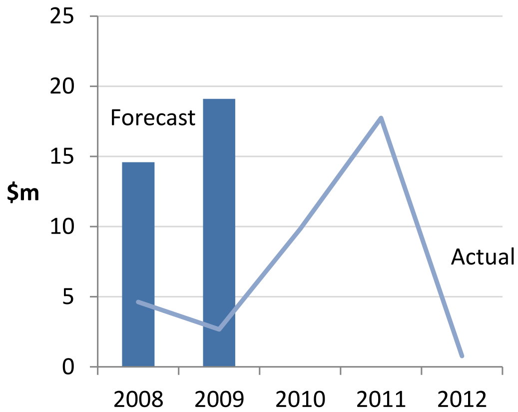
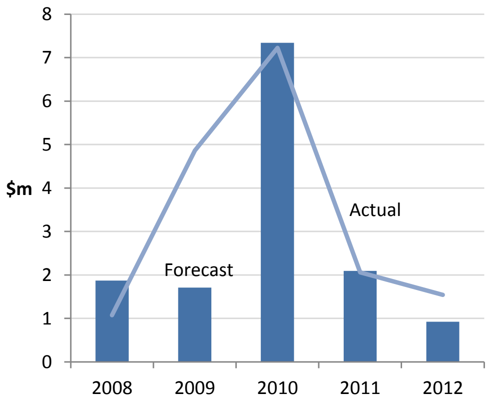


Figure H5: Variance between forecast and actual capex on airfield pavement maintenance



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

H19 At this time, we do not have actual expenditure information for PSE2 to assess the effectiveness of information disclosure in mitigating incentives to inefficiently delay capex. During PSE2, around half of the capex forecast for Year 1 and Year 2 is for the 'Building works' programme, which consists of projects subject to wash-up arrangements.[227] We expect that wash-up arrangements will provide some mitigation against deferring this investment, but that incentives to defer other investment will still remain.[228]

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

H20 Submissions from Wellington Airport regarding their conduct suggest it seeks to invest efficiently. For example:

H20.1 Wellington Airport submitted that they consulted with airlines about its capex projects significantly more than is required by the AAA regime;[229]

H20.2 Wellington Airport submitted that they deferred some investment in response to feedback from customers that did not support this component of their forecast;[230] and

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

[228] The wash-up arrangement is discussed in more detail in Attachments E and F. We note that the wash-up mechanism may create adverse incentives not to delay investment later than forecast when it may be more efficient to defer this investment.

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

H20.3 Wellington Airport agreed to airlines' proposals for wash-up arrangements for major capex projects in both PSE1 and PSE2.[231]

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

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

Attachment I: Is information disclosure promoting the sharing of efficiency gains with consumers at Wellington Airport?

Purpose

I1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Wellington Airport shares the benefits of efficiency gains with consumers, including through lower prices (s 52A(1)(c)) of the Act.

I2 In a workably competitive market, efficiency gains achieved by a supplier are likely to be shared with consumers over time through lower prices. Efficiency gains may also be shared through improvements to service quality or additional investment at no cost to consumers. To assess whether a supplier is sharing efficiency gains, an assessment first needs to be made of whether they are achieving efficiency gains. This is discussed in Attachments G and H.

I3 Our focus is on sharing efficiency gains made in the supply of regulated services. Some of these efficiency gains arise as a result of providing regulated and unregulated services in combination.

Conclusion

I4 We are unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers. This is because it is too early to conclude whether there are any opex and capex efficiency gains at Wellington Airport that could be shared with consumers.

I5 The key reasons for our conclusion are as follows.

- I5.1 There is limited evidence of historic efficiency gains at Wellington Airport that could be shared with consumers when resetting prices in PSE2.
- I5.2 There is limited evidence of forecast efficiency gains at Wellington Airport than could be shared with consumers during PSE2.
- I5.3 There are no mechanisms to ensure that Wellington Airport shares any efficiency gains within the pricing period that were not forecast.

How we have assessed the effectiveness of information disclosure

Incentives on Wellington Airport to share efficiency gains with consumers

I6 Wellington Airport has weak incentives to share efficiency gains with consumers, including through lower prices. Setting prices using a building blocks model provides some incentive to share efficiencies by making it more transparent whether efficiency gains have been made and shared. However, although Wellington Airport is required to consult with its customers on pricing, its ability to set charges as it sees fit means it is unlikely to have strong incentives to promote the sharing of efficiency gains outcomes sought under Part 4.

How information disclosure can provide incentives to share efficiency gains

I7 Information disclosure can strengthen incentives to share efficiency gains, by increasing transparency of whether efficiency gains have been made, and allowing interested persons to assess whether these have been shared with consumers. If efficiency gains are not shared with consumers over time, then this can indicate that excessive profits are being earned. This may increase the likelihood of further regulation. The ability of information disclosure regulation to be effective in this area relies on Wellington Airport making or forecasting efficiency gains in the first instance.

I8 Information disclosure may also strengthen incentives to share efficiency gains resulting from economies of scope through the cost allocation IM.[232] This sets rules on how common costs should be allocated between Wellington Airport's regulated aeronautical services, and its non-aeronautical services. The IM may help ensure that efficiency gains in common costs that are achieved through the joint supply of aeronautical and non-aeronautical services are shared with consumers of aeronautical services.

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

I9 We expect information disclosure regulation to become as effective as it can be in this area over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends in expenditure relative to forecasts to see whether gains are being made or forecast, and to see what if any impact they have on prices. We also expect information disclosure to be as effective as it can be in this area at price-setting events. This is because efficiency gains are likely to be shared with consumers through the prices set and investments planned at this time. Information on trends in Wellington Airport's expenditure was not available at the time prices were set for PSE2 to influence the decisions made.

I10 At this stage we consider that information disclosure regulation has not provided any disincentives for making efficiency gains or sharing them with consumers.[233]

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

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

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

I11 Our approach considers whether any historic or forecast efficiency gains are being shared with consumers through lower prices. As part of this, we examined:

I11.1 whether prices set by Wellington Airport reflect efficiency gains achieved in previous pricing periods (ie, between period sharing);

I11.2 whether prices set by Wellington Airport reflect any forecast efficiency gains for the pricing period (ie, within period sharing); and

I11.3 whether Wellington Airport has any explicit mechanisms for sharing efficiency gains that are not forecast.

I12 We also considered whether efficiency gains have been passed on in improvements to service quality at Wellington Airport or investment in aeronautical assets, at no cost to consumers.[234] This would mean that these investments or improvements are not funded through the prices set by Wellington Airport during the price-setting event.

I13 We have considered whether Wellington Airport is sharing efficiency gains with consumers both before and after the introduction of information disclosure regulation. This provides insight into the effectiveness of information disclosure regulation in promoting the sharing of efficiency gains.

Information used to assess whether Wellington Airport is sharing efficiency gains

I14 Our analysis relies on qualitative information provided by Wellington Airport in its disclosures for PSE1 and PSE2, and our assessment of the efficiency of Wellington Airport's operational and capital expenditure discussed in Attachments G and H. We have also considered submissions received as part of this s 56G review on whether Wellington Airport has shared efficiency gains.

Analysis of Wellington's Airports performance and conduct

I15 We are unable to conclude whether prices set by Wellington Airport reflect efficiency gains achieved in previous pricing periods. As discussed in Attachments G and H, the evidence of whether Wellington Airport has achieved efficiency gains is inconclusive.

I16 Similarly, we are unable to conclude whether the prices set by Wellington Airport include the sharing of any forecast efficiency gains for the pricing period. This is because there is insufficient evidence at this time to assess whether Wellington

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

Airport has forecast efficiencies, as discussed in Attachments G and H. We note that if there are any forecast efficiency gains, the approach and mechanisms used by Wellington Airport to set prices for PSE2 results in the forecast efficiency gains being shared with consumers through lower prices. This is because the building block model used by Wellington Airport to determine the revenue requirement includes forecasts of operational and capital expenditure. Forecast efficiency gains that are included in these expenditure forecasts will therefore automatically be reflected in lower prices through the revenue requirement.

I17 As a general note, prices for PSE2 are higher relative to PSE1.[235] This indicates that any efficiency gains shared with consumers are outweighed by increases in the other factors that determine the price set, for example, the regulatory asset base. This is discussed further in Attachment E.

I18 We are not aware of any actual or planned improvements in quality or investment at Wellington Airport's regulated business that were not funded through prices set for aeronautical activities for PSE1 and PSE2.

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