



**PROBLEM DEFINITION FOR INPUT METHODOLOGIES REVIEW:  
SUBMISSION TO COMMERCE COMMISSION**

**21 AUGUST 2015**

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## OVERVIEW

1. This submission responds to the invitation from the Commerce Commission ("**Commission**") to interested parties to contribute to identifying specific issues as they relate to the input methodology review ("**IM review**"). In particular it provides Auckland Airport's views on what it sees as the most important issues raised in the Commission's paper: Invitation to contribute to problem definition (the "**problem definition paper**").
2. We would like to repeat our thanks to the Commission, voiced at the Forum. We appreciate the Commission commencing the IM review in a constructive way that seeks to get all relevant issues on the table.
3. This submission is divided into six sections:
  - (a) **Section 1:** This section outlines the key issues set out by Auckland Airport at the problem definition forum,<sup>1</sup> which we encourage the Commission to consider during this IM review.
  - (b) **Section 2:** This section summarises Auckland Airport's concerns in relation to the WACC IM. In summary, we are concerned that proposed changes to the WACC IM will reinforce our concern that it could be interpreted as establishing a precise target rate of return by the Commission and interested parties. Estimating WACC is an imprecise science and so retention of a WACC range (the 25<sup>th</sup> to 75<sup>th</sup> percentile) for the ID regime remains appropriate.
  - (c) **Section 3:** This section responds to the problem definition for the assessment of returns (target and actual). Our concern is that adoption of a prescriptive, forward looking, profitability assessment indicator may have unintended consequences, such as increasing complexity and lessening transparency. We value a process (such as the s56G review) by which the Commission can evaluate and contextualise Auckland Airport's information. We therefore believe the Commission should focus on clarifying principles to inform the current approach to profitability assessment (target and actual), instead of adding further prescription.
  - (d) **Section 4:** In the context of the suite of secondary profitability issues covered in the Commission's problem definition paper, this section drills deeper into the treatment of land held for future use and sets out a problem statement that we consider should be addressed as part of the IM review. In summary we seek greater clarity around the principles and approach the Commission would take to assessing profitability in the event that an airport were to smooth prices in advance of commissioning an asset held for future use.
  - (e) **Section 5:** This section summarises our thoughts on the approach to setting the initial regulatory asset base ("**RAB**") value for land, following on from the High Court merits appeal judgment.
  - (f) **Section 6:** This section sets out our views on other discrete issues, including our views on tailoring the ID regime for the airline's benefit, and dealing with drafting and mechanical errors, all of which are important issues raised by the Commission.
4. This submission should be read together with the New Zealand Airports Association's ("**NZ Airports**") submission, which Auckland Airport supports and endorses.

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<sup>1</sup> Commerce Commission, forum with interested persons on the invitation paper, Te Papa Wellington, 29-30 August 2015.

5. Auckland Airport's contact for matters regarding this submission is:

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## SECTION 1: KEY ISSUES FOR THE IM REVIEW

### Key points:

- Auckland Airport is committed to the ID regime and believes it is operating effectively.
- It is open to improving the regime, but encourages the Commission to avoid potentially disruptive changes.
- Further prescription should be avoided and a flexible approach that provides transparency should be preferred.
- The WACC range should be maintained and a pricing percentile should be avoided.
- Important issues, such as long-term risk allocation and benefits to passengers, should not be overshadowed by residual points of contention between airports and airlines.

### Auckland Airport's commitment to the regime

6. In our view, the ID regime for the airports sector currently operates effectively and promotes the purpose of Part 4 of the Commerce Act (Act). The ID regime provides a significant amount of information, prepared on a transparent and consistent basis, for interested persons to assess the conduct and performance of Auckland Airport (and other regulated airports) over time.
7. We are committed to ensuring that the ID regime is successful for the long term. We consider the objectives of Part 4 are well supported by our corporate strategy. Auckland Airport remains committed to working with the Commission and its customers (airlines, passengers and others), to continue delivering positive outcomes for the long term.
8. Auckland Airport strongly believes the ID regime should be given an opportunity to settle in so that its benefits can be realised. To this end, we think the Commission should avoid material changes, to both the IMs and the ID approach to profitability assessment, at this early stage. It should instead focus on fine-tuning areas where a specific problem can be articulated and where the benefits of making changes outweigh the costs and risks of unintended consequences. It should also be considered whether establishing guidance and principles on how information can most usefully be disclosed under existing rules is a better option than changing the rules.
9. In approaching the IM review, it is important for the Commission to bear in mind the need for the regulatory regime to provide an environment of stability. That is key for Auckland Airport to be able continue its delivering innovation, efficiency and productivity improvements through timely and appropriate investment in our crucial infrastructure, thereby providing the nature of services that our airline customers and travellers demand, and doing that at a reasonable price; all of which, helps New Zealand's economy to thrive.
10. The single most important thing Auckland Airport can do for the travelling public and New Zealand's tourism industry is to ensure that there are no capacity constraints that create barriers for the entry of new airline services at Auckland. Passengers benefit greatly from increased capacity and competition between airlines. Introducing new carriers to routes currently operated by one airline, and introducing new routes to emerging tourism markets, is essential for the long-term growth of the tourism industry and for New Zealand's growth prospects generally. A regulatory regime intended to promote the long-term benefit of passengers will fail if it does not promote and support this. Passengers will suffer the most if efficient and growth enhancing investment by airports is deterred.

11. Attention should therefore be focused on how the ID regime can be made to work better, and potentially disruptive changes to the ID regime should be avoided.

### **Prescription in the IMs has created complexity**

12. We understand there is a very natural human desire for prescription and precision to be used when assessing complex businesses. However, we are concerned that an overly prescriptive application of the ID regime will result in needless complexity, and in the ID regime being applied in a manner that was never intended.
13. The ID regime was developed with the purpose of providing transparent and consistent insight into the performance of airports in order to encourage them to operate as if in a competitive market. A prescriptive approach requires airports to provide disclosure in a manner which differs from the actuality of how airports run their businesses. This pushes airports away from acting flexibly, as an efficient company would in a competitive market. It also does not lend to transparency, as it detracts focus from disclosure of information that is actually relevant to the operation of airports.
14. We encourage the Commission to avoid pursuing further prescription through this review and to instead consider how it can maintain (or provide more) flexibility for airports to transparently demonstrate outcomes consistent with workably competitive markets.

### **Setting a pricing percentile will create challenges**

15. We support NZ Airports' submission on the WACC range for airports. We share the concern about the Commission's application of the WACC IM as a target rate of return, or as a specific returns benchmark, that airports must achieve.
16. Setting a pricing percentile would create real hurdles for Auckland Airport in practice as it would not reflect our real world challenges. We think the WACC IM should be applied in a manner consistent with the intention of the ID regime, by providing an estimate of the range of acceptable outcomes, and not a precise estimate that is very likely to be wrong. For the reasons outlined in the NZ Airports submission, we encourage the Commission to retain the current WACC range.

### **Risk asymmetry is a concern for Auckland Airport**

17. Actual outcomes are always different to forecasts. Any number of factors (many outside Auckland Airport's control) will cause variation. Auckland Airport and its customers are exposed to this risk.
18. This is very relevant to the issues around profitability assessment the Commission is proposing to explore, and, in particular, discussions around time series profitability assessment. We note that the Commission has referred to its approach to risk allocation (at paragraph 105 of its problem definition paper) for price-quality paths: namely that risk is allocated following a process of consultation to those best placed to manage them.
19. This is consistent with Auckland Airport's experience of risk allocation. However, we encourage the Commission to focus on where the risks fall at the time of price setting events for airports, and to assess actual outcomes as against that starting point, in order to appreciate how risks have been borne. To illustrate:
  - (a) Risks around operating costs are allocated to the airports. These are not always within our control, but we have the most influence over day-to-day operating cost decisions, and can make trade-offs between decisions as necessary at the time of the price setting event.

- (b) In the case of demand risks, the airlines collectively influence whether demand turns out as forecast, but they do not act collectively, rather competitively.
  - (c) If passenger demand is higher than was forecast at the time of the price setting event, the airport faces the additional cost of providing capacity for that incremental demand (either in the form of capital expenditure or operational solutions).
  - (d) By contrast, if demand is lower than forecast at the time of the price setting event, the airport shares in the industry wide risks - ie of reduced return. The prime example of this for Auckland Airport was during the Global Financial Crisis, when demand was soft and airline trading conditions tough. Auckland Airport decided not to implement its prices as scheduled, rather electing to absorb the impact of poor trading conditions which could not be mitigated.
20. Our concern, in the absence of clear guidance from the Commission, is that outcomes outside of our control falling in our favour will risk findings of excessive returns, but we receive no recognition or compensation when risks outside of our control turn against us. Furthermore, we consider that it is in the long-term interests of consumers that suppliers do have incentives to grow demand so that the cost of supply can be shared over more users and to innovate and generate efficiencies.
21. We understand that the Commission will seek to understand performance and encourage regulated suppliers to improve performance over time. For that reason, we have for some time discouraged focus on single year returns, and preferred an understanding over the 5 year pricing period. If in the present review, the Commission proposes to take a longer term view of profitability, we would expect this to include a sound understanding of the risk allocation that existed for each airport at the time of price setting.

## SECTION 2: WACC RANGE

### Key points:

- Auckland Airport is concerned that the WACC IM has been applied as a "target rate of return" or "specific returns benchmark".
- Estimating WACC is an imprecise science and retention of a WACC range of the 25<sup>th</sup> to 75<sup>th</sup> percentile remains appropriate.
- The operation of the dual till regulatory regime should not impact on the choice of WACC range.

### The importance of placing the WACC IM in context

22. The proposed review of the WACC percentile range for airports is an issue of concern for Auckland Airport. We endorse NZ Airports' submissions on this issue.
23. Auckland Airport's experience of the WACC IM has been that:
- (a) At the time prices were set in 2012, it understood that the ID framework, including the IMs, was intended to impose disciplines on our pricing behaviour. Accordingly, the IMs, including the WACC IM, were a key reference point for our pricing decision in 2012.
  - (b) We further understood that ID regulation was intended to promote transparency around the decisions that we were making, and that we were not required to strictly apply the IMs in pricing, as the ID regime is premised on interested persons being able to understand our pricing and investment decisions, including our rationale and justifications for those decisions.
  - (c) We understood that the WACC IM, which is not required to be applied by airports for pricing or ID purposes,<sup>2</sup> certainly fell into that category. Our understanding was confirmed by the Commission in the Merits Review proceedings (as discussed further in the NZ Airports Submission).<sup>3</sup>
  - (d) We were therefore surprised with the approach taken by the Commission during the s56G review, where there was limited explicit engagement on the context of the WACC estimation for each airport, despite assurances that this would occur.
24. In Auckland Airport's view, in order for the WACC IM to effectively meet its intended purpose under ID regulation, a range must be maintained, and a point estimate avoided. A point estimate would completely undermine the spirit of what the Commission has previously set out as the intended operation of the WACC IM.
25. We are also concerned about the suggestion that the dual till implies the upper limit of the WACC ranged should be reduced. Auckland Airport acknowledges that there are some projects for which there are interdependencies between aeronautical and non-aeronautical outcomes. However, the existence of such "dual till" incentives is not pervasive or as straightforward as implied by the airlines. It would take a great deal of time and resources (and therefore cost) for the Commission to seek to understand the

<sup>2</sup> Commerce Act 1986, s 53F(1)(b).

<sup>3</sup> Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 89.



impact of the dual till on different types of investment choices facing the airports over the forthcoming decade or two. We do not see how such effort can be justified under an ID only regime.

26. Given the adverse consequences Auckland Airport faces if it targets returns above the Commission's WACC range, making a downward adjustment to the WACC range would undermine investment incentives as airports ration capital investment across competing interests. Like any commercial business, there is a finite pool of capital investment that an airport will commit to across its business over a given period. Therefore, reducing WACC could have unintended consequences for passengers, airlines, freight operators and other users of the airport. The scope of specified activities is broad. There may be any number of investments that our customers may request (e.g VIP lounges, hangars, plant equipment, which generates on airfield efficiencies for users), that if we are under-rewarded by WACC, will be de-prioritised.
27. We are also concerned about the signal such a material change would send to investors about the risks of investing in companies subject to Commission oversight. It would most certainly reduce regulatory predictability and heighten regulatory risk.
28. In summary, Auckland Airport submits that the Commission's problem definition statement on this issue should:
  - (a) Not advocate for a requirement to identify a WACC point estimate for airports.
  - (b) Detach the existence of the dual till from any assessment of the WACC percentile range, and refrain from seeking to disrupt the existing WACC percentile range.
  - (c) Include consideration of providing clarification of how the WACC IM will be applied in the Commission's analysis both at the time of price setting and in the s53B summary and review - eg how a full contextual assessment will be evaluated.
  - (d) Include clarification of what role, if any, the annual update of the WACC IM plays, in the context of prices which are set on a 5 year forward looking basis.

### SECTION 3: ASSESSING PROFITABILITY

#### Key points:

- Our experience has been that prescription in the IMs and ID requirements has complicated the ID regime. Therefore, we are concerned that setting a new prescriptive forward looking profitability indicator may have similar unintended consequences.
- The s56G report has provided a strong guide as to what airports can expect from the Commission when it assesses forward looking profitability.
- However, specifying a forward looking profitability indicator reduces the Commission's ability to exercise its judgement and respond to contextual information, which goes to the heart of the ID regime.
- We do not accept that the backward looking profitability indicator has proven to be ineffective when airports adopt tailored pricing approaches. We have made every effort to ensure interested parties have all the information they need to fully assess our profitability.
- To the extent there is a problem with forward and backward looking profitability assessment, this should be addressed by clarifying the principles the Commission can be expected to apply.

#### **Setting a prescriptive forward looking indicator may have unintended consequences**

29. The Commission considers that it is an issue that there is no forward-looking profitability assessment indicator to assist interested persons to assess if airports are targeting excessive returns when setting prices. It therefore proposes a solution of implementing a new indicator.
30. We think that the issue needs to be explored in greater detail at this stage of the review before potential solutions are considered bearing in mind
31. The pricing event disclosure requirements were comprehensively consulted on before being determined, and to our knowledge the need for such a profitability indicator was not discussed at that time. It therefore cannot be said to be a glaring or obvious omission from the regime. Indeed there is already a significant volume of information provided in the price setting disclosure in Schedule 18 regarding forecast returns. We appreciate that the Commission subsequently developed a method to assess target profitability during the s56G reviews, but it does not follow that this needs to be translated into a new ID requirement.
32. We therefore support NZ Airports' submission on this topic. In common with NZ Airports, Auckland Airport is not convinced that:
  - (a) the absence of a specified forward looking profitability assessment indicator causes any material issue; and
  - (b) that the creation of a prescriptive forward looking profitability indicator would create the transparency the Commission is seeking.
33. Our reasons for this are:

- (a) A material amount of information is disclosed at the point of pricing setting. Our experience has been that the Commission is equipped to undertake the analysis to summarise what is a complex decision-making environment. We would be surprised if the publication of a new forward looking indicator would remove the need for such analysis.
  - (b) Our experience has been that it has proven very difficult to predict that range of complicated decisions and trade-offs present at the time of price setting - or what the future may hold. Rather, the Commission has grappled with these following the price setting and (appropriately) endeavoured to contextualise these in the profitability analysis.
  - (c) Accordingly, predictability of the regulation is best supported by clear principles, rather than by recourse to prescription.
34. Further, it has been our experience that there is no absolutely "correct" position for each decision an airport faces. An attempt to create a "correct" position in advance via ID rules reduces an airport's ability to provide innovative commercial solutions applicable to airlines (and other airport users) and their changing requirements. This is exemplified by the decision by Auckland Airport to have a moratorium on revaluations for part of its asset base, which pre-dated the IM development. Our view is that because there was no pre-existing forward looking profitability indicator, the Commission was able to exercise its judgement to ensure that the forward looking profitability assessment responded in a manner to appropriately contextualise the anticipated return profiles from Auckland Airport's overall regulated asset base.
35. Auckland Airport has found processes, such as the s56G review, valuable in terms of understanding the Commission's approach to profitability assessment. Auckland Airport believes it is now in a stronger position to maximise transparency in the price setting disclosure with improved commentary and, where appropriate, utilisation of methods such as non-standard depreciation. Auckland Airport believes this review provides a valuable opportunity for it to contribute what it has learned to explore the range of tools that will provide transparency and be best suited to particular circumstances.
36. To the extent there is complexity associated with profitability assessment, this stems from the fact that airports can and have used different approaches in price setting and that the Commission, in the development of the IMs, had a preference to provide a specific reference point. At the time the IMs were developed, Auckland Airport's view was that, in order to allow assessment of whether the Part 4 purpose was being promoted, IMs and ID requirements simply needed to allow transparent disclosure of information calculated in accordance with a range of reasonable methods consistent with the purpose statement.
37. This is still our view and, accordingly, we endorse NZ Airports' submission on the principles that should guide the Commission's consideration of profitability assessment.
38. The same principles apply to the *ex post* profitability indicator. We do not accept that it has proven to be ineffective when airports adopt tailored pricing approaches. This is not to say that improvements cannot be made, but we are concerned about such a strong finding at this stage. Again, we would expect the Commission's summary and analysis process (which has yet to be carried out) to fully contextualise the disclosed information.
39. Turning to the secondary profitability assessment issues identified by the Commission, it is possible that some of the secondary issues may warrant a prescribed outcome – e.g. land valuations. Other secondary issues may be more dependent on the circumstances of the business' decision making. In such situations emphasis should be on the principles that would be applied for evaluating the decisions made. In particular, we consider principles (rather than prescription) to be suitable approaches to improvements to the

treatment of land held for future use; wash-ups; un-forecast revaluations; and discounting.

## SECTION 4: TREATMENT OF LAND HELD FOR FUTURE USE

### Key points:

- If Auckland Airport sets prices in a manner consistent with the IMs for land held for the Northern Runway, then there will be a significant increase in prices at the time of commissioning.
- The current IM provides transparency in disclosure. However, an issue is that the airlines consider the exclusion of land held for future use from the disclosure asset base to mean that such land must be excluded from prices. However, the IM is not solely determinative of workably competitive options for how pricing should be approached.
- Auckland Airport has not formed a view on how it will address this important matter in pricing, but it will be a priority issue for the forthcoming consultation process with airlines.
- Enabling new runways is commercially challenging for a range of reasons including the quantum of investment and the nature of supply change from one day to the next. During the course of the IM review, Auckland Airport is keen to advance its understanding of, and engage with the Commission on:
  - (a) The principles the Commission would consider relevant if Auckland Airport were to smooth prices in advance of the commissioning of the Northern Runway; and
  - (b) net present value ("NPV") neutral options for achieving a stable price path and providing transparency of forward looking and historic returns.

### The issue with land held for future use by Auckland Airport

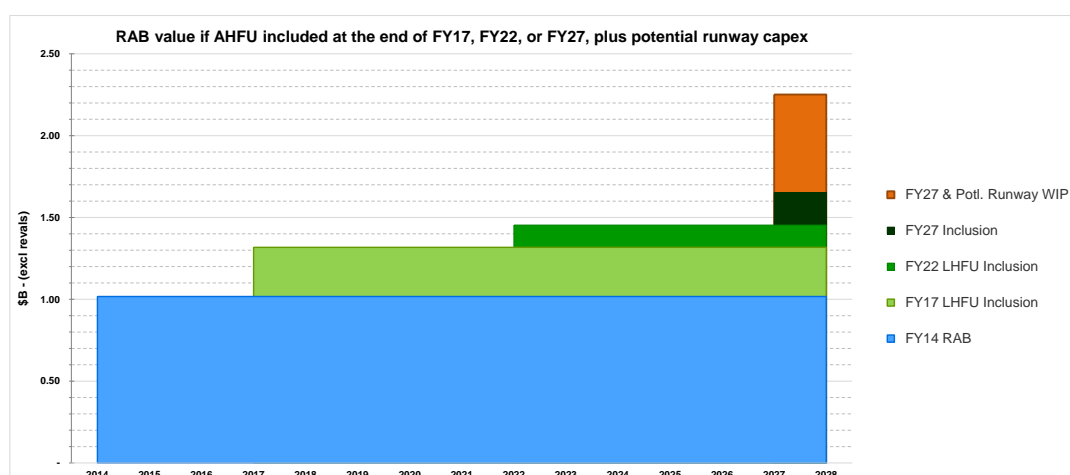
40. It is vitally important for New Zealand's future growth that land for future airport development and expansion is readily available. Auckland Airport considers that it is both responsible and efficient for Auckland Airport to safeguard land for future airport expansion by holding land. There would be considerable risks and costs for Auckland Airport if it did not do so.
41. Auckland Airport owns 1,500 hectare of freehold land, a proportion of which is held for future development as the Northern Runway. The land held for future development had a carrying value of about \$235 million as at 30 June 2014.
42. The IMs exclude land held for future use from the RAB until that land is commissioned. The Commission has previously assured airports that they can expect to be able to earn a full return on, and of, the costs incurred in holding and developing land for future use without profits appearing excessive, provided that land is eventually commissioned for use to supply airport services.<sup>4</sup> The value of the land and holding costs are transparently tracked under the existing IM.
43. Auckland Airport anticipates that the Northern Runway will be commissioned in 2025 (though this is, of course, subject to demand and other fluctuating economic circumstances). In the meantime, the costs of holding that land are real.

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<sup>4</sup> IM Reasons Paper at paragraph 4.7.34.

44. If Auckland Airport was to continue to apply the IM in its pricing approach, it would have the following consequences:

- (a) Auckland Airport estimates that the land held for use for the Northern Runway will be worth approximately \$500 million to \$600 million when the runway is commissioned (depending on actual timing). This is more than double the value of the land as at 30 June 2014.
- (b) Northern runway capex has not yet been costed, but could conceivably be in the order of \$600m.
- (c) The commissioning of the Northern Runway will therefore cause Auckland Airport's RAB to increase suddenly to nearly double its current RAB.
- (d) This will, in turn, result in a consequent sharp increase in Auckland Airport's charges, or a "price shock". The forecast RAB is illustrated below if the land was to come into the RAB in FY22 or 2027 and the runway commissioned in 2027. Introduction of AHFU into the RAB on either of those dates would increase Auckland Airport's RAB compared with today by ~30%, ~43% or ~62% respectively with a consequential impact on aeronautical prices. Inclusion of potential northern runway capex in FY27 could double the RAB increase, e.g at the end of PSE4, to more than 120% versus FY14.



- (e) We consider that a price shock would be undesirable as it would create potential for greater regulatory risk in the future. Specifically, a sudden increase in price may signal that information disclosure and transparency are not working effectively, thereby undermining trust in the ID regime.
- (f) Moreover, a sudden increase in Auckland Airport's charges would be undesirable to Auckland Airport's customers. We are concerned that customers (such as airlines) will exert pressure to avoid paying those fees, and as a result, Auckland Airport could be exposed to potential non-recovery of some of the return on its capital it would attain in a workably competitive market.
- (g) A price shock would challenge the business case for investment in Auckland Airport and would result in the regulatory regime having an adverse impact on Auckland Airport's confidence to invest.
- (h) A sudden rise in Auckland Airport prices would likely attract negative media interest for Auckland Airport.

- (i) A price shock would have negative implications for the travelling public and New Zealand's tourism industry (as it seems inevitable that airlines would seek to pass on the price shock to their customers to the maximum extent possible).

45. For those reasons, we consider that it would be commercially challenging and economically inefficient for the pricing approach implied by the IMs to be applied prescriptively so as to result in a price shock when a new capacity is commissioned into use.
46. We believe the objective of Part 4 can be better met by focusing on how the IMs can enable more flexibility, so as to transparently illustrate the outcomes consistent with workably competitive markets. Where land held for future use is concerned, we believe this means considering how assessments can be made under the IM and ID requirements to enable airports to recover costs over a longer period of time, so as to achieve a stable price path.

#### **Auckland Airport has consulted with interested parties on the issue**

47. When prices were last set in 2012, Auckland Airport explored scenarios for including the Northern Runway in the asset base for pricing in future price-setting events and has consulted with customers on these scenarios. Most airlines prefer to have the charges deferred for as long as possible and might rely on the ID regime to support the side-stepping of important discussions about how the costs for this critical development will be met over time.
48. However, we received independent economic advice that it would be more efficient, rational, and consistent with workably competitive markets, for the cost of holding the land, and its subsequent development, to be smoothed over time.
49. Despite the pressure from customers to defer charges, there has been general agreement that transparency would be required for any future mechanism used to recover the value of the land held for future use.

#### **Suggestion for addressing the issue of land held for future use in the IM review**

50. We continue to be of the view that a long-term approach, involving a steady price path, is likely to be the most consistent with workably competitive markets and will be the most efficient for customers and suppliers in the long term. Although the current IM and ID regimes provide transparency regarding the costs of land for future use, the problem is there is no clarity today on how transparency should be enabled and profitability assessed in the event that an airport were to smooth prices in advance of commissioning an asset held for future use.
51. One potential price-smoothing alternative has been considered by Auckland Airport and is summarised briefly as follows:
- (a) Auckland Airport believes that the value of land held for future use could be monitored through ID showing the holding costs and net income attributed to that land.
  - (b) An interim levy could be introduced and the net income attributable to the land held for future use would be deducted from the original value of, and the holding costs associated with, that land.
  - (c) The land would therefore be commissioned at a reduced value, ameliorating the RAB impact when the asset is commissioned.

52. Auckland Airport believes this would be a transparent way to deliver a NPV neutral price path under the current IM and ID regimes and demonstrate the returns on assets in use versus the assets held for future use.
53. At the same time, we acknowledge that we are only at the early stage of exploring methods for achieving price efficiency for the commissioning of the Northern Runway. Other methods might include:<sup>5</sup>
- (a) for the costs of construction related to commissioning to be transitioned to the asset base over time;
  - (b) to use non-standard depreciation (as discussed by Christchurch Airport and by the Commission at the forum);<sup>6</sup> or
  - (c) providing transparency of departures from the IMs, such as the amended profitability assessment and the disclosed difference approach discussed by Commission staff.
54. Auckland Airport has formed no view on the pricing of land held for future use, however it is a very real pricing and investment challenge that it will face in the near future. Therefore, we believe it is important as part of the IM review for the Commission to explore this matter and indicate the principles and approach it would take to assessing profitability assessment in the event that an airport were to smooth prices in advance of commissioning an asset held for future use.
55. We believe the IM and ID regimes can be conducive to Auckland Airport using a NPV neutral option for achieving a stable price path and alternative approaches to recovering costs. We are keen to explore options further with the Commission and to engage with the Commission to consider how transparency could be best enabled if price smoothing is considered to be efficient.
56. Finally, we note that the potential for flexible depreciation to play a role here was raised in the forum. Although we are not opposed to exploring that idea further, our initial reaction is aligned with BARNZ - it could be putting a square peg into a round hole. We agree the focus should be directly on how price smoothing can be transparently assessed.

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<sup>5</sup> Transcript of Input Methodologies Review Forum (29-30 July 2015) Te Papa, Martin Harrington (Wellington Airport) at p 366.

<sup>6</sup> Transcript of Input Methodologies Review Forum (29-30 July 2015) Te Papa, Hamish Groves (Commerce Commission) at pp 312 - 313.



## SECTION 5: DETERMINING THE VALUE OF THE INITIAL RAB

### Key points:

- Auckland Airport believes that, if an initial RAB at 2010 is required to be disclosed, an appropriate approach would be to use a midpoint between Auckland Airport's existing 2009 valuation and its 2011 valuation (an interpolated value).
- Auckland Airport believes the result of an interpolated value would be the same as (or very similar to) a new 2010 valuation.
- The high costs of conducting a new valuation for 2010 outweigh any benefits, especially when a more efficient alternative approach is available.

57. As a result of the 12 December 2013 judgment of the High Court, the IMs now require the airports to have a land valuation for the RAB for the last day of 2010, rather than 2009.<sup>7</sup> In response to that judgment, and following the release of the draft orders, the Commission sought the views of Auckland Airport and Air New Zealand on how to give effect to the High Court decision.
58. Auckland Airport and Air New Zealand met with the Commission in 2014 to discuss a pragmatic way forward. Auckland Airport made the following points:
- (a) Auckland Airport does not want to create inefficiencies for its own business when inefficiencies can be reasonably avoided;
  - (b) Auckland Airport is supportive of transparency, provided it is meaningful and efficient for all involved; and
  - (c) Auckland Airport considers that complex changes to the IMs may not be the best way to give effect to the High Court decision.
59. Additionally, Auckland Airport made informal suggestions to the Commission on how an initial RAB value for 2010 could be determined, without the airports needing to prepare a full valuation for 2010.
60. The Commission has noted the merit of using an alternative approach, and has welcomed submissions on how the initial RAB value in 2010 could be determined.<sup>8</sup> This section summarises the informal suggestions that were made by Auckland Airport to the Commission in 2014, using Auckland Airport as an example, which would benefit from consideration in the IM review.

### Proposed interpolation of land values for initial 2010 RAB

61. Auckland Airport proposes that, if it is necessary to disclose an initial land RAB value for 2010, this can most efficiently be achieved through an interpolation of Auckland Airport's 2009 valuation and its subsequent 2011 valuation. Auckland Airport's land assets were valued in accordance with Schedule A in 2009 and in 2011. The RAB land value for Auckland Airport was \$305 million in 2009 and \$356 million in 2011. The mid-point or

<sup>7</sup> *Wellington International Airport Ltd & Others v Commerce Commission* [2013] NZHC 3289 (December 2013); Commerce Commission *Input methodologies review: Invitation to contribute to problem definition* (16 June 2015) at [309].

<sup>8</sup> Commerce Commission *Input methodologies review: Invitation to contribute to problem definition* (16 June 2015) at [355] and [356.5].

interpolation of these two values would result in an RAB land value of \$331 million for 2010.

62. Auckland Airport believes that an interpolated valuation should be used for the initial 2010 RAB, rather than a new 2010 land valuation, for the following reasons:
- (a) Any new valuation at 2010 would be in very close range to an interpolation of the 2009 and 2011 land values.
  - (b) If a new land valuation for 2010 were required, it would result in Auckland Airport incurring significant cost. It would be inefficient for Auckland Airport to incur this cost when the aim of providing an initial RAB reference point for 2010 can be met by using interpolated values.
  - (c) There has been a significant passage of time since the implementation of the current ID regime, and all airports have re-valued their land since 2009. A new 2010 valuation would make no difference to practical carrying values, to disclosed values or to transparency. The cost of requiring a new valuation outweighs any potential benefits, given this passage of time.
  - (d) There is no requirement for Auckland Airport to "re-disclose" the initial RAB under the ID regime. Nevertheless, Auckland Airport understands that there may be interest from the Commission in having an initial RAB reference point. The Commission's interest can be met pragmatically by using an interpolated value of 2009 and 2011 land values.
63. We note that there was broad support for pragmatism in approaching the initial 2010 RAB at the time of the discussions in 2014. The Commission has historically taken a pragmatic approach to establishing the initial RAB and we believe the same factors that have historically supported a pragmatic approach are relevant today.
64. Auckland Airport strongly supports NZ Airports' view that the purpose of the IMs is to provide certainty and that any changes should be applied on a prospective basis, not retrospectively. Therefore, we disagree with BARNZ's observation that there is any difference between a change to an IM that clarifies an ambiguity or is a completely new change. It would create a very poor precedent if the Commission were to retrospectively require the airports to undertake a 2010 valuation in 2017. Our view is that such an approach would be disruptive and inappropriate, and we encourage the Commission to remove it from consideration as a potential option to the earliest opportunity.

## SECTION 6: OTHER MATTERS

### Key points:

- Leased assets have been included in Auckland Airport's pricing disclosure.
- The AHFU Input Methodology should be corrected for a technical error as part of this review. Interpretation of the schedule is problematic for interested parties and would also benefit from clarification or simplification.
- If the moratorium is unwound in the future, and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner). Auckland Airport is open to considering other principled options for rolling the asset base forward in the forthcoming aeronautical pricing round.

### Leased assets

65. Contrary to the statement at [320] of the problem definition paper, Auckland Airport has not excluded leased assets from its pricing disclosure. Rather, to respond to the requests of airlines in the pricing setting disclosure, we provided a supplementary schedule reconciling the scope of the consultation on assets covered by standard charges, to those covered by lease negotiations. We note that these are standard leases, not finance leases.
66. We understand that there is some pressure from the airlines to tailor the information disclosure regime to exactly mirror the scope of the pricing consultation which directly affects their cost base.
67. Our view, consistent with NZ Airports' submissions on leased assets, is that it is inappropriate to change the scope and structure of reporting on regulated returns to a sub-set of consumers.
68. The reasons for this include:
- (a) As noted by NZ Airports, activities that involve leased assets are included in the definition of 'specified airport services' for the purpose of ID regulation and airports are correct to price leased assets separately.
  - (b) It is inappropriate for the regime to be tailored completely to one segment of interested parties if a further layer of disclosure is added, or indeed removed, which overlooks returns on regulated assets priced outside of the standard consultation with airlines.
  - (c) The scope of what is covered by standard consultation and lease negotiations can vary from airport to airport.
  - (d) Segmental analysis of specified airport activities provides a strong proxy indicator of returns from general pricing consultation vs leased activities. The segmental analysis has a defined scope enshrined in the Airport Authorities Act.

### Asset held for future use – technical errors

69. At [40] of the problem definition paper, the Commission seeks views on whether correcting any drafting errors or ambiguities in the current IMs fits into the decision making framework. We consider that:
- Correcting of drafting errors need not wait until an IM review.
  - However, the opportunity should be taken to identify residual drafting errors and ambiguities during the IM review.
  - The decision making framework ought to be applied to guide how these errors or ambiguities ought to be addressed.
70. Auckland Airport has previously noted to the Commission that we consider that the tracking of excluded assets held for future use contains a mechanical error in relation to the mis-treatment of tax<sup>9</sup>. Auckland Airport's understanding of the IM associated with the Cost of the Excluded Asset<sup>10</sup> is that:
- If Auckland Airport earns interim revenues on an asset held for future use, this should be subtracted from the carrying value of the assets. In our view this is logical and fair.
  - However, Auckland Airport would be required to pay tax on any interim revenue that may be earned on a future use asset, but would be required to subtract the gross revenue from the carrying value of the assets. We consider this to be a mechanical error in the IM which would discourage airports from finding interim uses for assets held for future use.
71. We have also received feedback from interested parties (eg analysts) that they find it difficult to interpret the schedule in information disclosure which also contains a calculation error. The following extract from the FY14 disclosure exemplifies this.

4b(viii): Assets Held for Future Use					
	Base Value	Holding Costs	Net Revenue c	Tracking Revaluation c	Total
Assets held for future use—previous disclosure year	170,957	65,752	(+434)	(2,517)	216,088
plus: Assets held for future use—additions <sup>1</sup>	1	18,312	(951)	(8,517)	10,747
less: Transfer to works under construction	-	-	-	-	-
less: Assets held for future use—disposals	-	-	-	-	-
Assets held for future use <sup>2</sup>	170,958	84,063	(5,385)	(11,034)	226,815

<sup>1</sup> Holding Costs, Net Revenue, and Tracking Revaluation are net of the Assets held for future use—additions available to the value incurred during the disclosure year.  
<sup>2</sup> Each category value shown in the Assets held for future use line (Base Value, Holding Costs, Net Revenue, and Tracking Revaluation) is carried forward into the following year's disclosure as Assets held for future use—previous disclosure year.

Assets held for future use. To correct for a formulaic error in the Commission's "Total" column of row 122 below in schedule 4b(viii): Assets Held for Future Use, positive "Tracking Revaluations" in assets held for future use must be entered as negative figures. The negative \$8,517k figure shown in that row below reflects the positive tracking revaluation of \$2,824k for 2014 (entered as a negative). It also corrects for the positive tracking revaluation of \$1,199k in 2013 and \$1,647k in 2012 that that were incorrectly entered as positives in the FY13 and FY12 disclosure accounts, respectively (corrected by subtracting twice the respective figures).

### Revaluations

72. The Commission asked at the conference what we considered to be a principled treatment of revaluations. Auckland Airport has given the following assurances previously:<sup>11</sup>
- Auckland Airport currently has no intention to revalue its asset base for pricing in PSE3. Continuing the moratorium or an approach involving indexing of the moratorium from 2017/2018 onwards are both distinctly possible outcomes.

<sup>9</sup> Section 56G Review Of Auckland Airport Cross Submission on Commerce Commission Draft Report 14 June 2013.

<sup>10</sup> IM Determination 3.11 Cost of Excluded Asset.

<sup>11</sup> Auckland Airport Cross Submission on the Auckland Airport Section 56G Draft Report page 5.

- (b) If the moratorium is unwound in the future, and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).
- 73. We have indicated that if the pricing asset base is revalued in PSE3, any revaluation gains will be treated appropriately in pricing. That is:
  - (a) Unaccounted for increases in the asset base used for pricing would be treated as revenue.
  - (b) Prospective revaluations in the forthcoming pricing round would be treated as an offset to the revenue requirement.
- 74. At this stage the most likely options include retaining the moratorium or, as BARNZ suggested at the Auckland Airport s56 Conference, a roll forward which indexes the moratorium asset base from 2018 onwards, with revaluations to assets also accounted for in income. We are open to exploring principled options going forward and will consult on this when aeronautical pricing begins next year.