

## **SUBMISSION BY BARNZ ON PROBLEM DEFINITION PAPER FOR THE INPUT METHODOLOGIES REVIEW**

21 AUGUST 2015

### **INTRODUCTION AND EXECUTIVE SUMMARY**

BARNZ thanks the Commission for the opportunity to make submissions at the problem definition stage of this review of the input methodologies (IMs) set under Part 4 of the Commerce Act.

From BARNZ's perspective the IMs set in 2010 have helped improve certainty for suppliers and consumers. The most significant exception for us has been in relation to the treatment of unforecast revaluations when undertaking forward looking profitability assessments. It seemed that both airports and airlines had reached common ground that unforecast revaluations needed to be treated as income when resetting prices if they were to enter the asset base on which charges were being set (with Christchurch Airport making this commitment as it set prices in 2012, Auckland Airport making this commitment to the Commerce Commission during the s56G review process in relation to what could happen if its moratorium on asset revaluations was moved away from, and Wellington Airport initially making this commitment to airlines during consultation in 2013 but subsequently moving back from it). However the Commission's decision to not take into account Christchurch Airport's revaluation wash-ups as it assessed Christchurch Airport's targeted profitability has created considerable uncertainty for BARNZ members over this very significant aspect of assessment of regulatory profitability for airports which, by their very nature, occupy large areas of land adjacent to (or even within) urban areas.

There are also areas where experience over the past five years has indicated that changes are needed to the level of detail in some of the IMs in order to improve certainty for regulated suppliers and consumers alike and to improve the ability of interested persons to make assessments of the extent to which the s52A purpose statement is being achieved.

#### ***Problem definition and potential solutions***

Responding to the matters the Commission has specifically sought submissions on at para 356, BARNZ:

- Considers that the Commission's description of the issues related to airports is largely accurate;
- Has only identified two additional issues, namely:
  - The cost allocation IM relating to assets that are not directly attributable is too broad and is not resulting in outcomes which appropriately reflect the use made

- of such assets or the benefit obtained from such assets by unregulated activities. As a result this particular IM is not achieving the s52A(1)(d) outcome of limiting the ability of the regulated supplier from extracting excess profits;
- The disclosures around financial incentives are currently not clear – improved definitions and disclosure lines could provide better clarity over the relationship between the incentives and the disclosed costs and revenues and between the incentives and the published charges;
  - Supports the proposal to develop an IRR calculation which can be used for forward looking and ex post profitability assessments;
  - Supports the addition of specified options in the IMs for airports on the degree of revaluations to apply (i.e. none, CPI indexing only or Schedule A land revaluations) when rolling forward the RAB (but does not support the introduction of complete or unconstrained flexibility);
  - Suggests that an IM specifically on non-standard depreciation be developed by the Commission comprising the principles underlying or guiding the use of non-standard depreciation, potentially supplemented by an optional more prescriptive methodology on the actual application and calculation of non-standard depreciation which an airport could choose to follow;
  - Suggests that leased assets be separately reported on outside of the main RAB just as assets held for future use are separately disclosed;
  - Considers that the current rules around assets held for future use provide the appropriate signals and allocation of risk where an airport acquires assets in advance of when they are needed to provide the regulated services, and does not consider that any changes are required in relation to the IMs relating to assets held for future use;
  - Suggests that changes be made to the ID schedules to enable more transparent forward looking disclosure of any wash-ups adopted when airports reset their charges, as well as providing a mechanism enabling adjustments to be made to ex post disclosures to reflect those wash-ups;
  - Suggests a time restriction be introduced for when land revaluations undertaken under Schedule A can enter the asset base, and that that time be the first day of any new pricing period, which would result in the income from any unforecast land revaluation being taken into account in the same pricing disclosure period as the new valuation first impacts the targeted levels of profitability;
  - Suggests that the ID relating to financial incentives be clarified so as to improve transparency of how the incentives are measured and the relationship between them and the disclosed revenues and expenses;
  - Supports the pragmatic use of 2009 and 2011 land valuations to calculate a deemed 2010 land valuation where the 2009 and 2011 valuations were undertaken in accordance with Schedule A, which BARNZ acknowledges was the case for Auckland and Christchurch Airports but does not consider this to have been the case in relation to Wellington Airport's 2009 and 2011 valuations; and

- Considers that Wellington Airport needs to undertake a new 2010 land valuation in accordance with Schedule A taking into account the matters of concern raised by the Commission's land valuation expert during the s56G process.

### ***WACC percentile range for airports***

BARNZ cannot see how it would be in the long-term benefit of consumers, or consistent with outcomes in competitive markets, to measure the reasonableness of the returns being targeted using a WACC percentile greater than the best estimate of a normal return on an indefinite basis going forward.

When determining the WACC percentile input methodology, the starting point must be the best estimate of a normal return, which is the mid point. That should only be departed from if there is clear evidence that a higher return is in the long-term benefit of consumers through providing incentives to innovate and invest that could not be achieved to the same extent by other means. Any above normal return must be causatively linked to increasing the long-term benefit of consumers.

Moreover, the Commission should not base its analysis and monitoring on an uplifted WACC percentile above the best estimate of a normal return unless it is sure that doing so is the most appropriate way to incentivise investment and innovation, as opposed to other regulatory tools. The creation of certainty through the specification of input methodologies, which must be used when making regulatory decisions under Part 4, was the primary mechanism intended by the law drafters of Part 4 to promote incentives to innovate and invest.

Airports are fundamentally different from other regulated businesses such as gas pipelines and electricity lines businesses. Airports are able to leverage off their aeronautical activities to create extremely lucrative retail and car-parking businesses whose customers are the passengers carried by airlines, together with the farewellers and meeters and greeters of those passengers.

BARNZ considers that it is very unlikely in the airport context that there would be any material under-investment in regulated assets as a result of any potential mis-estimation of the WACC.

The regulated services provided by the airports either have (or directly enable) very significant complementary revenue streams, which carry with them additional incentives to invest, or are subject to a high degree of regulatory oversight which does not allow the level of service to be reduced below specified levels. There is therefore no reason to depart from the mid-point WACC estimate when assessing the appropriateness of the level of profitability being targeted by an airport.

If however the Commission considered that there are potential material asymmetric effects of mis-estimating the WACC, then BARNZ believes that it would be useful for the IMs to include an additional percentile estimate of the WACC reflecting this. Knowledge of the level of uplift above the mid-point estimate of the WACC which the Commission considers appropriate to provide appropriate incentive to suppliers to incentivise innovation and investment, would significantly

increase the ability of interested persons to make their own assessments of the reasonableness of the level of profitability being targeted by the airports.

## RESPONSE ON DECISION MAKING FRAMEWORK

### ***The relevance of the 'materially better' standard***

The Commission has expressed a preliminary view that it does not consider there is any specific statutory threshold for changing the IMs – in particular that it does not have to be established that any change would be 'materially better' than the existing IM.

BARNZ agrees. There is no statutory threshold or criteria for changing the IMs expressed in s52X or s52Y of the Commerce Act.

The materially better threshold applies to the merits review process. Obviously the Commission must ensure that it does not consider that any other IM (including the original) is materially better than the proposed amendment (or else the amended IM will be susceptible to being over-turned on a merits review application), but the reverse does not apply. There is no requirement that the amendment itself be materially better than the original.

### ***Whether jurisdiction exists to develop a new IM?***

The Commission has expressed a preliminary view that, as part of the IM review process, it cannot create an IM on a matter not covered by an existing published IM for a particular type of regulated service. The Commission considers that the discretionary decisions it made in 2010 as to what IMs it would and would not set cannot now be remade and any new matters cannot be now included in the IMs.

BARNZ has some difficulty understanding why the Commission feels so constrained. We cannot see anything in the scheme of the legislation which would make the Commission read into the legislation a gloss rendering the Commission unable to include new matters in an existing IM or develop a new IM in the review process under s 52Y.

While there is no express direction in ss52X or 52Y that the review process can include new matters not previously covered, similarly there is no express direction that input methodologies cannot be altered to include new matters. Indeed the fact that s52X specifically sets out procedural safeguards to be applied when an amendment of an IM would result in a material change (directing that the same process be followed as if it were the development of an initial IM) , suggests that the legislation contemplates the possibility of potentially fundamental shifts in the content of the IMs.

The purpose of the IMs as stated in s52R is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation. If the practical application of the IMs during their first period has highlighted a gap in the matters covered by the IMs, then it would seem to be contrary to the over-riding purpose of IMs to read into the legislation a total prohibition on amending the IMs to include that new matter. As both the High Court and Parliament recognised, the certainty intended to be achieved by the IMs will be developed over time. That will not be able to occur to the same degree if the Commission considers itself hobbled

from being able to develop new IMs or expand existing IMs to cover new matters where these are required in order to better promote certainty.

The fact that there are a range of matters included within s52T able to be included within the IMs as a matter of discretion on the part of the Commission suggests that Parliament intended that the Commission would have some ongoing flexibility to be able to adjust the matters included or excluded from the IMs from time to time as the application of the IMs under Part 4 evolved. Whether the topic is necessary in order to provide certainty to suppliers and consumers alike should be the guiding principle. An initial decision made as to whether or not a matter should be covered within the first set of IMs developed should not be determinative.

In the context of airports BARNZ has identified two topics which could potentially be impacted by the Commission's preliminary position:

- The first relates to non-standard depreciation. While the Commission did publish an IM relating to depreciation, non-standard depreciation was not a matter the subject of clear direction in the IM (instead simply being defined by reference to what the airport disclosed under its non-standard depreciation disclosure). Whether the matter was sufficiently covered to meet the Commission's interpretation of the legislation will need to be carefully considered. BARNZ has submitted that an IM for non-standard depreciation should be developed. The complexity and lack of transparency that arose out of CIAL's endeavours to use non-standard depreciation clearly indicate that greater guidance is required on this issue to provide certainty for suppliers and consumers alike. Moreover, it is not just a matter confined to CIAL. The other two regulated airports will also inevitably need to at least consider non-standard depreciation in relation to future lumpy infrastructure investments.
- The second topic relates to pricing methodologies for establishing a levelised pricing path over multiple pricing periods. No IMs relating to pricing methodologies were published by the Commission in the 2010 IM determination for airport services. However, in light of the difficulties experienced in the practical application of the concept of a levelised pricing path by CIAL, BARNZ is suggesting that IMs providing guidance on how to implement a levelised pricing path in a consistent and transparent manner would be beneficial.

**RESPONSE TOPIC 6: ON AIRPORT PROFITABILITY ASSESSMENT MATTERS**

The Commission has identified two main issues (specified in para 303) and a number of secondary issues (listed in para 304). BARNZ responds to each in turn below, as well as to the two additional topics BARNZ believes need to be considered, namely amendment of the cost allocation methodology to provide greater clarity around jointly used assets and improvements in the transparency and clarity of the disclosures of pricing incentives.

TOPIC RAISED BY COMMISSION	PROBLEM DEFINITION	DISCUSSION OF POTENTIAL SOLUTION	IM OR ID?
No forward looking profitability assessment is currently required to be disclosed	The lack of a forward looking profitability assessment indicator makes it difficult for interested persons to assess the reasonableness of the level of returns being targeted by the airport as it sets prices – in particular, whether excessive returns are being targeted.	The Commission has proposed developing a forward looking profitability assessment which airports must disclose as part of the price setting disclosures. BARNZ supports this proposal. The level of returns being targeted is a key element in assessing the degree to which the purpose of s52A is being achieved or successfully promoted, and in comparing the performance of regulated suppliers, and most members of the general public will not be able to undertake such assessments themselves. The experience during the s56G review process demonstrated not only how important an assessment of the level of profitability being targeted is to reaching any judgment on the degree to which the purpose of Part 4 is being achieved, but also how complex the assessment is as a result of the different approaches taken by each of the airports.	ID
Airports use different methodologies to set prices	When airports use alternative approaches to setting prices (not based on the standard IM consistent building blocks approach) then the ex post profitability assessment indicator based on a standard IM consistent building blocks approach, which is currently specified in the ID, is ineffective at providing transparency and sufficient information for interested persons to	The Commission has identified several potential solutions, one of which is requiring disclosure of a new schedule comparing the differences between the forward looking IM compliant building block inputs with the building block inputs used by the regulated airport to set charges (I.e. the ‘disclosed difference approach’ at slide 28 of the Commerce Commission Problem Definition presentation at the IM Forum). BARNZ supports the disclosed difference approach, with the following additional requirements: <ul style="list-style-type: none"> <li>The disclosed difference schedule should include space for commentary on the scope of and reasons for the difference, including a short summary of the views of substantial customers expressed during consultation on any departures from the</li> </ul>	ID & IM

	<p>assess the reasonableness of the level of returns being targeted by the airport</p>	<p>IM compliant inputs.</p> <ul style="list-style-type: none"> <li>• The disclosed difference schedule should include a line to reflect the positive or negative effect on allowable revenue from any wash-ups adopted by the airport.</li> <li>• The addition of a new line in the schedule 18 forecast revenue schedule to transparently disclose any wash-ups adopted.</li> <li>• The addition of a new disclosure requirement within the price setting event disclosures comprising a new schedule setting out the actual building block outcomes and return earned by the regulated airport each year for, and across, the pricing period just finished. This schedule should include a line or lines enabling adjustments to be made to historic returns to reflect any wash-ups adopted by the regulated airport (such as WIAL’s capex wash-up for the delayed construction of The Rock or CIAL’s unforecast revaluation wash-up) as prices were reset by the airport for the new pricing period. This schedule would both provide a summary for interested persons of historical performance for the previous pricing period, as well as provide a mechanism allowing historical disclosures to be adjusted to reflect any wash-ups adopted by an airport.</li> <li>• The addition of a new over-arching principle to the information disclosure requirements that regulated suppliers have a positive duty to disclose sufficient information to enable interested persons to assess whether the purpose in s52A is being achieved, which may in some situations require additional disclosure or explanations beyond completion of the standard disclosure templates.</li> </ul> <p>BARNZ does not support the alternative possible solution put forward by the Commission of using non-standard depreciation as a back-calculated amount to result in a level of return consistent with a standard IM compliant building block approach. We consider this just confuses the matter and uses depreciation for something different to its well-understood function of reflecting the diminution in value of an asset over its lifetime.</p> <p>Another tool to address the complexity of certain pricing decisions would be for the Commission to develop an input methodology to guide economic pricing profiles</p>	
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		where large lumpy investment occurs. In its analysis to date on CIAL's pricing the Commission has commented that the concept of a levelised pricing approach is consistent with efficient pricing principles, however CIAL's implementation in practice was not clear or transparent or straight-forward. Given that levelised pricing approaches may well be an ongoing issue (with investment such as AIAL's domestic terminal and northern runway and potentially WIAL's runway extension) the development of a pricing methodology setting out guiding principles for levelised pricing for lumpy investment could be beneficial to suppliers of regulated airport services and consumers of those services.	
Land valuation	The land valuations completed under the Schedule A guidelines are showing variances of up to 30%, which is a greater than acceptable divergence of professional judgment.	Amend the land valuation guidelines to provide greater guidance and to clarify areas where differences of interpretation have arisen, in particular: <ul style="list-style-type: none"> <li>• Additional specification of matters to be considered and covered in the development of the alternative land use plan (which is the foundation stone upon which the land valuation sits and therefore fundamentally impacts on the resulting value);</li> <li>• Inclusion of an express requirement to undertake independent economic based demand analysis for alternative land uses (including the forecast timing of such demand);</li> <li>• The addition of a principle that the alternative land uses adopted must be ones which are credible in light of the characteristics of the land in question, current zoning or likely zoning changes and economic demand; and</li> <li>• Clearer articulation of how the time and costs involved in obtaining any zoning changes necessary for the alternative land use should be taken into account in determining the land valuation.</li> </ul>	Sch A of IMs
Opening land valuation date	The High Court directed that the opening land valuation for the RAB be assessed as at 2010. Airports have 2009 and 2011 or 2012 values, but not 2010 values.	Auckland Airport has proposed deeming an average of the 2009 and 2011 values as the 2010 value in order to avoid the cost and time of undertaking an additional valuation. The Commission has indicated it sees merit in using an alternative approach rather than new valuations, given the availability of land valuations before and after 2010.  Where an airport's 2009 and 2011 valuations were undertaken in accordance with	



		<p>Schedule A then BARNZ does not object to such an approach. This is the case for CIAL (which BARNZ’s valuation advisors accepted as having a reasonable alternative land use) and AIAL (where BARNZ’s valuation advisors differed only in relation to the amount of commercial land). BARNZ would accept an averaging of the 2009 and 2011 valuations for these two airports.</p> <p>However that is not the case for WIAL where the Commission’s land valuer advised that there were numerous areas where the 2009 and 2011 valuations were not in accordance with Schedule A, most significantly in relation to the credibility of the proposed mix of land uses, the likelihood of consenting for the proposed development and the constrained timeframe for the development. BARNZ’s valuation advisors had also identified these same issues as well as other less material matters. Subsequently, in its 2013 valuation, WIAL has partially adjusted for some of these matters, altering its land use splits to substitute industrial uses for some of the business park and retail areas, and increasing the development period by one year. The 2013 valuation resulted in a \$16m reduction to WIAL’s land value. However BARNZ’s valuation advice was that the valuation still did not comply with Schedule A, in particular in relation to the time-frame allowed to obtain zoning changes for the development. BARNZ considers that WIAL needs to undertake a new valuation as at 2010 in accordance with Schedule A.</p>	
Depreciation profiles	There is currently no specification around the purpose or parameters of non-standard depreciation, with the IMs simply defining non-standard depreciation as the approach disclosed by the airport in question. CIAL’s disclosure of standard depreciation profile with its long run pricing model designed to under-recover in early years of the asset’s life, with subsequent over-recovery in later years, did not provide sufficient transparency to enable interested persons to understand the	<p>While non-standard depreciation arose in relation to CIAL’s new terminal, it will also likely arise in relation to AIAL’s new domestic terminal expected to be required by 2020 at a likely cost of at least \$300m depending on staging, AIAL’s northern runway with a cost likely to be in the vicinity of \$600m with a timing in the late 2020s, and WIAL’s potential runway extension with a cost estimate of \$300m. There will also be other future, as yet unknown, projects requiring consideration of non-standard depreciation profiles.</p> <p>Given the confusion, complexity and lack of transparency which arose with CIAL’s conversion to non-standard depreciation, BARNZ considers that it would be beneficial for regulated airports and users alike for the Commission to:</p> <ul style="list-style-type: none"> <li>Expand its IM for depreciation contained in section 3.4 of the Airport IM Determination to specify principles which non-standard depreciation should</li> </ul>	ID & IM

	<p>level of returns being targeted or assess the degree to which excess prices were being set. CIAL's subsequent conversion to a non-standard depreciation profile was similarly highly technical and not transparent.</p>	<p>reflect; and</p> <ul style="list-style-type: none"> <li>• Provide greater specificity in the disclosure requirements (schedule 4 and the definition of non-standard depreciation disclosure) of the matters to be disclosed when non-standard depreciation is adopted.</li> </ul> <p>In addition, BARNZ considers the Commission should consider whether it is able to develop a non-mandatory detailed model solution for non-standard depreciation, which could be adopted by an airport if it choose (like the Building Act uses standard solutions specified in the Building Code with property owners free to adopt other solutions if they can prove they meet the outcomes specified in the Building Act). If a model 'non-standard' depreciation solution was specified (say in a new schedule to the IMs or disclosure requirements) then an airport following the specified 'non-standard' solution, would not have to disclose its approach in as much detail. An airport adopting a unique non-standard approach would however have to ensure it disclosed its approach in sufficient detail in order to enable interested persons to understand it and assess its effect on the levels of targeted returns being sought and the outcomes specified in s52A.</p>	
<p>Revaluation approach</p>	<p>Airports can use different asset values in their pricing asset base and different revaluation approaches to the IMs, which makes the regulatory assessment of profits different to the price setting assumptions.</p>	<p>This issue is a direct outcome of the section 4A power airports have under the Airport Authorities Act to set charges as they see fit. While airports continue to have the power to set prices as they see fit, using different valuation and revaluation assumptions, BARNZ considers that it is vitally important that the IMs provide a clear lode-stone against which the reasonableness of the airport's approach can be compared in order to judge its reasonableness. BARNZ does therefore not see any merit in the IMs reflecting different asset valuation methodologies. However, BARNZ would not have any objection to the introduction of a limited choice in relation to whether or not to revalue, whereby an airport can elect to either:</p> <ul style="list-style-type: none"> <li>• Index its specialised assets annually at CPI or not index specialised assets at all;</li> <li>• Index land annually at CPI; revalue land applying the Schedule A methodology at the beginning of a pricing period; or not index or further revalue the land.</li> </ul> <p>However, several important matters to consider, if a choice over whether to continue to revalue assets is introduced, are:</p>	<p>ID &amp; IM</p>

		<ul style="list-style-type: none"> <li>• When is an airport able to make such an election? At the first year following the introduction of the ability to make an election? At the beginning of the next pricing period? At the beginning of any pricing period? Or at any time?</li> <li>• How is any election by the airport to be disclosed?</li> <li>• Can the election of whether or not to revalue assets be subsequently changed?</li> <li>• If so, how are any subsequent changes in approach (and consequential upwards or downwards revaluations) to be managed? For instance, if a regulated supplier has elected not to revalue its assets, and has set prices on this basis, but subsequently it changes its mind and elects to resume indexing the value of its assets or undertakes a Schedule A revaluation of its land, then that regulated supplier would likely earn more revenue than it had targeted when it set prices, which would be inconsistent with s52A and not produce an outcome beneficial to the long term interests of consumers, unless a wash-up is required treating any revaluation as income when prices are reset. Consistency and continuity over time is extremely important.</li> </ul>	
Leased assets	The airports all exclude leased assets from their pricing asset base whereas leased assets form part of the definition of regulated services and therefore fall within the RAB. This difference in asset categories reduces transparency for interested persons and makes it difficult to assess the level of profitability targeted for the pricing assets.	BARNZ suggests that leased assets and associated costs and revenues be separated out into a separate schedule (or table) so that the performance of pricing assets, which formed the basis on which charges were set, can be clearly seen within the pricing and annual disclosures.	ID
Land held for future use	The Commission notes ongoing uncertainty as to how Auckland Airport will treat its land held for future use when determining charges (ie whether it will include it in or exclude it from the pricing asset base).	BARNZ considers that the present position in the IM of assets held for future use being excluded from the RAB used for disclosure purposes, but being separately disclosed on an ongoing basis (including accumulated net holding costs) is appropriate. It provides appropriate signals regarding the cost of holding the asset and leaves asset owners bearing the costs of holding future assets until they become used to provide regulated services, at which time the assets, and associated holding costs, enter the asset base. It means that the risk of assets being imprudently	ID

		<p>acquired, and never actually being needed to provide the regulated services, is borne by the asset owner.</p> <p>The addition of a new schedule comparing the differences between the forward looking IM compliant building block inputs with the building block inputs used by the regulated airport to set charges (ie the disclosed difference approach proposed by Commission) should enable any change in Auckland Airport's approach to land held for future use to be taken into account when assessing profitability.</p>	
Wash-ups	<p>Airports can undertake a variety of wash-ups as they set prices which make adjustments between pricing periods to reflect matters such as delayed capex or unforecast revaluations. This creates complications when assessing profitability for individual pricing periods.</p>	<p>BARNZ considers that this problem would be resolved by making two changes to the disclosure requirements:</p> <ul style="list-style-type: none"> <li>• The addition of a line in the schedule 18 (forecast revenue requirements) of the price setting event disclosures specifically for wash-ups, for example 'plus (less) wash-ups'. This would provide greater transparency about the effect of any wash-up on the level of profitability being targeted by the airport.</li> <li>• The addition of a new disclosure schedule in the price setting disclosures which discloses actual outcomes both on a year by year basis and in total for the pricing period just finished, including a line enabling adjustments to be made to the revenues earned in that previous pricing period to reflect the effect of any wash-up adopted by the airport as it reset prices for the forthcoming new pricing period.</li> </ul>	ID
Unforecast revaluations	<p>Unforecast revaluations are treated as income in the historical disclosures reflecting the expectation that a higher asset revaluation will result in higher future cash-flows. However the Commission has not taken into account the income from any unforecast revaluations, or wash-ups adopted by airports to reflect any unforecast revaluations, in its assessments of targeted forward looking profitability. This understates the levels of returns being targeted, and results in the timing</p>	<p>BARNZ has identified three possible solutions, the first of which is our preferred solution:</p> <ul style="list-style-type: none"> <li>• Provide that revaluations of land under Schedule A can only enter the RAB on the first day of a new pricing period. This would ensure that the treatment of the unforecast revaluation as revenue will occur within the same disclosure period as the unforecast revaluation affects the prices set (and hence revenues being targeted) by the airport. There are currently no restrictions on when unforecast land revaluations can be undertaken. Restricting unforecast revaluations to having to occur on the first day of a new pricing period is BARNZ's preferred solution.</li> <li>• If a new disclosure requirement of forward looking profitability assessments is introduced, then require any unforecast land revaluations from the previous</li> </ul>	ID & IM

	of the treatment of revenue from the unforecast revaluation not matching the disclosure period when the unforecast revaluation affects the charges paid by consumers.	<p>pricing period to be treated as a wash-up in the new pricing period in that forward looking profitability assessment.</p> <ul style="list-style-type: none"> <li>Not permit unforecast land revaluations to continue, which would completely remove the problem of how and when to treat unforecast land revaluations as income when measuring profitability. This would mean land values would only be indexed forward at forecast CPI (or alternatively remain at 2010 levels if the Commission changes the IMs to provide airports with a choice as to whether or not to revalue), however it may result in a gap developing between disclosed land values and the opportunity cost value of the land.</li> </ul>	
Discounting	The Commission has identified as a problem how the profitability assessment process should take into account any commercial decisions by an airport to set prices at a level which reflects a discount from prices set under a standard IM consistent building blocks approach.	During its assessment of CIAL's targeted profitability, the Commission adjusted the closing asset base to reflect CIAL's commercial decision to set prices at a lower level than the airport considered it was entitled to target. Adjusting the closing asset base appeared to be accepted as the appropriate solution by all participants at the time for discounts intended to be permanent. However, it does beg the question as to how the level of the discount should be measured. In other words, from what level of WACC – the mid-point WACC which is the starting point for assessing profitability? From the lower or upper end of the WACC range? Or from the WACC level being targeted by the supplier?	ID
Pricing incentives	BARNZ has an additional issue concerning lack of clarity around the financial disclosures in schedule 2 of pricing incentives and other incentives, in particular what discounts are included within these disclosed incentives and how they are measured and what their relationship is to the costs and revenues disclosed earlier in the schedule.	<p>BARNZ suggests potential amendments to the disclosure definitions and schedules be considered to:</p> <ul style="list-style-type: none"> <li>More transparently disclose how any financial incentives relate to the disclosed costs and revenues (perhaps with specific cost and revenue lines for these in schedule 2a under the disclosures of income and expenses)</li> <li>Clarify the definition of how the discounts etc are to be measured – against the prices actually set by the airport at the end of the pricing process? Or against the prices which the airport was considering setting during the pricing process?</li> </ul>	
Cash-flow timing assumptions	The end of year cash flow timing assumptions specified in the airport ID requirements result in the return being targeted being understated as it does not reflect the time value of money in	The Commission has indicated that its current thinking is that cash flow timing assumptions should be applied in a manner consistent with the approach applied in the s56G reports. BARNZ does not support this approach. The s56G reports were undertaken on the basis of end of year cash flows, with a sensitivity analysis undertaken based on mid year cash flows. The outcome of the analysis using the mid	ID

	relation to the revenues received during the year.	year cash flows was in each case a return approximately half a percent higher than the return produced using end of year cash flows. Given that revenues are received (and expenses incurred) throughout the year BARNZ considers that the end of year calculations understate the level of returns being targeted. BARNZ considers that the ID requirements in relation to intra-period cash-flow timing assumptions should be amended to reflect mid-year cash flows. Unless there are good reasons otherwise, the same timing assumptions should be applied to airport ID as are applied in the ID for other industries regulated under Part 4.	
Additional issue: asset allocator	The very general principles based IM for allocating assets not directly attributable to the regulated services is not resulting in contestable retail activities meeting an appropriate portion of general circulation and seating space, thus has not been effective in limiting excessive profits from being able to be targeted.	The IM relating to asset allocations needs to be amended to more clearly require that where assets are used for the provision of both regulated and unregulated activities, then those unregulated activities must be allocated a share of the assets that reflects either the relative use made of the assets by the unregulated activity or the relative benefit obtained (directly or indirectly) by the unregulated activity from the joint utilisation of the asset.	IM

### Discussion of general principle

When determining the WACC percentile input methodology, the starting point must be the best estimate of a normal return, which is the mid point. That should only be departed from if there is clear evidence that a higher return is in the long-term benefit of consumers through providing incentives to innovate and invest that could not be achieved to the same extent by other means. Any above normal return must be causatively linked to increasing the long-term benefit of consumers.

The Commission should not apply an uplift in its monitoring and analysis work of regulated airports above the best estimate of a normal return without proof that greater returns on the existing RAB are necessary in order to incentivise new investment or innovation.

Moreover, the Commission should also not apply an uplifted WACC percentile above the best estimate of a normal return in its monitoring and analysis work of the regulated airports unless it is sure that doing so is the most appropriate way to incentivise investment and innovation, as opposed to other regulatory tools. The creation of certainty through the specification of input methodologies, which must be used when making regulatory decisions under Part 4, was the primary mechanism intended by the law drafters of Part 4 to promote incentives to innovate and invest. In the merits review process the High Court observed that *'the certainty to be provided over time by the new Part 4 is central to the promotion of appropriate incentives to invest'* (para 691). It did not consider new asset valuations were necessary to incentivise investment. Similarly, it is difficult to see why applying a return above the best estimate of a normal return when the Commission is undertaking its monitoring and analysis work is necessary to incentivise investment. As the Court stated *'...the expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier'* (para 1472).

BARNZ cannot see how it would be in the long-term benefit of consumers or consistent with outcomes in competitive markets to measure the reasonableness of returns being targeted by regulated airports using a WACC higher than the best estimate of a normal return on an indefinite basis going forward.

We urge the Commission to ensure that it only moves away from its best estimate of a normal return if it has clear and tangible proof that this is necessary for the long-term benefit of consumers and will result in tangible benefits for those consumers rather than benefits accruing to the regulated suppliers in the form of excess profits.

BARNZ notes that Professor Dobbs makes this same point several times in his advice to the Commission in relation to the appropriate WACC percentile for electricity and gas businesses when he observed that *'it is important to consider carefully what the likely impact of the choice of allowed rate of return (AROR) is likely to have; after all, if the choice of AROR is unlikely to affect the pace of new investment, there is little point in offering a higher rate'* (para 14). Professor Dobbs returned to this concern again later in his paper stating that if firms do not respond to incentives *'then any uplift in AROR is simply a windfall benefit to them and a loss to consumers'* (para 36).

## **Airports have significant complementary revenue streams**

Airports fundamentally differ from other regulated businesses such as gas pipelines and electricity lines businesses. Airports are able to leverage off their aeronautical activities to create extremely lucrative retail and car-parking businesses whose customers are the passengers carried by airlines. Any internal consideration by airports of the business case for adding additional aeronautical capacity (such as additional contact gates, hard stands or passenger processing capacity), will not only take into account the forecast aeronautical revenue to be earned from such investment, it will also consider the likely increase in retail and car-parking revenue from the additional passenger volumes. The complementary nature of the retail and car-parking activities occurring at airports has led many countries to treat airports as single till businesses, with aeronautical charges set after taking into account the non-aeronautical revenue earned by the airport. Heathrow Airport is one of the most well-known examples. Regulation of New Zealand airports is currently based on a dual till approach, whereby assets, costs and revenues are split between the different activities, with charges for aeronautical activities set in isolation from the tens of millions of dollars able to be earned from the provision of car-parking and retail activities to airline passengers. The fact that such a lucrative complementary revenue stream exists, means that it is not necessary for airports to set charges above the mid-point estimate of a normal return in order to be incentivised to innovate and invest – the presence of the ability to earn additional revenue from provision of these complementary services already provides additional incentive to airports to invest in maintaining or adding aeronautical capacity.

As the volume of passengers moving through the airport increases, so too does an airport's car-parking and retail concession revenue. Auckland Airport itself describes international passenger volumes as 'our biggest value driver'<sup>1</sup> and 'a key driver for our company performance'<sup>2</sup>.

## **There is no reason to depart from a mid-point WACC estimate**

In the case of airports there are a significant range of characteristics which combine to mean that additional strong incentives to invest, over and above the level of return earned from regulated activities, exist across virtually the whole chain of regulated services. There is therefore simply no reason to depart from the mid-point estimate when assessing the level of returns being targeted by airports or the profitability achieved by an airport.

The characteristics specific to airports mean that it is very unlikely that there would be any material under-investment in regulated assets as a result of any potential mis-estimation of the WACC used by the Commission and interested persons to assess the reasonableness of the level of profitability being targeted by the regulated airports.

These airport specific factors which mean there is no reason to depart from the mid-point WACC estimate include the following:

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<sup>1</sup> Refer Auckland Airport Annual Report for year ended 30 June 2011, at pages 11 and 16.

<sup>2</sup> Refer Auckland Airport Interim Results for six months ended 31 December 2011 at page 8.



- Airports earn significant complementary revenue streams from retail and car-parking activities provided to passengers, and their farewellers and greeters. As passenger volumes increase, so too does the amount of revenue able to be earned from these complementary retail and car-parking activities. For every additional aircraft or passenger able to use the airport, the airport will not only earn regulatory income, it will also earn revenue from the complementary retail and car-parking services it provides those additional passengers. Airports therefore have an additional incentive in the form of this second unregulated revenue stream to ensure sufficient regulated assets and facilities are constructed to meet all available demand for both passengers, and the aircraft they travel on.
- For departing passengers, airports are incentivised to ensure passengers pass through the necessary formal processing as quickly as possible in order to maximise their retail dwell time. Therefore the airports are strongly incentivised to ensure that the service level for departing passengers is particularly high.
- Airports are obliged under legislation to provide Customs and MPI with any space, equipment or facilities which those organisations consider is reasonably required to carry out their functions and responsibilities (see for example s18 of the Customs and Excise Act). Therefore service levels relating to the available space for any border processing of both arriving and departing passengers will be maintained at a satisfactory level as a result of this statutory requirement for airports to provide any requested space, and an additional incentive or motivation to invest (over and above the incentive provided by the prospect of earning a normal return) is already present.
- Airport safety is highly regulated by both international requirements and domestic laws, with the Civil Aviation Authority having a strong level of oversight. Safety therefore cannot be diminished or compromised due to an under-estimation of WACC. Again an additional incentive or motivation to invest (over and above the incentive provided by the prospect of earning a normal return) is already present.
- Aviation security is similarly also highly regulated by both international requirements and domestic laws, with the Civil Aviation Authority and Aviation Security having a strong level of oversight, as well as audits occurring by some overseas regulators such as the Transportation Security Administration (TSA) department of the United States. Security aspects of assets or services therefore cannot be diminished or compromised due to an under-estimation of WACC. Again an additional incentive or motivation to invest (over and above the incentive provided by the prospect of earning a normal return) is already present.
- Airports have a relatively small number of direct airline customers, therefore direct engagement on the level of service and investment plans can and does occur which will help ensure investment reflects consumer needs. This direct engagement with airlines will help ensure that investment occurs where appropriate.
- Airlines are increasingly reporting their on-time performance publicly, with the travelling public taking a high level of interest in airline performance in this respect. If lack of airport investment resulted in a pattern of degradation of on-time performance at an airport, then this would be apparent to the public and political and public pressure would result in an incentive to undertake appropriate investment to improve performance.

In BARNZ's opinion these factors mean that the risk of potential under-investment as a result of a mis-estimation of the WACC used to assess the reasonableness of the level of profitability being targeted by the airports is extremely low. There are a number of other mandatory regulatory compliance requirements and other financial incentives (particularly the complementary revenue streams from providing retail and car-parking services) acting on airports which will ensure that any necessary investment occurs.

### **The costs to consumers from potential under-investment**

The Commission has asked for information on the form (and if available estimates of the magnitude) of costs to consumers from under-investment in regulated airport infrastructure.

As outlined above, there are strong incentives already present incentivising airports to undertake the necessary investment to enable the efficient and timely provision of regulated airport services at an appropriate level of quality and safety.

We have reviewed the chain of services provided to passengers and airlines moving through an airport and we have only been able to identify two areas where we consider there could possibly be a potential degradation of service levels, that would not be fully prevented by other incentives to invest or regulatory over-sight of standards. These potential areas of possible under-investment are:

- Whether to construct additional contact stands as opposed to a greater use of remote stands with bussing operations; and
- The quality and size of the land-side arrivals area where meeters and greeters congregate.

The use of remote aircraft parking areas and bussing operations could potentially be a cheaper means for an airport continuing to obtain the benefit of increased complementary revenue streams through increasing capacity, while avoiding the cost of constructing additional airbridges and piers, although the operational costs of bussing operations is high to both airlines and airports on a per passenger basis. There would not be any additional cost to consumers – just the potential discomfort of walking outside to a stand close to a terminal, or the additional time taken to board or disembark using busses. Airlines estimate that:

- Boarding of a departing aircraft can occur within the normal time allowed for passenger boarding (although an extra staff member is required to manage the process and will take longer to reach the aircraft and return to the terminal).
- Disembarkation of an arriving aircraft can take an additional 20 to 30 minutes (dependent upon its size) as compared with using a contact gate (and an additional one to two staff members are required to manage the process, again with additional travel time for the staff).
- If passengers with reduced mobility are travelling then some form of mechanical lifting device such as an 'ambulift' will be required, which takes at least 20 minutes, and will most likely push the processing times out beyond those indicated and often cause a delay in the aircraft departing.

If there was a marked increase in the use of remote stands which was significantly detrimental to on-time performance, or which passengers perceived resulted in a materially unacceptable reduction of service levels, then airline and public pressure could well result in investment then occurring, and the perceived under-investment problem being resolved.

The second area of potential under-investment which we have identified as being possible, is in relation to the facilities for meeters and greeters. The cost of providing meeting and greeting space for arriving passengers is usually included in the asset base on which terminal charges are set. The meeter or greeter is primarily a user of car-parking facilities or food and beverage outlets which could provide some additional incentive to invest in this space – although less than for farewellers who tend to remain longer at an airport. An airport believing it was suffering from a mis-estimation of its WACC could allow the service levels in this area for meeters and greeters of arriving passengers to degrade, through potential over-crowding or lack of provision of seating or lack of refurbishment of the space. However this would then reduce the airport's car-parking and food and beverage income earned from those meeters and greeters. There would not however be any direct costs to consumers as a result of this potential reduction of service.

As noted above and in the previous section, all other elements of the services provided by the airports either have (or directly enable) very significant complementary revenue streams and therefore carry with them additional incentives to invest, or are subject to a high degree of regulatory oversight which does not allow the level of service to be reduced below specified levels. Therefore, there is not likely to be any material under-investment in regulated airport infrastructure and there is no need to depart from the mid-point WACC estimate when undertaking monitoring and analysis of airport profitability.

### **Would an additional WACC percentile be useful?**

The Commission has asked whether it defining and publishing an additional percentile estimate of the WACC, taking into account potential asymmetric effects of mis-estimating the WACC, would be a useful addition to the IMs.

As just noted, the very significant complementary revenue streams able to be earned by airports; combined with the strong regulatory over-sight; the direct engagement with airlines on levels of service; and the very public nature of the quality levels of airport facilities – together mean that there is not likely to be any material under-investment in regulated airport infrastructure and there is no need to depart from the mid-point WACC estimate as additional incentives to invest are not required.

If however the Commission has sound analysis which leads it to conclude that there was potential material asymmetric effect of mis-estimating the WACC, then BARNZ considers that it would be useful for the IMs to include an additional percentile estimate of the WACC reflecting this. The current WACC range from the 25<sup>th</sup> percentile estimate to the 75<sup>th</sup> percentile estimate is large. It represents a difference of 2% to the current WACC estimates. The combined regulatory investment value for FY14 was \$2.04b for the three regulated airports. Therefore the current annual difference

between the bottom and top of the Commission's range of acceptable returns for the three regulated airports is \$41m after tax (or \$57m before tax).

Knowledge of the level of uplift above the mid-point estimate which the Commission considers justifiable within that rather wide range to provide an appropriate incentive to suppliers to incentivise innovation and investment would significantly increase the ability of interested persons to make their own assessments of the reasonableness of the level of profitability being targeted by the airports.