Auckland Airport

17 August 2012

Ruth Nichols
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Regulation Branch
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Dear Ruth

AUCKLAND AIRPORT – SECTION 56G CROSS SUBMISSION

Auckland Airport provides the following submission in its capacity as an Interested Party to the submissions, cross-submissions and conference.

The NZ Airports Association has made a cross-submission on the Section 56G Review Conference. Auckland Airport is a party to and has contributed to the NZ Airports Association submission and it should be read in conjunction with this submission.

In this cross-submission we provide comment on the following:

- Clarification of matters raised by Air New Zealand in its cross-submission that relate to Auckland Airport;
- The scope and adequacy of evidence to be considered by the Commission as part of the Review;
- WACC; and
- Feedback on process.

At the end of this cross-submission are three tables providing comment on the following:

1. Evidence of the effects of Information Disclosure ("**ID**");
2. Opportunities for improvement to ID; and
3. Responses to specific questions directed towards all interested parties from the Conference.

Matters of concern raised by Air New Zealand in its cross-submission

Auckland Airport supports the ID Regime and believes that it will be effective in promoting the four limbs of the Part 4 purpose statement. We are committed to ensuring that we implement ID effectively, with open and transparent disclosures to date, and will strive to continuously improve disclosures over time. We also understand that an important component of the ID Regime is that information is subject to scrutiny under the Review process.

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To that end, Auckland Airport is concerned that Air Zealand has mischaracterised and misrepresented a number of matters we raised in our submission. We address these briefly below in turn.

Air New Zealand has mischaracterised our attempt to define the lawful scope of the Review as a heavy handed threat directed at the Commission. In its cross-submission, Air New Zealand made the following comments:[1]

> "Further, AIAL seeks to limit the Commission by stating that "if the review seeks to do too much too soon, then it will be inevitably flawed and open to challenge". Heavy-handed threats such as this says much about its attitude towards Parliament's intention to "protect consumers from excessive prices" through open disclosure and examination of information.

Auckland Airport wishes to clarify that our submission was simply intended to emphasise the importance of ensuring that the Commission carefully and correctly confines the scope of the Review in determining the "effectiveness" of the ID Regime. Auckland Airport does not believe that it is a heavy handed threat to point out that the Commission must carry out the Review in accordance with Parliament's statutory direction.

Auckland Airport is also concerned that Air New Zealand has mischaracterised our request for a single report as an apparent unwillingness to respond in any detail on the questions the Commission has posed in respect of WIAL, when it commented as follows:[2]

> It is difficult to see how a combined process (particularly in relation to consultation) would be workable when each airport is so reluctant to engage on issues that do not relate directly to it.

Despite Wellington Airport's public approach to price setting, Auckland Airport did not study the Wellington materials in detail and therefore did not feel qualified to provide detailed comment. Auckland Airport's focus was and will remain on the demands of our own commercial issues, feedback from customers and expert advice. Auckland Airport's current and future pricing has and will continue to be informed by substantial customer feedback, its own experiences and pricing issues, its independent expert views and the regulatory environment.

Where Auckland Airport has commented on aspects of Wellington Airport's price setting, it reflects areas of common concern, such as legal and policy issues that have broader application to all Airports. By way of example, in our submission we made the following comment:[3]

> WIAL appeared to carefully consider the Commission's input methodologies used for information disclosure along with substantial customers' feedback and expert advice. Although WIAL has not chosen to adopt the Commission's input methodologies for pricing in all cases, it is not required to do so. Where WIAL has not adopted the input methodologies, it appears to have been transparent about the reasons for the decision.

Indeed, in instances where Auckland Airport has endeavored to constructively participate, Air New Zealand has sought to mischaracterise our comment as unqualified support of Wellington Airport's approach:

[1] Air New Zealand Limited Cross-submission to the Commerce Commission, Commerce Act 1986, page 4.
[2] Air New Zealand Limited Cross-submission to the Commerce Commission, Commerce Act 1986, page 4, para 3.2.4.
[3] Auckland Airport Submission on the Commerce Commission's Process and Issues Paper (Airport Services – Section 56G Reports), page 13.

> AIAL's focus on whether or not WIAL has applied the input methodologies rather than whether or not WIAL's decision has resulted in pricing outcomes consistent with the s 52A purpose statement is of concern. AIAL's endorsement of the process and outcomes of WIAL's decision indicates that AIAL would be comfortable adopting the same approach in future, and this should be taken into account when considering the effectiveness of the ID regime.

None of the claims made here by Air New Zealand follow from a proper interpretation of our statements. Auckland Airport continues to believe that an airport not applying an IM in pricing is not evidence per se that the regime has failed, as the IMs are not binding for pricing. Rather the airport's obligation is to consult under the Airport Authorities Act. This requires airports to consult with an open mind and consider the relative merit of feedback from its substantial customers, experts or commercial experience, in the context of the regulatory environment and decisions. The automatic application of the IMs by an airport in pricing would indeed indicate that the airport did not have the open mind required for consultation under the AAA.

Scope and adequacy of evidence to be considered in the review

Auckland Airport agrees with the Commission that the section 56G Review requires an assessment of not only the information disclosed, but the effectiveness of the information disclosure regime in promoting the purpose in section 52A(1).

We continue to consider that it is too soon for the Commission to form a conclusive view on whether or not the ID regime is successful in delivering on the purpose of regulation, because the available time series of evidence currently is too limited.

We note that the Commission has also properly acknowledged the limitations created by the lack of time series data at this point in time and has undertaken to acknowledge these limitations in the reports it prepares for the relevant Ministers.[4] Nonetheless, the Commission is of the view that the price setting event provides the key information required for it to carry out the s 56G review, given that prices have been set for the next five year period.

Auckland Airport requests that, in order to appropriately and holistically consider the effectiveness of the ID Regime, that the Commission looks at all information disclosed, and not solely the price setting information disclosed.

Price setting disclosure

The price setting event and the consultation that precedes it, are important processes. Accordingly, Auckland Airport agrees that these processes are an important consideration for the Commission as they provide information on:

- how each airport behaved during consultation; and
- the role that information disclosure played in that process to promote outcomes consistent with outcomes produced in competitive markets such as objectives in section 52A(1)(a)-(d).

[4] Airports – section 56G Update on process and issues 27 July 2012.

Importantly, the price setting disclosure is based on forecasts. While forecasts ought to represent unbiased best estimates as at the time of pricing, they are by their very definition imprecise. By way of example, Auckland Airport considered its 2007 price setting forecasts to be reasonable and unbiased forecasts. Annual disclosures to be made in November will show that actuals for the last price setting event have been materially lower in many instances, largely due to the impacts of the global financial crisis ("**GFC**").

In our view, evaluation of the price setting event ought to include consideration of the following matters:

- Quality of the information disclosed;
- Consideration given to feedback from customers and expert advisors regarding priorities addressed in the price setting event;
- Lack of systematic bias in forecasts, acknowledging that agreement may not be reached, but that forecasts should be professionally established for material items and neither be too high or too low;
- Whether incentives remain for the business to outperform the forecast; and
- The forecast overall return off an efficiently held asset base.

We do not think it is possible to draw definitive conclusions regarding the effectiveness of the ID Regime based on the forecast information alone.

As discussed above in relation to Air New Zealand's comments, Auckland Airport has not formed a comprehensive view on Wellington Airport’s price setting event. Having just completed our own consultation, we are cognisant of the complexity of setting prices for five years, and have had insufficient time to confidently get across all of the detail underpinning the decision and the history of the first price setting event at Wellington Airport.

Annual regulatory disclosure

In our view, the annual regulatory disclosure has also played a role in promoting the purpose in section 52A(1), and should therefore also form part of the evidence which the Commission considers in assessing whether the ID Regime is effectively promoting the purpose in section 52A(1). In Auckland Airport’s experience, the implementation of the new ID regime has had a broad impact on the business in raising awareness among employees that Auckland Airport is expected to deliver outcomes consistent with competitive market outcomes and communicate that - namely, that Auckland Airport:

- is investing appropriately in both capacity and replacement;
- is identifying, facilitating or providing innovative solutions;
- has operating and capital expenditure that is efficient and commensurate with the quality demanded by consumers and that there is good engagement with airlines and other stakeholders prior to major decisions in relation to such expenditure;

- shares the benefits of efficiency gains with consumers, including through lower prices; and

- has returns that are reasonable and not excessive.

Accordingly, Auckland Airport would expect that the annual disclosures should provide interested parties annual evidence of how Part 4 has influenced the day-to-day decision making of the business, with a greater level of detail than has existed in the past. Additionally, operating processes and conduct ought to have been adapted as a result of the new ID, to better align with the information requirements to be demonstrated to interested parties.

In Auckland Airport's view, commercial incentives have long existed, due to the dual-till environment. Nevertheless, faced with the new ID regime cost, it has been helpful to complement the company's existing values and strategy, with a message that these outcomes must not be assumed by the Company but need to be clearly demonstrated to Interested Parties.

While there was some discussion around quality during our Aeronautical Pricing Consultation, in our experience, such discussions occur regularly at the operational level. Based on discussions at the Conference, this also appears to be the practice at Wellington Airport.

Auckland Airport has collated some evidence of the extent to which ID regulation is promoting the purpose of Part 4 as set out in section 52A, and the extent to which information disclosure regulation under Part 4 has had an impact on Wellington airport's performance and conduct, (see **Table 1**).

We note the discussions in relation to quality outcomes and innovation are examples of where it seems to be accepted that the current regulatory environment is delivering on quality and innovation for customers.

WACC

Auckland Airport considers that the Commission's industry WACC estimates are insufficient to incentivise investment.

In its pricing consultation, Auckland Airport used the Commission's methodology as a starting point and made discrete adjustments, providing its substantial customers with the details of the rationale for those adjustments and welcoming their feedback. The nature of the adjustments made by Auckland Airport are provided in the accompanying table addressing the questions raised by the Commission following the conference on what adjustments ought to be considered by the Commission, (**Table 3**).

We note that Vector has also submitted to the Commission, advocating that the IM WACCs are inappropriately low. This was disputed by Air New Zealand in its cross submission which states it has not encountered evidence that current WACC would impede investment[5].

[5] Section 5.2

Air New Zealand is decidedly vague in its reference to current WACC. Auckland Airport assumes that Air New Zealand is referring to the Commission's industry WACC, given this was its stated preference in consultation. Auckland Airport is clear in its view that it does not consider the Commission's industry WACC to be sufficient to incentivise investment at Auckland Airport. Auckland Airport carefully explained its reasoning for its approach in the consultation process. It was disappointing that there was limited consideration of each adjustment, rather BARNZ and Air New Zealand were clear that the Commission's industry-wide WACC for monitoring purposes should be applied by Auckland Airport for pricing purposes, with some discussion regarding the range which should be used for the evaluation.

Due to the significant decline in risk free rates that has occurred in some markets during the GFC, the Commerce Commission's estimates of airport industry WACC have fallen from 8.1% (June 2010), to 7.6% in June 2011, to just 6.5% in June 2012.

In response to Auckland Airport's price setting disclosure, UBS Investment Research (market analysts) also queried the significant decline in WACC estimates, given development capitalisation rates have remained unchanged in the market as follows:[6]

> We continue to highlight Com Com's "theoretical" return levels are yet to be seen in "real world" investment activity in the property sector (development cap rates unchanged).

Auckland Airport and its advisors have consulted in detail with substantial customers on why the Commission's current industry WACC would impede investment, and limitations with the methodology. In Auckland Airport's experience during its consultation process, WACC is an area where the airlines did not have an open-mind to the information provided.

In our view, it is appropriate for the Commission to reflect on whether it is realistic that WACC requirements of debt and equity investors have truly fallen by over 1.2% (which amounts to more than 15%) in the course of a year, and whether, by setting its reference point off this artificially low base, it risks dis-incentivising investment.

Auckland Airport does not consider it appropriate in the current economic circumstances to continue to use a long term MRP of 7%, as this underestimates the return required to incentivise equity holders. Further discussion of why it is inappropriate to use a long term MRP is extracted from Bishop and Officer (2009).[7]

> The MRP will change over time to reflect the "market's" changing view of risk and attitudes to risk. A positive risk premium, relative to a "risk free" asset, is required because investors are risk averse and require compensation for bearing risk. The MRP cannot be constant over time, if it was constant this would imply there was no risk and therefore there could be no risk premium. In the current economic circumstances where there is greater market variability and economic uncertainty than has typically been experienced over at least the past 50 years we do not believe that a constant MRP reflecting the long term average is appropriate.
>
> In the past we have recommended the use of the long term average historical MRP. This is not because we believe it to be stable over time but because there has been little in the way

[6] UBS Investment Research Auckland International Airport, 3 August 2012.
[7] Market Risk Premium Estimate for January 2010 – June 2014 Prepared for WestNet Energy Dr Steven Bishop & Professor Bob Officer, December 2009, page 1.

of evidence or theory that has allowed or encouraged other than the use of the average MRP. The current circumstances warrant a change:

• We have abnormal levels of market volatility that reflect the so-called GFC; and

• We have an approach that allows us to modify the average MRP for current economic circumstances.

The GFC has had a significant impact on the capital market. The stock market return for 2008 was a negative 40.4%, the lowest in the 126 year history of market returns available to us. The most recent data available to us (end November 2009) shows market risk, although declining from its peak, is still over 50% above our estimate of the long term average risk level.

While there has been a recovery from the 'bottom' of the stock market fall, it is still only 76% of the peak prior to the crash. Both history and other forward looking data suggest the "Global Financial Crisis" is not over and still has considerable time to run i.e. it is not a short term phenomena and the market has not returned to 'normal'. On these grounds we recommend a MRP for the regulatory period January 2010 to June 2014 above the long term average.

The use of an historical average as an input to the risk premium on equity contrasts with the widespread use of spot rates on debt to estimate the cost of debt. In practice this difference has not been of great concern however the current environment calls this into question. **Because of large increases in debt premiums, there is a substantive disconnect between the risk spread on debt and equity when the historical average MRP is used to estimate the cost of equity. This process substantially under-estimates the required return on equity.** In fact, it is possible for the cost of equity estimated this way to be below the cost of debt, which is a nonsense outcome. [Emphasis added].

In his report to the Commission on the WACC input methodology,[8] Professor Marsden noted evidence to suggest that the MRP is negatively related to short-term interest rates (namely, Scruggs (1998), and Harris and Marston (1992)). That evidence supports the proposition that when short-term interest rates are low (as present now for Government bond and Treasury yields), the MRP is high, and vice versa.

Auckland Airport considers that the GFC continues to affect the market risk premium and that the Commission ought to consider the analysis put forward by Sapere, together with the Commission's previous temporal adjustment of the MRP to 7.5% on the basis that the GFC was continuing to impact at the time of the price setting event.

More generally Auckland Airport considers that the Commission will need to reflect on that appropriateness of applying a pin point estimate of WACC when assessing returns. In this we reflect on the aphorism of the importance of getting it generally right than precisely wrong.

Protocols for Auckland Airport's Conference

Auckland Airport appreciates that at some point in the future, the Commission will be scheduling the section 56G review for Auckland Airport. In its submission, BARNZ has noted that further time ought to be provided for the Review of Auckland Airport due to the broader set of interested international carriers. Auckland Airport also notes that another

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[8] Uniservices, Comments on the Commerce Commission's Approach to estimate the Cost of Capital, 2 December 2009, page 60 and 61.

key differentiator between Auckland Airport and Wellington Airport is the existence of confidentiality arrangements between the parties. Auckland Airport will discuss protocols with those parties to assist the Commission's Review process.

Yours sincerely

Adrienne Darling
Manager, Regulatory Affairs and Aeronautical Pricing

TABLE 1: Evidence of the effects of Information Disclosure

Note: Unless specifically noted, the following table pulls together a summary of information noted during the submission, cross submission and conference process

Information Disclosure Area	Positive Evidence of Performance and / or Effects of ID	Negative Evidence / Effects of ID	Auckland Airport comment
Quality	Prior to the ID regime, Wellington Airport had not invested in the ASQ quarterly passenger monitoring. As a consequence of the ID regime, Wellington now participates in this industry survey and uses this feedback from passengers (consumers) to inform decision making and the Board regarding quality experiences.[9] Wellington Airport has also indicated in the annual disclosure that initiatives are underway to address the lower rated areas, particularly in respect of the washroom and comfort of waiting/gate areas[10]. Wellington Airport has established a process for the year ended 31 March 2012 that requires each interruption to be evaluated by Wellington Airport Managers as it occurs. The interruptions are then discussed with participants at the Operational Process Improvement Forum to confirm	Air New Zealand and BARNZ sensitivity on quality is limited to a high-level concern about over investment risk, with concern raised in particular regarding The Rock.	Evidence of performance is provided in Wellington's annual disclosure. Neither BARNZ nor Air New Zealand have raised concerns regarding day to day quality issues – which is a credit to Wellington Airport. Air New Zealand and BARNZ have indicated that ID has had no material effect on quality, but also suggested that there are no day to day performance issues with respect to quality outcomes at Wellington – ie. there is no day to day quality issue for information disclosure to resolve. This raises the question of whether all the information in Schedules 11 and 14 was in fact necessary. It was not costless.

[9] Wellington Conference Transcript 7 August, page 10, S Fitzgerald.
[10] Wellington annual disclosure 31 March 2011, Schedule 14.

Information Disclosure Area	Positive Evidence of Performance and / or Effects of ID	Negative Evidence / Effects of ID	Auckland Airport comment
	responsibility for the interruptions and discuss whether any process improvements are required.[11] Provided a list of sources of service quality monitoring conducted and initiatives undertaken to improve quality outcomes[12]. BARNZ and Air New Zealand confirmed that service quality is not a material issue.[13]		There is evidence at the margin that new ASQ information is being used in decision making as a result of ID. Given that this relates to day to day quality issues, the airlines may not have observed this.
Expected revenue and profitability from price setting disclosure	The price setting disclosure provides a clear public record of the pricing decision for interested parties to form their own views on.	The information disclosed is complex and unless an airport uses the IMs for pricing, also adds a complexity to interpretation of the annual disclosures.	Auckland Airport has had insufficient resources to form a view on the extent to which ID assisted the effectiveness of the second price setting event, versus the first price setting event. That said, it was evident from the conference that points of discussion quickly moved to detailed points. It is likely given the process focused on points of disagreement, that the process is potentially overlooking discrete areas such as cost and asset allocation which were

[11] Wellington annual disclosure 31 March 2011, Schedule 15.
[12] Wellington annual disclosure 31 March 2011, Schedule 15.
[13] Wellington Conference Transcript 7 August, page 9.

Information Disclosure Area	Positive Evidence of Performance and / or Effects of ID	Negative Evidence / Effects of ID	Auckland Airport comment
			less contentious during the second PSE versus the first, and that this movement occurred as a result of the ID. The reasonableness of forecasts needs to be considered as part of the overall context of a price setting decision. For example, incentives should not be considered in isolation of an assessment of the reasonableness of demand forecast and whether it creates the right incentives over the pricing period. Adjustments (called Commercial Concessions) should not be considered in isolation of the overall decision and it should be noted that if one parameter is materially changed, the adjustment may not have been offered. The Commission should also consider how its interpretation may influence future price setting. WIAL has recently earned sub-WACC returns, yet still committed to a wash-up. If the Commission disregards this concession in the second PSE, WIAL may

Information Disclosure Area	Positive Evidence of Performance and / or Effects of ID	Negative Evidence / Effects of ID	Auckland Airport comment
			not be incentivized to offer such wash-ups in the future in similar circumstances.
Innovation	It is perhaps unrealistic to expect a regulatory solution like ID, to have a significant impact on innovation. Auckland Airport recognised that ID required Auckland to be clearer with interested parties on various innovations in the airport environment. In this respect a positive effect may be increasing the awareness both within the organisation and with our key stakeholders on the nature of innovations occurring on an annual basis. Air New Zealand noted that many innovations are actually resolutions of operational issues on a day-to-day basis and there is good collaboration on a day-to-day basis in resolving those kinds of things and putting in sensible solutions.[14]		Auckland Airport agrees with the observations of Commissioner Begg that the key question is whether Wellington Airport is open to innovation. In some instances Wellington may lead, while in others it may facilitate or support innovative ideas brought to it by a range of stakeholders. Feedback indicates that Wellington Airport is innovating and that no material issues exist in this area. There is broad acknowledgement that Air New Zealand has developed world-leading kiosk solutions.

[14] Wellington Conference Transcript 7 August, page 90.

Table 2: Opportunities for Improvement to ID

Information Disclosure Area	Opportunities for Improvement	Rationale
Quality	For the time being the level of detail on quality measures should be retained.	Parties seem to be in broad agreement that the current level of quality information is a reasonable starting point. The airports have invested in systems to record the information and to embed this information in processes. Auckland Airport considers that interested parties may not yet have had the time to fully evaluate the vast quantity of quality information.
	Addition of international benchmarking on holistic measures of price	Air New Zealand commented at the conference that "the price quality trade-off is unclear".[15] This could be addressed by the addition of annual benchmarking on international and domestic charges, though care would need to be taken in development of the specification of such benchmarking and the on-going costs of producing such a report. Auckland Airport notes though that this information is often voluntarily supplied during consultation processes and the airlines do not appear to value it.

[15] Wellington Conference Transcript 7 August, page 15.

Information Disclosure Area	Opportunities for Improvement	Rationale
Assessment of expected revenue and profitability following price setting	To either: • narrow the ID to the costs, assets and revenues to the scope associated with the price setting event (consultation), or • add a schedule to the Price Setting Disclosure to reconcile Schedule 18 components for the Standard Charges consultation versus Other Regulated Activities.	Auckland Airport noted BARNZ' view that: BARNZ considers that there needs to be a better disclosure of the costs, assets and revenues associated with the price setting event. By only having disclosures presented across specified services as a whole, without the price setting event costs, assets and revenues shown separately, then readers cannot clearly ascertain the profitability of the services where the Airport used its AAA power to set the charges. The costs, revenues and performance of the services that charges are set for is camouflaged by the costs, revenues and performance of other services (such as leased activities or negotiated charges) having also been included.[16] Auckland Airport agrees that the ID specification does not assist BARNZ and other airlines to focus on consultation materials (or the price setting event) in which they are most interested. The Price Setting Disclosure is already extremely detailed and Auckland Airport considers that feedback from BARNZ indicates it would be sensible to streamline the disclosure, removing Aircraft and Freight and other areas negotiated by way of lease (where revenues are set in relation to market comparables, rather than a building block model). An alternative method to address this would be to add a simple table, to formalise the record of the Aeronautical Pricing information, in the form of Schedule 18. Auckland Airport has certainly not sought to "camouflage" any matters and consider that the approach taken by Wellington was to comply with the ID requirements. Auckland Airport took the opportunity to respond to

Information Disclosure Area	Opportunities for Improvement	Rationale
WACC	Auckland Airport has given significant consideration to the Input Methodologies, including WACC as part of the price setting process. Auckland Airport considers that future price setting events could be improved, if the Commission was clearer to the airlines that the industry WACC was not binding for pricing decisions and that airlines therefore ought to meaningfully engage and test the basis for the adjustments proposed by the airport. There is an opportunity for the Commission to remove the WACC IM noting that it was not compulsory for pricing.	In our experience, substantive engagement on WACC was limited because Substantial Customers quickly formed a view that there was no reason for airports to depart from the industry WACC per the WACC IM for ID. Whilst Auckland Airport cannot comment on the WIAL price setting event, Auckland Airport does consider that consultation on WACC, reduced in the second price setting event relative to the first price setting event, because Substantial Customers, did not consider it a priority to engage on the information put forward during consultation, but rather sought to limit consideration to whether or not the approach complied with the Input Methodology. This was evidenced by : - The commissioning of a report from Futures International Consultants by BARNZ to comment on whether there is any valid reason for departing from these methodologies when setting charges in the first stage of consultation. - No further expert advice was sought in the

[16] BARNZ Response to WIAL Section 56G Issues Paper Page 30
[17] Auckland International Airport, Price Setting Disclosure, page 17.,

Information Disclosure Area	Opportunities for Improvement	Rationale
		second stage of consultation when the airport's expert advisor responded to the Futures Consultants points; - The limited feedback in the consultation record from the airlines on rationales provided for variations to industry estimates.
	Clarification of how the Commission intends to use the annual WACC estimates for ID, when the majority (~85%) of revenues based on a 5 year estimate of WACC	As the Commission is aware the IM Determinations provide a rolling annual estimate of WACC and these annual WACC estimates are required for Information Disclosure Reporting. At present the Commission has not disclosed how it will use the cost of capital estimate; in an environment where 85% of revenues are based on a price setting event which occurs only once every five years. In Auckland Airport's view this increases regulatory uncertainty and does not provide an environment in which regulated suppliers have incentives to invest, innovate and improve efficiency. We therefore consider that Information Disclosure could be improved by the Commission clarifying how it will use the annual cost of capital estimate.

TABLE 3: Questions/issues arising from the Wellington Airport conference held on 7 August 2012.

Number	Question	Auckland Airport's View
4	Which published cost of capital estimate should the Commission use as a basis for its profitability assessment – the March 2011 or the April 2012 estimate, and what adjustments may be necessary? - All	We have assumed that the Commission's question relates to the basis for assessing forecast profitability, and have formed the view that the cost of capital estimate should be reasonably close to the price setting event. Wellington Airport's pricing decision was made on 1 March 2012. In this respect, it would be inappropriate to use a WACC estimate of March 2011 for pricing. Auckland Airport would expect that estimates of WACC would have been updated in mid-January to mid-February for a March 2012 pricing decision. Auckland Airport does not consider that the Commission's WACC estimate for the industry should be applied as the basis for the profitability assessment. However, if the Commission intends to use this as a starting point and then to consider each adjustment on its merits, Auckland Airport would recommend that the Commission either: • develop a new published estimate, using data circa 2-6 weeks prior to the pricing decision; or • use the most recent prior published cost of capital estimate, updated for airport industry wide parameters (which should be no greater than six months old); and • then make adjustments. There are aspects of the current WACC IM which Auckland Airport considers needed adjustment for the purposes of pricing by Auckland Airport. We would expect that Wellington Airport will have made adjustments appropriate for their own corporate structure and practices and concerns regarding the market risk premium, therefore the following adjustments should be reviewed based on the rationale put forward by

Number	Question	Auckland Airport's View
		Wellington for departures from the IM for: • the appropriate term of the risk-free rate; • Wellington Airport's asset beta; • Wellington Airport's leverage; • market risk premium; • an allowance for asymmetric risks if these were not accounted for in the cashflows; • consideration of model error; • the appropriate WACC range. In our view, the Commission should have regard to expert advice, together with disclosures on actual corporate practice. The Commission is concerned that airports might have incentives to adapt their treasury policies to increase their WACC estimate for pricing. The Commission's experience in other industries may have led it to form the view that the price setting event drives capital and treasury policies. This is not so for airports, where the price setting event accounts for less than 50% of revenues and comes about every 5 years. The commercial reality is that the capital and treasury policies are reviewed annually by the Board and Management and have the joint objective of ensuring appropriate risk management policies and attracting capital on a global and in particular Australasian basis. Perhaps, if the Commission were to observe shifts in corporate structure that have occurred since the IM had been published, we could understand the Commission's concern. Auckland Airport has not observed any such shifts, and in this respect, we consider that the Commission risks undermining incentives to invest if it does not have some consideration of firm specific factors borne out of efficient practices.

Number	Question	Auckland Airport's View
		Auckland Airport practices include holding a monthly Treasury Management Committee (TMC) meeting with members including management and Treasury operational team from Auckland Airport and independent Treasury advisors to discuss current domestic and global economic and financial trends, treasury performance, funding and hedging arrangements and Treasury policy reporting and compliance. A formal annual review of the treasury policy is performed to amend the policy if required to meet market best practice, and to review the target credit rating and ratios, the hedging parameters and the funding parameters, with any changes to the Treasury policy requiring Board approval. In addition, a semi-annual report is presented to the Board reporting treasury results against Treasury policy. A Treasury Operational Performance Report (OPR) is provided to the Board on a monthly basis, including: • Summary of Auckland Airport's debt position including borrowing facilities, bonds, commercial paper, money market, interest rate swaps and interest rate options. • Cost of funds summary, including comparison to budget and other benchmarks. • Funding and hedging profile. • Compliance with hedging parameters, funding parameters, counterparty credit limits and other treasury policies. Our debt funding is considered critical to our ongoing business continuity and source of ongoing funding for maturing debt and capital investment. The methodology for measuring WACC in NZ has not changed and has been the methodology for years. It has not driven any behavior at Auckland Airport to change leverage. Consistency in rating over time is a key factor in how debt investors consider risk associated with their investment (an increase in leverage would reduce the value of their investment). This is a key consideration for Auckland Airport in maintaining a strong A- credit rating over time.

Number	Question	Auckland Airport's View
		Auckland Airport has tested the theoretical estimate of WACC against commercial realities and concluded: • the estimate of WACC using the Commission's WACC IM fundamentally understates Auckland Airport's actual debt costs. The Commission's April 2012 WACC of 8.04% infers a pre-tax cost of debt of 5.9%. Auckland Airport's pre-tax cost of debt for its portfolio is 6.5%. Auckland Airport does not consider that the theoretical debt cost of funds calculated in the WACC model represents a commercially viable debt funding rate for funding an entire debt portfolio. • Estimation of WACC is an imperfect science and therefore considered the WACC range of 75-85th percentile for pricing, instead of a point estimate which implied a degree of artificial precision. • The theoretical WACC estimate is too volatile and that investor expectations have not changed by more than 15% in one year (as implied by the changes in the published Comcom WACC's for airports). Auckland Airport has provided its substantial customers with evidence that its corporate financing practices are "award winning". Whilst it may be convenient to dismiss this in favour of theoretical assumptions, this does little to incentivise efficient practices. Even if it was practically possible to reset all debt funding to a five year period as per the IM assumptions, it would impose further compliance costs. Auckland Airport considers does not consider this theoretical approach is practically possible, or efficient. Auckland Airport considers no evidence has been provided that: • it is inefficient to issues debt at an average period longer than five years and it would be efficient to change its practices to a five year period; • it is inappropriate to account for asymmetric risk within the WACC range, rather

Number	Question	Auckland Airport's View
		than via a cashflow estimate. Indeed, on the day of the airport conference, all airports are now reasonably wondering what affect a volcanic eruption might have on forecast demand; • it should use a theoretical leverage of 17% when this bears no resemblance, to its long held leverage of 30% and 17% would be an imprudent leverage;[18] assumption, which would lead to regular takeover interest; or • investor required returns have fallen by more than 15% in the last year as implied in the Commission's analysis.
5	Should the Commission use the midpoint or the 75th percentile in its ex ante assessment of profitability?	Auckland Airport considers that it is most sensible to consider the WACC range in assessing forecast profitability. If asymmetric risks have not been modelled within the cashflows and no model error has been explicitly included, then the range of the 75th -85th percentile would be a sensible point range for ex ante assessment of profitability.
6	Should the MVAU methodology be more tightly specified? If so, in what way? - All	At the Conference, the Commission appeared to be sensitive to the apparent disagreement between experts on the MVAU. In some respects it is positive that through ID, airlines have had detailed transparency on the basis for the valuation and an opportunity to test the process using Schedule A of the IM. In Auckland Airport's view, the MVAU methodology has been well specified, but by definition is a theoretical exercise and therefore it is inevitable that different views exist. The Commission should reasonably test whether: • the process was robust; • there has been any contravention of standards; and • professional standards been met.

[18] As at 30 June 2011 Auckland Airport's leverage was 30.9%.

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		Further specificity is unlikely to resolve the fact that the MVAU valuation is a highly theoretical exercise. Unfortunately, in Auckland Airport's view it is not realistic for the Commission to expect that if five planners were asked to assess the scheme upon which the MVAU valuation at Wellington Airport should be based, that a single agreed MVAU plan would be developed. If the Commission wishes to progress this issue the Commission might need to engage a planning expert to peer review the MVAU plans developed by both parties. However, the ID Regime does not include a negotiate/arbitrate form of regulation in which it is incumbent on the Commission to arbitrate between two expert views. The ID Regime requires the airport to commission an independent valuation, and it is clear that the MVAU element of the valuation from Boffa Miskell should be adopted, unless the peer reviewer considers: • the process was not robust; • there was a contravention of standards; or • professional standards have not been met. Put another way, it would be incumbent on the Commission to find fault with the process and approach of Boffa Miskell in forming its professional view.
7	General observations on how ID is working. - All	There is evidence that the airports have taken their obligations for ID seriously and committed significant resources to complying with the requirements. Transparency has been increased for Interested Parties. IMs have not been adopted in all instances for the purposes of price setting for a variety of reasons. On one hand this adds a level of complexity which will need to be explained in the annual disclosure. On the other, that explanation <u>will</u> be provided in

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		the fullness of time. Interested Parties will have evidence of whether all limbs of Part 4 are being promoted, based on outcomes measured through application of IMs. In our view, the key point is that there is always likely to be some disagreement at the time of price setting, but ID will provide an objective method for measuring outcomes on a long term basis. In this respect we agree with BARNZ' sentiments that: As the first sets of information have only just been released, the full extent of the benefits have not yet been experienced. However, it is BARNZ' expectation that over time the information will prove beneficial, particularly as data series are built up, and as actual performance is able to be measured against forecast performance from price setting events.[19]
12	What benefits would the provision of further information on costs and revenue for non-aeronautical services provide?	The ID regime has resulted in an extensive cost impost on the industry, which creates on-going information requirements. The production of this information is not costless and also has an opportunity cost in terms of resource deployment. Auckland Airport has seen only limited evidence that the current information disclosure data is being used by the airlines (a significant subset of interested parties – largely for whom the regime was developed). In our view, any requests for further information disclosure must clearly demonstrate than the information is necessary for monitoring regulated services and follow the same sound evaluation process applied in the ID development period.
14	How should airports treat the cost of litigation?	Auckland Airport considers that the cost of litigation relating to the regulatory business is a legitimate although potentially avoidable cost of running an airport business in New Zealand.

[19] BARNZ Response to WIAL Section 56G Issues Paper, page 29.

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		Auckland Airport agrees with the comments of Mr Fitzgerald at the conference that it is a nonsense that shareholders should be allowed to earn an appropriate risk adjusted return on their investment less the costs of litigation. In a workably competitive market, firms that do not recover their costs and their cost of capital in responsibly doing business, go out of business. To the extent that litigation costs are reasonably foreseeable and predictable, they are a cost that should be borne through the regulated side of the business and should not be distinguished from other costs of the business.
15	What do airports expect would be in the Commission's s 53B summary and analysis reports?	The Commission's s53B reports should include: • plain language summaries of an airport's performance, which take the thorough and detailed disclosures to a summary form which is potentially more accessible to the public and helps to assist stakeholders with isolating the key material from the information disclosed. • identifying any concerns the Commission has regarding the way in which disclosure is being made, or any observations it may have around particular aspects of Airport performance. Auckland Airport expects that the Commission's summary and analysis reports will evolve over time, as further disclosure occur under the ID Regime and the Commission feels better able to reach more definitive conclusions.
16	Interrelationship between ID, s 56G reports and CC's IMs? How can the Commission carry out its task under s 56G if it cannot consider input methodologies?	Auckland Airport accepts that although the IMs are not legally binding, they are directly relevant. Accordingly, it is appropriate that the IMs form one part of information that the Commission considers as part of the Review process. However, it is critical that the Commission also considers expert advice as to why approaches adopted by Airports that are different to the IMs have been taken and are effective.

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		As outlined in detail in NZ Airports' submission, our primary concern is that the Commission does not compromise the correct lawful scope of the Review by placing too much emphasis on the IMs, which may result in *de facto* price control. Instead, the focus of the Review should be on: • the information disclosed; • whether that information is robust; and • whether the airports can reasonably justify departures from the IMs (which seems an appropriate compromise between the fact that the IMs are not legally binding and the fact that they are directly relevant).
17	How should airports treat the cost of Part 4 judicial review and merits appeals litigation?	Auckland Airport has considered feedback from Substantial Customers that these costs should be excluded from aeronautical pricing. Some airlines have argued that if successful, airports may receive an award for costs and that these costs should be attributed to the non-aeronautical side of the business. Auckland Airport acknowledged Substantial Customer concern in this area, however notes that the process did not provide for an award for costs and that it was therefore appropriate to recover costs associated with aeronautical regulation, particularly as the Commission's regulatory functions were intended to be paid for by consumers on the basis that they benefit from the regulation. Auckland Airport explored a mechanism to pass through the costs for the Merits Appeal– this had an upside which incentivised parties to reach agreement to avoid the costs. As, if agreement was not reached, the costs were to be passed through. At the time of the price setting event, the window of opportunity for withdrawal of the Merits Appeal had virtually closed. In the final pricing decision, the merits review costs were included in standard charges. As a consequence the cost to consumers is effectively capped within this

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		pricing period to the figures included in the forecast and the airport is appropriately incentivised to manage its costs in this area.