

SECTION 56G REVIEW OF AUCKLAND AIRPORT: SUBMISSION ON COMMERCE COMMISSION DRAFT REPORT

31 May 2013

1. The Commerce Commission ("**Commission**") published its Draft Report on the effectiveness of information disclosure ("**ID**") regulation at Auckland Airport on 30 April 2013, under section 56G of the Commerce Act 1986 ("**Auckland Draft Report**"). The New Zealand Airports Association ("**NZ Airports**") makes this submission in response to the Auckland Draft Report on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch International Airport Limited (together, "**Airports**").
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INTRODUCTION AND EXECUTIVE SUMMARY

3. The Auckland Draft Report is a positive step in the development of the ID regime. The Commission has appropriately recognised that ID regulation:
 - (a) is an effective regulatory tool which allows interested parties to assess airport behaviour and performance (albeit that this effectiveness is expected to improve over time as feedback and analysis information becomes available through section 56G review, publication of ongoing disclosures, and the Commission's annual monitoring reports);
 - (b) can promote the Part 4 purpose statement by providing transparency and a threat of further regulation (which, in turn, provides incentives for airports to seek outcomes that are consistent with workably competitive markets); and, as such
 - (c) the ID regime is currently providing incentives for airports to align their conduct with the Part 4 purpose statement.
4. In assessing the effectiveness of ID regulation for Auckland Airport, the Commission has correctly noted that:
 - (a) behaviour and conduct can provide good evidence of the effectiveness of ID regulation, including where an airport has taken steps to adjust its culture and decision-making processes, respond to customer demands, and to seek lower returns than it may otherwise have done; and

- (b) assessing performance outcomes in an area can be a good way to test whether ID is providing the right incentives (including providing incentives to maintain previous positive performance).
5. Against that positive backdrop, NZ Airports' key concern is to ensure that conclusions about airport performance and the effectiveness of the ID regime are based on the most robust and appropriate evidence that is currently available. This may require the Commission to carefully consider and balance the respective weight that it gives to evidence of conduct and behaviour, forecast performance, and actual outcomes as the ID regime develops.
6. At this early stage in the life of the ID regime, NZ Airports considers there should be more emphasis on the evidence that demonstrates ID regulation has influenced decision-making to be consistent with the Part 4 purpose statement. Assessment and modelling of forecast and assumed outcomes, although relevant to the exercise, may not be the best evidence of how effectively ID regulation is promoting the Part 4 purpose statement in an environment where airports were not aware of how performance would be assessed and all parties acknowledge that the influence of the ID regime will strengthen over time. In particular:
- (a) It is clearly too early to draw definitive conclusions about actual performance over time, and to reach a view on the success or failure of the ID regime. The necessary information to draw these conclusions is simply not available, and the ID regime (including the feedback loops established by Commission monitoring and analysis) has not yet been fully established. NZ Airports notes that the actual returns published by each of the Airports since the commencement of ID regulation are below the Commission's published WACC estimates for ID purposes (when unrealised non-cash revaluations are excluded).
- (b) Although it is true that ID regulation will be more effective over time, positive findings can be made at this stage to the extent that those findings are supported by the evidence currently available. For example, it may be possible for the Commission to assess the disclosed information to make findings about airports' forecast performance, and the impact of ID regulation on forecast outcomes.
- (c) However, when doing so, the impact and effectiveness of ID regulation must be assessed based on the way in which it affected airports' decision making at the time the relevant decisions about forecast performance were made. As such, less weight should be given to the outcomes of *ex post* modelling given the evidence that, at the time prices were set, ID regulation did not provide airports with clear and uncontested guidance on acceptable returns or the way that performance would be assessed under the ID framework.
- (d) The Commission considers that ID regulation is currently effective at limiting Auckland Airport's ability to earn excessive profits based on the output from its formulaic modelling approach. However, what the Commission is actually saying is that ID regulation has appropriately limited Auckland Airport's profit-seeking intentions. The evidence of the role of ID regulation in that process cannot be fully explained by the Commission's internal rate of return ("**IRR**") analysis. Evidence about the moderating effect of ID regulation on Auckland Airport's behaviour and conduct at the time that its pricing decision was made is clearly very important.
- (e) The Commission has already recognised this positive behaviour in its Auckland Draft Report. NZ Airports is simply asking the Commission to acknowledge that, at this early stage of the ID regime, this positive behaviour provides the best evidence of the impact of ID regulation, and should be given greater emphasis than contentious *ex*

post modelling of forecast returns expectations (which, in any event, are heavily reliant on assumptions about future pricing decisions).

7. In this submission, NZ Airports addresses the following key points:
 - (a) the nature and effectiveness of ID regulation, and the way in which that effectiveness can be assessed;
 - (b) the uncertainty the Commission's approach creates for airports going forward;
 - (c) our particular concerns with the profitability analysis undertaken by the Commission; and
 - (d) the Commission's suggestions for amendments to ID regulation.

THE NATURE AND EFFECTIVENESS OF ID REGULATION

8. The ID regime is, at its heart, an evidence gathering mechanism to allow an assessment of whether the Part 4 purpose statement is being promoted. By gathering information and making that information publicly available, ID regulation enables a better and more informed understanding of airport decisions, decision-making processes, and performance, so that the outcomes produced by airports are fully scrutinised.
9. This increased transparency combined with the threat of further regulatory intervention, and the Commission's monitoring and analysis role, creates an effective regime. This regime increases the countervailing power of customers by providing them with further tools and information to put increased pressure on airports, and imposes additional discipline on airports to engage in appropriate conduct.
10. It is clear that incentives-based regulation is intended to be a dynamic process. As such, there is no single standard of performance to "achieve" the purpose statement. Instead, ID regulation seeks ongoing promotion of the desired outcomes over time.
11. The input methodologies ("**IMs**") and benchmarks established by the Commission are important. However, airports must be free to depart from these standards if they believe that evidence, customer feedback, and/or airport-specific circumstances warrant appropriate departures. Provided that airports are transparent about the decisions they have made, and disclose the information which supports those decisions, interested parties can judge the choices that have been made.
12. This is an essential distinction between ID regulation and heavier-handed forms of regulation. It is also one of the key benefits of the ID regime. As such, ID regulation can and should encourage airports to adopt tailored and innovative approaches in the long-term interest of consumers. This ensures that the appropriate incentives exist while the risk of regulatory error that would result from a prescriptive approach can be avoided. This is particularly important in the airport industry given the role that airports play in promoting air traffic movements, and driving trade and tourism (both within New Zealand and from overseas).
13. The Commission's Auckland Draft Report goes some way to addressing these points. However, further progress can be made.

Assessing the effectiveness of ID regulation

14. When examining the effectiveness of ID regulation, the key question is whether the ID regime has helped to:

- (a) provide greater transparency and promote a better understanding of airport performance;
 - (b) give airports and interested parties a better understanding of what is required to promote the Part 4 purpose statement over time; and
 - (c) through this increased transparency and understanding, incentivise airports to engage in behaviour that promotes the long-term benefit of consumers.
15. NZ Airports believes that progress has been made in relation to each of these aspects, but that further progress will be made over time. In particular, there is evidence that the ID regime has been effective because:
- (a) sufficient information about airport performance and conduct is available to interested parties;
 - (b) airports are continuing to engage in positive behaviour that was present before the transition to the Commerce Act ID regime; and
 - (c) where areas of concern have been identified, conduct and performance are moving closer to the Part 4 outcomes.
16. A key question going forward will be whether airports are adjusting behaviour if necessary to better align performance with the Part 4 purpose statement. However, we have not reached a point where the assessment tools for use in that analysis have been finally determined (and, in any event, there is continuing debate on the way in which those tools are used). For example, the Commission has acknowledged that the merits review decision may require it to revisit its conclusions on profitability.
17. That said, airports and interested parties are learning through the section 56G process how the Commission approaches its profitability analysis, including the role that the IMs will play in that analysis (which was not known at the time prices were set).
18. The fact that ID regulation is in its infancy does not mean that the Commission is unable to draw conclusions in its section 56G review. The Commission's task is to review the information that has been disclosed and to consider how effectively ID regulation is promoting the purpose statement at the current time.
19. However, there are challenges to assessing the effectiveness of ID regulation at this early stage. In particular, although it would ordinarily be correct to assess actual performance (as well as behaviour) to test whether the right incentives are being provided:
- (a) there is limited actual performance data at this time; and
 - (b) although forecasts can provide some indication of current incentives, they should not be considered in isolation of the circumstances and reasons for the decisions underlying those forecasts.
20. We are therefore concerned that the Commission's approach to the section 56G review does not fully acknowledge that absolute standards do not exist when assessing the effectiveness of ID regulation. For example, the Commission considers that: "finding some evidence of progress

in a particular performance area does not necessarily mean that the intended outcome has been achieved".¹ However:

- (a) The section 56G review does not require an absolute conclusion on whether ID regulation has succeeded or failed. That would be unrealistic at this early stage of the regime. The question is **how** effectively ID regulation is promoting the purpose statement.
- (b) Most importantly, evidence of progress in an area does amount to promotion of the purpose statement. Part 4 does not set out performance outcomes to be achieved. Indications of positive behaviour change or maintenance of previous positive behaviour are signs of the start of an effective ID regime, across all limbs of the purpose statement. In this way, the Commission can appropriately conclude that ID is being effective in its early stages, while acknowledging that it will take time for the full impact and effectiveness of the regime to develop.
- (c) Indeed, the Commission has already done so in the way that it has assessed the impact of ID regulation on pricing efficiency for both Wellington Airport and Auckland Airport. The Commission's assessment model in this area is an example of successful ID in action, in the following ways:
 - (i) The Commission has considered movements in performance and conduct against a range of clearly set out economic principles. The Commission asks whether ID regulation has incentivised airports to move towards improved economic outcomes which are likely to promote the purpose statement over time.
 - (ii) Both performance and conduct are considered to be relevant, and airline views are properly viewed as relevant but not determinative.
 - (iii) The impact of ID regulation in encouraging airports to consider and evaluate their decision-making is appropriately acknowledged, and ID is found to be effective in its early stages.

We encourage the Commission to reflect this measured approach across all elements of its section 56G review.

THE COMMISSION'S APPROACH CREATES UNCERTAINTY GOING FORWARD

- 21. A key problem now is that, despite a positive finding for Auckland Airport on a number of the Commission's key performance elements, the Commission's analytical approach generates a great deal of uncertainty going forward.
- 22. The essence of the problem is that the Commission is drawing a false distinction between returns, where it believes the impact and effectiveness of ID regulation can be definitively assessed with accuracy now, and other elements of the purpose statement, which it believes can only be assessed over time. In particular:
 - (a) The Commission is purporting to bring a degree of precision and firmness to assessing "returns over time", which overstates the certainty of the analytical framework and the measurement tools it is using to assess airport forecast returns.

¹ Commerce Commission *Auckland Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport: Section 56G of the Commerce Act 1986*, 30 April 2013 ("**Auckland Draft Report**") at paragraph 2.7.

- (b) As discussed above, the Commission is taking a "wait and see" approach to assessing the effectiveness of ID regulation for other performance components. This includes waiting for actual data before it will draw conclusions on the appropriateness of airports' conduct and performance.
- (c) However, each of the performance areas interact, including those areas where the Commission is waiting for actual results before it can assess performance. Going forward, some differences to forecast will emerge through superior performance in any or all areas of the purpose statement (or through factors outside the control of airports). These differences may result in returns that, while above forecast and/or above the Commission's estimate of an appropriate return, cannot and should not be considered "excess returns". Under the Commission's current approach there is no comfort that this will be recognised. Similarly, there is no guidance about what types of behaviour will be considered to be superior, and what evidence will be accepted as demonstrating superior performance.
- (d) For example, in order to conclude that ID regulation is effective in promoting operating efficiency, the Commission appears to be looking for reductions in operating expenditure while quality and quantity of service is maintained. As the Commission considers it is too early to draw conclusions and that actual data is needed, the key at this point is to ensure the approach to ID regulation in the section 56G review provides incentives to achieve actual reductions going forward.

However, the Commission has already made a decision about the appropriateness of returns. In light of that decision, if an airport achieves efficiency gains over PSE2, resulting in actual returns that are higher than the Commission's "benchmark" returns and/or the level of forecast returns, there is considerable risk that this will be seen as excess returns rather than superior performance.

Similarly, where passenger volumes increase (and therefore operating costs per passenger decrease), it is not clear the Commission will recognise the positive role that airports play in that process. The Auckland Draft Report appears to consider that passenger growth is an airline product, without recognising the active role that airports can play in driving passenger growth, and that airports are doing their job to produce efficiencies where quality and service standards are maintained for a greater number of passengers.

- (e) This uncertainty is complicated by the lack of clarity in how the Commission will assess and reflect historical perceived under or over-performance in its assessments over time.

PROFITABILITY REMAINS THE KEY ISSUE OF ANALYTICAL CONCERN

- 23. As discussed above, the key concern going forward is that airports must have sufficient incentives to engage in positive behaviour across all limbs of the purpose statement. However, the inherent links and interdependencies between each of these performance areas and the level of airport returns means that the Commission's prescriptive approach to its profitability analysis risks affecting those incentives. In other words, the Commission's analytical approach risks negatively impacting incentives for future behaviour.
- 24. In NZ Airports' view, the solution is for the Commission to acknowledge that:
 - (a) Relying on an IRR analysis as the sole proxy for assessing whether returns are limited is inappropriate. As such, and as the Commission has acknowledged in parts of the

Auckland Draft Report,² the correct approach is to first stand in the shoes of the airports at the time of pricing, and consider how they responded to the incentives present at the time. We encourage the Commission to consider how it can fully reflect this approach in its Final Report, rather than retrospectively judging the incentives that existed at the time of price-setting based on the results of a prescriptive IRR analysis that is yet to be determined for each airport. The IRR analysis is relevant as a guide, but should not be determinative.

- (b) **Constraints on profit levels show that ID is effective (even to some degree).** If there is evidence of constraints on profitability, then that should be acknowledged as a degree of effectiveness. Further, the question under the purpose statement is whether airports **are limited in their ability** to extract excess profits. If constraints are present, the answer to this question must also be yes. The Commission has converted the question to whether ID regulation has successfully (and instantly) eliminated all excess profits, which does not reflect the nature of the ID regime or the outcome that ID regulation is seeking to promote.
- (c) **There is still considerable debate about what "excess returns" look like.** Instead, the Commission is purporting to bring a degree of precision that is not realistic, does not reflect the uncertainty in the tools it is using to measure profits, and is inappropriate in ID context. In particular:
- (i) Airports were not able to closely predict how performance would be assessed at the time prices were set. When prices were set there was uncertainty regarding how all elements of performance, especially returns, would be assessed. This uncertainty, combined with the specific circumstances of each airport, has led to different airports taking different approaches.
 - (ii) Considerable information about the operation of the ID regime and the way that performance will be assessed has emerged through the course of the section 56G review. It would be inappropriate for the airports to be judged in hindsight as if this information was a controlling influence on behaviour at the time of pricing.
 - (iii) The airports made reasonable and appropriate decisions based on robust and reliable forecast information feedback from substantial customers and the regulatory guidance that was available at the time of pricing. These decisions are particularly appropriate in the context of an ID regime centred on transparency and increased information about the actual decisions made by airports.
 - (iv) Contextual factors should be part of every assessment of profitability, not just when returns are above the weighted average cost of capital ("**WACC**") IM. This is because the context is necessary to determine what an appropriate return actually is, not as a way to justify "excess returns". In this way, despite the language used in the Auckland Draft Report, the Commission's approach continues to raise red flags about whether its WACC IM will be appropriately contextualised.
 - (v) The Commission has recognised that the fall in WACC estimates leading up to Auckland Airport's pricing decision created uncertainty about the appropriate WACC estimate to use in the section 56G review. However, this

² See for example, the Auckland Draft Report at paragraph E19, E54-56.

illustrates a broader concern. The fall in WACC estimates over a short period of time reinforces the difficulties in using the WACC estimate as a clear indication of the appropriate return, and supports the need to carefully consider contextual factors at all times (including when airports are setting prices and when the Commission is assessing performance).

- (d) Many complex factors will interact to produce actual returns, which must be fairly and fully considered. However, where there is sufficient evidence to do so, the Commission can validly draw conclusions that demand, opex and capex forecasts were reasonable at the time those forecasts were made.
- (e) **There are weaknesses in the Commission's formulaic approach.** As discussed above, the advantages of ID regulation lie in its ability to present a full analysis of airports' tailored and individual decisions. As such:
 - (i) Airport-specific factors remain relevant to how "excess returns" are assessed, particularly given the flexible, fit-for-purpose nature of ID regulation.
 - (ii) Further balance is needed to ensure interested parties understand that a formula cannot fully describe the impact and effectiveness of ID regulation. The outcome of a modelling process needs to be balanced and appropriately weighted against key performance elements that cannot be reduced to numbers, so that interested parties fully understand the relationships between conduct, intentions, quality, innovation, investment and returns.
 - (iii) Assumptions about future pricing significantly drive the Commission's analysis. The Commission has acknowledged how sensitive its assessment of expected returns is to various factors,³ yet continues to apply its formulaic approach without fully contextualising the impact of that approach for interested parties.

PROPOSED AMENDMENTS TO ID REQUIREMENTS

- 25. The Commission's suggestions to amend certain ID requirements do not reflect problems with the ID regime. Instead, these suggestions reflect the difficulties with the formulaic and prescriptive approach the Commission has taken to assessing airport performance.
- 26. In particular:
 - (a) Requiring airports to disclose an indicator of expected returns in the same way as the Commission has done is an attempt by the Commission to short-cut the challenges presented by assessing performance in the early stages of the ID regime. The Commission is attempting to use assumptions about future pricing to draw conclusions about returns over an extended period, and to therefore make inferences about airport profitability over the life of the assets involved. Information based on these types of assumptions should be treated with considerable caution.

However, there is no short-cut that can overcome the reality that the ID framework is new, and that there is limited data available to make assessments about returns over time. This is not a problem with the ID regime that needs to be fixed. Instead, the ID regime needs to be given time to bed in, and given the opportunity to build up the

³ Auckland Draft Report at paragraph E46.

necessary information set to make longer-term assessments. The Commission's suggested approach attempts to disguise what is, in essence, a "snapshot assessment" as an assessment of returns over the life of airport assets, which is likely to create confusion and misinterpretation, rather than promoting understanding and transparency. NZ Airports continues to submit that the most appropriate way to assess profitability and performance is to review actual results over time.

- (b) The Commission's suggestion that the asset valuation IM should be amended undermines the Commission's stated intentions behind the asset valuation IM (to ensure consistent information about the value of airport assets is available across airports and over time) and incorrectly blurs the distinction between pricing and information disclosure.

The fact the Commission considers this approach to be necessary highlights the dangers in relying on technical and prescriptive IMs and a formula-based approach to assessing returns. The better approach, as airports have always argued, is to have high level and principles-based IMs for disclosure purposes, and to have an assessment approach which takes a broad and contextual view to assessing airport performance, behaviour and outcomes.