CROSS SUBMISSION ON PROBLEM DEFINITION SUBMISSIONS

5 September 2015

This cross submission responds to the submissions by Auckland, Wellington and Christchurch Airports as well as the submission by the NZ Airports Association.

Airports avoiding consideration of solutions

At the outset BARNZ notes that the airports appear to be adopting a strategy of avoiding engaging in discussing possible solutions as invited to by the Commission at the commencement of its discussion of the airport topic. Instead, the airport submissions encourage the Commission to re-examine the problems exposed through the s56G reviews and spend more timing defining those problems, and examining the principles and policies underpinning the original input methodologies.

The Commission indicated that it was of the view that it had *'a good problem definition, some possible solutions for the issues and a view that final solutions can be accommodated through changes to either the IMs or information disclosure determinations.'* It therefore invited submissions to focus *'on the completeness of the issues identified and discussion of possible solutions.'*

The s56G processes undertaken by the Commission were extremely thorough, and have highlighted many issues that only emerged as a result of the practical application of the IM and ID regimes. BARNZ does not consider that there would be a significant benefit from engaging in a further process re-examining the underlying principles of the existing IMs as sought by NZ Airports or a process of re-identification and re-statement of problems. That would absorb time and resources which could otherwise be put to use in developing solutions and improvements.

The processes already undertaken in relation to airports mean that all parties should be well positioned to constructively put forward and discuss potential solutions to the issues which have arisen whether these solutions are implemented through amendments to the IMs, or through amendments to ID requirements.

Contextual analysis vs amendments to the IMs or ID

The airport submissions all place a significant amount of emphasis and reliance on the Commission undertaking what is described as future "contextual analysis". The airports argue that this "contextual analysis" provides the appropriate solution to any problems with the current IMs and ID regime, rather than amendments to provide greater clarity or requiring additional information to be disclosed.

While the Commission's monitoring and analysis role under s53B is an important component in the overall ID regime, in the five years during which the regime has been in place, it is not a component which interested persons have seen in action to date. Rather, the review and analysis work occurred under s56G, which has a different statutory purpose of assessing the extent to which the purpose of s52A was being promoted.[1] The s53B analysis and monitoring is therefore not, as yet, a visible, regular or reliable feature of the regulatory environment. Whether it can fulfil the purpose the airports are purporting to assign to it is completely unknown.

However, from a practical sense, the Commission's monitoring and analysis role is significantly constrained by its budget for regulating airport services created by the levies set in relation to those services – levies which the airports successfully lobbied to have significantly reduced when they were last reset. BARNZ understands that this limited budget for airport regulation was a factor in the Commission electing to defer consideration of the appropriate WACC percentile for airports. We have also noticed that, as well as s53B analysis not yet being undertaken for any of the annual disclosures, the Commission has also not progressed its draft summary spread-sheets for regulated airports. All of this points to the budget for regulating airport services being significantly below the level required to enable thorough reviews to be undertaken under s53B, and to airports having a vehicle through which they can attempt to constrain the practical ability of the Commission to undertake such "contextual analysis".

In any event, leaving the ID requirements and the IMs so unspecific that "contextual analysis" is required in order to provide interested persons with the ability to assess whether the purpose of Part 4 is being achieved, hardly seems to meet either the purpose of IMs as specified in s52R of promoting certainty, or the purpose of ID of providing interested persons with sufficient information to assess whether the purpose of Part 4 is being achieved.

In BARNZ's view, where experience has demonstrated that the current IM or ID requirements are not meeting their statutory purpose, and amendments could help improve the ability of the relevant IM or ID requirement to promote the statutory purpose, then those amendments need to occur. Reliance on "contextual analysis" hardly seems to assist in providing certainty or a regular source of information for interested persons.

How is the long term benefit of consumers measured?

A recurring theme in the airport submissions is that the long term benefit of consumers in the context of regulated airport services is achieved through enabling or incentivising airport investment which facilitates the entry of new operators of airline services as well as market growth of airline services, thereby reducing the cost of travel to the public and providing more travel choices around destinations or levels of service as a result of increased competition between airlines.

This argument of the airports effectively mixes markets. It suggests one group of regulated suppliers should be permitted to earn excess returns so as to increase competition within a down-stream group of unregulated suppliers to the benefit of the consumers in that second market.

[1] Commerce Commission s56G review of Auckland Airport Price Setting, 31 July 2013, para 2.17.

The airports are asking the Commission to ignore, offset or allow the extraction of excessive returns by regulated airports from consumers in the market for regulated airport services due to potential benefits to consumers in the (competitive and unregulated) market for domestic and international regular scheduled air transport services – which is a different market. Effectively the airports are saying that they should be allowed to earn above normal returns (or should be less limited in their ability to extract excessive profits) because of potentially lower prices paid by consumers of air services as a result of increased competition among airlines.

Section 52A specifically refers to the purpose of Part 4 being to 'promote the long term benefit of consumers in markets referred to in section 52'. Section 52 refers to markets in which there is little or no competition which are regulated under Part 4. In this case, that regulated market is the airport services market. As such, it is the impacts on consumers of regulated airport services which the Commission must consider as it undertakes its responsibilities under Part 4, not any subsequent benefit to consumers in downstream markets for domestic and international regular scheduled air transport services.

Treatment of unforecast revaluations as income

At the problem definition forum and in its subsequent submission, BARNZ proposed that one solution to the problem of how to align the timing of the treatment of income from unforecast revaluations with the disclosure period when the unforecast revaluation affects the charges paid by consumers, would be to provide that revaluations of land under Schedule A can only enter the RAB on the first day of a new pricing period.

We are pleased to see that Christchurch Airport in its submission agreed that the timing set out in the IMs for the consequences of revaluation gains to be reported for disclosure purposes should be addressed, so that the revaluation gain or loss is booked in the relevant pricing period about to begin, not the one that has just ended.

Treatment of leased assets

Wellington Airport has opposed any changes to the ID requirements for leased assets, noting that such assets form part of the regulated asset base and are consequently included in the Part 4 regime.

BARNZ acknowledges that leased assets form part of the definition of regulated airport services, and therefore need to be disclosed within the IMs. However, the difficulty which we have experienced over the past five years (and indeed under the old AAA disclosures too) is that there is a disconnection between the pricing asset base, on which prices are consulted and set under the AAA and disclosed soon after the price setting event, and the regulatory asset base as a whole. The former is only a sub-set of the latter, therefore it is impossible to determine the return being achieved on the pricing asset base when the revenues and costs are not subsequently separately disclosed. This means one cannot (from the disclosed information) accurately compare the revenues

targeted from the pricing asset base with the returns actually earned on that base. That is what matters.

BARNZ is not seeking for leased assets to be removed from the disclosures or the Part 4 regime. Rather, like assets held for future use, we suggest that they be separately disclosed in a stand-alone table within the annual disclosure requirements. That would enable interested persons to be able to compare the actual performance of the airport achieved annually from the prices it set using its AAA price setting powers, in relation to the pricing asset base. The actual performance can then be compared with the returns the airport was targeting on its pricing asset base when it set its charges.

The airports tend to separate out the pricing and leased assets and targeted returns in their price setting disclosures, but this does not occur to the same degree in the annual disclosures. The non-separation of the leased assets and returns in the annual disclosures therefore prevents any accurate comparison of the actual performance in relation to the pricing asset base against the forecasts made when prices were initially set.

Whether a point estimate is needed for the WACC?

The airport submissions refer to s53F (which provides that regulated suppliers only subject to ID regulation do not have to apply the cost of capital IM) and argue that an additional point estimate within the WACC range is not required, with the currently published range from the 25th percentile to the 75th percentile providing sufficient information for interested persons to form their own views of the reasonableness of the returns being targeted by each of the airports.

As BARNZ noted in its submission on the problem definition paper, the current range is sufficiently wide that it is difficult for interested persons to make any accurate assessment about the reasonableness of the returns being targeted by the airports. Knowledge of the appropriate point within that range at which the Commission considers the competing interests in s52A are balanced (that is, where regulated airports are provided with a sufficient return to incentivise investment while, at the same time, the ability of the airports to extract excessive profits is limited) is an important piece of information for interested persons to have to assess the reasonableness of the returns being targeted by the airports.

Moreover, BARNZ disagrees with the assertion by the airports that an additional percentile estimate would lead to a "bright line" and effectively amount to de facto price control. The work undertaken to date by the Commission has clearly shown that the Commission sees the entire range as being acceptable, despite the fact the Commission had previously indicated the mid-point estimate of the WACC was the starting position for assessing profitability. Hence, if anything, the published range is a bright range, as opposed to a bright line, with the Commission currently moving to the upper end of that range as it considers the reasonableness of the returns being targeted by the airports.

Is the dual till relevant to determining regulated WACC?

The airports submit that the dual till is irrelevant when considering the regulated WACC because returns from the retail and car-parking activities undertaken by airports are not regulated, and therefore fall outside of the services which are regulated under Part 4. The airports assert that taking into account the returns able to be earned from the complementary unregulated revenue streams would amount to regulating the unregulated business as, first, it would mean that profits from the unregulated business would effectively be being used to top up any shortfalls in the returns to the regulated business and, secondly, it would be causing the unregulated business to bear the risk that the regulatory WACC had been under-estimated.

This is to mis-state how the presence of the dual till affects the appropriate WACC percentile. There is no suggestion of deliberately under-estimating the regulatory WACC and using the unregulated business to top this up. There is also no suggestion of transferring the risk of mis-estimation onto the unregulated business. The WACC for the regulated business should be determined in an unbiased manner so as to obtain the best estimate of a normal return on that business. The High Court held this was the approach previously undertaken by the Commission, and BARNZ is not suggesting any change. It is just that, given the line between the tills in New Zealand, the mid-point is sufficient to incentivise investment in the airports.

Rather, the question is whether it is necessary (or in the long term benefit of consumers of regulated airport services) for airports to target a return above the mid-point estimate of a normal return in order to be incentivised to innovate and invest.

In BARNZ's view, the presence of the ability for airports to earn additional revenue from the provision of these complementary services already provides additional incentive to airports to invest in maintaining or adding aeronautical capacity. It is not necessary for airports to set charges above the mid-point estimate of a normal return in order to be incentivised to innovate and invest.

The airports are able to use some of the same assets with which regulated services are provided to also provide unregulated services and earn additional returns. This makes those unregulated returns directly relevant when determining whether an uplift above the best estimate of a normal return for the regulated activities is necessary to incentivise investment in those regulated activities.[2]

This is not to top-up the return to the regulated business or transfer risk from one business to the other as suggested by the airports. It is simply to acknowledge that there is no benefit to consumers of regulated airport services in the form of an increased incentive to invest from determining an above-normal return as acceptable in the case of regulated airports, as those airports already possess an additional incentive to invest in the form of those complementary revenue streams.

UK case study not relevant to effect of WACC on investment incentives

NZ Airports commissioned a report referred to as the Bush/Earwaker report, which devoted a considerable amount of time to a case study of delayed investment in London airport facilities,

[2] The relevance of benefits gained from unregulated activities that flow from the regulated business to the investment decisions by regulated firms, and hence the question the degree to which an allowed margin above the estimate of the mid-point is necessary was specifically raised by Professor Lally at page 13 of his 19 June 2014 paper for the Commission entitled 'The Appropriate Percentile for the WACC Estimate'.

specifically in relation to the construction of Terminal 5 at Heathrow and the (still ongoing) decision of where to construct an additional runway. As acknowledged in the body of the Bush/Earwaker report itself, the delay in commencement of these two projects was not attributable to an under-estimation of the allowable WACC or lack of an uplift to the WACC. Rather these projects were directly delayed (and are still being delayed) by the convoluted local and central government planning rules and regulatory environment applying for those airports. The outcome was one of significant delay to the commencement of these projects with undeniably extreme congestion outcomes. However, congestion of the level outlined in the Bush/Earwaker report does not arise over-night, or even within a five year pricing period. It is the product of decades of regulatory and local government planning strangulation.

Can airline consultation effectively prevent under-investment?

NZ Airports has alleged that far from guarding against under-investment, airlines actually have a strong incentive to lobby against additional investment, and have in 'numerous cases' sought to delay or prevent investment from occurring.

This allegation of airlines engaging in anti-competitive behaviour in order to keep facilities at a constrained level and exclude new entrants from the market is a theme which the airports have repeated in a number of their previous submissions.

BARNZ strongly refutes it. In our experience, when a project is justified, current airlines operating into the New Zealand airports support it and are willing to pay the resulting charges. Congestion or capacity constraints do not just affect new entrants. They also prevent current operators from adding new services, upgauging or increasing frequencies. Moreover, even if an existing airline was not planning to increase capacity or services, congestion or capacity constraints would have negative operational impacts on all existing carriers, resulting in increased operating costs, a lower level of service or delays to on time departure.

It is in the interests of all airlines to support additional investment when it is justified. To that end, as examples, BARNZ can cite existing carriers operating in New Zealand supporting the following significant developments which substantially increased the capacity at that stage of the airport process:

- the addition of an entire new baggage hall at Auckland Airport in 2005
- the construction of the entirely new immigration arrivals area at Auckland Airport in 2008
- the construction of Pier B and connector at Auckland Airport in 2009 (which airlines had lobbied the airport to build after the airport had instead intended to utilise greater levels of bussing operations)
- the construction of a new taxiway improving access of aircraft to and from Pier B, thus reducing taxing times and increasing potential utilisation of the pier
- the extension of the baggage reclaim hall and construction of two new large baggage reclaim belts currently occurring at Auckland Airport, which will increase baggage reclaim capacity by 40%.

- the imminent extension and redevelopment of the eastern portion of the terminal to create a substantially larger new outbound processing area for emigration and Avsec at Auckland Airport (which is a currently one of the key congestion points limiting the scheduling of additional outbound aircraft movements at certain peak times of the day)
- acceleration of the next stage of construction of additional contact stands on Pier B
- the construction of Christchurch Airport's new integrated terminal (with the disagreements prior to it being built centering on ensuring consultation over design rather than whether it should proceed or not)
- Many many other projects of a less significant nature which have been supported by the airlines.

If airlines had wanted to restrict airline entry and competition they could have opposed these developments. But that is simply not what happened. Airlines operating at busy New Zealand airports require sufficient facilities in order to be able to operate their services both efficiently and on time. Moreover, they also have a vested interest in ensuring sufficient capacity exists to be able to grow their own services through upgauging aircraft or increasing frequency or services. For example, recent new services or upgauging by existing carriers already serving NZ airports has occurred or been announced over the last twelve months by Air NZ, Qantas, Jetstar, China Southern, Singapore Air, Fiji Airways, Cathay Pacific and Korean Air.

This allegation of airlines engaging in anti-competitive behaviour in order to keep facilities at a constrained level and prevent new entrants to the market is simply not true. When airlines oppose a development, or the timing of a development, it is because there is a genuine view it is either not necessary, or is too early.