BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND INC

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Ruth Nichols
Senior Legal Counsel
Regulation Branch
Commerce Commission

ruth.nichols@comcom.govt.nz

Dear Ruth

Feedback on the Airports s56G review process

The Commission has sought feedback on the process it followed to satisfy the requirements of s56G of the Commerce Act 1986. BARNZ's comments are set out below. We have grouped the matters the Commission specifically requested feedback on into relevant topics.

1. FEEDBACK SOUGHT ON MATTERS OF PROCESS

- **Conferences**
  BARNZ found the conferences well organised, logically structured and of the right duration. From our perspective, the conferences provided a useful opportunity for Commissioners and staff to engage directly with interested persons and explore areas on which the Commission wanted greater understanding or information.

- **Process updates**
  These were very useful, although possibly a few days to a week too late in some instances. However, Commission staff were always willing to provide indicative timelines when we phoned or emailed in order to assist us with our internal planning.

- **Availability of staff**
  Commission staff were always readily available and promptly returned all phone-calls and responded in a timely fashion to any email queries. We felt welcome to make any procedural query we had.

- **Frequency and sufficiency of opportunity to respond on process**
  BARNZ considered that the opportunities to respond on matters of process were appropriate. There was no instance when we felt that the Commission did not consult on process when we would have liked it to. The time provided to respond on matters of process was considered appropriate.

- **Length of time to respond to documents**
  For the most part BARNZ found that the time the Commission allowed for responses to be prepared was sufficient. While we had to work hard to respond in time this was usually not unmanageable. The one exception was in relation to responding to the initial issues papers for the three airports. This entailed a significant amount of collection and compilation of evidence in relation to various questions, and liaising with airline staff and head offices – more so than when responding to other subsequent papers where we were able to refer to the information already collated. The Commission allowed additional time for this stage with the Auckland Airport review in response to a request from BARNZ due to the number of interested airlines, and this was appreciated. For future reviews such as these, we recommend the Commission allow a greater period for responding to the first substantive paper in order to enable that compilation of evidence to be completed.

2. FEEDBACK SOUGHT ON COMMISSION'S REPORTS AND ANALYSIS

- **Analytical models**
  The question and answer sessions on the analytical models were very useful. Holding these after parties had first had time to familiarise themselves with the model was appropriate. However, we would suggest that in future a date be set for these sessions in the process timetable (say a week after the release of the draft report), rather than a date being determined after the release of the draft report, as the difficulty of determining a date suitable to a large number of people meant that the sessions sometimes occurred later than ideally desirable.

- **Analyst briefings**
  From the perspective of a body representing users, the timing and format of the analyst briefings was useful. In particular, it was valuable to have the power-point summary of the Commission's key findings to be able to share with interested persons, such as airlines.

- **Clarity of documents**
  For the most part, BARNZ found the Commission's documents very clear and well written and easy to follow. They were well structured, and the concept of providing the detailed work in separate appendices organised by relevant topic or issue worked well.

  In relation to the treatment of wash-ups, of revaluations or unspent capex, the wording of the reports was a little more difficult to follow. At times it was not clear from which perspective the Commission was phrasing its conclusions, and it was therefore difficult to ascertain whether wash-ups were being included within the analysis as revenue or were being excluded from the analysis.

3. FEEDBACK SOUGHT ON APPLICABILITY OF STANDARD DISCLOSURES WHERE A DIFFERENT PRICING APPROACH WAS ADOPTED

The Commission has sought feedback on its observations that:

- The profitability analysis needed to be significantly tailored to the different airports' approaches
- There may be a limit to the effectiveness of information disclosure where airports take a pricing approach that is not explicitly contemplated by the regime

With respect to the first observation, BARNZ's reading of the reports suggests that the Commission was able to use the same underlying analysis for all three airports – albeit decisions on the appropriate inputs had to be tailored to reflect the varying approaches. For example, the Commission had to take a different approach to rolling forward the asset base and the appropriate closing asset base for each of the three airports. In our view it was the inputs, rather than the profitability analysis itself, that had to be tailored.

With respect to the second observation, BARNZ would agree that, in its current format with a highly prescriptive set of information disclosure requirements, there is a limit to the effectiveness or the ability of information disclosure to provide interested persons with sufficient information to determine whether the objective of Part 4 has been met. This is likely to continue to be the case where a standard pre-specified template approach is used, given that airports retain the ability to set prices as they see fit, and that even if regulation of airports was strengthened to bring airports under the negotiate/arbitrate regime airports would still have the flexibility to develop pricing approaches best suited to their circumstances (and that BARNZ would not want to constrain the development of innovative or fit for purpose pricing approaches). Given this, we would suggest that the information disclosure requirements should specify as an over-arching principle that *airports must ensure that sufficient information is disclosed in order to ensure interested persons are able to determine the extent to which the purpose of Part 4 has been met.*

The prescriptive information disclosure requirements reflecting the standard pricing approach would continue to apply, and would be able to be used where a standard pricing approach is adopted, but, if an airport took a pricing approach which meant that disclosure using the standard templates did not provide sufficient information, then the onus would be on the airport to provide supplementary disclosures in order to ensure that interested persons are able to assess the degree to which the purpose of Part 4 was being met.

In other words, an airport could not simply 'fill in the blanks' and treat that as compliance. Instead, there must be an active consideration of whether the standard information disclosure requirements provided sufficient information to meet the s53A purpose statement.

This principle approach to the output would also overcome the difficulty of the Commission being unable to specify information disclosure requirements to cover every possible permutation of pricing.

4. REFINEMENTS TO INFORMATION DISCLOSURE REQUIREMENTS

The Commission commented that changes to the information disclosure requirements could make disclosures more transparent and assist future analysis work. BARNZ agrees that it is always important to be refining disclosure requirements and monitoring whether improvements will assist in making disclosures easier to understand and the performance of airports more transparent. The need for ongoing monitoring of the performance of regulations and continuous improvement was one of the Productivity Commission's findings with respect to regulation in New Zealand.

During the s56G process the Commission identified several matters that it felt could be usefully reviewed in the future, which BARNZ comments on below. In addition, it invited parties to identify any areas for improvement. The matters raised by BARNZ are also summarised below.

Importantly, however, the final s56G report released by the Commission, which related to Christchurch Airport, exposed what BARNZ considers to be a fundamental flaw in the current information disclosure regime. This flaw relates to the treatment of non-indexed land valuations in the Commission's forward looking IRR analysis. It was not the subject of specific consideration during the earlier s56G reports because it was only highlighted clearly in the case of Christchurch Airport, which was the only airport to apply the Commission's asset valuation methodology in its pricing decision. This matter will be discussed first, before comment is offered on the improvements already identified by the Commission and BARNZ for consideration.

Timing and treatment of non-indexed land revaluations

BARNZ considers that the Commission needs to re-examine the issue of whether and when periodic revaluations of land can occur. The treatment of asset revaluations has been one of the most contentious issues in airport pricing over the last decade – in particular the treatment of the difference between actual revaluations and what was forecast when prices were previously set (commonly referred to as unforecast revaluations or in the Commission's disclosures as non-indexed revaluations).

The input methodologies allow periodic revaluations of land following the methodology specified in Schedule A. There is no time specified for such revaluations, other than a requirement that all land in the RAB must be revalued at the same time. The outcome of the revaluation exercise must be disclosed and included as income in the year in which it occurs for information disclosure purposes.

As the actual outcomes of the revaluation exercises are unknown when the airport determines prices for the relevant period, a forecast revaluation rate is usually applied in the price setting process. To the extent that this forecast revaluation rate is too low (or too high), the airport will either have enjoyed a windfall gain (or suffered a windfall loss) if prices are subsequently set off the revalued asset base without those unforecast revaluations being treated as income (or a loss) in the subsequent pricing period.

Reflecting this, Christchurch Airport accordingly treated all of its unforecast revaluations as income as it set prices in PSE2. BARNZ considered this to be the correct treatment.

By contrast, the Commission did not make any adjustment for these unforecast revaluations when it assessed the IRR being targeted by Christchurch Airport, instead regarding the unindexed revaluations as relating to prior years before the commencement of the new price setting period. In so doing, the Commission under-estimated the levels of return targeted by the Airport, both within the next five years and over the 20 year period the Airport's pricing model related to.

If the Commission is not going to take into account unforecast or non-indexed revaluations in its assessment of the targeted IRR going forward, then BARNZ considers that the Commission needs to amend the input methodologies to either:

- Not permit ongoing revaluations of land; or
- Only permit revaluations of land to occur in a year in which prices are being reset, with the non-indexed revaluations being disclosed as income in the first year of the new pricing period.

Otherwise, the Commission's approach will allow regulated suppliers to increase their prices as a result of such revaluations, without having undertaken any corresponding investment. It will incentivise airports to deliberately under-forecast future revaluations, so that when actual revaluations exceed those forecasts the airport is able to retain the difference. Christchurch Airport, for example, had forecast zero revaluations going forward, yet the Commission made no adjustment for the unindexed revaluations of around $20m which had occurred since the establishment of the 2010 RAB.

BARNZ sees this issue as creating a very serious shortcoming in the ability of information disclosure and the input methodologies to promote the long term benefit of consumers and, in particular, to limit the ability of suppliers to extract excessive profits. These un-forecast revaluations need to be incorporated into the forward looking assessments of targeted returns otherwise the whole regime is rendered ineffective.

The Commission's approach is inconsistent with the objective in s52A of limiting the ability of suppliers to extract excessive profits, and represents a significant step backwards in terms of the interests of consumers.

We attach our letter to the Commission dated 14 March which set out our concerns more fully, including the ramifications for Auckland and Wellington airports.

Changes floated by the Commission

In the course of its reports on the three airports the Commission specifically highlighted the following matters as areas where the information disclosure requirements could be refined:

- ***Disclosure of expected returns for relevant pricing period***
  This would be useful, but it is key that the Commission specify how the calculation should be undertaken, and how adjustments for variations between the pricing approach and standard information disclosure requirements should be made. For example, Auckland Airport used a moratorium asset base which was less than the information disclosure RAB, and also did not

forecast any asset revaluations whereas the information disclosure requirements index the RAB. Disclosing returns using the higher information disclosure RAB rather than the lower moratorium asset base would tend to understate the returns being sought by the airport in that case. Christchurch Airport's economic based depreciation profile (as yet undefined) is another example of an input requiring an adjustment in order to avoid understating the return being sought.

- ***Mid-year cash-flows***
  The Commission undertook its analysis during the s56G reviews utilising an end of year cash-flow approach which it had applied when the airport information disclosure requirements were determined. Subsequently the Commission has moved to using a mid-year approach for information disclosure for EDBs and GDBs reflecting the fact that revenue is received and costs are incurred during the year.[1] An ROI calculation based on end of year cash-flows under-estimates the return to the suppliers. The Commission has indicated that it intends amending airport information disclosure requirements to better reflect the actual timing of cash-flows.[2] BARNZ supports this change.

Changes suggested by BARNZ during s56G process

In the course of submissions during the s56G process for the three airports, BARNZ identified the following as matters which would improve the ability of interested persons to use the disclosed information to assess whether the purpose of s52A was being achieved:

- ***Disclosure of the costs, assets and revenues associated with the price setting event.***
  BARNZ considers that as well as disclosing the performance of each of the segmented activities, there also needs to be disclosure of the financial performance in relation to the pricing asset base – i.e. the set of assets and costs for which the Airport set charges using its price setting powers under section 4A of the AAA. It is this decision, and the profitability of these charges, which provide the primary signal of whether the airport is limited in its ability to extract excessive profits. Currently, there is no transparency over the performance of Airports in relation to the charges which they set using the section 4A AAA power.

- ***Changes to the asset base resulting from cost allocation.***
  Generally speaking, disclosures to date have not included sufficient information or detail to understand the causes of changes in cost allocations, whether they are reasonable and whether they are stable or likely to be reversed in the future.

- ***Disclosure of costs and assets for each key service provided by the airport in the price setting disclosures.***

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[1] Commerce Commission, Information Disclosure for Electricity and Gas Pipeline Businesses Final Reasons Paper, 1 October 2012, paragraphs E10 to E13.

[2] Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport, 31 July 2013, page 96.

BARNZ has noticed a trend during the second PSE for airports to be less willing to disclose the costs and assets associated with providing particular services. Without such information it is difficult for interested persons to meaningfully or reliably assess whether cross-subsidies are occurring or are likely to occur within the charges set. BARNZ therefore considers that the price setting disclosures should include an obligation for each airport to provide a statement of the assets (both direct and indirect), required capital return, depreciation, tax and operating costs (both direct and indirect) for each category of charge which the airport levies.

- ***Better totalling and disclosure of relevant percentages within disclosure of forecast demand and volume schedules***
  Because the schedules are only disclosed in PDF format, any interested person seeking to use this information has to constantly have a calculator in hand in order to make any sense of the information. Adding better totals, and including disclosure of percentage growth figures, would improve the workability of the forecast demand schedules in their disclosed format, without adding any discernible cost.

- ***Disclosure of key land valuation metrics***
  It would be very useful to add a standard form summary of the land valuation outcomes, including the amount of land, value per ha, movement in overall value and changes in allocation, to the disclosure schedules. This information is currently not present in the disclosure schedules and most interested persons will be unlikely to have the time to wade through long valuation reports to obtain this information (not all of which will be present in the valuation report in any event). Adding a summary of these matters to the disclosure requirements (potentially within schedule 4) will make the information considerably more accessible to interested persons (at minimal additional cost to airports). The proposed summary could include:
    - The total area of land allocated to the RAB, broken down to each of the three identified airport activities
    - The changes in area allocated that year
    - The value per ha, both overall and broken down to each of the three identified airport activities and the movement in value on a per ha basis for that year
    - The resulting land value, both overall and broken down to each of the three identified airport activities.

- ***Improvements to the Schedule A valuation requirements***
  In response to the Commission's invitation during the conference relating to Wellington Airport BARNZ tabled suggested improvements to Schedule A. These are attached. BARNZ's land valuation advisers considered that the current format of Schedule A is focused primarily on providing directions to the valuer. However, the valuation is first and foremost an output of the alternative land use plan. There is minimal direction contained in Schedule A with regard to the development of the alternative land use plan. BARNZ's land advisers suggested the following amendments:

- There is no requirement to undertake independent economic based demand analysis for potential alternative uses of the land. This is a necessary first step in the process, so that the land is placed in the context of the future demand environment for various land uses in the area, before the land use plan is developed. It is suggested that this requirement be inserted as a new A10(f)(i).

- The current A10(f)(ii), which concerns market demand for the proposed development (ie once the land use plan has been developed) needs to be split into two distinct requirements. The first stage should be the determination of market demand for the proposed land development plan (in light of the independent economic analysis of demand for alternative land uses undertaken earlier). In the light of that demand, in the second stage the time period for the sale or realisation of the developed land needs to be determined. These are distinct issues, and there is a concern that they have not been given the separate consideration necessary in order to have a realistic outcome.

- The addition of the principle of the development being credible, which is a well-known and understood Resource Management Act criterion. Resource Management Act case law frequently refers to a development or land use as needing to be 'credible' and 'non-fanciful'. For example, the Environment Court in *Kaikaiawaro Fishing Co Ltd v Marlborough DC*[3] phrases the question as being *'What could be done on site as of right involves credible developments, not purely hypothetical possibilities which are out of touch with the reality of the situation'*. BARNZ therefore suggests that the addition of a requirement that the alternative land use be 'credible' would help reduce potential differences of expert opinion with respect to the alternative land use plan.

5. ANALYSIS AFTER FUTURE PRICING REVIEWS

The Commission has asked whether its annual monitoring under s53B should be more in depth in years when prices have been reset compared to other years. BARNZ would welcome the Commission undertaking more in depth analysis in years when pricing resetting occurs, however we doubt the degree to which this is permitted under the legislation. As things stand, the Commission will not have the power to undertake an analysis similar to that undertaken as part of the s56G reviews.

The statutory framework for the annual monitoring provided for in s53B is much narrower than the statutory parameters for the s56G inquiry. Section 56G asked how effectively information disclosure regulation was promoting the purpose in s52A in respect of the specified airport services.

By contrast, the s53B monitoring work is focused on 'promoting greater understanding of the performance of individual regulated suppliers'. The ability to request additional information under

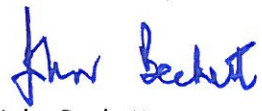
[3] (1999) 5 ELRNZ 417

s53B is expressly limited to that required 'for the purpose of monitoring the supplier's compliance with the section 52P determination' (in other words, with the information disclosure requirements). The s53B monitoring work is not expressly linked to whether or not the purpose in s52A is being achieved.

If the Commission sought to broaden its review under s53B to look at the degree to which the purpose in s52A is being met, as opposed to the degree to which information disclosure is providing transparency (which is the s53B purpose statement), then this would likely be challenged by the airports.

We thank the Commission for seeking feedback from parties with respect to the process undertaken by the Commission during the s56G reviews. We hope that you will have realised that BARNZ considered the Commission undertook a very thorough professional review, with a process that could not be materially faulted. During the course of the reviews, a number of areas were highlighted by both the Commission and the parties where the information disclosure requirements could be improved. We trust that the Commission will be able to take these learnings into account in the near future and review these aspects of the information disclosure requirements at the earliest practical opportunity.

Yours sincerely



John Beckett
Executive Director

Attached: Suggested changes to A10 of Schedule A of the Airport Input Methodologies

Letter to Dr Mark Berry dated 14 March 2014