BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND

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Autumn Faulkner
Major Airports review
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Dear Autumn,

Options for improvement to airport regulation

BARNZ welcomes MBIE consulting on two areas of potential improvement to the Part 4 regulation of Airports, namely:

- the extent of the power the Commerce Commission has to analyse airport disclosures; and
- the process for altering the type of regulation applying to regulated airports.

The Commission's ongoing power to assess the effectiveness of ID Regulation in promoting the purpose of Part 4

It is important to ensure that the Commission has sufficient powers to effectively undertake analysis work with respect to information disclosed by the airports, particularly information disclosed following price setting events. BARNZ does not consider that this is the case going forward, given that the s56G review process was only framed as a one-off transitional requirement. It therefore follows that we do not agree with MBIE's initial view that the Commission's existing analysis powers are sufficient.

Going forward, the Commission's ability to analyse disclosures by the airports will be limited to the s53B summary analysis reports. BARNZ does not consider that analysis under s53B is likely to be able to achieve the same result as that achieved by the reviews undertaken by the Commission under s56G.

The s56G inquiry process (temporarily) significantly strengthened the effectiveness of regulation of New Zealand Airports under Part 4 during the most recent price setting events as a result of the

analysis undertaken by the Commission staff and Commissioners, the questioning of the airports by the Commissioners, and the substantial reports written by the Commission. For example:

- It was only in response to directed and repeated questioning by the Chair of the 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 in 2012 after adverse draft and final s56G reports from the Commission concluded that WIAL was targeting excessive returns with these price increases. Information disclosure and consultation had not achieved this.
- Christchurch Airport persisted in clinging to a blatantly incorrect tax calculation (over-estimating required tax by $35m over the 2012–17 pricing period) 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.

The one-off s56G review was therefore able to bring about the changes of approach in the current pricing period which improved the long term interests of consumers in a way which consultation and information disclosure alone had not been able to achieve. However, it is unclear whether airports will continue to adopt these altered approaches going forward. There is no requirement for them to do that.

Moreover, it is highly doubtful that analysis under s53B would be able to achieve the same influence or ability to alter the approach adopted by the airports.

Airports have been preparing information disclosures under Part 4 since 2011 – five sets of annual disclosures. Despite the fact that s53B provides that the Commission 'may monitor and analyse all information disclosed' and 'must, as soon as practicable after any information is publicly disclosed, publish a summary and analysis', there has not, as yet, been a final 'summary and analysis' published by the Commission relating to the annual disclosures by the airports.

The s53B analysis tasks have not been given the same priority by the Commission as the more explicit requirement in s56G for a review of the effectiveness of the information disclosure regulation with a specific reporting requirement to the Ministers of Transport and Commerce.

The lack of any explicit requirement to undertake 'monitoring and analysis' under s53B has resulted in a lack of funding, which will have directly contributed to the low priority being given to this work. Furthermore, the Commission may also give a low priority to this work because of legitimate concern over legal challenge as to its ability to carry it out. Going forward there is real doubt as to whether the Commerce Commission would be appropriately funded to carry on analysis to the same level of detail under s53B as it did for its s56G inquiries in 2012.

The Commission's power to undertake analysis under s53B is quite different in nature to the inquiry directed under s56G:

- The purpose of the analysis is different – s53B analysis is directed at promoting understanding of performance and relative performance and changes over time as opposed to the s56G analysis which was directed to assess how effectively the purpose of s52A is being promoted by information disclosure regulation;
- S53B contains specific information gathering powers which are limited to monitoring the supplier's compliance with the information disclosure requirements. Section 56G did not contain any information gathering powers, hence the Commission was able to rely upon its general information gathering powers, which are wider than in relation to monitoring the supplier's compliance with the information disclosure requirements. A significant amount of additional information was requested by the Commission to enable it to understand, model and analyse the pricing approaches adopted by each of the airports. This information would not have been able to be requested relying on the more limited information gathering provisions in s53B;
- There is a specific requirement to provide the report to the Ministers of Commerce and Transport under s56G, whereas s53B is only subject to a general direction of publication. The express direction to report to the Ministers of Commerce and Transport has focused the attention of the relevant Ministers and ministries on the Commission's conclusions.

There were some very complex issues involved in the charge setting decisions of the three airports in 2012 that were only able to be unravelled by detailed examination of airport financial models, the provision of additional information and significant analysis by the Commission. For example:

- How WIAL's capex wash-up from a major project (the Rocks) that was forecast to occur in the previous pricing period (PSE1), 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?
- 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?
- 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?
- 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?

Moreover, as a result of the Commission's emerging view (released 19 February) regarding the importance of the mid-point WACC estimate as the starting point for assessing airport returns, the Commission is likely to have to undertake increased individual airport specific analysis when assessing airport profitability going forward. The Commission's indicated new approach is to provide

a mid-point WACC estimate, together with information on its probability distribution, and then assess whether the justification, reasoning and evidence disclosed by the airport for any divergence from the mid-point represents a legitimate reason for the airport targeting returns above (or below) that WACC. The Commission has indicated that the current specification of the WACC percentile range is likely to have placed too much emphasis on the upper limit of the range when assessing profitability, which has resulted in the 75th percentile being used as the 'de facto' upper limit.

Summary analysis and monitoring under s53B is extremely unlikely to be able to delve into issues such as whether a divergence from the mid-point WACC is justified in the particular circumstances of an airport or any of the other complex issues which the Commission needed to investigate and address during the s56G review process. It is unlikely that the Commission will have the time, the resources, the funding, or the right under s53B to be able to obtain the necessary further information and explanations to unravel such complicated matters.

As noted earlier, the s56G review was able to bring about changes of approach which improved the long term interests of consumers in a way which consultation and information disclosure alone had not been able to achieve. BARNZ considers that it is highly unlikely that analysis undertaken under s53B will be able to have the same influence in promoting outcomes more consistent with the purpose of Part 4, unless:

- There is an express requirement added to s53B for the Commission to undertake analysis into whether information disclosure is achieving the Part 4 purpose; and
- The information gathering powers contained in s53B(1)(c) are expanded to include requesting information necessary to enable the monitoring and analysis work expected to be undertaken by the Commission under s53B.

Ideally, also, provision would be made for such reports to be provided to the Ministers of Transport and Commerce.

The express provision for analysis to assess the effectiveness of information disclosure in achieving the Part 4 purpose will enable the Commission to seek funding to undertake this work. Without this express power, it is unlikely that the Commission would have sufficient funding allocated to it to undertake such a task, especially when it would be likely to face the question as to whether it legally could initiate such analysis.

Of option one and option two identified by MBIE, our preference is for option two – an express requirement for a review to be undertaken following each price setting event. BARNZ considers that only a clear obligation that a review will occur is capable of creating any form of constraint on the ability of airports to exercise market power to the detriment of consumers. A potential review does not contain a sufficiently credible threat of a thorough regulatory review, and potential ministerial consideration, to cause an airport to price and otherwise act in accordance with the outcomes sought by Part 4.

An express requirement for a review following prices being reset would be similar in frequency to the reviews which occur in Australia where, as well as information disclosure and monitoring by the Australian Competition and Consumer Commission (ACCC), five yearly reviews are undertaken by the Productivity Commission reporting to the Treasurer on matters the Treasurer has requested be

examined. It would also more accurately reflect the original intention of Cabinet in 2007 when the decision to bring airports under Part 4 was made.

The papers prepared for Cabinet by the Ministers of Transport and Commerce in 2007 clearly envisaged regular periodic reviews would occur after airports set charges. Paragraph 47(b) of the November 2007 paper by the Ministers of Transport and Commerce to Cabinet, after referring to the five yearly comprehensive reviews of airport pricing by the Productivity Commission which occur in Australia, stated:

> *We also propose that the Commerce Commission would be required to undertake periodic reviews after airports set charges, starting from the price reset in 2012, on major international airports' compliance with its pricing principles, the effectiveness of the price monitoring regime and whether further regulation is warranted.*

However, this was not reflected in the drafting of the amendments, with the review provided for in what ultimately became s56G being characterised in its heading as a transitional provision and therefore a 'one-off' inquiry, as opposed to a regular occurrence after every five year price reset, which is the practice in Australia and which was what Cabinet intended.

The prospect of regular reviews by the Commerce Commission would likely act as some constraint on the possibility of an airport exercising its market power, and thus would promote the long term interests of consumers as outlined in s52A. BARNZ therefore asks that the Ministers of Commerce and Transport recommend amending s53B to provide for a clear on-going review process, occurring every time prices are reset, of the effectiveness of information disclosure regulation at promoting the purpose of Part 4. That would put right the omission in 2008, when the drafters of the provisions of Part 4 did not reflect Cabinet's intention for there to be regular on-going reviews of airports by the Commerce Commission.

If there is not now a change made to Part 4, expressly requiring the Commerce Commission to review how effective information disclosure has been at achieving the Part 4 purpose, then there will have effectively been a reduction in the level of regulatory over-sight of airports as a result of the expiry of the s56G review process, which will significantly reduce the effectiveness of the Part 4 regulatory package applying to airports, to the detriment of the long-term interests of consumers.

In summary, with reference to the specific questions posed in the discussion document in relation to the Commission's ongoing power to assess the effectiveness of information disclosure:

- Q1.1 BARNZ agrees with the identified risks to the Commission's existing powers, namely that the lack of express power under s53B for the Commission to consider the effectiveness of ID regulation at promoting the purpose of Part 4 creates a risk of both legal challenges by stake-holders to the Commission undertaking such analysis, and a risk of the Commission not undertaking such analysis for fear of such challenges. Contrary to the view expressed by MBIE, BARNZ does not consider that the Commission's existing powers are sufficient under s53B.

- Q1.2 As discussed in this submission, BARNZ considers that additional risks which exist are the Commission not receiving sufficient funding to undertake such analysis as a result of the lack of express power, and limitations which will exist on the Commission's ability to request

additional information given the constrained nature of the information seeking powers currently contained in s53B.

- Q1.3 BARNZ's preference for change is option two, a specific requirement relating to airports requiring the Commission to consider how effective information disclosure has been at promoting the Part 4 purpose following a price setting event. Only a clear, unambiguous requirement to review will act to constrain regulated monopoly suppliers from exercising market power to the long-term detriment of consumers. The mere possibility of a review is not a sufficiently strong regulatory threat to constrain the natural profit-maximising behaviour of a firm with monopoly characteristics – such a firm would be likely to back their ability to resist the review occurring rather than feel constrained by the possibility of a review.

- Q1.4 The most useful time for the inquiry to occur is as soon as practicable after the airport in question has made its information disclosures relating to the reset prices – as occurred with the reviews under s56G.

The process for altering the type of regulation

We agree that there is a lack of clarity with respect to how the form of regulation applying under Part 4 for specified airports could be altered, and we support the general thrust of the proposed process outlined by MBIE. It is important that this uncertainty in the current legislation over whether and how the form of control of regulated airports can be altered is resolved, so that in appropriate circumstances, where an airport is found to have misused its market power and acted in a manner which is in conflict with the purpose of Part 4, a credible threat exists that steps can readily be taken to apply an increased form of regulation to that airport.

We question whether requiring the benefits of the increased regulation to 'materially exceed' the costs of the additional regulation (beyond information disclosure) is appropriate for firms which are already regulated and subject to Part 4. For firms which are already regulated under Part 4, the interests of consumers are made 'front and centre' by the s52A purpose statement. To only adjust the form of regulation where the benefits of the increased regulation 'materially exceed' the costs of the additional regulation, is to accept a degree of on-going harm to consumers that is inconsistent with the principles of s52A, and would create inertia over potential strengthening of regulation. It would result in a de facto level of acceptable harm to consumers with regulated suppliers likely to price up to a level of over-recovery beyond (although not materially beyond) the costs of additional regulation. BARNZ believes that while the 'materially exceeds' threshold might be considered appropriate for the initial decision of whether to regulate a firm or not, this standard is too high for decisions regarding alteration of the form of control within Part 4. We suggest that a simple requirement for the benefits of the increased regulation to exceed the costs of the additional regulation (beyond information disclosure) better reflects the Part 4 purpose statement of promoting the long term benefit of consumers.

BARNZ thanks MBIE for the effort it has taken to review the analysis undertaken by the Commerce Commission in the s56G reviews of the three airports, and the consultation process MBIE has subsequently undertaken on potential improvements to the regulatory regime for the three airports regulated under Part 4 of the Commerce Act.

If there is any point made by BARNZ in this submission which MBIE would like clarification on, please do not hesitate to contact me.

Yours sincerely

John Beckett
Executive Director