28 November 2014

Major Airports Review
Ministry of Business, Innovation and Employment
PO Box 1473
WELLINGTON 6140

majorairports@mbie.govt.nz

Effectiveness of information disclosure regulation for major international airports

The Board of Airline Representatives of New Zealand (BARNZ) is an incorporated society comprising 19 member airlines operating scheduled and code share international and domestic services, to, from and within New Zealand. Its members are:

Air Calin	Air New Zealand (Group)	Airwork
Air Tahiti Nui	Air Vanuatu	Cathay Pacific Airways
China Airlines	China Southern	Emirates
Fieldair	Fiji Airways	Korean Air
LAN Airlines	Malaysia Airlines	Qantas Airways (incl Jetstar)
Singapore Airlines	Tasman Cargo Airlines	Thai Airways International
Virgin Australia	Menzies Aviation (NZ) Ltd	

All of its airline members (other than Air NZ and Qantas which represented them-selves) authorised BARNZ under s2A of the Airport Authorities Act to represent them in pricing and capital expenditure consultations with Auckland, Wellington and Christchurch Airports. Subsequently, BARNZ also made submissions on behalf of those airlines to the Commerce Commission during the reviews the Commission held under s56G of the Commerce Act into the effectiveness of information disclosure regulation on those three airports.

BARNZ is therefore well placed to comment upon the interaction between the Airport Authorities Act and Commerce Act in relation to pricing and information disclosure and the effectiveness of information disclosure regulation at promoting the purpose of Part 4 of the Commerce Act.

Any queries regarding this submission should be directed to John Beckett, Executive Director of BARNZ.

General comments on the current regulatory regime for major international airports

The regulatory regime for New Zealand's three main international airports comprises reliance on general competition law supplemented by an information disclosure regime (originally under the Airport Authorities Act but since 2011 occurring under Part 4 of the Commerce Act) and the obligation on those airports to consult before setting charges and before undertaking material capital expenditure.

From a comparative international perspective, this level of regulation is extremely light-handed. Most significantly, there is no appeal process available to, or approval requirement by, an independent regulator. Instead, the Airport Authorities Act provides that airports have the right to set prices as they think fit.

This can be contrasted with Australia which, as well as information disclosure and monitoring by the Australian Competition and Consumer Commission (ACCC) , also has five yearly reviews undertaken by the Productivity Commission reporting to the Treasurer as well as a process whereby access to airport services can be declared by the Minister on recommendation from the National Competition Council. A declaration has the outcome of enabling a party to apply to have the ACCC conduct an arbitration to determine access and price terms, unless the parties reach agreement themselves through negotiation. Airport services have been declared on two occasions – once in relation to access to freight aprons at Sydney and Melbourne Airports and again for runway, taxiway and apron facilities at Sydney Airport.

Airports in other developed countries have either a stronger form of regulation or direct Government control through asset ownership.

In the UK for example the main airports in London which have significant market power are subject to economic regulation through price control and other licence conditions by the Civil Aviation Authority, with appeal rights to the Competition and Markets Authority.

In the United States conditions for eligibility to FAA funding effectively create a very strong incentive on airports to reach negotiated outcomes with airlines over charges and capital expenditure plans in order for airports to qualify for FAA grants.

In Asia Pacific, robust economic regulation involving an independent regulator administering price cap regulation and incorporating user consultation was recently established in Singapore and India in direct response to airport privatization and corporatization respectively. There is recourse as well for stakeholders who disagree with the decision of the regulator – by appealing to the Ministry of Transport in the case of Singapore and to the Airports Economic Regulatory Authority Appellate Tribunal in the case of India.

In the European Union Directive 2009/12/EC on airport charges requires states to each develop a framework for setting and regulating airport charges comprising compulsory consultation over charges between airlines and airports with recourse to an independent supervisory authority whenever a charging decision is contested by airport users.

Airport regulation in New Zealand is missing this fundamental backstop of recourse to an independent supervisory authority in the event of disputes.

In 2008 at the time that Auckland, Wellington and Christchurch Airports came under information disclosure regulation under the Commerce Act, the Government considered whether or not to also put those airports under negotiate/arbitrate regulation. Treasury considered further information was required before considering if additional interventions were justified. The s56G review was intended to inform that policy analysis (which is now occurring) of whether there was a need for further regulatory intervention, such as negotiate/arbitrate regulation.[1]

In BARNZ's view, the Commission's conclusions clearly show that information disclosure regulation (supplemented with input methodologies and the obligation under the Airport Authorities Act for airports to consult before setting charges) has not been effective in promoting the purpose in s52A. In particular, it has not effectively limited the ability of suppliers of regulated airport services to target excessive profits.

The Commission's analysis in the course of the s56G review process has shown that:

- Wellington Airport set prices targeting excess returns of between $81m to $139m over the remaining life of its assets.
- Christchurch Airport's disclosures based on a standard depreciation profile suggest that while prices for the current pricing period were within an acceptable range[2] the Airport is targeting excessive profits over the 20 year pricing path which forms the core of their pricing methodology, and the basis of the current charges.
- Auckland Airport was targeting above normal returns (of up to $41m), however, this fell just within the upper boundary of the Commission's acceptable WACC range of the mid-point to the 75th percentile WACC estimate.

The overall conclusion is a clear picture that information disclosure regulation alone has not been able to prevent excessive profits being targeted. It is very clear to BARNZ that the current regime of information disclosure regulation alone for airports is inadequate to achieve the purpose of s52A and there now needs to be a decision to strengthen the regulatory over-sight of the main airports. In our view, this should be by moving airports to negotiate/arbitrate regulation under the Commerce Act.

Airports are particularly suited to the negotiate/arbitrate form of regulation. Each airport has a relatively small number of key airline customers with whom it would need to consult or negotiate (from five at Wellington Airport to around twenty at Auckland Airport). These customers are relatively well resourced, sufficiently informed and motivated to participate in the negotiation and any arbitration in a meaningful manner. Airlines have a vested interest in ensuring both the long term viability of airports and that requisite standards of maintenance, security and investment occur – otherwise the ability of airlines to operate their own businesses and meet the needs of their own customers will be adversely impacted. As such, the risks of the negotiation process being gamed or

[1] Refer para 33, 34 and 49 of Cabinet Policy Paper by Ministers of Commerce and Transport on Commerce Act Review: Airports.

[2] It should be noted that the Commerce Commission based this conclusion on the standard depreciation profile disclosed by Christchurch Airport. This was significantly higher than the economic depreciation profile adopted by the Airport in setting charges. The Commission therefore noted that if the economic depreciation profile was applied in the calculations, the results may well be different.

manipulated are minimal. It is in the interests of airlines to ensure it operates smoothly and it is sensible to rely initially on negotiation between airlines and airports.

Consultation has shown that a large number of matters are able to be resolved directly by the parties. Operating expenditure, demand forecasts and forecast capital expenditure are often matters on which a degree of consensus is reached. In most cases, there is just a small number of material outstanding issues. For example, at Christchurch Airport there were only two issues unresolved – the appropriate formula to calculate the tax input to the required revenue and the appropriate cost of capital. However, together these issues represented a difference in forecast revenue of between $31m to $57m over the pricing period. At Wellington Airport, the appropriate WACC, valuation methodologies, land valuation and treatment of forecast revaluations were the outstanding issues. At Auckland Airport, the sole difference related to the appropriate target WACC for terminal assets (where the Airport was targeting a post-tax return of 11%). Negotiation should therefore allow a degree of consensus or acceptance to be reached on most issues, with the remaining few outstanding issues being referred to arbitration. Over time, precedent from earlier arbitrations will further reduce the issues needing to be referred to arbitration.

Section 53I of the Commerce Act empowers the Commission to specify the form and process of both the negotiation and any arbitration. The negotiation process can be based on the well-established current consultation processes – but with the significant difference that the purpose is to endeavour to reach agreement with the airlines, rather than just hear the airlines before making a decision.

For the arbitration process, the Commission could limit the scope of issues able to be referred to arbitration to ensure that recourse to the arbitration process was reserved for significant issues, or for matters of precedent applicable across a number of airports. In some overseas jurisdictions a threshold is set in terms of a number or percentage of dis-satisfied users which must be reached before an unresolved issue can be referred to arbitration (variously calculated by measures such as the proportion of carriers, passengers, revenue or movements). In this way the arbitration process can be protected against a multitude of unresolved matters.

Taking no action and leaving the airport provisions in Part 4 unaltered would, in BARNZ's view, not be an appropriate action in response to the clear findings in the Commerce Commission's reports that information disclosure has been ineffective in preventing the targeting of excess returns at two of New Zealand's three major airports. It would result in the regulatory regime surrounding those airports being substantially less effective than it was in 2012 when the three airports set charges because there would not be a review equivalent to those just completed under s56G and neither the Government, nor other interested parties, would have the benefit of a report from an independent body such as the Commerce Commission assessing the reasonableness of the prices set by the airport. Even a series of s56G reviews would not be effective as there would still not be an independent dispute resolution mechanism readily available to the parties.

BARNZ is not looking for heavy handed price control regulation. Airlines simply seek an effective and efficient form of regulation, the essence of which enables the parties to attempt to negotiate between them-selves in the first instance, supplemented by a readily available and independent dispute resolution process where agreement is not able to be reached. BARNZ considers that where unresolved matters remain, arbitration by the Commerce Commission under Part 4 would be effective and efficient. As commonly disputed issues are settled, such decisions will act as a

precedent at both the originating airport and other airports, further improving the prospect of negotiation being able to achieve fair and reasonable prices in the first instance.

BARNZ members strongly consider that, in the present circumstances being considered by the Ministers, where two of New Zealand's three major airports were found by the Commerce Commission to have set prices targeting the earning of excessive returns contrary to the objectives in s52A(1)(d), and where the Commerce Commission found that information disclosure had not been sufficient or effective in preventing this, then there must be a clear regulatory response from the Government to tighten the regulation applying to those airports. If this does not occur, consumers of regulated airport services will suffer through paying excess charges well into the future.

BARNZ therefore strongly urges the Government to increase the regulation applying to the three major airports to the next form of regulation available under Part 4 of the Commerce Act – namely to negotiate/arbitrate regulation.

Are there any reasons why the Commission's analysis should not be accepted?

The Commission undertook an extremely thorough review into the pricing decisions made by each airport, and the underlying inputs and approaches.

BARNZ acknowledges the appropriateness of the Ministers making their decisions regarding the effectiveness of information disclosure regulation at promoting the purpose of s52A, and whether any changes are required to the regulatory regime surrounding New Zealand's main airports, based on the analysis undertaken by the Commission and the conclusions it reached in its three final reports.

We would, however, like to point out that in the course of that analysis the Commission made a number of decisions or adopted particular positions which it described as conservative or in the favour of the airport in question. The quantitative outcomes of the Commission's analysis therefore tend to understate the degree of excess returns being targeted by the airports and the cost to consumers.

Particular examples include:

- The Commission focusing on the 75th percentile WACC estimate in its analysis, rather than a mid-point WACC, even though it has described the mid-point WACC as being the starting point for assessing profitability in the case of information disclosure;

- The inclusion of leased assets within the profitability analysis. Returns on leased assets are significantly lower than the returns being targeted through airport charges by all three airports using their Airport Authority Act price setting powers. Lease returns are much closer to outcomes produced by workably competitive markets as the leases usually incorporate arbitration provisions and reference market rates. Returns on aeronautical leases at the time of the Commission's analysis were around 6%, considerably below the 9% returns being targeted by Wellington and Christchurch Airports. Inclusion of the lower (market based) returns on aeronautical leased assets has the effect of diluting or understating the returns being targeted by the airports on their pricing asset base where they have monopoly power.

- The decision by the Commission to undertake its analysis using end-of-period cash-flows, rather than a mid-year cash-flows, which are a better reflection of when costs are incurred and revenue is earned throughout the year. The Commission's sensitivity analysis showed that using end of year cash-flows results in an IRR approximately half a percent lower than if mid-year cash-flows were used. The Commission has acknowledged that this gives rise to a conservative estimate of the IRR in favour of the airports, as opposed to attempting to approximate the actual timing of the cash-flows.

- The Commission not treating Christchurch Airport's previous unforecast revaluations (which occurred during and at the end of the previous pricing period) as income in its analysis of returns being targeted by Christchurch Airport in the forthcoming pricing period. The Commission's approach was strangely at odds with that of Christchurch Airport which did treat these revaluations as income. The result is to understate the returns being targeted as those unforecast revaluations have not been treated as income for the purposes of setting prices in either PSE1 (when they were unanticipated due to Christchurch Airport's previous adoption of a moratorium on revaluations) or PSE2. Coved has advised BARNZ that if only revaluations post the commencement of Part 4 are taken into account, then the Commission's approach understates the return CIAL is targeting by 0.4% over twenty years (i.e. the return increases from the Commission's measured 8.9% to 9.3%) or by 1.1% for the first (almost) five year pricing period (i.e. the return increases from the Commission's measured 6.8% to 7.9%). These calculations are available upon request. Not reflecting actual revaluations as income in the assessments of targeted profitability creates an incentive for airports to under-forecast anticipated revaluations going forward, so that if higher revaluations occur, the airports can set increased charges based on the higher revaluations without having to treat the additional unforecast revaluations as income. This was the most contentious aspect of airport pricing under the previous Airport Authorities Act information disclosure regime and was a prime contributing factor behind the need to increase the regulatory oversight of airports in 2008. As the High Court in the last years merits review decision commented, increased profits resulting from allowing a regulated supplier to revalue its assets would be a windfall gain rather than a reward for superior performance, which is contrary to the long-term benefit of consumers and to the objective in s52A(1)(d) of limiting a supplier's ability to extract excessive profits.[3] Regrettably the treatment of actual revaluation gains looks likely to continue to be a significant unresolved and controversial issue under the new Part 4 information disclosure regime.

- Using a higher WACC for its analysis of Auckland Airport based on the Commission's closest WACC determination to the time at which the airport set prices (of 1 April 2012) which was some six weeks earlier than when Auckland Airport's board last updated its analysis and reached its decision on the new prices (on 21 May 2012). The 21 May WACC was 0.36 basis points lower than the 1 April WACC. If judged against the relevant 21 May 2012 WACC, Auckland Airport's targeted returns exceeded the upper limit of the appropriate WACC range.

- Numerous other assumptions or decisions by the Commission favouring the airports which by themselves each did not have a material effect, but when taken together have a significant cumulative effect. For example the Commission:

    - did not review the efficiency of forecast operating expenses despite significant cost increases at the end of PSE1 by all three airports;
    - did not review the appropriateness of space allocations between retail and aeronautical activities within the retail and food-court areas of airports;

[3] *Wellington International Airport Ltd v Commerce Commission*, High Court, 11 December 2013, para 383.

- included approach land in the case of Auckland Airport which the Commission had previously held in the 2002 Airport Price Inquiry was not necessary for the airport to own; and
- did not make any adjustment for Wellington Airport increasing the charges set for existing customers to recoup the forecast cost of discounted airport charges it offers to new entrants or operators of new services.

In addition, it is important to remember that the impact on consumers from having to pay the revenue to fund the excess returns an airport is targeting, is significantly greater than the net benefit to the airport. The Commission's measurement of excess returns targeted is both a net present value figure, and an after tax figure. The additional revenue paid by consumers will have incorporated the cost of the tax paid by the supplier. The difference between the excess returns targeted by the supplier and the excess revenue necessary for consumers to pay in order to fund those excess returns is significant. For instance, in the case of Auckland Airport, the Commerce Commission calculated that consumers had to pay an additional $71m of revenue in order to fund the $41m above normal profits being targeted by Auckland Airport.[4] In addition, end consumers also bear the cost of GST payable on those charges.

Are there any new matters that were not considered that you believe may have affected the Commission's conclusions?

The Commission considered all relevant matters and circumstances which existed at the time the s56G review processes occurred (albeit that, as outlined above, in some cases the Commission declined to make adjustments for such matters in its analysis).

Are there any new matters or information that may affect any of the Commission's conclusions regarding the effectiveness of information disclosure for the three major international airports?

Subsequent to the conclusion of the s56G reviews four material events have occurred, two as the result of decisions by airports, one the outcome of the merits review process and one due to a decision by the Commission. However, BARNZ does not consider that these events affect the validity of the Commission's analysis of the effectiveness of information disclosure at promoting the purpose of s52A at the time prices were set.

The events are:

- A decision by WIAL to re-consult and set new prices based on an information disclosure compliant asset valuation methodology (albeit that issues still existed over whether WIAL appropriately applied that methodology and whether the resulting valuation was reasonable) targeting returns consistent with the Commission's upper WACC percentile;

[4] Commerce Commission, Report under s56G of the Commerce Act into the Effectiveness of Information Disclosure Regulation on Auckland Airport, 31 July 2013, para E38.

- CIAL's work towards revising its information disclosures so as to correct its overstatement of tax payable and to restate its depreciation profile to reflect the economic depreciation profile it had adopted in pricing rather than the straight-line profile used to prepare its disclosure accounts;
- The High Court's decision in December 2013 in the merits review appeals of the input methodologies specified under Part 4 to move the date for assessing the initial value of land in the regulatory asset base out one year from 2009 to 2010;
- The Commerce Commission's review of the appropriate WACC percentile estimate for electricity lines and gas pipelines pricing paths which resulted in the appropriate percentile being reduced from the 75th percentile to the 67th.

The outcome of the High Court's merit review was not known by airports or airlines at the time prices were set. Therefore we consider that the change in date for determining the initial regulatory asset base value is not directly relevant to the question of the effectiveness of information disclosure at promoting the purpose of s52A at the time of the pricing decisions that the Commission was assessing. However, the change only affects the AIAL analysis as the other airports both used later 2011 or 2012 valuations.

The Commission's decision to reduce the appropriate WACC percentile estimate to the 67th percentile for default and customised pricing paths was similarly not something known by airports or airlines at the time prices were set. Therefore we consider that this is not directly relevant to the question of the effectiveness of information disclosure at promoting the purpose of s52A at the time of the pricing decisions the Commission was assessing. However, this decision does further illustrate how much the Commission's decision to emphasis the outcomes at the 75th percentile upper end of the WACC range favours the regulated airports over consumers.

The two airport decisions also occurred after the price setting was completed. They did not arise as a result of information disclosure regulation. Rather they occurred well after and outside of information disclosure requirements. Specifically, these events were a direct result of adverse conclusions reached by the Commerce Commission in the s56G review process, and the possibility of increased regulation being introduced by the Government.

BARNZ considers that these airport initiated events or decisions do not affect the appropriateness of the Commission's conclusions regarding the ineffectiveness of information disclosure at preventing Wellington and Christchurch Airports setting prices targeting excess profits.

If the question for the Ministers was how effectively the reviews undertaken under s56G promoted the purpose in s52A, then these changes in approach adopted by the airports would be directly relevant. However, the statutory question is *how effectively information disclosure regulation … is promoting the purpose in section 52A* and it was not information disclosure which led to those changes in approach.

Rather it was the vigour of the analysis conducted by the Commerce Commission in the s56G processes, the adverse conclusions reached by the Commission over the targeting of above normal and excess returns by the three airports, the consequential adverse publicity as a result of those

findings and the prospect of the Government taking steps to strengthen the regulation of the airports under Part 4 which led to WIAL and CIAL making those changes.

CIAL's over-statement of its tax payable is an apt example. The issue was that CIAL was calculating the tax payable building block to be included in charges on all regulatory income – including that forecast to be earned from asset revaluations. Under New Zealand's tax laws, tax does not have to be paid on income from revaluations. BARNZ pointed this out to the airport during consultation. The airport's answer was that it was *'irrelevant … no tax is payable on the notional income'* as the approach it had adopted meant that *'any tax incentives provided by the Government are treated as a benefit to the investor, rather than passing those incentives to the consumer'*.[5] The Commission's input methodology for tax recognised the lack of tax payable on income from revaluations, with the formula for calculating tax (which is used to prepare the information disclosure schedules) specifically requiring income from revaluations to be deducted from regulatory income in order to calculate taxable income.[6] BARNZ pointed this out repeatedly to CIAL. However, the airport disregarded the inconsistency of its approach with both New Zealand's tax laws and with the Commerce Commission's input methodologies and information disclosure requirements and continued to apply its own approach of charging airlines tax on income forecast to be earned from asset revaluations. BARNZ calculated that this approach increased required revenue by $35m over the first pricing period.

In its s56G report the Commission commented that it did not agree with CIAL's pre-tax approach.[7] Subsequently, CIAL has commenced a voluntary revision of its information disclosure statements in which it proposes to correct for this overstatement of tax through treating the additional sums as depreciation of the closing asset base at the end of the current pricing period (i.e. from FY18 onwards).

It is plain that information disclosure had no effect in preventing the airport from overstating its required revenue through this mechanism of charging tax on income which is not taxable. The fact that the airport's proposed approach was blatantly inconsistent with the Commission's input methodologies for the preparation of information disclosure statements had no effect at all on the airport's determination (or its legal right) to overstate its required revenue through this mechanism.

It was only the adverse comments by the Commerce Commission in the subsequent s56G review process, together with the associated adverse publicity and the potential for airport regulation under Part 4 to be strengthened, which proved to have some effect.

WIAL's approach to the selection of asset valuation methodologies for its assets tells a similar tale regarding the complete ineffectiveness of information disclosure in contrast to what was achieved as a result of the subsequent s56G review process. WIAL set prices in 2012 using the long controversial market value existing use valuation (MVEU) methodology for its land, which took a base market value alternative use (MVAU) valuation and then added holding costs onto that to reflect the time a

[5] Christchurch Airport Responses to Airline Queries, 20 April 2012, page 3.

[6] Definition of Regulatory Taxable Income at page 31 of Commerce Commission Airport Services Information Disclosure Determination; see also Commerce Commission Input Methodologies (Airport Services) Reasons Paper at paragraph 5.1.5.

[7] Commerce Commission, Report under s56G of the Commerce Act into the Effectiveness of Information Disclosure Regulation on Christchurch Airport, 13 February 2014, para E55.

hypothetical new entrant would have to hold the land while it was converted to airport use. This caused WIAL's land valuation to increase from a (already overstated) MVAU valuation of $141m to an MVEU valuation of $242m, an increase of $101m, effectively increasing its aeronautical land value by 73%.

The Commerce Commission had twice rejected this valuation methodology – first in the 2002 Airport Price Inquiry undertaken under Part 4 and again in 2010 as it specified the input methodologies to be used by airports in their information disclosure statements. In both cases the Commission had specified that a MVAU valuation methodology should be used. WIAL set its prices using the higher MVEU valuation methodology – despite this being inconsistent with the Commission's information disclosure statements. In so doing, it targeted earning excess profits, contrary to the purpose of s52A. Even after the Commerce Commission undertook its s56G review process and found that WIAL was targeting significant excess returns, the airport still relied on its power to set charges as it sees fit contained in the Airport Authorities Act to justify its pricing decisions, expressing the view that the Commission's *'theoretical model doesn't apply to [Wellington] Airport'*.[8] It appears to have only been a fear of increased regulation which led WIAL to revise its prices and reset them based on an input methodology compliant asset base (albeit one which BARNZ has been advised is still overstated).

Information disclosure had no effect at all on WIAL's determination to use the higher MVEU land valuation methodology in order to enable it to target earning excess profits. Like CIAL, it was only the adverse comments by the Commerce Commission in the subsequent s56G review process, together with the associated adverse publicity and the potential of airport regulation under Part 4 being strengthened, which proved to have some effect.

In essence, BARNZ considers that the subsequent changes in approach by CIAL to its calculation of tax and by WIAL regarding land valuation methodology do not affect the validity of the Commission's conclusions that information disclosure was not effective in the case of those two airports at preventing the targeting of excess returns.

The only message those changes can give over the effectiveness of any of the regulatory tools, is in relation to the effectiveness of the s56G process coupled with the threat of further regulation which was present in 2014 as a result of that process. That the changes needed to be made at all by WIAL and CIAL is tantamount to how ineffective information disclosure proved to be in relation to preventing the targeting of excess returns contrary to s52A(1)(d).

In areas where the Commission has been unable to draw a conclusion on the effectiveness of information disclosure, do you consider it likely that conclusions would be able to be drawn in the future?

The Commission concluded that it was too early to be able to reach clear conclusions on how effectively information disclosure was promoting the purpose of Part 4 in relation to:

- Its effect on the efficiency of investment in terms of level or timing

[8] 'Wellington Airport Questions Commission's Report', Wellington Airport media release, 8 February 2013.

- Its effect on the efficiency of operating expenditure
- Its effect on the sharing of efficiency gains

As time passes and actual information is disclosed through the annual information disclosure requirements (which will enable comparisons to be made between forecast and actual outcomes in terms of the level and timing of capital and operational expenditure) then BARNZ believes there will be a more complete information set available under the Commerce Act disclosure requirements enabling conclusions to be drawn in relation to these matters.

With respect to investment, the Commission concluded that while current levels of investment appear prudent and necessary, it was too soon to reach conclusions on the efficiency of investment in terms of timing and level. Limited information was available at the time of the review process to compare actual capex levels and timing as against what the airports had forecast as they had set prices. Capital expenditure (forecast and actual) had not been required to be disclosed under the previous Airport Authorities Act disclosure regime. By contrast, the Part 4 information disclosure requirements do require the disclosure of forecast and actual capital expenditure, and a comparison of variations. The Commission will thus have a more complete set of information going forward comparing the timing and level of investment against the forecasts made by airports as they set prices, which will enable more definitive conclusions to be reached regarding the efficiency of the level and timing of investment. For example, subsequent information disclosure statements by the airports post the s56G reviews have shown that all three airports have (to date in PSE2) invested less than they forecast as prices were set in 2011 and 2012. Whether this continues to be the case remains to be seen as time goes on.

What scope of future analysis by the Commission would ensure that sufficient information is readily available to interested parties to assess whether the purpose of Part 4 is being met?

The same level of analysis and investigation as was undertaken by the Commission during the s56G review process will be necessary going forward in order for interested parties to have sufficiently unambiguous information to assess whether the purpose of Part 4 is being met.

The standardised information disclosure templates did not provide sufficient information to enable the differing pricing approaches of each airport to be properly reflected or appropriately understood without the additional analysis undertaken by the Commission.

Moreover, there were instances where the airports had disregarded the Commission's input methodologies resulting in differing views of the level of returns being targeted being held by the airports and airlines.

Dr Berry, the chair of the Commerce Commission, writing to the Ministers of Transport and Commerce after the completion of all three s56G reviews, commented that it is difficult to design a reporting regime flexible enough to accurately reflect performance under all available price setting approaches. Dr Berry observed that *'the airports' use of different pricing approaches may continue to create some difficulties in assessing airport performance in the future'*. [9] Interested persons

[9] Letter, Dr M Berry to Ministers Foss and Brownlie, 13 February 2014.

simply will not be able to accurately assess the level of returns being targeted by the airports, and the reasonableness of these returns, using the information required to be disclosed by the airports under the standard information disclosure templates.

There were some very complex issues that were only able to be unravelled by detailed examination of airport financial models and the provision of additional information and significant analysis by the Commission. For example:

- How WIAL's capex wash-up from a major project that was forecast to occur in the previous pricing period (PSE1), and which was reflected in charges for that period, but which was subsequently deferred with a credit carried forward to the following pricing period (PSE2), should be treated. Specifically, should this credit be treated as income of PSE1 or PSE2?
- What asset base should be used in assessing WIAL's targeted returns – the input methodology regulatory asset base or WIAL's higher asset base derived from its own preferred valuation methodologies?
- How the revaluation gains occurring as a result of WIAL continuing to use its own preferred higher valuation methodologies should be treated?
- What asset base should be used in assessing AIAL's targeted returns – the input methodology regulatory asset base or the moratorium asset base adopted by AIAL? Depending upon the approach taken, should AIAL's asset base be rolled forward or held at an implied historic cost when targeted returns are assessed?
- How had CIAL forecast its tax costs and was this consistent with the Part 4 input methodology on tax? What was the appropriate method to forecast tax costs when assessing CIAL's targeted returns?
- What was the appropriate level of depreciation to include in the calculations assessing CIAL's targeted return? Straight line depreciation or an economic depreciation profile reflecting CIAL's levelised 20 year pricing path?
- What target level of revenue was CIAL targeting, given that its financial modelling only covered a ten year period, despite the airport adopting a 20 year levelised pricing path and given the differences in approach between the financial modelling spreadsheets and the written descriptions of CIAL's approach and what it was intending to charge?
- How CIAL's wash-up of unforecast revaluations occurring during and at the end of the previous pricing period should be treated in the calculations assessing CIAL's targeted return? Specifically should these be treated as a credit in PSE2 as CIAL did, or should they be left as income attributable to PSE1?

Summary analysis under s53B is extremely unlikely to be able to delve into issues such as these, and it is unlikely that the Commission will have the time or the right under s53B to be able to obtain the necessary further information and explanations to unravel such complicated matters. The information provisions contained in s53B(1)(c) only enable information to be requested for the purpose of determining compliance with information disclosure requirements – not for the purpose of assessing whether or how effectively the s52A purpose statement is being achieved, or whether there is sufficient information for interested parties to make such assessments.

Is information disclosure for major international airports working effectively to achieve the objectives in Part 4 of the Commerce Act?

The Commission's conclusions clearly show that information disclosure regulation (supplemented with input methodologies and the obligation under the Airport Authorities Act for airports to consult before setting charges) has not been effective in promoting the purpose in s52A. In particular, it has not effectively limited the ability of suppliers of regulated airport services to extract excessive profits. Moreover, in the case of CIAL the Commission held that it had not achieved the promotion of efficiency in relation to the pricing structure, nor the s53A purpose of promoting transparency for interested persons to be able to assess whether the purpose of s52A had been achieved.

The Commission's analysis has shown that:

- Wellington Airport set prices targeting excess returns of between $81m to $139m over the remaining life of its assets.
- Christchurch Airport's disclosures based on a standard depreciation profile suggest that while prices for the current pricing period were within an acceptable range[10] the Airport is targeting excessive profits over the 20 year pricing path which forms the core of their pricing methodology, and the basis of the current charges.
- Auckland Airport was targeting above normal returns (of up to $41m) however this fell just within the upper boundary of the Commission's acceptable WACC range of the mid-point to the 75th percentile WACC estimate.

The overall conclusion is a clear picture that information disclosure regulation alone has not been able to prevent excessive profits being targeted. The Commission itself commented that the effectiveness of information disclosure regulation in preventing the extraction of excess profits should be able to be identified by the time that their reports were completed.[11]

Any changes to date in the approaches of the airports to price setting are attributable to the s56G review, the associated adverse publicity and the potential of airport regulation under Part 4 being strengthened; – not information disclosure regulation. For example:

- It was only in response to directed and repeated questing by the Chair of the Commerce Commission that Auckland Airport committed to treat asset revaluations as income after the expiry of its current moratorium on asset revaluations in 2017. The airlines had not been able to extract this commitment during consultation, despite their best endeavours. Nor had information disclosure regulation produced it.
- Wellington Airport only committed to reconsidering the annual 8% to 9% increases it had imposed after adverse draft and final s56G reports from the Commission. Information disclosure and consultation had not achieved this.

[10] It should be noted that the Commission based this conclusion on the standard depreciation profile disclosed by Christchurch Airport, noting that if the economic depreciation profile was applied the results may well be different.

[11] See for example paragraph E33 of the Commission's final report on Christchurch Airport.

- Christchurch Airport persisted in clinging to a blatantly incorrect tax calculation (over-estimating required tax by $35m over the pricing period in question) despite this being clearly inconsistent with the formulas contained in the input methodologies and information disclosure regulation requirements. It was only an adverse draft s56G report that led Christchurch Airport to indicate that it would change its approach when it next resets its charges.

BARNZ considers that the changes signalled by the Airports are not the result of information disclosure regulation – they are the result of the one-off s56G review by the Commerce Commission. Information disclosure regulation by itself has clearly been inadequate to bring about change or to effectively protect the long term interests of consumers.

Airport Authorities Act

How does the presence of information disclosure affect how prices are set under section 4A of the AAA?

The annual disclosures of results have very little effect on pricing. The new pricing disclosures occurring five months after new prices are set do have some small effect due to their closer proximity in time to the pricing decisions and because they mean that airport decisions are open to public comment and any differentiation from the Commission's input methodologies is apparent. However, the effect is limited because airports have the statutory right to ignore the views of airlines or other customers expressed during consultation. In effect, airports consider the information disclosure requirements, but regard themselves as free to differ from these if they so choose – and legally, they are entitled to do so.

How prices are affected depends wholly on the approach of the management and Board of the airport – which varies across the three airports and can change over time at a given single airport.

For example, when CIAL set prices it continued its previous approach of using the market value alternative use valuation methodology for land, which is consistent with the Commission's input methodologies, but at the same time it adopted a target WACC significantly higher than the Commission's identified reasonable range and it also calculated its tax using an approach inconsistent with the formula contained in the Commission's input methodologies.

In essence, during the pricing process the airports treat the information disclosure requirements as a relevant but not mandatory consideration. The airports collective reaction to the Commerce Commission's decision to reduce the appropriate WACC percentile for default price paths provides an apt example – the airports commented that *'for energy companies subject to information disclosure only, it cannot be assumed that the 67th percentile of the WACC range [will be] used for pricing*.[12] A little later the airports went further and commented that the 67th percentile *'is likely not to have been used to set the prices'*. Quite clearly, the airports do not see the WACC input methodology as a matter they need to apply when setting prices.

Vice versa, do the price setting provisions in section 4A of the AAA affect how effective information disclosure is in promoting the purpose of Part 4 of the Commerce Act?

The presence of the power to set charges as they think fit in the Airport Authorities Act means that airports have been free to disregard and not follow the input methodologies as they set prices – because legally there is no requirement on them to follow the input methodologies and the charges that are set cannot be challenged or reviewed for failure to follow the input methodologies or the information disclosure requirements.

[12] Submission by NZ Airports Association on behalf of AIAL, WIAL and CIAL on proposed amendment to the WACC percentile range for information disclosure regulation, 14 November 2014, paragraph 14.

If section 4A of the AAA is removed for smaller airports, would this have an effect on price setting for major international airports? Should it be removed for larger airports also?

Section 4A provides that airport companies have the right to set charges as they think fit. The Ministry of Transport's Discussion Document proposed deleting this requirement for smaller airports on the basis that the powers conferred upon companies generally under the Companies Act to undertake any business or activity and to do any act renders this provision unnecessary.

BARNZ supports the repeal of section 4A. The ability of airport companies to set charges as they think fit under section 4A creates an environment in which monopoly pricing by airports can thrive unchallenged. The effect of High Court and Court of Appeal decisions on this section are that the Airport Authorities Act as currently drafted confers a virtually unconstrained ability on airports to set charges with no right for airlines (or others) to challenge the charges set via a judicial review process on the grounds of unreasonableness due to the presence of monopoly rents.[13] Section 4A gives airports the right to recover unilaterally imposed charges for the use of essential monopoly infrastructure via summary judgment proceedings with no meaningful grounds of defence. The presence of section 4A means that it is not necessary for the airports to prove the existence of a valid contract or agreement.

BARNZ has not been able to find other examples in New Zealand of the statutory granting to a private company of the right to set charges as it thinks fit. All other statutory charge setting powers that BARNZ has come across contain a set of guiding principles which must be adhered to, and against which the exercise of the power can be tested.

While BARNZ supports the repeal of section 4A we consider that the Airport Authorities Act needs to contain principles guiding how airport charges should be set. BARNZ supports the purpose statement in section 52A of the Commerce Act being used as a template for the principles which should be applied by airports when setting airport charges.

How does the presence of information disclosure impact on consultation requirements in section 4B of the AAA?

Information disclosure requirements only minimally impact on consultation under the Airport Authorities Act today.

In the past, as airports and airlines were learning what consultation entailed, the information disclosure requirements provided a floor of the minimum information requirements necessary for consultation. They helped resolve debates over whether matters such as asset valuation reports and WACC reports needed to be shared with airlines. Prior to the introduction of information disclosure requirements under the Airport Authorities Act airports had resisted providing this information.

Over the last decade, case law, and experience gained by airlines and airports over a number of consultation processes, have together provided a fairly well established understanding of the type of

[13] *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98.

information required for airlines to be sufficiently fully informed so as to be able to meaningfully analyse and comment upon pricing proposals made by airports.

The information provided by airports during pricing consultations today goes well beyond that required to be disclosed through information disclosure requirements. In essence, the information disclosure requirements represent a summary of the more detailed information which is worked through in the consultation process. For example, under information disclosure the key building block inputs in the revenue targets are disclosed; – in consultation airports provide airlines with the full financial model calculating the required revenue. This is also the case for each building block input such as forecasts of operating expenditure and capital expenditure – key projects or high level categories of expenses are required to be disclosed for information disclosure purposes, whereas in pricing consultations the breakdown provided to airlines in order to enable them to assess the reasonableness of the forecasts is significantly more granular.

In essence, today information disclosure requirements merely shape the format in which information is provided during consultation, rather than defining what information is provided. Airports understandably endeavour to use the same method of organising the information across both processes (i.e. information disclosure and pricing) wherever possible in order to avoid duplication of work. However, the level of detail provided during consultation is considerably greater than that required in information disclosure.

Do you have any comments on how the requirement to consult on capital expenditure in section 4C of the AAA fits into the overall regulatory regime for major international airports?

If set at an appropriate financial level, then the requirement to consult on capital expenditure above a certain threshold would be a key component of the regulatory regime surrounding New Zealand airports. Capital expenditure consultation enables airlines and other users to express their views over the appropriateness of proposed capital projects in terms of timing, scope and design. Waiting until a price setting consultation occurs to express such views is too late as by that point the airport may be contractually committed to the project with it inevitably entering the asset base and affecting charges.

Consultation with users over significant capital expenditure projects has the potential to add considerable value to the decision making process. The airport is able to test its proposal – not only in terms of whether the project itself reflects the needs of users and is seen as necessary, but also with respect to the operational design, the aeronautical functionality and future proofing for changes in technology and aircraft design. Airlines possess considerable expertise in this area. Airlines may have suggestions that the airports have not considered and bring a fresh perspective to the evaluation process.

Consultation with users also places an external discipline on airports to clearly set out the parameters of a project and evaluate its costs and benefits. A well-managed airport will be doing this in any event – internally for management and the board. In this case, consultation over capex should add very little cost as all of the materials and reports should already be in existence (or would have to be by the time the matter came before the board). There should therefore be little

additional cost other than management time. For an airport which is not undertaking this discipline, then an obligation to consult with users may result in additional costs being incurred but it will considerably improve the quality of the airport's decision making and evaluation process.

The benefits can be considerable. At one end of the spectrum, consultation can provide feedback which results in an unneeded project not proceeding (as occurred with a proposal in 2008 by Auckland Airport to construct additional arrivals processing space upstairs prior to the Rugby World Cup). It is much better for an airport to have the knowledge that the project is not considered necessary by its users (or at least not at the present time) prior to spending millions of dollars. At the other end of the spectrum the airport can learn that the project is wholly supported and its design hits the mark operationally, which gives it confidence to proceed with the investment. Most commonly in BARNZ's experience, the consultation results in a modification of the design to better reflect aeronautical needs and processing requirements. The airport obtains the benefit of airline expertise in aircraft operational requirements and passenger processing needs at no direct cost to it, other than the investment of its own management time in conducting a consultation process.

However, the current threshold for consultation on capital expenditure is set significantly too high, currently amounting to $225m at AIAL (and potentially about to become significantly higher depending upon the decisions the airport has made regarding revaluing its aeronautical land which are due to be disclosed on 30 November 2014) and $97m at CIAL and $78m at WIAL. The MOT is consulting over amending the threshold. BARNZ supports a considerably lower threshold, with the preference of our members being a threshold of $30m applying to the three major airports, a threshold previously agreed as appropriate between BARNZ and the NZ Airports Association.

Do you see any issues in the interaction between the Commerce Act and the Airport Authorities Act for regulation of price setting at major international airports?

The primary issue of concern to BARNZ members with respect to the interaction between the two acts is the continued presence of the statutory right airports have to set charges as they think fit contained in s4A of the Airport Authorities Act which means airports are free to disregard the pricing and input methodologies set by the Commerce Commission under Part 4 as they set charges, and which removes any incentive on airports to seek commercially agreed terms with airlines as there is no need to establish an agreed contract.