

NZ AIRPORTS ASSOCIATION - CROSS-SUBMISSION ON WELLINGTON AIRPORT DRAFT REPORT

12 DECEMBER 2012

1. The New Zealand Airports Association ("**NZ Airports**") makes this cross-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 ("**WIAL Draft Report**"). This submission is made on behalf of Auckland International Airport Limited, Wellington International Airport Limited and Christchurch International Airport Limited (together, "**Airports**"), and responds to submissions made to the Commission by BARNZ, Air New Zealand, and Qantas (together, "**airlines**").
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1. EXECUTIVE SUMMARY

3. The submissions on the WIAL Draft Report have reinforced NZ Airports' concern that the airlines are approaching the section 56G review process from the wrong perspective, advocating incorrect tests and pressing the Commission to draw hasty conclusions in an effort to undermine the regulatory framework for airports and push for heavier and more restrictive regulation.
4. Rather than focussing on whether information disclosure ("**ID**") is effectively promoting the Part 4 purpose statement (as the Commission has), the airlines are simply encouraging the Commission to find adverse performance outcomes wherever possible, and/or increase the magnitude of the draft negative findings regarding profits. Airline submissions demonstrate a pattern of urging the Commission to make negative findings about airport performance in its analysis and conclusions, even where those findings are:
 - (a) Not justified by the evidence available at this time; and/or
 - (b) Outside the scope of the section 56G review process.
5. In effect, the airlines are seeking to enlist the Commission in their campaign to overturn the current regulatory regime, and this has inappropriately coloured their submissions.
6. We expand on these key concerns below.

2. THE REGULATORY FRAMEWORK FOR AIRPORTS IS EFFECTIVE

7. The airlines argue that the ID regime has already failed. Their submissions contend that:
- (a) The ID regime lacks a credible threat to incentivise behaviour, and WIAL's failure to acknowledge the relevance of the Part 4 regime or the Commission's input methodologies ("IMs") to pricing demonstrates the failure of the regime.
 - (b) Information disclosure has failed to achieve the purpose of Part 4.
 - (c) The Airport Authorities Act 1966 ("AAA") is flawed and ineffective because its consultation requirements do not:
 - (i) Have a constraining influence in the price setting process; or
 - (ii) Provide an effective constraint on capital expenditure (and therefore on effective innovation and investment), because the 20% threshold has been rendered redundant through increasing asset values.
8. NZ Airports is disappointed that the airlines continue to take a negative approach to the ID regime. Airlines are, of course, entitled to strongly advocate their views on airport performance, and NZ Airports appreciates that the section 56G review may identify areas of performance that require improvement.
9. However it is important that the debate occurs within the proper bounds of the ID regime and the section 56G review, which means recognising that section 56G does not call for a definitive conclusion on whether ID has succeeded or failed, as that would be unrealistic at this early stage of the regime.
10. In response to the airlines' arguments, NZ Airports notes that:
- (a) The airports have continued to demonstrate that ID has impacted on their pricing decisions. In contrast, the airlines appear to consider that "acknowledging the relevance of the Part 4 regime to pricing" requires a strict application of the Commission's IMs, and that departures from the Commission's ID framework in pricing demonstrate the failure of the regime.

NZ Airports encourages the Commission to maintain an approach (as evidenced in the WIAL Draft Report) that draws no negative inferences regarding the effectiveness of ID merely on the basis that IMs have not been applied in pricing. However, the next step, as explained in our previous submission, is to also recognise that the WACC IM does not and cannot provide an accurate measure of reasonable returns, and should not be applied in a rigid way.
 - (b) Similarly, it is opportunistic for airlines to now assert that ID provides no credible threat to incentivise airport behaviour, when:
 - (i) Due to the infancy of the regime, aeronautical charges for PSE1 and PSE2 were set before the release of:
 - (aa) Any guidance on how the Commission would conduct assessments of disclosed information; and

- (bb) Any feedback on the airports' performance as contemplated by the Commission's ongoing monitoring and analysis requirements under the Act.
- (ii) During consultation on IMs, airlines were clear that:¹
 - The prospect of further regulatory intervention if information disclosure fails to promote the Part 4 purpose statement is well-known, well-signalled, and a requirement for information disclosure to succeed.
- (c) The correct test to measure the effectiveness of the ID regime is whether it is providing the appropriate incentives and encouraging behaviour that is consistent with workably competitive market outcomes (including allowing previous positive behaviour to continue). Asking whether ID has achieved the outcomes in the purpose statement, and whether it has done so immediately, is misconceived.
- (d) Parliament chose to retain the AAA regime for airports, and deliberately intended ID and the AAA to co-exist, with ID complementing and improving the quality of the AAA consultation process. The airlines' continued assertions that the AAA is inherently flawed ignore Parliament's clear decision that the two regimes should operate side-by-side to form the regulatory framework for airports.
- (e) The market evidence demonstrates that the AAA does in fact have a constraining influence in the price setting process. In addition, the airports have previously provided extensive evidence that:
 - (i) Price setting consultations are extensive processes where airports seek, value and respond to feedback from substantial customers.
 - (ii) The enduring consultation requirement in the AAA ensures that information on airports' aeronautical businesses is subject to considerable customer scrutiny when prices are reviewed.
 - (iii) The airlines are very large international businesses which are well able to fund and conduct vigorous negotiations through the consultation process (particularly because of their experiences at other airports around the world). This significant countervailing power is magnified when they act through BARNZ - centralising the shared experience and reducing the cost incurred by any particular airline.
 - (iv) The airports have, in the past, made considerable commercial compromises to the airlines as part of the consultation processes. Although each airport tailors these commercial decisions to the circumstances at the time of pricing and to the feedback from its existing customers at that time, past examples of commercial decisions have included:
 - (aa) Growth agreements providing rebates of landing charges;
 - (bb) Inclusion of cost efficiency targets in advance of determining how such outcomes will be achieved;

¹ See, for example: Air New Zealand Cross Submission on the Draft Input Methodologies (Airport Services) Determination, 3 August 2010, paragraph 158.

- (cc) Exclusion of assets from the pricing asset base that could quite properly be included in setting charges;
- (dd) Sharing expected revaluation gains with airlines; and
- (ee) Sharing unexpected revaluation gains with airlines.

NZ Airports strongly believes that the flexibility provided by the AAA regime, balanced against the discipline provided by ID and the countervailing power of well-resourced customers, allows much greater scope for innovative and tailored approaches to meet the interests of consumers in a complex and difficult operating environment. Although we understand the airlines' fixation on reducing aeronautical charges, it would be contrary to the intent of Part 4 (and to the detriment of consumers) if successful airline advocacy acted as an inappropriate barrier to future investment and/or resulted in heavier-handed regulation that restricted the ability of airports to adopt approaches that allow them to provide quality services and infrastructure that benefit passengers now and for the long term.

- (v) For major investment decisions, the existing consultation process under the AAA is generally productive and effective. The airports and their airline customers need to (and do) work closely together for major investment in aeronautical infrastructure. As recognised by BARNZ, common ground on investment and expansion is often reached between airports and airlines, due to the high level of mutual interest in ensuring that there are sufficient facilities to accommodate reasonably expected passenger volumes and aircraft movements.²
- (vi) In practice, consultation occurs on capital expenditure projects at a much lower threshold than 20%. Airlines currently receive the appropriate information and opportunity to comment on the proposed timing, scope and design of aeronautical investments.
- (vii) Consistent with this practice, NZ Airports and BARNZ made a joint proposal to the Ministry of Transport in 2010, which proposed that the trigger for the capex consultation requirement be lowered.³ The proposal did not gain sufficient priority within the Ministry of Transport to be implemented. However, there has been little impetus to formalise the arrangement between airports and airlines, or take the matter further, as the suggested lower threshold is materially consistent with the current practice of the airports in any event.

3. AIRLINE CRITICISM OF COMMISSION'S ANALYSIS AND DRAFT CONCLUSIONS ARE UNJUSTIFIED

11. The airlines have advanced a number of criticisms of the Commission's analysis and draft conclusions. We comment on these below.

² BARNZ *Submission on Commerce Commission Input Methodologies Discussion Paper*, 31 July 2009, page 49.

³ The proposal suggested that the consultation requirement be triggered for projects that exceed the lower of a fixed threshold of \$30 million, or 20% of the value of the airport's identified assets: BARNZ and NZ Airports Association *Capital Expenditure Consultation Thresholds Under the Airport Authorities Act*, Letter fo Ministry of Transport, 25 November 2010.

Innovation

12. BARNZ considers that the Commission should find that "information disclosure has had neither a positive nor negative impact in relation to the promotion of innovation by airports".⁴ In BARNZ's view, the fact that ID does not provide negative incentives does not support a finding that ID is promoting a certain aspect of the purpose statement. In response, NZ Airports notes that:
- (a) Behaviour prior to the introduction of Part 4, and incentives outside the ID regime, can be positive and consistent with the purpose statement.
 - (b) A regulatory regime that allows positive behaviour to continue is an effective regime. In this regard, the Commission is properly justified in concluding that, by not providing negative incentives, ID is actively promoting the purpose statement.
 - (c) By considering all limbs of the purpose statement, the Commission is justified in concluding that, although ID is neither creating nor removing incentives in one limb, it is effectively promoting the purpose statement overall.

Efficiency and efficiency gains

13. BARNZ argues that:
- (a) The Commission should find that ID is failing to promote opex efficiency on the basis of the two years of actual data from PSE1; and
 - (b) WIAL should have achieved efficiency gains in PSE1 which should have been shared in PSE2.
14. NZ Airports has previously emphasised the danger in drawing adverse conclusions on airport performance based on data in PSE1, which was the product of pricing decisions made before the ID regime was introduced. We have also highlighted the risks associated with drawing conclusions about the long-term benefit of consumers from a short time series of data.
15. Accordingly, NZ Airports is pleased that the Commission has recognised that ID will be more effective in promoting the appropriate efficiency incentives once trends are known and comparisons can be made.⁵ BARNZ's comments contradict this sensible position, and are also in contrast to its own view in its submission on the WIAL Draft Report, where it notes that:⁶
- In BARNZ's opinion, it is the measurement of trends over time at each Airport which will provide the strongest evidence about whether efficient levels of operating expenses are being achieved.
16. BARNZ claims that the Commission is entitled to find that WIAL "should have achieved efficiency gains" in the period before ID was introduced, and that these gains should have been shared with consumers. In this context, BARNZ's claim is another example of the airlines focussing on areas outside the scope of the review and attempting to "score points"

⁴ BARNZ Submission on Wellington Airport Draft s56G Report, 30 November 2012, page 5.

⁵ 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, at paragraph B9.

⁶ BARNZ Submission on Wellington Airport Draft s56G Report, 30 November 2012, page 3.

through encouraging adverse findings about airport performance that do not relate to the effectiveness of the ID regime.

Profitability

17. In this section, we respond to the airlines' suggestions that:

- (a) The Commission should use the 50th percentile estimate of WACC in its profitability assessment;
- (b) The non-parametric uncertainty in the Commission's WACC IM will lead to overstating the cost of capital;
- (c) The Commission should calculate and emphasise expected profits on the basis of the revenues paid by consumers;
- (d) The inclusion of leased regulatory assets in the Commission's profitability analysis understates the returns earned by Wellington Airport on its target asset base; and
- (e) The Commission has made an array of assumptions which favour WIAL in its analysis.

Use of the 75th percentile to assess profitability

18. BARNZ and Air New Zealand consider, in reliance on Futures Consultants Limited ("FCL"), that the Commission should use the 50th percentile estimate of WACC in its assessment of target returns, as:

- (a) The use of the 75th percentile is a tool that was used to recognise asymmetric risks in the context of the control of gas distribution businesses, and these concerns do not apply to airports because of the dual till nature of airport businesses; and
- (b) This ignores the social costs of setting airline fees too high (particularly given the proportion of marginal and low cost airline fees that is due to landing charges).

19. In response, NZ Airports notes that:

- (a) The use of the 75th percentile is a recognised regulatory approach that is not specific to the Commission's gas inquiry. For example, the Commission and its experts used the 75th percentile in its 2004 gas inquiry,⁷ and in choosing a WACC for electricity distribution businesses in 2005.⁸ Further, the principle behind the use of the 75th percentile (the preference for dynamic over allocative efficiency in order to promote the long-term benefit of consumers) has been recognised by the Commerce Commission in other regulatory contexts.⁹ It has been recognised that the use of the 75th percentile estimate of WACC in price-setting is a rational

⁷ Commerce Commission *Gas Control Inquiry Final Report*, 29 November 2004, paragraph 9.92.

⁸ Lally *The Weighted Average Cost of Capital for Electricity Lines Businesses*, 8 September 2005, page 62 - 63.

⁹ See, for example: Commerce Commission *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector: Discussion Paper*, 31 July 2009 at paragraph 135, where the Commission states that: "The Commission has previously indicated that where a tension exists between short-term allocative efficiency and long-term dynamic efficiency, the Commission will give greater weight to the promotion of the latter. The Commission considers that this approach remains appropriate. Ongoing innovation and efficient investment over time can deliver significant long-term benefits to end-users, and the adverse consequences of deterring or delaying such investment may be substantial."

economic approach to ensure that the appropriate incentives are provided to regulated suppliers.

- (b) The assertion that the 75th percentile is not necessary due to the multi-faceted nature of airport businesses is misguided and without evidential foundation. If correct, this argument would appear to be advocating for airports to treat aeronautical investment as a means to an end (ie obtaining revenue from non-aeronautical services), rather than promoting genuine investment in aeronautical infrastructure as required under Part 4. Airports would be incentivised to undertake aeronautical investment to the minimum extent necessary to increase passenger numbers, with efficiency and quality considerations, as well as airline needs, taking a back seat for the regulated services. This cannot be the purpose of Part 4 regulation.
- (c) Parliament made the decision to retain a dual till system for airport regulation. Part 4, including the incentives that it creates and the outcomes that must be promoted, applies to regulated services only. The Commission has appropriately limited its focus to these services. The airlines' assertion that the dual till regime provides sufficient motivation for aeronautical investment to compensate for any social risks of understating WACC ignores the fact that aeronautical services are regulated because, among other things, airports need to have independent incentives to invest in those services (including efficiently and to the appropriate quality) for the long-term benefit of consumers.
- (d) The airlines are taking an opportunistic and short-term view, without proper regard to the practical consequences of getting it wrong. As recognised by the Australian Productivity Commission, decisions made by a regulator on WACC can have significant impacts for investment at airports:¹⁰
 - ... setting parameters that result in a lower-than-required WACC (and thus lower prices as the cost of capital feeds into the building blocks model) can result in inadequate or delayed investment, as investors seek higher returns elsewhere...
 - For airports, many of their lumpy investments will be an 'all or nothing' venture. If a regulator only allows the airport operator to earn 80 per cent of the return it needs to attract investment funds, it is generally not possible to build only 80 per cent of the runway those funds were intended for.
- (e) The use of the 75th percentile estimate of WACC is an appropriate way of recognising these undesirable practical consequences. Accordingly, it is inconsistent to use a different (and lower) percentile estimate when assessing profitability.
- (f) Discussing the social consequences of setting airline fees too high in this context is misguided, as:
 - (i) The concept of accounting for asymmetric social consequences is tied to regulatory risk and the consequences that getting regulation wrong may have for infrastructure investment.

¹⁰ Australian Productivity Commission "Economic Regulation of Airport Services" (Inquiry Report no. 57, Canberra), 14 December 2011, page 126-127.

- (ii) Giving effect to asymmetric social consequences in this way has already taken into account the risk that consumers may pay too much (including through higher airfares, if that is the case), and decided that this risk is less severe than the risks and consequences of underinvestment in aeronautical services.

Non-parametric uncertainty

20. Futures Consultants Limited ("FCL") considers that three of the four non-parametric uncertainty factors work in the direction to overstate WACC, and that the true mid-point would be centred on a point materially below the Commission's midpoint estimate.¹¹ NZ Airports **attaches** a report from UniServices which comments on this claim, and FCL's conclusion, in more detail. In UniServices' view:

- (a) It is not clear what FCL means when it refers to three of the four non-parametric uncertainty factors, as it appears to mention five uncertainty factors in its discussion.
- (b) In respect of the factors discussed by FCL:
 - (i) FCL provides no empirical evidence to support the view that a measurement period greater than one month would decrease betas for the comparative sample airport companies used by the Commission in its IM Reasons Paper to produce its WACC IM. Accordingly, there is no evidence that the method used by the Commission to estimate the asset beta for airport services will lead to an overstatement of WACC in the way claimed by FCL.
 - (ii) UniServices notes that there is no evidence either way that the Brennan-Lally model is biased either in favour of airports or in favour of the users of airport services, such as airlines.
 - (iii) FCL fails to recognise that the Commission has addressed the uncertainty that may result from the potential leverage anomaly in the Brennan-Lally Model by using a notional leverage drawn from its sample of comparative firms that are used to estimate asset beta.
- (c) It is difficult to compare models and / or quantify differences. Accordingly, FCL has provided no strong evidence that the use of the Brennan-Lally CAPM, and any other non-parametric uncertainty in that model, will result in an upward or downward-biased estimate of the cost of capital.
- (d) Even if the uncertainty factors discussed by FCL did lead to an overstatement of the WACC estimate, the Commission has made a number of judgments in respect of the parameter inputs into its WACC IM that are in favour of the users of the airport services. In particular, the Commission's WACC:
 - (i) Adopts inputs that are generally favourable to users of airport services; and
 - (ii) Fails to account for costs and risks that are borne by regulated airports.

¹¹ Futures Consultants Limited *The Commerce Commission's Draft 56G Report on WIAL: Comments on Selected Aspects*, 27 November 2012, page 3.

21. NZ Airports also notes that:
- (a) FCL notes that "illustrative calculations suggest the bias towards overstatement could be material".¹² However, FCL provides no evidence of these illustrative calculations, and no quantification of the potential bias that it suggests results in the WACC estimate. The only numbers presented by FCL are those discussed by the Commission in its 2008 Gas Control Decision Paper, where the Commission noted that the use of the domestic rather than the international CAPM and use of monthly data of estimating betas may inflate the estimates of WACC by up to 1.4%.¹³ FCL fails to note that, while the Commission considered that this may be the case, it remained satisfied that the use of the 75th percentile estimate was appropriate (in part because the other unquantifiable factors could go the other way).¹⁴
 - (b) A conclusion that WACC is systematically overstated in the way claimed by FCL would require assessing the magnitude of each uncertainty factor. It is entirely possible that the fourth factor (which, although it is not clear, NZ Airports assumes to be that the CAPM does not fully describe investors' expected returns) outweighs the other three factors mentioned by FCL. This would clearly be an important consideration to take into account when assessing whether the true range for WACC would be centred on a point "materially below the midpoint estimate", as claimed by FCL.
22. In light of these factors, it is not possible for FCL to conclude that the Commission's WACC estimate is inherently biased towards airports and will likely overstate the true mid-point estimate of WACC. The use of the 75th percentile estimate when monitoring profitability (on both a forward-looking and backward-looking basis) remains appropriate in these circumstances.
23. NZ Airports also notes that the appropriateness of the Brennan-Lally CAPM, the issue of upwards bias in the CAPM model, and any non-parametric uncertainty factors were not raised or discussed by the airlines in IM consultations (other than for the airlines to simply state that the 50th percentile estimate was appropriate). It is disappointing that further uncertainty regarding the proper application of the WACC IM to airport businesses is being created at this stage, contrary to the statutory purpose of IMs to provide certainty regarding the regulatory rules and processes. It also demonstrates that the WACC IM remains subject to debate and contention, meaning it simply could not provide a clear benchmark for reasonable returns at the time prices were set.

Profitability analysis based on consumer revenue

24. NZ Airports agrees that it is sensible to include, as part of the Commission's analysis, the profitability impacts on consumers. However, we emphasise that any analysis of the revenues paid by consumers must be considered in terms of the impact on the ultimate consumers of airport services, and should also be considered on a per passenger basis. This would enable the Commission to evaluate the prospective impact on the propensity of

¹² Futures Consultants Limited *The Commerce Commission's Draft 56G Report on WIAL: Comments on Selected Aspects*, 27 November 2012, page 3.

¹³ Commerce Commission *Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd: Decision Paper*, 30 October 2008, paragraph 758.

¹⁴ Commerce Commission *Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd: Decision Paper*, 30 October 2008, paragraph 758 - 763.

consumers to travel, and the contribution of the per passenger airport cost to the total costs of travel (including airline fares).

Inclusion of leased regulatory assets

25. BARNZ argues that the inclusion of leased regulatory assets in the Commission's profitability analysis understates the returns earned by Wellington Airport on its target asset base. Accordingly, BARNZ considers the returns from leased assets should be excluded from the Commission's analysis of airport profitability.
26. NZ Airports disagrees that these assets should be excluded from the Commission's analysis. The leased assets in question are all **regulated assets**. The Commission's role is to monitor returns on **all** aeronautical assets. The leased assets form a proper part of that monitoring and analysis.
27. BARNZ and FCL also argue that the leased assets are more analogous to assets in a workably competitive market. FCL considers that because WIAL has historically earned lower returns on its leased assets than its targeted WACC, this suggests that the WACC (and therefore the targeted return) on the overall aeronautical asset base is excessive. This argument is misconceived. As regulated assets, the leased assets are by definition not subject to workable competition. It does not make sense to attempt to separate out the regulated asset base and attempt to categorise different assets by degrees of competition in the way that FCL suggests.
28. Given the complexities of airport operating environments, there are likely to be practical and commercial reasons why returns on leased assets vary from returns on other aeronautical assets, which each airport will be able to respond to if necessary. Theoretical (and flawed) high level assumptions such as those made by FCL are unhelpful in that context.

An "array of favourable assumptions"

29. BARNZ argues that the Commission has made a number of assumptions which are in favour of WIAL, and fails to make adjustments for points raised by the airlines that the Commission considers to be immaterial to the outcome of its analysis. BARNZ argues that the cumulative effect of these decisions is highly significant, and results in an end point that "hides the level of excess returns being sanctioned by the Commission".¹⁵
30. NZ Airports notes that any specific comments on these matters will be provided by WIAL. However, it is clear that BARNZ appears to be cherry-picking isolated areas where it considers the Commission should make adjustments to information that has been disclosed in accordance with the ID regime, including making adjustments to:
 - (a) Costs that have been incurred;
 - (b) MVAU valuations undertaken in compliance with the IM and ID Determinations;
 - (c) Forecast operating costs;
 - (d) Assets that are part of the regulatory asset base;
 - (e) "Inefficient" capital investment decisions occurring prior to the ID regime; and

¹⁵ BARNZ Submission on Wellington Airport Draft s56G Report, 30 November 2012, page 11.

(f) Cost allocation decisions.

31. It is clear that these proposed adjustments are outside the proper operation of the ID regime, which involves the Commission monitoring and analysing information that has been prepared and disclosed in accordance with the ID requirements. In particular, NZ Airports is pleased that the Commission has:

- (a) Properly refrained from making an ad hoc adjustment to an MVAU valuation that has been prepared by qualified valuers in accordance with the Commission's guidelines for land valuation;
- (b) Conducted its analysis across the scope of regulated activities, and included all regulated assets (including leased regulatory assets) in that analysis, as it is required to do; and
- (c) Recognised that investment decisions taken by a regulated supplier prior to the implementation of the ID regime do not have a bearing on the effectiveness of the ID regime, and should not be factored into assessing that effectiveness.