NZ AIRPORTS

PROPOSED SCOPE, TIMING AND FOCUS FOR THE REVIEW OF INPUT METHODOLOGIES, AND FURTHER WORK ON THE COST OF CAPITAL INPUT METHODOLOGY FOR AIRPORTS

20 MARCH 2015

1. The NZ Airports Association ("**NZ Airports**") makes this submission in response to the Commerce Commission's open letter on its proposed scope, timing and focus for the review of the input methodologies ("**IM Review**"), as well as its proposal to consider the WACC percentile for airports as part of the IM Review. The affected airports - Auckland International Airport, Christchurch International Airport and Wellington International Airport - have been involved in the preparation of this submission.

2. The NZ Airports contact for matters regarding this submission is:

Kevin Ward
Chief Executive
PO Box 11 369
Manners Street
Wellington 6011
DDI: (04) 384 3127
Mobile: 021 384 524

Email: Kevin.ward@nzairports.co.nz

Executive summary

3. NZ Airports recognises the IM Review as an important opportunity to consider and consolidate the information disclosure ("**ID**") regime for airports.

4. We consider the IM Review should seek to support the significant progress that has been made so far to establish an effective ID regime. In the interests of regulatory stability and predictability, we wish to constructively work with the regime in its current form. In our view, the best way to do so is by seeking to refine the foundations of the regime only where there is clear evidence that a change will deliver a materially better ID regime.

5. Although our material concerns with the IMs are well documented, we accept that they are now established as the key rules to promote disclosure of consistent and readily understandable information by the regulated airports.

6. Accordingly, our approach is that the IM Review should focus on considering whether any refinements to IMs can:

   (a) assist with building a more robust understanding of the nature of the airport sector, the way that decisions are made, and the outcomes and trends over time;

   (b) facilitate more transparent explanations of airport decisions and performance to the Commission, airline customers, and other interested parties; and

(c) remove any unnecessary complexity, surplus or irrelevant disclosure, or correct errors in the regime.

7. In this context, we are aware that an issue identified during the section 56G review process was that it can sometimes be difficult to assess aspects of airport performance when approaches used in pricing are different to the disclosure approach anticipated by the IMs. Conversely, from NZ Airports' perspective, there are some prescriptive IMs (such as land held for future use) that are causing challenges in practice. However, we anticipate that the answers to these types of issues lie in the ID requirements and continuing to build a more solid understanding of how airport performance (including departures from the IMs) will be assessed, and not in seeking to introduce greater prescription or complexity into the IMs.

8. NZ Airports makes the following key points in response to the Commission's open letter on its IM Review process:

(a) We agree that it is appropriate to incorporate the review of the WACC percentile into the full IM Review. However, we remain concerned about where the Commission's review of the WACC IM is heading, and the timing of the review does not alter these concerns.

(b) At a practical level, in this instance, we are comfortable with the Commission's proposed timetable for the review of the IMs. Having said this, we are concerned that the Commission's approach appears to be that it should consider changes to IMs before each major regulatory milestone (eg price path resets). This will (over time) convert a statutory seven-year review timeframe into a five-year review timeframe, and is likely to have adverse implications for regulatory stability and predictability.

(c) In terms of the appropriate scope of the Commission's review, although each IM must be reviewed, we do not believe this requires the Commission to undertake a line-by-line detailed analysis of each IM. We consider the Commission will meet its statutory duty where it turns its mind to each IM as a whole, and (in consultation with interested parties) confirms that the IM is appropriate for the particular regulatory mechanism or, if required, identifies topics for particular focus. For some (perhaps the majority) of IMs in the airport sector, we would anticipate this process will be relatively straightforward.

(d) Where more detailed changes are proposed by the Commission or interested parties, we consider the role of IMs needs to be considered in the context of the regulatory mechanism (ID or price control) to determine whether changes are consistent with good regulatory outcomes, including the interest of all parties in a stable and predictable regulatory regime.

(e) In the airport context, ongoing changes to the IMs - particularly prescriptive and detailed changes - are unlikely to be helpful. We encourage the Commission to be careful not to adopt a stance of seeking the "perfect IM" through pursuing incremental changes during each IM review. This progressive “tinkering” is likely to be very detrimental to incentives to invest, because investors are likely to form the view that the detail of the IMs will change constantly and unpredictably over the 50 year life of infrastructure investments. As noted above, we think robust discussion and understanding of airport performance is the best way to promote good outcomes for the sector.

(f) Accordingly, we have some concerns that the need to try to reach a precise "answer" for price control purposes in other sectors will result in changes to the IMs for the airport sector. If changes are made to IMs in other sectors, this does not necessarily

mean changes are justified for airport information disclosure purposes. We think the key question is whether there is evidence of a material issue that needs to be addressed in light of the purpose of ID regulation and, if so, whether there is evidence that the benefits to the ID regime of making a change will outweigh the costs involved. As such, we consider it will be highly relevant and time efficient for the Commission to identify upfront whether topics for particular focus are relevant for all regulated entities or just those subject to price control - to allow the costs and benefits of potential changes to be explored at an early stage in the IM Review.

(g) Finally, we think there is scope to improve the efficiency and robustness of the IM Review process, and have suggested options to identify the key areas of potential change upfront, consider alternative ways to involve expert advisors, and to collect feedback before draft decisions are released.

Should the review of the WACC percentile be incorporated into the full IM Review?

9. We agree with the Commission's proposal to incorporate the review of the WACC range for the airport sector into the full IM Review. As we have indicated previously, the prospect of material changes to key aspects of IMs outside of the formal seven-year review process is unlikely to support the ongoing stability of the regulatory regime. The Commission's proposal will also allow it to consider the appropriate approach to the WACC range alongside the other components of the regulatory WACC for airport ID.

10. Having said that, we are concerned about where the Commission's review of the WACC range for airports might be heading. We think the WACC range should not be changed. The timing of the WACC review does not alter these concerns.

11. For the energy sector, the Commission was clear that its early review of the WACC percentile took place so that an appropriate pricing percentile could be identified in time to directly control the prices that could be charged by suppliers over the next five years. We are concerned that the corresponding airport review will seek to have the same practical effect, albeit using the language of "acceptable" rather than "allowable" returns.

12. In our view, this example reinforces the value in stepping back and first considering the role of the IMs in the context of ID regulation (as discussed further below). Before detailed submissions and expert evidence are provided about the appropriate WACC range for airports, we consider there is merit in considering the function that the WACC IM performs in the statutory scheme and the ID framework.

13. For example, what is the role of the WACC range? How is it currently used by the Commission? How should it be used? Exploring these issues up front will help the Commission to review the IM and determine whether changes would promote the purpose of section 52A more effectively or more effectively meet the purpose of ID regulation.

14. If, once those issues have been discussed and settled, the Commission considers that there is still merit in considering changes, targeted submissions and expert evidence can be prepared and provided at that stage.

Can the full IM Review be brought forward?

15. We do not dispute that the Commission has legal power to bring forward the IM Review. In this instance, NZ Airports is comfortable with the timeframe proposed (albeit we note that the interaction of this review with any pricing consultation processes may see resourcing stretched at affected airports). However, we caution that the Commission has a material role to play in establishing regulatory stability and predictability. Following the further work on WACC in

particular, this will not be aided by establishing an approach of considering changes to the IMs prior to each significant regulatory milestone.

16. Although we recognise that some flexibility in the regime is necessary, a key purpose of the Part 4 regulatory regime and of setting IMs is to give greater certainty, transparency and predictability to businesses. As such, the regime and the IMs are expected to be relatively stable over time.[1] We are concerned that the prospect of early IM reviews on a regular basis may interfere with this stability.

17. There has always been the prospect that changes could be made to any aspects of the IMs as part of the seven-year reviews required by the Act. However, the Commission's rationale for proposing this early review suggests that it intends to effectively turn a statutory seven-year review process into a five-year review process. This raises the genuine possibility of changes to any aspect of the IMs at more regular intervals than contemplated by the Act, which has the potential to damage the certainty and stability of the regulatory regime.

18. Of course there will be technical or mechanical errors identified in the IMs from time to time. Where a change to an IM is to fix this type of error, that correction does not need to wait until a review of the IMs (provided there is appropriate discussion with interested parties).

What is the appropriate scope of the IM Review?

19. The Act is silent on what a review must involve, what the appropriate starting point might be, and the factors the Commission should consider to assess whether or not changes may be appropriate.

20. In this context, we do not believe the review process in the Act requires the Commission do to a line-by-line detailed analysis of each IM. We consider the Commission is likely to meet its statutory duties if it turns its mind to each IM as a whole, and, informed by the views of interested parties, satisfies itself that:

    (a) the nature and content of the IM as a whole is appropriate for the type of regulation and industry in question;

    (b) the IM (including any main sub-areas) is promoting good regulatory outcomes that are in the long-term benefit of consumers;

    (c) the technical and mechanical aspects of the IM are operating well; and

    (d) the IM is sufficiently certain and does not require clarification.

21. For some IMs, we would anticipate that the above process would be relatively straightforward, and could be undertaken in a reasonably short period of time. For other IMs, there may be proposals for change put forward by interested parties that require more detailed consideration.

22. When considering any proposal for changes to the IMs or their sub-components, we generally agree that the purpose of Part 4 (section 52A), the purpose of input methodologies (section 52R), and the desire to reduce compliance and other regulatory costs are important and relevant factors for the IM Review. However, we also consider the function that an IM performs in the statutory scheme is relevant.

23. Although the "materially better" standard does not apply to the review of IMs, some aspects of the High Court's reasoning provide useful guidance for the upcoming IM Review. In particular,

[1] See eg Commerce Amendment Bill 2008 (201—1) (explanatory note) at pages 3 and 5.

the High Court considered that any proposed changes should be considered in the context of the particular IM in question and by bearing in mind the particular function that an IM performs in the statutory scheme.[2]

24. It follows that the purpose of ID regulation is also highly relevant to the Commission's IM Review. It will be important for the Commission to step back and consider the role of the IMs in promoting transparent and robust ID in the airport sector, before it considers the merits of potential changes to any of those IMs for entities regulated under ID. This step is crucial to ensure that proportionality and cost-benefit analysis are given due weight as key elements of good regulatory practice.

25. In that context, we generally agree with the Commission's view that substantial changes to the current IMs are unlikely to be desirable. For the airport sector:

    (a) The IMs have been subject to considerable scrutiny over the past several years, including through the section 56G review, where the Commission (in general) used and applied its IMs to assess information disclosed by airports and to review airport performance against the purpose of Part 4 regulation.

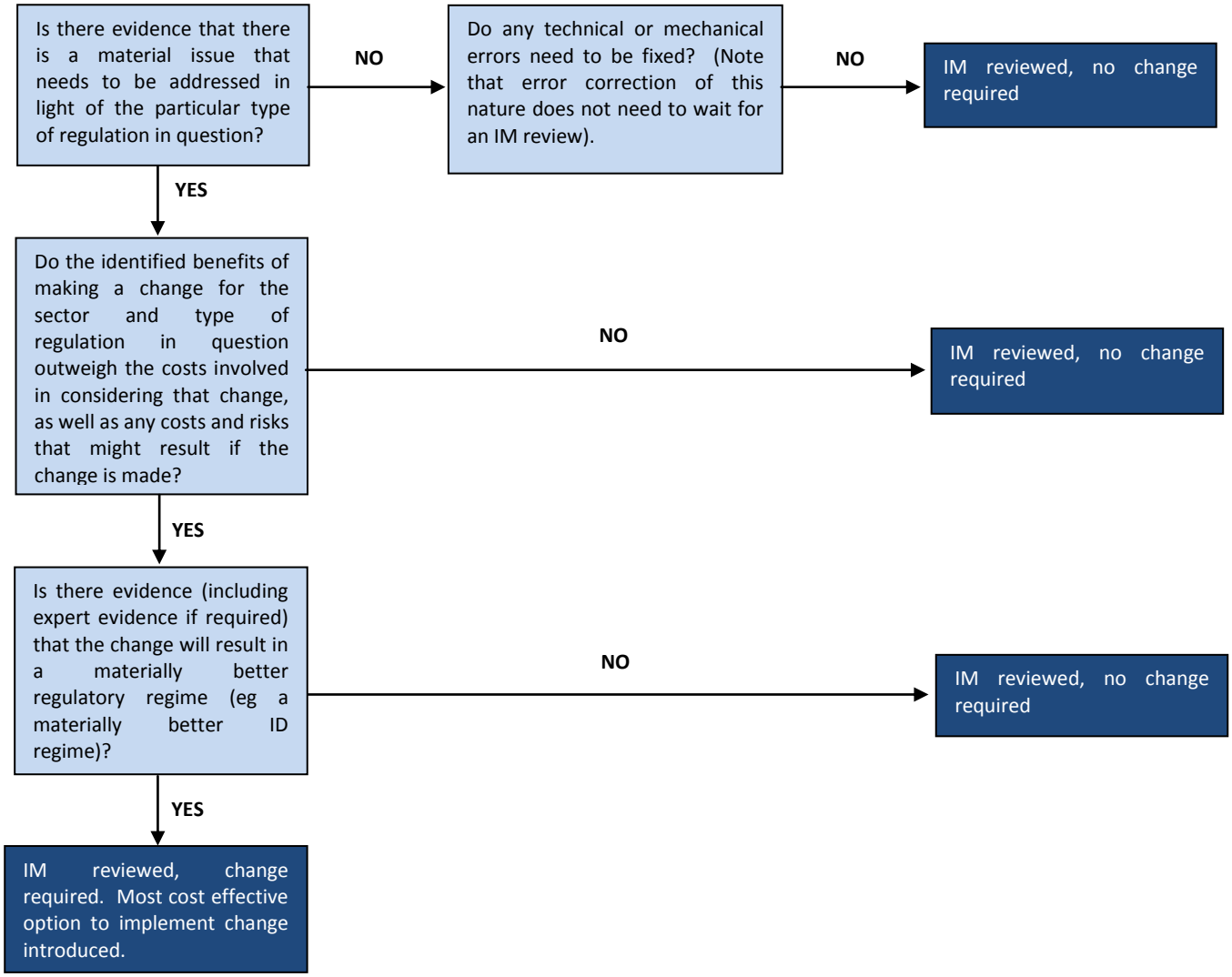
    (b) We remain of the view that aspects of the IMs should be changed to better align with economic principles and the nature of the airport sector. However, our focus now is to work with the IMs - not change them. We think it is more important to build an increased understanding of how the sector operates in practice, and to work constructively with the Commission and interested parties to ensure that performance continues to be transparent over time. Promoting sophisticated discussion between interested parties about airport performance (including by ensuring the ID requirements help that discussion take place) may help to achieve this objective. However, changes to the IMs - particularly if they involve additional prescription and complexity - are unlikely to assist.

26. We anticipate that the Commission's pan industry approach could be a hindrance in this regard (as elaborated on below). Where changes to an IM are considered in the electricity or gas sector, this does not necessarily mean that the same change, or any change at all, needs to be made in an airport ID context. The sectors are different and, in our view, the IMs do and should have a different function for each sector.

27. As such, we encourage the Commission to carefully consider whether any proposed changes need to be explored for all sectors, or just for those subject to price control. To do so, we think it will be useful for the Commission to consider, for each sector, whether there is evidence that there is a material issue with an IM that needs to be addressed in light of the type of regulation that applies for that sector, and whether the potential benefits of making a change outweigh the costs and likely risks involved (again, for the particular sector). Once those questions have been addressed, the merits of the potential changes can be considered. This process could, for example, follow the chain of questions set out in the diagram below.

[2] *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, paragraph 166.

Potential decision-making chain (to apply to each sector)



28. Asking these types of questions early in the IM Review process will provide considerable assistance in managing the workload required to respond appropriately to the Review, as well as ensuring the Review proceeds in a way that is predictable for all interested parties. For example, we would be concerned if amendments are considered and progressed in relation to an element of detail for electricity lines businesses, and then translated to the airport sector at a later stage of the IM Review process. Such a process is not predictable and will add cost for all participants in the sector.

How might the IM Review process operate most effectively?

29. All interested parties, including the Commission, have a mutual interest in ensuring the IM Review proceeds efficiently and effectively. The Commission's open letter is a positive step towards doing so, including its stated commitment to constructive dialogue and an efficient review process.

30. The Commission now has an opportunity to draw on previous experience with Part 4 consultations to ensure that the current IM Review process is as robust and streamlined as possible. Where there is potential for change to the IMs, that streamlined review process should look to quickly identify any core substantive issues, promote genuine discussion by all

interested parties about the best approach going forward, and make efficient use of expert evidence where that might be required.

31. We encourage the Commission to consider ways in which these objectives can be achieved. In our view, there is the potential to:

(a) **Follow an airport-specific process to the greatest extent possible.** The Commission notes the "desirability of taking a cross-sector approach to reviewing input methodologies". We understand (albeit have never agreed with) the Commission's desire to have consistency across IMs. In our view, that is more relevant to the fundamental economic principles that inform each IM, which are now largely established. As discussed above, and as demonstrated during the section 56G process, it is apparent that there are unique challenges in applying IMs under airport ID regulation, and that the key to addressing such issues will be to consider the IMs within the specific context of that regulation.

Accordingly, in our view, the Commission should seek to structure its process in a way that fully allows for airport IM issues to be considered separately, and that recognises changes to other sectors will not necessarily be appropriate for the airport IMs. This could include:

(i) to the extent there are issues that are common to all sectors, identifying them up front to be dealt with on a pan industry basis and explaining how changes may advance the objectives of the ID regime for airports;

(ii) considering whether any changes to the IMs for airport ID purposes are likely to produce benefits (eg increased transparency, reduction in compliance costs or surplus information) that will outweigh the costs of exploring and ultimately making those changes (including any potential risks involved); and

(iii) for any airport specific issues, committing to dealing with them separately within the broader IM Review (e.g. separate consultation papers and conferences/workshops).

(b) **Work together with interested parties to identify the key issues upfront.** As noted above, we do not consider the duty to review the IMs requires the Commission to work through each existing IM on a line-by-line basis. We think there is merit in a narrower and more focused approach where the Commission first seeks to identify the IMs that are unlikely to require substantive amendments. To the extent that any IMs may require more detailed discussion, we would encourage the early development of a list of those aspects of the IMs that are likely to be considered in more detail during the IM Review. This list could then effectively operate as a road-map for the review process. In our view, within the construct of identifying pan industry versus airport specific matters (as above) it would be useful for this list to set out responses to each of the following questions:

(i) Which IMs (or parts of IMs) may require changes?

(ii) Are changes required for all sectors? For example, is there evidence to suggest that changes for sectors subject to ID regulation only are likely to have a beneficial impact on the quality of disclosures or the ability to monitor and measure airport performance?

(iii) Is the potential outcome a technical/mechanical change, or a change to the substance of the IM?

(iv) For each of those IMs, what are the key issues?

(v) Where will the Commission seek expert input? What are the key issues that it will ask its experts to address in each area?

(c) **Seek to engage experts more constructively and efficiently.** In our experience, it is not always clear what questions the Commission has asked its expert advisors to address. Regulated suppliers and other interested parties often instruct their own expert advisors to address a different set of questions, which can result in the respective experts talking past each other in the consultation process. This effect is compounded when the Commission's expert reports are released at the same time as (or shortly before) a draft or final decision from the Commission, as was generally the case in the original IM consultation process.

For example:

(i) During the process to establish the IMs, the majority of expert reports were peer reviews of the Commission's draft or final decisions, or critiques of the submissions put forward by interested parties. This made it difficult for the respective parties to engage with the expert advice put forward by the Commission (and ultimately made it difficult for the Court when seeking to understand the evidential support behind the propositions put to it during the appeal).

(ii) During the WACC percentile consultation for the energy sector, the Commission released several expert reports in advance of releasing its draft decision, which was a more positive development. Terms of reference were also released several weeks later, which allowed interested parties to more clearly understand the issues that the Commission's expert advisors had been instructed to address. However, there was no opportunity for interested parties to provide their views on those terms of reference, nor were parties able to provide submissions or responses to these expert reports until after the draft decision was released.

We think there is a good opportunity to make small changes to the way experts are involved in the consultation process to facilitate more constructive engagement. In particular, we think it would be useful for the Commission to identify those areas where it anticipates seeking expert advice at an early stage of the process, and to invite views on the appropriate terms of reference for that expert advice. Once the terms of reference are settled, publishing these at the same time as they are provided to the Commission's experts would allow interested parties to seek their own expert input in parallel (if they wish to do so). This would also provide a clear understanding, in advance, of the issues the Commission considers to be most important, so that any expert involvement can be more targeted and relevant in scope.

There may also be scope to consider the use of an expert panel, made up of representatives appointed by the Commission, regulated suppliers, and interested parties representing intermediate and/or end consumers. This could involve the panel of experts meeting, discussing the terms of reference, and producing a combined report that sets out the key areas of agreement and disagreement between each of the experts on the core issues involved in a particular area.

(d) **Consider the best way to seek feedback prior to releasing a draft decision.** In our experience, once a draft decision has been published, any changes from that point are generally in the nature of minor tweaks to the technical aspects of the decision, with limited changes to the analytical framework or the approach to particular IMs. On the other hand, under the initial consultation on IMs, some material changes were made prior to draft decisions (eg after discussion papers and emerging view papers). This reinforces the importance of open dialogue before a draft decision is published.

We think there is scope to improve this dialogue through greater informal engagement with regulated suppliers and other interested parties before the Commission forms its draft view. By way of example, this could include the use of technical working groups within each sector to seek feedback on potential proposals for change prior to releasing a draft decision. This approach is used by some overseas regulators, which hold regular meetings with a technical working group made up of representatives from regulated suppliers and other industry experts to work up options and test proposals in light of a better understanding of stakeholder concerns.[3]

In our view, this approach could work well in the Part 4 context, where Commission staff could meet with industry experts to present an overview of the various options/proposals being considered, and to test views and concerns before a draft proposal is selected. This would also allow Commission staff to talk through proposed drafting changes to the wording of the IMs, and to identify any issues that may arise (improving understanding of the mechanics and drafting of the IMs, and minimising the need for later amendments and/or clarifications).

This process would be particularly beneficial for the airport sector. Understanding how the IMs are used by airports to prepare disclosures, airlines to assess disclosed information, and the Commission to monitor airport performance will help to promote robust discussion and understanding about the benefit, if any, of proposed changes at an early stage of the IM Review process.

[3] See, for example: Ofgem *Electricity Balancing Significant Code Review - Final Policy Decision*, 15 May 2014 (available at https://www.ofgem.gov.uk/ofgem-publications/87782/electricitybalancingsignificantcodereview-finalpolicydecision.pdf).