

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

12 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 report was published as part of the Commission's review of the information disclosure regime under section 56G of the Commerce Act 1986 ("**Act**"). This 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**").
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### OVERVIEW

3. Christchurch Airport has put considerable effort into developing an alternative pricing model that is aimed at delivering a positive outcome for passengers and airlines over the current pricing period ("**PSE2**"), taking into account the impact of the Christchurch earthquakes on its costs and demand expectations, and the construction of its new terminal. Christchurch Airport's price-setting disclosure indicates it endeavoured to carefully balance the needs of the airlines, the travelling public, and its intention to recover no more than the efficient costs of current service delivery and the new terminal.<sup>1</sup> It has noted that the input methodologies and the purpose of Part 4 of the Commerce Act have been an integral part of its deliberations for the pricing reset.<sup>2</sup>
4. We think that the evidence available in relation to Christchurch Airport supports our general position that information disclosure is effectively promoting Part 4 outcomes, and can be expected to grow in effectiveness over time.

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<sup>1</sup> See Christchurch International Airport Limited *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010*, 19 December 2012 at pages 6-7.

<sup>2</sup> Christchurch International Airport Limited *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010*, 19 December 2012 at page 8.

5. The section 56G review process has been a critical and important step in the development of the information disclosure regime, and has been a valuable learning experience for the regulated airports. We 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.
6. This understanding will inform and shape the ongoing role of the regime in effectively promoting positive airport behaviour and performance. Even where airports may disagree with the Commission's views about aspects of the regime such as input methodologies, they should be able to make informed choices about whether to adhere to those methodologies, or seek to justify departure from them, bearing in mind that future decisions will be subject to close scrutiny by the Commission and other interested parties.
7. Accordingly, NZ Airports has a number of key concerns with the Commission's approach to the Christchurch Draft Report:
  - (a) The Commission expects that airports should have already learnt all the lessons provided by information disclosure regulation by the time prices were set for PSE2 - prior to the section 56G review process. If the lessons were not properly learnt at that time, then the Commission finds that information disclosure is ineffective. This is an unfair characterisation of the information that was available to airports at the time pricing decisions were made. Further, this approach does not recognise the ongoing learning process that will influence future airport behaviour and performance.
  - (b) The ability for airports to seek to justify departures from the Commission's view of acceptable standards now carries increased uncertainty and regulatory risk, even where those departures result in lower prices for consumers. While the Commission has acknowledged that airports are entitled to depart from the information disclosure requirements and input methodologies when setting prices, airports risk that their genuine attempts to design pricing models that respond to the challenges of providing long-term infrastructure and introducing large lumpy investments will be criticised as lacking transparency, making it difficult for interested parties to assess airport performance, and as providing evidence that information disclosure regulation is not effective. The Commission's approach creates a real concern that airports will be criticised for not simply applying the input methodologies in their pricing decisions.
  - (c) The Commission's approach risks discouraging the commercial behaviour by airports that the regime was intended to promote. This risks affecting airports' incentives to make commercially-based decisions that are innovative, tailored to their specific circumstances, acknowledge the real world market factors (such as demand considerations) that influence pricing decisions, and best meet the needs of passengers, airlines and freight consumers. For example, wash-up arrangements that are in the interests of consumers could be disincentivised.
  - (d) The Commission continues to assess the effectiveness of the information disclosure regime now based on how it assumes airports will act in the future. Although such assumptions are made on the basis of current evidence, the limitations inherent in such an approach should be more explicitly recognised. By basing its assumptions on decisions made by Christchurch Airport prior to the section 56G review commencing, the Commission fails to give sufficient attention to the guidance now available and that will continue to develop over time as the information disclosure regime provides clearer information and feedback to airports, interested parties and the Commission. Accordingly, the Commission should be open to changing its assumptions about future conduct in response to any new information provided by Christchurch Airport regarding its future intentions.

8. Essentially, we think that the Commission has established an impossible standard of effectiveness, by requiring information disclosure regulation to immediately lock in, for the next 20 years, the Commission's current view of acceptable returns. The Commission's finding that information disclosure is not effectively limiting excessive profits is particularly concerning in light of the Commission's acknowledgement that Christchurch Airport's approach to pricing was understandable in the circumstances, and that its returns for the next five years are acceptable.
9. If the Commission considers that aspects of Christchurch Airport's performance need to be carefully monitored in the future, this is not a sign that information disclosure is currently ineffective. As with the Commission's findings for Auckland Airport, the correct approach is to draw the conclusions that can be made now, based on the evidence that is currently available, and monitor any areas of potential future concern once the relevant decisions have actually been made. Ongoing monitoring based on airport disclosures is a key part of the information disclosure system.
10. The consistent message from all three airports is clear: information disclosure is the right form of regulation, it is and will continue to be effective, and they are keen to learn from and adjust to the guidance given by the Commission. The Christchurch Draft Report has provided new guidance to Christchurch Airport, and we anticipate it will respond constructively to that guidance. For example, finding that disclosure could have been more transparent in some aspects is the exact type of useful feedback contemplated by information disclosure, and is a sign that the regime is working as intended. This feedback will continue to improve the effectiveness of the information disclosure regime and strengthen the incentives provided by the regulatory framework over time.
11. We therefore urge the Commission to adjust its view of what effective information disclosure regulation should look like at this point in time. We also invite it to explain why it believes its analytical approach of requiring acceptable returns to be locked in now for the next 20 years does not exceed the statutory purpose of information disclosure.
12. In that context, in this submission we discuss:
  - (a) the Commission's view that the regulatory framework indicates information disclosure regime is expected to have the most immediate and direct impact on profitability;
  - (b) the Commission's approach to assessing the effectiveness of the information disclosure regime over a 20-year period;
  - (c) the importance and role of transparency in the information disclosure framework;
  - (d) comments made by the Commission about the future impact of information disclosure regulation; and
  - (e) inconsistencies in the Commission's reasoning in relation to the current impact of information disclosure.

#### **REVISITING THE REGULATORY FRAMEWORK**

13. NZ Airports continues to be concerned that the Commission is using an incorrect analysis of the regulatory framework to justify its view that information disclosure is expected to have the most immediate impact on limiting airports' ability to earn excessive profits.
14. The Commission establishes a series of propositions to justify its view in this respect, as follows:

- (a) Airports have some incentives outside of information disclosure to promote the Part 4 purpose. However, the Commission considers that these incentives are primarily driven by airports' incentives to operate as a profit maximising entity.<sup>3</sup>
- (b) Without information disclosure, there are limited or no incentives in place to limit the ability of airports to make excessive profits. Incentives provided by information disclosure should therefore be strongest in this area.<sup>4</sup>
- (c) The effectiveness of information disclosure regulation at limiting excessive profits should be seen immediately because airports have set their revenue requirement, and therefore their expected profits, for the next pricing period, and the input methodologies provide the Commission with a benchmark of the profitability that would be expected in a workably competitive market.

15. The problem is that each of these propositions is incomplete, incorrect or inappropriately applied by the Commission. NZ Airports strongly encourages the Commission to acknowledge that:

- (a) **Airports have a greater variety of incentives to promote the Part 4 purpose than the Commission considers exist.** The Commission accepts that consultation under the Airport Authorities Act 1966 ("**AAA**") encourages airports to provide services at the quality consumers demand. It is unclear why the Commission cannot also accept that consultation under the AAA encourages airports to provide services at an appropriate price and provides incentives for airports to limit their returns expectations. Consultation in this respect is just as effective as consultation on service quality (and indeed the two are inherently linked).

In this way, paragraph 2.17 of the Christchurch Draft Report is incomplete. Airports' operating environments also include real world and market factors that promote behaviour consistent with the Part 4 purpose. For example, airports face incentives to take into account market factors (including demand) to maximise the efficiency of their pricing and to set charges at appropriate and reasonable levels. Airports also face external pressures to improve performance through regular pressure from strong and well-resourced airlines (including pressure applied through media attention). Indeed, the finding that Christchurch Airport adjusted its return expectations in response to demand considerations should be highlighted as key evidence of incentives to limit expected profits.

An effective information disclosure regime allows these positive incentives to continue, and makes their existence and effect transparent for interested parties. It should therefore not be a concern if such incentives, rather than information disclosure itself, are the more apparent driver of limited returns.

- (b) **Historical evidence establishes that incentives can and do exist that limit the ability of airports to make excessive profits.** It is not clear why the Commission considers that information disclosure regulation under Part 4 must provide new and additional incentives for airports to limit excessive profits that did not already exist under the previous regulatory framework. Indeed, this is inconsistent with the Commission's own historical analysis, which reveals consistently acceptable performance in this area for Christchurch Airport (establishing that appropriate incentives can and do exist outside the Part 4 information disclosure regime).

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<sup>3</sup> See eg Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.17.

<sup>4</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.21.

In its 2002 inquiry into airfield pricing, the Commission examined historical returns at Christchurch Airport between 1989 and 2001, and considered the expected returns under Christchurch Airport's then new pricing decision. The Commission found that Christchurch Airport had not earned excess returns between 1989 and 2001,<sup>5</sup> had not used its market power historically in airfield activities,<sup>6</sup> and that excess returns were not likely in the future for Christchurch Airport.<sup>7</sup>

For Christchurch Airport, there is no evidence of a historical problem in relation to charging that would require immediate attention. There is, accordingly, no reason to imply that information disclosure regulation should have an instant impact on Christchurch Airport's expected returns. Information disclosure regulation will obviously provide guidance to airports, and greater information to interested parties to allow them to assess performance, but it is entirely possible that a successful information disclosure regime could have no discernible impact on Christchurch Airport's pricing outcomes. Again, this should not cause any concern when assessing the effectiveness of information disclosure.

- (c) **Although airports have set revenue requirements and expected profits for the current pricing period, this does not mean that information disclosure must have created an immediate and direct change in behaviour to be effective.** Performance outcomes may be fulfilling the purpose of Part 4 without being directly driven by information disclosure (which, as the Commission has acknowledged for other limbs of the purpose statement, indicates the information disclosure regime is effective<sup>8</sup>). If outcomes are appropriate (such as Christchurch Airport's returns expectations for PSE2), information disclosure is effective. As we discuss further below, the Commission should not require proof that information disclosure regulation will be effective beyond the period of disclosed information in order to conclude that the regime is currently effective.

16. By failing to acknowledge these factors, the Commission's approach leads to a fundamentally flawed conclusion. On one hand, the clear evidence establishes that Christchurch Airport's performance and incentives before Part 4 were appropriate, current performance is acceptable, and future performance over the next five years will promote the purpose of Part 4. Despite these findings (which are very strong evidence that information disclosure regulation is currently effective), the Commission appears to consider that:

- (a) there is insufficient evidence this performance was directly caused by information disclosure regulation;
- (b) because airports allegedly have no or weak incentives to limit excessive profits without information disclosure regulation, it is not conceivable that positive behaviour was not directly driven by the information disclosure regime; and, therefore
- (c) even though expected performance is appropriate for 2012 - 2017, information disclosure is ineffective because it has not guaranteed expected returns will be "acceptable" for the next 15 years after that.

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<sup>5</sup> Commerce Commission *Final Report: Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports*, 1 August 2002 at paragraph 10.118.

<sup>6</sup> Commerce Commission *Final Report: Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports*, 1 August 2002 at paragraph 10.119.

<sup>7</sup> Commerce Commission *Final Report: Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports*, 1 August 2002 at paragraph 10.165.

<sup>8</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.23.

17. We do not consider these conclusions to reflect the purpose of information disclosure or a proper approach to assessing its effectiveness. Instead, it appears the Commission has instead followed its (incorrect) assumption that only regulatory intervention can produce acceptable returns.

#### **ASSESSING THE EFFECTIVENESS OF INFORMATION DISCLOSURE REGULATION OVER 20 YEARS**

18. The Commission's primary criticism of the effectiveness of the information disclosure regime for Christchurch Airport is that it has failed to prevent Christchurch Airport from targeting (in the Commission's view) excessive returns for the period between 2018 and 2032. This is despite the fact that expected returns for 2012 to 2017 are within the Commission's estimate of an appropriate return.
19. This approach is deeply problematic. The Commission's concerns about the effectiveness of the information disclosure regime appear to be based on its finding that information disclosure regulation has not locked in "normal returns" for the next 20 years. This is an impossible standard for any regulatory regime to meet, let alone an information disclosure regime that is based on encouraging self-initiated behaviour change over time through transparency of performance.
20. To the contrary, the draft report is another example of information disclosure being effective, including through providing feedback to airports about their behaviour. This is because:
- (a) The disclosed information reveals Christchurch Airport has made decisions that lead to an appropriate forecast outcome for the next five years. This is the only period to which Christchurch Airport can legally commit (and it has done so).
  - (b) The Commission considers it can assess the effectiveness of information disclosure regulation in relation to profitability at the current time because Christchurch Airport has set its revenue requirement, and therefore its expected profits, for the next pricing period.<sup>9</sup> However, the Commission appears to put this important statement to one side in its overall analysis, and does not fully recognise that the pricing decisions that have actually been made relate to Christchurch Airport's expected profits for the current pricing period ("PSE2"), and not the next 20 years.
  - (c) Where decisions in relation to a particular pricing period are informed by a longer-term model, it is sensible for those longer-term considerations to be discussed in the Commission's analysis, but it must always be remembered that conclusions cannot be drawn now about information disclosure's effectiveness based on information about future pricing periods when the decisions in relation to these periods have not yet been made. Those future decisions will, undoubtedly, reflect the learning that has developed through this section 56G review process and the future learning that will follow from section 53B analyses. As NZ Airports has submitted previously, the focus should be on outcomes than can be properly measured at the current time. For Christchurch Airport, the outcomes for PSE2 are strong evidence that the right incentives exist to make appropriate decisions.
  - (d) As with all airports, Christchurch Airport's decisions beyond this period will be informed by its long-term views but will ultimately be shaped by a number of factors, including the feedback and guidance about appropriate outcomes and behaviour that has developed through the section 56G review process.<sup>10</sup> Similarly, analysis and

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<sup>9</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.25.1.

<sup>10</sup> For example, Wellington Airport's decision to reconsult on its prices following the Commission's section 56G report is a clear sign that airports will respond appropriately to the feedback and guidance that is received. Self-initiated behaviour such as this demonstrates the effectiveness of the regime.

trends identified through the Commission's ongoing monitoring role will feed into future pricing decisions for all airports.

- (e) The level of scrutiny and analysis that has been brought to Christchurch Airport's performance through information disclosure regulation has highlighted some aspects of its decisions and disclosures that could be improved in the future, and will give Christchurch Airport the opportunity to address any concerns that have been raised, including in relation to its pricing model before prices are set for PSE3. This is an example of successful information disclosure in action.
- (f) The Commission's monitoring and analysis role is part of information disclosure regulation and part of what allows interested parties to assess the performance of Christchurch Airport against the objectives in Part 4 of the purpose statement. The fact that monitoring reveals aspects of performance that can be improved in the future does not mean that the regime is not working. Rather, it means the regime is working exactly as intended.

21. In summary, instead of finding that Christchurch Airport's decisions at PSE2 mean it will earn excess returns from 2018 (and therefore information disclosure is ineffective), the more reasonable finding would be that **if** Christchurch Airport does not make adjustments for PSE3, at the appropriate time, then it **may** earn excess returns. Such a finding does not provide evidence that information disclosure is currently ineffective.

#### **The disclosure templates establish a five-year period of forecast information**

22. The Commission states that the effectiveness of information disclosure in limiting excessive profits can be assessed based on whether it considers Christchurch Airport is targeting excessive profits when setting prices. It states that its analysis uses Christchurch Airport's own forecast information for PSE2.<sup>11</sup> However, in attempting to draw definitive conclusions about expected performance over 20 years based on disclosure templates that provide information about a five-year period, the Commission goes too far.
23. The Commission's reasoning in this respect goes beyond the statutory scope of its task under section 56G. It must be remembered that section 56G directs the Commission to assess the effectiveness of the information disclosure regime on the basis of the information that has been disclosed by suppliers of specified airport services.<sup>12</sup>
24. The information disclosure requirements provide transparency and information about airport price-setting over the five year period that airports have actually set prices. It requires some discrete aspects of information for the following five year period (such as some high-level capital expenditure and demand forecasts). This is the right period for effective information disclosure and, as noted by the Commission, is "consistent with the view that longer-term forecasts are likely to be less certain than shorter-term forecasts".<sup>13</sup>
25. The intent of these forecast information disclosure requirements is to provide transparency about the decisions that have been made for the forthcoming pricing period. This provides transparency for the medium-term, which is the most relevant and reliable information set for interested parties. The price setting disclosure templates capture in detail the basis for the five year forecast that underpins the prices that have been set and the decisions that have actually been made. This contributes to an effective information disclosure regime by providing detailed information to interested parties about current airport decisions. This is reinforced by the

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<sup>11</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.7.

<sup>12</sup> Commerce Act 1986, s 56G.

<sup>13</sup> Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2012 at paragraph 5.24.

Commission's reasons when setting the information disclosure requirements, where it noted that:<sup>14</sup>

The disclosures relating to forecast total revenue requirements are intended to align with the price setting process that airports are required to undertake under the AAA. These disclosures will provide key planning assumptions behind the setting of Airports' revenue requirements, and will include supporting information about proposed capital expenditure, operational expenditure and demand information.

26. The Commission went on to note that the information disclosure requirements were designed to:<sup>15</sup>

[...] align the pricing period with the period for which forecast total revenue and supporting information applies, so that interested persons can effectively compare prices set for the pricing period with the related forecast total revenue and supporting information.

27. For this reason, the information disclosure requirements are appropriately limited to the context of the current price setting decision. At the current time, the Commission does not have sufficient evidence to draw a conclusion on expected returns beyond the PSE2 period within the proper scope of its section 56G task, which is limited to the information that has been disclosed based on decisions actually made.

#### **TRANSPARENCY AND INFORMATION DISCLOSURE REGULATION**

28. NZ Airports accepts that information disclosure regulation should provide transparency. That is, after all, the predominant purpose of an information-based regulatory regime. We also accept that a lack of transparency could indicate that there may be weak incentives on regulated suppliers to promote the purpose of Part 4 of the Act. However, NZ Airports has some concerns with aspects of the Christchurch Draft Report and the conclusions the Commission is drawing about the transparency of airport performance, and therefore the effectiveness of ID regulation. In our view, the current framework (including the role of the Commission's summary and analysis of airport performance) provides considerable transparency, and will continue to build a clearer picture of airport performance over time as the regime beds in.

29. The Commission nevertheless raises concerns about the ability of information disclosure to provide sufficient transparency regarding Christchurch Airport's performance in three ways. It claims that:

- (a) interested parties may find it difficult to assess Christchurch Airport's profitability because it has taken a pricing approach that is not "explicitly contemplated" by the disclosure regime;<sup>16</sup>
- (b) the impact of commercial considerations that favour the airport's consumers are difficult to accurately reflect under the information disclosure regime and may further complicate the ability of interested parties to assess whether Christchurch Airport is limited in its ability to earn excessive profits;<sup>17</sup> and
- (c) sufficient information is not available to interested persons to assess Christchurch Airport's expected profitability performance because its price setting disclosure does not fully or transparently reflect its pricing approach.<sup>18</sup>

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<sup>14</sup> Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2012 at paragraph X11.

<sup>15</sup> Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2012 at paragraph 5.56.

<sup>16</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.33.

<sup>17</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.32.

<sup>18</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.17.



30. The first two of these claims are of real concern because they suggest that, where airports depart from information disclosure requirements and input methodologies in pricing, this will result in adverse conclusions about airport performance and the effectiveness of information disclosure regulation. This includes where those departures represent efficient pricing approaches that are understandable in an airport's particular circumstances, and where commercial concessions favour consumers.
31. The third claim is also of concern. In our view, it is unduly harsh to criticise Christchurch Airport for failing to fully reflect its 20-year pricing approach in the disclosure templates in circumstances where those templates are designed to provide information about the five year forecasts and assumptions that underpin an airport's five year pricing decision (the most relevant information set for interested parties as it relates to the period for which pricing decisions have been made). The Commission's claim also fails to recognise that identifying areas where transparency can be improved is a key part of information disclosure regulation — it is the airports' responses to these areas of suggested improvement that provide information about whether the regime is operating effectively.
32. We expand on these concerns below.

**The ability to depart from input methodologies and information disclosure requirements is becoming increasingly uncertain**

33. The Commission has accepted that Parliament's purpose for imposing information disclosure regulation was to improve the information and analysis available to facilitate effective consultation between airports and their users in relation to pricing decisions.<sup>19</sup> As such, information disclosure was intended to provide greater incentives to improve commercial relationships, and to allow airports, airlines, and other customers to reach commercial agreements taking into account efficiency, productivity, investment and other issues while providing clear guidance to assist commercial negotiations.<sup>20</sup>
34. This is entirely appropriate. An information disclosure regime should allow scope for airports to adopt innovative pricing approaches that are tailored to the needs of airlines, passengers and communities, and to the particular circumstances facing the airport in question.
35. However, when assessing the effectiveness of the regime for Christchurch Airport, the Commission has raised concerns that commercially-based pricing decisions result in a lack of transparency and may complicate the ability of interested parties to assess whether an airport is limited in its ability to earn excessive profits. It considers that "there may be a limit to information disclosure's effectiveness in limiting excessive profits where an airport decides to take a pricing approach that is not explicitly contemplated by the disclosure regime".<sup>21</sup> It goes on to note that it "is the impact of these commercial considerations which favour the airport's consumers, and any future commercial considerations that Christchurch Airport might continue to make, that are perhaps most difficult to accurately reflect under the information disclosure regime".<sup>22</sup>
36. This approach is deeply problematic. Information disclosure regulation should not "contemplate" a particular pricing approach, either explicitly or implicitly. Information disclosure should not drive airports towards a single, one-size-fits-all solution — its focus should be on providing information about the decisions that have actually been made. For this reason, assessing the effectiveness of the regulatory regime should reflect the Commission's aims when setting the disclosure requirements — ensuring that disclosures can accurately reflect pricing

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<sup>19</sup> See eg Commerce Commission *Respondent's submissions, Volume 2: Cost of Capital*, 20 August 2012 at paragraph 46.

<sup>20</sup> Commerce Amendment Bill (201-1) (explanatory note) at pages 40-41.

<sup>21</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraphs 3.2-3.3.

<sup>22</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph F109.

practices.<sup>23</sup> The current regime provides the ability for this to happen. However, the Commission must be very careful that it does not confuse a lack of transparency with difficulties in aligning legitimate and efficient pricing approaches adopted by airports with a prescriptive building blocks pricing model derived from a price-control context and based on its information disclosure methodologies. If adverse conclusions about the transparency of airport performance are drawn where airports depart from this prescriptive building blocks model, this risks discouraging justified departures from input methodologies and would be contrary to the Commission's correct position that airports do not have to apply input methodologies when setting prices.

37. It is this attempted comparison which creates confusion and a lack of clarity, rather than the information disclosure regime itself. Throughout the development of the information disclosure regime, NZ Airports has consistently warned against too much prescription on the basis that an overly prescriptive regime risks being unhelpful and confusing.<sup>24</sup> In our view, the variances in airport performance are a key reason in favour of the information disclosure regime, which allows those variances to be explored and understood by interested parties.
38. Instead, the Commission should focus on assessing whether information disclosure allows airports to explain complex decisions as contemplated by the regime, rather than trying to align those decisions with a prescriptive monitoring approach - an analysis which can create, rather than reduce, confusion. The key thing is for airports to clearly disclose what they have actually done and for the Commission to analyse this information in a robust manner. As noted above, any identified shortcomings in the clarity of its disclosures provide useful feedback and will no doubt be addressed by Christchurch Airport going forward.

#### **The Commission's approach risks discouraging appropriate commercial behaviour**

39. The Commission notes that it is difficult to assess airport performance when commercially-based pricing decisions are made. These comments are of grave concern because they suggest that Christchurch Airport is being penalised for the model that it has chosen and for making particular commercial pricing decisions that the Commission acknowledges are in favour of consumers.
40. We believe that revealing commercially-based pricing decisions (including the rationale for those decisions) is a key function of an information disclosure regime. If the Commission has concerns about the ability of information disclosure to fully explain decisions that have been made, then NZ Airports is keen to work with the Commission to find solutions. However, we stress that this should be seen as part of a commitment to ongoing implementation of the regime, and not evidence of current ineffectiveness.
41. Further, the Commission's approach risks discouraging airports from providing commercial concessions in pricing decisions for fear that this will attract criticism and be considered non-transparent pricing behaviour. This creates a risk that the input methodologies will become the only reference point for airport pricing decisions, inappropriately restricting the ability of airports to reach tailored and innovative pricing approaches that reflect their individual circumstances as well as industry-wide characteristics. If this occurs, this risks significantly reducing the ability for airports to discover and provide the most appropriate, innovative and efficient outcomes for consumers through genuine consultation with airlines.
42. As a result, airports are now in an uncertain situation. The Commission has accepted in theory that alternative pricing models (including long-run pricing approaches) can be sensible, efficient,

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<sup>23</sup> Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2012 at paragraph 6.13.

<sup>24</sup> See eg NZ Airports Association *Submission on Input Methodologies Discussion Paper*, 31 July 2009 paragraphs 13-22; NZ Airports Association *Cross submission by NZ Airports Association following the Commerce Commission Input Methodologies Conference for Airports*, 15 October 2009 at paragraphs 19-23, 56-60.

conceptually sound, and in the interests of consumers. It accepts that airports do not have to apply the input methodologies in pricing or follow a building blocks approach. However, if airports adopt a different pricing methodology and different inputs to that methodology, they risk being accused of a lack of transparency and risk the Commission finding that information disclosure is ineffective. The consequence is that airports may be discouraged from adopting efficient and innovative pricing approaches that deliver clear benefits for consumers, due to the risk that these arrangements will be seen as "not transparent" by the Commission.

#### **Price setting disclosure templates and transparency improvements**

43. The Commission states that sufficient information is not available to interested persons to assess Christchurch Airport's expected profitability performance because its price setting disclosure does not fully or transparently reflect its pricing approach.<sup>25</sup> It uses this finding to support its conclusion that information disclosure regulation has not been effective at limiting Christchurch Airport's ability to extract excessive profits.
44. As we discuss above, the price setting disclosure templates are designed to provide information about the five year forecasts and assumptions that underpin an airport's five year pricing decision (with particular aspects of the disclosure template requiring information about 10-year forecasts). It is unfairly harsh to criticise Christchurch Airport for failing to fully reflect its 20-year pricing approach in the disclosure templates in these circumstances.
45. In addition, the Commission appears to judge Christchurch Airport's disclosure on the basis of the information that the Commission would expect to see in order to carry out its assessment approach that it has developed through the course of the section 56G review — expectations not reflected in the information disclosure framework at the time Christchurch Airport set prices or made its disclosure. A finding that disclosure could have been more transparent in some aspects is the exact type of useful feedback contemplated by information disclosure. In our view, this is a sign that the regime is working as intended.

#### **Transparency is also promoted through the Commission's analysis**

46. In part, the Commission has drawn adverse conclusions about the transparency of Christchurch Airport's disclosures where it considers Christchurch Airport has oversimplified the information that it has presented for interested parties. NZ Airports considers that some aspects of the Commission's analysis are in danger of repeating this oversimplification and affecting the ability of interested parties to assess Christchurch Airport's performance. In particular, we note that:
  - (a) The Commission has criticised Christchurch Airport for not explicitly modelling the full 20-year price period when determining its levelised price, instead using shorter-term (10-year) data as the basis for its pricing model. However, the Commission's analysis involves a substantially similar process. It purports to draw conclusions about the appropriate return for Christchurch Airport over a 20-year period, but has assumed that its estimate of a normal return for the five year period beginning October 2012 is the same as an estimate of a normal return for the next 20 years.
  - (b) The Commission does not discuss the challenges of assessing returns over a 20-year period against its current, short-term estimate of appropriate returns. The Christchurch Draft Report does not highlight for interested parties that this may not be a valid comparison, that interest rates over a 20-year period could be expected to differ materially from current rates, and that the estimate of an appropriate return in 5 years time could be vastly different to its current estimate. Instead, the Commission's simplistic approach conveys the impression to interested parties that

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<sup>25</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.17.

long-term performance can be assessed against short-term benchmarks to draw firm conclusions without any limitations.

- (c) Further, the Commission fails to reflect in its draft report a key area where airports and airlines both considered that an upwards departure from the Commission's estimate of a normal return was warranted when setting prices. Where consumers and airports agree that a particular approach is justified (as in the case of an uplift to the asset beta for Christchurch Airport), this is an important detail to reflect in the Commission's analysis in order to present a complete picture for interested parties.

- 47. These examples illustrate that aspects of the Commission's analysis do not present a sufficiently transparent and detailed analytical approach. In failing to take into account the above matters, or to at least highlight these matters in its report, the Commission does not present an accurate picture of the analytical issues in question and does not promote the ability of interested parties to assess airport performance to the extent that could be expected.
- 48. NZ Airports emphasises, again, that it is not seeking changes to the *content* of the Commission's cost of capital input methodology through this process. We simply reiterate that this is an area where sophistication in the *application* of that methodology is required and where more, rather than less, information can be expected to assist interested parties to interpret the Commission's findings and draw their own conclusions about Christchurch Airport's performance.
- 49. Again, in these circumstances, a more reasonable finding would be that excess returns **may** be earned in the future **if** all current factors remain the same, including the Commission's estimate of the cost of capital.

#### **THE INFLUENCE AND IMPACT OF INFORMATION DISCLOSURE**

- 50. The Commission considers that demand considerations, rather than information disclosure, have been influential for Christchurch Airport in PSE2. It uses this finding as a basis to conclude that information disclosure may not be influential in the future. This is a very surprising chain of reasoning, and creates significant new uncertainty for airports.
- 51. The Commission has accepted that airports do not have to apply its input methodologies in pricing. However, its approach in the Christchurch Draft Report suggests that it will still criticise suppliers in circumstances where the input methodologies clearly influenced pricing decisions but market factors were a greater driver of behaviour. This approach is concerning for a number of reasons:
  - (a) It is inconsistent with the Commission's stated view (applied for other limbs of the Part 4 purpose statement) that, if outcomes are appropriate, information disclosure can be effective even if it is not providing the main incentives for behaviour.<sup>26</sup>
  - (b) Demand considerations influencing pricing is a good thing and is consistent with the intent of information disclosure regulation. All airports include demand considerations in airport pricing decisions, and no airport has set a price path that is simply the outcome of a building blocks approach, as the Commission appears to suggest was the case for Wellington and Auckland Airports.<sup>27</sup> Market factors such as demand can be hugely variable for airport businesses, significantly more so than for electricity or gas networks, and require careful attention when setting a pricing approach for long-term infrastructure assets. Accordingly, it is important that information disclosure allows interested parties to observe the impact of demand on airport decisions.

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<sup>26</sup> See, for example Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraphs 2.23, B3.

<sup>27</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E42.3.

- (c) This is particularly important given the Commission has found the decision benefits consumers - the information disclosure regime should encourage sensible commercial decisions that take account of market factors in a way that leads to better outcomes for consumers (ie reduced price shocks). NZ Airports encourages the Commission to reflect on any disincentives that may be created by its approach in the Christchurch Draft Report, and to recognise that that reflecting demand considerations and the nature of the airport market in pricing is an example of successful information disclosure regulation.

52. The Commission considers that, if return expectations are within its view of an acceptable range, it would have to apply its judgement as to whether this is the result of information disclosure or other factors (such as demand considerations). It considers that it is unlikely it would be able to form a view whether any such factors might continue to be an influence on prices in the future.<sup>28</sup> This reasoning does not make sense in the context of an information disclosure regime.

53. We also note that the Commission's reasoning in this respect involves a number of inconsistencies:

- (a) It is difficult to reconcile the Commission's finding that Christchurch Airport did not think it was targeting excess returns and that it is not expected to earn excess returns for PSE2,<sup>29</sup> with its finding that information disclosure is not effective at limiting excess profits.<sup>30</sup> As we note above, the best evidence of the impact of information disclosure at this stage is the outcomes that can be measured based on decisions that have actually been made.

- (b) It is illogical for the Commission to find that Christchurch Airport may not have considered it was targeting excess returns for PSE2 (by reference to Christchurch Airport's understanding of the Commission's expectations),<sup>31</sup> and also find that the regime does not appear to have materially influenced price setting behaviour for PSE2.<sup>32</sup>

- (c) The Commission notes that, without information disclosure, Christchurch Airport has weak incentives to limit excess profits.<sup>33</sup> As the Commission has found that there are no expected excess profits for PSE2,<sup>34</sup> this must mean that information disclosure is providing the right incentives. As the Commission has noted numerous times, if outcomes are appropriate it does not need to be concerned that those outcomes are contributed to by factors other than information disclosure regulation.<sup>35</sup> The Commission also acknowledges that, if information disclosure was being effective, it would not necessarily have resulted in different outcomes for PSE2.<sup>36</sup>

- (d) The Commission also notes that Christchurch Airport used the input methodologies as an important reference point to calculate its full cost of service.<sup>37</sup> This is inconsistent with a finding that Christchurch Airport had no regard to information disclosure, and inconsistent with the Commission's view there is no evidence that Christchurch Airport had direct regard to the information disclosure regime.<sup>38</sup>

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<sup>28</sup> See, for example, Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E36.

<sup>29</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E4.

<sup>30</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E3.

<sup>31</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E4.

<sup>32</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph E3.1.

<sup>33</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.21.

<sup>34</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.14.

<sup>35</sup> See eg Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 2.23.

<sup>36</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph 3.17.

<sup>37</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraphs F26-F27.

<sup>38</sup> Commerce Commission *Draft Section 56G Report for Christchurch Airport*, 15 October 2013 at paragraph X4.

54. Part of the effectiveness of information disclosure is that it provides opportunities for all stakeholders interested in airport regulation to continue to learn as they go. Airports, airlines and the Commission are all building a better understanding of the capability of information disclosure regulation and the way the regulatory regime translates into practice. Through the section 56G review process, all parties are learning that the regulatory regime provides the opportunity for ever-increasing transparency. As a result of this process, where airports are considering future pricing approaches (including the choice of pricing models), they will be in a considerably better position to:
- (a) have an informed debate with airlines, the Commission and economists about the pros and cons of departures from the input methodologies; and
  - (b) ensure that existing information disclosure requirements are utilised to provide optimal transparency (including through disclosure of additional information if required and consulting on non-standard depreciation approaches if appropriate).
55. The threat of regulation will remain strong. The section 56G review was a mandatory transitional measure, but the Commission has already indicated that it intends to carry out more extensive summary and analysis reports in the year following airports' pricing disclosures.<sup>39</sup> As discussed above, airports now have a much clearer (although not complete) picture of how those assessments will be carried out.
56. Similarly, the commentary that the Commission has provided in its section 56G reports (and the ongoing commentary it will provide in its section 53B reports following each annual disclosure) will greatly assist interested parties to use the information disclosure reports for the purposes intended under the Act. In this way, it will be an essentially ingredient in promoting and shaping a three-way conversation between airlines, airports and the Commission.
57. For these reasons, information disclosure will continue to be influential in the future as more information becomes available to guide airport decision making. This should be taken into account when considering its potential influence on future conduct. Further, as discussed above, the incentives on airports outside the information disclosure regime (such as the need to respond to demand) will continue to apply.
58. Further, it is important to emphasise that if performance is acceptable now, information disclosure is effective now. Decisions about the future influence of information disclosure and its future impact should be made in the future.

#### **What are "normal returns"?**

59. It has become apparent that the Commission will assess the influence of information disclosure regulation in the future based, in large part, on its view about whether airports are earning "normal returns". NZ Airports continues to have grave concerns over the meaning and level of precision the Commission is attempting to allocate to this phrase.
60. In particular, over the section 56G review process, the Commission has been progressively evolving its view that any amount above the cost of capital input methodology will constitute "excess returns" or "above normal returns".<sup>40</sup> It then considers that an exercise in judgment is required to determine if the above normal returns are "excessive profits".<sup>41</sup>
61. NZ Airports continues to have serious concerns with this approach, and continues to disagree with the Commission's view that the 50<sup>th</sup> percentile estimate of its cost of capital is the only

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<sup>39</sup> Commerce Commission *Commerce Act Part 4 Funding Review: Discussion Document*, 11 June 2013 at paragraph 88.

<sup>40</sup> See, for example, Commerce Commission *Draft Section 56G Report for Auckland Airport*, 30 April 2013 at footnote 25.

<sup>41</sup> See, for example, Commerce Commission *Final Section 56G Report for Auckland Airport*, 31 July 2013 at paragraphs 2.9-2.10.

proxy for "normal" returns. The very purpose of a cost of capital range is to recognise that there is considerable uncertainty and error involved in attempting to determine what "normal" returns are.

62. In addition, as noted previously by the Commission, the 75<sup>th</sup> percentile is a valid and appropriate benchmark when assessing performance:<sup>42</sup>

A 75<sup>th</sup> percentile estimate of the cost of capital has been considered as a benchmark in addition to the midpoint estimate because in trade-offs between assessing outcomes that promote dynamic efficiency (eg, incentives to invest) and static allocative efficiency (ie, higher short-term pricing) under Part 4, we generally favour outcomes that promote dynamic efficiency.

63. And further, the Commission has previously noted that the 75<sup>th</sup> percentile is a key part of determining an acceptable range for target returns:<sup>43</sup>

[...] for the purpose of assessing the effectiveness of information disclosure regulation, we consider an acceptable range for target returns to lie between the mid-point and 75<sup>th</sup> percentile estimate of the airport's cost of capital, because that is generally consistent with limiting the ability of the airport to earn excessive profits, while allowing it to achieve a normal return. As such, information disclosure would in most cases be seen as effective for expected returns that are targeted within this range.

64. In our view, these comments are not consistent with the Commission's decision to describe returns that are above the 50<sup>th</sup> percentile estimate of its cost of capital as "above normal" or "excess returns", which necessarily carry a negative implication. Such an approach creates considerable uncertainty for airports when making pricing decisions, as it appears open to the Commission to decide that any level of target returns over the 50<sup>th</sup> percentile estimate is evidence of excessive profits. This is contrary to the understanding that the use of the 75<sup>th</sup> percentile in pricing on a forward-looking basis is a recognised method of providing for the asymmetric social consequences of under-investment.<sup>44</sup>

65. NZ Airports considers the better approach is to recognise that a single point estimate is not the only proxy for normal returns. If the Commission continues to use its cost of capital as the benchmark for assessing returns, it would be consistent with its overall approach to describe returns between the 50<sup>th</sup> and 75<sup>th</sup> percentile as "normal returns" (and to acknowledge that returns outside this range can equally be considered normal).

66. In addition, as we have noted before, contextual factors should be part of every assessment of profitability, not just when returns are above the cost of capital methodology (whether above the 50<sup>th</sup> or 75<sup>th</sup> percentile). This is because context is necessary in every circumstance to determine what a "normal" return is, rather than only relevant as a way to justify "above normal" returns.<sup>45</sup>

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<sup>42</sup> Commerce Commission *Draft Section 56G Report for Wellington Airport*, 2 November 2012 at footnote 171.

<sup>43</sup> See, for example, Commerce Commission *Final Section 56G Report for Auckland Airport*, 31 July 2013 at paragraph 2.9.

<sup>44</sup> See, for example, Lally "The Weighted Average Cost of Capital for Gas Pipeline Businesses", 28 October 2008, at page 94-95.

<sup>45</sup> See, for example NZ Airports *Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report*, 31 May 2013 at paragraph 24(c).