

## SUBMISSION ON THE COMMERCE COMMISSION DRAFT REPORT ON THE SECTION 56G REVIEW OF WELLINGTON AIRPORT

30 NOVEMBER 2012

1. The New Zealand Airports Association ("**NZ Airports**") makes this submission on the Commerce Commission's Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 of the Commerce Act 1986 ("**Act**") for Wellington Airport ("**Draft Report**"). This submission is made on behalf of Auckland International Airport Limited, Wellington International Airport Limited and Christchurch International Airport Limited (together, "**Airports**").
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### 1. EXECUTIVE SUMMARY

3. NZ Airports acknowledges that the Commission has sought to provide a robust and structured analytical framework to underpin its preliminary findings regarding the effectiveness of information disclosure ("**ID**") in relation to Wellington International Airport ("**WIAL**"). NZ Airports' objective for this submission is to identify aspects of the Commission's approach and findings that, in our view, should be reconsidered in order to ensure a more balanced and robust final report that better reflects the nature of ID regulation.
4. NZ Airports supports the ID regime as light-handed regulation, and is keen for it to be given an opportunity to succeed. We are pleased that, for the most part, the Commission has not been drawn into issues such as whether other forms of regulation should apply or whether additional services should be regulated, that are advanced by parties who have made very clear that they believe ID is the wrong form of regulation.
5. While there are many positive features in the Draft Report, in our view, it fails to properly account for important limitations on the Commission's ability to assess the effectiveness of ID at this time. Key in this respect is that the effectiveness of ID in promoting the purpose statement, as a light-handed regulatory regime, depends on the incentives it provides for

airports to achieve outcomes consistent with workably competitive markets. The strength or weakness of the incentives will depend on whether clear expectations of appropriate conduct have been established at the time key pricing and investment decisions are made. We also note that, given that the airport sector is in good health and provides a high quality service to consumers, at efficient prices, it is entirely possible that a successful ID regime could have no discernible impact on performance.

6. The ID regime is in its infancy, and has yet to be fully implemented. Much of the Commission's analysis does not account for this critical fact, which places severe limitations on the Commission's ability to assess whether ID is providing the right incentives:

- (a) The Commission's profitability analysis relies on findings of outcomes in PSE1, which are a product of decisions made prior to the introduction of ID. Accordingly, PSE1 outcomes tell interested parties nothing about the incentives provided by ID.
- (b) At the time of PSE2, the ID regime did provide some guidance on expectations of appropriate conduct. However, it was reasonable for airports to expect that they could adopt pricing approaches which differed to the benchmarks established by the Commission's input methodologies ("**IMs**") if justified by expert advice, economic conditions and airport-specific circumstances, given that:
  - (i) ID was new;
  - (ii) ID is a light-handed form of regulation that is not price control;
  - (iii) Key IMs were subject to merits review and are therefore subject to the potential for material change;
  - (iv) There was no guidance available on how the Commission would conduct assessments of disclosed information; and
  - (v) The consultation and price-setting provisions of the Airport Authorities Act 1966 ("**AAA**") were expressly retained.
- (c) Much of the analysis of returns is based on estimates and assumptions regarding future decision-making by WIAL. Clearly, this provides no reliable evidence of the current incentives provided by the ID regime. Further, the analysis of profitability is coloured by the Commission's unsubstantiated assumption that ID will fail to provide the correct incentives in the future.

7. NZ Airports encourages the Commission to more fully account for these limitations in its final report, including by addressing the following matters:

- (a) In addition to noting the positive outcomes regarding quality and innovation, the Commission should more carefully consider the market context that demonstrates a sector in good health. NZ Airports believes that airports are doing the key things well in terms of promoting the long-term benefit of consumers.
- (b) In some cases, such as for operating efficiency, investment and sharing of efficiency gains, the Commission has found that it is too early to draw definitive conclusions based on predictions of what may occur in the future. However, relevant limitations have not been adequately explored and explained in relation to the Commission's preliminary finding that WIAL is earning excess returns over time. NZ Airports encourages the Commission to reconsider:

- (i) Whether there is a sufficient evidential foundation for that finding;
  - (ii) Whether it is supported by an appropriately balanced analytical framework; and
  - (iii) Whether the finding on profitability is in balance with its more tentative findings on other limbs of the purpose statement.
- (c) Considering whether departures from the industry benchmark WACC established by the IM are appropriately justified for airport-specific application in pricing. The Draft Report could be interpreted as suggesting that any achieved or targeted returns above the WACC IM are excessive,<sup>1</sup> despite the fact that WACC is an imprecise measure and the clear Parliamentary intent that ID regulation should not create a position where airports feel compelled to price at the level of the WACC IM.<sup>2</sup>
- (d) Signs and evidence that airports are constrained when setting prices should be considered, such as airports adopting positions which are more conservative than available to them based on expert advice.
- (e) Ongoing disagreements between airlines and airports are inevitable, and are not an indication that ID is ineffective.
8. NZ Airports accepts that the Commission has identified some concerns regarding potential future outcomes which WIAL should consider in relation to its conduct going forward. Such an approach is consistent with NZ Airport's view that the section 56G review is a valuable opportunity for the Commission to provide guidance on matters of concern. This is 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.
9. We do not accept that, at this early stage, the Commission is in a position to conclusively determine that the areas of concern will not be addressed and/or that problems will endure over time, such that ID is not effective at meeting the Part 4 purpose statement. In particular, a finding now that WIAL is earning excess returns over time conveys a false sense of precision in estimating a complex and difficult matter.
10. Ultimately, critical findings regarding an airport's performance and the effectiveness of ID should be based on decisions made, actual performance and information disclosed in accordance with the ID regime, and not on assumptions that future conduct will diverge from IMs which are themselves subject to being revoked or amended by the High Court.

## **2. TIMING AND SCOPE OF THE REPORT AND REVIEW**

### **Timing of the report**

11. A key question for the Review is what impact ID could reasonably be expected to have at this very early stage of its implementation, bearing in mind that it is a light-handed regime

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<sup>1</sup> See, for example, Commerce Commission "Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport", 2 November 2012 ("**Draft Report for WIAL**") at [X13.2].

<sup>2</sup> See, for example: Ministry of Economic Development "Report on the Commerce Amendment Bill", 4 July 2008 at p 25, where the Ministry disagreed that IMs for the cost of capital should be binding, on the grounds that such a requirement "could be interpreted to mean that the business has to price in a certain way including earning no more than its WACC. This amounts to price control, but the business is not under price control".

designed to incentivise rather than dictate outcomes consistent with the Part 4 purpose statement.

12. The Commission notes that:<sup>3</sup>
- (a) It is appropriate to make the Draft Report now because WIAL set new prices on 1 March 2012 and has made two disclosures of information under ID and a specific price-setting event disclosure containing detailed financial information;
  - (b) It would not be consistent with reporting "as soon as practicable" to delay the review in order to wait for:
    - (i) Other information disclosures in the future;
    - (ii) Current court appeals on input methodologies to be resolved; and
    - (iii) Summary and analysis reports to be published under section 53B(2).
  - (c) Waiting for the above events would likely result in the report being delayed for at least 2-3 years, and sufficient information is available now to carry out the section 56G review.
13. Importantly, the Commission states that "any limitations in our analysis or to the conclusions that we have drawn are explained in the relevant parts of this report".<sup>4</sup>
14. NZ Airports acknowledges that the Commission has in some cases recognised when it does not have sufficient evidence available to make firm conclusions - such as in relation to efficiency and investment.
15. However, in our view, the Commission has not fully recognised the limitations of conducting the Review at this early stage. The Commission is therefore at risk of underestimating the impact that the ID regime will have when fully established. NZ Airports considers that the Commission should consider which elements of ID were in play (and to what extent) in the short period the regime has been in place. For example, the Commission should acknowledge that there are elements of the regime that:
- (a) Were in place **before** the price-setting events that took place in 2012 (ie PSE2). This would include the IMs, but would also require the Commission to acknowledge factors affecting the potential influence of the IMs, namely:
    - (i) In developing the IMs, the Commission was required to make judgements between a range of options and approaches that would be consistent with workably competitive markets. It is appropriate for the Commission to recognise that the IMs are not "clear cut" measurement and analytical tools, and for its analysis to acknowledge that the IMs themselves were the subject of inherent judgement and discretion.
    - (ii) The IMs were not required to be applied for pricing purposes. Although the IMs were treated as relevant considerations in pricing, it was reasonable for airports to proceed on the basis that other approaches could be consistent with the Part 4 purpose statement. For example, the Commission has never found that replacement cost valuations are

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<sup>3</sup> Draft Report for WIAL, at [1.6]-[1.8].

<sup>4</sup> Draft Report for WIAL, at [1.9].

inconsistent with the Part 4 purpose statement - only that it believes using the most recently disclosed valuations is a better approach. Similarly, given that the WACC IM was an industry-wide benchmark for ID purposes, it was reasonable for airports to expect that they could justifiably adopt airport-specific WACCs for pricing purposes.

- (iii) The fact that IMs were subject to merits review and therefore could be materially changed is relevant when considering decisions for PSE2. It would have been premature and inappropriate for airports, on the basis that IMs had been set for ID purposes, to ignore expert advice and depart from pricing approaches they believed were consistent with Part 4 while the Commission's preferred assessment tools were subject to challenge (including by interested parties).
  - (iv) Although the Commission is entitled to apply its IMs for analysis purposes, it should be recognised that its analytical approach could require material alteration in the future, depending on the outcome of the merits review.
- (b) Were in place **during** PSE2, such as any additional information available to airlines and other interested persons.
- (c) Will be in place **following** PSE2, such as the annual disclosures in that period, and the Commission's summaries and analyses, the outcomes of the section 56G reviews, and the outcomes of the merits review proceedings.
16. NZ Airports emphasises that the Act provides for ID to be a feedback system, and the signals that have been coming back to airports at this early stage have been limited. Accordingly, any conclusions about the effectiveness of ID at this time should more clearly recognise the current partial implementation of the overall ID regime.
17. These limitations must also be considered in the proper context of the regulatory framework. When prices were set for PSE2, it was entirely reasonable for airports to expect that forecast outcomes would be assessed against the purpose statement, and that they were not expected to apply to IMs and/or meet the profitability benchmarks established by the IMs as though price control applied. The key question in this respect is whether there is evidence that ID has contributed to constraining airport behaviour (such as by seeking returns lower than were supported by expert evidence, implementing risk sharing arrangements or other commercial approaches), rather than whether returns are forecast to be lower than the Commission's estimate of WACC.
18. The Commission has also welcomed further submissions on its view that section 53B(2) reports are not a prerequisite of the section 56G review. NZ Airports has previously submitted on this point. In summary:
- (a) We agree that the section 53B(2) reports are not a legal prerequisite for the section 56G review;
  - (b) However, they are an important part of the ID regime.<sup>5</sup> Amongst other things, they should serve to clarify expectations for performance;

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<sup>5</sup> This has been recognised by BARNZ, who noted that ID regulation under Part 4 must necessarily include all elements of ID, including the monitoring and analysis reports to be prepared by the Commission under section 53B: BARNZ Post-Conference submissions on section 56G review of WIAL, 17 August 2012, page 33.

- (c) In the absence of those reports, the section 56G review is the first time that interested parties have been exposed to the Commission's proposed analytical framework for assessing performance, and it is the first time that the proposed framework has been tested; and
- (d) It must therefore be acknowledged that there was uncertainty regarding expectations at the time prices were set for PSE2 (especially when considered in conjunction with the further limitations discussed above).

#### **Scope of the review**

- 19. NZ Airports has noted the Commission's view that it is not required to assess or recommend whether:
  - (a) Other forms of regulation should apply; and / or
  - (b) Other services should be regulated.
- 20. For the reasons set out in our previous submissions on the section 56G review, we agree with this position. It is important to focus on the ID regime implemented by Parliament, and not be distracted by arguments from parties who have never accepted that ID is the right form of regulation, and whose campaign for heavier-handed regulation would be weakened by any findings that ID is effective.

### **3. ANALYTICAL AND REGULATORY FRAMEWORK**

#### **How information disclosure can promote the Part 4 purpose**

- 21. NZ Airports agrees with the Commission's observations that ID can have a direct impact on the incentives airports have to perform consistently with the Part 4 purpose statement, including by having an impact on airport incentives when setting prices.
- 22. The Commission notes that information disclosure can directly promote the Part 4 purpose statement in two main ways:<sup>6</sup>
  - (a) By providing transparency about how well a supplier is performing relative to other suppliers and over time; and
  - (b) Through the threat of further regulation (including the incentives created by the Review).
- 23. NZ Airports agrees that ID is a light-handed regime that promotes the Part 4 purpose statement by incentivising rather than controlling conduct. We believe that airports have provided and will continue to provide evidence that:
  - (a) The transparency required by ID has enhanced the existing incentives under the AAA for airports to adopt approaches consistent with outcomes in workably competitive markets; and
  - (b) The threat of further regulation further enhances these incentives.
- 24. NZ Airports believes that the Draft Report does not sufficiently consider the evidence that such incentives exist. It highlights areas of disagreement between WIAL and customers, but

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<sup>6</sup> Draft Report for WIAL, at [2.5].

does not consider the evidence which demonstrates that WIAL has not always followed its preferred approaches and/or those which would have been justified in accordance with its expert advice. NZ Airports anticipates that WIAL will provide further evidence in this respect.

25. Further, NZ Airports submits that the extent of the impact that ID should or could reasonably have on pricing and investment decision-making needs to be assessed under an analytical framework that takes into account that:
- (a) The sector was in good health prior to the introduction of ID, such that the new or further incentives provided by ID could be minimal.
  - (b) There is no single correct method to promote the Part 4 purpose statement. As the Commission has acknowledged, there are multiple combinations of approaches that could produce outcomes consistent with the Part 4 purpose statement. However, we remain concerned that it remains unclear whether the Commission would accept that combinations that result in returns above the benchmark WACC can be consistent with the Part 4 purpose statement.
  - (c) The interdependencies between the different limbs of the purpose statement should be considered more carefully, particularly when the Commission has stated that it generally favours outcomes that promote dynamic efficiency over lower short-term pricing.<sup>7</sup>
  - (d) ID could have no impact on outcomes in PSE1, given that PSE1 pricing decisions were made before ID was implemented and before the benchmarks established by the IMs were known. However, as previously submitted by the airports, they believe the approaches taken prior to ID regulation were consistent with the Part 4 purpose statement.
  - (e) When decisions were made for PSE2, considerable uncertainty existed regarding the expectations for performance consistent with the Part 4 purpose statement, as discussed above.
26. In summary, it is fair for the Commission to expect that ID could have an impact on pricing decisions. However, given that the ID regime is in its infancy, combined with the analytical limitations discussed above, a finding that an airport has not yet met the Commission's view of appropriate performance should not necessarily equate to a definitive finding that ID is ineffective. NZ Airports believes that each airport has provided (and will continue to provide) evidence that ID has been an important consideration in their pricing decisions.

#### **AAA and Information Disclosure**

27. The Commission notes that the "AAA provisions relating to charges are primarily concerned with ensuring that the decision making process for airport pricing is clear".<sup>8</sup> When discussing the fact that suppliers have incentives other than those provided by ID, the Commission notes that WIAL is subject to the requirement under the AAA to consult on large capex programmes.<sup>9</sup>

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<sup>7</sup> Draft Report for WIAL, at Table H4, Note 1.

<sup>8</sup> Draft Report for WIAL, at [A28].

<sup>9</sup> Draft Report for WIAL, at [2.8].

28. NZ Airports emphasises that the influence of the AAA is significantly more extensive than suggested by the Commission in the Draft Report. Although the AAA provides that airports can set charges "as they see fit", the consultation process does provide a real and substantive limitation on that right, as intended by Parliament.
29. Throughout the consultation on IMs, each airport provided extensive evidence on how consultations under the AAA effectively amount to intense and lengthy negotiations. Inevitably, it is not possible for airlines and airports to agree on all pricing matters (which is why the obligation is to consult rather than agree), but it would be incorrect to suggest that the pressure that airlines bring to bear during the consultation process, combined with the additional scrutiny under ID, does not provide an incentive for airports to adjust their decision-making accordingly.
30. NZ Airports is concerned that the Commission is placing undue weight on and drawing negative inferences from the fact that areas of disagreement remain following the most recent price setting events, and is unduly giving weight to airline views without properly evaluating the merits of their arguments. The positions advocated by the airlines need to be very carefully assessed, bearing in mind that:
- (a) It would be unnatural to expect perfect alignment between airports and airlines on pricing decisions.
  - (b) The disagreements are largely focussed on WACC and asset valuation, both of which are subject to merits review, making it unrealistic to expect agreement in advance of those proceedings being concluded.
  - (c) For other areas of disagreement, such as operating efficiency and particular capex projects, it should not be assumed that airlines' views and interests are aligned with the long term interests of **all** consumers. A regulatory regime focussed on the long-term benefits of consumers should give more weight to the long-term interests of ultimate consumers (ie passengers and freight shippers) than to intermediate consumers (ie airlines). The result is that airports sometimes need to be the "circuit breaker" to determine what is required for the long-term interests of passengers (which is of particular importance when making investment decisions).
  - (d) Airlines can and do have divergent views, which need to be balanced by the airports when making pricing, investment, and quality decisions.
  - (e) For passengers, the efficiency and reliability of airport services and the quality of the overall service experience needs to be balanced against the possibility of small savings on ticket prices through lower aeronautical charges.

**The context is important when assessing incentives**

31. The Draft Report, by being very focused on a limb-by-limb analysis, does not step back and consider the full picture of airport performance in New Zealand. In particular, a fully informed view of airport conduct and performance necessarily requires an analysis of the surrounding market context in order to assess whether the long-term benefit of consumers is being promoted.
32. Once that context is taken into account, it is clear that market evidence demonstrates the New Zealand airport sector is in good health. Passenger growth has been achieved over an extended period of time, and airports continue to invest in facilities and service



improvement for the benefit of passengers.<sup>10</sup> Airports are also investing in capacity that fosters competition.

33. At the risk of over-simplification, the Commission should acknowledge that the Airports are currently performing well in the key areas that are necessary to promote the long term benefit of consumers. It should also carefully consider whether there would be ongoing incentives to maintain the good health of the sector if returns were reduced to those sought by the Commission. Indeed, the Commission acknowledges on the face of the Draft Report that investment, innovation, efficiency and quality are important to its task under the Review. However, NZ Airports is concerned that the Commission has nevertheless adopted an analytical structure that gives prominence to short-term prices, at the potential expense of the quality outcomes that passengers are really concerned about.

#### **The effect of information disclosure for each outcome**

34. The Commission has advanced the proposition that the potential impact of ID will vary between the different outcomes sought under Part 4, and that the time taken for ID to have an effect on each of the Part 4 outcomes will vary. The Commission has not previously expressed this view.
35. As discussed further below, NZ Airports accepts that, since IMs are directed towards profitability measures, the ID regime does allow airport profitability to be scrutinised on a consistent basis, in accordance with the purpose of ID. We also note that the concept of findings differing across each limb of the purpose statement may be appropriate in the circumstances. However, that does not logically translate into an assumption that ID will have the most noticeable and immediate impact on prices, as though price control applied. As set out earlier, there are many reasons why it is too early to expect that outcome.
36. NZ Airports also emphasises that a light-handed information disclosure analysis should ask whether ID is producing incentives for *all* limbs of the purpose statement to be promoted over time.
37. The Commission will recall NZ Airports' submissions during consultation on IMs that the most important limb of the Part 4 purpose statement was to ensure that suppliers have incentives to innovate and to invest, including in replacement, upgraded, and new assets. In response, the Commission stated:

**A balancing between the limbs in paragraphs (a)-(d) of the Part 4 purpose statement is clearly required.** Ensuring that regulated suppliers have the opportunity to receive at least a normal return on their new investments provides the incentives for them to make those investments in the first place. Where those investments are made at an efficient level and time, and are employed to provide services at the appropriate quality, then consumers will benefit over the long term.<sup>11</sup> [Emphasis added]

38. Accordingly, it is important to recognise that seeking to incentivise returns that are too low will have the impact of undermining the naturally occurring incentives to invest.

#### **Application of input methodologies to the s56G review**

39. The Commission states that:

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<sup>10</sup> See, for example, New Zealand Government, National Infrastructure Plan, March 2010, at page 93. The Infrastructure Plan also notes that: "Ports and airports operate within a competitive market and their investment decisions respond to a combination of market signals and local interests. The Government encourages these sectors to carefully consider their investment decisions but does not see conditions that might justify government intervention" (at page 27).

<sup>11</sup> Commerce Commission "Input Methodologies (Specified Airport Services) Reasons Paper", 22 December 2010, at [2.6.32].

- (a) IMs provide a benchmark for assessing how effectively ID is promoting the Part 4 purpose statement;<sup>12</sup> and
  - (b) The purpose of setting the input methodologies is to provide certainty to regulated suppliers as to the tool the Commission will use in assessing the impact of information disclosure on the promotion of outcomes consistent with outcomes produced in workably competitive markets such that s52A(1)(a) to (d) occur.<sup>13</sup>
40. Although we do not dispute that IMs are relevant and important, we are concerned that the Commission's reliance on them in this way gives them undue prominence, and contributes to the Commission's unsubstantiated conclusion that ID should have the most noticeable and immediate impact on prices.
41. For example, there are no IMs for quality, innovation, sharing of efficiency gains, or efficient investment. However, this does not mean that inadequate information exists to allow interested persons to assess whether those outcomes are (or will be) consistent with the Part 4 purpose statement.
42. In NZ Airports' view, the purpose of setting the IMs was to provide certainty regarding:
- (a) The asset valuation, cost allocation and tax methodologies that should be used to compile disclosed information. This would ensure that information important for assessing profitability is disclosed on a consistent basis; and
  - (b) In conjunction with the WACC IM, the methodologies that the Commission would use for monitoring and analysis purposes.
43. Much of the discussion in the Draft Report is consistent with an approach that recognises the proper place of IMs. The Commission acknowledges that the IMs do not have to be applied in pricing, and that various approaches or combination of approaches could be consistent with the Part 4 purpose statement.
44. However, it does not take the next critical steps which flow from that analysis, namely:
- (a) Just as there are no precise benchmarks for quality, innovation, sharing of efficiency gains and efficient investment, the Commission must acknowledge that the IMs it uses to assess profitability are not the only approaches consistent with the Part 4 purpose statement; and
  - (b) It must therefore be accepted that not aligning with the benchmark established by the IMs does not necessarily mean that performance is inconsistent with the Part 4 purpose statement.

#### **4. COMMISSION'S PRELIMINARY CONCLUSIONS**

45. NZ Airports does not intend to comment on the detail of the Commission's preliminary conclusions for WIAL. However, there are several areas of general application in the Commission's analysis, which we comment on below.

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<sup>12</sup> Draft Report for WIAL, at [A6].

<sup>13</sup> Draft Report for WIAL, at [A7].

## **OPERATIONAL EFFICIENCY AND SHARING EFFICIENCY GAINS**

46. NZ Airports appreciates that the Commission has found that the evidence in this area is mixed, that "it is too early to assess meaningful trends in operational expenditure",<sup>14</sup> and that it is therefore not in a position to conclude whether ID is effectively promoting operational efficiency. The Commission also notes that, as it cannot measure whether capex and opex efficiency gains are being achieved at this time, it is not possible to assess whether efficiency gains are being shared.
47. NZ Airports does not wish to dispute these findings, but notes that it is difficult to understand why, in relation to efficiency, the Commission has declined to make findings that were potentially available on the evidence, when compared to its conclusive findings for profitability, which rely heavily on assumptions about the future.

## **INVESTMENT, INNOVATION AND QUALITY**

48. The Draft Report finds that WIAL is innovating appropriately, is providing services at a quality demanded by consumers, and the signs are that it is investing efficiently (subject to further monitoring over time).
49. NZ Airports emphasises that it is important for the Commission to pay particular attention where airports are performing well in the areas of performance that are critical to dynamic efficiency and the long-term benefit of consumers. We encourage the Commission to ensure that these key performance indicators are appropriately highlighted in its analysis of airport performance in the ID regime. In particular, NZ Airports encourages the Commission to continue to recognise where an airport is investing:
- (a) In the capacity that will facilitate competition between airlines; and
  - (b) To achieve service quality improvements identified as necessary by passenger surveys and airline customer feedback.

## **PROFITABILITY**

### **Overview**

50. NZ Airports submits that the Commission's approach to, reasoning for, and definitive conclusion regarding excess profits is out of balance with the rest of findings in the Draft Report.
51. The analytical framework adopted by the Commission appears to be to consider:
- (a) Whether there has been any change to WIAL's approach to profitability targets between PSE1 and PSE2. The Commission considers that no change implies that ID is ineffective.
  - (b) Analysis of historical profitability over PSE1, and analysis of expected profits over PSE2 and beyond (using IRR analysis).
  - (c) Whether the excess profits are justified by superior performance or other conditions. In the Commission's view, excess returns are due to the valuation methodologies used by WIAL and it targeting a return above the WACC IM, and no such justifications exist.

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<sup>14</sup> Draft Report for WIAL, at [3.10].

- (d) Whether ID has reduced disagreements between WIAL and its customers. The Commission appears to consider that, given disagreement still exists, there is good evidence that excess returns will continue through PSE3.

52. The following explains NZ Airports' concerns with each limb of the Commission's approach.

**PSE1 and PSE2 target returns**

53. The Commission has clearly been influenced by its comparison of WIAL's WACC estimates for PSE1 and PSE2.<sup>15</sup> NZ Airports encourages the Commission to recognise the limitations inherent in this analysis. In particular:

- (a) It does not consider the economic conditions and the estimate of WACC at the time prices were set for PSE1 (in 2007). Such factors include that, although risk free rates have subsequently fallen, the GFC has meant that the cost of securing debt from the market has increased, as investors are seeking greater compensation for risk, which is not reflected in the WACC IM model.<sup>16</sup>
- (b) Airport pricing is guided by a collection of building block inputs (including WACC), combined with customer feedback and commercial decisions. It is the collective outcome of these factors that produces each airport's target return. As recognised by the Australian Productivity Commission:<sup>17</sup>

The [building block] model is a starting point, and may be used to 'test' the reasonableness of offers made during commercial negotiations. As such, the final price set may not emerge as the result of the scientific application of formula, but rather a balance of issues (including the bargaining power brought to bear) during tough commercial negotiation. In effect, the price contains more 'information' about the use of market power. Given this, it is appropriate to observe the final prices that emerge from negotiations (rather than ambit claims that may be made relating to model parameters at various stages) when monitoring for market power purposes.

*Volatility of the WACC IM*

54. NZ Airports is also concerned that the Commission appears to be drawing adverse conclusions based on a perceived failure to respond to its shifting WACC estimate between price periods. Putting aside the fact that the appropriate points of comparison should be the start of PSE1 and the start of PSE2, the Commission should reconsider whether, under an ID regime, it is realistic to expect airports to match their decision-making to the Commission's volatile WACC IM.

55. We note that the Commission tested its estimate of the post-tax WACC produced by its WACC IM (as at June 2010) against a range of information when it was developing the WACC IM, to ensure that its IM produced a reasonable and commercially realistic estimate (in its view).

56. Accordingly, NZ Airports encourages the Commission to consider, as part of the section 56G review, whether the WACC estimate produced by its WACC IM remains reasonable and commercially realistic at the time of its assessments. This is particularly important given that the

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<sup>15</sup> Draft Report for WIAL, at [H7]. This difference has been predominantly caused by the changes in risk free rates.

<sup>16</sup> Following the WACC conference in December 2009, the Commission accepted that an additional allowance to TAMRP was appropriate while the GFC continued. It is difficult to see that the effects of the GFC have subsided to an extent that such allowances should be discontinued.

<sup>17</sup> Australian Productivity Commission "Economic Regulation of Airport Services" (Inquiry Report no. 57, Canberra), 14 December 2011, page 129-130.

Commission's mid-point WACC estimate has dropped from 8.1 percent as at July 2010,<sup>18</sup> to 6.49% as at July 2012.<sup>19</sup>

57. At least, the volatility of the Commission's WACC estimates produced by its IM over the past two years (and the significant differences that can occur between WACC estimates calculated a few months apart<sup>20</sup>) should be noted. Given this volatility, we consider that the Commission should have appropriate regard to the airports' contention of what is an appropriate, commercially realistic WACC estimate at the time of price-setting (where prices are set for a five-year period). The Commission should also be cautious about drawing negative inferences from airport decision-making that is consistent with WACC estimates being far less volatile in practice than suggested by the Commission's model.

*Use of the 50<sup>th</sup> and 75<sup>th</sup> percentile estimates*

58. NZ Airports also does not agree with the distinction the Commission draws between the appropriate estimate of WACC for ex post and ex ante assessment of returns. The Commission's position is that, for ex post analysis, the 50<sup>th</sup> percentile is appropriate because it does not need to worry about promoting investment, but the 75<sup>th</sup> percentile should be used to promote investment going forward.
59. NZ Airports believes that this logic is misconceived because airports will always face the prospect of their returns on any investment being assessed against the 50<sup>th</sup> percentile on an ex post basis. Accordingly, a forward looking 75<sup>th</sup> percentile estimate can provide no comfort or certainty that the airport will not be penalised in the future for earning over the 50<sup>th</sup> percentile. The use of the 75<sup>th</sup> percentile on a forward-looking basis is a recognised method of providing for the asymmetric social consequences of under-investment,<sup>21</sup> and the Commission risks undermining this important principle with its use of the 50<sup>th</sup> percentile estimate in its ex post analysis. This approach creates significant regulatory uncertainty, and risks negatively affecting investment incentives, and NZ Airports encourages the Commission to reconsider its approach.
60. Further uncertainty is created by the fact that the estimate of WACC used to assess returns on an ex post basis will be different than the estimate of WACC determined at the time the investment decision was made.

**Profitability analysis**

61. The Commission has used historic profitability data from PSE1, expected outcomes from PSE2, and assumptions about anticipated pricing behaviour in PSE3 to conduct its analysis of profitability for the period after information disclosure was introduced.

*Historic profitability over PSE1*

62. The Commission begins its profitability analysis by reviewing disclosed outcomes in PSE1 (2011 and 2012) as an indicator of profitability levels prior to the introduction of ID. The Commission's IRR analysis then uses these two periods as part of the 7 year period for which prices have been set by Wellington Airport (2011-2017) following the introduction of ID regulation.

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<sup>18</sup> As calculated in its IM Reasons Paper, at Table E23 (page 346).

<sup>19</sup> Commerce Commission Cost of capital determination for information disclosure year 2013 for Transpower, gas pipeline businesses and specified airport services (with a June year-end) [2012] NZCC 20, 30 July 2012, page 3.

<sup>20</sup> Compare the Commission's mid-point estimate in April 2012, at 7.06%, to its July estimate of 6.49%.

<sup>21</sup> See, for example, Lally "The Weighted Average Cost of Capital for Gas Pipeline Businesses", 28 October 2008, at page 94-95.

63. Blurring the use of historic profitability data over PSE1 in this way is inappropriate because, as the Commission acknowledges, outcomes in PSE1 are a product of decisions made prior to the introduction of ID. Any analysis of post-ID profitability must necessarily exclude the data from PSE1.

*Profitability in PSE2 - evaluation of expected outcomes*

64. Looking forward over the forecast period, the Commission's focus should be on:
- (a) Confirming that forecasts were robust. NZ Airports understands that airports engage with customers in this respect, and that there is no evidence that forecasts are biased.
  - (b) Considering whether there is an expectation of quality, innovation, investment, efficiency, and overall performance (including indications of superior performance or other factors) which supports the level of forecast returns.
  - (c) Appropriately acknowledging the inherent limitations of its assessment tools, particularly its WACC IM (as discussed elsewhere in this submission).
  - (d) Qualifying any conclusions that are being drawn to make sure this range of factors are recognised and considered.

*Assessing returns "over time" - 7 year IRR analysis*

65. The Commission observes that:

Having established a regulatory asset value, determining an appropriate approach for assessing returns for regulated suppliers like Airports, which invest in long-lived infrastructure assets, **is still a challenge. This is because the analysis will almost always be over a time period much shorter than the lifetimes of the assets involved.**<sup>22</sup>

[Emphasis added].

66. In order to "obtain an accurate picture over time",<sup>23</sup> the Commission adopts an IRR assessment over the life of the assets. It perceives this to be a solution to the challenges faced by single year assessments (which are subject to multiple variations and may not be a good indicator of profitability), and the complicating factor of asset revaluations.<sup>24</sup>
67. In NZ Airports' view, there is a deep flaw in the Commission's approach. While any analysis will involve some element of assumption, NZ Airports is concerned that the Commission's analysis hinges on assumptions about future price-setting periods, without:
- (a) A proper foundation for those assumptions; and
  - (b) Properly considering and explaining the impact of those assumptions on its ability to draw conclusions from its analysis.

68. The Commission notes that:<sup>25</sup>

However, if the IRR calculation cannot be undertaken over the lifetimes of all assets, then both an opening and closing asset value are required, in addition to the net cash

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<sup>22</sup> Draft Report for WIAL, at [I9].

<sup>23</sup> Draft Report for WIAL, at [I11].

<sup>24</sup> Draft Report for WIAL, at [I14].

<sup>25</sup> Draft Report for WIAL, at [I15].

flows associated with the opening asset value (which is the deemed capital outlay at the time). Ideally, the closing asset value should represent the value of future net cash flows at that time (discounted by the WACC). 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.

69. Regarding whether the Commission has derived "good estimates", it states that:<sup>26</sup>

**We do not know what asset value Wellington Airport will use as the basis for setting prices in PSE3, or whether there will be any wash ups associated with any revaluations.** However, we believe it is reasonable to assume that, at the very least, Wellington Airport expects to price off its current forecast of the closing asset value for PSE2.

70. In short, the Commission's "good estimate" of returns is in fact heavily based on assumptions regarding pricing decisions that may or may not be made in approximately five years time. Further, the assumption is that WIAL will deliberately set prices to recover (in the Commission's view) excess returns (by using a non-IM compliant asset base).

71. NZ Airports believes that in making this assumption, the Commission has overreached and failed to consider that:

- (a) As information disclosure continues to bed in and, in particular, once the merits review proceedings are concluded, the threat of further regulation, constructive engagement with airlines and/or changes in economic conditions could encourage WIAL to adopt different approaches in the future; or
- (b) The outcome of the merits review proceedings could reinforce WIAL's existing belief that its approach to asset valuation is the best approach under the Part 4 purpose statement, with the corollary that the IM is shown to be a flawed benchmark for assessment.

72. The Commission also fails to highlight how sensitive its conclusion is to the assumption that it makes about future pricing conduct. The result is that the IRR provides one possible estimate of returns, but is far from being "an accurate picture over time".

73. The Commission has also decided to compare the IRR to an estimate of WACC that was determined **after** WIAL made decisions for PSE2. Given that the analysis should focus on whether WIAL has responded to relevant incentives under ID, a WACC determined after decisions were made should be irrelevant.

74. NZ Airports therefore does not understand how the analysis can be translated into a firm conclusion that WIAL is earning excessive returns over time. It follows that the Commission's 7 year IRR model should not be a basis upon which the Commission reaches a conclusion on WIAL's (or other airports') achievement of profits "over time".

75. We also note that the Commission's approach to WIAL's terminal wash up arrangement appears to depart from the way this information has been disclosed under the ID requirements. As a point of general principle, this appears to be an example of where clear expectations have yet to be established. It would therefore be inappropriate, in our view, for any adverse conclusions to be drawn from the Commission's analysis where that may create increased uncertainty for airports, or disincentivise future risk sharing arrangements.

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<sup>26</sup> Draft Report for WIAL, at [H38.2].

## Consideration of other factors

76. The Commission dismisses, in fairly short order, the notion that the excess returns it has found to exist could be justified by other factors.

### *Balancing of qualitative and quantitative factors in profitability analysis*

77. NZ Airports' overarching concern is that the Commission's analytical framework provides no clarity as to how (if at all) quality, efficiency and performance measures have been or will be factored into its analysis of both ex post returns and ex ante expected returns.
78. Indeed, the Commission provides no indication that efficiency and quality factors have impacted on its profitability analysis.
79. NZ Airports is concerned that the quantitative focus of the Commission's profitability analysis does not give effect to the Commission's stated intention to assess all analytical areas before it is able to assess the effectiveness of ID in promoting one particular outcome (ie profitability).<sup>27</sup>
80. The outcomes that are intended to be promoted by the Part 4 purpose statement are necessarily interlinked. Any analysis needs to have appropriate regard to the interdependency between the relevant outcomes, and appropriately balance quantitative and qualitative factors in drawing any conclusions.

### *Engagement with departures from IMs*

81. The Commission's analysis does not test, evaluate, or engage with any departures from its IMs that were developed for ID purposes. The Commission states that it has considered departures from the IMs "if relevant". However, it is not clear where (or whether) the Commission has actually done so. NZ Airports encourages the Commission to engage with pricing approaches that differ from its IMs.
82. These concerns are most relevant to the Commission's application of its WACC IM. In the merits review proceeding, the Commission provided its first real insight into how the WACC IM would be used, noting that:<sup>28</sup>

The cost of capital IM produces an estimate of a normal rate of return for the Commission so that, in monitoring and evaluating the information it receives, it can critically assess the reasons advanced for departures from that estimated normal return over time.

83. The Commission further stated that:<sup>29</sup>

A cost of capital IM provides a basis for comparison with the actual methodologies used by the airports in determining cost of capital. This will encourage airports to be explicit about the assumptions and rationales used in their own modelling, and give interested parties (such as airlines in consultation with the airports over charges) some information for testing the airports' own assessments.

The advantage of a specific IM, is to provide interested persons with an objective basis upon which to evaluate airports' own assessments of their cost of capital.

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<sup>27</sup> Draft Report for WIAL, at [3.9].

<sup>28</sup> Commerce Commission submissions on cost of capital, 6 August 2012 (CIV-2011-404-820: *Auckland International Airport Limited v Commerce Commission*) 6 August 2012, at [47].

<sup>29</sup> Commerce Commission submissions on cost of capital, 6 August 2012 (CIV-2011-404-820: *Auckland International Airport Limited v Commerce Commission*) 6 August 2012, at [68]-[69].



84. Despite this strong indication that the WACC IM would be used to judge airports' own assessments of an appropriate cost of capital, NZ Airports is concerned that the Draft Report:
- (a) Does not appropriately recognise that the Commission exercised its regulatory discretion and judgment when selecting the WACC parameters for its industry benchmark, despite the acknowledgment of its expert panel (when advising on the development of the WACC IM), that there is "inevitable judgment required in the process of cost of capital estimation";<sup>30</sup>
  - (b) Does not engage with the possibility that a particular airport may be equally justified in exercising its own discretion and "inevitable judgment", based on expert advice, when producing its WACC estimate for pricing purposes;
  - (c) Does not recognise that each airport has a different risk profile; and
  - (d) Does not undertake sensitivity analysis for relevant WACC inputs to compare the industry benchmark WACC IM to approaches adopted by airports in their specific circumstances, or consider sensitivities to the WACC yardstick.
85. In doing so, the Commission inappropriately attributes a false sense of precision to the WACC estimate produced by the WACC IM. This ignores the caution of the Commission's expert panel in the IM consultation process, which agreed that:<sup>31</sup>
- ...the tools the Commission must use in estimating a firm's cost of capital are imperfect and often require compromises and adjustments.
86. In particular, one of the Commission's experts went further, and recommended that the Commission should:<sup>32</sup>
- ...not feel compelled to select one methodology or adjustment to the exclusion of all others when estimating components of the cost of capital. Instead, the Commission should carefully describe all alternatives and the implications of choosing each of these, and then using its judgment select one or a combination of methods and adjustments.
87. As is demonstrated by the WACC IM, it is clear that there will be differences in opinion on how best to meet the Part 4 purpose statement in any particular circumstances, and it is likely that a number of outcomes can be consistent with outcomes produced in workably competitive markets.
88. NZ Airports acknowledges that the Commission may apply its WACC IM in its monitoring and analysis tasks as an objective tool to assess the methodologies and assumptions made by the airports. However, it is concerned that the Commission has not attempted to substantively evaluate the decisions that have been made by airports in an area of estimation that involves considerable differences in expert opinion, and necessarily requires judgments to be made about the most appropriate outcome.
89. Essentially, NZ Airports is concerned that the Draft Report has not addressed the fact that an industry-wide WACC combined with an asset valuation IM for information disclosure purposes cannot reasonably provide a precise measure or hard target for evaluating airport specific returns. It is therefore very bold for the Commission to find that WIAL is earning

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<sup>30</sup> Franks, Lally, Myers "Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology", 18 December 2008, page 4.

<sup>31</sup> Franks, Lally, Myers "Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology", 18 December 2008, page 5.

<sup>32</sup> Franks, Lally, Myers "Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology", 18 December 2008, page 6.

excess returns over time, given that the evidential foundation for that finding is highly contentious, subjective, and imprecise.

**Disagreement with airlines**

90. NZ Airports does not understand why the Commission concludes that evidence of disagreement between airports and airlines means that WIAL's conduct is inappropriate or that it will continue to earn excess profits in PSE3.
91. When considering agreement or (lack thereof) between airports and airlines, it should be borne in mind that:
  - (a) It is axiomatic that airline customers will disagree with the returns targeted by airports. Airline shareholders properly expect them to reduce their costs, and therefore increase profitability, to the maximum extent possible;
  - (b) Airlines disagree with the asset valuation IM and have appealed it to the High Court;
  - (c) Agreements or pricing arrangements could in fact result in outcomes different to the Commission's view of the proper approach under Part 4; and
  - (d) Air NZ and BARNZ have stated their wish for heavy-handed regulation and consequently are incentivised to portray the current regime as ineffective.
92. At the very least, the Commission should be more tentative in its conclusions about the impact of disagreement on future pricing conduct. Airports approach all consultations under the AAA with an open mind (as required) and take all relevant factors into account when making pricing decisions. In addition, the increased transparency under the ID regime and the threat of increased regulation are treated seriously by the airports.