

SECTION 56G REVIEW OF CHRISTCHURCH AIRPORT: CROSS-SUBMISSION ON DRAFT REPORT

26 November 2013

INTRODUCTION

1. The Commerce Commission ("**Commission**") published its draft report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Christchurch International Airport Limited ("**Christchurch Airport**") on 15 October 2013 ("**Christchurch Draft Report**"). This cross-submission on the Christchurch Draft Report is made by the New Zealand Airports Association ("**NZ Airports**") on behalf of Auckland International Airport Limited, Wellington International Airport Limited, and Christchurch Airport (together, "**airports**").
2. The NZ Airports contact for matters regarding this submission is:

Kevin Ward
Chief Executive
PO Box 11 369
Manners Street
Wellington 6011
DDI: (04) 384 3127
Mobile: 021 384 524

Email: Kevin.ward@nzairports.co.nz

OVERVIEW

3. The submissions on the Christchurch Draft Report have demonstrated some important points relevant to assessing the effectiveness of information disclosure:
 - (a) Information disclosure is having, and will continue to have, a material impact on airport conduct and performance. The Christchurch Airport submission describes numerous changes in approach that Christchurch Airport intends to make in response to guidance from the Commission.
 - (b) Airports are committed to the spirit and intent of information disclosure. The Christchurch Airport response to the Draft Report characterises the positive and constructive approach of all airports to the new regulatory framework.
 - (c) Although there may be some points of detail still to work through regarding the complexities of assessing airport pricing decisions under the information disclosure framework, this should not detract from the evidence that information disclosure is providing clearer and sharper incentives on material issues. A good example is the treatment of revaluation gains, which was one of the most contentious issues prior to the introduction of information disclosure - challenges in assessing returns should not

detract from the fact that airports are dealing with revaluation gains in pricing decisions in a way acceptable to their airline customers.

4. Such outcomes are a product of a period of intense activity for the airports, airlines and the Commission to establish an effective information disclosure regime. The development of the Commission's input methodologies ("IMs"), the design of the information disclosure requirements, the merits review proceedings and the section 56G review process have each been important steps in the development of the information disclosure framework.
5. As previously indicated, NZ Airports remains committed to working constructively with the Commission and airlines to resolve any outstanding issues regarding the design of information disclosure regulation, with the aim of making it even more effective into the future.
6. However, as the final section 56G review nears an end, it is useful to reflect on the airports' experience of information disclosure regulation and the lessons that have been learned to date, including the positive impact of the section 56G process, which we do in this submission.
7. We also briefly respond to technical aspects of the BARNZ submission on the Christchurch Draft Report that are of concern to all airports.

THE LEARNING PROCESS OF INFORMATION DISCLOSURE REGULATION

The criteria for effective information disclosure

8. The development and implementation of the information disclosure regime (including the section 56G review) has been a learning experience for all parties. In our view, this process has provided a valuable opportunity to explore what effective information disclosure regulation looks like now, and may look like in the future.
9. We summarise below (in **Figure 1**) the key criteria for an effective disclosure regime from the airports' perspective, as distilled from the information disclosure regime to date.

Figure 1: What is effective information disclosure regulation?

In NZ Airports' view, effective information disclosure should:

- ensure that interested parties have access to sufficient and accurate information to make a robust assessment of airport performance;
- provide transparency so that the outcomes produced by airports are fully scrutinised;
- allow existing incentives for airports to engage in positive behaviour to continue;
- influence airport behaviour by imposing discipline through transparency and analysis, providing guidance about appropriate performance, and by encouraging airports to adjust their behaviour if information disclosure reveals that change may be required;
- support and encourage commercial consultations between airports and substantial customers;
- provide scope and flexibility for airports to design tailored and innovative solutions to the challenges they and their customers face (while providing for full disclosure of those solutions); and
- result in performance outcomes consistent with the outcomes in the Part 4 purpose statement over time.

The progress to date

10. The section 56G review has revealed that the above criteria are currently being achieved. The signs are that an effective and robust regime has been established, which is impressive at this early stage. Considerable progress has been made by the three regulated airports to adjust their operations in support of an effective and influential regulatory framework. We set out the ways in which the above criteria are being met in **Figure 2** below.

Figure 2: How effective is information disclosure regulation?

Is information disclosure regulation ...

Ensuring that interested parties have access to sufficient information?

• Yes. The information disclosure requirements require comprehensive disclosure of information about airport decisions and performance. Airports have taken a careful and thorough approach to preparing annual and price-setting disclosures, which have provided substantial information to interested parties (and, in turn, this has helped promote the scrutiny and analysis discussed below). Airports have provided additional information when they believe it will helpfully explain their decisions. The Commission has indicated that aspects of Christchurch Airport's price-setting disclosure could be changed to provide greater transparency to interested parties, and Christchurch Airport has indicated that it intends to make a number of constructive changes to its disclosures in response to this feedback. Going forward, the section 53B(2) summaries should provide an additional stream of useful information.

Providing transparency so outcomes are fully scrutinised?

• Yes. When setting prices, airports knew that their decisions and reasoning would be fully scrutinised under the information disclosure regime. The section 56G review has demonstrated that the Commission, airports, airlines and freight consumers can have robust discussions on matters of investment, innovation, operating and pricing efficiency, quality and airport profitability. This is a sign that the regime is working as it should to promote transparency, encourage debate, and allow informed assessment and scrutiny of performance and outcomes.

Allowing existing incentives for positive behaviour to continue?

• Yes. Prior to the introduction of Part 4, all three regulated airports were delivering high-quality, innovative and efficient services as well as timely and responsive investment. The Commission has found that quality and innovation performance has remained high under Part 4, and has not identified any problems at this early stage in relation to investment or efficiency (albeit it considers information over time is required to draw conclusions). The fact positive outcomes are being achieved in a number of areas of the purpose statement independently of information disclosure is evidence that light-handed regulation is right for airports — the additional value of the regulatory regime is in transparently highlighting performance for interested parties and ensuring incentives remain for airports to continue positive behaviour.

Influencing airport behaviour (including by encouraging airports to adjust their behaviour where change may be required)?

• Yes. The section 56G process has provided a valuable opportunity for the Commission to provide guidance on areas of potential concern with airport performance, and this feedback has triggered positive responses from all three airports (see paragraphs 13-17 below). The early signals are that airports can and will respond appropriately to feedback from the information disclosure regime (including to feedback about areas of performance that can be improved) — an important sign that information disclosure is effective. The regime will continue to have an important influence on airport behaviour going forward, particularly as the Commission's regular monitoring and analysis role is established.

Supporting and encouraging commercial consultations?

• Yes. The Airport Authorities Act and information disclosure regimes can and do work effectively together. Information disclosure regulation has played a positive role in the pricing consultation processes for each of the three airports, including by providing airlines and airports with a common language to approach pricing consultations, and by providing a reference point for airlines to consider and engage with the pricing approaches proposed by the airports. It has also introduced additional pressure on airports to explain pricing decisions (and any departures from IMs within those decisions) in a transparent, rigorous and disciplined way. As discussed in submissions on the Christchurch Draft Report, it will be important going forward to ensure incentives for commercial engagement with airline customers are not undermined.

Providing scope and flexibility for tailored and innovative solutions?

• Yes. For example, Christchurch Airport put considerable effort into developing an alternative and innovative pricing model that is aimed at delivering a positive outcome for passengers and airlines over the current pricing period, taking into account market factors (the impact of the Christchurch earthquakes on costs and demand expectations), unique investment needs (the construction of its new terminal) and other airport-specific circumstances (such as its level of systematic risk, which its customers also agree is higher than that estimated by the Commission). This is exactly the type of outcome that should be promoted under information disclosure.

Promoting performance outcomes consistent with the Part 4 purpose statement over time?

• Yes. The transparency provided by information disclosure has enhanced airports' existing incentives to adopt approaches consistent with outcomes in workably competitive markets. Positive performance outcomes have been demonstrated for all airports in relation to the quality and innovation of airport services. The early signs are that investment and operating efficiency performance are appropriate (albeit the Commission considers that more information over time is needed to draw conclusions in these areas). In areas where the Commission has identified potential areas for improvement, the airports have already responded in ways that can give the Commission and interested parties significant comfort that performance outcomes will continue to be consistent with the Part 4 purpose statement. Clearly, debate remains about whether all airports are targeting acceptable returns - however, as discussed below, considerable progress has been made to establish what the Commission considers to be acceptable, and even clearer guidance should be available once the merits review proceedings are concluded and the Commission makes any necessary adjustments to its analytical approach.

11. As can be seen, information disclosure regulation has provided a significant change to the regulatory landscape for the airports in its early days. All airports are fully committed to the new regime and are striving to produce comprehensive and detailed disclosure documents, and to respond appropriately to the additional incentives provided by information disclosure regulation.
12. Airports have dedicated significant resources to understanding and considering the information disclosure regime, and each of the airports has provided considerable evidence in their submissions throughout the section 56G review about how information disclosure regulation impacted positively on the most recent pricing consultations and has affected performance and behavioural outcomes.
13. As noted above, positive performance outcomes have been demonstrated for all airports in relation to the quality and innovation of airport services. The early signs are that investment and operating efficiency performance are appropriate (albeit the Commission considers that more information over time is needed to draw conclusions in these areas). In areas where the Commission has identified potential areas for improvement, the airports have already responded in ways that can give the Commission and interested parties significant comfort that performance outcomes will continue to be consistent with the Part 4 purpose statement.
14. In our view, the behaviour of all three airports demonstrates a genuine willingness to:
 - (a) engage with the information disclosure regime;
 - (b) seek to do the right thing based on the information that is available;
 - (c) learn from the Commission's guidance; and
 - (d) explore ways to improve both airport performance and the effectiveness of the regime over time.
15. This is evidenced by (among other things), thorough and careful information disclosures and constructive and full engagement with the Commission throughout the development of the regime and the section 56G review. It has also been demonstrated by clear commitments from each of the three regulated airports to address material areas of potential current and/or future concern in response to feedback from the Commission. These have included, for example:
 - (a) Wellington Airport's decision to re-consult with substantial customers on airport charges in response to feedback from the Commission in the Wellington Final Report;
 - (b) Auckland Airport's assurances about the future treatment of its moratorium on asset revaluations in response to discussions with the Commission and airline customers in the section 56G review process; and
 - (c) Christchurch Airport's constructive response to the concerns that were raised in the Christchurch Draft Report, its commitment to produce additional disclosures to improve the transparency of its performance in line with the Commission's feedback, and the changes it has indicated it will make to its disclosures going forward.
16. NZ Airports sees these actions as strong evidence of the airports' commitment to the regulatory regime, and as clear signs that the airports can and will respond seriously to the discipline imposed by transparency and scrutiny of their performance through information disclosure.
17. In short, the regulated airports have taken considerable guidance from their experience with information disclosure to date and from the section 56G review. In our view, the evidence demonstrates that information disclosure is currently working effectively in its early days across all performance areas, for all three airports.

The additional benefits of information disclosure

18. In our view, the development of the regime to date has had additional benefits. In particular, the early days of information disclosure have provided an opportunity for the Commission and interested parties to learn about the nature of the airport industry and the three regulated airports.
19. As a result of the increased attention on airport performance (particularly through the section 56G review), NZ Airports hopes the Commission and interested parties now have a greater understanding of the unique circumstances and challenges of the airport industry and of New Zealand's regulated airports — how they operate, how decisions are actually made, and how a number of complex factors interact to influence airport behaviour (including the influence provided by the information disclosure regime).
20. We summarise below (in **Figure 3**) the growing understanding of the airport sector that we hope information disclosure regulation is revealing to the Commission and to interested parties.

Figure 3: Building an understanding of the airport sector

Information disclosure regulation has revealed that:

- Airport infrastructure in New Zealand is currently in good health, and positive outcomes are being delivered across a number of key performance areas. Consumers are benefiting from a healthy and well-performing airport sector, characterised by quality airport services at a level reflecting passenger and airline demands, efficient and innovative airports, and reasonable charges that benchmark well by international standards. It is important to ensure the right incentives are in place for these positive outcomes to continue.
- Airports are very different to network utilities. Every airport is different and faces its own unique challenges (driven, in part, by specific investment needs and the individual consumer/demand profile of each airport).
- There is no one-size-fits-all approach to airport performance and decision-making. In NZ Airports' view, the section 56G process has underscored the importance of encouraging tailored and innovative quality, investment and pricing decisions, and reinforced that an equally tailored approach to assessing those decisions is required.
- Airport decisions (particularly pricing decisions) are difficult and complex, and require a balance between the needs of passengers, airlines, local and national economies, and the airport. Information disclosure is an important guide in these decisions but is not the sole driver (and is not the only factor that produces incentives to promote the long-term benefit of consumers).
- The nature of the consultation process between airports and substantial customers on airport charges is intense, sophisticated, thorough and lengthy. This process involves real, robust debate with well-informed airline customers, and heavily influences airport pricing decisions. Airports seek, value and respond to feedback from substantial customers and, as a result, make considerable commercial compromises for the benefit of their customers in price-setting.
- Care must be taken to ensure that the information disclosure framework is applied in a way that preserves incentives for airports to offer commercial concessions, respond to market factors, and adopt tailored and innovative approaches that are in the long-term benefit of consumers.
- Airports have, in general, high quality relationships with consumers of airport services. For example, airports and airlines are partners in the growth and success of the aviation industry and are substantially aligned in a number of key areas. It would be unnatural to expect perfect alignment between airports and airlines on pricing decisions, and areas of disagreement are not an indication that information disclosure is ineffective.
- Importantly, the quality of the current and future passenger experience (as the ultimate consumers of airport services) is central to airport performance and decision-making.

Moving forward under information disclosure

21. We acknowledge that the regime is not yet perfect. There are still some issues to work through and differences of opinion, and we support an approach of seeking ongoing improvement in the regime. In particular, although all parties agree that assessing airport profitability is important for effective information disclosure, legitimate differences remain between the Commission, airports and airlines about what an appropriate level of return is for an airport business, and how to calculate the level of expected returns for a particular airport under the information disclosure framework.
22. These differences are predominantly on points of detail that have been robustly debated by economic experts throughout the development of the information disclosure regime.¹ They represent complicated and technical areas that involve inherent judgment and imprecision, and areas on which experts can genuinely disagree as to the best approach. It would be unnatural to expect alignment on these technical aspects in advance of the merits review proceedings being resolved.
23. In any event, however these points of detail are resolved, this does not change the evidence that exists currently. In our view, this evidence demonstrates that airports are responding appropriately to the guidance that is available to them at the time decisions are made.
24. It is also important to acknowledge that the regime is not yet fully in place. The Commerce Act provides for information disclosure to be a feedback system, and the signals that have been coming back to airports at the early stage of the regime have been limited. The completion of the section 56G reviews marks an important step towards the full implementation of the regime and the establishment of clear guidance to the regulated airports. As a result of this process, NZ Airports understands that the airports now have a much clearer idea (but not complete picture) of what the Commission considers to be acceptable behaviour and performance under an effective information disclosure regime.
25. The next key milestone will be the establishment of the Commission's summary and analysis of annual information disclosures. Once this occurs, a robust feedback process will be established as the Commission reports on annual disclosures, and as performance and behavioural trends (as well as areas for potential improvement) are identified. As such, information disclosure will continue to inform interested parties and positively influence airport behaviour going forward.
26. The threat of further regulation will also be ever-present. It is wrong to think that the section 56G review was this "regulatory threat". It was a mandated transitional process. Airports are fully aware that if they fail to respond to the guidance and incentives under information disclosure regulation, the Commission and Government have the necessary powers to consider whether further intervention may be warranted.

RESPONSE TO THE BARNZ SUBMISSION ON THE DRAFT REPORT

27. From NZ Airports' perspective, the BARNZ submission demonstrates that the remaining matters to work through are points of detail. In our view, the BARNZ submission places too much emphasis on getting the "right number" now in relation to airport profitability and expected returns. This task is fraught with error, because:
 - (a) the benchmarks the Commission is using to calculate the "right number" are subject to merits review; and

¹ Broader questions will continue to be discussed over time, such as when and how contextual factors are relevant to the question of whether an airport is limited in its ability to earn excessive profits, how multiple combinations of approaches can produce outcomes consistent with purpose of Part 4, and what is superior performance (including how it may impact the assessment of airport profitability). These differences can be expected to narrow going forward, but assessing profitability is not a precise science and there will likely always be some scope for debate about the best approach in any particular situation.

- (b) as discussed above, regardless of the outcome of the merits review proceedings and how these points of detail are resolved, this does not change the fact that airports were responding appropriately to the signals available to them at the time of pricing (with these signals necessarily including the fact that the information disclosure regime could impact differently following the merits review process).

28. The majority of the BARNZ submission relates to matters of technical detail that we anticipate will be responded to by Christchurch Airport in its cross-submission. We make the following comments from NZ Airports' perspective:

- (a) Overall, the technical nature of the submission demonstrates the dangers that have been created by the Commission's approach to assessing airport performance. As we have submitted before, after-the-fact adjustments to the Commission's modelling approach do not provide any information about the incentives provided by information disclosure regulation at the time prices were set and therefore do not reflect on the effectiveness of the regime. BARNZ' submission that the Commission is required to make adjustments to its model to increase the returns estimate by 0.1% or 0.3% are simply another example of seeking to bring a false level of precision to assessing returns.
- (b) The fact that the Commission, BARNZ and Christchurch Airport disagree on the level of returns being targeted further demonstrates that measuring the level of returns is not a precise science. In NZ Airports' view, the Commission would be better to focus on its own findings and the compelling evidence presented by Christchurch Airport in its submission that Christchurch Airport believed it was not targeting excessive returns, and that this belief was shaped by its understanding at the time of setting prices how returns would be assessed under the information disclosure regime. This is the best evidence of the incentive effects of information disclosure.
- (c) BARNZ makes a number of comments about the treatment of revaluation gains in the Commission's analysis, and suggests that the Commission's approach will be problematic and inconsistent going forward. Although it is not clear, BARNZ' key concerns appear to be that unforecast revaluations will not be taken into account in assessing airport profitability, and that airports will be incentivised to under-forecast expected revaluations.

In response, we note that:

- (i) Airports have previously provided extensive evidence to the Commission (as part of the development of the IMs) about the careful and thorough process that is undertaken to establish forecast asset values. We do not repeat that evidence here, but we are disappointed that BARNZ has revived its unfounded allegation that airports deliberately under-forecast elements of their pricing decisions.
- (ii) Further, the information disclosure requirements and the Commission's approach throughout the section 56G review make it clear that all revaluation gains will be treated as income for the purpose of assessing profitability. This knowledge will carefully guide airport behaviour in pricing.
- (iii) In relation to Christchurch Airport, the key point is that information disclosure regulation is promoting the right incentives for Christchurch Airport to act appropriately in the decisions it has made. We note that:
 - (aa) Airports have always considered that it is appropriate for forecast revaluation gains to be treated as income and that, where there

has been an unbiased ex ante forecast, it is appropriate for airports to accept the risk and reward of any differences to forecast.

- (bb) A situation where no forecasts have been made is different, and Christchurch Airport has acted appropriately by treating the revaluation impact of lifting its moratorium as an offset to its revenue requirement in pricing. Similarly, Auckland Airport has given commitments as to how any revaluation impact will be treated in the event that its moratorium is lifted in the future.
 - (iv) The Commission has suggested it may require airports to disclose an indicator of expected returns in line with the Commission's IRR model in the future (to allow clearer disclosure of forecast returns). NZ Airports considers that doing so is likely to create complications and challenges that would outweigh any potential benefit an IRR indicator may deliver.² This is because the Commission's modelling has generated considerable debate and confusion during the section 56G process about how to properly assess expected returns on an IRR basis. In our view, the BARNZ submission highlights that it is the Commission's IRR model that is a source of confusion, rather than the current information disclosure requirements or what Christchurch Airport has actually done in pricing. In light of this, NZ Airports would see limited utility in amending the information disclosure requirements in the way suggested by the Commission.
29. Where airports continue to make positive efforts to engage with the regime and seek to improve both the effectiveness of the regime and airport performance, it is frustrating that airlines continue to concentrate solely on arguments about the level of expected returns. In our view this ignores the very positive progress made in the early days of the information disclosure regime, and the ways in which information disclosure will increase in effectiveness over time.
30. On the other hand, the airline approach is predictable and natural, and therefore cannot be taken as evidence of ineffectiveness in the regime. It is unrealistic to expect complete alignment between airlines and airports on pricing decisions. Information disclosure is the right form of regulation in these circumstances — allowing airports to continue to make decisions informed and influenced by airline feedback but, ultimately, focused on the long-term interests of all consumers of airport services (with those decisions transparently disclosed and scrutinised by interested parties).

CONCLUSION

31. The section 56G review has been a helpful progress report on the early days of the regime. It has provided valuable feedback to airports and interested parties that will continue to shape the information disclosure framework and airport performance going forward.
32. The end of the section 56G review process represents the end of an intense period of regulatory development for the airport sector. NZ Airports looks forward to the completion of the remaining pieces of the regulatory framework (the merits review judgment and the Commission's summary and analysis reports), and the ongoing operation of the regime.
33. As intended, this regime will build up a full and comprehensive picture of airport performance over a number of years, which will allow interested parties to assess the ways in which airports continue to promote the long-term benefit of consumers over time.

² NZ Airports has also previously expressed concern that this approach would require continuing assumptions about future pricing, and is therefore inappropriate on that basis: see *NZ Airports Submission on Auckland Airport Draft Report*, 31 May 2013 at paragraph 26(a).