CROSS SUBMISSION BY BARNZ TO AUCKLAND AIRPORT SUBMISSION ON COMMERCE COMMISSION DRAFT REPORT

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Is Auckland Airport performing at a superior level entitling it to earn returns above a normal WACC range?

A key theme of Auckland Airport's submission is that the Airport is being managed, and is performing, in a superior manner. Accordingly, says the Airport, the Commission needs to both provide increased recognition of Auckland Airport's positive conduct across all four purpose limbs and recognise that any returns above the 75th percentile WACC estimate would be a reflection of the Airport's superior performance and should be permitted and considered a normal return, rather than an excess return.

The Airport particularly emphasises the following factors as evidence of its superior performance:

- Its route development programme (which they claim is now associated with 10.8% of FY12 pax volumes);
- Operational improvements as a result of its LEAN 6 sigma processes;
- Its consistent scores of very good (4 out of 5) on the ASQ quality surveys;
- Its regular Skytrax awards;
- Innovative capital projects such as CAT III, the GPUs, Pier B MARS gates and Air NZ check in kiosks; and
- Its constructive approach to capital expenditure consultation.

BARNZ has previously advised that it considers quality and service levels at Auckland Airport to be appropriate. BARNZ has also acknowledged Auckland Airport's improved willingness to engage with airlines on operational improvements and its constructive approach to capex consultation.

However, it is not apparent to BARNZ or to its member airlines that Auckland Airport is doing anything over and above what an efficient well run airport should be doing. There is nothing, in BARNZ's view, that would elevate the ranking of Auckland Airport's performance from one of efficient and well-run to one of superiority, entitling it to earn returns above a normal level.

Auckland Airport's submission is considered akin to a business claiming it is innovative and operating in a superior fashion due to it equipping their employees with cell phones rather than wooden wall mounted manual wind Ericson telephones.

Many of the examples provided by Auckland Airport of operational improvements following its Lean six sigma process[1] are standard operational tasks replacing out-dated or end of life equipment with new current technology or making incremental additions as volumes increase. Replacement of old flight information display boards, ensuring appropriate signage, way-finding and delineation of queuing space are all standard operational practices, yet are being presented by Auckland Airport as evidence of superior performance warranting it earning returns above a normal level.

The replacement of the flight information display provides an interesting example. After the old board was decommissioned, the Airport auctioned it in pieces on Trade Me with proceeds going to a local youth charity, thereby both supporting charity and giving the public (in the Airport's words) a 'chance to secure a piece of aviation history'. The Airport's media release at the successful conclusion of the auctions notes that the board was 'believed to be the last of its kind in New Zealand, and so rare that the parts for it ceased being made over five years ago'.[2] Yet, the necessary replacement of this out of date piece of equipment is being relied upon by the Airport as evidence of superior performance and innovation, entitling it to earn higher returns.

Similarly the task of extending a baggage belt (another of the examples provided by Auckland Airport of its innovation) is simply a case of adding incremental capacity and adding spill guards to it is a routine solution to an everyday problem – both normal practice for any efficient service provider.

Many other Lean outcomes relied upon by the Airport as proof of its superior performance are improvements undertaken by other stakeholders – the baggage tracing units are run and equipped by the airlines and ground handlers, MAF carried out exit facilitation work and improved its processing times and is continuing to make changes. MAF Biosecurity identified and implemented the faster dis-insection process for aircraft not already treated. While Auckland Airport works with these other service providers and airlines, it is not valid for it to claim improvements and innovations by these other agencies or companies as evidence of the Airport performing in a superior fashion, which would entitle the Airport to earn higher than normal returns.

The capital projects relied on by Auckland Airport as evidence of superior performance for the most part reflect standard new technology being routinely employed by airports world-wide – new to Auckland Airport yes, appreciated and welcomed by airlines yes, but not ground breaking or superior. Any airport servicing a range of aircraft types which is installing new airbridges will be considering whether or not to use MARS gates (gates capable of being configured to serve a number of different aircraft types, or even several smaller aircraft at once).[3] These airbridges are common overseas. Using up-to-date equipment is sensible, desirable, even expected. But it is not superior. Likewise ground power units (which enable aircraft to be powered by electricity while at the gate thereby avoiding the pollution, noise and cost of using aviation fuel to run auxiliary power units)[4] are

[1] Refer Auckland Airport Draft Report Submission, pages 40 to 42.
[2] Auckland Airport media release, TradeMe Charity Auction – pieces of Auckland Airport history raise over $57 900 in TradeMe charity auction, May 2012.
[3] Referred to by Auckland Airport at paragraph 84(e).
[4] Referred to by Auckland Airport at paragraph 84(d).

sufficiently common at overseas airports that they are becoming standard practice and are expected. Again, welcomed and valued by airlines, ground staff and all concerned about the environment, but not superior performance entitling the right to earn a return above normal levels.

Moreover, just as was the case with the operational improvements, many of the capital projects listed by the Airport are actually the work of other service providers, such as airlines, MAF, Customs and Airways. The CAT III technology to enable aircraft movements in fog conditions[5] was installed by the Airways Corporation of New Zealand, which is responsible for providing air navigation services throughout New Zealand. The CAT III system is owned and operated by Airways. Airlines meet the cost of the CAT III equipment through charges levied on them by Airways. This system just happens to be installed in relation to the main runway at Auckland Airport – but it is not owned or operated by Auckland Airport and was not introduced by Auckland Airport.

Smartgate, which enables holders of New Zealand and Australian passports to be electronically processed using face recognition software – another example previously referred to by Auckland Airport, is an innovative initiative by Customs.

Similarly, it was Air NZ that undertook a detailed project and made considerable investment to develop its self-check-in kiosks for domestic, trans-Tasman and Pacific Island travellers.[6] This is a highly successful project and a visible example of innovation and improved efficiency, but it was not a project undertaken by the Airport.

It would be particularly unreasonable for Auckland Airport to seek to earn higher than normal returns because of alleged superior performance that is attributable to innovations and improvements carried out by the airlines and other airport users. If the outcome of such improvements by airport users was that the Airport became entitled to earn a higher return, with charges higher than would otherwise be the case, then this could perversely create a disincentive on airline users to undertake process and product improvements as they would pay for both the development or improvement of their own product or service as well as higher charges to the Airport.

The Commerce Commission has referred to the example of the introduction of grass to reduce bird activity near the runway as an example of innovation by Auckland Airport.[7] This is an example of innovative technology used at Auckland Airport. However, BARNZ notes that it is not an example of innovation by Auckland Airport. This grass was developed by AgResearch scientists, using AgResearch funding, resulting in what AgResearch describe as ‘pioneering endophte technology’. It is being patented and commercialised by AgResearch company Grasslanz Technology and is being marketed by PGC Wrightson Turf. It has won Grasslanz and AgResearch the Du Pont Innovation Award 2010/11, a NZ Hi-tech Award and the HSBC most innovative product in an emerging market award.[8] AgResearch and PGC Wrightson material indicate that the grass was trialled at Christchurch

[5] Referred to by Auckland Airport at paragraph 84(b).
[6] Referred to by Auckland Airport at paragraph 82(h).
[7] Commerce Commission, Draft Report on How Effectively Information Disclosure is promoting the Purpose of Part 4 for Auckland Airport, para B12.1.
[8] AgResearch media release, Ingenious Kiwi grass prepares to go global, 22 March 2013, http://www.agresearch.co.nz/news/.

and Hamilton Airports and is being used at Christchurch, Wellington, Hamilton and Auckland Airports as well as at sports grounds, so Auckland Airport is not alone in using this grass.

The capital expenditure consultation processes adopted by Auckland Airport, again while highly valued by BARNZ and its members, and held out as something for other New Zealand airports to strive to emulate, is not unusual in many overseas countries. In particular, airlines operating in Australia have noted that it is standard practice at Australian airports and is expected by airlines there and the ACCC. These airlines actually see other New Zealand airports as being out of line with their expectation of good corporate behaviour for large airports. These airlines have commented to BARNZ that they see it as more worthy of remark where such consultation does not occur, than where it does, as it has become standard practice and expected in Australia. Again, this is behaviour which BARNZ members value and wish to encourage, but it is not evidence of superior performance justifying increased profits.

There are many service providers and users which all contribute to making passengers' journeys through Auckland Airport possible, timely, efficient, safe and pleasant. There is not any single organisation which can take credit for, or indeed provide all of the necessary services in a stand-alone manner. The ASQ survey results reflect the operation and performance of the Airport as a whole.

It is wrong for Auckland Airport to be seeking to utilise innovations and improvements made by these other service providers to claim a superior performance on its part, entitling it to earn superior returns. The airlines which BARNZ is representing repeat their previous acknowledgements that Auckland Airport is well run, of appropriate quality, responsive to airline needs and undertakes appropriate consultations with airlines. However, there is not anything in Auckland Airport which these international airlines see as justifying a label of superiority which would entitle the Airport to earn above normal returns.

Measuring the value of the route performance activities

In its response to the draft report, Auckland Airport has claimed that 'at least 10.8% of FY12 volumes are associated with initiatives Auckland Airport has been involved with as part of its route development programme'. This is the first time BARNZ is aware of that Auckland Airport has made such a claim. Moreover, the claim is couched in extremely vague language without any of the underlying assumptions or the calculation methodology disclosed. BARNZ is disappointed that Auckland Airport has left it so late in the section 56G review process to table this assertion. The late stage at which the claim has been made, and the lack of any evidence or detail substantiating it, means that in BARNZ's view it would be inappropriate for the Commission to place any weight on, or even refer to, this claim.

Throughout the consultation process BARNZ repeatedly requested that Auckland Airport provide quantitative evidence of the benefits of the route development programme. The Airport declined, appearing unable or unwilling to provide this information. Rather broad and sweeping qualitative statements of benefit were all that was offered by the Airport to airlines in support of the cost of the route development programme.

BARNZ is not aware of the Airport providing any evidence which quantifies the benefits of the route development programme during the previous stages of the section 56G review process. This claim that the programme is associated with 10.8% of FY12 volumes does not appear in Auckland Airport's response to the issues paper, or in its cross submission on the issues paper. Nor was it made by the Airport at the Conference or in post-conference submissions.

BARNZ submits that it is not appropriate for the Airport to make such a late, and (so far as BARNZ is aware) unsupported and unsubstantiated claim. The Airport has not provided any means by which its calculations or estimate can be verified. Neither has it set out the assumptions on which its claim is made.

Furthermore, it is not clear what the assertion actually means. The phrase 'associated with' is extremely broad. Just exactly what degree of 'association' was necessary for the Airport to associate the passenger volumes with its route development programme:

- Did passengers have to fall within the category of being unlikely to have travelled to Auckland without the programme? Or does the 10.8% figure include services that, or passengers who, would have come to Auckland in any event, but the airline rationally utilised the available development programme funds.[9]

- Does the 10.8% figure purport to represent growth in the market overall or does it include passengers who may be travelling on a carrier which is receiving the support, but who would have travelled in any event?

- If the aircraft has been upgauged on a particular route, and marketing support was received under the programme, has the entire aircraft been counted within this 10.8% or just the additional seats?

- The same question arises in relation to increases in frequency – has the entire service been counted as 'associated' with the programme or just the additional flights?

BARNZ considers that the Commission should not place any weight on Auckland Airport's late, untested, unsubstantiated and unclear claim that 10.8% of FY12 volumes are associated with its route development programme.

If Auckland Airport had wanted to undertake such an assessment or make some claim of this nature for superior performance with any degree of veracity, then it should have occurred either during consultation, with review by airlines as part of the consultation process, or earlier in the Commission's section 56G review process, with review by Commission staff and interested parties.

[9] Because, after all, airlines are paying for a large portion of this programme through the international terminal charges paid to Auckland Airport.

How to measure whether the ability to extract excessive returns has been limited

Auckland Airport has submitted that when assessing how effectively information disclosure regulation has promoted outcomes such that suppliers of regulated airport services are limited in their ability to extract excessive profits, one must assess 'the role of ID regulation in providing information, promoting transparency, and incentivising changes in conduct and outcomes over time'[10] rather than undertaking financial modelling of returns.

Auckland Airport then goes on to submit that information disclosure regulation has had a noticeable impact in constraining airport profitability due to it:[11]

- Providing considerable transparency of conduct and performance;
- Resulting in airports thoroughly justifying their decisions and the reasons behind them;
- Highlighting the issues of main concern and promoting debate on them; and
- Influencing behaviour and outcomes (identified, in the case of Auckland Airport as including the removal of the second runway land from the pricing asset base, targeting a lower return in PSE 1 and price increases of less than inflation for PSE 2).

BARNZ considers that Auckland Airport's submission fundamentally misconstrues the statutory task section 56G places upon the Commission.[12]

Auckland Airport is seeking to limit the section 56G review to whether the purpose of information disclosure regulation as set out in section 53A is being met – namely to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met.

That is not what section 56G directs. Rather, section 56G directs that the Commission report on how effectively information disclosure regulation … is promoting the purpose in section 52A in respect of specified airport services.

The Commission is not asked to consider whether information disclosure regulation is providing interested persons with sufficient information to determine if the section 52A purpose is being met. Rather, the Commission is directed on report on how effectively information disclosure is promoting the purpose in section 52A.

The two are very different questions. The first is limited to the sufficiency of information to make an assessment of to whether the purpose in section 52A is being met. The second (and stated statutory direction) goes further to consider whether, in fact, the purpose in section 52A is being promoted by information disclosure regulation.

[10] Auckland Airport Draft Report Submission, para 121.
[11] Auckland Airport Draft Report Submission, para 122.
[12] Auckland Airport has previously presented the same argument attempting to limit the scope of the Commission's review under section 56G, refer Auckland Airport Submission on the Commerce Commission Process and Issues Paper, 29 June 2012, para 33. BARNZ's response that this argument inappropriately limits the scope of section 56G may be found in BARNZ's Cross Submission on Matters of Process Raised by the Airports, 20 July 2012, pages 4 – 5.

Under Auckland Airport's interpretation, if the disclosed information clearly demonstrated the presence of excess returns (as the Commission has concluded is the case with Wellington Airport), then Auckland Airport would have the Commission conclude that information disclosure was effective at promoting the profitability limb in section 52A so long as this over-recovery was transparent to interested parties. Quite clearly, this is nonsense. In providing for the section 56G reviews, Parliament was requesting a review of whether, in fact, information disclosure had been able to promote the purpose in section 52A in the case of the three regulated airports.

Whether the Commission's WACC passes the commercial test

Auckland Airport has submitted that observable market outcomes and investor expectations mean that returns above the input methodology compliant WACC should in fact be considered normal returns. The Airport considers that the WACC input methodology is inconsistent with these observable market outcomes and investor expectations as well as with the practical challenges that New Zealand's airports face in attracting sufficient capital to fund significant long-term investments.[13]

BARNZ does not consider that market evidence, of either investor expectations or the capital debt market, support Auckland Airport's claim. Indeed, evidence of market expectations and debt raising suggest the opposite – namely that the Commission's WACC input methodology is producing results which align rather well with market expectations.

For example, Morningstar produced a stock research report on Auckland Airport at the beginning of June 2013 (attached) which concluded that the Commission's draft report had lessened regulatory risk for Auckland Airport and, as a result, Morningstar reduced its WACC for the Airport from 8.5% to 7.5%. A 7.5% WACC is:

- Lower than the top end of the Commission's estimate of a reasonable WACC range as at 1 April 2012 of 6.08% to 8.04% (with the 8.04% WACC estimate being the basis on which the Commission reached its conclusions regarding the reasonableness of the level of forecast revenue);
- At the top end of the Commission's estimate of a reasonable WACC range as at 1 July 2012 of 5.51% to 7.48%; and
- Lower than the top end of the Commission's estimate of a reasonable WACC range as at 1 April 2013 of 5.71% to 7.67%.

This suggests that the output of the Commission's input methodology for WACC is consistent with current investor expectations and, in fact, the Commission's use of the older 1 April 2012 WACC of 7.06% to 8.04% produces a WACC range which, at its upper end (which was the estimate applied by the Commission) exceeds current market expectations, which are that a 7.5% WACC is appropriate.

In late 2012 Christchurch Airport offered a retail bond issue of up to $75m, with a term of seven years and a likely yearly interest payment of 5.15%. This issue raised more than $50m on its first

[13] Auckland Airport Draft Report Submission, para 131.

day, with Christchurch Airport CEO Mr Boult being reported in the Christchurch Press on 29 November 2012 (copy attached) as saying the offer would probably have to close early, possibly at the end of its second day, once it reached its $75m ceiling. Mr Boult was quoted as saying 'We are told there's a wall of money out there looking for quality investment'.

The 5.15% offered by Christchurch Airport, which was all snapped up within two days by the 'wall of money', is below the cost of debt produced by the Commission's input methodology WACC – of 5.31% as at 1 July 2012 or 5.59% calculated by BARNZ during consultation with Christchurch Airport applying the input methodologies as at 1 September 2012.

Clearly the cost of debt estimated by the Commission from applying its WACC input methodology is not inconsistent with the experience faced by New Zealand airports in attracting capital to fund long term investments.

Other comments by Auckland Airport on the profitability analysis

While Auckland Airport has not directly engaged on the Commission's profitability analysis, there are several points made by the Airport which require a brief response.

MVEU valuation approach wrongly characterised as 'speculative'

Auckland Airport has described airline submissions in relation to a potential future MVEU land revaluations and ODRC specialised asset revaluations as being 'speculative future assumptions'.[14]

As BARNZ has previously submitted, an asset base comprising a revaluation of land using MVEU and specialised assets using ODRC:

- Was Auckland Airport's stated preliminary view for charge setting at the beginning of consultation in PSE2;[15]
- Was the approach advocated by Auckland Airport to the Commerce Commission in the development of the input methodologies;
- Is currently the approach submitted by Auckland Airport to the High Court to be materially better than the Commission's valuation input methodology; and
- Is the valuation methodology adopted by Auckland Airport in its financial reporting valuations as articulated in its annual reports.[16]

There is nothing speculative about the possibility of these methodologies being used as the basis for future charge setting. Auckland Airport has set out the parameters which it uses for applying the MVEU valuation methodology in its Annual Report. These methodologies have long been the

[14] Auckland Airport Draft Report Submission, para 116 (e).
[15] Letter dated 14 September 2011 from Auckland Airport to its substantial customers.
[16] Refer, for instance, to page 72 of Auckland Airport's Annual report for the year ended 30 June 2012, the relevant contents of which are also set out at pages 11 to 12 of BARNZ's Submission on the Draft Auckland Airport Section 56G Report, 31 May 2012.

advocated and often used approach of Auckland Airport. MVEU was the underlying basis for the land valuations used to set charges at Auckland Airport until 2007. Updated ODRC revaluations of specialised assets were the basis of charges at the Airport up until 2012. Moreover, there is nothing in the Airport Authorities Act to prevent Auckland Airport from reverting back to these methodologies.

BARNZ considers that the Commission is right to have carried out analysis of an alternative scenario of Auckland Airport using these valuation approaches for pricing. However, as set out in BARNZ's submission on the draft report, BARNZ considers that the Commission has materially under-estimated the extent of the MVEU valuation uplift.

Airport is submitting the WACC should be assessed as at 1 April 2012

Auckland Airport's submission with respect to the date at which the WACC should be determined is deliberately vague, emphasising that:

- the key reference point used by substantial customers was the Commission's published April WACC;[17] and
- the April 2012 WACC estimate was 'part of the information set available to Auckland Airport at the time it set prices'[18]

The Airport has glossed over the fact that it always had a clear intention to update the cost of debt parameters of its WACC calculation as close as practicable to its charge setting decision, and that this was accepted by the airlines as appropriate. This process was well understood by all participants – and indeed viewed in the light of a mechanical adjustment or final step which was so accepted and regarded as appropriate and necessary that it was not worthy of comment or discussion. This same process of updating the cost of debt inputs immediately prior to the resetting of the charges had also been applied in 2007 as charges were reset – again without objection.[19]

The final written analysis by BARNZ of Auckland Airport's prices was provided to Auckland Airport on 4 May 2012, five working days after the Commission's 27 April 2012 WACC Determination. By chance, the Commission's WACC estimate had, quite simply, been undertaken by the Commission at the closest practicable point to the BARNZ analysis being finalised. There was no point in BARNZ updating the Commission's WACC estimate to take account of the few days that had elapsed – indeed there would not have been time to have had that work undertaken and then reflected in the Assessment undertaken by BARNZ. The fact BARNZ used the Commission's April 27 Determination as its key reference point was because it represented the WACC at the closest reasonably practicable time to BARNZ when it was preparing its last submission.

There was no conceivable notion on anyone's part (be they Airport or airline) that Auckland Airport would lock in its cost of capital as at that date. It was widely and well understood by all parties that the Airport would be updating its cost of capital, to reflect market changes in the cost of debt, as close as reasonably practical to when it determined charges. This had been signalled with the

[17] Auckland Airport Draft Report Submission, para 140.
[18] Auckland Airport Draft Report Submission, para 116 (c).
[19] Refer to the discussion of this practice during pricing consultations at page 15 of BARNZ's Submission on the Draft Auckland Airport S 56G Report, 31 May 2013.

Airport's Revised Pricing Proposal provided to airlines at the beginning of April 2012 [20] – and it occurred through a further report to Auckland Airport as it was preparing to set its charges from Uniservices dated 20 May 2012. That is the date at which the Commission should also update its WACC estimates to assess the reasonableness of the charges determined by the Airport.

For the Airport to argue that a 1 April WACC date should now be used by the Commission to assess the reasonableness of its charges because this was 'part of the information set available to Auckland Airport at the time it set charges' is inconsistent with and contradicts Auckland Airport's former well-established position of updating the cost of debt element of the WACC as close as practicable to charges being reset. The 20 May report by Uniservices updating its WACC estimate for Auckland Airport was the 'key reference point' used by Auckland Airport and incorporated into its financial model as it set its charges. The updated market data relating to the cost of debt in that report supplanted the (by then out of date) cost of debt elements of the Commission's April 27 Determination. The Commission's WACC should likewise be updated to that same date of 20 May 2012 in order to enable a like for like comparison and to ensure that the Commission is judging Auckland Airport's charges using a WACC estimate that reflects market expectations regarding the cost of debt and bond yields at the time that the Airport reached its charge setting decisions.

<u>The Airport believes the analysis should be based on an FY12 RAB</u>

Auckland Airport has repeated its submission that the Commission should undertake its analysis using a 2012 opening RAB value to assess the reasonableness of the regulatory revenue (excluding revaluations) over the pricing period.[21] Auckland Airport has previously estimated that this produces expected returns of 5.54%.

In its draft report the Commission did not model the scenario put forward by Auckland Airport of an opening asset base reflecting the 2012 RAB and a closing asset base reflecting the forecast 2017 RAB with the revaluations not being included in the profitability analysis. The Commission concluded that this approach *'is not appropriate as it does not reflect the moratorium on asset revaluations applied by Auckland Airport when setting prices for PSE2, which, … results in different asset valuations than disclosed in information disclosure'.*[22]

BARNZ agrees with the Commission's rejection of this scenario, which would artificially understate Auckland Airport's return by comparing its charges against a completely different, and significantly higher, asset base than was used by the Airport to set charges, and which would result in an inconsistency between the asset base (which under Auckland Airport's preferred option includes revaluations) and the treatment of revaluations (which Auckland Airport considers should not be treated as regulatory income).

[20] Refer Uniservices, Update on the Specified Parameter Inputs into the Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 2 April 2012, page 6.
[21] Auckland Airport Draft Report Submission, para 149.
[22] Commerce Commission, Auckland Airport Draft S 56G Report, F38.