

**ASSESSMENT BY BARNZ OF WIAL’S UPDATED PRICING PROPOSAL**

29 May 2014

**1. INTRODUCTION AND EXECUTIVE SUMMARY**

**1.1 Introduction**

Wellington Airport has initiated consultation over its airport charges three years before its current schedule of charges set in 2012 was due to expire. This is a result of the Commerce Commission concluding that the charges previously set by the airport would result in it extracting excess revenues from consumers of between \$38.3m to \$68.9m over the five-year period of PSE2, returns the Commission described as *‘well above what [is] considered appropriate under the Commission’s information disclosure framework’*.<sup>1</sup>

At a high level, Wellington Airport has proposed a decrease in required revenue of around 7% in the first year as compared with FY14, followed by resumed increases in revenue of around 7% pa. Different charges alter at different rates, but at the total pricing asset base level the outcome is as follows:

	FY14	FY15	FY16	FY17	FY18	FY19
Target revenue*	\$66.8m	\$62.2m**	\$66.7m	\$72.5m	\$76.8m	\$81.3m
Percentage change		-6.9%	7.2%	8.6%	5.9%	5.9%
Average passenger charge***	\$12.29	\$11.32	\$11.85	\$12.59	\$12.99	\$13.26
Percentage change		-7.9%	4.7%	6.3%	3.19%	2.1%

\* Includes incentive rebate costs charged to airlines

\*\* Blended outcome of two months of PSE2 prices and 10 months of new PSE3 prices

\*\*\* Before any growth incentive rebates are provided to airlines because actual payments are uncertain and will not be received by all airlines

This assessment has been undertaken by BARNZ in order to provide an independent review of the airport’s proposed revenue requirements as against the principles and approach applied by the Commerce Commission in its input methodology, information disclosure and price setting roles

<sup>1</sup> Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, 8 February 2013, page 84 and 87.

under Part 4 of the Commerce Act. This assessment is not a submission by, or on behalf of, any of the airlines operating scheduled services into Wellington Airport. Rather, it will be made available to those airlines for them to use (or disregard) as they see fit in the pricing consultation with WIAL. The status of the points raised in this assessment is therefore determined by whether or not they are adopted by WIAL's customer airlines. No comment is made on the proposed pricing structure.

The assessment begins in section 2 with a review of all the building block inputs to WIAL's calculation of its required revenue. Section 3 then provides further detail on what BARNZ considers to be the material outstanding key issues.

## 1.2 Summary of Assessment

The decrease in revenue being targeted by WIAL at the outset of PSE3 is due to several significant changes in WIAL's approach to pricing. The airport has moved to applying a number of the Commission's input methodologies, in particular:

- WIAL has applied the Commission's asset valuation methodologies (MVAU for land and the indexed approach for specialised assets) rather than its previous much higher approaches of MVEU for land and a new ODRC valuation of specialised assets;
- WIAL has applied the Commission's 75<sup>th</sup> percentile WACC forecast, which it estimates is currently 8.46%, rather than its own targeted WACC which was 9.51%.

These are welcome changes. They have brought WIAL's proposal and the BARNZ Assessment of what revenue is reasonably required under the Commerce Commission information disclosure and input methodology framework much closer together for the terminal cost centre where the difference has now reduced to between \$2m to \$12m, depending upon the point in the WACC range adopted.

However, there are still significant differences with respect to the inputs to the building block calculation in relation to the airfield. BARNZ estimates that over the four year ten month period, it is appropriate for revenue totalling between \$158m to \$174m to be targeted for the airfield (depending upon whether a return is targeted at the mid-point or 75<sup>th</sup> percentile estimate of the WACC range) – some \$29m to \$45m less than the \$203m being targeted by WIAL for its airfield activities.

### ***Key differences identified with WIAL's building block calculations***

The key differences between the BARNZ assessment and the airport's approach are:

- Where in the WACC range returns should be targeted – WIAL is targeting the 75<sup>th</sup> percentile estimate which the Commerce Commission uses for pricing, although the High Court has expressed scepticism over the appropriateness of targeting returns above the mid-point. The Commission has recently commenced re-examining this point;
- BARNZ has received advice that WIAL's MVAU land valuation is \$41m over-stated;

- Whether it is appropriate for the airport to treat its \$8.5m growth rebates as a cost for airlines to fund, thus increasing targeted revenue?
- At what rate movements in land valuation should be forecast? If WIAL only commits to treating forecast revaluations as income, then a forecast based on CPI (which implies zero real growth in land values) is inappropriate. BARNZ forecasts annual movement in land values of 4.5% pa.

The last question of the appropriate treatment of unforecast revaluations is a long-standing key difference which BARNZ has had over WIAL's approach to pricing. The Commerce Commission and the High Court have clearly set out the principle that where a nominal WACC is being used to determine prices, then all revaluations must be treated as income for the purpose of determining prices. WIAL accepted this principle in November 2013 during consultation with airlines, setting out its approach going forward as being that any actual revaluations above or below the revaluations forecast during PSE3, would be treated as a credit (or debit) when charges were reset for PSE4. However, the airport has since recanted, purporting to leave the issue of treatment of unforecast revaluations undetermined until consultation begins at the end of PSE3 for new prices to be set for PSE4 (beginning 1 April 2019). The regrettable inference is that the airport is seeking to leave its options open so as to retain the benefit for itself of any future increase in land values above forecast inflation.

This issue directly affects the charges being set now, as it means the reasonableness of the forecast revaluation rate for land needs to be reviewed in light of the fact there is no committed wash-up to reflect actual land valuation movements at the end of the pricing period.

There are also other issues that do not individually have as material an effect on the outcome as the key differences identified above that are mentioned in BARNZ's review of the inputs to each building block element in section 2 of this Assessment.

### ***Outcome of Alternative Revenue Modelling***

BARNZ has undertaken some alternative revenue modelling to illustrate the effects of making the above adjustments on the calculation of required revenue. This has been carried out using both the mid-point WACC estimate as well as the 75<sup>th</sup> percentile estimate. Adjusting for the matters identified above produces the following outcomes in terms of required aeronautical revenue at Wellington Airport:

#### *Outcome of alternative required revenue modelling for Wellington Airport for 4 years and 10 months*

	Airfield Pricing Assets	Terminal Pricing Assets	Pricing assets
WIAL's Revised Pricing Proposal	\$203m	\$144m	\$347m
BARNZ 75 <sup>th</sup> % WACC estimate	\$174m	\$142m	\$316m
BARNZ mid-point WACC estimate	\$158m	\$132m	\$290m

### *Summary of terminal outcome*

It can be seen that the outcome for terminal charges is much closer than has previously been the case in other consultations with Wellington Airport with the difference having narrowed to between \$2m and \$12m over the pricing period. This is primarily due to WIAL moving to adopt the upper end of the Commission's acceptable WACC range rather than utilising its internal WACC target.

The impact on the proposed charges of making the adjustments identified in the section above<sup>2</sup>, if the required revenue is recouped as WIAL proposes via a flat charge across all passengers designed to recover costs in the year they are incurred, reduces WIAL's proposed initial \$4.44 charge per arriving and departing passenger to one between \$4.05 and \$4.38 per passenger across the WACC range in year one of PSE3.

Across the entire pricing period, BARNZ's alternative revenue modelling suggests a terminal charge 8 cents lower per passenger than that proposed by WIAL if the 75<sup>th</sup> percentile WACC is applied or 45 cents lower if the mid-point WACC is adopted.

### *Summary of airfield outcome*

With respect to the calculation of required revenue for the airfield, significant differences still exist. These relate primarily to the opening land valuation, (where the advice received by BARNZ is that WIAL's land valuation is \$41m overstated) and to the appropriate level at which to forecast land revaluations going forward.

If WIAL is not committing to treating any difference between actual and forecast revaluations as income at the end of PSE3, then airlines need to attempt to ensure that land revaluations are forecast at an appropriate level; one no more likely to be too low as too high. WIAL's current forecast based on CPI is woefully too low if the airport is not committing to treat actual revaluations as income. It implies that no real increase in land values is forecast for the next five years in Wellington, which is not likely. BARNZ has sought advice from Property Advisory Ltd which advises that forecast increases of 4.5% pa to overall land values is more plausible. Of course, if WIAL were to commit to treating all unforecast revaluations from PSE3 as income in PSE4, then the question of forecast revaluation rates becomes less important to the current price setting calculations.

The impact on individual airfield charges is difficult to illustrate as it depends upon choices made between MCTOW based pricing and passenger based pricing. At an overall airfield level, however, WIAL's pricing proposal provides for required revenue to remain constant compared with FY14 in year 1 of the pricing period (i.e. FY15) followed by average increases to required revenue of 7% for each of the next four years.

BARNZ's analysis indicates that this level of targeted revenue will result in significant levels of excess returns being earned on the airfield over the forthcoming pricing period – up to \$45m if a mid-point WACC is targeted and up to \$29m if a WACC at the 75<sup>th</sup> percentile is targeted (in both cases this is

---

<sup>2</sup> In summary these adjustments are WACC, removal of capex to remodel the terminal entrance in FY19, removal of the food-court from the aeronautical asset base and sharing of the costs of the growth incentive scheme across the whole business.

based on WIAL's current position of refusing to commit to treat actual revaluations as income, hence requiring there to be a more accurate forecast of predicted increases in land values).

By contrast, BARNZ's alternative revenue modelling produces the following results:

- If the airport's current position of not committing to treat unforecast revaluations as income continues, then a more accurate forecast of land valuation movements will be required. In this case, at the 75th percentile WACC estimate, airfield required revenue can remain at its current levels for all of PSE3. At WIAL's proposed increased charges and targeted level of revenue, BARNZ calculates that \$29m of excess returns will be earned on the airfield in this instance applying a 75<sup>th</sup> percentile WACC target.
- If the airport's current position of not committing to treat unforecast revaluations as income continues as outlined above, but returns at the mid-point WACC are targeted, then an initial decrease of approximately 10% to airfield required revenue is necessary, followed by targeted revenue remaining relatively constant over the remainder of the pricing period. At WIAL's proposed increased charges and targeted level of revenue, BARNZ calculates that \$45m of excess returns will be earned on the airfield in this instance applying a mid-point WACC target.
- If however, the airport reverted back to its November 2013 commitment to treat all unforecast revaluations during PSE3 as income in PSE4, then the land revaluations could be forecast using CPI forecasts as prices are reset now (with reliance on a wash-up occurring in PSE4). In this case, at the 75th percentile WACC estimate, airfield required revenue could remain at its current levels for the first three years of the pricing period (i.e. FY15, FY16 and FY17), followed by increases of approximately 10% per annum for the last two years of PSE3 (FY18 and FY19). At WIAL's proposed increased charges and targeted level of revenue, BARNZ calculates that \$16m of excess returns will be earned on the airfield in this instance applying a 75<sup>th</sup> percentile WACC target.
- If the airport commits to treating actual revaluations as income as outlined above, but targets returns at the mid-point WACC, then an initial decrease of approximately 3% to airfield required revenue is necessary, followed by targeted revenue remaining relatively constant over the remainder of the pricing period, will produce returns equivalent to the mid-point WACC. At WIAL's proposed increased charges and targeted level of revenue, BARNZ calculates that \$32m of excess returns will be earned on the airfield in this instance applying a mid-point WACC target.

The alternative airfield scenarios described above are summarised in the table below:

*Summary of airfield alternative revenue modelling*

Scenario being modelled	Required revenue over PSE3	Potential required revenue path
WIAL proposal at 75 <sup>th</sup> % WACC	\$203m	Revenue unchanged from FY14 in FY15, followed by average increases of 7%pa for each of FY16, FY17, FY18 and FY19.
BARNZ alternative revenue modelling with no revaluation wash-ups and at 75 <sup>th</sup> % WACC	\$174m	Revenue unchanged from FY14 in FY15, FY16, FY17, FY18 and FY19.
BARNZ alternative revenue modelling with no revaluation wash-ups and at mid-point WACC	\$158m	Decrease to revenue in FY15 of 10% followed by revenue remaining unchanged thereafter for FY16, FY17, FY18 and FY19.
BARNZ alternative revenue modelling with revaluation wash-up in PSE4 and at 75 <sup>th</sup> % WACC	\$187m	Revenue unchanged from FY14 in FY15, FY16 and FY17 followed by increases of 10%pa for FY18 and FY19.
BARNZ alternative revenue modelling with revaluation wash-up in PSE4 and at mid-point WACC	\$171m	Decrease to revenue in FY15 of 3% followed by revenue remaining unchanged thereafter for FY16, FY17, FY18 and FY19.

2. COMPARISON OF BUILDING BLOCKS INPUTS AGAINST COMMERCE COMMISSION INPUT METHODOLOGIES AND PRICE SETTING APPROACH

INPUT	WIAL's APPROACH	COMMENT AS AGAINST INPUT METHODOLOGIES AND COMMISSION'S APPROACH FOR SETTING PRICING PATHS
WACC	WIAL have moved to applying the CC 75 <sup>th</sup> percentile WACC, which is currently estimated as 8.46%, but will be updated prior to charges being set.	<p>There is currently a degree of uncertainty at a regulatory level in NZ as to whether the mid-point WACC or the 75<sup>th</sup> percentile estimate of the WACC range is the appropriate point to use to set prices:</p> <ul style="list-style-type: none"> <li>• The CC have adopted a WACC range of the 25% to 75% for information disclosure for airports, describing the mid-point as being the starting point for assessing profitability.</li> <li>• When assessing whether an airport had been limited in its ability to extract excessive profits during the s56G reviews, the CC undertook its analysis using both the mid-point and 75th percentile WACC estimate.</li> <li>• The CC IMs specified use of the 75th percentile estimate for setting DPP and CPP for ELBs and GDBs.</li> <li>• The High Court in its December 2013 merits review decision expressed scepticism as to the appropriateness of using the 75% WACC point, given this targets returns above a normal level and directed the CC to consider this aspect further when it next reviews the IMs.</li> <li>• The CC has just initiated a review of whether the uplift from the midpoint to the 75<sup>th</sup> percentile WACC estimate is justified. An outcome is not expected until November.</li> </ul> <p>This uncertainty over the appropriate point on the WACC range to use for setting prices will remain unresolved during the current price setting process.</p> <p>Futures Consultants Ltd have reviewed WIAL's WACC calculations and have advised that, other than a minor discrepancy around the timing of the market data, the resulting WACC range is in accordance with the outcome FCL obtains using the CC methodology.</p> <p>WIAL have not yet specified the date at which the final WACC will be calculated as at. BARNZ considers that setting a WACC as at 1 June 2014, being the first day of the new pricing period, utilising market data from the month of May, is the most appropriate approach.</p>

<p>Asset valuation</p>	<p>WIAL have moved to applying the CC input methodology valuation approaches of:</p> <ul style="list-style-type: none"> <li>• MVAU for land, using the valuation guidelines published by the Commission</li> <li>• The 2009 valuation of specialised assets, indexed for CPI and rolled forward for acquisitions, disposals, depreciation and adjustment for lost and found assets.</li> </ul>	<p>A review of WIAL’s land valuation by valuation, planning, resource management law and economics experts commissioned by BARNZ has disclosed that the land valuation is approximately \$41m over-stated due to:</p> <ul style="list-style-type: none"> <li>• Insufficient allowance being provided for the time necessary to obtain the required planning changes from its current airport zone to the zones which would enable the envisaged mixed use subdivision. WIAL have allowed nine months whereas the advice received by BARNZ is that it would take two to three years.</li> <li>• No allowance being made in the costs for ongoing seawall maintenance, which will either need to be funded through a mechanism such as a capitalised maintenance contribution to the Council or additional reserve contributions to set off the future liability assumed by the Council.</li> <li>• The land use mix containing a town centre 7.7 ha larger than justifiable, and insufficient land for reserves.</li> </ul> <p>Land valuation is a key issue which BARNZ expands upon in section 3 below. The specialised asset valuation methodology reflects the CC input methodologies. BARNZ does not have the information to conduct a review of the actual calculations, given the size of WIAL’s asset register. There is however no reason to believe that the airport has not properly followed the CC’s IM, given that disclosure accounts are required to be independently audited as well as being signed off by the airport’s directors.</p>
<p>Asset allocation</p>	<p>WIAL has applied the asset allocations it used for PSE2, which were not amended by CC during the s56G inquiry. It includes assets used for aeronautical purposes, excludes assets used for retail, commercial and car-parking activities, and shares common assets such as roads and egress areas by allocation factors such as floor area, land area or value of directly allocated assets. It has advised that leased assets have been excluded from the price setting asset base.</p>	<p>With two main exceptions, BARNZ considers WIAL’s asset allocation methodology is appropriate.</p> <ul style="list-style-type: none"> <li>• BARNZ has continuing concerns over the seating area around the bar and cafes in the central hall being allocated 74% to aeronautical and 26% to retail activities. This seating area is primarily required for retail food and beverage activities, and the rents paid and profits earned by the cafes reflect the availability of this seating area. From the construction of the terminal in 1998 up until 2012, WIAL consistently treated this area as retail space. The adjustment would reduce the aeronautical asset base by \$2.25m, which translates to a reduction in required revenue of \$2m over the pricing period. While the CC noted the issue during the s56G process, it did not determine how the space should be allocated, as it considered the matter was not of sufficient materiality to its s56G analysis. (refer F65)</li> <li>• BARNZ also considers that the Western Apron is not part of the airfield or terminal activities for which prices are being set. This apron space services leased hangars, and is part of the aircraft and freight set of activities, and hence should be the subject of a specific charge to those users or activities using it, and not fall within the asset base used to set airfield charges.</li> </ul>



CAPEX	<p>The airport has forecast \$110m of capex with the key projects being:</p> <ul style="list-style-type: none"> <li>• The domestic terminal south expansion forecast at \$41m</li> <li>• \$4.3m optimisation of the main terminal building</li> <li>• \$2m to improve the north pier domestic gates</li> </ul> <p>The previously proposed expansion of international processing space in the north pier and works necessary to increase rescue fire capability to CAT8 have been removed from the pricing model, instead being treated as specific project charges (SPC) to be consulted upon separately if they proceed.</p>	<p>While the majority of forecast capex appears justified and related to the pricing asset base, BARNZ considers that it is questionable whether the \$3m to reorganise the main entranceway to the terminal in FY19 (part of the \$4.3m optimisation project) is an essential spend or one that will increase passenger processing capacity. Its inclusion as justified expenditure is debateable.</p>
OPEX	<p>The airport is forecasting opex at levels which represent 2007 costs per pax in real terms.</p>	<p>The airport is forecasting opex at levels which represent 2007 costs per pax in real terms. 2007 costs were at a level BARNZ has previously acknowledged was efficient, therefore containing costs on a per pax basis at this real level does represent a level of cost containment.</p> <p>The airport has escalated its costs using a wider range of CPI forecasts than the CC, which focuses just on the Department of Statistics and the Reserve Bank forecasts. The airport's forecasts are higher than the Commission's in the early years of the pricing period, but lower than the CC's in the later years. Over the five years, the Commission's forecast CPI would total 10.6%, whereas WIAL's totals 11.2%.</p> <p>WIAL has adjusted its forecast opex to address the four matters raised by BARNZ in its previous Assessment, namely</p> <ul style="list-style-type: none"> <li>• The \$264 000m opex associated with CAT 8 RSF has been removed;</li> <li>• The \$180 000 pa for additional staff to undertake gate allocation and apron control tasks has been removed, with all parties instead relying upon the new IT solution acquired by WIAL being administered by Air NZ following a clear allocation process determined by WIAL.</li> <li>• The forecast costs for moving to domestic slot coordination have been revised downwards.</li> <li>• The forecast costs of WIAL providing gatehouse security has been reduced as levels of service, obligations and costs have become clearer.</li> </ul>

Depreciation	<p>Straight line depreciation has been applied of:</p> <ul style="list-style-type: none"> <li>• 4.4% for buildings &amp; infrastructure</li> <li>• 3.8% for civil works</li> <li>• 15.5% for plant and equipment</li> </ul>	No issues identified.
Tax	The airport has applied a post tax approach, with tax being calculated transparently applying the formula in the CC input methodologies.	No issues identified.
Revaluations	<p>The airport has forecast revaluations using the average of a number of available CPI forecasts. It applies this revaluation rate to its opening asset base each year and treats these revaluations as income annually. It has moved back from its previous commitment to treat actual revaluations above those forecast as income in PSE4, and now makes no commitment.</p>	<p>The airport's CPI forecasts differ from the CC, which focuses just on the Department of Statistics and the Reserve Bank forecasts. This has led to the airport's forecast revaluations being higher than the CC's in the early years of the pricing period, but lower than the CC's in the later years. Over the pricing period, the CC's forecast revaluations would total 10.6%, whereas WIAL's total 11.2%.</p> <p>The airport has calculated the annual revaluations on the opening asset base only. While the CC specified this approach in its Airport ID requirements in 2010, subsequently in its pricing models for ELBs the CC has included revaluations of capex in the year it occurs. The impact of WIAL's approach is an understatement of the forecast revaluations by \$1.3m over the five years if proportionate capex is revalued in the year it occurs or \$2.7m if all capex is revalued in the year it occurs. Given the inconsistent approaches by the CC between its Airport ID requirements and its ELB pricing modelling, BARNZ has not made any adjustment for this matter in its alternative revenue modelling.</p> <p>The airport is only committing to treat forecast revaluations as income – not actual revaluations. This differs to the airport's initial information package where WIAL committed to treat actual revaluations (or losses) as a credit (or debit) in the following pricing period (i.e. PSE4). It is inconsistent with the principle in the CC's reasons paper and the High Court's recognition that all revaluations must be treated as income for pricing purposes. However, in spite of these principles, the CC itself did not treat unforecast revaluations made by CIAL as income in the following pricing period when it undertook its S56G analysis of the return being targeted by CIAL, although it characterised this as a conservative approach in favour of CIAL.</p> <p>If WIAL confirms its approach of only committing to treat forecast revaluations as income, then the question of what revaluation rate to forecast for land becomes extremely important. Forecast increases based on CPI implies no real growth in land values is expected for the next five</p>

		<p>years, which is highly unlikely in the current economy where house prices in Wellington rose by 5.5% in the last 12 months and where net immigration (which is a strong driver of land values) is at its highest levels in a decade. BARNZ has obtained advice from Property Advisory Ltd on appropriate rates for forecast movements to land values over the forthcoming pricing period. Property Advisory has advised that a blended growth rate of 4.5% across the various land uses is appropriate.</p> <p>Treatment of actual revaluations is a key issue discussed in section 3.</p>
Growth incentive payments	WIAL is forecasting growth incentive rebates totalling \$8.5m as a negative income amount in its pricing model.	<p>WIAL forecasts making incentive payments of \$8.5m over the pricing period. It treats these payments as a negative income item in its pricing structure model, which has the effect of increasing the revenue required from charges. BARNZ has a number of concerns over the airports treatment of these costs:</p> <ul style="list-style-type: none"> <li>• In the first place there is a concerning lack of transparency as the airport nets the forecast rebate payments off its disclosed revenue, without disclosing the full amount of income from charges expected to be received in the first place from airport users in either its building block model or its proposed Schedule 18 disclosures;</li> <li>• Second, its approach transfers the risk of this portion of its forecast growth to airlines, with the airport receiving full payment of the forecast rebates from all airlines through the rebate cost being included within the required revenue from aeronautical charges – whether or not the growth occurs;</li> <li>• Third, with respect to the structure of the rebates for international growth, if growth occurs, but the specific requirements triggering the obligation to pay the rebates are not triggered, then WIAL may well earn excess returns. This risk was specifically highlighted by the CC in its s56G review of WIAL;</li> <li>• Fourth, the airport’s approach does not reflect the fact that it receives considerable complementary revenue from non-aeronautical retail and car-parking activities which is driven by passenger volumes. If these costs are to be recouped from users, then they should be met by all users across the entire business in an appropriate reflection of the shared benefit of the costs. This is the approach which has been taken by both Auckland and Christchurch Airports in relation to their route development costs; and</li> <li>• Finally, it is questionable whether the airport’s approach is in accordance with ICAO principles, which specify that aircraft operators should not be charged for facilities and services they do not use or which are not in general use.</li> </ul>

Demand forecast	<p>WIAL has forecast:</p> <ul style="list-style-type: none"> <li>domestic passenger growth averaging 2.1% pa</li> <li>international passenger growth averaging 6.5% pa</li> <li>Domestic aircraft movements reducing by an average 0.2% pa reflecting aircraft up-gauging</li> <li>International aircraft movements increasing by 4.2% pa on average</li> </ul>	<p>While on average the total growth rate appears reasonable across the five year period (albeit that international growth is at the optimistic end of the scale and domestic growth at the conservative end), BARNZ still has a residual concern that the growth is 'rear-end loaded' with higher growth rates forecast later in the pricing period and lower rates earlier:</p> <table border="1" data-bbox="884 352 2000 459"> <thead> <tr> <th></th> <th>FY15</th> <th>FY16</th> <th>FY17</th> <th>FY18</th> <th>FY19</th> </tr> </thead> <tbody> <tr> <td>International pax growth</td> <td>0.95%</td> <td>5.94%</td> <td>6.19%</td> <td>4.13%</td> <td>9.63%</td> </tr> <tr> <td>Domestic pax growth</td> <td>1.17%</td> <td>1.83%</td> <td>1.51%</td> <td>2.44%</td> <td>2.62%</td> </tr> </tbody> </table> <p>This has the effect of lifting the required revenue being targeted.</p>		FY15	FY16	FY17	FY18	FY19	International pax growth	0.95%	5.94%	6.19%	4.13%	9.63%	Domestic pax growth	1.17%	1.83%	1.51%	2.44%	2.62%
	FY15	FY16	FY17	FY18	FY19															
International pax growth	0.95%	5.94%	6.19%	4.13%	9.63%															
Domestic pax growth	1.17%	1.83%	1.51%	2.44%	2.62%															
Modelling of revenue	WIAL has moved to modelling a 4 year ten month pricing period.	This assumption addresses the previous concern that WIAL was under-stating likely revenue when it modelled a five year pricing period without reflecting the fact that the terminal passenger charge was at a higher level for the first two months.																		
Level of required revenue	WIAL has calculated that it requires revenue of \$347m over PSE3.	BARNZ's assessment of the required revenue after making the adjustments identified above is that the required revenue ranges from \$290m at the mid-point WACC to \$316m at the 75 <sup>th</sup> percentile WACC. This is \$31m to \$58m less than the revenue the airport is targeting. The vast majority of this difference (\$29m to \$45m) relates to the airfield, where the key differences are the appropriate land valuation and the forecast revaluation rate. The difference with respect to the terminal is significantly less (\$2m to \$12m).																		
IRR calculation	WIAL has undertaken an IRR calculation, which it describes as the same approach as that used by the CC, which it says results in a return equivalent to its WACC (currently 8.46%) over the five years (with the capex wash-ups included as income).	WIAL has undertaken its IRR calculations using end of year cash-flows. This significantly under-states the returns being targeted by the airport because it does not reflect the time value of money in relation to the revenues received throughout the year. While the CC used end of year cash-flows as its base scenario in the s56G reviews, this was only because that was the approach used by the CC at the time airports set prices for PSE2. Subsequently, the CC has moved to using a mid-year approach for information disclosure for EDBs and GDBs and it has signalled in its s56G reports that it intends making the same change for information disclosure requirements for airports (see for example page 96 of the CC's report under s56G relating to Auckland Airport) . An IRR calculation based on mid-year cash-flows produces an outcome of 8.9%, rather than the 8.4% under an end of year approach. This calculation as prepared by BARNZ by Covec is attached.																		

### 3. FURTHER COMMENT ON KEY ISSUES

As previously identified, the key differences between the BARNZ assessment and the airport's approach are:

- Where in the WACC range returns should be targeted? – WIAL is targeting the 75<sup>th</sup> percentile estimate which the Commerce Commission uses for pricing, although the High Court has expressed scepticism over the appropriateness of targeting returns above the mid-point. The Commission has recently commenced re-examining this point;
- Whether the MVAU land valuation is over-stated? – BARNZ has received advice that WIAL's MVAU land valuation is \$41m over-stated;
- Whether it is appropriate for the airport to treat its \$8.5m growth rebates as a cost for airlines to fund, thus increasing targeted revenue?
- At what rate movements in land valuation should be forecast? If WIAL only commits to treating forecast revaluations as income, then a forecast based on CPI (which implies zero real growth in land values) is inappropriate. BARNZ forecasts annual movement in land values of 4.5% pa.

This section provides further detailed comment on these differences.

#### 3.1 Where in the WACC range returns should be targeted?

As was noted in section two above, there is currently a degree of uncertainty at a regulatory level in New Zealand as to whether the mid-point WACC or the 75<sup>th</sup> percentile estimate of the WACC range is the appropriate point to use to set prices:

- The Commission has adopted a WACC range of the 25% to 75% for information disclosure for airports, describing the mid-point as being the starting point for assessing profitability.<sup>3</sup>
- When assessing whether an airport had been limited in its ability to extract excessive profits during the s56G reviews, the Commission undertook its analysis using both the mid-point and 75th percentile WACC estimate, confirming the mid-point as the starting point for its analysis but describing the 75th percentile being *'the upper limit of an acceptable range of returns'* to allow *'for the uncertainty of estimating the cost of capital and limit[ing] the potential asymmetric consequences of estimation error on investment'*.<sup>4</sup>
- The Commission IMs specified use of the 75th percentile estimate for setting DPP and CPP for ELBs and GDBs.

---

<sup>3</sup> Commerce Commission, Specified Airport Services Input Methodologies Determination, 22 December 2010, para E 11.2; Confirmed Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, 8 February 2013, para F36.

<sup>4</sup> Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport, 31 July 2013, para E4, and F60-62.

- The High Court in its December 2013 merits review decision expressed scepticism as to the appropriateness of using the 75<sup>th</sup> percentile WACC point, given this targets returns above a normal level, and directed the Commission to consider this aspect further when it next reviewed the IMs.
- The Commission has just initiated a review of whether the uplift from the midpoint to the 75th percentile WACC estimate is justified. An outcome is not expected until November 2014.

In particular, the High Court noted that:<sup>5</sup>

- Use of the 75<sup>th</sup> percentile WACC estimate for setting default and customised pricing paths involves the likelihood that suppliers will earn excess returns – contrary to the s52A(1)(d) objective of ensuring suppliers are limited in their ability to extract excessive profits.
- The prospect of earning a normal return on new investment should be a sufficiently attractive proposition to provide appropriate incentives for investment.
- Allowing higher than normal expected returns to be earned is likely to create inefficiencies and not incentivise invention, innovation or the need to strive for efficiency.
- Allowing higher than normal expected returns to be earned is likely to lead to wasteful investment.
- Applying a higher than normal WACC estimate to past investments is unlikely to be necessary to promote incentives to undertake future investment and innovation.

Given the points made by the High Court, BARNZ does not believe that it is appropriate for Wellington Airport to seek a return above the mid-point WACC estimate, which represents a normal level of return.

Moreover, in the case of airports, there is also no need for there to be an uplift over and above the mid-point WACC in order to create an incentive to invest – a more than sufficient incentive already exists in the form of the ability to earn a normal level of return on the aeronautical assets plus the ability to retain the high level of profits earned from complementary car-parking and retail activities which spring-board off the presence of aeronautical activity. In the case of WIAL, its car-parking and retail activities earned \$32.8m in FY13, which represents more than \$6 per passenger.<sup>6</sup>

This uncertainty over the appropriate point on the WACC range to use for setting prices will remain unresolved during the current price setting process. The Commission does not envisage completing its work until November. BARNZ has therefore undertaken its modelling work reviewing the reasonableness of WIAL's targeted revenue using both a mid-point WACC and a 75<sup>th</sup> percentile WACC estimate, so that airlines and WIAL can see both outcomes.

<sup>5</sup> *WIAL v Commerce Commission*, [2013] NZHC 2389, para 1460 – 1486.

<sup>6</sup> WIAL Annual Report for the year ended 31 March 2013, page 3.

### 3.2 Whether the MVAU land valuation is over-stated?

#### ***Summary of further advice sought by BARNZ***

BARNZ has obtained advice on the appropriateness of WIAL's MVAU land valuation from the experts listed below:

- Market Economics - economists specialising in assessing demand for various land uses, on the demand for the proposed land uses;
- Zomac Planning Solutions – on the appropriateness and feasibility of the proposed masterplan for the hypothetical alternative use;
- Gillian Chappell – barrister specialising in resource management law on the likely timeframe to obtain planning consent for the proposed masterplan; and
- Property Advisory Ltd – on the reasonableness of the valuation adopted by WIAL and the impact of any issues.

This advice was initially obtained in December 2013, supplemented by additional comment in April 2014 and, in the case of Property Advisory Ltd, further comment in May 2014. All reports are attached.

This work has disclosed that the land valuation adopted by WIAL is approximately \$41m over-stated due to:

- Insufficient allowance being provided for the time necessary to obtain the required planning changes from its current airport zone to the zones necessary to enable the envisaged mixed use subdivision. WIAL have allowed nine months whereas the advice received by BARNZ is that it would take two to three years.
- No allowance being made in the costs for ongoing seawall maintenance, which will need to be funded through a mechanism such as a capitalised maintenance contribution to the Council.
- The land use mix containing a town centre 7.7ha larger than justifiable and insufficient land for reserves.

#### ***These concerns were echoed by the Commission's land valuation expert***

BARNZ notes that the concerns expressed in their reports by Market Economics, Zomac Planning and Property Advisory over the likelihood of obtaining planning consent and time required to obtain it and the over-statement of the size of a supportable town-centre are concerns which were also held with regard to the airport's two earlier MVAU valuations.

These concerns were echoed and repeated by the Commission's valuation expert, Darroch, in its expert reports to the Commission on WIAL's 2009 and 2011 MVAU land valuations in the course of the s56G review process.

In those reports Darroch:<sup>7</sup>

- Noted *'concern over the number of hectares proposed for uses such as the town centre and business park and ... wonder[ed] whether these areas are greater than required in this locality'*. Darroch *'wonder[ed] whether all proposed uses would readily be permitted'* and later posed the question *'would a town centre of this size even be permitted given the other competing centres (such as the Kilbirnie town centre) nearby?'* Darroch concluded that the 2009 and 2011 valuations did not comply with the requirements of Schedule A with respect to determining the highest and best use and preparation of a land use development plan appropriately reflecting this highest and best use. (pages 5 and 6)
- Noted there was *'no consideration given to the costs of any zoning changes'* or *'discussion around the likelihood of a zone change'* and that the valuation report did not comply with the requirements of Schedule A with respect to taking into account zoning requirements. (pages 2 and 4)
- In relation to the seven year development period then being used by Telfer Young (which has now been increased to eight years), Darroch expressed *'real doubt'* over the sufficiency of that time *'given the time that will likely be required to receive all necessary consents and approvals'*. Darroch stated that *'it is more likely that a development period of at least ten years (and possibly longer) may be required.'* Thus Darroch would have increased the development period by three years to provide time for all necessary consents and approvals to be received. Darroch concluded the 2009 and 2011 valuations did not comply with the requirements of Schedule A with respect to determining market demand. (pages 6 and 7)
- In relation to the (then) 9.6 ha of reserves being proposed by Boffa Miskell (now 10.0 ha), Darroch stated that *'there has been very little mention of the reserve requirements for the development and I doubt that these are sufficient'*. This contributed to Darroch's view that the land use plan was not an appropriate reflection of the likely highest and best alternative use (page 6).

The concerns with WIAL's valuation raised by the experts engaged by BARNZ were therefore virtually all confirmed by the valuation expert engaged by the Commission. These same shortcomings still exist in the 2014 MVAU undertaken by WIAL.

### ***Most significant difference is time allowed to obtain planning consent***

The most significant contributing factor to the \$41m overstatement in land valuation is the question of allowance for obtaining planning changes.

As noted above, WIAL's valuers have only allowed nine months for this process. This is surprising because Property Economics, which provided WIAL with advice on market demand for the various land uses, described the proposed alternative land use as one which *'would provide a 'game changing' proposition that would force the entire planning of Southern Wellington to be reviewed'*. Property Economics considered that the alternative land use scenario and land holding *'encompass such an extensive and significant piece of land in the context of Wellington that the District Plan would have to change ...'*

---

<sup>7</sup> Darroch, Review of Land Valuation Methodology Wellington International Airport Ltd, 1 February 2013.



From BARNZ's experience with a number of plan changes over the last fifteen years it seems fanciful to suggest that a review of the entire planning of Southern Wellington could be achieved within nine months.

The advice received from Zomac Planning Solutions is that a 9 month allowance for obtaining planning changes is woefully inadequate with a more realistic timeframe being in the vicinity of two to three years.

Advice from Gillian Chappell, an independent barrister specialising in resource management law, is also that the time reasonably required to obtain planning consent will be somewhere between two to three years. This is irrespective of whether a plan change process is followed (as put forward by WIAL's market demand advisers) or whether the call-in process under the Resource Management Act is opted for (as put forward by WIAL's valuers, Telfer Young). Gillian Chappell noted that a call-in process would not realistically be able to be completed within 9 months (the time-frame adopted by Telfer Young in its valuation for WIAL). Rather the statutory process would typically take 12 to 16 months plus appropriate preparation time prior to lodgement (conservatively estimated at 9 to 12 months). She advised that any lack of time invested in the preparation phase would inevitably result in delays during the call-in process.

PAL uses the lower two year end of this estimate to quantify the impact of this one factor on the valuation as being \$30m.

As an alternative to adopting a shortened period for obtaining planning consent, WIAL has also put forward the argument that *an available interpretation of the input methodologies is that consents are already in place for the alternative use and hence no planning costs or time period are required.*

No reasoning or support has been provided by WIAL for this opinion. The assertion that no allowance for planning costs or the likely time to obtain consent is required is surprising. It is contrary to accepted valuation practice that all likely development costs need to be taken into account by a valuer when preparing a valuation. Moreover, it is at odds with the clear direction in Schedule A of the Airport Services Input Methodologies Determination 2010 for account to be taken of zoning changes required. It is also contrary to the approach taken by the Commission's valuation expert, Darroch, that Schedule A requires any likely zoning or plan changes and associated costs to be taken into account and that WIAL's 2009 and 2011 valuations were not compliant with Schedule A due to consideration not being given to the likelihood or costs of any zoning changes.

#### *The requirements in the valuation input methodology*

Sections A9 and A10 of Schedule A of the Airport Services Input Methodologies Determination 2010 set out the detailed practical valuation requirements and steps.

Section A9 contains the practical valuation requirements. Under the heading *Designation, zoning, district plan and other legal requirements* Schedule A states:

- (4) The land is likely to be designated or zoned for the various aeronautical activities of the airport owner. In addition to considering the likely alternative uses for the land, the valuer should also consider the likelihood of the designation being uplifted or the land rezoned, and costs (if any) likely to be involved in this. (Emphasis added)

Later in section A9, paragraph 13 makes express reference to including the costs of resource consents relating to the alternative use in the MVAU valuation calculations (as opposed to the costs of resource consents relating to airport development which are directed to be excluded from the valuation).

Section A10 of Schedule A sets out valuation steps which must be completed by a valuer when undertaking an MVAU valuation. Specifically relevant to the question of planning consents for the alternative use, Section A10 provides that the valuer must:

- ‘determine the existing or underlying zoning of the land or designations, and the likely zoning of the land for the highest and best alternative use, including the likelihood of zoning change or uplifting of designations’;
- ‘consider and determine the highest and best alternative use, which must be ... legally permissible’;
- ‘consider resource management (including reserve) requirements’; and
- determine the direct and indirect costs of developing the land.

It is thus clear that both the need for any zoning change, and any related costs, must be taken into account in determining the MVAU valuation. The valuation input methodology is clear on this as it directs that the valuer must take into account ‘*the likelihood of the designation being uplifted or the land rezoned, and costs (if any) likely to be involved in this*’. This is consistent with the subsequent direction that the highest and best alternative use must be one which is ‘legally permissible’ – in other words, one for which the developer has worked through the process to obtain any necessary planning consents. These are not instant or cost-less processes and will logically need to be taken into account when determining the direct and indirect costs of developing the land.

Contrary to WIAL’s assertion that the IMs require the valuer to assume that *consents are already in place for the alternative use and hence no planning costs or time period are required*, there is no directive anywhere in the Commission’s land valuation methodology that the valuer should assume that alternative land use consents are in place. This can be contrasted with the Commission’s treatment of potential remediation and demolition costs, where Schedule A expressly directs the valuer to ‘assume that the site is vacant and unencumbered by airport-related improvements’. There is a substantial list of remediation or demolition costs which should not be included within the valuation.

By contrast, planning costs and the time required for planning changes and consents to be obtained are not listed as costs to be excluded. There is no direction to assume that the site has the necessary consents in place for the selected alternative uses. Rather, as noted above, the valuer is instead expressly directed in sections A9 and A10 to specifically consider the need for any planning changes and the likelihood of obtaining such changes, and any likely costs of doing so.

BARNZ considers that the airport’s argument that the IM’s should be read as assuming that *consents are already in place for the alternative use and hence no planning costs or time period are required* is baseless and without merit. The time and cost of obtaining any necessary planning changes to enable the alternative use are clearly identified within the IMs as a cost needing to be taken into account in determining the MVAU of the airport land.

### 3.3 Whether it is appropriate for the airport to treat its \$8.5m growth rebates as a cost for airlines to fund, thus increasing targeted revenue?

WIAL forecasts making incentive payments of \$8.5m over the pricing period as follows:

	FY15	FY16	FY17	FY18	FY19
Incentive rebate	\$316 000	\$2,146,000	\$1,586,000	\$1,463,000	\$3,034,000

BARNZ has a number of concerns over the airport's treatment of these costs:

- In the first place there is a concerning lack of transparency in the airport's building blocks financial model and its proposed disclosures under Part 4 as the airport deducts the forecast rebate payments off its disclosed revenue, without first disclosing the total amount of income from aeronautical charges expected to be received in the first instance from airport users;
- Second, its approach transfers the risk of this speculative portion of forecast growth to airlines, with the airport receiving full payment of the forecast rebates from all airlines through the rebate cost being included within the aeronautical charges – whether or not the growth occurs;
- Third, in the case of the international rebate, if growth occurs, but the specific requirements triggering the obligation to pay the rebates are not triggered, then WIAL may well earn further excess returns;
- Fourth, the airport's approach does not reflect the fact that it receives considerable complementary revenue from non-aeronautical retail and car-parking activities which is driven by passenger volumes. BARNZ considers that, if these costs are to be recouped from users, then they should be shared with the retail side of the business and not solely charged to aeronautical activities; and
- Finally, the airport's approach is not in accordance with ICAO principles, which specify that aircraft operators should not be charged for facilities and services they do not use or which are not in general use.

#### ***Lack of transparency over forecast income***

The airport curiously treats the forecast rebate payments as a negative income item in its pricing structure model, which has the effect of increasing the revenue required from charges in order to meet WIAL's targeted required revenue. However, this negative income or cost does not appear in the airport's building block calculation of its required revenue, in the figures the airport puts forward of average charges per pax, or in the airport's proposed schedule 18 disclosures under Part 4 of its revenues from charges.

There is a concerning lack of transparency for interested persons endeavouring to understand what the total revenue is that users will be paying to the airport in aeronautical charges in the first instance. By only disclosing the net revenue, after the forecast rebates, there is an understatement of the total revenue forecast to be received by WIAL.

In order to show the effect on the revenue being targeted by the airport, BARNZ has included the forecast rebates as a separate element in its replication of the building block model. This is the only way of reconciling the charges proposed to be set as against the level of return being targeted. BARNZ considers that WIAL needs to similarly increase the transparency of the revenue it is targeting before payment of the rebates in both its financial modelling and its disclosures under Part 4.

***The airport is transferring all risk relating to the proposed rebates to the airlines***

BARNZ does not consider that the airport's treatment of the rebate costs is appropriate. No matter what happens, the airport is proposing to set its charges so as to receive from all users the forecast cost of it making the planned rebates – whether or not the forecast growth occurs and whether or not those rebates are paid.

By including the forecast rebates as a negative income amount in its price structure model, the airport has arranged a situation where:

- Irrespective of whether or not the growth relating to the rebates occurs, the airport is reimbursed for its forecast of likely rebates through the negative income amount it has included for the forecast rebate cost within its calculation of aeronautical charges. This amount commences at \$316 000 in FY15 and increases to \$3.0m by FY19. We will refer to this as 'the forecast rebate cost within the aeronautical charge'.
- If growth occurs, WIAL's financial modelling has the 'growing airline' paying charges as per the posted aeronautical charges in WIAL's published schedule of charges.
- If growth triggers the rebate conditions, then WIAL will rebate back a percentage of the charges paid by the 'growing airline'. This varies between 25% to 100%, depending upon the type of growth, and how recently it occurred.

By including 'the forecast rebate cost within the aeronautical charge', the airport has transferred the risk of the rebate related volume growth occurring to the airlines. There is no cost or risk to the airport. Taking FY15 as an example, where the rebates are forecast to amount to \$316 000:

- If the growth occurs as forecast, WIAL will receive payment from all users of 'the forecast rebate cost within the aeronautical charge' (\$316 000 in FY15), receive further payment from the airline or airlines that 'grew' of the relevant aeronautical charges, and will then pay the rebate to the airline or airlines that 'grew' (forecast to amount to \$316 000 but may in fact differ depending upon the level of growth). The outcome is net revenue of at least \$316 000 to WIAL. The cost of the rebate is met by the users – not by the airport.
- If the rebate related growth does not occur at all, then WIAL will still receive payment from all users of 'the forecast rebate cost within the aeronautical charge' (\$316 000 in FY15), but it will not receive any aeronautical charges related to the expected growth from the relevant airline and will not pay out any rebate. The net result is again net revenue of \$316 000 to WIAL. WIAL is still 'reimbursed' for the cost of the rebate – even though it has not had to make any payment.

The outcome is one where WIAL has not only passed on the cost of the rebate to the airlines (through charging them 'the forecast rebate cost within the aeronautical charge'), thereby absolving

itself from incurring any of the cost of the rebate, it has additionally structured matters so that the risk of the growth not occurring is also passed to the airlines – with WIAL receiving ‘the forecast rebate cost within the aeronautical charge’ whether or not the growth occurs. In BARNZ’s view, this is a heavy-handed and totally inappropriate abuse of the right the airport has to set charges as it thinks fit.

***Excess returns may be earned if growth eventuates without rebates being triggered***

Given the particular circumstances which must be met in order to trigger the international rebates (such as a new international service or additional international capacity needing to be 3 x weekly), the possibility exists of growth occurring without the rebate being triggered. In this situation WIAL would:

- Receive the standard aeronautical charges from the new services or growth;
- Receive the forecast cost of the rebate from all airlines through the ‘forecast rebate cost within the aeronautical charges’
- Not have to pay the rebate, due to it not being triggered.

This would lead to the airport over-recovering its forecast cost of the rebate scheme, and potentially earning excess returns.

This potential problem was recognised by the Commission, which stated that it ‘*consider[ed] that excessive profits may be earned if the discounts provided for in the volume growth incentive scheme are not triggered*’. However, the Commission concluded that it did not have sufficient expertise in this area to predict whether or not the rebates would be triggered and hence ‘*an assessment of actual performance in this area is required before we can fully conclude whether Wellington Airport’s pricing methodology is likely to lead to excessive profits*’.<sup>8</sup>

***Airport’s approach does not appropriately allocate the cost of the rebate scheme***

WIAL treats all of the forecast rebates as an aeronautical cost, to be met by the airlines. This differs from the airport’s treatment of its route marketing costs which it categorises as a common cost, to be met by both the aeronautical and non-aeronautical sides of the business, reflecting the fact passenger volumes drive non-aeronautical revenue from activities such as duty free retailing, food and beverage sales, car-parking charges and taxi concession payments. WIAL’s treatment of its forecast rebate costs also differs from how Auckland and Christchurch Airports have treated their route development activities, where such costs have been shared across the aeronautical and non-aeronautical parts of the business.

Significant profits can be earned by airports from complementary car-parking and retail activities which spring-board off the presence of aeronautical activities. Such commercial ventures are ubiquitous at airports worldwide. In the case of WIAL, the revenue earned from its car-parking and retail activities totalled earned \$32.8m in FY13, which represents over \$6 per passenger.<sup>9</sup>

---

<sup>8</sup> Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, 8 February 2013, para D37.

<sup>9</sup> WIAL Annual Report for the year ended 31 March 2013, page 3.

Expenditure designed to increase passenger volumes benefits both the aeronautical business through increased aeronautical revenue and potential economies of scale (assuming surplus capacity exists) as well as the retail and car-parking businesses whose growth is primarily driven by passenger volumes. If the airport is using its power to set charges to recoup incentive rebates from users, then cost allocation principles demand that this cost should also be shared across both aspects of the business – namely the retail and car-parking business as well as the aeronautical business.

Failure to appropriately share the costs across the whole business also means that WIAL is not sharing the benefits of economies of scope and scale achieved through the presence of multiple activities with airlines.<sup>10</sup>

### ***Airport's approach not in accordance with ICAO requirements***

BARNZ considers that WIAL's approach is inconsistent with ICAO principles, which set out that when determining the cost basis for airport charges, aircraft operators should not be charged for facilities and services they do not use or which are not in general use (refer para 30 (ii) and (iii) ICAO Document 9082). WIAL is here charging all airlines for the cost of the airport providing a rebate on fees to a subset of airlines. In other words, it is charging all airlines the cost of a rebate only enjoyed by some airlines, which is not in accordance with the ICAO charging principles.

By way of example of the inconsistency of the airport's approach with the ICAO principles, in 2011 the Regulatory Service for Brussels Airport Operations corrected Brussels Airport's decision to charge regulated activities the cost of commercial incentives to support airlines in their start-up or further development as that would have resulted in *'commercial advantages of some airlines [being] paid by all airlines'*. The Regulatory Service corrected the cost allocation to be 100% non-regulated.

The European Commission has recently released a report on the application of its Airport Charges Directive.<sup>11</sup> One of the issues highlighted in this report in relation to airports using the dual-till charging system was the need to ensure that the cost of airline incentives designed to boost traffic at an airport are applied in a way which does not have an impact on the charges paid by airlines not benefitting from the scheme. This issue was referred for further examination by the newly created forum comprising representatives of all of the Independent Supervisory Authorities of the EU member nations.

---

<sup>10</sup> Commerce Commission, Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, 8 February 2013, para D43.

<sup>11</sup> European Commission, COM (2014) 278, Report from the Commission to the European Parliament and the Council on the Application of the Airport Charges Directive, 19 May 2014, sections 3.3 and 4.

### 3.4 Treatment of unforecast revaluations

#### *WIAL's changed approach*

Wellington Airport has performed a full circle in its position over the treatment of revaluations over the previous few months.

Wellington Airport's original (and highly controversial) position was that only forecast revaluations had to be treated as income for pricing purposes, with unforecast revaluations being to the benefit of the asset owner, and not being required to be treated as income for the purposes of price setting. As at 2010 when the input methodologies were being developed, BARNZ estimated that this approach had resulted in the airport failing to properly treat \$119m of revaluations as income.

Following the merits review hearings, where the principle that all revaluations must be treated as income for pricing purposes was, in the High Court's words, 'generally accepted', in November 2013 Wellington Airport proposed setting charges on the basis that at the end of PSE3 all actual revaluations in excess of (or below) the forecast revaluations used to set charges at the beginning of PSE3 would be treated as a credit (or debit) to charges in PSE4. The airport's 18 November 2013 paper on asset valuations stated:

*WIAL also proposes that should:*

- *Actual PSE3 revaluations exceed forecast these would be applied as an offset against required revenue in the next pricing period (PSE4), OR*
- *Actual PSE3 revaluations be below forecast these would be applied as an addition to required revenue in the next pricing period (PSE4)*

*WIAL considers that this is an appropriate risk share approach to future revaluations.*

Air NZ, Virgin Australia and BARNZ agreed with this approach in their various responses to the airport. It was seen as an appropriate application of the Commerce Commission and High Court principles in practice, and an approach that would avoid the prospect of further windfall gains if actual asset revaluations exceeded forecasts.

However, despite the level of consensus which had been reached, Wellington Airport has now recanted on its November 2013 approach in its more recent March 2014 proposal and its April Key Issues Paper, instead proposing '*to consider the actual outcomes against forecast at the end of PSE3 and propose an approach for recognition of any variations from forecast at that time and to consult with its substantial customers on that issue*'.

The airport's reversal in its previous position has created considerable uncertainty and has reopened the most controversial element of airport pricing – namely the practice of extracting windfall profits through forecasting revaluations at a low level and then not treating any actual revaluations above those forecast as income when resetting prices.

## **Commerce Commission and High Court statements on the principle of how unforecast revaluations should be treated**

As the High Court explained in its merits review decision:<sup>12</sup>

Because a supplier's allowed maximum revenue (or assessed return) is derived in part from the value of the RAB, an increase in valuation directly affects the level of allowed revenue. In other words, in the absence of a regulatory constraint a regulated supplier could increase its allowed revenue simply by revaluing its assets, without any increase in investment or efficiency. Higher profits resulting from such a revaluation would be a windfall gain rather than a reward for superior performance, which is contrary to the long term benefit of consumers, and to the objective in s 52A(1)(d) of limiting a supplier's ability to extract excessive profits.

The High Court affirmed the general principle articulated by the Commerce Commission that all revaluations must be treated as income, stating:<sup>13</sup>

The Commission's approach for the future is generally accepted. Consistent with its use of a nominal WACC, which incorporates an allowance for inflation, all revaluation gains are required to be treated as income for pricing purposes. (Emphasis added)

In its reasons paper accompanying the input methodologies for regulated airport services, the Commerce Commission had articulated the general principle as being that, if a nominal WACC is applied to a revalued asset base, then all revaluations, whether undertaken by indexing or as a result of a new valuation, must be treated as income in order to be consistent with the FCM or NPV = 0 principle:<sup>14</sup>

... if a nominal cost of capital is applied to an inflated/indexed asset base, any revaluations of the asset, such as an upward revaluation for inflation, must be treated as income in the ROI for profits to be monitored effectively.

The same principle applies, however, even where a revaluation occurs for reasons other than economy-wide inflation, and where the extent of the revaluation differs from the change in the CPI. Because the use of a nominal WACC with a non-revalued asset base is consistent with FCM, any revaluation gain must be treated as income in the ROI.

Accordingly, for information disclosure purposes, the Commission required airports to disclose both indexed and unforecast revaluations of land and specialised assets, and to include these as income in its calculations of return on investment (ROI).

As the High Court recorded, this principle also applies *for pricing purposes*. The High Court, which had heard months of submissions by all of the regulated suppliers, described the principle as being 'generally accepted' by the parties (of which WIAL was one) and 'uncontroversial' among them.

WIAL's withdrawal from its short-lived commitment to treat any unforecast revaluations as income (or a cost) in the subsequent pricing period is both disappointing and a step backwards to its previous approach of exploiting the forecasting of revaluations so as to be able to retain any difference between the forecast and actual revaluations.

---

<sup>12</sup> *Wellington International Airport Ltd v Commerce Commission*, [2013] NZHC 2389, para 383.

<sup>13</sup> *Wellington International Airport Ltd v Commerce Commission*, [2013] NZHC 2389, para 268.

<sup>14</sup> Refer Commerce Commission, Specified Airport Services Input Methodologies Determination, 22 December 2010, para 2.8.13 – 17, quote in text is para 2.8.14 – 2.8.15.



### ***The impact of WIAL's approach on current charges***

If WIAL continues its currently proposed approach of forecasting asset revaluations at predicted CPI movements, without making any commitment as to how any difference between actual and forecast revaluations will be treated, then airlines will need to carefully consider whether forecasting revaluations of land assets at forecast CPI rates is appropriate, given that it implies a zero real growth rate in land values, which is extremely unlikely given the current relatively buoyant economy.

A CPI based forecast for land revaluations in a situation where market based revaluations will periodically occur is only appropriate if it is accompanied by a commitment to treat any revaluations above or below that CPI based forecast as income when charges are next set. If no mechanism exists to treat unforecast revaluations as income (or a cost), then a revaluation forecast is required which more closely predicts the movements in land valuations.

REINZ figures show growth in house prices in the Southern Wellington suburbs in the 12 months to February 2014 was 5.5%, which exceeded CPI by approximately 4%.

In New Zealand's most recent budget, Treasury forecast net immigration to amount to between 38 000 and 41 500 this year – which represents approximately 1% of the population of New Zealand. There is a strong correlation between positive net immigration and real increases in property value, with a recent Treasury working paper quoting research showing that every 1% increase in population caused by net immigration correlates to an 8% to 10% increase in property values nationally.<sup>15</sup> The last significant peak in net immigration in 2002-2003 coincided with the 2002 to 2004 surge in property values. The current spike in net immigration therefore suggests property prices will increase by substantially more than inflation in the short term, and it is not infeasible that there could be a sharp increase in land values as occurred during 2002 to 2004.

BARNZ has sought additional advice from Property Economics on the likely movement in property values in the Wellington region over the next five years. Property Economics have advised that the appropriate forecast growth rate for land values, weighted across the land uses in the Telfer Young alternative use valuation, is for growth of 4.5% pa. This advice is attached.

In its alternative revenue modelling BARNZ has therefore applied a 4.5% revaluation forecast to land assets.

Each airline will need to consider whether it would prefer WIAL to forecast land revaluations at CPI (as per the input methodologies) with a subsequent wash-up of actual revaluations (be they above or below forecast) when prices are next reset as WIAL proposed to do in its November 2013 land valuation paper; or whether the airline prefers WIAL to adopt a more appropriate forecast of valuation movements over the forthcoming pricing period with the airport making no commitment as to how the benefit (or loss) of actual valuation movements being above or below those forecasts will be treated.

---

<sup>15</sup> Treasury Working Paper 14/10, Migration and Macroeconomic Performance in New Zealand: Theory and Evidence, Julie Fry, April 2014, section 4.2; available at <http://www.treasury.govt.nz/publications/research-policy/wp/2014/14-10/14.htm/>.

### ***Assessment of previous revaluations as against forecasts***

WIAL has claimed that it has over-estimated revaluations by \$42m since the commencement of the disclosure regime. Whether revaluations have been over or under-forecast over time is highly dependent upon where one draws the line. For instance, BARNZ has calculated that from 2002 to 2014 WIAL has failed to treat approximately \$80m of revaluations as income.<sup>16</sup>

WIAL's \$42m claim, commencing from FY10, is particularly problematic because it does not take into account the fact that WIAL made an unscheduled mid-pricing period upwards revaluation to its specialised assets in FY09 amounting to some \$32m, at the very time the Commerce Commission was working on the development of the input methodologies.<sup>17</sup> Moreover, WIAL's calculation of this alleged shortfall seeks to treat the reduction of its previous over-stated 2009 and 2011 MVAU valuations as a deficit to it, when both BARNZ's advisors and the Commerce Commission's expert on land valuations found that those valuations were over-stated in the first place and did not comply with material aspects of the Commerce Commission's MVAU valuation requirements.

Over the previous complete pricing period (i.e., PSE1 which ran from 1 April 2007 to 31 March 2012), WIAL's consultation information prepared at the end of that pricing period showed that it forecast \$54.6m of revaluations to occur over the pricing period, whereas actual revaluations (which included MVEU land valuation movements) were \$119.2m, representing \$64.6m of unforecast revaluations.<sup>18</sup>

The question of whether actual revaluations have been greater than or less than forecast is thus highly dependent upon where one starts counting from, and what adjustments are made to take account of altered approaches to valuation methodologies and forecasting of revaluations.

WIAL has made a fundamental shift in its valuation approach in the last six months, agreeing to move from its previous MVEU approach to the Commission's MVAU approach and agreeing to index forward its specialised assets at CPI rather than undertaking regular ODRC revaluations. This should be welcomed by airlines.

WIAL itself described this as 'a fundamental change' in its November asset valuation, which is what led it to effectively propose that all ledgers should be wiped clean with accounts of unders and overs recommencing from the beginning of PSE3. Having referred to recent CPI movements being below what was forecast when prices were set for PSE2, WIAL proposed its approach as follows in its November 2013 Asset Valuation paper:<sup>19</sup>

*Despite this outcome, WIAL proposes that by adopting asset bases consistent with the Commission's IMs, a similar "line in the sand" approach should be taken in respect of historical asset revaluations.*

BARNZ considered that this represented an appropriate position for all parties to move forward from. It is disappointing that WIAL has moved away from its November 2013 position.

---

<sup>16</sup> This is a reduction from the \$119m estimate in 2010 mentioned earlier, which is partly attributable to the reduction in land value as the airport moved from MVEU to MVAU and partly due to forecast revaluations in the first two years of PSE2 not being achieved.

<sup>17</sup> WIAL Identified Airport Activities Disclosure Financial Statements for the year ended 31 March 2009, note 18 to financial statements.

<sup>18</sup> WIAL Revised Pricing Proposal, 22 November 2011, Appendix 9, 2011 Revaluation Wash-up Analysis.

<sup>19</sup> WIAL Asset Valuation and Allocation, 18 November 2013, page 13.