

19 December 2017

Introduction

1. This is the New Zealand Airports Association ("**NZ Airports**") cross-submission on the substantive issues and questions raised in the process and issues paper for the review of Auckland International Airport Limited's ("**AIAL**") and Christchurch International Airport Limited's ("**CIAL**") third price setting events ("**PSE3**") (July 2017 - June 2022) ("**Issues Paper**").
2. As with our previous submission, NZ Airports has focussed its comments on regulatory framework issues raised by submissions. AIAL and CIAL will separately submit on matters in relation to their price setting events.
3. In their submissions on process, Air New Zealand ("**Air NZ**"), Qantas and BARNZ ("**Airlines**") advocated for a material broadening of the review. NZ Airports has not sought to respond to the Airlines views on the "new" topics. If the Commerce Commission ("**Commission**") does decide to expand the review, then NZ Airports expects that the Commission will adjust the process to provide parties with an opportunity to submit on any new or expanded topics included.
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Executive Summary

5. This submission process naturally tends to highlight and focus on points of disagreement between the parties. However, the matters on which the Airlines express displeasure are confined to what would be expected at the outset of this review. We hope that the natural tension between airports and the Airlines on matters such as target return and cost forecasting does not unduly detract from the assessment of performance areas where parties agree that performance is positive.
6. The main substantive point raised by Airlines that NZ Airports strongly disagrees with is that AIAL's and CIAL's adoption of a target return higher than the Commission's mid-point estimate is inappropriate, and means that the airports will achieve excess profits in PSE3. In response, NZ Airports submits that:
 - (a) Airports have set their prices in accordance with the framework established by the Commission after the Input Methodologies Review ("**IM Review**"). This framework encourages the airports to adopt a target return that is appropriate to their specific circumstances, and fully explain their reasons.

- (b) The Airlines have not engaged with this framework, as evidenced by their attempt to quantify any target return above the Commission's mid-point estimate as "excessive". Characterising AIAL's and CIAL's target returns as involving a wealth transfer of \$75 million from passengers to the airports is misleading and inaccurate, as it incorrectly treats the mid-point as being the "correct" target return for each airport.
 - (c) Our expectation is that the Commission will follow an approach to this review that upholds the target return framework it has established, and does not present the mid-point estimate as a "bright line". The quantification undertaken by BARNZ is inconsistent with that framework.
7. The airlines also raise various points in relation to risk allocation. Again, NZ Airports believes that the approach taken by the airports, in respect of risk allocation and expenditure forecasts, is entirely consistent with the Commission's guidance.

WACC

Role of regulatory mid-point estimate

8. The Airlines assert that there is no justification for airports targeting returns above the Commission's mid-point regulatory WACC estimate.¹ It is clear that the Airlines will continue to treat the mid-point as a bright line benchmark, regardless of the strength and legitimacy of the airports' reasoning for determining an appropriate airport-specific target return.
9. Accordingly, NZ Airports takes this opportunity to remind the Commission that the airports have, in good faith, sought to constructively engage with the framework established by the Commission under the IM Review. In particular:
- (a) The Commission was clear, based on advice it received from Professor Yarrow, that the mid-point regulatory WACC was not a bright line benchmark.
 - (b) Instead, considering the airport's reasons for setting its pricing WACC should be the focus of the assessment. Understanding the airport-specific circumstances and context that informed decisions is very important.
 - (c) The outcome, as encouraged by Professor Yarrow, is that the regulatory mid-point estimate should not have any particular prominence – it is one factor among others to consider when assessing profitability. Most importantly, "the WACC by and of itself is not an appropriate benchmark for setting a threshold at which profits might reasonably be judged to be excessive".² This advice was informed by his view that WACC estimates "are derived from a series of propositions that contain significant, speculative elements".³
10. The Airlines' submissions have made it clear to NZ Airports that the Commission will need to carefully present its analysis on profitability to ensure that it does not reinforce incorrect perceptions that the regulatory mid-point WACC is a bright line benchmark.

¹ Board of Airline Representatives New Zealand, Review of Auckland and Christchurch Airport's third price setting events – Process & Issues paper, 28 November 2017 ("**BARNZ Submission**") at 1; Air New Zealand, Response to the Process and Issues Paper: Auckland and Christchurch Airports' third price setting events (July 2017-June 2022), 28 November 2017 ("**Air NZ Submission**") at 1 and 5.

² Professor George Yarrow, Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector, February 2016 ("**Yarrow Report**"), at 20.

³ Yarrow Report, at 5.

11. For example, BARNZ has quantified a dollar value for the forecast difference between the mid-point regulatory WACC and airport-specific target return. This may have been modelled on the historic section 56G reviews, where the Commission quantified and characterised forecast returns above the mid-point as "excess", even if they were within its acceptable range. BARNZ has also sought to inflame the issue by referring to the amount as a "wealth transfer" from consumers to airports.
12. However, we have now been through the IM Review, which benefitted from Professor Yarrow's input (as discussed above). Professor Yarrow's clear advice was that the regulatory WACC is not an appropriate benchmark for setting a threshold at which profits might be judged to be excessive. Accordingly, any purported quantification of "excess" returns or "wealth transfers" is illusory – as it relies on a starting point that is an estimate subject to error.
13. Accordingly, NZ Airports submits that, under the new framework established in accordance with Professor Yarrow's advice, it would be wrong to quantify the difference between the regulatory mid-point WACC and an airport's target returns and present it as an indicator of "excess" returns. In the context of assessing the appropriateness of an airport-specific target return, which requires consideration of all relevant factors, it would be an uncertain, arbitrary and inflammatory figure. It would not optimally inform interested persons about airport performance, as it would likely mislead them into believing that the mid-point regulatory WACC was an accurate bright line benchmark for an airport-specific target return.
14. The correct approach, as advised by Professor Yarrow, is to engage with each airport's reasons for its target return to assess whether its target profitability is in the long term interest of consumers. As part of that, we anticipate the Commission will express a qualitative view on whether the airports reasoning justifies its airport-specific target return.

Unregulated till does not prevent airport-specific WACC

15. In the Issues Paper the Commission refers to its position that, because airports have complementary revenue streams, the case for making an uplift to the regulatory mid-point WACC estimate published by the Commission for information disclosure purposes, due to the concept of asymmetric social costs, was weaker for airports compared to the Commission's approach when setting the WACC estimate for price paths for electricity companies.⁴
16. This has prompted the Airlines to argue that an airport's complementary revenue streams means a target return higher than the Commission's mid-point WACC estimate cannot be justified.⁵ In their view, the commercial income earned by both AIAL and CIAL lowers their commercial risk and means that a target return that differs from the regulatory mid-point WACC is not justified. Further, BARNZ now believes that the Commission is unwilling to consider departures from the regulatory mid-point:⁶

The airports have targeted high WACCs despite the Commission's view that an uplift above the mid-point of the range is not justified in the case of Airports because the return obtained from complementary unregulated activities (in which Airports enjoy significant market power) serves the purpose that justifies the uplift in price-quality regulated industries.

⁴ Commerce Commission, Process and issues paper on the review of Auckland and Christchurch Airports third price setting for airport services, 20 October 2017 ("**Issues Paper**"), at [47].

⁵ BARNZ Submission at 1 and Air NZ Submission at [20].

⁶ BARNZ submission at 1.

17. Clearly, this cannot be correct. As set out above, the Commission made it abundantly clear in the IM Review that it can be legitimate for airports to target returns that vary from the mid-point WACC estimate. It therefore cannot be the case that the existence of complementary revenue streams prevents an airport from establishing a target return that is appropriate in its circumstances.
18. NZ Airports thinks the confusion has arisen because of the Commission's reference to "an uplift to the mid-point cost of capital".⁷ Such language implies that the mid-point is a bright line benchmark. This must be inadvertent because, although the Commission has referred to the regulatory mid-point as a starting point for analysis, it has been clear that it is not a bright line benchmark.
19. Consistent with the Commission's guidance from the IM Review, each airport has sought to carefully justify the WACC and/or target return that is appropriate in their specific circumstances, bearing in mind that the Commission's regulatory mid-point is an industry-wide estimate. The airports have not sought to quantify or justify an "uplift" to the regulatory mid-point in the same way that the Commission does for energy companies subject to price control. Again, doing so would treat the mid-point as more than a starting point, with more importance than other relevant contextual factors, contrary to Professor Yarrow's advice.

There should be different reasons for airport-specific WACCs

20. BARNZ has alleged that AIAL and CIAL have contradictory justifications for why their target returns differ to the mid-point regulatory WACC estimate, which BARNZ argues is a bad outcome of the regulatory framework:⁸

The arguments that Auckland and Christchurch Airports have offered to justify setting a WACC higher than the mid-point of the range are different and contradictory – they cannot both be correct. BARNZ is concerned that the regulatory framework is producing a situation where each airport finds their own reason to justify an uplift, but those reasons are not consistent over time or with each other. We suggest the Commission needs to decisively reject this type of unorthodox claim regarding WACC estimation.

21. In response, NZ Airports submits that:

- (a) The consultation record shows that the airports have sought to be guided by the Commission. CIAL and AIAL have taken different approaches to establish their WACC estimates, according to their airport-specific circumstances.
- (b) This is entirely consistent with the framework established by the Commission. In fact, it is required by the framework. Each airport is required to carefully consider an appropriate airport-specific target return, and must not assume that the industry-wide regulatory WACC estimate is appropriate (and of course, each airport must explain its approach). As noted by the Commission in the context of rejecting the option of publishing a specific point estimate analogous to the 67th percentile for energy companies: 9

We consider that determining a specific percentile in this way is not consistent with our view that the appropriate

⁷ Issues Paper at [47].

⁸ BARNZ Submission at 1 and 10.

⁹ Commerce Commission, Input Methodologies review decision – Topic Paper 6 – WACC percentile for airports 20 December 2016, at [111].

percentile is potentially different for each airport and potentially differs between particular projects. It is also unlikely to be consistent over time.

We consider that allowing flexibility in how a WACC applies to the assessment of airport profitability is a more appropriate approach. Evidenced explanations for adopting an estimate of the WACC above the mid-point estimate **should be made on a case-by-case basis.**

[Emphasis added]

- (c) Airlines characterise differences in airport approaches as inconsistencies in each airport's reasoning. However, this is an undue simplification of the explanations provided by AIAL and CIAL. It is incorrect to suggest that there are simple trade-offs, such that a reason used by one airport should have a corresponding cause and effect on the other airport.
 - (d) When Wellington Airport next sets prices, it will also need to establish a target return that is appropriate to its specific circumstances. It should not be required to take an approach of seeking to translate AIAL's and CIAL's approaches into a Wellington Airport WACC, which is what the Airlines appear to suggest.
22. In summary, as NZ Airports has repeatedly submitted, airports reasonably expect their decisions to be assessed based on the information available to them at the time they set prices, under the airport-specific WACC framework established by the Commission. The airlines could have tested the logic of each airport's arguments against each other, in a general way without revealing confidentiality, at the time of price setting. However it was not reasonably possible for airports to compare their approaches at the time they set prices. The Airlines have now contrasted each airport's reasoning *ex-post*, yet have still missed the primary requirement that the assessment should focus on whether the reasoning is sound for the circumstances particular to each airport.
- Need to promote long term benefit of consumers*
23. BARNZ and Air NZ assert that a target return needs to be justified by reference to consumer benefits.¹⁰
24. NZ Airports agrees. Each airport has carefully explained why they believe their price-setting decisions will promote the long term benefit of consumers.
25. However, we disagree with the claim that the airports have failed to demonstrate such benefits. As we cautioned in our submission on the Issues Paper, it is not reasonable to expect every decision on WACC to be fully supported by empirical evidence.¹¹ Exercise of reasonable judgement is required. Equally, the airports were also well aware that any general uplift that was not carefully justified would fall short of the Commission's expectations.

¹⁰ BARNZ Submission at 19 and Air NZ Submission at [60].

¹¹ NZ Airports Association, Submission on process and issues paper on review of Auckland and Christchurch Airports third price setting for airport services, 28 November 2017 ("**NZ Airports Submission**") at [37].

Conflict between price setting and information disclosure

26. Air NZ has suggested that the different approaches to WACC highlight the inherent conflict between information disclosure and the ability to set prices:¹²

Air New Zealand notes that these approaches [to WACC] were advocated by airports during the IM Review process but were dismissed by the Commission. This highlights the inherent conflict between the Commerce Act information disclosure regime and airports' ability under the Airports Authorities Act 1966 ("AAA") to set their own return and price accordingly. No other business can do this.

27. AIAL and CIAL will respond to the incorrect allegations that their approaches are inconsistent with the IM Review. NZ Airports confines its response to the alleged conflict between the Information Disclosure Regime ("**ID Regime**") and price setting under the Airport Authorities Act 1966 ("**AAA**"). Our strong view is that the ID Regime operates as a cohesive and effective whole:

- (a) The power to set prices provides important flexibility for airports to adopt tailored approaches that best meet the requirements of a range of consumers. They carefully consider, and are materially influenced by, views provided by consumers during consultation.
- (b) Airports are also materially influenced, and constrained by, the guidance provided by the Commission under the ID Regime. This is not confined to the input methodologies, but also includes other guidance and explanations provided by the Commission in reasons papers and workshops.
- (c) At the time of price setting, airports anticipate that their decision-making will be assessed by the Commission in accordance with the guidance it has provided. The evidence now before the Commission explains how Commission guidance has influenced airport decision-making.
- (d) If the section 53B(2) review identifies any concerns, these will form part of the guidance that airports can take into account when they next set prices. If the concerns are sufficiently material, then airports will need to carefully consider whether more immediate action is appropriate (and have a history of doing so, as illustrated by the section 56G process).
- (e) Accordingly, consumers can be confident that their long term interests are promoted by the ongoing interaction between the price setting and regulatory overview process under the ID Regime.

Comparison to electricity lines

28. BARNZ alleges that electricity lines companies do not need a higher WACC under Customised Price-quality Paths ("**CPPs**") to fund significant investment, and therefore airports should not require a WACC higher than the regulatory mid-point estimate:¹³

Orion, Transpower and Powerco have, or are about to, undertake investment step changes. These businesses did not require a higher WACC as part of

¹² Air NZ Submission at [19].

¹³ BARNZ Submission at 10.

those step changes. In fact, Orion's WACC under their customised price-quality path was lower than it would have been under the default price-quality path.

29. NZ Airports believes this analogy is misconceived. Electricity lines companies are a very different sector, under a very different regulatory regime. A key differentiating feature is that airports' substantial customers have the ability to directly engage on and influence commercial outcomes, and airports have the flexibility to tailor approaches to allow them to meet a range of consumer demands – including investment. Airports are subject to information disclosure only, in recognition of this dynamic and the lower risk of harm to consumers.
30. We understand that, under the Default Price-quality Path ("**DPP**")/CPP Regime, the WACC IM is the same, regardless of whether an entity is subject to a DPP or a CPP. In other words, unlike under the ID Regime, there is no scope for these businesses to request a different WACC estimate or for the Commission to consider whether a different WACC estimate is appropriate. In the past, differences in WACC could arise depending on the timing of when a CPP was set, relative to a DPP. However, this was remedied under the IM Review. BARNZ has also failed to note that the WACC percentile used to set prices under a DPP/CPP (the 67th percentile) is materially higher than the mid-point WACC estimate.
31. In that context, the key driver for CPP applications is that capex allowances under DPPs do not cover new significant investment. This issue does not arise under the ID Regime, where a key benefit is that airports and airlines can work together to develop investment plans and to engage on the appropriate return to support that plan and reflect the risks involved.

Risk sharing

Capital expenditure

32. Air NZ argues that airports are inclined to not risk share, in order to maximise their return. In its view, risk sharing would be a natural inclusion in a regulated contract under a negotiate-arbitrate regime:¹⁴

In another regulatory model, such as negotiate/arbitrate, such risk sharing would be a natural inclusion in a regulated contract. Little incentive exists for airports to share risk. In participating in a risk sharing mechanism, airports effectively agree to lower their asset beta, and therefore their rate of return. To the extent that any risk sharing was entered into, that risk would be reallocated every year. Under the current settings, it is unlikely that airports will adopt any mechanism to share risk as available in the Input Methodologies.
33. NZ Airports disagrees. We expect that the same principles for risk allocation would apply regardless of the form of regulation. As previously submitted, NZ Airports understood from the IM Review that the Commission's key principle was that risk should be allocated to those best able to manage it.¹⁵ Revaluations were the only exception to the position that airports were in the best position to manage risks, but that consultation provides flexibility to consider whether alternative approaches are appropriate in the circumstances.
34. When considering whether moving away from this "default" position is appropriate, NZ Airports considers that the relevant considerations would be the same under any form of

¹⁴ Air NZ Submission at [27] – [28].

¹⁵ NZ Airports Submission at [43].

regulation. A key factor will be whether any alternative risk sharing arrangement provides for better management of the risk in the long term interest of consumers.

35. The Airlines are mainly concerned about the risk of the delayed commissioning of assets, and propose wash-ups to mitigate this.¹⁶ However their proposals do not recognise the complexity of capital expenditure programmes, and the need for airports to consider on an ongoing basis what is efficient in changing circumstances, in the face of sometimes competing interests of their airline customers (for example, depending on their commercial interests, airlines can have different views on the need for, and timing of, expansion plans).
36. Indeed, in many cases, changes in capex plans will be agreed with, or instigated by, airline customers. It is therefore important to carefully consider the full reasons and circumstances for changes in investment plans.
37. Accordingly, while the Airlines may now have an incentive to raise concerns about airport capital expenditure programmes under this review, and seek to present the issue as being about airports' (theoretical) incentives to increase returns, NZ Airports encourages the Commission to carefully assess the detailed disclosures for a full account of what has actually occurred in practice, and the views of the Airlines at that time.
38. In addition, airports can, and do, adopt risk-sharing mechanisms that are not wash-ups. For example, AIAL has excluded the new domestic terminal from PSE3 pricing, and has over time changed its price structure toward a greater reliance on passenger based charging. Wellington Airport excluded some forecast projects from its PSE3 price setting pending further consultation with airlines. CIAL removed \$16m in allowable revenue permanently to bear the risk of the reduction in demand in PSE2 experienced following the Christchurch earthquakes.
39. In that context, wash-ups agreed at the time of price setting need to be carefully designed so as not to undermine efficiency incentives, and need to be considered in light of other risk sharing mechanisms already in place. Further, the current regime has not precluded airports from implementing wash-ups if material projects are delayed – an example of this is the Wellington "Rock" terminal development.
40. The Airlines also allege that airports are over estimating their capital expenditure in forecasts to obtain higher returns.¹⁷ These allegations are without foundation. There is no evidence from historical performance that airports' actual expenditure is systematically below their capex forecasts. Indeed, both AIAL and CIAL incurred expenditure materially above forecast for PSE2. Airlines do not propose wash-ups that would allow airports to recover such additional unforecast expenditure.
41. Overall, NZ Airports firmly believes that:
 - (a) Airlines continue to discuss capital expenditure forecasts and wash-ups at a theoretical level. They have not evaluated the explanations in disclosures that demonstrate that airports are behaving appropriately. Capital expenditure forecasts are rigorously tested during consultation, and airports have a history of consulting with airlines and adjusting actual expenditure, as appropriate, as circumstances change.

¹⁶ BARNZ Submission at 12.

¹⁷ BARNZ Submission at 3.

- (b) A key positive feature of the ID Regime is the flexibility it provides for airports and their customers to constructively engage on complex capital expenditure programmes for the long term benefit of consumers. This includes considering risk allocation approaches on an ongoing basis. We think it would be a significant backwards step if the ID Regime sought to impose a more rigid approach to capital expenditure forecasting and risk allocation.

Demand forecasts

42. In its submission on CIAL's demand forecasts, Air NZ states that CIAL's preference was to establish headline prices, and then deal with airlines individually to develop bespoke arrangements. It alleges that "this strategy demonstrates CIAL using the regulatory pricing regime to disguise a 'divide and conquer' strategy, in play to benefit the airport".¹⁸
43. NZ Airports finds it surprising that an airline customer is concerned about an airport's willingness to engage with customers individually on bespoke arrangements. Substantial customers have different business models, and different plans and aspirations for the future. Clearly, this involves the consideration of commercially sensitive information that airlines presumably do not want to share with their competitors.
44. A key benefit of the AAA and ID Regime is that airports and airlines can seek to agree tailored arrangements, outside the formal consultation process.

¹⁸ Air NZ submission, at [85].