COMMERCE COMMISSION
NEW ZEALAND
Te Komihana Tauhokohoko

Problem Definition—Airports

Review of input methodologies

30 July 2015

John McLaren

Purpose of afternoon session

To assist airport stakeholders responding to the Commission's *Invitation to contribute to problem definition*

- Publication date: 16 June 2015
- Submissions due: 21 August 2015

Agenda

Before break

- Regulatory framework and recent learnings
- Stakeholder statements—Key issues with input methodologies
- Profitability assessments—The Challenge

After break

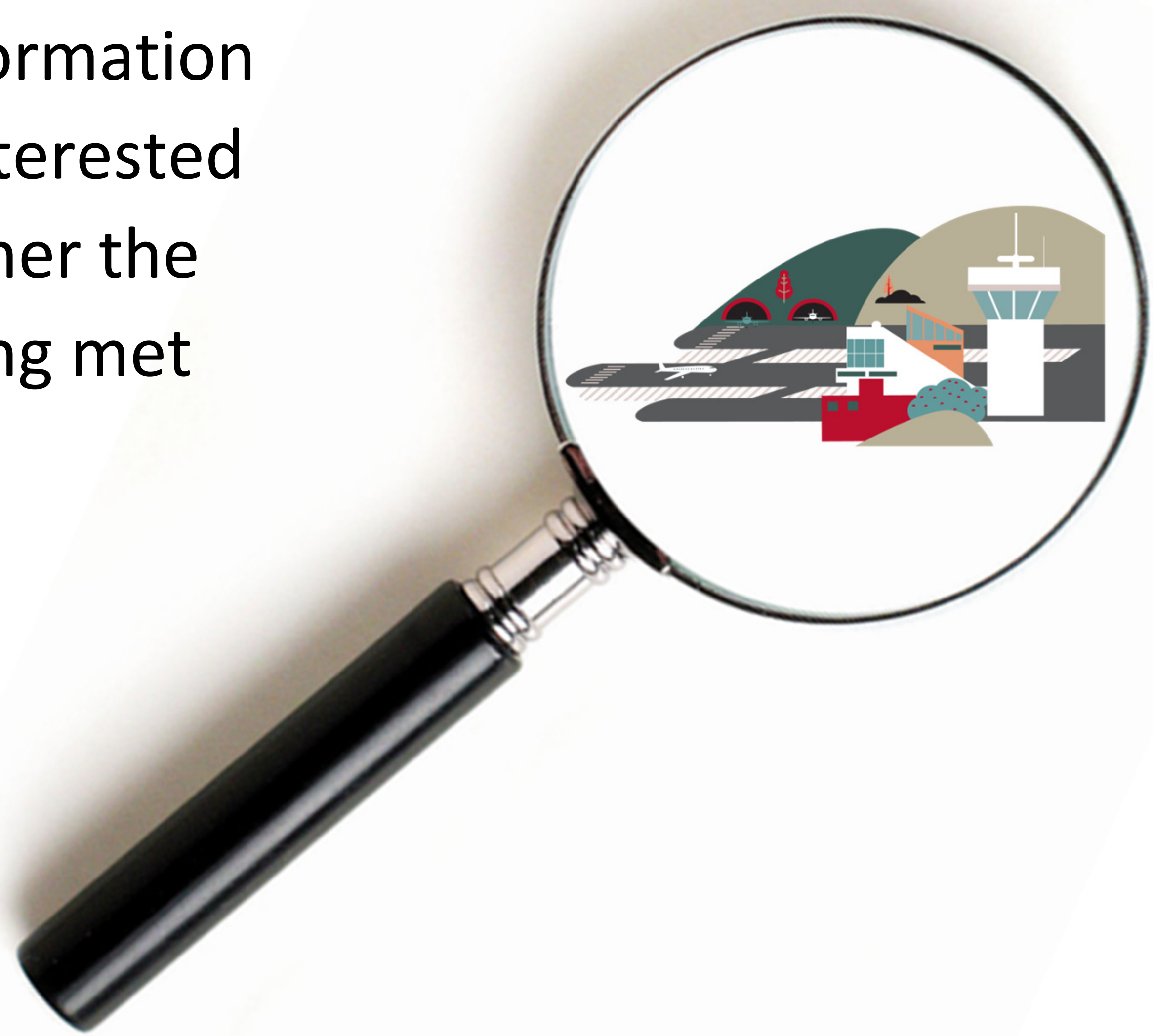
- 'Deep dives' into individual issues
- Stakeholder presentations
- Round table discussion

Setting the scene

Overview of regulatory framework and learnings from recent regulatory processes

Purpose of information disclosure

To ensure sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met



Airport fee system slack, say airlines

DAVE BURGESS

PASSENGERS will be better off, at least in the short term, after Wellington Airport set new prices for airlines to use its terminal and runway.

But a group representing airlines operating in New Zealand has called for a stricter regime to make air travel even cheaper.

The new charges at Wellington Airport announced yesterday will reduce by 7 per cent for the 10 months ending March 31, then gradually increase.

Charges passed on by airlines to passengers would drop on average by about $1, then slowly rise so that by April 1, 2018, they would be about $2 higher.

The introduction of the new charges coincides with the airport's $112 million terminal expansion, set to start soon.

Airport chief executive Steve Sanderson said the new prices had been set in "collaborative consultation" with Air New Zealand, Jetstar, Qantas and Virgin.

He said the airport's targeted return for the five-year period would remain within the acceptable regulatory benchmark, and the process used by the airport to set new prices was consistent with Commerce Commission guidelines.

Last year the airport released its 2013 performance results to the commission and its return on aeronautical assets was 6.23 per cent, well under the regulatory benchmark of 8 per cent.

Board of Airlines Representatives New Zealand executive director John Beckett said the reduction in charges came after the Commerce Commission reviewed the airport's aeronautical charges set in 2012.

"The commission found they would have provided an excessive return, so the airport undertook a new consultation process.

"We are pleased about that. Prices are going to be about 16 per cent lower than they would have been under the previous setting."

He said it was regrettable the review was "only a one-off" under a transitional provision in the Commerce Act.

"An improved regime is the key to getting lower travelling costs for the long-term benefit of the travelling public."

Beckett said a regime called Negotiate/Arbitrate was already in the Commerce Act but did not cover airports.

If it were "switched on" it would require the airport to negotiate with the airlines. If that were unsuccessful, it would go before a Commerce Commission-appointed arbitrator.

Air New Zealand group general manager airports John Whittaker supported the call for a new regime.

"The airline ... remains concerned that the current regulatory regime does not adequately and efficiently ensure that excessive charges, like those originally planned for Wellington, are avoided."

Sanderson said that in September, the airport would start on the extension to the main terminal. It would add 5200 square metres of space, double the width of both southern piers and remove the large air-conditioning units that occupy a significant footprint in the main terminal.

"We are also going to improve the domestic lounges at the northern end of the terminal, along with introducing washroom facilities at the gates."

Airport price cuts hailed

Airlines have welcomed Wellington Airport's planned cut in charges. The decision follows a Commerce Commission review. Board of Airlines Representatives NZ executive director John Beckett said it was regrettable the review was only a one-off under a transitional provision in the Commerce Act. He said airlines had been asking the Government for a broader review of laws covering airport pricing "for some time".

Reduced Wellington Airport charges welcome

Air New Zealand welcomes Wellington International Airport's decision to reduce landing fees following a Commerce Commission report concluding previously set charges were excessive.

Air New Zealand Group General Manager Airports John Whittaker says: "The airline is pleased that Wellington Airport has reduced its pricing but remains concerned that the current regulatory regime does not adequately and efficiently ensure that excessive charges like those originally planned for Wellington are avoided."

The airline supports the call by the Board of Airline Representatives New Zealand (BARNZ) for a review by the Government of the current light-handed regulatory regime on major airport pricing.

"These changes follow a one-off review process by the Commerce Commission that will not occur again under the current legislation. It is also of great concern that this outcome has taken well over two years.

"Fair airport pricing is a key factor in ensuring the travelling public enjoys the lowest possible airfares," Mr Whittaker says.

Airport fee hike slashed, but critics still remain wary

Dave Burgess

Passengers will be better off, at least in the short term, after Wellington Airport set new prices for airlines to use its terminal and runway.

But a group representing airlines operating in New Zealand has called for a stricter regime to make air travel even cheaper.

The new charges at Wellington Airport announced yesterday will reduce by 7 per cent for the 10 months ending March 31 next year, and then gradually increase.

Charges passed on by airlines to passengers would drop on average by about $1, then slowly rise so that by 1 April 2018 they would be about $2 higher.

The introduction of the new charges coincides with the airport's $112 million terminal expansion set to start shortly.

Airport chief executive Steve Sanderson said the new prices had been set in "collaborative consultation" with Air New Zealand, Jetstar, Qantas and Virgin.

He said the airport's targeted return for the five-year period would remain within the acceptable regulatory benchmark, and the process used by the airport to set new prices was consistent with Commerce Commission guidelines.

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"The commission found they would have provided an excessive return, so the airport undertook a new consultation process. We are pleased about that. Prices are going to be about 16 per cent lower than they would have been under the previous setting."

He said it was regrettable the review was "only a one-off" under a transitional provision in the Commerce Act.

"An improved regime is the key to getting lower travelling costs for the long-term benefit of the travelling public."

Beckett said a regime called Negotiate/Arbitrate was already in the Commerce Act but did not cover airports. If it was "switched on" it would require the airport to negotiate with the airlines. If that was unsuccessful then it would go before a Commerce Commission-appointed arbitrator.

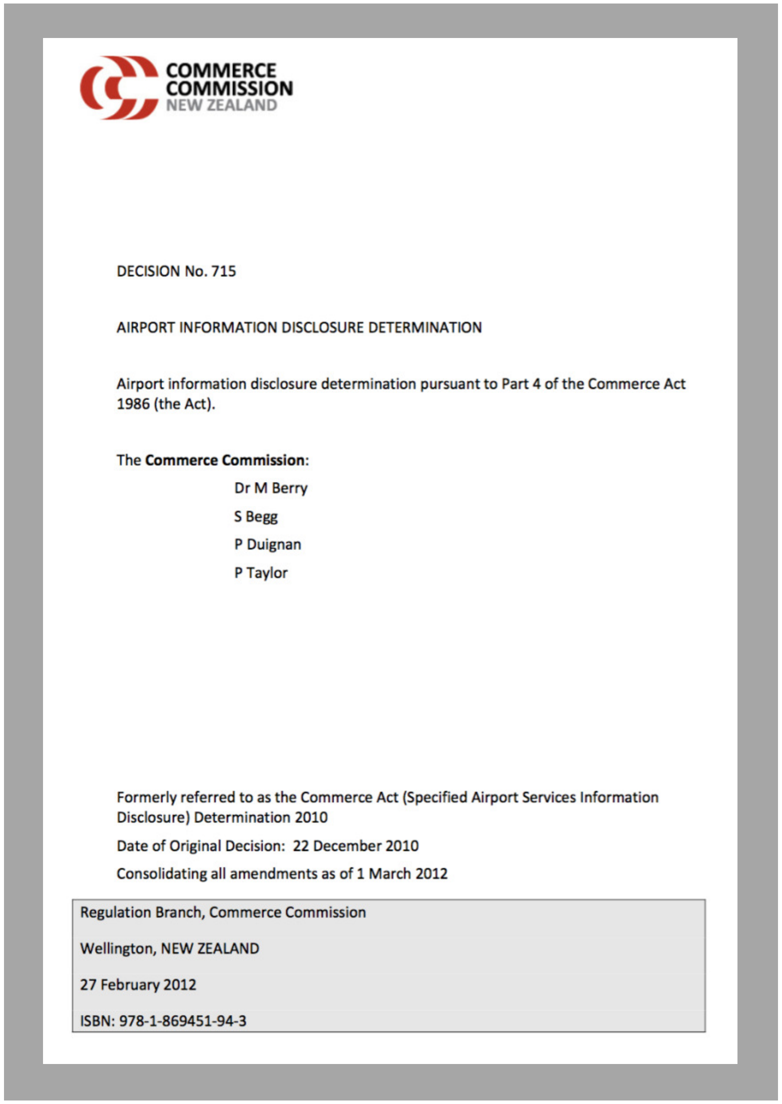
"The legislation is set up. All we are looking for is the government to press the switch so it does apply to the airports."

Air New Zealand Group General Manager Airports John Whittaker supported the call for a new regime.

"The airline is concerned that the regulatory regime does not adequately ensure that excessive chargesare avoided." Fairfax NZ


Investment
Innovation
Pricing
Airport Performance
Quality
Efficiency
Profitability

Disclosure requirements



COMMERCE COMMISSION NEW ZEALAND

DECISION No. 715

AIRPORT INFORMATION DISCLOSURE DETERMINATION

Airport information disclosure determination pursuant to Part 4 of the Commerce Act 1986 (the Act).

The **Commerce Commission**:

Dr M Berry
S Begg
P Duignan
P Taylor

Formerly referred to as the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010

Date of Original Decision: 22 December 2010

Consolidating all amendments as of 1 March 2012

Regulation Branch, Commerce Commission

Wellington, NEW ZEALAND

27 February 2012

ISBN: 978-1-869451-94-3

Cover all areas of performance

- Input methodologies affect how costs must be disclosed and assessed
  - Asset valuation
  - Cost allocation
  - Treatment of taxation
  - Cost of capital
- DO include a **backward** looking profitability indicator for individual years
- DO NOT include a **forward** looking profitability indicator for pricing periods

Learnings from recent events

- Timeline
- Lessons learned
- Problem definition
- Secondary issues

Contributions invited

Timeline

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2012 – 2014

- Statutory requirement (under s 56G of the Commerce Act) to report to the Ministers of Commerce and Transport on whether information disclosure was effective
- Reports published as soon as practicable after prices set in 2012

2014 – 2015

- Commission analysis (under s 53B) of Airport response to s 56G reports
- MBIE review of effectiveness of information disclosure regulation
- MoT review of Airport Authorities Act

2015 – 2016

- Review of input methodologies
- Expected completion—December 2016

2017 – 2018

- Price Setting Events for Auckland and Christchurch Airports (2017 Q2)
- Commission review of Airport pricing decisions under s 53B

Lessons learned

An assessment of target profitability is required to determine whether airports are limited in their ability to earn excessive profits

Internal Rate of Return (IRR) analysis requires information about:

- Forecast cash flows
- Opening asset values
- Forecast closing asset values

Problem definition

Current state—Two main issues

- No forward-looking profitability indicator to help interested persons assess whether airports are targeting excessive profits when setting prices
- Backward-looking profitability indicator for individual years has proven ineffective when airports use alternative approaches

Secondary issues

As outlined in the invitation paper…

- Land valuations
- Leased assets
- Depreciation profiles
- Revaluation approach
- Implications of airports using different approaches in setting prices
- Land held for future use
- Wash-ups
- Unforecast revaluations
- Discounting
- Intra-period cash flow timing assumptions

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Stakeholder Statements

Review of input methodologies

30 July 2015

Airports, airlines, and industry representatives

Input methodologies—Key issues

Focus for rest of today

To explore stakeholder views on improvements to profitability assessments through changes to:

- input methodologies
- disclosure requirements
- additional guidance

Scope

OUT

- WACC (specification, parameters, percentile, etc)
- Land valuation methodology (MVAU)
- Disclosure requirements unrelated to input methodologies
- Single till vs. dual till

IN

- Almost everything else related to profitability assessments
- eg, treatment of land revaluations

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Profitability Assessment—The Challenge

Review of input methodologies

30 July 2015

Hamish Groves

Overview

- Airport context
- Assessing target profitability
- Stylised examples
    - Three potential approaches
    - Forward and backward looking profitability assessment

Airport Context

- Airports can set prices as they see fit
- Information disclosure requirements – sufficient information to interested persons to assess performance
- Summary and analysis requirement

Assessing target profitability

- Target profitability determined at price setting event
- Part 4 purpose including - airports are limited in their ability to extract excessive profits
- Being clear on how profitability will be assessed is important
- Understand how prices have been set relative to profitability assessment
- Stakeholder views on forward looking profitability assessment problem

Stylised Examples

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The purpose of this session:

- Outline issues through stylised examples
- Propose potential approaches to solving the stylised issues - may also be relevant for other issues
- Approaches can be applied to forward or backward looking profitability assessments
- Seek feedback

Stylised example

	Airport Pricing Assumptions	Profitability Assessment Assumptions	Difference (Revenue effect)
Opening asset values	100	100	-
Depreciation	10%	10%	-
Revaluations	5%	5%	-
Closing asset values	95	95	-
Expenses	50	50	-
Revenue	63	63	-
Target return/ assessed return	8%	8%	-
Assessed under or over recovery		$-	

Complexity

- Airports have and may continue to adopt approaches that are not consistent with the current profitability assessment when setting prices
- Examples with potential approaches
  - Non-standard depreciation
  - Amendment of profitability assessment
  - Disclosed difference

Revaluation Assumption

	Airport Pricing Assumptions	Profitability Assessment Assumptions	Difference (Revenue effect)
Opening asset base	100	100	-
Depreciation	10%	10%	-
Revaluations	**-**	5%	**5% ($5)**
Closing asset base	**90**	95	**5 (nil)**
Expenses	50	50	-
Revenue	**68**	**68**	-
Target return/ assessed return	8%	**13%**	**5% ($5)**
Assessed over recovery		**$5**	

Potential Approach – Non-standard depreciation

	Airport Pricing Assumptions	Profitability Assessment Assumptions	Difference (Revenue effect)
Opening asset base	100	100	-
Depreciation	**15%**	**15%**	-
Revaluations	**5%**	5%	-
Closing asset base	90	90	-
Expenses	50	50	-
Revenue	**68**	**68**	-
Target return/ assessed return	8%	**8%**	-
Assessed over or under recovery		**$-**	

Potential Approach – Amend profitability assessment

	Airport Pricing Assumptions	Profitability Assessment Assumptions	Difference (Revenue effect)
Opening asset base	100	100	-
Depreciation	10%	10%	-
Revaluations	-	-	-
Closing asset base	90	90	-
Expenses	50	50	-
Revenue	68	68	-
Target return/ assessed return	8%	8%	-
Assessed under or over recovery		$-	

Potential Approach – Disclosed difference

	Airport Pricing Assumptions	Profitability Assessment Assumptions	Difference (Revenue effect)
Opening asset base	100	100	-
Depreciation	10%	10%	-
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Closing asset base	**90**	95	**5 (nil)**
Expenses	50	50	-
Revenue	**68** →	**68**	-
Target return/ assessed return	8%	**13%**	**5% ($5)**
Assessed over recovery		**$5**	

Tracking under or over recovery

- Pricing and profitability assessment assumptions may not always align
- Over or under recovery relative to profitability assessment may be assessed as appropriate
- How should over or under recovery in one period be taken into account in another period?

Summary of Potential Approaches

1. Non-standard depreciation
   - Option currently available
   - Not applicable in all scenarios
2. Profitability assessment reflects pricing decision
   - Consideration of implications required
   - Required to be enduring
3. Disclosed difference
   - Clarity of difference and reason
   - Tracking under or over recoveries

Break

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