

29 June 2012



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Submissions  
Commerce Commission  
WELLINGTON

To whom it may concern,

## **Airport Services – s 56G**

### **Introduction**

1. Vector welcomes the opportunity to submit on the Commerce Commission's Process and Issues Paper "Airport Services – s 56G Reports", dated 31 May 2012. No part of our submission is confidential and we are happy for it to be publicly released.
2. Vector's contact person for this submission is:

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### **Vector's views**

3. Vector has a number of observations in relation to the Process and Issues Paper.
4. As a general comment, in considering how effectively Information Disclosure Regulation under Part 4 is promoting the purpose in section 52A in respect of the specified airport services, it should be recognised that Information Disclosure does not operate in a vacuum. Information Disclosure for specified airport services is part of a regulatory regime which also includes consultation requirements and the threat of price control.
5. The effectiveness of Information Disclosure should be considered in relation to:
  - a. The extent to which it helps inform consultation. This is as reflected in the Commission's question "Has information disclosure had any impact on the effectiveness and scope of consultation as part of WIAL's second price setting event (PSE), and why?" and "What role did information disclosure regulation play in negotiations concerning WIAL's expenditure forecasts?"
  - b. How useful the disclosed information is in determining whether price control under Part 4 is warranted. A concern Vector has is that the Commission's Information Disclosure Input Methodologies (IMs) across the different sectors may produce "false-positives" ie identify excess or supranormal profits where suppliers are actually earning below normal returns (this point is discussed further in the following section).

### ***How reasonable are WIAL's asset valuations, and why? What is an appropriate level of target return for WIAL, and why is the level appropriate?***

6. Information Disclosure Regulation will not best meet the purpose of Part 4 of the Commerce Act, particularly s 52A(1)(a), if the Information Disclosure IMs for

WACC, asset valuation etc are not adequate to enable Airports, or regulated suppliers, to earn commercially realistic (sustainable) returns, and recover the costs of their investments (sunk and future).

7. Based on the IMs the Commission has set, Vector would expect that this is a very real risk. This is supported by the appeals against the Commission's IMs for specified airport services.
8. Vector would expect the WACC and asset valuation Airports adopt for price setting purposes to differ from the Information Disclosure IMs to the extent that the latter are inadequate for Airports to earn commercially realistic (sustainable) returns.
9. Airports are not subject to price control (they are subject to Information Disclosure, consultation requirements and the threat of price control) so are able to remedy shortcomings with the Commission's IMs by adopting target returns and asset values that are higher than the IMs would produce. This means use of asset valuations/target returns in excess of that produced by the IMs is not, in-and-of-itself, necessarily evidence of excessive pricing.

***What is an appropriate level to reflect normal performance, and why? What is an appropriate level to reflect superior performance, and why?***

10. Vector welcomes the questions the Commission has asked about what is an appropriate target return, and what the differences should be for normal and superior performance.
11. As the Commission is aware, Vector agrees with the Commission's statement that "it is unlikely to be in consumers' long-term interests to attempt to fully eliminate all excess returns"<sup>1</sup> and "the faster the rate of sharing efficiency gains with consumers, the weaker the incentive for businesses to make efficiency gains".<sup>2</sup> Regulated suppliers need to be meaningfully rewarded for efficiency gains to ensure they have incentives to improve efficiency.
12. Vector reminds the Commission of our "Submission to the Commerce Commission on the Setting of Starting Prices for Gas Pipeline Businesses (GPBs) under the Initial Default Price-Quality Path", 28 September 2011. While the submission was made in relation to Gas Pipeline Businesses, it outlines the importance of ensuring Part 4 of the Commerce Act is not operated as de facto rate of return regulation.
13. The Commission should avoid the trap of treating any returns in excess of the WACC it sets as being excessive. The Commission needs to be clear that excessive and supranormal profits are not the same thing and that there is a distinction between functionless and functional rents. Supranormal profits have an important role (as they do in workably competitive markets) in incentivising efficiency gains. The greater the extent to which supranormal profits are allowed as a reward for efficiency gains the greater the potential scope for efficiency gains will be. A critical judgment is to determine the appropriate balancing of incentivising efficiency and innovation (productive and dynamic efficiency) versus limited excessive profits (allocative efficiency). Vector has consistently advocated the Commission should operate Part 4 in a way that encourages above normal returns to incentivise/reward greater efficiency/cost savings which would ultimately benefit consumers (from prices that are lower than otherwise and/or improved service quality).

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<sup>1</sup> Commerce Commission, 2010-15 Default Price-Quality Path for Electricity Distribution: Draft Decisions Paper, July 2011, para 1.48.

<sup>2</sup> Commerce Commission, Regulation of Electricity Lines Businesses: Discussion Paper, 21 March 2002, para 8.63.

14. The Australian Energy Regulator's (AER) Annual Performance Report's for electricity distribution network services providers<sup>3</sup> provides a good illustration of how regulators can recognise that variation from the regulated WACC can and should be permissible and expected.
15. The AER set the regulated post-tax return for Victorian electricity distribution businesses (EDBs) at 5.9%.
16. The AER's expectation of forecast returns differed from the regulated post-tax return reflecting, amongst other things, an efficiency carry-over mechanism. In the case of SP AusNet the AER expected returns to be less than the regulated post-tax return. The actual returns also differed from the regulated post-tax return reflecting factors such as improved efficiency/cost savings.

**Table 2.2 Pre-tax return on distribution assets, 2010 (per cent). Percentage, based on 2010 reported asset values**

	Forecast	Actual
Jemena	6.8	10.0
CitiPower	6.7	8.8
Powercor	6.4	9.9
SP AusNet	5.6	6.9
United Energy	7.2	8.5

***Is WIAL providing services at a quality that reflects consumer demands?***

17. Auckland Airport's consultation on building a new (superior quality) domestic terminal highlights the importance of s 52A(1)(b) of the Commerce Act 1986, and that the Commission should not operate Part 4 in a way that effectively locks in current service quality. (Again, this is a particular concern of Vector's in relation to the operation of Part 4 of the Commerce Act/service quality setting for electricity and gas.)
18. The trade-off between service quality and price is particularly stark in relation to Airports as service quality does not just include service reliability (flights are able to safely leave/land on time etc) but also the quality of the service (how good the Airport terminal is). The operation of Part 4 of the Airports is presently more permissive of service quality improvements (subject to consultation with airlines) than is the case for electricity and gas.
19. Vector is of the view that Information Disclosure coupled with consultation requirements is a useful way of determining whether major investments should go ahead, not only in relation to Airports but also for electricity and gas distribution and transmission.<sup>4</sup>

<sup>3</sup>

<http://www.aer.gov.au/sites/www.aer.gov.au/files/Victorian%20electricity%20distribution%20businesses%20comparative%20performance%20report%202010.pdf>

<sup>4</sup> This has been reflected, for example, in Vector's proposals for a Regulatory Investment Test (RIT) for gas transmission. Vector, Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper (27 May 2011) and Submission to the Commerce Commission on Gas Transmission Form of Control and Investment (27 May 2011).

## **Concluding remarks**

20. In summary, Vector is of the view that:

- a. Deviation from the Commission's IMs can indicate the IMs would not be adequate to enable a normal rate of return, or recovery of investment costs (past and future).
- b. The Commission should recognise that above normal returns (supranormal profits): (i) are not necessarily excessive; but instead (ii) can act as an incentive to improve efficiency, if Part 4 of the Commerce Act is operated well and consistent with the purpose of Part 4.
- c. The successful operation of Part 4, including Information Disclosure, should be reflected in incentives to improve, and not just maintain, service quality, except where it can be shown consumers would prefer to trade-off service quality for lower than otherwise price levels.
- d. The Commission should consider the extent to which Information Disclosure, coupled with consultation requirements, should reasonably be relied on to determine future investment requirements of regulated suppliers, including Airports, EDBs and GPBs.

Kind regards



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