

The Commerce Commission's
Draft 56G Report on WIAL:
Response to criticisms of closing values

Report to BARNZ

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Futures Consultants Limited

Contents

1. Introduction	1
2. Assessment of NERA's submission.....	1
2.1 NERA's claims about the Commission's purpose	1
2.2 Appropriateness of Commission's approach	1
2.3 NERA's straw person.....	2
2.4 NERA's example misleading	2
3. Assessment of other submissions on issue	3
3.1 NZAA	3
3.2 CIAL.....	3

Authorship

This report has been prepared by Brent Layton.

Futures Consultants Ltd
183 South Karori Road
Karori
P O Box 17-359
Wellington 6147
Tel: +64 4 476 9041
Fax: +64 4 476 9042
Mobile: +64 21 384 147
e-mail: brent.layton@xtra.co.nz

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1. Introduction

On 2 November 2012 the Commerce Commission (the Commission) released its 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 (the Act) for Wellington International Airport Ltd (WIAL).¹ The Commission is required to prepare this report under s 56G of the Act.

Auckland International Airport Limited (AIAL) included with its submission on the *Draft Report* a memorandum from NERA entitled *Asset values in the Commission's IRR analysis of Wellington Airport*. In this, NERA argues that it is inappropriate for the Commission to adopt, as it has in its Draft Report, "market value existing use" (MVEU) closing values for assets in its internal rate of return analysis to assess WIAL's profitability. NERA claims that the Commission's approach biases upwards its assessment of returns in 2012-17 (PSE2). Other allegations about the Commission's approach in this regard have been made in the submissions of the New Zealand Airports' Association (NZAA)² and Christchurch International Airport Limited (CIAL).³

The Board of Airline Representatives in New Zealand (BARNZ) has asked me to comment on these claims. I have done so in accordance with the High Court Rules for expert witnesses

2. Assessment of NERA's submission

2.1 NERA's claims about the Commission's purpose

NERA is very cautious in what it writes. It prefaces its criticism of the Commission using MVEU closing asset values by stating "***If the Commission's objective is*** to assess whether PSE2 returns are in excess of what would be observed in a workably competitive market, ..." [Emphasis added].

It is very clear from the *Draft Report*, however, that the Commission's objective is not accurately described as assessing WIAL's prices in PSE2. The Commission's objective is to produce a report that fully meets the statutory requirements set out in s 56G of the Commerce Act 1986. This requires the Commission to report on how effectively information disclosure regulation under Part 4 of the Act is promoting the purpose of Part 4 as set out in s 52A in respect of specified airport services.

2.2 Appropriateness of Commission's approach

Despite the information disclosure regime being in operation and requiring assets to be valued on an MVAU basis for information disclosure purposes, WIAL has chosen to continue in PSE2 its long standing preference to use MVEU values for price

¹ 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: Section 56G of the Commerce Act 1986*, 2 November 2012. (Hereinafter referred to as the "Draft Report").

² New Zealand Airports' Association submission p.15.

³ Christchurch International Airport Limited's submission, pp.10-11.

setting. In these circumstances, it is entirely reasonable and appropriate that the Commission uses WIAL's MVEU closing values for assets in its internal rate of return analysis to assess how effectively information disclosure regulation is promoting, for example, limitations on the ability of airports to extract excessive profits. There is no bias upwards in returns from the Commission's approach as the realistic assumption to make for the purpose of assessing the effectiveness of information disclosure is that WIAL will continue to pursue what it claims to be the right approach to setting charges for it. This is what the Commission assumes.

For the Commission to adopt MVAU closing values, which is what NERA is urging, would amount to it assuming that WIAL is going to conform with the Commission's view as to the appropriate asset valuation input methodology when price setting in PSE3 and abandon its long held and recently repeated views. There is no evidence WIAL will do this, and considerable evidence it will not. This evidence includes the arguments WIAL pursued in the lead up to PSE2, the prices it adopted in PSE2 and the closing asset values in 2017 it used in its PSE2 pricing models.

2.3 NERA's straw person

In short, NERA has inaccurately defined the objective of the Commission and then criticised what it has done relative to this misstated objective. The Commission is not trying to measure the profitability of WIAL during PSE2 *per se*; it is trying to identify how effective information disclosure regulation has been in promoting the purpose of Part 4 of the Act.

The Commission has rightly used WIAL's actual observed behaviour in disregarding input methodologies relating to asset values as the basis of its analysis. It would be inappropriate of the Commission to accept NERA's invitation that it assume without any evidence that WIAL will in 2017 change its behaviour and conform to the Commission's asset value input methodology. This would bias downwards to a considerable extent the assessment of WIAL's excessive profits from what its information disclosures and observed practices indicate it will be.

2.4 NERA's example misleading

Furthermore, the hypothetical example provided by NERA is misleading. It assumes that the value of the opening regulatory asset base (RAB) is correctly stated and that it is only the closing RAB that is misstated. However, relative to the Commission's input methodology for asset values, WIAL's actual opening asset value is inflated by using MVEU instead of MVAU values. The consequence is that, even if it were accepted that the closing value should be on an MVAU basis, the hypothetical example does not properly reflect the impact or effect. In short, the hypothetical example is misleading.

3. Assessment of other submissions on issue

3.1 NZAA

The submission of the New Zealand Airports' Association (NZAA) in relation the Commission using the MVEU closing values goes much further than NERA's. Instead of suggesting an alternative valuation assumption, as NERA does, NZAA submits the Commission cannot draw "a firm conclusion that WIAL is earning excessive returns over time"⁴ if it bases its analysis on assumptions regarding WIAL's pricing decisions in 2017, at the start of PSE3.

Since some assumption about closing asset values has to be made to undertake the internal rate of return calculations for a sub-period of the life of the assets, NZAA's submission is tantamount to claiming the Commission cannot undertake the s 56G report at this time. Such a submission is clearly contrary to Parliament's intention as it set the timing of the preparation of the report. The Commission should reject NZAA's submission on this matter and is clearly on very safe grounds to do so, and would be on weak grounds if it accepted it.

3.2 CIAL

According to CIAL:

*There is a logical circularity in this approach [to closing asset values]: the Commission is seeking to make an assessment of whether WIAL is using its market position to earn an "extraordinary return" by assuming that it will seek to make "extraordinary returns" in the future.*⁵

This allegation of logical circularity is, however, based on a misrepresentation by CIAL of what the Commission has done. The Commission is not assuming "extraordinary returns" in the future. As it explains in the *Draft Report* it is merely making what it considers to be the "reasonable" assumption that, when setting prices in PSE3 ..." at the very least, Wellington Airport expects to price off its current forecast of the closing asset value for PSE2."⁶ As I have already noted, there is plenty of evidence to support the reasonableness of the assumption that WIAL intends to use MVEU values despite the information disclosure regime. Any assessment of the effectiveness of the information disclosure regime has to reflect this.

⁴ New Zealand Airports' Association submission p.15.

⁵ CIAL submission p.10.

⁶ *Draft Report*, p.103.