NZ AIRPORTS

NZ Airports Association

Submission on Productivity Commission Inquiry: Regulatory Design and Operation

25 October 2013

INTRODUCTION

1. The New Zealand Airports Association ("**NZ Airports**") appreciates the opportunity to submit its views on the Productivity Commission's Regulatory Institutions and Practices Issues Paper. NZ Airports represents 30 airport operators throughout New Zealand, including Auckland, Wellington and Christchurch international airports.

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OVERVIEW

3. In our view, a good outcome from this inquiry would be meaningful guidance that could have a positive impact on the quality of both the design and operation of regulation.

4. In our experience, design and operation are equally important to a quality regulatory regime. It cannot be assumed that a well designed regime will always lead to quality outcomes. We therefore think it would be most useful for the Productivity Commission to investigate regulatory design and operation at two levels:

   (a) upstream design and operation, which will include institutional arrangements and regulatory practices such as independence and accountability of the regulator, the relationship between the regulator and policy makers, the formal and informal decision-making processes, the transparency and predictability of decision making, and the organisational structure and resources of the regulator; and

   (b) downstream design and operation, which involves regulatory practices such as the clarity, predictability and comprehensiveness of decisions, the proportionality and fitness for purpose of regulatory actions, the application of regulatory tools, the escalation and reduction of regulation, and the way regulatory analysis is undertaken.

5. In other words, we do not think it will be sufficient to focus on regulator incentives at the structure and design level. It will also be necessary to consider what guidance can be provided to enhance the quality of actual decision making. To achieve this, we think the Productivity Commission will need to consider tailoring its guidance for different types of regulation — especially where a regulator is given broad discretion to make the regulatory rules that apply to regulated entities, as opposed to enforcing rules set out in legislation or legislative instruments. We also consider the Productivity Commission will need to go deeper into operational matters than existing materials that give general guidance on the structure and institutional characteristics of regulated entities.

6. We appreciate that this inquiry is not about any particular regulatory regime or regulator. Nevertheless, our focus throughout this submission is on information disclosure regulation under Part 4 of the Commerce Act, as that is the regime that has the greatest impact on the productivity of the airport sector. In our view, information disclosure under Part 4 is the right form of regulation, and is effective at promoting the relevant legislative objectives (and will become more effective over time). It is also the area which we are able to most usefully provide examples based on our experience.

7. However, it is also a new form of regulation, and its design and implementation has, in our view, suffered from teething problems and (perhaps natural) material disagreements between the regulator and interested parties. The point we wish to make in this submission is that, with the benefit of hindsight, there was significant scope to improve the design and operation of the information disclosure regime, such that those teething problems and disagreements could have been materially reduced. We hope that the issues and lessons we identify from our Part 4 experience will assist the Productivity Commission to develop guidance to improve regulatory outcomes for all sectors.

8. This submission is structured as follows:

- **Section A** provides an overview of the role of airports in New Zealand's productivity, and discusses how the current regulatory framework can help to promote a strong, sustainable and successful airport industry.

- **Section B** briefly considers the nature and definition of regulatory success from NZ Airports' perspective, in light of the inquiry's focus on examining the features that shape successful regulation and, ultimately, improve regulatory outcomes.

- **Section C** discusses the two levels of regulatory design and operation that influence and incentivise regulatory regimes, and which impact on the quality of regulatory decisions. In this section, NZ Airports discusses the importance of downstream design and operation in the Productivity Commission's inquiry in addition to the institutional arrangements and regulatory practices already identified in the issues paper.

- **Section D** discusses upstream design and practice features, and presents case study examples from our experience of airport regulation in New Zealand where relevant and responsive to the questions in the issues paper.

- **Section E** considers the key downstream design features and regulatory practices that influence the quality of regulatory decisions, including putting forward case study examples that illustrate these features in practice.

- **Section F** provides some brief concluding comments.

9. **Appendix 1** provides a chronology of airport regulation to assist the Productivity Commission to consider the examples discussed throughout this submission.

SECTION A: AIRPORTS, REGULATION AND NEW ZEALAND'S PRODUCTIVITY

11. Airports in New Zealand are subject to a diverse and extensive range of regulation. This is particularly so for Auckland, Wellington and Christchurch Airports, which are subject to regulation under Part 4 of the Commerce Act 1986, in addition to a variety of safety, environmental, occupational and other regulatory regimes.

12. NZ Airports' members are also very aware that their business and operational performance has a material impact on the welfare of passengers, airlines, local communities, and New Zealand's wider economy. For example:

    (a) Recent research has found that the direct and indirect contribution of airports represents 25 percent of the New Zealand economy. In 2012, airports contributed $419 million directly to GDP, with this figure increasing to $40 billion when the indirect flow on benefits for communities are taken into account. 61 percent of this economic benefit is provided by Auckland, Wellington and Christchurch Airports.[1]

    (b) New Zealand's major airports also generate significant employment. More than 12,645 people are directly employed by airports and in air transportation, while around 78,810 work within airport environments. However, once the flow-on benefits into other industries are taken into account, the overall number of jobs generated is estimated at more than 710,000. A third of New Zealand's workforce is linked to airports.[2]

    (c) As a geographically isolated country, access to affordable air travel linking New Zealand internally and with the rest of the world is critical to our economy, including our tourism industry, and to the standard of living of all New Zealanders. New Zealand's major airports are investing in long-term infrastructure that will continue to provide quality facilities and economic benefits to New Zealand well into the future.

13. Given the key role that New Zealand's airports play in the wider economy, it is clear that regulation that impacts on airport productivity will have a significant impact on the productivity of New Zealand's economy as a whole. Accordingly, NZ Airports supports a commitment to quality regulation that is simple, clear, and produces benefits that clearly outweigh its costs.

14. Much of this submission is focussed on Part 4 of the Commerce Act, as that is the regulatory regime that has the most pervasive impact on airport investment and behaviour, and therefore has the greatest impact on productivity.

15. NZ Airports' observations on Part 4 are informed by its views that regulation is appropriate when the relevant services are not subject to competition. However, it is equally necessary to ensure that regulation is fit for purpose. In an airport context, this means acknowledging that:

    (a) Airports are very complex operating environments, with different consumers having different interests. For example, airlines can and do have divergent views, airline and passenger interests do not always align, and the short-term and long-term interests of consumers may not be the same. Airport decisions are the product of a delicate balancing act taking into account the need to operate as commercial entities and the current and future needs of a number of stakeholders (including the general interest of New Zealanders in quality national and international gateways). Accordingly, there can be no "one size fits all" approach to matters such as pricing, investment and quality of services.

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[1] These figures are from a draft economic impact study commissioned by NZ Airports. The final report is currently being prepared, and can be shared with the Productivity Commission once finalised.

[2] See n1 above.

(b) There is a high risk of regulatory failure (ie regulation fails to make outcomes better, or makes them worse). Prescriptive regulation can be expensive, inhibit investment, and requires a regulator operating at a natural information and expertise disadvantage to "second guess" decisions made by the industry (in which airlines as intermediate consumers are often well-informed, sophisticated commercial parties who also have greater knowledge than the regulator). Regulation that is not appropriately designed risks inhibiting commercial relationships and preventing innovative and efficient solutions to complex problems.

(c) Commercial agreements between major airports and airlines represent the best outcome for the airport sector (including the best outcomes for passengers through a combination of increased choice, availability and quality of services), and should be encouraged. This goal is achievable, and several successful examples already exist. Airports are also playing an increasing role in partnering airlines in growth initiatives and joint marketing**.**

While this is the goal, we also note that there are natural differences between the business models and investment horizons of airports and airlines (including differences that arise from the role of airports in facilitating new airline entrants, new routes, and enhanced capacity) which mean that alignment on all decisions is not expected.

16. In recognition of the above factors, the three major airports have been subjected to a unique form of regulation. Essentially, these airports:

(a) retain the right to set prices as they see fit, subject to consultation; and

(b) must fully and publicly disclose their pricing decisions and annual financial performance, in accordance with rules set by the Commerce Commission.

17. In our view, this is the right form of regulation for airports. It acknowledges that it is appropriate for interested parties to have access to quality information about airport performance, and the resulting transparency provides strong incentives for airports to ensure that their behaviour promotes good outcomes for consumers (including airlines, passengers and exporters). It also recognises that airport pricing decisions are increasingly sophisticated and innovative, and made in an environment where both airports and airlines are better informed about the airport sector than a regulator can ever hope to be.

18. We set out at **Appendix 1** a more detailed discussion of the history of airport regulation and information about the current regulatory framework. The key features of the current regime are set out in **Box 1** below.

Box 1: Features of the current regulatory regime for Auckland, Wellington and Christchurch Airports

The current regulatory regime for the three largest airports under the Commerce Act 1986 is intended to be a light-handed regime focussed on increased information, transparency, and guidance to support and assist consultation between airports and airlines on airport charges. This light-handed regime has three main elements:

- Annual information disclosures are produced and disclosed following the end of each financial year. These disclosures provide an historical "snapshot" of airport performance over the past year. Information is disclosed about the value of airport assets, airport operating expenses, capital expenditure, quality measures, demand, capacity, tax, and regulatory profit. This information is compiled and presented by applying the Commission's detailed rules (input methodologies).
- Price-setting disclosures are produced and disclosed after each price-setting event. These disclosures include forecast financial information about the basis on which charges have been set and the methodologies that have been used by the airports in setting charges.
- The Commission has an ongoing summary and analysis role under the Commerce Act, in which it must publish a summary and analysis of disclosed information to promote greater understanding of airport performance and trends in that performance over time.

Airport pricing remains subject to the Airport Authorities Act 1966. Airports are required to consult with substantial customers on all aspects of pricing, including aspects such as asset valuation and cost of capital. The Commission's input methodologies, set for information disclosure purposes, play an important role in these consultations by providing tools and guidance to both airports and airlines, but are not required to be applied in pricing.

19. Ideally, the current regime should provide flexibility for airports and airlines to agree, to the greatest extent possible, the timing, nature and quality of investment in services, with the discipline of full transparency and the threat of further regulation providing additional incentives for airports to promote consumer benefit. This regime also appropriately provides for airports to be the "circuit-breaker" in circumstances where the natural business incentives of airports and airlines mean that agreement cannot be reached, protecting the ability of airports to act in the long-term interests of ultimate consumers and of New Zealand.

20. Information disclosure regulation is currently working. A significant amount of information — the key focus of the regime — is available to interested parties about airport performance. The Commerce Commission's reviews of the effectiveness of information disclosure regulation have provided detailed information to airports about how the Commerce Commission views its regulatory role and will analyse airport behaviour in various performance areas. In many areas the Commerce Commission has found behaviour and outcomes are very positive. Areas for improvement have been identified and airports have responded appropriately to this feedback — a key sign the regime is working. The effectiveness of information disclosure will continue to improve over time as the regime beds in and the feedback loops contemplated by the regime are established and provide a continuing source of guidance to airports and interested parties.

21. As discussed throughout this submission, our concern is that although airports are subject to the right form of regulation, and that this regulation is currently working, there are many aspects of its design and implementation that could have been or could be better. In particular, NZ Airports is concerned that the design and operation of the regime has resulted in regulation that, in practice, is not what it was intended to be. This submission highlights those design and operational factors which may result in regulation that impacts negatively on regulatory success, and therefore productivity, in the airport sector. It draws on this experience with Part 4 with a view to helping the Productivity Commission produce guidelines and recommendations that will improve regulatory outcomes.

SECTION B: WHAT IS REGULATORY SUCCESS?

22. The focus of the Productivity Commission's inquiry is on examining the features that shape regulation to succeed.[3] As such, the issues paper presents a number of institutional and regulatory practices that will be examined to determine how they incentivise regulators to produce the best possible decisions.[4]

23. NZ Airports is aware that a large amount of international research on successful regulation has been undertaken. Here we briefly outline key features of successful regulation that we identify with, based on our experience in New Zealand.

24. At a broad level, the sustainability and success of any regulatory system depends on three pre-requisites: credibility, legitimacy, and transparency.[5] However, they are not the end of the matter. The key to regulatory success is to design and implement fit for purpose regulation that meets these overarching principles, meets the objectives of good regulation (see **Box 2**), produces good quality regulatory decision making, and promotes good outcomes for the regulated sector.

> **Box 2: What is good regulation?**
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> The OECD notes that good regulation should:
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> - serve clearly identified policy goals, and be effective in achieving those goals;
> - have a sound legal and empirical basis;
> - produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account;
> - minimise costs and market distortions;
> - promote innovation through market incentives and goal-based approaches;
> - be clear, simple, and practical for users; and
> - be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.
>
> (Source: OECD *Guiding Principles for Regulatory Quality and Performance* (2005) at page 3)

25. A good regulatory system will produce a flow of good regulatory decisions, minimise the number of poor or mistaken decisions, correct errors quickly, and avoids repeating mistakes or poor decisions.[6] In our view, there should also be enduring and constructive relationships between the regulator and regulated entity when the nature of regulation demands a cooperative rather than adversarial approach to decision making (ie economic regulation). Incentivising good quality decisions is critically important, as regulatory decisions are the concrete outputs of a regulatory system, and have an immediate and direct effect on sector outcomes.[7]

26. In Airports' experience, it is important to remember at all times that there is a trade-off between imperfect competition and imperfect regulation.[8] Although regulation may be necessary to address market imperfections, it must be borne in mind that regulatory interventions are imperfect as well,[9] and can result in worse outcomes. This trade-off is important. Regulators and legislators must remain conscious that regulation can fail in a number of ways (see **Box 3**), and that "there is a real risk that regulations can become an obstacle to achieving the very economic and social well-being for which they are intended."[10]

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3 Productivity Commission *Regulatory Institutions and Practices: Issues Paper* (August 2013) at page 2.

4 Productivity Commission *Regulatory Institutions and Practices: Issues Paper* (August 2013) at page 3-4.

5 For example, as noted by the World Bank, in infrastructure regulation investors must have confidence that the regulatory system will honour its commitments (credibility), consumers must believe the regulatory system will protect them (legitimacy), and the system must operate transparently so that investors and consumers know the "deal" they are facing (transparency): The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 55.

6 The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 149.

7 The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 151.

8 This is also recognised by the Australian Productivity Commission. See, for example: Australian Productivity Commission *Economic Regulation of Airport Services: Inquiry Report* (December 2011) at page XXV. Also see Productivity Commission *Regulatory Institutions and Practices: Issues Paper* (August 2013) at page 8.

9 For example, see The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 208.

10 OECD *The OECD Report on Regulatory Reform: Synthesis* (1997, Paris) at page 5.

Box 3: What is regulatory failure?

Lochner discusses three types of regulatory failure. He notes that regulation can fail where:

- it does not accomplish its stated purpose;
- the adoption of regulation does not take into account all of the effects that regulation may have (ie regulation may accomplish its stated purpose, but may have so many reasonably foreseeable and material adverse side effects that, on balance, it may legitimately be seen as a failure); and
- it is counterproductive (ie regulation not only fails to accomplish its stated purpose but it aggravates the very condition that it was designed to alleviate).

(Source: Lochner *Economic Regulation and Democratic Government* (2000) J. Corp. L. 831 at 831)

27. NZ Airports believes that, ultimately, the key to regulatory success is good outcomes. Successful regulation means that the characteristics of the regime and its regulatory decisions lead to better outcomes than would have occurred without regulation. In other words, regulation must produce benefits that justify its costs (including the cost of implementing regulation and the cost and consequences of regulation at a sector-wide and national level).

28. In this context, it is insufficient to resort to high level assumptions to justify regulatory intervention. For example, NZ Airports' experience is that airports were subject to information disclosure regulation under Part 4 because it was perceived to be a low cost and light-handed form of regulation,[11] and while there was a theoretical risk of major airports exercising their market power there was no clear evidence of this behaviour. However, without clear direction to ensure a low-cost and light-handed outcome, information disclosure has in fact become expensive, heavy-handed and/or difficult to distinguish from heavier-handed forms of regulation (see also **Box 4**).

Box 4: How much should "light-handed" regulation cost?

Since the introduction of the new Part 4 regime in 2008, $11.7 million has been spent in developing and implementing the detailed regulatory rules (input methodologies). This was a pan-industry project with costs shared across electricity, gas and airport sectors. In addition, $2.8 million has been spent by the Commerce Commission in relation to airport information disclosure regulation over this time, equivalent to $961,000 per regulated airport. This can be compared to $632,000 per regulated electricity lines business (which are subject to price control regulation) over the same time period.

Of course, these amounts do not include the costs incurred by regulated suppliers in engaging in the Commission's consultation processes, carrying out new regulatory valuations as required at the beginning of the regime, undertaking various other steps that were required to bring existing financial reporting practices into line with the information disclosure requirements, and the ongoing cost of disclosures and compliance. In addition, these figures exclude costs associated with the merits appeal proceedings for the Commerce Commission, regulated suppliers and interested parties. See also **Appendix 1** at paragraphs 35 to 41.

29. The considerable time and resource that has been expended on developing the information disclosure regime has, in our view, placed strong incentives on the regulator to demonstrate that it is immediately delivering better outcomes for consumers.[12] This is despite a clear intention for the regime to focus on the long-term interests of those consumers, and for the regime to focus on transparency of performance rather than immediate changes by suppliers (not least because performance before Part 4 regulation was already promoting good outcomes for consumers).

30. NZ Airports is keen for guidelines and recommendations to be developed by the Productivity Commission that focus on addressing the critical risk of regulatory failure (as discussed by the Productivity Commission at page 8 of its issues paper). This will best meet the overall purpose of the inquiry, which is ultimately to improve regulatory outcomes.[13]

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11 See **Appendix 1** at paragraphs 10 to 24.

12 See the discussion of the section 56G review in the table below (at pages 8 and 16).

13 Minister of Finance and Minister for Regulatory Reform *Terms of reference: Improving the design and operation of regulatory regimes* (10 July 2013) at paragraph 2.

31. We have presented a chronology of airport regulation at **Appendix 1** because we believe it provides an excellent case study of design failure at policy and legislative level leading to design problems at the implementation and operational level. As we discuss in the next section, this is because a feature of economic regulation, which has not been fully addressed in the Productivity Commission's issues paper, is that the regulator has broad discretion to make the rules that determine whether regulation will be successful.

SECTION C: TWO LEVELS OF REGULATORY DESIGN AND OPERATION

32. In our experience of Part 4 regulation, a number of design features have combined to impact on the success of the regulatory regime.

33. The first set of these features relates to the design of the legislation (including the direction (or lack thereof) that this provides to the regulator), and the institutional arrangements of the regulator. For example, the Part 4 legislation asks a single regulator to design and implement a graduated, low-cost system of regulation, involving both light-handed information disclosure and heavier-handed regulation such as price control, across a diverse range of regulated entities. It asks the regulator to do so under a common purpose statement and using common regulatory rules (input methodologies), and provides limited legislative guidance to the regulator as to how different types of regulation are to be designed and operated so that they are different from each other. There is very little substantive accountability to ensure that the regulator has undertaken its task in the way that was intended. In addition to being rule-maker and enforcer, the regulator is also tasked with reviewing the effectiveness of the regime that it has designed (soon after it was implemented). Such a convergence of roles, which best practice demands be kept separate, was always bound to cause difficulties in the design and implementation of the regulatory regime.

34. Accordingly, although it is important to review institutional and governance arrangements such as legislative direction, substantive accountability, separation of rule-making from enforcement functions and the independence and expertise of the regulator, our experience of regulation suggests that this should not be the limit of the Productivity Commission's inquiry. In NZ Airports' experience, these types of "upstream" regulatory features are not the sole (nor in some cases the main) contributor to regulatory outcomes. Ultimately, it has been regulatory substance — the real actions and decisions of the regulator — driven by "downstream" factors, that has most directly affected regulatory outcomes for the airport sector.[14]

35. The reason for this is that there will always be limits on how far legislation and governance arrangements can go to produce successful regulatory outcomes. Ultimately, the regulator will need to exercise discretion — and for economic regulation there will be a large amount of discretion. This effectively means the regulator designs the regulation. It cannot be assumed that the regulator will always get it right — they are just as fallible as the entities they regulate.

36. Our experience is supported by commentators such as the World Bank, which has noted there has been a tendency to implicitly assume that a sector will achieve good outcomes if the regulatory framework requires independence, accountability, transparency and other institutional and process characteristics.[15] However:[16]

> Although poor governance is more likely to produce poor results, good governance is not an automatic guarantee of good outcomes. In other words, ***good institutions can and sometimes do make bad decisions***. [...] So if the goal is to assess the effectiveness of a regulatory system, one also must look at the actual decisions produced by the regulatory system in addition to its institutional and legal characteristics.

37. For this reason, NZ Airports' suggests that it would be beneficial for the Productivity Commission to review regulatory practices at both the upstream and downstream levels in its inquiry (see **Box 5** and **Figure 1**). That is because, in assessing the influences and incentives on regulatory regimes, it is important to assess both the "how" and "what" of regulation to examine the entire regulatory system. This means that both regulatory governance (ie upstream design and operational practices) and regulatory substance (ie downstream design and operational practices) should be examined when considering ways in which regulatory design and operation can be improved.

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[14] See also The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page xiii, which notes that "ultimately [the real action and decisions of regulators] most directly affect the performance of regulated enterprises and the overall sector."

[15] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 38.

[16] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 38 (emphasis in original).

Box 5: Upstream and downstream design and operation

There are two basic dimensions of any regulatory system: regulatory governance and regulatory substance. This means that there are two levels of design and operation that influence a regulatory regime (see also Figure 1):

- **Upstream design and operation** seeks to incentivise regulators to operate high quality regulatory regimes. Also referred to as regulatory governance, it is the "how" of regulation, and refers to the institutional and legal design of the regulatory system and the framework within which decisions are made. It aligns with the institutional arrangements and practices identified in the Productivity Commission's issues paper, and involves decisions about the independence and accountability of the regulator, the relationship between the regulator and policy makers, the formal and informal decision-making processes, the transparency and predictability of decision making, and the organisational structure and resources of the regulator.

- **Downstream design and operation** involves creating a regulatory regime to give the appropriate incentives to regulated entities and consumers, in order to produce better outcomes than if there was no regulation. It gives rise to regulatory substance and shapes the content, or the "what" of regulation. Through its impact on regulatory substance, downstream practices influence the actual decisions made by the regulator, along with the rationale for those decisions. In our view, downstream design and operation involves the clarity, predictability and comprehensiveness of decisions, the proportionality and fitness for purpose of regulatory actions, the application of regulatory tools, the escalation and reduction of regulation, and the way regulatory analysis is undertaken.

(Sources: The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at p 5; Guerin *New Zealand Treasury Working Paper 03/24: Encouraging Quality Regulation: Theories and Tools* (September 2003) at p 8)

38. Reviewing both levels of design and operation in the Productivity Commission's inquiry is also important because downstream and upstream design are linked in a number of ways. For example, upstream factors such as clear legislative direction and strong substantive accountability are important to incentivise the regulator to act in a way that promotes best practice downstream design and operation. Put another way, understanding the factors that drive good regulatory substance is important when considering how to improve regulatory governance (and to, ultimately, improve regulatory outcomes).

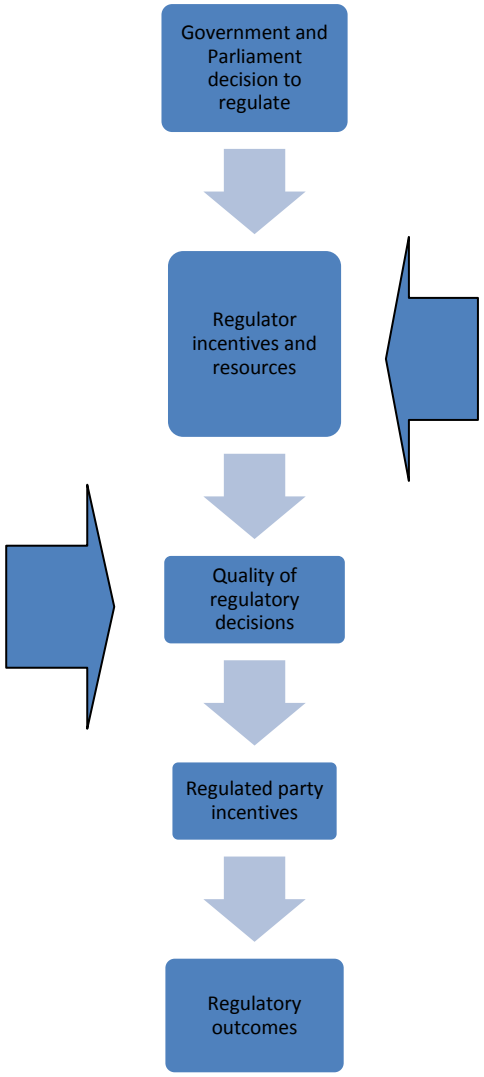
39. In addition, while the upstream design recommendations and guidelines that are produced by the Productivity Commission inquiry will be helpful,[17] NZ Airports anticipates that direction to regulators about the key principles of good regulatory substance could have a tangible impact on the quality of regulatory decisions regardless of the legislative framework and institutional characteristics of the regulator.

40. This is not to suggest the Productivity Commission needs to look at the substance of each regulatory regime in any detail. We appreciate the inquiry is not a review of specific regulators and regulatory regimes. But, in our view, there are some common downstream design and operational factors that influence the quality of regulatory decisions and which are important for successful regulatory regimes. We suggest below (in Section E) some regulatory practices we consider should be examined as part of the Productivity Commission's inquiry, supported by case study examples where relevant.

[17] In relation to upstream regulatory design and operation, the Productivity Commission has already identified the key practices and relevant principles in its Issues Paper, drawn from OECD *Principles for the Governance of Regulators: Public Consultation Draft* (21 June 2013). We provide feedback on these practices from NZ Airports' perspective in Section D.

Figure 1: Regulatory design and operation: Influences and incentives on regulatory regimes (adapted from Productivity Commission, 2013)

Regulatory substance: "Downstream" design and practice features	
Regulatory practices and techniques	**Brief description**
Clarity, predictability and comprehensiveness of decisions	Considers the way that regulatory decisions establish benchmarks and expectations for acceptable behaviour
Proportionality	Considers how regulation can be designed and operated in a way that is fit for purpose and reflective of the challenges the regulator is addressing
Application of regulatory tools	Considers how to select, design, and implement different regulatory tools to best meet legislative objectives
Escalation and reduction of regulation	Considers how regulatory intervention should be increased or reduced, including ways to prevent regulatory inflation
Regulatory analysis	Includes bottom-up and top-down analysis approaches, qualitative and quantitative evaluation, and examination of sector-wide and contextual factors



Regulatory governance: "Upstream" design and practice features	
Institutional arrangements and regulatory practices	**Brief description**
Clarity of role, functions and duties	Considers clarity of the objectives of the regulation, and assists regulators to understand the boundaries of their authority and prioritise work
Overlapping and consistent regulatory regimes	Considers consistency with other regulatory regimes including existing legislation and other relevant policies
Regulatory independence and institutional form	Considers how to prevent a regulator being used for partisan purposes, considers a range of institutional forms for regulators
Decision-making structures, processes and approaches	Considers the way regulatory decisions are made, which will inform the shape of the governance structure of the regulator
Decision review and appeal	Considers ways in which the decisions of public bodies can be scrutinised
Allocation of risk through the regulatory system	Considers whether risks are managed by those who have the ability to control them, the right incentives, or take steps to prevent problems
Funding and resourcing	Considers whether regulators have sufficient funds to allow them to undertake the functions necessary to achieve regulatory outcomes
Regulator workforce capabilities	Considers how to maintain the right kind and amount of capability for regulators to deliver on regulatory outcomes
Compliance monitoring and enforcement	Considers the appropriate range of enforcement tools and the appropriate level of discretion to give regulators
Engagement	Includes gathering information, promoting awareness of obligations; early warnings; understanding community expectations and priorities
Organisational culture	Includes learning and consistency; empowering staff to make difficult calls; risk aversion and customer service; potential for professional capture
Accountability and transparency	Considers how regulator is held to account for its use of powers and resources, and provides access to information about conduct
Performance assessment	Considers how regulators drive continuous improvement in the way regulation is undertaken

SECTION D: IMPROVING UPSTREAM REGULATORY DESIGN AND OPERATION

41. NZ Airports agrees with the discussion in the issues paper on the general principles of upstream regulatory design. In this section, we present case study examples from our experience of airport regulation in New Zealand where relevant to the Productivity Commission's questions.

42. We acknowledge that the relevant regulators for airport purposes (the Civil Aviation Authority[18] and the Commerce Commission) are both tasked with administrating technical and complex regulations. Although we do not always agree with the decisions they make, we appreciate that they make decisions that they believe will produce the best outcomes under the applicable regulatory frameworks. Accordingly, our examples illustrate where design features may nevertheless be preventing these regulators from making the best possible decisions or promoting the best possible regulatory outcomes.

Table A: Comments on questions in Productivity Commission issues paper

	Question	Comment
		Clarity of role, functions and duties
7	Where regulators are allocated multiple objectives, are there clear and transparent frameworks for managing trade-offs? What evidence is there that these frameworks are working well/poorly?	The Commerce Commission must carry out its economic regulatory functions in a way that meets the legislative objective of Part 4 of the Commerce Act 1986. This purpose statement requires the Commission to design and operate regulation that promotes the long-term benefit of consumers by promoting outcomes that are consistent with outcomes produced in competitive markets, such that suppliers of regulated goods and services: • have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and • have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and • share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and • are limited in their ability to extract excessive profits.[19] These objectives are inherently interrelated. For example, regulation that aims to limit profits must be carefully balanced against the other elements of this purpose statement, given the risk that insufficient funds would significantly impact investment levels and cause potentially long-term consequences for the quality and availability of services. In practice, these (at times) competing objectives have impacted on the Commerce Commission's performance of its regulatory functions. Regulated suppliers have consistently argued that the policy and legislative history of Part 4 supports a preference for promoting incentives to invest and innovate whenever the objectives may potentially be in conflict. In general, airlines and the Commerce Commission have disagreed. All parties have pointed to policy materials and Parliamentary debates to support their respective positions. However the trade-offs are managed, the divergence in opinion demonstrates there is limited guidance and a lack of clear and transparent frameworks in place for how the Commerce Commission is required to balance its competing objectives. For example, in the recent section 56G reviews of the effectiveness of information disclosure regulation, the Commerce Commission has appropriately noted that the performance areas under assessment (which translate to the elements of the purpose statement set out above) are interrelated, and that it is appropriate to consider relevant outcomes in other areas in order to assess the effectiveness of information disclosure in promoting particular outcomes. However, beyond this statement, it is not clear precisely how the Commerce Commission has considered other areas or the trade-offs that may be involved. The lack of guidance to the regulator on how to balance the broad purpose statement has also, in our experience, resulted in a relatively lower level of focus by the regulator on incentives to invest (due to an assumption that regulated entities have natural incentives in this area) than other limbs of the purpose statement. Difficulties have also been created through the interaction between the purpose of information disclosure set out in the Commerce Act (to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met), the purpose of Part

[18] The Civil Aviation Authority establishes civil aviation safety and security standards, sets out specific obligations for industry participants (including airports), and monitors adherence to those standards and with those obligations.

[19] Commerce Act 1986, s 52A.

	Question	Comment
		4 (as set out above), and the requirement for the Commission to undertake a transitional review of how effectively information disclosure regulation is promoting the purpose of Part 4 (when that is not the statutory purpose of information disclosure regulation). This has led to a divergence in opinion between the Commerce Commission and regulated suppliers, where: • suppliers consider that information disclosure regulation is focused on promoting the right incentives through transparency and access to information; but • the Commerce Commission considers that information disclosure regulation is ineffective if it does not directly promote the outcomes in the Part 4 purpose statement. Greater legislative direction as to the interaction between the various purpose statements would have significantly reduced such disputes about the nature of the regulation and its purpose.
8	Can you provide examples of where assigning a regulator multiple functions has improved or undermined the ability of the regulator to achieve the objectives of regulation?	In New Zealand, the Commerce Commission has both competition and economic regulatory roles. Within its role as an economic regulator, the Commerce Commission sets the regulatory rules (known as input methodologies) for all sectors subject to economic regulation under the Commerce Act, designs the regulatory tools (such as the information disclosure requirements that apply to airports), monitors and analyses the performance of regulated suppliers and, for airports, was required to conduct a one-off transitional review of the effectiveness of information disclosure regulation. The Commission is also tasked with conducting inquiries into whether particular goods or services should be regulated, and recommending which type of regulation should apply. These multiple roles have presented a number of challenges: • The Commerce Commission is tasked with setting input methodologies for electricity, gas, transmission and airport services. These services are fundamentally different, and the types of regulation involved range from light-handed information disclosure to price control regimes. In practice, the content of the input methodologies that apply to each sector is virtually identical, and the Commerce Commission's multiple roles has contributed to input methodologies for airports (which are subject to information disclosure only) that have been taken from electricity price control context and adapted (very slightly) at the margins. This has resulted in a regime that does not reflect its light-handed objectives. • As noted, the Commerce Commission has been tasked with conducting a transitional review to report to Ministers on how effectively the information disclosure regime is meeting the statutory objectives. There have been a number of issues with this review caused by various design features, which are discussed throughout this submission. For present purposes, the review highlights that there can be real problems where a review of the effectiveness of a particular regulatory framework is undertaken by the regulatory entity that was responsible for the design and implementation of that framework. In practice, this has resulted in the Commerce Commission: o expecting airports to have foreseen regulatory interpretations which have in fact been developing during the review and were not evident when information disclosure was established; o escalating the review into a detailed analysis of airport performance and pricing (as opposed to a review of the regulatory framework more generally); o judging the regime to be ineffective if it failed to immediately achieve the same results in relation to profitability as the price control regime it applies to other sectors; and o giving little consideration as to whether the outcomes observed are or may be a consequence of potential gaps in the design of the regime. • If this evaluation had been carried out by an independent third party, it is reasonable to assume that it would have included, at least in part, greater emphasis on the effectiveness of the design of the regime, including the degree to which it met its legislative objectives (or could be expected to meet these objectives over time). Overseas examples can provide a useful reference. For example, we note that: • In Australia, annual price monitoring is carried out by the Australian Competition and Consumer Commission against a set of pricing principles implemented by the Australian Government in 2002 following the removal of price cap regulation at Australia's major airports.[20] Despite calls from the ACCC for increased regulation, the Australian

[20] The National Competition Council also has the ability to intervene to impose access conditions for airport infrastructure in accordance with general rules governing access to monopoly infrastructure (following a set process).

	Question	Comment
		Productivity Commission has carried out reviews of the economic regulatory framework in 2007 and 2012, concluded that the regime is performing well, and rejected calls for increased regulation (with its recommendations adopted by the Australian Government). This approach demonstrates the importance of reviews of the regulatory framework being undertaken by a suitably independent body that is tasked with and resourced to consider wider sector and welfare considerations. • In the United Kingdom, a fundamental reform of the provisions governing airport economic regulation was recently undertaken (which included substantially revised legislation). The regulatory changes were driven, in part, by the recommendations of the Competition Commission, which made a number of criticisms of the regulatory framework and the way the Civil Aviation Authority carried out its economic regulatory functions, during the Commission's investigations into the British Airports Authority.[1] This reinforces the value that multiple bodies can bring to a successful regulatory framework when they are in a position to make conclusions and recommendations about the regulatory regime and the performance of the regulators within that regime.
		Overlapping and consistent regulatory regimes
13	Can you provide examples of where two seemingly similar regulatory areas are regulated under different regulatory structures? What factors have contributed to differences in the regulatory structures?	The Airport Authorities Act 1966 includes information disclosure requirements which apply to smaller and regional airports. The allocation of these information disclosure requirements between the Commerce Act and the Airport Authorities Act strikes the right balance for the nature of New Zealand's airports, recognising that: • more extensive disclosure (and the associated monitoring by the Commerce Commission) is appropriate for Auckland, Wellington and Christchurch Airports, due to the scope for these airports to exercise market power; but • a lighter-handed and lower cost form of information disclosure is appropriate for smaller airports, recognises that airlines often have the market power in relation to their dealings with these airports (and that the necessary threshold for Commerce Act regulation would not be met), and ensures that regional airports are not subject to a relatively high cost regulatory regime that may harm the productivity of the sector. For completeness we note that, under the Airport Authorities Act 1966, all airports retain the ability to price as they see fit (deliberately retained by Parliament when information disclosure regulation under the Commerce Act was imposed). As discussed further below, although airports retain this ability, the design of the information disclosure regime for Auckland, Wellington and Christchurch Airports has, in practice, impacted on the operation of the Airport Authorities Act regime.
		Regulatory independence and institutional form
17	What should be the limits of regulator independence? What sorts of regulatory decisions should be the preserve of Ministers rather than officials?	For economic regulation, it is important that a regulator is politically independent. Transparent and appropriate mechanisms should be in place for Government and policy direction. Further, a clear and independent regulatory process is important to avoid political intervention or circumvention of appropriate controls in response to isolated incidents. For example, in Australia, the Australian Competition and Consumer Commission recommended airport services be "deemed declared" under Part IIIA of the Competition and Consumer Act 2010. The National Competition Council and the Australian Productivity Commission cautioned against the circumvention of the processes contemplated in the legislation for declaration under the Act. The Australian Government generally agreed with these concerns and considered no changes were required as the existing legislation provided appropriate mechanisms that should be followed if increased regulatory intervention was required. No further action has been taken. It is important that Ministers, rather than officials or the regulator, retain the power to make decisions on whether regulation applies to a particular business/sector and, if so, what type of regulation applies. Appropriate legislative controls must be in place to ensure that these decisions are made transparently, follow due process, involve substantial cost-benefit analysis, and that regulatory intervention is made only when necessary (ie its benefits outweigh its costs) and only to the minimum extent necessary to address the problem in question.
		Decision review and appeal
26	How effective and consistent are the review and appeals processes provided for in New Zealand regulatory regimes?	It is important that core regulatory decisions are subject to appropriate appeal processes. For this reason, NZ Airports supports the availability of merits review appeals against decisions such as the setting of input methodologies by the Commerce Commission. However, it is also important to ensure that the appeal forum has the appropriate expertise and procedural flexibility to handle the challenges that come from a factual appeal against very technical and detailed decisions. For example, it may be appropriate for a decision-maker on appeal (whether

	Question	Comment
27	Can you provide examples where the review and appeals processes provided for are well-matched or poorly suited to the nature of the regulatory regimes?	the Court or an expert panel) to be empowered to adopt an inquisitorial role where this will assist with the efficient and just determination of the issues on appeal. It is also important to carefully balance the evidence that may be referred to on appeal. NZ Airports accepts there is a need to prevent parties "gaming" regulatory consultations by not presenting relevant material to the regulator and relying on this material on appeal. However, a "frozen record" (whereby parties are not allowed to introduce any new material on appeal - see, for example, section 52ZA of the Commerce Act) can result in an artificial appeal process and may not be appropriate in all instances. For example, the input methodologies decisions were made in December 2010. The appeal began in September 2012, but had to be argued based on a world as at December 2010. This meant that, in some instances, parties were forced to argue about hypothetical consequences of the methodologies when real evidence of the consequences of the methodologies existed. This may not be conducive to optimal sector outcomes, particularly when the relevant threshold is for the Court to be satisfied that a materially better methodology exists on its merits. NZ Airports may be able to provide further comments following the release of the merits review judgment for the airport sector.
	Allocation of risk through the regulatory regime	
29	Can you provide examples of regimes where risks are borne by a regulator, regulated party, or the public/consumers, but they are not best-placed to manage those risks?	NZ Airports agrees with the Productivity Commission that it is important for a regulatory regime to allocate risk and responsibility to the party best placed to manage that risk. It is important for this allocation to be clear, well understood and consistently applied. Allocation of risk under Part 4 is not a precise science. The decisions made by the Commission on various parts of its detailed rules (input methodologies) involve a combination of legal and economic factors, and inherently involve judgment and discretion. Many of these decisions can be more "art than science".[21] Importantly however, the risks of getting a decision wrong can be severe, particularly if the consequence is inadequate investment in the short-term (which will have a significantly negative impact in the long-term). For this reason, it is better for economic regulators to err on the side of being broadly right and run the risk of allowing some excess returns, rather than striving for an unattainable level of precision and being exactly wrong. NZ Airports has argued that the Commerce Commission's approach, in seeking precision where that does not reflect the nature of the regulatory tools (which are inherently imprecise) goes too far and places the risk of getting regulatory decisions wrong on airports and future consumers. Under a regime whose fundamental premise is that future consumers cannot manage those risks (the purpose is to promote the long-term interests of consumers), this is a problematic allocation of risk. We also note that the Civil Aviation Act 1990 and Civil Aviation Rules allocate regulatory obligations to airports, airlines, and airways operators for aviation safety. However, there are some aspects of this regime that are unclear about where particular responsibilities lie. For example, the regime does not clearly allocate responsibility for the management of airspace in the vicinity of an aerodrome. In practice, this means that participants (ie Airways, airports and airlines) are unsure of the extent of their individual responsibility (and therefore liability). This has not been helped by the Civil Aviation Authority's position that the responsibility is "joint" or "shared". In the unlikely event of an accident, this ambiguity will lead to disputes between participants about the allocation of liability. This is not an appropriate position given the civil aviation industry is clearly premised on safety of operations. In our view, this underscores the importance of clear and well-understood risk and responsibility allocation to the party best placed to manage the risks involved.
	Funding and resourcing	
30	Can you provide examples of where the mix of funding sources contributes to the effectiveness or ineffectiveness of a regulatory regime?	As a general principle, NZ Airports considers that the costs of regulation should be funded by its beneficiaries (ie consumers). In addition, funding and resourcing should be subject to appropriate oversight while ensuring the regulator has sufficient resources to carry out its statutory roles. For regulated airports, the Commerce Commission has recently proposed an increase in its funding requirements from 2014/2015 onwards from previously approved baseline levels (see **Appendix 1**). Original baseline levels have been incorporated into airport prices that have been set for the next five years, and therefore it is not clear that regulated airports will have the ability to pass on the increased costs to consumers (as is the intention of the funding levy).
32	Which New Zealand regulators (or regulatory	Although the funding proposal discussed above was circulated for feedback, NZ Airports considers that aspects of the proposal could have been improved. In our view, outputs, budgets

[21] A sentiment expressed by the Australian Productivity Commission. See, for example: Australian Productivity Commission *Economic Regulation of Airport Services: Inquiry Report* (December 2011) at page 128.

	Question	Comment
	regimes) provide good example of open and transparent funding arrangements? Can you provide examples where the transparency of funding needs to be improved?	and costs would need to be more transparently disclosed by a regulator, and broken down by sector, to explain any increase in funding that was proposed for airport regulation (for example, staffing levels, work streams and costs should be set out in detail by sector). This would allow a better assessment of whether the costs are justified and the work streams proposed align with the statutory functions of the regulator.
		Engagement
47	What forms of engagement are appropriate for different types of regulatory regime?	Regulatory regimes that require the regulator to have in depth knowledge about the regulated business require a comprehensive engagement approach. For example, airports are complex multi-faceted businesses delivering a wide variety of services to a range of intermediate and ultimate consumers. The majority of the information needed to reach appropriate outcomes for the sector sits with airports (and airlines) and, for that reason, a regulator will always be at an information disadvantage to the regulated airports. Careful analysis of airport performance is essential in order to avoid simplistic or misleading conclusions. Accordingly, an approach that incorporates both formal and informal engagement with airports is important. This is particularly important given the Commerce Commission also has competition functions. In those functions, it could be expected the Commerce Commission would take an investigative role that keeps the businesses it deals with at arm's length. In a regulatory context however, it is critical that the regulator and regulated entities have strong relationships involving good communication, free flowing information, and opportunities to test and explore understanding of regulatory rules and supplier performance to facilitate successful regulatory outcomes.
		Organisational culture
51	Can you provide examples where the culture or attitude of the regulator has contributed to good or poor regulatory outcomes? How?	The culture of the Commerce Commission is directed towards regulation, not considering whether regulation is the optimal outcome or not. This is proper for a regulator who is an enforcer, but is problematic when the enforcer and regulatory "designer" are the same entity. Our experience under Part 4 suggests that there is a lack of clear differentiation between the heavy and light-handed regimes the Commerce Commission is asked to regulate. This is perhaps not surprising given the more heavy-handed regulatory history of the Commerce Commission and the lack of clear guidance on how different types of regulation should be distinguished from each other. We also note that the Commerce Commission has approached its analysis of airport performance under the information disclosure regime under an assumption that behaviour change was required (when, in many cases, behaviour before Part 4 was introduced was already promoting good outcomes for consumers and the airport sector). This may reflect on the history of the Commerce Commission as a regulatory enforcer that acts when problems have already been identified. In our view, it would have been more appropriate and reflective of the regime for the Commerce Commission to have started with an evidence-based approach based on disclosed information and annual analysis of performance, rather than assuming that changes were required.
53	Can you provide examples where a regulator places too much value on managing risks to itself, relative to other priorities (such as the regulatory objective, or customer service)? What are the consequences?	There is some evidence that the Commerce Commission manages risks to itself in a way that may impact on other priorities. For example: • The Commission has developed prescriptive information disclosure requirements to apply to airports. This could be driven, in part, by a perception that more prescriptive requirements are "safer", easier to monitor compliance against, and less likely to attract negative attention than consumer complaints in the event the regulatory regime was less prescriptive and found to be ineffective. However, as noted by the Productivity Commission, a heavy-handed approach and over-stringent application of regulation can undermine cost-effective intentions. • The Commission currently consults extensively on its projects, but there is a general reluctance on the part of the Commission to engage with regulated suppliers outside the formal consultation steps when a consultation is underway. This could perhaps be due to an aversion against process challenges to the performance of its regulatory functions. • There is a tendency for airline concerns to be treated as the concerns of all consumers (despite the fact that airlines may have natural business incentives which are at play in a regulatory environment that do not always align with passenger interests). This may reflect a concern on the part of the Commission to be seen to be protecting consumers and to be firm with regulated suppliers.

	Question	Comment
54	Can you provide examples of regulators whose approach to their business is largely shaped by their reliance on a particular profession? How might that approach be different if it drew on a wider range of professions?	Over the development and implementation of Part 4 regulation, aspects of the regulatory regime have relied heavily on academic and theoretical viewpoints that do not fully acknowledge the commercial and practical challenges of providing airport services and running a well-functioning airport that contributes positively to short and long-term economic productivity. This has resulted in the development of rules and approaches that can diverge from market realities and prudent commercial and financial approaches. The relationship between electricity/gas network businesses and their consumers is significantly different to the relationship between airports and airlines. In our view, the Commission's experience with these other regulated sectors, its preference to use academics with a background in network utility regulation, and the lack of legislative guidance as to how commercial pressures facing airports were to be factored into the information disclosure regime has led to a lack of recognition of the constraints on airport behaviour from well-resourced and seasonally experienced counterparties. A greater acknowledgement of industry, market and commercial viewpoints when developing regulatory decisions would see airport regulatory decisions that are more reflective of the realities that face regulated businesses in the airport sector.
	Accountability and transparency	
55	Can you provide examples of how accountability or transparency arrangements improve or undermine the effectiveness of a regulatory regime?	In our experience, greater financial and substantive accountability could be expected to deliver benefits in the context of light-handed information disclosure regulation, which was intended to be a low-cost regulatory regime.[22] For example, greater financial accountability is required to ensure the regulator is acting efficiently, is not inappropriately enlarging its statutory role where this is not warranted and justified, and that the regulation is developed and implemented in a low-cost manner that is proportionate to the issues being addressed. Our experience to date has been that the Commerce Commission has sought to increase the level of funding for its functions in relation to airport services to a level that the airports do not consider reflects the light-handed and low-cost intentions of the regime. Given that these costs are intended to be borne by consumers, it provides an incentive for the regulator to demonstrate the off-setting benefits of regulation (and potentially narrows the regulator's focus). Substantive accountability is important to provide feedback to a regulator on their performance and to ensure that the design and operation of the regulatory regime is carried out in a way that ensures the best possible decisions and achieves good outcomes for the regulated sector. In our view, substantive accountability to an independent third party that is equipped to consider the impact of the regulatory regime on broad, sector-wide and economy-wide issues would promote greater regulatory effectiveness and increase the prospects of good quality, targeted and proportionate regulation.
	Performance assessment	
58	Can you provide examples of where performance assessment of regulatory regimes is working well, or needs improvement?	In relation to performance assessment of regulatory regimes: • It is important for performance assessments of the regulatory framework to be appropriately timed. This timing must be clear, and must make sense in the context of the overall regulatory regime. Importantly, the conclusions that are drawn about the regulatory regime should reflect the data that is available at the time. • Regulators can face incentives to draw particular conclusions about the effectiveness of their own regimes (including incentives to draw conclusions where there may be insufficient data or consider whether the regime's reach should be expanded). This supports evaluations being undertaken by a suitably independent third party. For example, as noted above, we do not consider it is appropriate for the Commerce Commission to have been tasked with reviewing the performance of its own regulatory framework for airport information disclosure regulation. • When the performance of any regulatory framework is being evaluated, it is important to remember that "regulation is a means to an end and the end is better sector performance".[23] This means that any assessment of the performance of a regulatory regime must look at overall sector outcomes and assess whether the regulatory framework helps or hinders in achieving the goals that the government has established for that particular sector.[24] This may involve quantitative measures, but it is important to consider the broad impact of regulation at a qualitative level.

[22] See, for example, **Box 4** above. See also **Appendix 1** at paragraphs 10 to 24, and 35 to 41.

[23] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at 6.

[24] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at 6.

	Question	Comment
		By way of example, key points from the review of the airport information disclosure regime (carried out under section 56G of the Commerce Act) are as follows: • The effectiveness of the performance assessment was impacted in a number of ways by the legislative design. In particular, our experience has suggested that the regulator was required to carry out the review too early in the life of the information disclosure regime. In practice, this has meant that the review was carried out at a time when the regime is in its infancy and when limited guidance, trend analysis and clarity were available to airports about the standards for acceptable behaviour. • Our experience is that the regulator was incentivised to attempt to draw firm conclusions about the regime wherever it considered it was possible, and to overstate the impact that the regime could be expected to have had on airport performance at the time of the assessment. • Very limited guidance was available to the regulator as to how it was to carry out the review. This has, in our experience, resulted in the review escalating from a "check up" on the performance of the regime in its early stages to a detailed and prescriptive analysis of airport pricing decisions. • This lack of guidance as to how the review was to be carried out has also impacted on the type of analysis that has been undertaken. In our experience, the tendency was for the regulator to attempt to focus on quantitative measures and descriptions of behaviour, and to draw on its experience in other industries to assume that airports understood how the Commission would approach things (when this was a new form of regulation in New Zealand that was unknown and untested). For example, the Commission has had little regard to independent international comparative assessments of airport pricing (despite these comparisons being made available. Similarly, a consideration of broader sector outcomes has been largely absent from the review. In our view, this has resulted in conclusions being drawn that do not reflect the current, very positive, state of the airport sector. • Lack of legislative guidance about how to factor in commercial pressures facing airports has also, in our experience, led to under-recognition of the role of experienced and knowledgeable airlines in the pricing process. • There is also some evidence that the requirement for the Commission to carry out a review immediately following the establishment of the regime impacted on the regime's design. In our view, this requirement is a factor that contributed to the level of prescription in the regime's design. • It is useful for consumers and stakeholders to be involved in these types of performance assessments. However, in our experience, this has resulted in areas of disagreement between airports and airlines receiving disproportionate attention, detracting from the substantial degree of alignment between airports and airlines on a number of important aspects of airport performance and service delivery. In addition, the views of passengers, the ultimate consumers of airport services, have received insufficient attention in the performance assessment of the regime (with airline views operating as an imprecise proxy for the views of this group). It is also important to ensure that regulators are subject to regular performance assessment and periodic peer review to ensure that regulatory decisions are of a high quality and are targeted, proportionate, and directed towards legislative objectives and positive sector outcomes. Performance review is an important part of ensuring a regulator is subject to proper substantive accountability (and, therefore, is a critical part of ensuring quality regulatory decisions). Regular performance assessment and periodic peer review provides important feedback to both regulators and regulated entities about the operation and interpretation of the regulatory system. Guidelines and recommendations in this area could be expected to produce significant benefits given the current lack of monitoring and accountability mechanisms for Crown Entities such as the Commerce Commission, and we would encourage the Productivity Commission to consider what recommendations it can make in this respect. For example, guidance about when performance assessments are required, who they should be carried out by, what aspects of regulatory structure and regulatory substance should be evaluated and how those assessments should be carried out, and the performance standards that regulated entities should be assessed against could be expected to contribute positively to improving regulatory quality in New Zealand.

SECTION E: IMPROVING DOWNSTREAM DESIGN AND OPERATION

43. In this section, we consider the key downstream design features and regulatory practices that influence the quality of regulatory decisions. In our view, these include:

    (a) clarity, predictability and comprehensiveness of regulatory decisions;

    (b) proportionality and fitness for purpose;

    (c) application of regulatory tools;

    (d) escalation and reduction of regulation; and

    (e) regulatory analysis and decision making.

44. As discussed in Section C, we consider these elements are an important part of the Productivity Commission's inquiry, and will allow the full picture of influences and incentives affecting the quality of regulatory regimes to be examined. This is particularly so in relation to economic regulation, where the regulator has a broad discretion to make the substantive rules that determine the success or failure of the regulatory regime.

45. NZ Airports acknowledges that there are inevitably areas of overlap between the regulatory practices we discuss. Nevertheless, we consider the categories help to identify what good regulatory design and practice looks like in the New Zealand context, and how they can be improved. These practices are also useful to bear in mind when considering the regulatory governance factors discussed above.

Clarity, predictability and comprehensiveness of regulatory decisions

46. It is important for regulatory decisions to be clear, predictable and comprehensive. It is well accepted international practice that regulated entities should not be held to account for any activity unless the standards and expectations with which they are expected to comply are formally in place and publicly available.[25] The relevant rules should be thorough, complete and clear as to the rights, responsibilities, expectations and consequences that apply to all stakeholders.[26]

47. There will be times that it is not possible to have all elements of a regulatory system formally set out in advance. Aspects of the regulatory regime will evolve and develop over time. Regulation is a learning process, and should seek continuous improvement. This is particularly important in an information disclosure framework that is focussed on building an increasing body of performance information and monitoring trends in behaviour and outcomes over time.

48. However, in these types of situations, it is important to recognise that regulated suppliers are at an information disadvantage to the regulator, and will have less information about how their performance and behaviour is to be judged. Conversely, the regulator has an information deficit in relation to the operation of the business of the regulated entities. Accordingly, conclusions that are drawn by the regulator about whether regulatory objectives are being achieved should credibly reflect the level of maturity of the regulatory regime at the time the assessment is made. In the experience of NZ Airports to date, this has not always been the case (see **Box 6**).

[25] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 200.
[26] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 66.

Box 6: "At the time they set prices"

- The section 56G review has involved a detailed review of airport performance and pricing decisions, and an assessment by the Commerce Commission of the impact of information disclosure regulation at the time that airports set prices. In some cases, the Commission has drawn adverse conclusions about airport pricing behaviour based on an inference that airports "knew" their pricing levels were different to the Commission's standards of "acceptable returns".
- In our view, the Commission has overstated the certainty of the expectations provided by information disclosure regulation at the time airports set prices, and overstated the impact the regime should have had on airport decision making.
- At the time of pricing, the information disclosure regime did provide some guidance on expectations of appropriate conduct. However:
    - The information disclosure regime was very new at this time. There was no guidance available on how the Commission would conduct assessments of disclosed information. No monitoring and analysis reports (which the Commission is required to carry out on an annual basis under section 53B of the Act) had been prepared - an important element of the feedback loop to provide guidance to airports on appropriate behaviour and performance, as well as to provide information about how the Commission would undertake its regulatory functions.
    - At the time of pricing, the rules the Commission has used to calculate its level of "acceptable returns" (which it uses to judge airport behaviour) were subject to merits review by the High Court and were subject to the potential for material change. The High Court decision is still yet to be released. In addition, discussion and expert opinion through the consultation process had shown there was scope for genuine differences of opinion on these elements.
    - Information disclosure was a light-handed form of regulation that is not price control. In addition, the consultation and price-setting provisions of the Airport Authorities Act 1966 were expressly retained. The input methodologies developed as part of the information disclosure regime were not binding for pricing purposes.
    - It was clear that information disclosure regulation would increase in effectiveness over time as more information became available to the regulator and interested parties about performance, and as more information was available to airports on the expectations of the regime.

Proportionality and fitness for purpose

49. It is well accepted that regulatory intervention should be targeted, proportionate to the challenges the regulators are addressing, and accomplished at minimum cost to the regulator and regulated entities.[27] This means that intervention should be the minimum necessary to remedy the problem that is being addressed, and should only be undertaken if the likely benefits outweigh the expected economic and social costs.[28] In our view, proportionality and fitness for purpose are regulatory practices that allow regulators to strike the balance between acting consistently and acting in a way that is tailored to the nature of the problem being addressed.

50. Legislators often use terms like "fit for purpose" and "light-handed" to describe regulation and regulatory regimes (see **Box 7**). Proportionality requires that these policy and legislative intentions actually translate into regulatory decisions and the way regulatory functions are carried out. Part of this is ensuring that clear guidelines and expectations exist, both for what is meant by terms such as "light-handed regulation", and for how regulators should implement rules and processes to match.

[27] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 67.
[28] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 61.

Box 7: Proportionality in regulatory regimes

Internationally, proportionality is being given an increasingly important place in regulatory regimes. For example, under new legislation introduced in 2012, the United Kingdom Civil Aviation Authority (which is responsible for, among other things, the economic regulation of airports) is now expressly required to regulate "in a way which is transparent, accountable, proportionate and consistent", targeting regulatory activities "only at cases in which action is needed" (UK Civil Aviation Act 2012, section 1).

In relation to the Part 4 regime in New Zealand:

- Parliament considered it was "desirable to provide a range of regulatory options to provide fit-for-purpose regulation" (see the comments of the Minister of Commerce at 2008 NZPD 649 at 18314). These comments are reflected in the expanatory note of the Bill, which states that the regime "provides for lighter-handed forms of regulation as well as for conventional price control. This is designed to allow "fit for purpose" regulation to meet the circumstances of specific suppliers and sectors" (Commerce Amendment Bill (201-1) (explanatory note) at page 5).
- However, beyond providing the regulator with different forms of regulation (such as information disclosure and price control) the Act provides limited guidance to the regulator as to these regulatory forms are to be different from each other and how a particular type of regulation should be developed so that it is "fit for purpose". In our view, this has resulted in a regime that does not reflect its "fit for purpose" intentions.

51. For example, to ensure proportionality, the following regulatory practices are particularly important, and should be reflected in the design and operation of regulatory regimes:

(a) Regulation should be cost-effective, and its benefits must outweigh its costs (both of administration and to society through the risk of adverse outcomes). The difficulty is that most regulators are not able to assess the hidden costs of regulation and to ensure that regulatory powers are used cost-effectively and coherently.[29] They also have little incentive to constrain the costs of regulation when levies are available to fund their functions. This underlies the importance of clear design, guidance, and oversight of regulators' performance.

(b) A regulatory agency should possess the ability to vary its regulatory tools and practices so that it can accomplish the objective at minimum cost to itself and regulated entities.[30] Further, although having this ability is important, it is not sufficient by itself to promote proportionality. Regulators must apply the tools they have in appropriate and proportionate ways. This is particularly important given that a regulator may have incentives to adopt the same level of prescription across different regulatory regimes in order to minimise its own costs, without adequately accounting for the impact this has on business productivity.

(c) Proportionality requires regulators to acknowledge and seek to understand the particular characteristics of the industry that is being regulated, and act in ways that are relevant to the nature of the regulated entities.[31] This means that the regulatory response to any situation must be carefully tailored in light of the nature of the parties involved.[32] This is particularly important as the regulated industry increases in complexity. We discuss the impact of this in the airport sector at **Box 8**.

[29] OECD *The OECD Report on Regulatory Reform: Synthesis* (1997 Paris) at page 9.
[30] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 67.
[31] See, for example, The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 67.
[32] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 214.

Box 8: The nature of the airport industry and its impact on the design and operation of regulation

- Intermediate consumers of airport services (airlines) are sophisticated commercial entities that will, in many cases, be better informed than a regulator could ever be. For example, in the United Kingdom it has been noted that: "Experience has borne out the [UK Civil Aviation Authority's] view that, in an increasingly complex market, airlines and airports are more knowledgeable than the regulator about their own preferences and about the opportunities open to them. In some respects they can agree better (mutually preferred) specifications than the regulator can specify" (Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 27.8).
- Airports increasingly compete to attract airline services. This means that airlines have greater buying power, and airports must carefully consider what airlines and passengers want. As noted by the Australian Productivity Commission: "Few would dispute that a major hub airport will have a stronger bargaining position than an airport in a more competitive environment. Nevertheless, it is also unreasonable to treat airlines as powerless. [...] In short, the presence of market power does not automatically mean an airport will exercise and misuse it" (Australian Productivity Commission *Economic Regulation of Airport Services: Inquiry Report* (December 2011) page 169-170).
- Airport investment is characterized by lumpy, long-term investments that often result in excess capacity when new assets (such as a new runway or terminal) are commissioned. This warrants a careful, long-term focus on the appropriate pricing paths and options to smooth the recovery of these investments over time.
- These factors warrant a very different approach to the development of regulatory rules under Part 4 of the Commerce Act (including both the rules of information disclosure and the content of input methodologies) for the regulation of airport services than is appropriate for network utilities such as electricity and gas distribution. Instead, detailed and prescriptive methodologies were taken from the electricity and gas sectors and adapted at the margins, resulting in virtually identical methodologies across these very different industries.
- A major concern has now arisen regarding airports' ability to implement efficient pricing approaches to recover the costs of lumpy investments (such as the new terminal at Christchurch Airport and the future new runway at Auckland Airport).

(d) Regulators and regulation should encourage market dynamics within a regulated industry. The existence of market power does not mean that there is no scope to promote competition,[33] or to promote competitive-type constraints within the regulatory system. As noted by Steven Littlechild, the designer of price-cap regulation (which is now applied to a number of British network utilities), "even a monopolist needs to discover what its customers want".[34]

Wherever possible within a regulatory regime, it is therefore important to encourage and enable suppliers to discover what customers actually want, and incentivise them to provide it.[35] Regulatory constraints should not assume in advance they know what customers want and the best way of providing this,[36] particularly where customers are well informed, sophisticated commercial entities that are capable of putting substantial pressure on regulated suppliers.

For example, an approach to Part 4 regulation that took into account the nature of the airport industry in New Zealand (see **Box 8** above) would recognise that there is scope to foster and encourage airports and airlines to reach commercial arrangements, and that doing so can be a good way of "promoting outcomes that are consistent with outcomes produced in competitive markets" (a key part of the legislative objective of Part 4).[37] NZ Airports'

[33] Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 10.7.

[34] Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 10.7.

[35] Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 10.7.

[36] See, for example, Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 11.3. Although these comments are made in the context of promoting competition, NZ Airports considers they apply equally when considering how to promote outcomes consistent with those in workably competitive markets (as required under Part 4 of the Commerce Act), particularly in industries where there is scope for market influences through consultation with well-informed, sophisticated and commercial consumers (such as airlines) that impose some competitive constraints on the behaviour of regulated suppliers.

[37] See Commerce Act 1986, s 52A. See also the comments of the Australian Productivity Commission, which notes that: "Perhaps most importantly, as compared with more intrusive regulation, price monitoring can facilitate commercial negotiations between airport operators and users (provided there is no automatic recourse to regulatory determination of prices)": Australian Productivity Commission *Price Regulation of Airport Services: Inquiry Report No 19* (January 2002) at page xxxiii.

experience of Part 4 regulation to date suggests the design and operation of the regulatory regime may prevent this from occuring in the future (see **Box 9**).

Box 9: Prescription and allowing market constraints to produce commercial pricing decisions

- NZ Airports accepts that information disclosure regulation was intended, in part, to impose some disciplines on airport pricing behaviour. However, information disclosure (including the specification of input methodologies) was not intended to drive airports towards a particular outcome in pricing.
- Instead, information disclosure was intended to provide better information to guide consultations between airlines and airports and pricing decisions. It was intended to provide greater incentives to improve commercial relationships, and to allow airports, airlines, and other customers to reach commercial agreements taking into account efficiency, productivity, investment and other issues while providing clear guidance to assist commercial negotiations (Commerce Amendment Bill (201-1) (explanatory note) at pages 40-41).
- This is a sensible approach. An information disclosure regime should allow scope for airports to adopt innovative pricing approaches that are tailored to the needs of airlines, passengers and communities, and to the particular circumstances facing the airport in question.
- However, when assessing the effectiveness of the regime in its recent section 56G review processes, the Commerce Commission has raised concerns that commercially-based pricing decisions results in a lack of transparency and may complicate the ability of interested parties to assess whether an airport is limited in its ability to earn excessive profits. It considers that "there may be a limit to information disclosure's effectiveness in limiting excessive profits where an airport decides to take a pricing approach that is not explicitly contemplated by the disclosure regime" (Commerce Commission *Draft Section 56G Report for Christchurch Airport* (15 October 2013) at paragraphs 3.2-3.3). It goes on to note that it "is the impact of these commercial considerations which favour the airport's consumers, and any future commercial considerations that Christchurch Airport might continue to make, that are perhaps most difficult to accurately reflect under the information disclosure regime" (at paragraph F109).
- This is not a problem with the approach taken by Christchurch Airport, which the Commerce Commission acknowledges is in favour of consumers. Instead, the Commerce Commission's comments in this respect reflect on the design of the regime rather than the airport's decision to adopt a particular pricing method. Information disclosure regulation should not "contemplate" a particular pricing approach, either explicitly or implicitly. Instead, it should be designed in a way that focuses on providing information about the decisions that were made. In other words, the regulatory regime should focus on trying to explain complex decisions, rather than trying to align those decisions with a prescriptive monitoring approach - an analysis which can create, rather than reduce, confusion.
- The core of the problem so far is that the design of the regime means acceptable behaviour is assessed by reference to an "explicitly contemplated" pricing approach based on the building blocks approach used in a price control situation and a narrow range of "acceptable returns".[1] As a result, these may become the primary reference point for pricing consultations between airports and airlines over time. If this occurs, it risks significantly reducing the ability for airports to discover and provide the most appropriate, innovative and efficient outcomes for consumers through genuine consultation with airlines.
- The consequence of this design flaw is that airports may be discouraged from adopting commercial pricing approaches that are clearly in favour of consumers, due to the risk that these arrangements will be seen as "not transparent" by the regulator. This would be a negative outcome that would not reflect the intentions of the information disclosure regime. There is also an inherent risk that the approaches "contemplated" by the disclosure regime may not be the best ways to meet the regulatory objectives.

Application of regulatory tools

52. There is no single regulatory tool which constitutes "good regulation". Instead, a method of regulation must be designed and implemented to deliver good quality regulatory outcomes in each particular context.

53. As noted above, it is important for regulators to have access to a range of regulatory tools to allow them to appropriately tailor their response to the actual degree of market imperfection and resulting harm.[38] However, providing regulators with these tools is not the end of the matter. It is important to both consumers and regulated companies that regulators design and operate these tools in carefully

[38] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 209.

calibrated ways.[39] This concern reflects a tendency for regulators to seek to apply the same rules to everyone in a uniform and extensive way.[40]

54. For example, if light-handed tools such as information disclosure and price monitoring are not designed carefully, they can mirror heavier-handed regulatory tools and effectively amount to "shadow" price control regulation, rather than reflecting their legislative objectives. In NZ Airports' experience, there is a real risk of this happening given the design and operation of the information disclosure regime for the regulated airports (including the information that is currently known about the way the Commerce Commission will monitor airport pricing) (see **Boxes 10 and 11**).

Box 10: Information disclosure regulation or shadow price-path regulation?

The purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to allow those persons to assess whether the purpose of Part 4 regulation is being met.

During the development of the Part 4 regime and the regulatory rules that would apply to airport information disclosure regulation, airports were concerned that the Commerce Commission's prescriptive approach would lead to information disclosure regulation being dangerously close to shadow price control. This is because the information disclosure regime was designed by taking rules and methodologies from sectors that were subject to price-path regulation and adapting these at the margins. This meant that the rules that were developed for airports mirrored the detailed "building blocks" that would be used by the Commerce Commission to set a price-path if airports were subject to price control. In particular, airports were concerned that the cost of capital methodology would be treated by the Commerce Commission and interested parties as a "target" level of returns the airports were expected to achieve.

During the development of the legislation that underpins the Part 4 regime, the Ministry of Economic Development disagreed with the Commission that methodologies for the cost of capital should be binding where a business is subject to information disclosure regulation only. The Ministry noted that: "Such a requirement could be interpreted to mean that the business has to price in a certain way including earning no more than its WACC. This amounts to price control, but the business is not under price control." (Ministry of Economic Development *Commerce Amendment Bill: Report of the Ministry of Economic Development*, 4 July 2008 at 25).

Although the cost of capital methodology is not binding for information disclosure purposes, this concern has played out under Part 4 in practice. NZ Airports acknowledges that the Commerce Commission has stated on a number of occasions that it is not attempting to implement de facto price control of airport services, and that it continues to repeat that airports are able to charge as they see fit (see eg Commerce Commission *Input Methodologies (Airport Services) Reasons* Paper (22 December 2010 at paragraph 2.9.2); *Draft Section 56G Report for Wellington Airport* (8 February 2013) at paragraphs 2.29 and 2.31). However, the core of the issue is that the detailed and prescriptive design of the information disclosure requirements means that airport performance is compared to a building block model that would apply if airports were subject to price-path regulation.

This has a number of consequences:

- During pricing consultations, the experience to date is that airlines are less willing to consider outcomes that differ from what price-path regulation would provide. This reduces the scope for genuinely tailored, innovative and commercial pricing decisions that benefit all parties, including passengers and exporters.
- The Commission uses the forecast approach that price-path regulation would provide to assess the reasonableness of airports' pricing approaches. Forecast prices which exceed the level implied by this model have been labelled "excessive" by the Commission, and attract negative attention from media and airlines. The Commission has been steadfast in the use of this approach, even when faced with departures from its approach that were agreed to by both an airport and airlines at the time of pricing (for example, when setting prices, Christchurch Airport proposed to add an increment of 0.5 to a particular parameter used by the Commission when estimating the cost of capital for information disclosure purposes. BARNZ agreed that an uplift of 0.5 was appropriate, yet the approach adopted by the Commission to assess Christchurch Airport's performance makes no mention or adjustment for this agreed position).
- This comparison has also been used as evidence that information disclosure is not effective. For example, the Commerce Commission has drawn a conclusion that information disclosure regulation is not effective where forecast returns exceed its estimate of an "appropriate" return (see eg Commerce Commission *Section 56G Report for Wellington Airport* (8 February 2013) at paragraph 3.19). This essentially amounts to a conclusion that information disclosure regulation is not effective because it is not producing prices that would be generated under price-path regulation. This is not, and should not, be the test of effective information disclosure regulation.

[39] The World Bank *Handbook for Evaluating Infrastructure Regulatory Systems* (2006) at page 208 - 209.

[40] See, for example, Philip Lochner *Economic Regulation and Democratic Government* (2000) J. Corp. L. 831, who notes that (at page 836): "Democratic governments, and particularly their administrative organs, are also inclined to standardize and simplify things. That is, what they do is characterized by the more or less uniform and extensive application of the same rules to more or less everyone. In order to make and apply rules, governments put things and activities into categories and simplify distinctions for purposes of administrative convenience [...] Efforts by government to simplify and categorize are fundamentally at odds with the market and behavioural complexity.".

Box 11: Price monitoring or price control by another name: international views

- Under the price monitoring regime that applies to airports in Australia, airlines have sought tight prescription of the price outcomes that pricing negotiations should deliver, including calling for detailed costing guidelines and specification of asset values (Australian Productivity Commission *Review of Price Regulation of Airports Services: Inquiry Report* (14 December 2006) at page 63). Airlines have also proposed that other building blocks parameters (such as asset betas, market risk premiums and the weighted average cost of capital) should be subject to regulatory specification (Australian Productivity Commission *Economic Regulation of Airport Services: Inquiry Report* (December 2011) at page 169).
- These proposals have been rejected. The Australian Productivity Commission has noted that the airlines' suggestions, if implemented, could "effectively dictate a very precise level of 'allowable' revenue" for the monitored airports (Australian Productivity Commission *Review of Price Regulation of Airports Services: Inquiry Report* (14 December 2006) at page 64), and would get very close to a return to heavy-handed price regulation (Australian Productivity Commission *Economic Regulation of Airport Services: Inquiry Report* (December 2011) at page 177 and 207).
- Similar comments have also been made by the Australian Competition and Consumer Commission (ACCC), which is responsible for annual monitoring of airport pricing. The ACCC has been critical in some aspects of the current monitoring regime, as it considers the regime makes it difficult to interpret whether airports are generating revenue consistent with the long-run costs of efficiently providing aeronautical services. However, it has also noted that more detailed monitoring would be likely to "represent 'shadow' retrospective rate of return regulation which is 'too heavy' to be justified" (Australian Competition and Consumer Commission *Submission to the Productivity Commission's Inquiry into Price Regulation of Airport Services* (August 2006) at page vi).
- As noted in a report prepared for the UK Civil Aviation Authority, "the Productivity Commission and the Australian government have stuck rigidly to a policy of describing the dividing line between acceptable and unacceptable in high-level qualitative terms. The fear appears to be that specificity or quantification creates a price cap by another name." (First Economics *Airport Price Monitoring: Further Insights - Report prepared for the CAA* (12 March 2013) at page 1).
- This report went on to contrast the New Zealand regulatory approach to information disclosure. It stated that it is "noticeable that the Commerce Commission lays down prescriptive guidelines to regulated companies for the calculation and reporting of financial information. This prescription extends all the way to the method and assumptions to be used when calculating a cost of capital". The report went on to note that the New Zealand model was more "hands on" than its recommended options for a price monitoring regime in the UK airport sector (First Economics *Airport Price Monitoring: Further Insights - Report prepared for the CAA* (12 March 2013) at page2).

Escalation and reduction of regulation

55. Regulators have incentives to be seen to be taking action and achieving the relevant political objective.[41] It has been noted that:[42]

> Both ministers and officials tend to be held more accountable for failing to regulate than for regulating at excessive cost, as the former is more transparent and can be held up as the reason for any negative outcomes in the activity to be regulated. Excessive regulation, however, is much harder to detect and the costs will be dispersed among those who are regulated, or those to whom the costs can be passed on. This effect skews regulatory decisions [...].

56. This effect is compounded when powerful and well-resourced intermediaries push for a regulatory response to particular circumstances, including through media pressure calling for increased regulation. For example, commentators have noted that regulators find it difficult in practice to respond to customer complaints by saying "there isn't in fact a problem".[43] In these circumstances, it is easier for a regulator (or Ministers and officials) to respond by taking action of some kind against the regulated entity. This can increase the extent of regulation beyond what the policy maker or regulator might otherwise intend.[44]

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41 See, for example: Guerin *New Zealand Treasury Working Paper 03/24: Encouraging Quality Regulation: Theories and Tools* (September 2003) at page 7.

42 Guerin *New Zealand Treasury Working Paper 03/24: Encouraging Quality Regulation: Theories and Tools* (September 2003) at page 7.

43 See, for example, Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 18.6.

44 Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraph 18.6.

57. Such incentives can lead to either intentional or unintentional escalation of regulation through greater regulatory intervention, increased levels of prescription, or the way the regulator exercises its discretion when monitoring and assessing performance. NZ Airports has discussed above various ways in which it believes the information disclosure framework for regulated airports has been escalated beyond its legislative intentions through various design and operational features.

58. In our view, the design and operation of regulatory regimes requires that clear measures be in place to ensure that any regulatory escalation is controlled, follows due and proper processes (including only being introduced where there is clear evidence of a problem and the benefits of escalating regulation clearly outweigh the costs of doing so), and that any unintentional escalation is kept in check. In this way, regulation can continue to achieve its legislative objectives and promote good regulatory outcomes for the sector and the wider economy. The regulatory framework also needs to provide for the reduction of regulation where this may be contemplated.

Regulatory analysis and decision making

59. Thorough regulatory analysis and decision making is critical to good quality regulatory decisions. In NZ Airports' view, a number of common elements impact on the quality of regulatory analysis. In order to improve the quality of New Zealand's regulatory regimes, it is important that regulators have incentives to:

(a) Incorporate more intuitive and "top-down" analysis approaches that consider relevant factors in a relatively general way, including through reference to less tangible indicators of performance and sector outcomes.[45] Where regulators undertake a formulaic and mechanistic analysis, this should be balanced against a broader qualitative approach. If the two approaches lead to different conclusions, the formulaic model may be out of step and may need to be modified.

(b) Take into account evidence of commercial and market realities as well as an overall picture of the business and regulated sector as part of that "top-down" analysis. Regulators should have incentives to evaluate regulatory substance on a sector wide basis to check that regulation is driving positive outcomes for the sector. This includes having regard to broader social and economic conditions, including where those conditions are changing.

(c) Draw conclusions that are based on a sufficient time series of information. A small amount of data can create limitations in attempting to identify trends and monitor behaviour. This is not to say that an analysis should not be carried out, rather that the limitations should be clearly identified and the conclusions should reflect the level of data that is available. For example, conclusions about long-term performance require information collected over a long-term period, rather than assumptions or forecasts about future behaviour.

60. We have provided examples of where these incentives have not existed and have impacted on the airport economic regulatory regime in our discussion above. For example, we have discussed above where aspects of the Commerce Commission's regulatory analysis in relation to information disclosure regulation of airports has been overly formulaic and mechanistic, without regard to appropriate contextual and sector-wide factors.[46] We have also noted that the conclusions drawn by the Commerce Commission about the effectiveness of airport behaviour have been based on assumptions about future behaviour, rather than current evidence and performance.[47]

61. In our view, guidelines and recommendations for robust regulatory analysis (possibly directing regulators to have regard to sector context, to fully explain the limitations of the mechanical tools and benchmarks used in their analysis, to conduct regulatory analysis at an appropriate degree of sophistication (ie avoiding over-simplification and over-complexity) and to draw thorough, robust and

[45] Stephen Littlechild *Regulation of an Increasingly Competitive Airport Sector* (26 May 2013) at paragraphs 4.1 - 4.4.
[46] See, for example, the discussion in answer to questions 52 and 58 in Table A, and Boxes 8, 9 and 10.
[47] See, for example, the discussion in answer to questions 8 and 58 in Table A.

evidence-based conclusions) could provide regulators with a set of best-practice guidelines to inform their analytical tasks.

62. The importance of thorough regulatory analysis is also important when considering upstream design features. For example, it is important to recognise where design features such as separation of roles influence regulatory analysis and decision making. In our experience, the requirement for the Commerce Commission to conduct a review of the regulatory regime shortly after its implementation affected the level of prescription incorporated into the design of the regulatory regime. For this reason, it is important to ensure quality regulatory analysis by properly separating between roles, and by utilising an independent body empowered to consider broad national interests (such as the Productivity Commission) to review the effectiveness of regulatory regimes.

63. In our view, it is vital to regulatory success that sufficient checks and balances are in place to supervise the quality of regulatory regimes. Substantive accountability and performance assessment of both regulatory regimes and of regulators are important to ensure that good quality regulatory analysis is carried out.

SECTION F: IMPACT ON THE PRODUCTIVITY COMMISSION'S INQUIRY

64. NZ Airports has presented a number of examples from the information disclosure regime that applies to New Zealand's three major airports to illustrate where we consider design and operational features have impacted on regulatory quality and outcomes. As we have noted, despite the challenges faced in the development and implementation of the regime, information disclosure regulation is working to promote transparency of airport performance and to introduce additional discipline on airport behaviour.

65. We think that airports and the Commission are learning as they go, and that this has been assisted by constructive engagement between them (despite differences of opinion on material issues). The effectiveness of information disclosure will continue to improve over time, including as a result of Government's focus on improving regulatory outcomes and through any guidance and recommendations from this inquiry.

66. In our view, the examples we have presented illustrate the importance of clear legislative guidance, clarity of a regulator's functions and roles, and strong substantive accountability for regulators (including through robust performance assessment of regulators and regulatory regimes). In addition, these examples demonstrate the relevance and usefulness of considering both upstream and downstream regulatory practices when developing guidelines and recommendations to improve the quality of new and existing regulatory regimes.

67. In this way, NZ Airports encourages the Productivity Commission to consider how it can develop targeted guidelines that can be expected to address the quality of regulatory decision-making as well as guidelines that address the incentives on regulators at an institutional and governance level. This will ensure that the inquiry's recommendations are focused both on establishing independent, accountable and well-structured regulatory institutions, as well as promoting good regulatory outcomes through a focus on high quality regulatory substance.

68. In our view, this best meets the scope and focus of the Productivity Commission's inquiry, and will align with the key determinant of regulatory success: outcomes under regulation are better than outcomes without.

APPENDIX 1: CHRONOLOGY OF AIRPORT REGULATION

Table B: Key milestones in information disclosure regulation of airports

MILESTONE	DATE
Airport Authorities Regime	
Airports corporatised and consultation obligations imposed. Airports directed to act as commercial enterprises and given statutory power to set charges as they see fit.	1986 - Airport Authorities Amendment Act 1986
Consultation requirements strengthened and disclosure requirements introduced for airports.	1998 - Airport Authorities Amendment Act 1997, see also the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999.
Commerce Commission Inquiry into Airfield Activities recommends price control for Auckland Airport (control was not recommended for Wellington or Christchurch Airports). The Commission's recommendation was dismissed by the Minister on the basis that the benefits of control (estimated to be $0.35 per passenger) did not warrant intervention.	1 August 2002
Ministry of Economic Development, Discussion Paper: Further work on airport regulation.	2007
Part 4 - Commerce Act Regime	
Information disclosure for Auckland, Wellington and Christchurch airports migrated into new subpart 11 of Part 4 of the Commerce Act 1986. All other airports remain subject to information disclosure under the Airport Authorities Act 1966 ("**AAA**"). All airports' ability to set charges as they see fit under the AAA retained.	2008 - Commerce Amendment Act 2008
Development of Input Methodologies	
Review of the Regulatory Provisions of the Commerce Act Discussion Paper	19 December 2008
Input Methodologies Discussion Paper	14 August 2009
Input Methodologies Conference	15 September 2009
Emerging Views Paper	23 December 2009
Airports Workshop	February 2010
Airports Draft Decision	25 June 2010
Airports Technical Consultation	1 October 2010
Airports Input Methodology Determination	22 December 2010
Merits review proceedings commence	1 February 2011 - **Ongoing**
Implementation of the disclosure regime	
Information Disclosure Discussion Paper	29 July 2009
Request for cross-submissions on Information Disclosure Discussion Paper	1 October 2009
Airports Information Disclosure Quality Working Session	16 December 2009
Information Disclosure (Airport Services) Draft Reasons Paper	May 2010
Airports Information Disclosure Determination	22 December 2010
Annual disclosures made under the new provisions in Part 4	2011 and 2012
First price-setting disclosures made under the new provisions in Part 4	2012
Commerce Commission commences its section 56G review of the effectiveness of the information disclosure regime	31 May 2012 - **Ongoing**
Annual monitoring and analysis by Commerce Commission of disclosed information (under section 53B of the Commerce Act)	**Not yet undertaken**

The Airport Authorities Act regime

1. Prior to 1985 the principal airports in New Zealand had been developed as joint ventures between government and local authorities. Fees charged to airport users were set by regulation and were reviewed from time to time. There was no policy requiring airports to operate profitably.

2. Corporatisation was proposed in 1985. The necessary legislative authority was given by the Airport Authorities Amendment Act 1986. This included the power to set "charges as an airport thinks fit". The select committee had rejected calls by the airlines for statutory charging criteria, or that charges be "genuinely cost based", but approved the Ministry of Transport's proposal that there be consultation with airport users.[48]

3. Accordingly, the fundamental premise of the Airport Authorities Act 1966 ("**AAA**") is that every airport may set aeronautical prices "as it from time to time thinks fit".[49]

4. The original power was in s 4(2)(a) of the AAA (effective as from 18 December 1986). It provided that every airport company may:

> Notwithstanding the provisions of any regulations in force under section 13 or section 13A of the Civil Aviation Act 1964,[50] after consultation with airlines which use the airport, charge and set such fees, charges, and dues as it from time to time thinks fit for the use of the airport operated or managed by it, or the services or facilities associated therewith ….

5. As a constraint on this ability, however, the AAA regime imposes obligations on airports to consult on their aeronautical pricing and capital expenditure decisions.[51] Those consultations are subject to administrative law obligations to act reasonably and fairly, and to provide airlines with sufficient information so that they can engage with the airports on an informed basis. These consultation requirements were introduced on 26 November 1998 by the Airport Authorities Amendment Act 1997.

6. The Airport Authorities Amendment Act 1997 also introduced financial disclosure obligations for all airport companies (in conjunction with the disclosure requirements set out in the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999). Price-setting restraints and review provisions sought by the airlines were rejected as unnecessarily heavy-handed. The Amendment Act's strengthened consultation and information disclosure were seen to strike the right balance.

7. The only change to the power to set charges since then has been the insertion of s 4A(4) as from 14 October 2008. Section 4A(4) provides that s 4A does not limit the application of Part 4 regulation, and confirmed the existing position.[52]

8. Under this statutory framework, consultations effectively amount to intense negotiations with airline customers, who possess significant countervailing power. Pricing solutions can be tailored to suit particular commercial circumstances, using a pragmatic approach if necessary.[53]

9. The AAA is an important part of the regulatory environment for airports, which:[54]

   (a) allows airports and airlines to reach commercially prudent and pragmatic pricing and investment outcomes to accommodate specific market challenges (for example commercial approaches to risk sharing);

   (b) encourages airports and airlines to reach common ground on investment and pricing;

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48 *Air New Zealand Ltd v Wellington International Airport Ltd* HC Wellington CP403/91, 6 January 1992 at 14.

49 Airport Authorities Act 1966, s 4A.

50 Section 4(2)(a) was later amended as from 1 September 1990 by substituting reference to the Civil Aviation Act 1990 for that to the Civil Aviation Act 1964.

51 Airport Authorities Act 1966, s 4B.

52 *Air New Zealand Ltd v Wellington International Airport Ltd* [2009] NZCA 259, [2009] 3 NZLR 713 at [43](c).

53 Auckland Airport *Submission on Input Methodologies Discussion Paper*, 7 August 2009 at [57].

54 Auckland Airport *Submission on Input Methodologies Discussion Paper*, 7 August 2009 at [24], [56]-[60].

(c) is effective at promoting the long-term benefits of passengers; and

(d) imposes substantive constraints on aeronautical pricing and investment decisions through the consultation obligations under the AAA, airports' commercial incentives and disciplines, and the substantial countervailing power which can be exercised by the airlines.

Movement towards the Commerce Act

10. The decision to include the major airports in Part 4 of the Commerce Act 1986 was not straightforward. The new Part 4 introduced a broader range of types of regulation, including information disclosure as a stand-alone form of regulation for airport services, which Parliament and the Commerce Commission ("**Commission**") have acknowledged represents a type of "fit-for-purpose" regulation.[55]

Inclusion of airports in Part 4

11. Unlike the electricity and gas sectors, airports were not already subject to direct regulation by the Commission (although the threat of control under the Act was always a possibility) under the Commerce Act. The Government had rejected the Commission's recommendation in 2002 that Auckland Airport should be price controlled on the basis that this would result in a negative benefit to the public.[56]

12. In addition, the airports were already subject to information disclosure under the AAA regime which was administered by the Ministry of Transport.

13. In 2006, MED and Treasury officials were unconvinced that there was a problem requiring regulatory intervention:[57]

> Ministry of Economic Development ('MED') officials are of the view that there is currently inconclusive evidence of a marked change in circumstances from 2002, and **insufficient evidence yet of whether and where there is a problem, and the scope, and magnitude of the problem to warrant further regulatory intervention. Before regulatory intervention can be considered, further investigation is required into the existence of any inefficiencies in airport charging practices in the context of the full range of airport services.** Treasury supports this view.
>
> [Emphasis added]

14. The further investigation referred to was never carried out. Thus, when Ministers considered regulatory intervention in 2007 following overseas interest in Auckland Airport, Treasury reaffirmed that there was no case for intervention:[58]

> **Treasury however considers that the case has not been made for changing the regulatory regime at this time**. It agrees that the overall aim should be to ensure that prices over the long run are broadly consistent with those sustainable in a workably competitive market and that submissions have raised questions about whether the current regime is meeting that aim in the best way possible. However, it notes that:
>
> - Airports and airlines are making deals and new airlines are entering the New Zealand market
> - There is no objectively verified and independent analysis of excessive pricing since the Commerce Commission inquiry conclusions of 2002
> - There is no evidence of chronic infrastructure inadequacy or lack of timely investment (that is, there is no crisis justifying early action)

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55 Commerce Commission *Information Disclosure (Airport Services) Final Reasons Paper*, 22 December 2010 at [1.2.17]; Commerce Amendment Bill 2008 (201-1) (explanatory note) at p 5.

56 Airports Regulatory Control Inquiry, 2002.

57 MED Briefing on Airport Pricing, 10 March 2006.

58 Draft Cabinet Paper, "Commerce Act Review: Airports", October 2007, paragraph 25.

- The government has repeatedly committed itself to basing regulation on evidence and rigorous analysis (such as Quality Regulatory Reform, RIA guidelines, and the proposed new test for Part 4 of the Commerce Act on whether regulation should be introduced). **It would be inconsistent with these commitments for the government to take action now without rigorous independent analysis and consultations**. This is particularly the case since the Commerce Act discussion document did not make specific proposals for airport regulation and not all interested parties made submissions on the review

- There is a risk that any precipitate decision to regulate would harm our reputation with international investors.

[Emphasis added]

15. Although consultation on the reforms to the Commerce Act was extensive, it did not include options to regulate airports. Instead, the decision to regulate airports under the Commerce Act was made *after* consultation was completed, and appeared to be (in part) in response to drivers unrelated to the rationale for regulation as embodied in the new Part 4 purpose statement and test for regulation.

16. Background policy documents show that Treasury officials were concerned that prematurely introducing airport regulation under the Commerce Act would breach the "virtuous disciplines" of the new Part 4 of the Act at their first important test.[59] Treasury officials went on to note that a premature regulatory response could risk the ability of New Zealand to attract foreign capital:[60]

> One of the Government's main aims for the review of part 4 of the Commerce Act is to reduce regulatory uncertainty. Treasury agrees that it is important to New Zealand's reputation as a place for investment that potential investors are aware of proposed changes to regulatory settings. Given recent interest by foreign investors in Auckland International Airport, **introducing unanticipated regulation might be perceived adversely, affecting not only any eventual foreign investors in Auckland Airport, but those considering investing in New Zealand industry generally.**
>
> Treasury considers that regulatory certainty is important to all investors, domestic and foreign, current and prospective shareholders. While it is important to signal that the Government will consider criticisms of current airport regulation with a view to reform, we wonder if announcing a regulatory response now is premature. In our view, Ministers' concerns might be adequately dealt with by announcing a proposed review, rather than taking a precipitous decision on the former regulation. That said, such an announcement could include a clear statement of the outcomes that Ministers are seeking from its regulation of airports - that is, outcomes that mimic those of a workably competitive market.
>
> **Maintaining a commitment to due process, along the lines announced as part of the quality of regulation review and also the proposals for considering whether and how markets should be regulated under the Commerce Act, is fundamental to confidence in New Zealand as a destination for investment. *Ad hoc* exceptions undermine the integrity of such processes.**
>
> [Emphasis added]

17. Treasury considered that any concerns about the regulatory regime for airports and any signals to foreign investors could, and ought to be, satisfied in a way consistent with good regulatory practice.[61]

18. Although Treasury's views were watered down in the final Cabinet Paper, it noted in its separate advice to Hon Phil Goff, then Associate Minister of Finance responsible for the airport sector, that:[62]

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[59] Draft Treasury Report, "Proposal to Regulate Airports through Information Disclosure and Arbitration", 12 October 2007 (T2007/1950), paragraph 23.

[60] Draft Treasury Report, "Proposal to Regulate Airports through Information Disclosure and Arbitration", 12 October 2007 (T2007/1950, paragraphs 31-33.

[61] Draft Treasury Report "Proposal to Regulate Airports through Information Disclosure and Arbitration", 12 October 2007 (T2007/1950), paragraph 40.

[62] Treasury Report, "Proposal to Regulate Airports through Information Disclosure and Arbitration", 17 October 2007 (T2007/1950), paragraph 18.

> A central concern with the current proposal is (at least, as it appears from the most recent draft cabinet paper) that it lacks such analysis, even at the level of a robust problem definition. We have a thorough analysis of airport pricing in 2002, but a much less comprehensive understanding of how the regime has worked up to 2007. Have prices been constrained to much the same as they might be in a workably competitive market? **We lack the independent information and analysis necessary to answer this question**.
>
> [Emphasis added]

19. Treasury's clear position was that airport infrastructure was healthy, which could be put at risk by regulatory intervention:[63]

> We note that there is no crisis in the sector that would indicate the need for urgent action. Indeed, the macro indicators (passenger numbers, investment in airport infrastructure, entry of new airlines) are indicative of a sector in good health. There is some risk that a hurriedly designed new regime might change incentives for the worse.

20. It is apparent from the final Cabinet Paper "Commerce Act Review: Airports", released on 21 November 2007, that:

    (a) claims by airlines that the airports were overcharging had not been independently reviewed or verified; but

    (b) action was required urgently because of the possible acquisition of a substantial interest in Auckland Airport by an overseas investor:[64]

> The recent interest by overseas investors in Auckland Airport means there is some urgency for clarity as to the nature of the regulatory regime going forward. In the absence of a robust regulatory regime there is a risk that either:
>
> a Overseas investors will pay a discounted price for ownership based on the expectation that a robust regime will be put in place for New Zealand's major international airport. If such a regime does not eventuate, and high returns continue, there will be a transfer of monopoly rent out of New Zealand, which is a loss to New Zealand, or:
>
> b Overseas investors will expect that the regulatory regime will remain as it is. Any subsequent Government action to introduce a tougher regime might be perceived as aimed at foreign owners, with a consequent reputational risk for New Zealand. Furthermore, if they initially over-pay for assets (in the light of their unrealised expectations about continuation of the current regime), it may be difficult to subsequently reduce the asset base to a reasonable level.

21. The Regulatory Impact Statement accompanying the Cabinet Paper contained no analysis of the effect the new regime would have on investment. In addition, there was no analysis of how the new regime would promote the purpose of Part 4.

22. Ultimately the information disclosure regime was migrated to the Act because it was considered that:[65]

> [...] the information disclosure regime currently provided for under the Airport Authorities Act is not effective because there are no detailed rules on how disclosed information must be compiled, and there is no monitoring and analysis by a regulator of the disclosed information. We support the proposed inclusion of airports in subpart 11 of the bill as introduced.

23. Parliament intended that the inclusion of airport services in Part 4 of the Commerce Act would improve the information disclosure regime by:

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63 Treasury Report, "Proposal to Regulate Airports through Information Disclosure and Arbitration", 17 October 2007 (T2007/1950), p 2.
64 Officers of the Ministers of Transport and Commerce, "Commerce Act Review: Airports" (Cabinet Paper, 21 November 2007) at paragraph 21.
65 Commerce Amendment Bill 2008 (201-2) (select committee report) at p 13.

(a) strengthening the information disclosure regime which had previously existed under the AAA, and addressing concerns about the transparency of information and the way disclosed information was calculated;

(b) providing better information to guide consultations between airlines and airports, including allowing airports, airlines and other customers to reach commercial agreements taking into account efficiency, productivity, investment, and other issues;[66]

(c) providing for the Commission to take an express monitoring and reporting role;[67] and

(d) imposing some disciplines on airport pricing behaviour through increased transparency and information, creating a more credible threat of further regulation.[68]

24. Information disclosure under Part 4 was therefore intended to be a targeted and cost-effective response to perceived deficiencies in existing information disclosure.

Early stages of implementation

25. It is early days for the information disclosure regime for airports. Although the amendments to the Commerce Act took effect in 2008, the development of the regulatory regime has (and will continue to) take time to fully establish. Key elements in this development timeline were:

(a) The Commission was required to determine specific elements of the regulatory tools and processes within the structure and framework outlined by Parliament in the Commerce Act (including the development of input methodologies, started in late 2008).

(b) The Commission completed these tasks for airports in December 2010, when it published its input methodologies and information disclosure determinations. These input methodologies are subject to challenge, as discussed further below.

(c) The first disclosure of annual financial information in accordance with this regulatory framework took place in 2011, and the first price-setting events in the context of the enhanced information disclosure framework took place in 2012.

(d) The information disclosure framework includes a requirement for the Commission to undertake annual summary and analysis reporting in relation to the information disclosed by airports (section 53B). This important feedback loop between the Commission and airports (as well as interested parties) has not yet been established.

26. A transitional review provision (section 56G) was built into the Commerce Act as part of the amendments to the legislation. This provision requires the Commission to report to the Ministers of Commerce and Transport on how effectively information disclosure is promoting the purpose of Part 4 of the Act. The trigger for the timing of this transitional review was the setting of airport charges in or after 2012.

27. The Commission has now completed its reviews of Wellington and Auckland Airport, and issued its draft report for Christchurch Airport.

The role of input methodologies and the merits review proceedings

28. Input methodologies are intended to promote certainty for suppliers and consumers about how the various types of regulation operate. Accordingly, input methodologies are rules set by the Commission

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66 Commerce Amendment Bill 2008 (201-1) (explanatory note) at pp 40-41.
67 Commerce Amendment Bill 2008 (201-1) (explanatory note) at p 41.
68 Commerce Amendment Bill 2008 (201-1) (explanatory note) at p 41.

about how certain elements should be calculated, evaluated, or determined. This includes factors such as asset valuation, cost allocation, the treatment of taxation, and cost of capital.

29. In an information disclosure context:

    (a) The input methodologies must be applied by the airports when calculating and disclosing information in their annual information disclosures. The exception to this is the cost of capital input methodology, which is not required to be applied by airports.

    (b) The input methodologies (including the cost of capital input methodology) may be used by the Commission to monitor and analyse the information that is disclosed by airports.

    (c) The input methodologies have also informed the Commission's assessments under the section 56G review.

30. Due to the importance of getting these input methodologies "right", the Commerce Act provides a right of appeal once these input methodologies are determined by the Commission. The methodologies have been challenged in the High Court across all regulated sectors, in the merits review proceedings.

31. All three regulated airports have challenged the cost of capital input methodology and various methodologies relating to asset valuation. The regulated airports have particular concerns about the asset valuation and weighted average cost of capital ("**WACC**") input methodologies. The airports consider that alternative methodologies are materially better at promoting the long-term benefit of consumers (and, therefore, meeting the purpose of Part 4 of the Commerce Act).

The section 56G review

32. The section 56G transitional review is a mechanism in the Commerce Act for the Commission to review how the information disclosure regime is operating in its early stages.

33. The Commission has approached its analytical task by breaking down airport performance into seven areas: innovation, quality, pricing efficiency, profitability, operational expenditure efficiency, efficient investment and sharing the benefits of efficiency gains.

34. The Commission's general approach to assessing each performance area has been to undertake a relative comparison of conduct and performance before (effectively pre-2012) and after the introduction of Part 4 information disclosure regulation. The Commission has considered whether performance has moved closer to the desired regulatory outcomes, and considered the impact of information disclosure regulation on any changes in performance and the incentives that guide airport behaviour. For profitability, the Commission has taken a different approach, instead using its input methodologies to calculate a benchmark level of profitability that it uses to assess the airports' expected returns.

Funding

35. Section 53ZE of the Commerce Act allows the Minister to levy suppliers of regulated goods and services in order to fund the performance of the Commerce Commission's functions. Before levying suppliers (ultimately consumers), the Minister must consult with suppliers under section 53ZE(4). Accordingly, the Commission released a Discussion Document on 11 June 2013 in respect of proposed funding for the Commission's administration of Part 4 of the Commerce Act. Following the establishment phase of the information disclosure regime, the Commission is now considering its ongoing obligations under the Act in relation to the airports sector. This is the second funding review in recent years - the Commission reviewed its funding in 2011 increasing its levy by $5.1 million over three years.[69]

[69] Ministry of Economic Development, *Revising Funding of the Regulation of Electricity, Gas and Airports under Part 4 of the Commerce Act 1986*, February 2011.

36. The approximate costs incurred by the Commerce Commission under the Part 4 regime (in relation to each sector) since its introduction in 2008 are set out in the following table:

(000s)	**08/09**	**09/10**	**10/11**	**11/12**	**12/13**	**Total**
Input Methodologies	3075	4910	3242	475	0	**11702**
Airports	110	687	695	389	1003	**2884**

37. Under the Commerce Commission's preferred option for Part 4 funding as set out in its recent Part 4 Funding Review Discussion Document, approximate costs would be:

(000s)	**13/14**	**14/15**	**15/16**	**16/17**	**17/18**	**18/19**	**Total**
Input Methodologies	0	0	0	3185	1743	0	**4928**
Airports	600	610	425	481	874	386	**3376**

38. Because the Commission is partially industry-funded, the above tables illustrate that regulated businesses and therefore consumers (who ultimately bear the cost of the levies), have incurred significant expense as a result of the implementation of the Part 4 regime. Since implementation the Commission has spent approximately $11.7 million[70] across the Part 4 regulated sectors in its pan-industry project to develop its detailed rules (input methodologies). In addition, it has spent approximately $2.9 million in relation to information disclosure regulation of the airport sector.

39. Importantly, these figures exclude the costs incurred by regulated suppliers in engaging in the Commission's consultation processes, appealing input methodology decisions, carrying out new regulatory valuations as required at the beginning of the regime and undertaking various other steps that were required in order to comply with the new regulatory requirements.

40. Under its preferred option in its Funding Discussion Document, the Commission has proposed to increase the amount spent to operate the regime over the next five year period (with $3.3 million of this increase earmarked for airport regulation, an increase of approximately 17%).[71]

41. It is important to consider these costs on a per supplier basis. For example, for the implementation of the regime to date, the costs involved in the electricity sector (involving 29 suppliers subject to default/customised price path regulation and information disclosure regulation) equate to $632,000 per supplier. The costs involved for the airport sector (three suppliers subject to information disclosure regulation only) equate to $961,000 per supplier. Similarly, the Commission's proposed costs equate to $1.049 million per supplier for the electricity sector, but $1.125 million per supplier for the airport sector. Where the Commission's statutory functions and ongoing regulatory role are (and should be) significantly lighter for airport regulation, NZ Airports would expect the associated costs to be substantially lower on a per supplier basis than for sectors subject to more extensive regulation.

[70] Figures are based on the Commission's annual reports published on its website at the following link; http://www.comcom.govt.nz/the-commission/about-us/accountability/

[71] Commerce Commission, *Commerce Act Part 4 Funding Review Discussion Document*, released 11 June 2013, at p 27.

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