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Have your say on the review of Auckland and Christchurch Airports' third price setting events (July 2017 – June 2022)

Process and issues paper

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Introduction

Purpose of this review

1 We are undertaking this review of prices set by Auckland International Airport Limited (Auckland Airport) and Christchurch International Airport Limited (Christchurch Airport) under section 53B(2)(b) of the Commerce Act 1986 (Act). In June 2017, Auckland and Christchurch Airports set the prices that will apply during the period 1 July 2017 to 30 June 2022. We received the price setting disclosure information from Auckland and Christchurch Airports in August 2017.

2 Under section 53B(2)(b) of the Act we must publish summary and analysis as soon as practicable after information is disclosed by an airport. The purpose of summary and analysis is to promote greater understanding about the performance of each airport, their relative performance, and changes in performance over time.

3 Part 4 of the Act provides for the regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition. The purpose of Part 4 as set out in section 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.

4 Information disclosure regulation has its own specific purpose (section 53A of the Act). 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.

5 Given the Part 4 purpose, it is clear that the supply of regulated services is likely to be, and is intended to be, influenced by the relevant types of regulation.[1] The requirement to publish summary and analysis confers an ongoing, active role on

[1] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 132.

us in respect of the information disclosure regime after the information disclosure requirements have been set.

Purpose of paper

6 This paper outlines our proposed approach for this review. Specifically, this paper explains:

6.1 that Auckland and Christchurch Airports have reset prices;

6.2 our preliminary thoughts on how we might approach this review, including possible areas of focus;

6.3 our proposed timetable for undertaking this review; and

6.4 how you can have your say on this review.

7 After we have considered comments on this paper, we will provide an update if there are any substantive changes to our proposed scope, process or timeframes for this review.

Auckland and Christchurch Airports have reset prices

Airport Authorities Act

8 Under section 4A of the Airport Authorities Act 1966 (AAA), airports are able to set prices "from time to time" as they see fit. Section 4B of the AAA requires that airports must carry out consultation with "substantial customers" before fixing or altering charges and within at least five years after fixing or altering charges.[2]

9 This means that airports must consult on and set prices at least every five years. It also means that once prices have been set airports cannot change prices without carrying out another consultation.

Part 4 of the Act

10 Auckland and Christchurch Airports are two of the three airports in New Zealand that are currently subject to information disclosure regulation under subpart 11 of Part 4. As mentioned in paragraph 1, Auckland and Christchurch Airports have set the prices that will apply during the period 1 July 2017 to 30 June 2022. We received the price setting disclosure information from Auckland and Christchurch Airports in August 2017.[3] Wellington Airport is the third airport

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[2] Substantial customer has the meaning set out in section 2A of the Airport Authorities Act 1966.

[3] Auckland Airport's price setting disclosure can be found at https://corporate.aucklandairport.co.nz/~/media/Files/Corporate/Regulatory-Disclosures/2017/Price-setting-disclosure.ashx?la=en.

subject to information disclosure regulation, but is not expected to reset prices until 2019.

11 The Airports Information Disclosure (ID) Determination requires regulated airports to publicly disclose information about their forecast total revenue requirement following a price setting event.[4] This includes a description of how each of the key components of the forecast total revenue requirement have been determined and an explanation of any differences between the determination of each component for price setting purposes and the approach for historic information disclosures.

12 The disclosure of information about the 2017 price setting event is the third of its kind for both Auckland and Christchurch Airports since information disclosure requirements were set under Part 4. This third price setting event is referred to in this document as PSE3.

Preliminary thoughts on the possible focus of our review

Background

13 Under section 56G of the Act, we were required to carry out a one-off review to report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation was promoting the purpose in section 52A(1) of the Act in respect of specified airport services regulated under Part 4 (section 56G reports). We completed the section 56G reports in February 2014.[5]

14 As part of the section 56G review we considered how effective information disclosure was in promoting each of the limbs of the purpose of Part 4. That is, we considered whether:

14.1 airports were earning excessive profits;

14.2 airports were operating and investing in their assets efficiently and effectively;

14.3 airports were innovating appropriately;

14.4 airports were providing services at a quality that reflects consumer demands; and

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Christchurch Airport's price setting disclosure can be found at http://www.christchurchairport.co.nz/media/873623/cial_pricing_disclosure_1_july_2017_to_30_june_2022.pdf.

4 *Airport Services Information Disclosure Determination 2010* (Commerce Commission Decision 715, 22 December 2010), clause 2.5.

5 The section 56G reports can be found at http://www.comcom.govt.nz/regulated-industries/airports/section-56g-reports/.

14.5 prices set by the airports reflected efficiency gains and were consistent, to the extent feasible, with efficient pricing principles.

15 Our section 56G report on Auckland Airport concluded that information disclosure was limiting excessive profits, promoting innovation, and encouraging an appropriate quality of service. We were unable to conclude whether information disclosure was working effectively in other areas (ie, operational expenditure efficiency, efficient investment and the sharing of benefits from efficiency gains) as there was an insufficient time series of data available.[6]

16 For Christchurch Airport, our section 56G report concluded that information disclosure was not effective at limiting excessive profits. This was because Christchurch Airport's target return over the 20 year period it used to set prices was above an acceptable range. We also had significant concerns with the transparency of Christchurch Airport's approach to pricing, and the ability of interested parties to properly assess what the airport was intending.[7]

17 Following the release of our section 56G report, Christchurch Airport voluntarily published a revised price setting disclosure. The revised disclosure included changes to improve the transparency of its pricing approach. While it did not lead us to change our conclusions on the effectiveness of information disclosure in limiting Christchurch Airport's ability to extract excessive profits, the revised disclosure did address most of our concerns about the lack of transparency as to its pricing approach.[8]

18 Our obligation under section 53B of the Act is different to that under section 56G of the Act. As indicated earlier, our obligation under section 53B(2) of the Act is to promote greater understanding about the performance of each airport, their relative performance, and changes in performance over time. We have greater flexibility under section 53B of the Act to determine which areas of performance we focus on and are not required to consider all aspects of performance at one time.

19 We consider that the factors identified in paragraph 14 remain the key aspects of airport performance. However, the information disclosed in the airport price setting event disclosures provides the most detail about expected profitability, prices and forecast operating and capital expenditure. The price setting event

6 Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), paragraphs X3 – X6.

7 Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch Airport" (13 February 2014), paragraphs X2 – X9.

8 Commerce Commission "Summary and analysis of Christchurch Airport's revised information disclosure for its second prices setting event" (9 July 2015), paragraphs 91 – 92.

disclosures do not provide significant detail about quality, innovation or efficiencies, which are better considered as part of ex-post analysis of annual disclosures.

Possible key focus areas

20 We propose to focus on particular areas of airports' performance in this review. We have identified these areas based on:

20.1 where we expect to gain the greatest insights from the information provided by airports in their price setting event disclosures; and

20.2 our preliminary view on what the key performance issues are likely to be for each airport in PSE3.

21 For both Auckland and Christchurch Airports, we are planning to consider whether the airports have been limited in their ability to extract excessive profits, including:

21.1 the reasonableness of their target return, as this is the most obvious contributor to airports' ability to extract excessive profits;

21.2 the value of the regulated asset base, as the approach to disclosing this value can mask the expectation of excessive profits if the approach is not transparent;

21.3 the appropriateness of demand forecasts, as these directly impact on the reasonableness of airports' forecast revenues;

21.4 the appropriateness of forecast operating and capital expenditure, to the extent that they could affect our assessment of whether an airport is expected to earn excessive profits; and

21.5 the impact of any risk sharing arrangements, including consideration of the use or lack of any opening or closing carry forward adjustments, as these decisions affect which stakeholders bear the risk of actual outturns being different to forecast.

22 For both Auckland and Christchurch Airports, we intend to consider whether there are any concerns that prices have been set inefficiently.

22.1 For Auckland Airport, this would include considering whether the absence of congestion charging could send inefficient signals about the timing of its planned second runway.

22.2 For Christchurch Airport, this would include considering whether the new pricing structure is inconsistent with efficient pricing principles and, in particular, whether it appropriately reflects the costs associated with international and domestic passengers.

23 For Auckland Airport only, we expect to:

23.1 assess whether the airport is investing efficiently including considering the appropriateness of its capital expenditure forecasts for PSE3 and whether these are achievable; and

23.2 consider the impact and risk relating to any charges associated with assets held for future use.

24 We are not proposing to consider these specific aspects for Christchurch Airport. This is because the airport has not introduced any charges relating to assets held for future use and is not proposing significant capital expenditure investment in PSE3.

25 In addition to these proposed focus areas for airport performance, we are interested in understanding whether the recent amendments to the input methodology and information disclosure determinations for airports were effective in promoting greater transparency with regards to assessing airport profitability.

26 Additional context and detail on our approach to assessing these key focus areas for Auckland and Christchurch Airports is set out in Parts 1 and 2 of this paper respectively.

Our proposed timeframes for undertaking the review

27 Our timeframes take into account the likely scope of work and other regulatory work streams occurring in the airport sector.

27.1 The Commission is currently consulting with interested parties regarding updates to the ID determination for specified airport services[9] which is expected to conclude in December 2017.

27.2 Auckland and Christchurch Airports will be publishing their annual regulatory disclosures for financial year 2017 in November 2017.

27.3 Wellington Airport will be beginning consultation on its fourth price setting event in April 2018 with new prices expected to come into effect by 1 April 2019.

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[9] This process also includes other regulated sectors.

28 The table below sets out proposed timeframes for undertaking this review. These timeframes may change following finalisation of the scope of this review.

Milestone	**Indicative dates**
Process and Issues paper issued	24 October 2017
Submissions due	28 November 2017
Cross submissions due	12 December 2017
Update, if needed	22 December 2017
Draft report – Auckland Airport	March 2018
Submissions due – Auckland Airport	April 2018
Cross submissions due – Auckland Airport	April 2018
Draft report – Christchurch Airport	May 2018
Submissions due – Christchurch Airport	June 2018
Cross submissions due – Christchurch Airport	June 2018
Final report – Auckland Airport	August 2018
Final report – Christchurch Airport	August 2018

29 As indicated by these timeframes, we are proposing to undertake the review of Auckland Airport prior to the review of Christchurch Airport. We consider that the Auckland Airport review is likely to be of greater interest to a wider variety of interested persons given it is our largest national airport and the scope of investment it is proposing.

30 We expect our review of Auckland Airport will take longer than that of Christchurch Airport but we are proposing to release our final reports for both airports at the same time to ensure that any cross-airport issues are considered consistently.

How you can have your say on the review of airport price setting events

31 We are interested in your views about the appropriate scope and timeframes for this review.

32 We seek your responses to the following general questions.

32.1 Do you agree with the aspects of performance we propose to focus our efforts on for this review, as set out in paragraphs 21 to 23?

32.2 Do you have any concerns about the timeframes set out in paragraph 28?

32.3 Do you have any views about the way the airports have taken account of interested parties' views in their pricing decisions?

33 We are also seeking your responses, and supporting evidence where practicable, to more specific questions provided later in this paper. A summary list of the airport-specific questions we raise throughout this paper is contained in Attachment A.

34 Submissions are not limited to the issues raised in these questions. We ask that you highlight any additional issues in your response, and explain why they are relevant for this review in light of sections 53B(2)(b) and 53A of the Act.

How you can provide your comments

35 Please provide your comments on this process and issues paper by 5pm, 28 November 2017. Cross submissions are due no later than 5pm, 12 December 2017.

36 We intend to publish all submissions and cross submissions on our website.

37 Submissions should be addressed to:

Jo Perry (Chief Adviser, Compliance and performance analysis, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

38 Please include "Comments on proposed review of airport price setting events" in the subject line of your email.

39 We prefer to receive your comments in both MS Word and PDF file formats.

40 We recognise that there may be cases where parties wish to provide confidential information to us. If it is necessary to do so, the information should be clearly marked, with reasons why that information is confidential.

41 If submissions contain confidential information, an additional document labelled "public version" should be provided. The responsibility for ensuring that confidential information is not included in the public version of a submission rests entirely with the party making the submission.

Part 1 – Auckland Airport specific considerations

How we expect to approach assessing whether Auckland Airport is earning excessive profits

General approach to assessing profitability

42 As part of our recent review of the input methodologies and information disclosure requirements for airports (IM Review), we made several amendments to the way airports disclose information in order to increase the transparency of the disclosures relating to expected profitability. Airports are now required to disclose their target return for the price setting period and to identify proposed risk allocation adjustments.[10]

43 For this review, we intend to estimate Auckland Airport's expected return for PSE3 based on our understanding of the airport's forecasts and compare this to the airport's disclosed target return.

44 In establishing our estimate of the airport's expected return, we intend to carefully review the reasons why the airport has used different parameters or approaches from those that are set out in the information disclosure requirements. We intend to consider the impact of different views on forecasts and projections and may perform scenario analysis.

45 Finally, we intend to consider the impact of risk allocation decisions and the influence they may have on the assessment of expected returns. This is because the use of risk allocation adjustments allows airports to change which stakeholders bear the risk of actual outcomes being different to forecast.

Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?

Cost of capital

46 The mid-point weighted average cost of capital (WACC) represents our starting point when assessing the appropriate level of returns targeted by an airport.[11] However, we consider that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate.[12] We now

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[10] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 163.

[11] Commerce Commission "Input methodologies review decisions – Topic Paper 6 – WACC percentile for airports" (20 December 2016), paragraph 80.3.

[12] Commerce Commission "Input methodologies review decisions – Topic Paper 6 – WACC percentile for airports" (20 December 2016), paragraph 170.

require airports to provide evidence to explain such differences through information disclosure.

47 We indicated in the IM Review that the case for an uplift to the mid-point cost of capital seems significantly weaker for airports than for energy businesses given, among other considerations, airports are subject to a dual till structure (whereby they can earn significant revenue from unregulated complementary activities).[13]

48 Auckland Airport is targeting a return of 6.99% for aeronautical pricing activities and 7.06% for total regulated activities over PSE3. This equates to a 65th percentile return on pricing assets and a 67th percentile return on all assets in the regulated asset base (RAB) [14] relative to our mid-point post-tax WACC estimate of 6.41%.[15]

49 However, Auckland Airport has generated its own "Auckland Airport-specific" WACC range of 6.85% to 8.10%.[16] The airport states this approach is based on a range of contextual factors, including empirical evidence about its systematic risk and expert evidence from NERA Economic Consulting.[17] In particular, Auckland Airport highlighted the "unparalleled level of capital expenditure" it is facing in PSE3, and consequent impact on operating leverage, as justification for its target return.[18]

50 Auckland Airport's price setting event disclosure does not contain the evidence referred to by the airport and we would welcome the opportunity to review this, including reviewing a copy of any report by NERA or other experts (eg Uniservices) and to make this information publicly available. We would also like the opportunity to review any additional relevant reports commissioned by stakeholders as part of the price setting consultation.

51 Auckland Airport has targeted different returns in relation to different parts of its asset base. For its pricing assets, Auckland Airport has indicated it is targeting a return of 6.99%. For its non-pricing assets, the airport is targeting a return of approximately 7.93%. This results in an overall expected return on all regulated

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13 Commerce Commission "Input methodologies review decisions – Topic Paper 6 – WACC percentile for airports" (20 December 2016), paragraphs 133 – 145.

14 The RAB is made up of pricing assets and non-pricing assets. Pricing assets are used for aeronautical activities and are recovered by way of standard charges as set during a price setting event. Non-pricing assets are not recovered through standard charges and include assets used to provide aircraft and freight services, and specified passenger terminal activities subject to leases or licences.

15 Commerce Commission "Cost of capital determination – EBSs and Airports ID" (28 April 2017).

16 Auckland Airport "Price Setting Disclosure" (1 August 2017), page 32.

17 Auckland Airport "Price Setting Disclosure" (1 August 2017), page 13.

18 Auckland Airport "Price Setting Disclosure" (1 August 2017), pages 25-37.

assets of 7.06%. We are interested in understanding the rationale for the different target returns for assets within the RAB.

52 We recognise that consideration of Auckland Airport's cost of capital cannot be done in isolation and that there are likely to be overlapping considerations with our assessment of Christchurch Airport's cost of capital.

> Is Auckland Airport's targeted return appropriate and why?
>
> Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?

Asset valuation

53 Auckland Airport has restated the value of its pricing assets in its price setting disclosure by taking the historic information disclosure asset values and removing revaluations back to the start of the information disclosure regime in 2010.

54 This approach makes the asset values disclosed through information disclosure consistent with the moratorium on asset revaluations that Auckland Airport has had in effect for setting prices since 2006. Auckland Airport has continued the moratorium over the duration of PSE3 and has not undertaken a new market value alternative use (MVAU) land valuation.

55 Auckland Airport's restatement of its asset base allows for greater transparency of its expected returns through information disclosure. Auckland Airport's description of its approach appears to be consistent with the input methodologies for airports and, at this point in time, we are unaware of any concerns with the airport's approach to restating its asset values.

> Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?

Carry forward mechanism

56 As discussed in the IM Review,[19] risks should be allocated to suppliers or consumers depending on who is best placed to manage the risk. We use the term 'risk' as a way to describe the fact that actual outturns can be different

[19] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 170.

from forecast.[20] Where an airport has not identified any alternative risk allocations, the risk that actual outturns are different from forecast is assumed wholly by the airport.

57 There may be sound reasons for airports to set prices on a basis that reflects a risk allocation that differs from the default. For example, we saw Wellington Airport include a wash-up in PSE1 that returned to customers over-recoveries associated with delays in forecast capital investment. The carry forward adjustment mechanism was introduced as part of the recent information disclosure amendments to allow airports to reflect any decision to reallocate risk between airports and airlines over the upcoming pricing period (also known as a risk allocation adjustment).

58 As described in its price setting event disclosure,[21] Auckland Airport's opening carry forward adjustment is made up of two parts:

58.1 a positive adjustment relating to the recovery of the revenue for the Pier B development that was deferred from the first price setting event; and

58.2 a negative adjustment to account for permanent differences in revaluations between the start of the moratorium which Auckland Airport has had in effect since 2006 and the start of information disclosure in 2010.

59 The moratorium adjustment is also reflected in the closing carry forward adjustment. The moratorium adjustment is intended to be carried forward at the same value in future periods unless Auckland Airport decides to unwind the moratorium on asset revaluations in the future.

60 Auckland Airport has not proposed to include any other risk allocation adjustments to future price setting events. This means the airport will bear all of the risks or rewards if actual outturns are different to forecast.

Did Auckland Airport make effective use of risk allocation adjustments? In particular, were any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?

Demand Forecasts

61 Demand forecasts are an important component of determining an airport's expected returns as they are a key driver of the actual revenue that the airport will earn over PSE3 based on the prices set. Where airports are able to

[20] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 374.

[21] Auckland Airport "Price Setting Disclosure" (1 August 2017), pages 51 – 54.

outperform demand forecasts, they are able to earn returns that are greater than the target return.

62 We recognise that actual outturns will be different from forecast. However, there may be an incentive for airports to be more conservative in projecting demand for services such that, all else being equal, there is a higher likelihood of demand being greater than forecast than less than forecast. We propose to consider whether the demand forecasts used by Auckland Airport to set prices were a reasonably objective projection based on the information available at the time prices were set.

63 Auckland Airport has recently experienced significant growth in passenger demand. Average growth was 4.8% per annum for international passengers and 6.1% per annum for domestic passengers over the first four years of its second pricing period (2013 – 2016). Actual demand exceeded the airport's forecast of demand for all passengers by 4.2% over this four year period. However, during the section 56G review, it was concluded that Auckland Airport's demand forecasts were reasonable.[22]

64 Auckland Airport is forecasting a slowdown in demand growth over PSE3 compared to the 2012 – 2017 period covered by its second price setting event (PSE2). The airport is projecting 4.2% average annual growth for international passengers and 3.2% average annual growth for domestic passengers over the period 2017 – 2022. Auckland Airport's demand forecasts are based on advice from independent expert DKMA.

To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?

Expenditure forecasts

65 Similar to demand forecasts, forecast operating and capital expenditure are significant parameters for the determination of the expected return for airports. While we understand that actual outturns will be different from forecast, we propose to consider whether the expenditure forecasts used by Auckland Airport to set prices are a reasonably objective projection based on the information available at the time prices were set.

66 Where airports are able to spend less than forecast, they are able to earn returns that are greater than the target return. This provides incentives to airports to make efficiency gains and outperform their forecast of expenditure. However, there may be an incentive for airports to be more aggressive in

[22] Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), paragraphs F78 – F82.

projecting expenditure such that, all else being equal, there is a higher likelihood of expenditure being less than forecast than greater than forecast.

Are there any concerns that Auckland Airport's capital or operating expenditure projections are not reasonable?

Impact of revenues related to assets held for future use

67 Under the AAA, airports are able to price as they see fit.[23] While the input methodologies for airports require assets held for future use to remain outside of the RAB for information disclosure purposes until they are used to provide specified airport services,[24] airports are not required to apply the input methodologies when setting prices.

68 As part of the recent amendments to the information disclosure requirements for airports, we have tried to provide greater transparency where airports have included earnings on assets held for future use in standard charges and to require airports to quantify the expected value of these charges.[25]

69 The information disclosure amendments also encourage airports to treat any revenues associated with assets held for future use in a NPV neutral manner in the future by offsetting any revenues against the carrying value of the airport's assets held for future use.[26]

70 Auckland Airport has introduced a contingent 'runway land charge' which could be introduced no earlier than 2021. The runway land charge will apply only if Auckland Airport incurs a specified level of expenditure associated with the development of the second runway during PSE3, and has resolved to proceed with the construction of the second runway.

71 Auckland Airport has indicated that the 'runway land charge' will be NPV neutral and will be tracked against the carrying value of the airport's assets held for future use. This treatment largely mitigates the risk that the airport will earn excessive profits over the long term, but it significantly affects the profile of when returns are expected to be earned by the airport.

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23 Airports Authorities Act 1996, Section 4A(1).

24 *Airport Services Input Methodologies Determination 2010* (Commerce Commission Decision 709, 22 December 2010), clause 3.1.

25 Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 556.

26 Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraphs 557 – 558.

72 Auckland Airport has justified its proposed 'runway land charge' on the basis of the significant price shock that would occur if all land holding costs were to accrue until the second runway was commissioned. The airport also notes that the proposed charge is only related to the holding cost of the land the airport currently holds for the second runway.

73 We understand that there has been significant stakeholder concern during the price setting consultation process that Auckland Airport's proposed 'runway land change' introduces the ability for the airport to pre-fund its investments and that this may set a precedent for both the airport's future investment and for other airports in the region.

> Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?
>
> Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?

How we expect to approach assessing whether the prices set by Auckland Airport are efficient

74 As part of the section 56G review, we identified four principles that reflected the objective of pricing efficiency.[27] The four principles are:

74.1 prices should be subsidy free and 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;

74.2 prices should have regard to consumers' demand responsiveness;

74.3 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; and

74.4 the development of prices should be transparent, and promote price stability and certainty for consumers, where demanded.

75 Our section 56G review of Auckland Airport's prices for PSE2 concluded that Auckland Airport was setting prices efficiently.[28] Auckland Airport appears to be

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[27] Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), paragraph D15.

continuing its pricing methodology from PSE2 into PSE3 and has made only minor amendments.

76 Given that Auckland Airport is continuing its approach from PSE2, we do not have particular concerns at this stage about cross subsidisation, the ability to make trade-offs, or lack of transparency. However, we are interested in understanding if Auckland Airport's prices are ensuring services are consumed by those that value those services the most.

77 In its price setting event disclosure[29] Auckland Airport indicated that it considers its runway land charge provides "signals about the cost of demand in the transition to a second runway". The airport also indicated that it considered whether the runway land charge should apply to peak traffic only but made the decision to charge all passengers.

78 Peak demand is a key contributor to the need and timing of the second runway. Changes in peak demand could allow Auckland Airport to delay the need for a second runway. However, Auckland Airport's pricing structure does not currently incentivise any change in peak demand.

Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?

How we expect to approach assessing whether Auckland Airport is planning to invest in its assets appropriately

79 Auckland Airport is intending to invest significantly in its infrastructure over PSE3. The airport is forecasting to invest in aeronautical infrastructure at approximately five times the level of historical investment. Auckland Airport has indicated it has experienced a material change in conditions over the past two years as growth has outstripped projections. It stated that a step change in investment is required in order to ensure that it is able to provide sufficient capacity and quality services now and in the future.[30]

80 Much of this forecast investment relates to improvements to Auckland Airport's international and domestic terminals with a relatively small percentage (11%) of forecast investment in pricing assets set aside for the second runway infrastructure over PSE3. Auckland Airport is proposing a new domestic jet terminal and making improvements to the existing international terminal in

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28 Commerce Commission "Final report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport" (31 July 2013), paragraphs D4 – D5.

29 Auckland Airport "Price Setting Disclosure" (1 August 2017), page 58.

30 Auckland Airport "Price Setting Disclosure" (1 August 2017), page 61.

order to provide additional gates and to improve the passenger journey throughout the terminal. Auckland Airport is also planning improvements to its taxiways and is investing in new technologies.

81 As part of its price setting consultation for PSE2, Auckland Airport excluded any capital expenditure associated with the development of a new domestic terminal facility. At the time, the airport indicated that it still expected to commission this project during PSE2 and that it would recover any costs incurred during the pricing period in relation to the new terminal as part of a separate investment charge that would be determined following consultation with stakeholders.

82 Auckland Airport did not undertake the investment in the new domestic terminal as part of PSE2 nor did it introduce additional charges in relation to this project. However, the airport did accelerate some investment during PSE2 in response to the material growth experienced.

83 Auckland Airport's significant investment programme presents some additional risks when compared to a more 'business as usual' approach to investment.

83.1 There is a greater risk that Auckland Airport will be unable to meet its capital expenditure forecasts or may run behind its projections. As discussed in paragraphs 65 to 66, the expectation about whether the airport can achieve its forecast can impact on our assessment of expected performance.

83.2 There is a risk that Auckland Airport could be exposed to significant cost over runs.

83.3 It places additional importance on ensuring that the airport's approach to cost allocation is robust.

84 We have previously indicated that in general, airports are best placed to manage risks associated with capital expenditure projects.[31] However, Auckland Airport could have used risk allocation adjustments to reallocate risks between suppliers and customers (eg, Auckland Airport could have proposed a 'wash-up' if the airport was unable to achieve its forecasts). The airport did not choose to include any risk allocation adjustments when it set prices.

85 We note that Auckland Airport is expecting to commission $1.1b of its total capital expenditure in PSE3. Auckland Airport has not significantly increased prices for PSE3. However, there is expected to be a step change in prices in PSE4 when these assets are commissioned.

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[31] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraphs 443.

Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?

How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?

Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?

Part 2 – Christchurch Airport specific considerations

How we expect to approach assessing whether Christchurch Airport is earning excessive profits

General approach to assessing profitability

86 As part of the IM Review, we made several amendments to the way airports disclose information in order to increase the transparency of the disclosures relating to expected profitability. Airports are now required to disclose their target return for the price setting period and to identify proposed risk allocation adjustments.[32]

87 These amendments were also intended to provide greater clarity around the expectations for disclosures where an airport has used non-standard approaches to setting prices (eg, Christchurch Airport in PSE2).[33]

88 As discussed in relation to Auckland Airport in paragraphs 43 to 44, we intend to estimate Christchurch Airport's expected return for PSE3 based on our understanding of the airport's forecasts and compare this to the airport's disclosed target return.

89 We intend to carefully review the reasons why the airport has used different parameters or approaches from those that are set out in the information disclosure requirements.

90 Christchurch Airport's approach to setting prices during PSE2 was different to that of Auckland Airport and Wellington Airport. As part of our section 56G review, we indicated that the rationale for the airport's long run levelised pricing approach was understandable. However, we concluded that Christchurch Airport's PSE2 disclosure did not fully or transparently reflect its pricing approach, and there was not sufficient information to allow interested persons to assess the airport's expected profitability.[34]

Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Christchurch Airport?

[32] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraph 163.

[33] Commerce Commission "Input methodologies review decisions – Topic Paper 5 – Airport profitability assessment" (20 December 2016), paragraphs 274.

[34] Christchurch Airport voluntarily published a revised price setting disclosure in November 2014 which included changes to improve the transparency of its pricing approach.

Cost of capital

91 As discussed in paragraphs 46 to 47, we consider that there may be legitimate reasons for an airport to target returns that are different to our mid-point WACC estimate. However, the case for an uplift in the cost of capital seems significantly weaker for airports than for energy businesses.

92 Christchurch Airport has used our inputs for all cost of capital parameters except asset beta and credit rating when calculating its target return. Christchurch Airport has used its actual credit rating of BBB+ rather than our notional A- credit rating. The airport has also used an asset beta 0.05 higher than the asset beta calculated by us.[35]

93 Christchurch Airport's uplift in its asset beta was based on analysis provided by expert adviser Incenta. Christchurch Airport noted that:[36]

93.1 it previously applied an upwards asset beta adjustment in PSE2 due to a greater exposure to holiday/leisure travellers relative to other New Zealand airports; and

93.2 new proxy analysis undertaken by Incenta for PSE3 suggests that Christchurch Airport has a materially greater degree of exposure to systematic risk than the 'average' airport in the comparator sample used to generate our asset beta estimate.

94 Incenta's report was not included in the airport's price setting event disclosure. We would appreciate this report being made publicly available to interested stakeholders as part of this review process.

95 Christchurch Airport's use of a cost of capital that reflects airport-specific factors equates to a target return at the 61st percentile of our cost of capital distribution. We note that Christchurch Airport's target cost of capital has been applied consistently across pricing and non-pricing assets.

96 As noted previously, we recognise that consideration of Christchurch Airport's cost of capital cannot be done in isolation and that there are likely to be overlapping considerations with our assessment of Auckland Airport's cost of capital.

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35 Christchurch Airport "Disclosure relating to the reset of aeronautical prices for the period 1 July 2017 to 30 June 2022" (14 August 2017), para 113.

36 Christchurch Airport "Disclosure relating to the reset of aeronautical prices for the period 1 July 2017 to 30 June 2022" (14 August 2017), para 113.

Is Christchurch Airport's targeted return appropriate and why?

Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Christchurch Airport's price setting event?

Asset valuation

97 Christchurch Airport has changed its price setting approach from the 20 year levelised price used in PSE2 in response to concerns raised by us and other stakeholders. Christchurch Airport has adopted a tilted annuity approach to depreciation which the airport considers is more transparent and robust. Christchurch Airport's tilted annuity approach results in similar outcomes to its use of the levelised price path.

98 Christchurch Airport's approach appears to be consistent with the input methodologies specifications for non-standard depreciation. Christchurch Airport also indicated that stakeholders have supported its approach.

99 Christchurch Airport has not revalued its land assets for PSE3. The airport's land valuation forecasts are based on its disclosures for 2016, which have been rolled forward to determine an opening land asset value for PSE3 using an updated forecast of inflation for 2017. This opening value has then been projected over PSE3 using forecast CPI. We note that Christchurch Airport's most recent land valuation (from 2012) on which the land valuation disclosure are based was considered by the Commission to be consistent with the input methodologies as part of the section 56G review for Christchurch Airport.

Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?

Carry forward mechanism

100 As discussed in paragraph 57, airports may choose to introduce risk allocation adjustments when setting prices. The impact of these can be tracked using the carry forward mechanism in the information disclosure templates.

101 Christchurch Airport has made carry forward adjustments to its opening and closing RAB in its PSE3 disclosure. These adjustments have been made to reflect a permanent difference in the value of the assets disclosed by the airport through information disclosure and the value of the assets that the airport has used to set prices.

102 The adjustments are required because Christchurch Airport was unable to give effect to its non-standard depreciation methodology in the way it had intended when it set prices for PSE2, because doing so would have breached the cost allocation IMs. As a result, the disclosed asset values under information

disclosure do not appropriately reflect the value split between pricing and non-pricing assets.

103 The calculation of the value of Christchurch Airport's carry forward adjustment to the RAB has been reviewed by Deloitte. This review was carried out in response to requests made by stakeholders through Christchurch Airport's pricing consultation process.

104 Christchurch Airport has not proposed to include any other risk allocation adjustments to future price setting events. This means the airport will bear all of the risks or rewards if actual outturns are different to forecast.

Did Christchurch Airport make effective use of risk allocation adjustments? In particular, were any risk allocation adjustments proposed by stakeholders during Christchurch Airport's consultation but not implemented and what was the rationale for the proposed adjustments?

Demand Forecasts

105 As discussed in paragraphs 61 to 62, demand forecasts are an important component when determining an airport's expected returns as they are a key driver of the actual revenue that the airport will earn over PSE3 based on the prices set. Where airports are able to outperform projections, they are able to earn returns that are greater than the target return.

106 Christchurch Airport's demand forecasts for PSE2 were heavily influenced by the expected timing of the recovery from the 2010 and 2011 Christchurch earthquakes. International passenger numbers were projected to increase on average by 3.7% per annum over the pricing period, while domestic passenger numbers were projected to increase on average by 1.8% per annum. Christchurch Airport's actual total passenger volumes over the first four years of PSE2 were 1.5% above forecast.

107 Christchurch Airport engaged Three Consulting to provide independent passenger demand forecasts for PSE3. Passenger numbers at Christchurch Airport are expected to continue to grow over this period with forecast average annual demand growth of 3.6% for international passengers and 2.0% for domestic passengers.

108 In its price setting event disclosure, Christchurch Airport indicated that stakeholders were generally supportive of the airport's approach to forecasting demand. However, there were some concerns raised during consultation about whether the international passenger growth forecast was conservative.

To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?

Expenditure forecasts

109 As discussed in paragraphs 65 to 66, forecast operating and capital expenditure are significant parameters for the determination of the expected return for airports. There may be an incentive for airports to be more aggressive in projecting expenditure such that, all else being equal, there is a greater likelihood of expenditure being less than forecast than greater than forecast.

Are there any concerns that Christchurch Airport's capital or operating expenditure projections are not reasonable?

How we expect to approach assessing whether the prices set by Christchurch Airport are efficient

110 As discussed in paragraph 74, we identified four principles that reflected the objective of pricing efficiency as part of our section 56G review. Our section 56G review of Christchurch Airport's prices for PSE2 concluded that while the airport's pricing methodology is likely to promote efficiency, the development of this methodology was not transparent to stakeholders.

111 Christchurch Airport has substantially changed its pricing structure for PSE3. The airport has indicated that its revised pricing structure is intended to promote increased productivity and efficient use of the existing terminal asset while also being simple and transparent. The revised pricing structure moves towards greater reliance on single per passenger prices that apply to both domestic and international passengers.

112 Christchurch Airport's revised pricing structure involves a significant rebalancing of prices between international and domestic passengers compared to PSE2. Terminal prices will decrease for international passengers while increasing for domestic passengers. In addition, terminal prices for regional services will increase significantly. Christchurch Airport has proposed a transitional price path for PSE3 to reduce the impact of price changes on domestic and regional passengers. The airport considers that the transitional price path is still consistent with the efficient pricing principle of being subsidy free.

Does the pricing structure at Christchurch Airport for PSE3 reflect efficient pricing principles? What impact do you expect Christchurch Airport's proposed pricing structure and associated incentives to have on demand and revenues?

Attachment A - Summary of Airport Specific Questions

Auckland Airport specific questions

Profitability

113 Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Auckland Airport?

114 Is Auckland Airport's targeted return appropriate and why?

115 Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Auckland Airport's price setting event?

116 Do the asset values used by Auckland Airport provide an appropriate basis for assessing expected returns and why?

117 Did Auckland Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Auckland Airport's consultation but not implemented and what was the rationale for the proposed adjustments?

118 To what extent does the demand forecast, presented by Auckland Airport as part of PSE3, reasonably reflect expectations of future demand and why?

119 Are there any concerns that Auckland Airport's capital or operating expenditure projections are not reasonable?

120 Are there concerns relating to Auckland Airport's introduction of a contingent 'runway land charge'? In particular, is the proposed timing of Auckland Airport's returns on its assets held for future use appropriate?

121 Has information disclosure assisted in promoting stakeholder understanding of Auckland Airport's proposed approach to the 'runway land charge'?

Pricing Efficiency

122 Does Auckland Airport's pricing structure for PSE3 provide appropriate signals regarding the timing of investments in the second runway?

Investment

123 Is Auckland Airport's forecast investment sufficient to meet expected demand and desired service quality over PSE3?

124 How appropriate is Auckland Airport's approach to cost allocation when determining its capital expenditure projections?

125 Are there concerns that Auckland Airport will not be able to achieve its capital expenditure forecasts over PSE3?

Christchurch Airport specific questions

Profitability

126 Have the recent amendments to the Airport IM and ID determinations been effective at increasing the transparency of target profitability at Christchurch Airport?

127 Is Christchurch Airport's targeted return appropriate and why?

128 Can stakeholders provide any expert advice relating to the determination of the cost of capital that was included as part of the consultation on Christchurch Airport's price setting event?

129 Do the asset values used by Christchurch Airport provide an appropriate basis for assessing expected returns and why?

130 Did Christchurch Airport make effective use of risk allocation adjustments? In particular, were there any risk allocation adjustments proposed by stakeholders during Christchurch Airport's consultation but not implemented and what was the rationale for the proposed adjustments?

131 To what extent does the demand forecast, presented by Christchurch Airport as part of PSE3, reasonably reflect expectations of future demand and why?

132 Are there any concerns that Christchurch Airport's capital or operating expenditure projections are not reasonable?

Pricing Efficiency

133 Does the pricing structure at Christchurch Airport for PSE3 reflect efficient pricing principles?

134 What impact do you expect Christchurch Airport's proposed pricing structure and associated incentives to have on demand and revenues?