

BARNZ POST CONFERENCE SUBMISSION ON WELLINGTON AIRPORT

SECTION 56G REVIEW

17 August 2012

1. INTRODUCTORY REMARKS

The scope of the review

Section 56G requires the Commission to *'report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services'*.

BARNZ has previously submitted that the purpose of the Review is not confined to measuring how effectively the purpose of section 53A is being met, namely whether sufficient information has been provided to interested persons to enable them to assess whether the purpose of Part 4 is being met.

Parliament has deliberately charged the Commission with a greater task – not just whether there is sufficient information to judge whether the purpose of Part 4 is being met, but **whether information disclosure regulation is in fact effectively (or not as the case may be) promoting the purpose in Part 4.**

Whether there is effective promotion of the outcomes identified in section 52A is the key

Section 52A specifies that the purpose of Part 4 is the promotion of the long term benefit of consumers, by promoting outcomes consistent with those found in competitive markets. Those key outcomes are specified in paragraphs (a) through (d) of section 52A(1). It is against these outcomes that the Commission must assess the effectiveness of information disclosure in terms of whether or not, or the degree to which, it has promoted these outcomes in the case of the specified airport services provided by Wellington Airport.

Taking the outcomes identified in section 52A in turn, BARNZ considers:

- ***Incentives to invest exist – but at a higher level than necessary***

Wellington Airport has more than sufficient incentive to invest. The 9.5% cost of capital being applied by the Airport is significantly in excess of the range identified as reasonable through an application of the Commerce Commission's input methodologies. In fact, WIAL appear to be over-incentivised to invest, given the design it selected for The Rock which was highly complex, individualised and not cost effective, and given that the Airport is undertaking airfield investment at levels above that required by current aircraft types regularly operated at Wellington Airport.

- ***The strength of incentives to improve efficiency varies according to the stage of the pricing cycle***

Wellington Airport is not incentivised to improve efficiency leading into a price setting event, as it's right to set charges as it thinks fit means that it has the ability to pass any cost increases on to consumers. Operating cost levels per passenger are at extremely high levels having risen substantially in recent years. Through years 1, 2 and 3 of the pricing period the Airport will be incentivised to improve efficiency as the pricing structure set by it enables it to retain any cost efficiencies achieved from the very high forecasts adopted as it set charges. However, come years 4 and 5 of the pricing period, Wellington Airport will again be perversely incentivised to increase its operating expenses and reduce efficiency so that it will be able to reset prices on the back of an again increased operating cost base, so as to enable the cycle to recommence. The recent increases in operating cost experienced over the last few years fit this pattern.

- ***Incentives to reflect the quality levels demanded by users exists***

The working relationship at an operational level at the Airport, and the stringent safety and security regulatory oversight, together ensures that the Airport is incentivised to provide services at a quality that reflects the technical quality requirements of airlines. If the airfield services or terminal security facilities did not meet the specified regulatory requirements, then airlines would be unable to operate to the Airport, which provides a strong incentive for the Airport to ensure that all technical elements of quality are at the necessary standard. The very public nature of the terminal facilities provided by the Airport also ensures that the Airport is incentivised to ensure the publicly available aspects of airport services are provided at a quality that reflects passenger expectations.

- ***Sharing the benefits of efficiency gains does not appear to occur***

Despite the 29% increase in passenger volumes forecast to occur from FY07 to FY17, charges payable will have increased from \$10.70 per passenger in FY12 to \$14.43 per passenger in FY17. Economies of scale are not being passed onto consumers as they are being negated by WIAL's practice of regularly revaluing assets without fully treating the revaluation gains as income for the purposes of setting charges. Only half of actual revaluations were treated as income in the last pricing period.

- ***Wellington Airport is not limited in its ability to extract excessive prices***

Wellington Airport continues to rely heavily upon its right to set charges as it thinks fit under the Airport Authorities Act 1966 (AAA). The Airport has not been limited in any way in its ability to extract excessive profits. It has set what independent analysts have described as 'eye-watering' increases in charges which equate to an increase of 6.2% per annum for every passenger for each of the five years of the next pricing period. Charges per passenger will increase from \$10.70 in FY12 to \$14.43 in FY17. The Airport's aeronautical revenue will increase by approximately 9% per annum during the five year pricing period from \$56m in FY12 to \$86m in FY17, a 54% increase over five years. Overall BARNZ estimates that airlines will end up paying

¹ In FY12 there was \$55.744m in revenue from airport charges and 5.208m passengers.

² In FY17 WIAL forecasts receiving \$85.85m in revenue from airport charges and 5.949m passengers.

\$99m more in charges to Wellington Airport than would be the case if revenue requirements had been determined applying the Commerce Commission input methodologies and principles.

It is quite clear that, in the case of Wellington Airport, information disclosure under Part 4 has not effectively promoted the outcomes sought under section 52A. The Airport has continued to set charges using the same approach as it always had under the AAA and has not modified its behaviour in any way, with large excess returns being earned, primarily through regular asset revaluations not being treated as income in the charge setting process, and then subsequently being used as the basis for it further increasing its charges.

Part 4 seeks to balance the interests of acquirers and suppliers

At the beginning of the Conference Commissioner Duignan stated that the Commission needed to form a *'judgment regarding the effectiveness of ID in promoting outcomes consistent with WIAL having both incentives to innovate and invest, and being limited in extracting excessive profits, because it's the balance to achieve both of these objectives that is one of the key aspects of Part 4'*.

BARNZ agrees with this statement, which very succinctly summarises the opposing tensions.

BARNZ fully acknowledges that Airports have to have sufficient incentives to invest, or else they will not construct the facilities which airlines require in order to provide air travel and air freight services to the public of New Zealand and visitors to New Zealand.

However, Part 4 is not solely concerned with economic efficiency. The Government made a conscious decision as it designed Part 4 to recognise the interests of both suppliers and of purchasers of services within the regulatory control provisions of the Commerce Act. Unlike some overseas regulatory regimes, which are only concerned with economic efficiency, Part 4 of New Zealand's Commerce Act is concerned both with the net public benefit and with whether monopoly pricing is occurring. Transfers of earnings from suppliers of monopoly services to acquirers of monopoly services are directly relevant to considerations under Part 4.

The purpose of Part 4 is to achieve outcomes which ensure that suppliers have sufficient incentives to invest, while at the same time ensuring that suppliers are limited in their ability to extract excessive profits from consumers.

BARNZ does not consider that information disclosure regulation under Part 4 has been able to achieve this purpose in the case of Wellington Airport, which has continued to rely on its ability to set charges as it thinks fit under the AAA to set charges which contain substantial monopoly profits.

BARNZ also observes that, in this case, ensuring suppliers are limited in their ability to extract excessive profits, can also act as an incentive for airlines to innovate and invest in facilities at Airports in New Zealand. If the risk of excessive pricing is too high, then airlines may be reluctant to invest at, or even operate services to, a particular airport and become captive to ongoing excessive pricing.

The inter-relationship between the section 56G Inquiry and the input methodologies

The Airports are submitting that the Commission is limited to reviewing the information disclosed by the Airports under the Information Disclosure requirements, with the input methodologies specified by the Commission not being relevant as to whether information disclosure is effective.

BARNZ does not see how the Commission can assess the effectiveness of information disclosure regulation, and in particular whether or not the ability of an Airport to extract excessive returns has been limited, without comparing both the inputs used by the Airports to set charges, and actual and forecast outcomes, as against the input methodologies determined by the Commission.

Input Methodologies are an integral part of Information Disclosure Regulation. It is entirely artificial to characterise the input methodologies as being separate from, and not forming part of, information disclosure regulation. The Commerce Act very specifically incorporates the input methodologies into the heart of each form of regulation available under the Act. Specifically in relation to information disclosure regulation of Airports:

- Section 56E of the Commerce Act requires the Commission to make a determination under section 52P that determines how information disclosure regulation will apply to each supplier of specified airport services.
- Section 53C sets out the content which must be included in every section 52P determination in the case of information disclosure regulation. Section 53C(1)(g) expressly requires that the section 52P determination in relation to information disclosure regulation ***must specify the input methodologies that apply***.
- Section 52P(3)(c) also requires that determinations by the Commission of how regulation will apply must specify the input methodologies that will apply.
- Section 53F expressly confirms that the Commission may use the input methodologies to monitor and analyse information under section 53B.

In BARNZ's view, it is not feasible to suggest that a requirement to review the effectiveness of information disclosure regulation is limited to the outcomes disclosed by the information required to be disclosed, and without considering the input methodologies. Input methodologies are an essential part of information disclosure regulation, and form part of the core information disclosure requirements. One only needs to glance at the Commission's Airport Services Information Disclosure Determination to appreciate the level of cross-referencing which is made to the Airport Services Input Methodologies Determination. The two are inextricably inter-twined.

The fact that the Commission is expressly permitted to utilise the input methodologies when monitoring and analysing the disclosed information under section 53B highlights how absurd the submission is that the input methodologies may not be considered in the section 56G review of how effectively information disclosure regulation is promoting the purpose in section 52A.

When the statute in section 56G directs the Commission to review how effectively information disclosure regulation under this Part is promoting the purpose of section 52A, the intention was

clearly to incorporate all aspects of information disclosure regulation. This includes the input methodologies, which are a mandatory and key component of information disclosure regulation.

In BARNZ's view, the only way the Commission can assess how effectively information disclosure regulation is promoting the long term interests of consumers, and in particular whether suppliers have been limited in their ability to extract excessive profits, is by comparing the inputs to, and the outcomes of, the price setting event, as against the applicable input methodologies.

The central nature of the input methodologies in the information disclosure regime also answers the Airports' allegations that it is too early to review the Regime. The input methodologies have been determined and have been known for two years now. The effect of this key component of the information disclosure regime is readily able to be assessed as against the outputs of the Airports' price setting events.

2. QUALITY

BARNZ confirms the overall impression recorded by Chairman Berry that service quality is not a material issue between Wellington Airport and BARNZ members.

There are not any issues BARNZ is aware of where the quality of service provided by Wellington Airport is below that desired by airlines.

On the other hand, as outlined at page 22 of BARNZ's 28 June Issues Paper Response, BARNZ considers that Wellington Airport has undertaken investment at a level of quality greater than considered efficient by airlines. In particular, the recent Rock development was constructed using a unique multi-faceted architectural design, rather than a cost efficient modular design as was the case with the original terminal structure constructed in 1998. When the extensions to the international terminal were mooted during pricing consultations in 2007, BARNZ noted that insufficient consultation on design had occurred. This was at a time well before any suggestion of the ultimate copper-sheathed multi-faceted structure known today as The Rock. The Airport advised in its Final Pricing Proposal in 2007 that issues of optimisation and of over-design in terms of quality would be addressed in the 2012 consultation.³ That has not occurred.

In addition, the tunnels forming part of the RESA⁴ solution have been constructed to the size required by Code E aircraft, which are not likely to operate scheduled services to Wellington Airport. Airlines and passengers are therefore being charged for a return on and of both of these items of capital expenditure, notwithstanding that they are of a higher quality or size than that required by current users of Wellington Airport.

The Commission tested whether ID Regulation had had any impact on the quality of services provided at Wellington Airport. BARNZ confirms that it has not noticed any changes in the quality of service (either for better or for worse) at Wellington Airport or in the behaviour of the Airport in relation to the quality of services since the introduction of Part 4 ID Regulation.

³ See WIAL's Final Pricing Proposal, 9 May 2007, page 39

⁴ Runway End Safety Areas

3. REVENUE AND PROFITABILITY

How to do the numbers?

Commissioner Duignan asked a series of questions essentially concerning how the profitability in any given year, or pricing period, should be assessed, in light of adjustments made for matters over two pricing periods. Specifically, Commissioner Duignan requested interested parties' views on:

- When should the \$11m capex wash-up which arose out of The Rock being constructed later than forecast be treated as income for the purposes of assessing profitability – in the first pricing period when the revenue was paid by the airlines or in the second pricing period when the revenue was treated as a credit by the Airport as it set charges?
- When should the \$14.5m revaluation credit being applied by the Airport be treated as income for the purposes of assessing profitability – in the first pricing period when the revaluation occurred or in the second pricing period when it was treated as a credit by the Airport as it set charges?
- When should unexpected revaluations be treated as income for the purposes of assessing profitability?

Profitability can be judged over varying periods — a year, a pricing period, or a number of pricing periods. The most meaningful period in this context is a pricing period because prices remain set for those periods.

In order to assess profitability in a pricing period, any revaluations made during the pricing period should be treated as income as they form part of the profit made in that period.

In accounting terms, adjustments often need to be made if payments relate across two periods. Thus, while in general revenue should be treated as income in the period in which it is received, BARNZ considers that, where there is a firm commitment by an Airport to treat a particular class of revenue as income in the next pricing period, then that revenue amount represents an over-payment by the airlines and a liability to the Airport at the end of the first pricing period, and should be treated as reducing the profitability of the first pricing period, and should be treated as income in the second pricing period. On the other hand, if there is not a firm commitment by the Airport to treat the revenue in question as income in the next pricing period, then the general rule should apply and it should be considered to be income earned in the first period, increasing profitability in that period.

Applying this principle to Commissioner Duignan's questions on 'how to do the numbers', the answers are as follows:

- The \$11m capex wash-up which arose due to The Rock being constructed later than forecast should be regarded as a liability of the Airport at the end of the FY08–FY12 pricing period, reducing profitability in that period, and correspondingly be treated as income in

the second pricing period for the purposes of assessing profitability because the Airport committed to undertaking this wash-up when it set charges in 2007.

- The \$14.5m revaluation credit applied by the Airport to part of the un-forecast revaluations (representing its calculation of the difference between the Airport's revaluation forecasts and BARNZ's revaluation forecasts) should be regarded as a liability of the Airport at the end of the FY08–FY12 pricing period, reducing profitability in that period, and correspondingly be treated as income in the second pricing period because the Airport committed to undertaking this wash-up as it set charges in 2007.
- The remaining unexpected revaluations of \$62.7m should be treated as income in the first pricing period for the purposes of assessing profitability, with no adjustment made, because there was no commitment by the Airport to treat it as income in the second pricing period.

The effect of moving the treatment of the committed revaluations as income from the FY08 to FY12 pricing period to the FY13 to FY17 pricing period is to:

- Reduce the levels of return earned in the FY08 to FY12 pricing period by approximately 1.4% per annum on average (from 12.4% pa to 11% pa)
- Increase the levels of return forecast to be earned by Wellington Airport on its MVEU asset base in the FY13 to FY17 pricing period by approximately 1.4%⁵ (from 8% pa to 9.4% pa)

Going forward, once there is a history of disclosure over a number of years (and pricing periods) this will ensure that the Commission and interested persons should be able to look back over a number of years and/or pricing periods and reach an informed view of profitability.

However, in the present situation, where information disclosure under Part 4 only commenced with the first disclosures occurring in FY11, then there is a real risk that the full picture over the first and second pricing periods will not emerge, and revaluations or inter-period adjustments will effectively fall between the gaps of the old AAA information disclosure and the new Part 4 information disclosure requirements, and will not be reflected in the Commission's analysis. If revaluations and adjustments occurring as part of the transition between the two regimes are not taken into account, then the analysis or 'the numbers' will only tell a partial story. This risk is discussed in greater depth later in the following sub-section. It suffices to record here that Wellington Airport did not highlight to the Commission the 15% return on assets it earned in FY09 when specialised assets were revalued by \$30m, or the impact on the returns earned in relation to the pricing asset base which was further revalued by the Airport by just over \$100m in FY11. Together these revaluations totalled \$131.9m⁶, but this has not been reflected in Wellington Airport's focus on its perceived 'under-recovery' in FY11 and FY12.

⁵ This calculation is based on WIAL's inputs to its final pricing determination, which was based on its MVEU valuation methodology. The increased level of return using an MVAU asset base or the BARNZ inputs based on the PAL valuation will differ. The calculations supporting this figure are set out in **Attachment 3**.

⁶ Refer Attachment 1 to BARNZ's Post Conference Submission, which contains the statement provided by Wellington Airport to BARNZ during consultation setting out Asset Base Movements from 2006 to 2011 and Wellington Airport's Revaluation Wash-up Analysis, also provided to BARNZ during consultation. Both documents disclose revaluations over \$130m occurring over the previous pricing period.

BARNZ considers that Wellington Airport's focus on FY11 and FY12, with an alleged 6% to 7% returns on a significantly revalued asset base, presents an incomplete, and misleading, picture. BARNZ therefore believes that in this transitional period the Commission needs to also prepare an accurate statement of the returns earned by the Airport (including revaluations) over the last five years on its pricing asset base. This is discussed further in the next sub-section.

BARNZ also notes the importance of the Commission being alert to the accuracy of forecasts and whether there is evidence of divergences that favour the Airports occurring systematically — for instance, regular under-forecasting of asset revaluations, front-end loading of the capital expenditure profile, over-forecasting of operating expenditure or under-forecasting expected passenger volumes by the Airports in their charge setting decisions. This was the point made by Dr Layton at pages 19 to 20 of the Transcript in relation to the accuracy of the forecasts made and any systematic bias influencing the forecasts.

The level of past profitability

During the Conference Wellington Airport made much of its claimed under-recovery, with the Airport characterising itself as only having earned returns of 6% to 7% in FY11 and FY12. BARNZ has not seen the FY12 Disclosure Accounts as they have yet to be published by the Airport. Therefore BARNZ cannot comment on the FY12 returns until those Disclosure Accounts are published. We seek the opportunity to do so when that occurs, if this is necessary.

However, as noted above, BARNZ is firmly of the view that Wellington Airport's focus on FY11 and FY12 presents an incomplete, and misleading, picture.

Wellington Airport has failed to mention that in FY09 it made a \$32.5m revaluation of its specialised assets, some \$29.4m of which is attributable to the pricing asset base. The post-tax return earned by the Airport in FY09 is therefore approximately 15%, well in excess of both its cost of capital and the Commission's estimate of a reasonable WACC range for an Airport, and the 6% to 7% range of returns emphasised by the Airport.

Wellington Airport also failed to mention that in FY11 it revalued its pricing assets by a further \$100m. This figure is the level advised to the Airlines by WIAL during consultation, with the relevant documents contained in **Attachment 1** to this Submission. To date, this \$100m revaluation has not, to BARNZ's knowledge, been disclosed as a revaluation included in Wellington Airport's Information Disclosure Accounts. Part of the \$100m will be attributable to WIAL's adherence to the MVEU valuation methodology it espouses, which does not form part of the Commission's Input Methodologies and reporting requirements. Part of the \$100m revaluation is also likely to be attributable to the Airport having reallocated its underlying valuation between the pricing asset base and other regulated assets. Part of the revaluation is also likely to be due to increases in the underlying land valuation. However, it is extremely unclear. The lack of clarity and lack of disclosure of this highly significant level of revaluation demonstrates both that:

- Section 53A is not being met, with interested persons not having sufficient or clear information in this regard, to form a conclusion about the performance of the assets which are used to set

the charges consulted on and set under the AAA. This is a direct result of the Disclosure Statements not requiring:

- separate disclosure of the performance of the assets used to set prices under the AAA activities
 - the breakdown of the initial asset base and asset base movements by classes of assets for each of the three segmented activities in schedule 4 and/or schedule 7 of the information disclosure templates
- Section 52A(1)(d) is not being promoted as the Airport does not have any limitation on its ability to extract excessive profits, and has been able to disguise the level of returns it has actually earned on its pricing asset base, as a result of it not having had to clearly disclose the revaluation movements of these assets.

When the \$30m revaluation of specialised assets in FY09 is taken into account, and when the \$100m of assets in FY11 is taken into account, then it appears that the return on the pricing asset base over the FY08 to FY12 pricing period is in the vicinity of:⁷

- 11% per annum if the committed wash-ups are not treated as income in the FY08 to FY12 pricing period; or
- 12.4% per annum if the committed wash-ups are treated as income in the FY08 to FY12 pricing period.

Over this period returns were as high as 30% in FY11 when the largest revaluation occurred, but as low as 5% in the lowest non-revaluation years. However, on average the return on assets included in the pricing asset base was between 11% to 12% per annum, depending upon the timing of treating the wash-ups as income. This is vastly different from Wellington Airport's portrayal of it having been under-recovering, only earning returns around the 6% to 7% mark.

The estimated 11% to 12% return over the last pricing period has been calculated based on the various sources of information BARNZ has been provided with during consultation in 2006-7 and 2011-12. A spread sheet is attached in **Attachment 2** setting out the calculation and information sources utilised.

BARNZ acknowledges that it does not have a precise view of the performance of Wellington Airport's pricing activities because the outturn of the pricing activities over this period has never been separately disclosed by Wellington Airport.

BARNZ therefore suggests the Commerce Commission request that Wellington Airport prepare an accurate statement of the returns earned by the Airport (including revaluations) over the last five years on its pricing asset base.

In the absence of this information, BARNZ urges the Commerce Commission to treat Wellington Airport's claimed returns of 6% to 7% in FY11 and FY12 with a high degree of scepticism and as only resenting a partial picture and not being an accurate reflection of the recent performance of Wellington Airport.

⁷ The calculations supporting these figures are set out in **Attachment 2**.

Wellington Airport has also claimed that the unexpected GFC led to the Airport having lower passenger volumes than it forecast. This is untrue. Wellington Airport had more passengers, both international and domestic, than it forecast in every year of the previous pricing period, with total international passengers exceeding WIAL's forecasts by 1.5% and total domestic passenger exceeding WIAL's forecasts by 6.1% over the last pricing period.

Comparison Actual Passenger Volumes as Against Forecast Passenger Volumes

000 pax	FY08	FY09	FY10	FY11	FY12	Total
Domestic forecast	4,058	4,140	4,222	4,350	4,480	21,250
Domestic actual	4,418	4,645	4,491	4,480	4,510	22,544
International forecast	590	604	620	650	682	3,146
International actual	603	611	627	655	698	3,194

Wellington Airport has also claimed that it set charges expecting to earn a predicted 8% to 9% return. As illustrated by BARNZ above, when revaluations are treated as income, then the Airport earned returns of 11% to 12% per annum, depending upon the timing of the treatment of the wash-ups as income. Moreover, BARNZ notes that during the previous pricing period Wellington Airport exceeded both its forecast revaluations (which it forecast as \$54.6m, but which eventuated as \$131.9m) and its forecast revenue from charges (which it forecast at \$246.3m but which totalled \$252.5m).

Comparison Aeronautical Revenue from Charges as Against Forecast

\$ 000	FY08	FY09	FY10	FY11	FY12	Total
Forecast Revenue from Charges	46,020	47,995	49,006	50,726	52,510	246,257
Estimated Revenue from Charges	44,663	48,733	50,430	52,953	55,744	252,523

Treatment of previous revaluations

WIAL's inclusion of only forecast revaluation movements as income in the charge setting process, with a relatively minor additional wash-up, as opposed to actual revaluations, is not valid. It results in the airport retaining substantial windfall profits due to actual revaluations having exceeded the amount forecast. These windfall profits were made at the expense of airlines and the travelling public. This is directly contrary to the purpose of Part 4 as set out in section 52A which specifically contains as one of its outcomes limiting the ability of suppliers to extract excessive profits.

The economic advice which BARNZ has previously received, and provided to the Commission during the development of the input methodologies, was very clear. Where prices are set using a nominal WACC on a revalued asset base, then all revaluations must be treated as income in order to avoid breaching the NPV=0 principle.

The Commerce Commission has accepted this principle and applied it in the development of its input methodologies and information disclosure requirements, noting that all revaluations, not just forecast revaluations as alleged by WIAL, need to be treated as income when assessing profitability.

The Commission has stated:⁸

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

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

BARNZ is therefore very concerned with the language being used by the Commissioners during the Wellington Airport Conference, when the concept of ‘sharing’ unexpected revaluations was referred to on a number of occasions.⁹ The NPV = 0 principle does not equate to the airport “sharing revaluations” with airlines. The principle requires that **all** revaluations of assets incorporated into asset values used for calculating charges must be treated as a return to the airport in the charge setting process. It is not consistent with the principle if only a share of the revaluations is treated as a return to the airport in the charge setting process, with the remaining share instead being retained for the benefit of the airport.

In the present situation, WIAL’s consultation material¹⁰ highlights that by the Airport’s calculations:

- Revaluations of the pricing asset base of \$131.9m occurred from FY08 to FY12
- WIAL forecast \$54.6m of revaluations as income when it set charges in 2007
- WIAL is applying a \$14.5m credit in the next pricing period¹¹

Applying those figures, this means that \$69.1m or 52% of revaluations will have been treated as income in the charge setting process over the two pricing periods (through a combination of the forecasts and \$14.5m wash-up) and \$62.8m or 48% of those revaluations will not have been treated as income in the charge setting process. This approach effectively means that the NPV = 0 principle is breached by \$63m – just for the previous pricing period.

Wellington Airport has a long history of under-forecasting revaluations at a substantially lower level than actually occurs, and then retaining the benefit of the un-forecast revaluations for itself, despite having set charges for users with a nominal WACC on the revalued asset base, and continuing to set

⁸ Commerce Commission Input Methodologies (Airport Services) Reasons Paper, para 2.8.14-15

⁹ See for example page 33 of the Transcript, per Commissioner Duignan

¹⁰ This key documents from consultation setting out the amounts of actual and forecast revaluations are reproduced in Attachment 1 to this Submission

¹¹ BARNZ notes in passing that it does not accept that Wellington Airport’s calculation of the wash-up to be applied is correct. The Airport has escalated the 2006 valuations, without that escalation being declared or treated as revenue, and its figures for forecast valuations do not match the final pricing models of either the Airport or BARNZ. BARNZ agrees with the comment by Sean Ford that there is a degree of ‘murkinness’ in how the wash-up has been applied. However, BARNZ does not see any significant benefit in the Commission endeavouring to unravel this as, first, there is no real precedent value in terms of pricing principles as to the means of calculation in this ‘one-off’ situation, and secondly, BARNZ firmly adheres to the principle that where charges are being set off a revalued asset base, then all revaluations (whether expected or unexpected) have to be treated as income in the charge setting process. The wash-up adopted by Wellington Airport was a unilateral solution selected by the Airport, and not one which BARNZ accepts or would have accepted as appropriate.

charges using a nominal WACC on the revalued asset base – including the revaluations not treated as income. This also occurred in 2007 where revaluations exceeded the amount forecast by WIAL by \$118.8m over the FY02 – FY07 pricing period.¹²

It has occurred again just now with \$63m of un-forecast revaluations not being treated as income in the charge setting process (and also not appearing to even be disclosed in the Airport's Disclosure Accounts). There is every chance it will occur again in FY17, as the Airport is continuing to maintain the position that it has the right to set prices off an asset base which includes any unexpected revaluation gains and does not need to reflect such gains as income in the charge setting process, meaning that the Airport effectively retains the benefit of a large proportion of revaluations, even where the NPV = 0 principle is breached.

Clearly, information disclosure alone has proved completely unable to limit the ability of the Airport to extract excessive returns through the practice of undertaking regular revaluations, setting charges using the revalued asset base, but not fully treating those revaluations as income for the purposes of setting charges. Information disclosure regulation has not produced any behavioural changes in the pricing behaviour of Wellington Airport in this respect.

The Independence and Qualifications of BARNZ Valuation Advisers

At the Conference the independence and qualifications of BARNZ's expert advisers were subject to a sustained, and repeated attack by Mr Fitzgerald for Wellington Airport. BARNZ strongly refutes Mr Fitzgerald's slurs on the expertise and independence of the experts engaged by BARNZ, and does not consider such comments appropriate or helpful.

Indeed, the attitudes displayed by Mr Fitzgerald highlight the approach which Wellington Airport took to the consultation process, regarding its own experts as being of definitive standing, and applying little regard to the material supplied by or views expressed by BARNZ or its expert advisers. In BARNZ's view, the consultation process which occurred was a sham, with the Airport not having an open mind as required by the legal principles of consultation, but instead engaging in a series of carefully choreographed pre-planned adjustments designed to falsely paint a picture of it having an open mind. The reality was that Wellington Airport was not listening to the Airlines, and the comments by Mr Fitzgerald before the Commission starkly demonstrate the disregard with which the Airport treated submissions made by, or reports prepared for, the Airlines as part of consultation.

BARNZ confirms that it has engaged all of its experts as independent experts, ensuring they are aware that all advice must be prepared in accordance with the High Court Rules for expert witnesses, as this would be the basis on which the Commerce Commission would require experts to provide advice in the forthcoming section 56G reviews. It would be a derogation of BARNZ's duty to its members for BARNZ to do otherwise. Members, particularly overseas based airlines, rely heavily

¹² Refer Attachment 2, BARNZ Submission on Commerce Commission Input Methodologies Discussion paper, 31 July 2009 which contains WIAL's summary provided during consultation showing that actual revaluations were \$135.6m, forecast revaluations were \$16.8m, therefore the level of un-forecast revaluations was \$118.8m.

on BARNZ for objective and unbiased advice with respect to the regulatory rules and requirements in New Zealand regulating the behaviour of Airports. For BARNZ to instruct experts in a biased manner to act as advocates rather than as an independent expert would be for BARNZ to mislead its members, waste money and necessarily damage its reputation and its standing, even assuming BARNZ was able to locate an 'expert' so careless of his or her own reputation and so lacking in integrity that they would act that way.

BARNZ has every confidence in the independence and standing of the expert advisers it has engaged to review Wellington Airport's land valuation and to prepare an independent valuation.

Mr Mike Foster

Mr Mike Foster of Zomac Planning Solutions was engaged by BARNZ to provide advice on the alternative land use plan proposed by Boffa Miskell for Wellington Airport, and, if necessary, to advise an appropriate alternative land use mix following the Commission's Schedule A specifications.

Mr Foster is a senior planner with over 35 years of experience in some of the most complex urban land developments in New Zealand. There would be very few planners in New Zealand with more experience in major infrastructure planning and projects than Mr Foster. He was a member of the Resource Management Act Streamlining and Simplifying Technical Advisory Group, appointed by The Minister for the Environment. He is the Chairman of the Infrastructure Technical Advisory Group, established also by the Minister for the Environment. He was Director of Planning for Beca Carter Hollings & Ferner Ltd for 16 years, from 1985 until 2001, when he set up Zomac Planning Solutions as an independent planning consultant. Mr Foster's CV is attached as **Attachment 4**. Projects which Mr Foster has been involved in, which are of particular relevance to his expert ability to comment on Wellington Airport's alternative land use plan, include:

- Team Leader of the specialist consultant team engaged by Westfield NZ Ltd from 2003 to 2008 to obtain planning consent for Stages 1 and 2 of the Albany Town Centre, which will ultimately comprise an 85 000m² retail shopping mall when stages 1 and 2 are complete.
- Principal Specialist Retail Planning Adviser to Progressive Enterprises Ltd since 2000, which has included involvement in the selection, acquisition and consent of over 30 new or expanded supermarkets throughout New Zealand.
- The Project Director responsible for obtaining all statutory approvals and planning elements for the redevelopments of the St Lukes Shopping Centre from 1988 to 2000 and the Glenfield Shopping Centre from 1995 to 1999
- Project Director for work undertaken by Beca Carter Hollings & Ferner Ltd on the redevelopment of the Viaduct Basin in Auckland from 1989 to 1996
- Principal concept and strategic planning advisor for the redevelopment of 40 hectares of vacant commercial railway land adjacent to the Rotorua CBD
- Project Director responsible for the concept sub-division plan of Westfield Industrial Park comprising 40 hectares of industrial land in Mt Wellington.

Mr Dougal Smith

Mr Dougal Smith of Property Advisory Ltd was engaged by BARNZ to review the land valuations undertaken by Telfer Young for Wellington Airport, and to prepare a market value alternative use valuation of Wellington's Airport's land holdings following the Commerce Commission's requirements in Schedule A.

Mr Smith is a Director of Property Advisory Ltd. He is a registered valuer with considerable expertise in valuation of residential and industrial block land, investment property and specialised assets. He holds a Bachelor of Commerce, Valuation and Property Management. The company profile of Property Advisory is attached as **Attachment 5**.

Market Economics

When the discrepancy between the views of Boffa Miskell and Zomac Planning Solutions regarding the amount of commercial and retail land which was likely to be feasible and permitted to be developed on the Airport site came to light, BARNZ engaged Market Economics to independently assess the current and future demand for potential retail land use on the site, including undertaking an economic assessment to place the resulting likely supply in the context of the future demand environment for the area. BARNZ had not previously engaged Market Economics.

Market Economics is one of New Zealand's leading independent consultancies. Established in 2001, it specialises in both market and economic analysis and environmental and ecological research. With respect to market analysis, it assesses markets and identifies and quantifies their scale, growth and change. Market Economics has a detailed understanding of the expected future growth of residential and business activity (industrial, commercial and retail) and has access to comprehensive datasets and interactive modelling to support its analysis.

Market Economics lists major land development companies amongst its clients such as Westfield, AMP Capital Shopping Centres, Kiwi Income Property Trust and Progressive Enterprises. It is therefore ideally qualified to quantify the likely future demand of retail space on the Wellington Airport site, were the Airport to cease operating.

The MVAU valuation

As was highlighted at the Conference, the primary factor causing the difference in the MVAU valuation advised by Telfer Young to Wellington Airport of \$1.4m per ha, and that advised by Property Advisory Ltd to BARNZ of \$0.95m per ha, is the alternative land use plan. The key differences are the amount of retail space, and whether a business park was feasible. The land uses are summarised below:

Land Use	Boffa Miskell	Zomac Planning
Town centre	7.5 ha (46 000 – 53 000 m ²)	2 ha (14 000 m ²)
Large format retail	10.4 ha (36 000 m ²)	5 ha (25 000 m ²)
Business park	13.7 ha	0 ha
Apartments	23.5 ha	21 ha
Townhouses/detached dwellings	24.0 ha	45 ha
Open space/parks	9.6 ha	10 ha
Roads	21.0 ha	20 ha
Total	109.7 ha ¹³	103 ha

As noted above, when this difference between the views of Boffa Miskell provided to Wellington Airport and Zomac Planning Solutions provided to BARNZ became apparent, BARNZ commissioned additional economic analysis from Market Economics of the underlying demand for retail land use in the catchment around the Wellington Airport site. BARNZ notes that Wellington Airport had not (and subsequently has not) obtained any equivalent economic analysis of the demand for retail land uses in the catchment area surrounding the site.

The advice received from Market Economics was that demand would exist for 30 000m² to 45 000m² additional retail floor space. The 39 000m² proposed by Zomac Planning Solutions falls squarely within this range. The 80 000m² proposed by Boffa Miskell is double the demand for retail space identified by Market Economics as being sustainable. Market Economics concluded that the new retail/commercial centre developed on the Wellington Airport land would have a role of more than a small local centre but less than as a sub-regional centre. In Market Economics' view, it would be unlikely to lead to a decrease of the Kilbirnie sub-regional role, which was what Telfer Young was predicting.

The alternative land use plan forms the foundation on which the alternative land use valuation sits. The advice obtained by BARNZ from Zomac Planning Solutions, and independently confirmed by the additional work commissioned from Market Economics, point to the Boffa Miskell alternative land use plan having significantly greater commercial retail space than demand exists for within that area of Wellington. BARNZ therefore holds serious doubts as to the appropriateness of the \$1.4m per ha alternative use valuation adopted by Telfer Young, with the advice BARNZ has received indicating that the Telfer Young valuation is significantly overstated.

BARNZ urges the Commission to engage its own independent valuation advisers, as the Commission did during the Airport Price Inquiry, to determine an appropriate land valuation. Without independent verification of the appropriate MVAU value, the Commission will not be able to clearly assess the level of profitability of the Airport. Wellington Airport has claimed its level of return will be 8% at its MVEU valuation and 8.9% if its MVAU valuation is applied. However, if the Property Advisory MVAU valuation is applied, then the forecast level of return will be approximately 10% (and close to 11% if the committed revaluations are treated as income in the FY13 to FY17 pricing period).¹⁴ It is imperative that the Commission form a view on the validity of the alternative land uses and resulting land valuation.

¹³ The Boffa Miskell land use areas were then proportionally reduced to the 103 ha of aeronautical land

¹⁴ The calculations supporting this forecast return are set out in **Attachment 3**.

Looking forward, if Wellington Airport was subject to negotiate-arbitrate regulation, then differences over land valuations would be well-suited to a specific and confined referral to arbitration, applying the Commission's valuation principles in Schedule A.¹⁵ However, as Wellington Airport is only subject to information disclosure regulation, this avenue is not currently open to the Commission. Hence BARNZ considers that the only viable solution is for the Commission to engage its own independent valuer, and potentially, planner as well.

Improvements to Schedule A

The Commission has expressly requested that the parties, and their expert advisers, give consideration as to how the specifications in Schedule A could potentially be improved so as to reduce or limit the likelihood or scope of the differences in alternative land uses and resulting valuations which have been highlighted in relation to Wellington Airport's land valuation.

BARNZ has sought the advice of Mike Foster, Dougal Smith and Dr Layton on this issue. The view among these experts is that Schedule A is focused primarily on providing directions to the valuer. However, the valuation is first and foremost an output of the alternative land use plan. There is minimal direction contained in Schedule A with regard to the development of the alternative land use plan. This is the area where the Commission could easily improve the specifications provided.

The primary concern of both Mr Foster and Mr Smith is over the absence of any requirement to undertake independent economic based demand analysis for potential alternative uses of the land. This is considered necessary as the first step in the process, so that the land is placed in the context of the future demand environment for various land uses in the area, before the land use plan is developed. If Wellington Airport, or its advisers, had commissioned work of a similar nature to that undertaken by Market Economics for BARNZ, then it is unlikely that Boffa Miskell would have put forward an alternative land use plan containing a retail land area comprising double the space for which demand exists or is likely to exist. It is suggested that this requirement be inserted as a new A10(f)(i). Given that the demand for the various alternative land uses is such a critical factor in developing the alternative land use plan, BARNZ believes that the need for this work should be expressly recognised and spelled out within Schedule A.

Secondly, Mr Smith considers that the current A10(f)(ii), which concerns market demand for the proposed development (ie once the land use plan has been developed) needs to be split into two distinct requirements. The first stage should be the determination of market demand for the proposed land development plan (in light of the independent economic analysis of demand for

¹⁵ As an aside, BARNZ briefly notes that the arbitration over land valuation methodologies, referred to several times by Mr Fitzgerald, which occurred in 2003 between Wellington Airport and the Airlines, was undertaken under the 'guiding' auspices of the Airport Authorities Act. The Arbitrator regarded the statute, containing the right for airports to set charges as they think fit, as the starting point, and concluded that as a matter of statutory interpretation, since Airports have the right to set charges as they thought fit, and were directed to act commercially by the Act, then it was open for the airport to use the MVEU valuation methodology. The arbitral determination was in essence an affirmation of the lack of restraints on airports under the Airports Authorities Act, and the right Airports have to set charges as they think fit, as opposed to a positive endorsement of the appropriateness of the MVEU valuation methodology.

alternative land uses undertaken earlier). Secondly, in light of that demand, the determination of the time period for the sale or realisation of the developed land needs to be determined. These are distinct issues, and Mr Smith considered that they have not been given the separate consideration necessary in order to have a realistic outcome.

Third, Mr Foster has suggested the addition of the principle of the development being credible, which he advises is a well-known and understood Resource Management Act criterion. Mr Foster has informed BARNZ that Resource Management Act case law frequently refers to a development or land use as needing to be 'credible' and 'non-fanciful'. He has referred to the Environment Court in *Kaikaiawaro Fishing Co Ltd v Marlborough DC*¹⁶ phrasing the question as being 'What could be done on site as of right involves credible developments, not purely hypothetical possibilities which are out of touch with the reality of the situation'. BARNZ therefore suggests that the addition of a requirement that the alternative land use be 'credible' would help reduce potential differences of expert opinion with respect to the alternative land use plan.

BARNZ has tracked these suggestions on section A10 of Schedule A for the Commission's consideration. This is attached as **Attachment 6**.

The use of MVEU

At pages 62 to 65 the Commissioners appeared to be testing the view that the impact on airport charges of any uplift in valuation caused by applying an MVEU valuation methodology, which includes holding costs, is diluted by the treatment of revaluations as income.

If revaluations were treated by the Airport on an NPV = 0 basis, with all revaluations being treated as income, then this would hold true.

However, this is not the case as Wellington Airport only treats forecast revaluations as income, and (with the exception of a one-off relatively small partial wash-up adjustment) does not treat unexpected revaluations as income in the charge setting process.

As has been noted above, current best estimates indicate that \$63m of revaluations from the previous pricing period just concluded were not treated as income. In its submissions to the Input Methodology Determination process, BARNZ identified that from 2002 to 2006 Wellington Airport booked \$118.8m of revaluations which had not been treated as income. The level of un-forecast revaluations is therefore considerable. Any uplift in the asset valuation due to using the MVEU valuation methodology is therefore extremely unlikely to be fully treated as income by Wellington Airport.

In any event, BARNZ does not consider that MVEU is an appropriate valuation methodology as is quite plainly not the opportunity cost.

¹⁶ (1999) 5 ELRNZ 417

The incentive scheme

There was some discussion (particularly at pages 25 and 97 – 99 of the transcript) about the incentive scheme and its costs. The Commission has asked for further information on whether it benefits passengers and will result in lower average charges.

Wellington Airport extensively quoted that the scheme will generate an additional 885 000 passengers, and will reduce the average charge per passenger by about 43 cents (refer for example to page 26, line 20 of the Transcript).

BARNZ has considerable difficulties following the Airport's claims and believes the Airport needs to clearly substantiate these before they can be relied upon.

The cost of the incentive scheme, as disclosed in WIAL's Final Pricing Determination, is \$10.9m over the pricing period. As shown in the table below, this represents a cost of \$12.28 per additional passenger, as compared with the average charge per passenger of \$12.93 set by WIAL. The effective revenue earned by WIAL per passenger within the incentive scheme is therefore 65 cents per passenger, which represents approximately \$575 000 of revenue over the five years. If the \$10.9m costs of the incentive scheme (as disclosed in WIAL's Financial Pricing Determination) are stripped out of the revenue sought, and the passenger volumes reduced by the incentive scheme passengers, then the average cost per remaining passenger is two cents higher. BARNZ cannot see how the Airport's claim of a benefit of 42 cents per passenger is determined.

The facts of the incentive scheme

	The incentive scheme costs	Average charges set by WIAL	Average charges with cost of incentive scheme backed out
Pax volumes	0.885m pax	28.04m pax	27.15m pax
Total cost/revenue	\$10.87m	\$362.5m	\$351.6m
Cost/revenue per pax	\$12.28 per pax	\$12.93 per pax	\$12.95 per pax

Moreover, BARNZ seriously questions WIAL's assertion that the incentive scheme will be responsible for an additional 885 000 passengers. This represents nearly half of WIAL's forecast passenger growth over the next five years. If correct, this means that WIAL considers that without the incentive scheme the average passenger growth will only be 1.4% pa over the pricing period. This is the level of growth which occurred in FY12, when passenger growth was still affected by the continuing aftermath of the GFC. It means that WIAL is adopting the position that, without the incentive scheme, there would be no improvement in levels of passenger growth through Wellington over the next five years, which is, quite frankly, implausible.

BARNZ also continues to have difficulty with the Airport's characterisation of its scheme as a rebate or a discount. The Airport's pricing models clearly show that the level of required revenue upon which the Airport has calculated the charges payable by users is some \$11m higher due to the presence of the incentive scheme. There is no discount or rebate. This is simply the case of a supplier using its market power to increase the base charge by the corresponding amount, and then falsely characterise a subsequent reduction as a discount or rebate, conduct, which, if engaged in by

retailers, is investigated, and often prosecuted, by the Commerce Commission under the Fair Trading Act.

Commission staff asked about the impact on non-regulated revenues from the claimed uplift in passenger volumes. Airports earn significant commercial revenues from every additional passenger moving through the airport facility. Where an Airport is offering market support, then BARNZ considers such costs need to be proportionally shared between the aeronautical and non-aeronautical sides of the business, since both (should) benefit. Car-parking charges, taxi access fees, food and beverage purchases, advertising revenue and commission on duty free sales all increase directly in proportion with increased passenger volumes. Wellington Airport's Annual Report for the year ended 31 March 2012 disclosed that the Airport earned \$31.6m for 'retail and trading activities'. This equates to slightly over \$6 per passenger. If the incentive scheme resulted in an additional 885 000 passengers (as claimed by Wellington Airport), it would represent an uplift of approximately \$5m in the retail and concession revenue likely to be earned by the Airport.

WACC

Commissioner Duignan questioned Wellington Airport on whether it had taken into account the principles considered by the Commission in the development of its input methodologies surrounding WACC, particularly the anomalous result under the Brennan Lally model whereby as leverage increases, so too does the resulting WACC.

This was a matter raised by BARNZ in consultation too, particularly in light of the \$40m special dividend announced by Wellington Airport on 1 August 2011, a dividend which represents 10% of WIAL's regulatory investment value (or 9% of WIAL's inflated pricing asset base), and thus acts to maintain WIAL's leverage at a higher level. In response to WIAL's argument that the cost of debt inputs (debt premium, debt issuance costs and leverage) should be based on the airport's specific costs and structure (and not on an assessment of efficient costs and structure within the airport sector) Futures Consultants advised BARNZ as follows:¹⁷

WIAL's core argument is that it should be compensated for its actual target leverage and actual debt premium and issuance costs. This flies in the face of the long standing practice that regulated entities are compensated for efficiently incurred costs and not actual costs. The Commission has set what it thinks are reasonable values to use on this basis. That WIAL has decided to have a higher leverage ratio (ie put less equity into the business relative to total assets) and as a result incur a higher debt premium and higher debt issuance costs (in order to maintain its credit rating) is its decision, but not one it should be free to impose on consumers [in order to secure] the resulting higher WACC costs.

The Commission also sought feedback on whether it should be using the 50th percentile or 75th percentile WACC estimate in this *ex ante* assessment of profitability. BARNZ noted it would respond in writing. BARNZ's position is clearly set out in the last paragraph on page 5 of its 28 June Response

¹⁷ Refer BARNZ Assessment of WIAL Initial Pricing Proposal, 10 October 2011, page 8. See also Futures Consultant's Report to BARNZ on WIAL's Weighted Average Cost of Capital, 12 May 2011, provided to the Commission as Attachment 1 accompanying BARNZ's 28 June 2012 Response to the Commerce Commission's Issues Paper on Wellington Airport.

to the Issues Paper, and BARNZ confirms this response. BARNZ considers that the asymmetry of social risk from underinvestment if returns are too low (which has led the Commission to use the 75th percentile estimate of the WACC in price control situations) should not apply if the purpose is information disclosure only. Secondly, rather than make an *a priori* judgement that returns at the 75th percentile are acceptable, the long term interests of consumers would be better served if returns are measured *ex ante* relative to the mid-point WACC estimate (ie the 50th percentile) with a judgement being made *ex post* as to whether returns have been on average excessive, or have fallen short. In this regard, BARNZ notes that below average returns, albeit still within a normal range, could be expected within the range down to the 25th percentile. If returns were measured in the first instance against the 75th percentile estimate, then a consistent pattern of returns at the 75th percentile over ten years would be considered to be acceptable, whereas any reasonable person would consider that it looks very much like systematic over-recovery and a failure to limit excess returns.

The Commission staff sought feedback on Wellington Airport's submission that it would not be reasonable to judge its pricing decision using the Commerce Commission WACC determination published 1 April 2012, as this was not available to the Airport when it set its charges at the beginning of March. BARNZ notes that the Commission's methodology has been specified sufficiently clearly in its Input Methodology Determination such that interested parties (with access to sufficient expertise) are themselves able to update the WACC estimate. Indeed, the advice provided to BARNZ by Futures Consultants during the final stages of consultation with Wellington Airport was that the appropriate WACC estimate calculated using the Commerce Commission's input methodologies was 7.1% - which is virtually identical to the 7.06% published by the Commission at the beginning of April. There is no disadvantage or unreasonableness in the Commission using the output of its 1 April WACC Determination in assessing the reasonableness of the charges set by Wellington Airport in its price setting event.

Subsequent to the Conference, Dr Layton has raised an additional issue for the Commission's consideration, regarding the measurement of the debt premium in light of the growing and escalating scandal concerning the misreporting of rates by many large financial institutions overseas. This raises issues concerning the reliability of the data being applied by the Commission to measure the debt premium. Dr Layton's note raising this issue is attached as **Attachment 7**.

Cost allocation

The Commission sought to understand the difference between Wellington Airport and BARNZ over the allocation of the food court space within the main terminal building. BARNZ confirms that the issue is confined to the allocation of the food court as common space, namely the space occupied with tables and chairs and bar leaners surrounding the food and beverage facilities. The consequence of WIAL's changed approach is that 75% of the costs of that space will now be met by the aeronautical business.

Wellington Airport has sought to confuse the issue by endeavouring to paint BARNZ as wanting a previous short-term decision made by Wellington Airport to allocate the entire central area of the

main terminal building to its commercial side to continue. This is not the case. BARNZ is comfortable with the treatment of thoroughfares as common space.

The Commission may recall that, when the issue of space allocation within terminal buildings was considered during the development of the input methodologies in 2010, BARNZ tabled Wellington Airport's categorisation of its terminal space in 1997 and 2002 (ie for the first ten years of the life of the terminal) as either aeronautical, commercial or common space with access and egress routes, circulation space, toilets and plant-room being common, as an appropriate methodology for allocating space, which reasonably reflected the different activities occurring within the one facility. BARNZ did not seek to have the temporary allocation of the through-fares in the main terminal building as commercial (which Wellington Airport voluntarily adopted in 2008¹⁸) continue.

Wellington Airport's treatment of the food-court as being 75% aeronautical in its recent price setting event has reversed a 15 year pattern of the Airport treating this space as commercial. Moreover, it is highly likely to result in the Airport now recovering the costs of this space virtually twice over – first through the concessions paid by the food and beverage operators which will have been determined reflecting the availability of this seating area, and secondly through the allocation of 75% of the costs of the space to the asset base on which terminal charges payable by airlines have been set.

Impact of ID Regulation on Airport Behaviour re Profitability

BARNZ has not seen any evidence of behavioural change on the part of Wellington Airport as a result of ID Regulation. In this context, BARNZ sees ID Regulation as comprising the annual requirements to disclose information and the Input Methodologies specified by the Commission in relation to that information disclosure.

There has been no behavioural change in relation to asset valuation methodology. Wellington Airport has continued to apply the MVEU valuation methodology which it has used since 1993. While the Airport has applied the MVAU valuation methodology specified in Schedule A of the Input Methodology Determination for Airports to determine the underlying opportunity cost value of its land, it has continued to then gross up the value for the hypothetical cost of holding this land for five years while it is notionally developed as an Airport. This adds an additional \$1m per ha to the claimed value of the land. The Chairman summed it up very concisely at page 55 of the Transcript with the comment that *'in the case of asset valuation ... the Information Disclosure Regime is having really no immediate impact, you're going down the path of the way you've thought about this issue under the AAA'*.

There has been no behavioural change in relation to the treatment of revaluations. Wellington Airport is still maintaining that only forecast revaluations need to be treated as income in the charge setting process and any un-forecast revaluations fall to be retained by the asset owner and do not

¹⁸ BARNZ notes that the reason Wellington Airport gave at the time for allocating this space as commercial was so that it would be able to install additional commercial facilities and advertising through the terminal without the need to consult with the airlines. It had just created a subsidiary to sell advertising and bill-board space called i-site, and wanted to increase the potential for advertising space through the terminal. The Airport has just recently sold i-site for \$10m.

need to be reflected as income in setting charges. This breaches the NPV = 0 or FCM principle which underlies the Commission's approach to asset revaluations. In the latest price setting event there has been some \$63m of un-forecast revaluations which have entered the Airport's asset base which have not been treated as income in the charge setting process. This adds to the \$118.8m of un-forecast revaluations in 2007 which likewise entered the asset base without being treated as income in the charge setting process. To borrow Chairman Berry's turn of phrase *'in the case of the treatment of revaluation gains ... the Information Disclosure Regime is having really no immediate impact, you're going down the path of the way you've thought about this issue under the AAA'*.

There has been no behavioural change in relation to the estimation of the cost of capital.

Wellington Airport is still applying the input methodologies determined by its advisers. In each case where Wellington has adopted input methodologies which differ from the Commission's, its estimate acts to increase the resulting WACC. The most significant differences relate to asset beta, market risk premium and leverage. Interestingly, despite Wellington Airport having previously adopted an asset beta range of between 0.45 and 0.6 from 2003 to 2010 in its Information Disclosures under the AAA, its advisers have now moved to using an asset beta of 0.75. Despite the cost of debt being at historical lows, Wellington Airport has continued to apply a WACC of 9.5%. Borrowing Chairman Berry's phrase again, *'in the case of the estimation of the cost of capital ... the Information Disclosure Regime is having really no immediate impact, you're going down the path of the way you've thought about this issue under the AAA'*.

Overall, ID Regulation and the accompanying Input Methodologies determined by the Commission have not resulted in any behavioural change with respect to the setting of charges. Charges have still been set by Wellington Airport at levels which result in the extraction of excessive profits.

Outcome of Wellington Airport's Price Setting Event

	FY12	FY13	FY14	FY15	FY16	FY17
Forecast Revenue from aeronautical charges	55,744	60,303	65,686	71,918	78,706	85,850
Percentage increase		8.2%	8.9%	9.5%	9.4%	9.1%
Forecast passengers	5,208	5,293	5,425	5,595	5,775	5,949
Average Charge per passenger	\$10.70	\$11.39	\$12.11	\$13.85	\$13.63	\$14.43
Percentage movement		6.4%	6.3%	6.1%	6.0%	5.9%

Under the charges set by the Airport, its aeronautical revenue is forecast to increase by 9% per annum on average — from \$56m in FY12 to \$86m in FY17.

BARNZ estimates that over the five year pricing period, airlines will pay Wellington Airport \$99m more in charges than would be the case if charges were set applying the Commerce Commission input methodologies and principles.

Applying the PAL MVAU valuation obtained by BARNZ the level of forecast revenue will result Wellington Airport earning a return of between 10% to 11% pa over the forthcoming pricing period,

depending upon whether the committed wash-ups are treated as income in the previous pricing period or the new pricing period.

The average charge per passenger will increase from \$10.70 in FY12 to \$14.43 in FY17. This represents an average increase of 6.2% pa on a per passenger basis.

That Wellington Airport flippantly dismisses the Airlines as referring to 'histrionic' numbers when these increases are quoted patently high-lights the mindset of the Airport with respect to its right to set prices at levels which contain excess returns, and starkly demonstrates the complete ineffectiveness of ID Regulation under Part 4 of the Commerce Act on limiting the ability Airports have to extract excessive returns using their power under the AAA to set charges as they think fit.

Operating Expenditure Forecasts

Commissioner Begg referred to BARNZ's view that while Wellington Airport's operating costs had been at an efficient level up until 2007, subsequent increases in operating costs per passenger meant that operating costs per passenger were now too high. Commissioner Begg asked BARNZ why it had adopted the 2007 levels of operating costs per passenger as its starting point, from which it then proposed application of CPI to give an efficient level of operating costs per passenger.

BARNZ confirms the response by Ms Cooper that 2007 was the last year that BARNZ had actual data for operating costs per passenger for the pricing asset base, and so was considered to be the only objective starting point. Post 2007 BARNZ only has forecast operating costs for the pricing asset base, as provided in the financial model WIAL used to set charges in 2007. BARNZ does not have access to the actual operating costs for the pricing assets for FY08, FY09, FY10 or FY11. It is not until FY12 that BARNZ again has transparency over actual operating costs for the pricing asset base, as this was provided by WIAL during the consultation just concluded. However, by this time the operating costs per passenger have risen from \$2.29 per passenger in FY07 to \$3.05 per passenger in FY12, a 33% increase. Information Disclosure under the AAA suggests that the bulk of these cost increases occurred in the FY10 to FY12 period, when costs of identified airport activities as a whole (which is a wider set of activities than the pricing assets) increased by 25%.

Inflation rose by 14% from FY08 to FY12. Therefore Wellington Airport's operating expenses per passenger increased at more than double the rate of inflation. This was at a time when passenger volumes increased by 13%. As outlined on pages 14 to 16 of BARNZ's 28 June Issues Paper Response, WIAL has previously maintained operating expenses per passenger at a constant nominal level, meaning there had been real reductions in operating expenses per passenger. For WIAL to move from a situation of reducing real expenses per passenger, to increasing real operating costs per passenger demonstrates the complete loss of focus on operating efficiencies at Wellington Airport. The 13% increase in passenger volumes over this time provides a larger base across which to spread costs, and should have enabled the Airport to control operating costs at a flat real rate, if not the flat nominal rate forecast by the Airport.

The approach by BARNZ of taking the 2007 actual per passenger operating costs, and increasing that in line with CPI thereafter, not only compensates the Airport for any increases in inflation, it also gives the Airport the full benefit of passenger growth over this period for the purposes of forecasting operating costs. In other words, it does not assume any economies of scale for additional passenger volumes. The BARNZ approach suggests that operating costs should be 10% lower than the level forecast by Wellington Airport. BARNZ considers this quite a generous allowance for costs.

WIAL has sought to defend the increased levels of operating costs by specific reference to insurance costs and the costs of the new regulatory regime. While insurance costs are increasing across the board, this does not explain the \$5.3m increase (which is a 50% increase) in operating expenses for the pricing asset base from \$10.6m in FY07 to \$15.9m in FY12. The insurance costs allocated to the

aeronautical pricing assets have increased by \$0.9m over that period¹⁹, which represents less than one fifth of the cost increases. Insurance costs therefore cannot be blamed for cost ‘blow-out’ which has occurred over the last few years.

Rather, the significant amounts being spent by Wellington Airport fighting the introduction of the Part 4 information disclosure and input methodology regime, are likely to be a primary factor. In addition, the inevitable conclusion in light of such significant cost increases simply has to be that a previously commendable focus on keeping costs at an efficient level has been moved away from, in light of the fact that the Airport is able to pass every dollar of cost incurred directly on to users through its ability to set charges as it thinks fit.

Efficiency of Capital Expenditure

BARNZ confirms its statement at pages 83 and 84 of the Transcript that going forward its two main concerns with respect to the forecast level of capital expenditure are the practice of front end loading the expenditure profile and the degree of expenditure related to compliance for Code D and E aircraft.

BARNZ is, however, also concerned over the efficiency of previous capital expenditure work undertaken by Wellington Airport at levels beyond that required by current users, with only partial consultation with users. The values of these works have been included in WIAL’s asset base, despite the fact that such work is constructed at a level beyond that required. There are two particular examples of this concern.

The first is The Rock, which was constructed not as an efficient modular addition to the existing terminal, which was the basis on which airlines were consulted in 2007, and shown models of the additions of this nature. Instead, The Rock was constructed in a complicated, multi-faceted design involving more than 3600 individually measured and cut copper panels, which required tradespeople from the UK to come to New Zealand to install the roof. The additional cost from constructing this regional statement of pride should not be one which is passed into the required revenue sought from users. Rather it should be a shareholder cost.

The second piece of recent capital expenditure which has been constructed at a level beyond that required by users is the tunnel component of the RESA. BARNZ’s concern is with the tunnel component of the RESA project having been constructed to the requirements of Code E aircraft – despite the fact that there are no Code E aircraft operating scheduled passenger services at Wellington Airport. During consultation Wellington Airport advised BARNZ that the additional cost of constructing the RESA tunnel to the specifications required by Code E aircraft was approximately \$5m. BARNZ considers that it is inappropriate for users to be charged the capital costs of this ‘future proofing’ of the tunnel, given that it is not required by current users. This was a speculative decision by Wellington Airport to construct the tunnel to a higher specification than that required by current

¹⁹ Insurance costs increased from \$1.4m in FY07, \$0.8m of which was allocated to the aeronautical pricing activities cost centre, to \$2.2m in FY12, \$1.7m of which has been allocated to the aeronautical pricing activities.

users, and again, this additional cost should be borne by the shareholders of Wellington Airport until the time that regular scheduled operators require this additional capacity. Again, the construction of the RESA was a project where Wellington Airport undertook an incomplete consultation process, with the costs significantly blowing out from the initial cost estimates on which the Airport consulted with airlines.

Commissioner Begg asked BARNZ whether the level of compliance capital expenditure remaining in the current pricing period is now considered reasonable in light of Wellington Airport having moved the majority of it out to the next pricing period. BARNZ acknowledges that the movement of most of the compliance capital expenditure out of the current pricing period is a significant improvement. However, BARNZ is still concerned at a principled level regarding Wellington Airport engaging in speculative investment or investment to a standard not required by current scheduled users. While Wellington Airport was regularly serviced by Code D aircraft during the 1990s, since then the level of Code D aircraft have been minimal, averaging less than one per week over the last few years. There do not appear to have been any Code E movements. **Attachment 8** sets out a summary of Code D and E aircraft movements for the last 20 years as provided by Wellington Airport to BARNZ during consultation. In Wellington Airport's FY11 Information Disclosure, there are only seven Code D aircraft movements disclosed for the whole year.

Impact of ID Regulation on Airport Behaviour re Expenditure, investment and innovation decisions

The Commission has asked for views on the extent to which information disclosure regulation under Part 4 of the Commerce Act has affected the behaviour of Wellington Airport in relation to expenditure, investment and innovation.

BARNZ has not noticed any behavioural change in relation to predicted investment or innovation as a result of the Airport moving from information disclosure regulation under the AAA to information disclosure regulation under Part 4 of the Commerce Act.

With respect to operating expenditure, BARNZ notes that inclusion in Part 4 as an information disclosure regulated supplier has not prevented Wellington Airport from altering what was a long established and well-accepted pattern of its commercial food court space being treated as a commercial cost, instead changing the allocation of this clearly commercial space to 75% aeronautical. Quite clearly, information disclosure regulation under Part 4 has not limited the ability of the Airport to take whatever approach it sees fit to cost allocation.

The most noticeable impact from being regulated under Part 4 on the behaviour of Wellington Airport regarding expenditure is the level of money the Airport is spending challenging the new regime, with these costs being subsequently included in the cost base on which charges to airlines are set.

Passing on the benefits of economies of scale

Commissioner Begg asked whether economies of scale exist as volume through-put increases, and if so, whether these are being factored into forecasts of expenditure and being passed onto consumers (refer page 93 of the Transcript).

This issue of economies of scale falls to be considered both from the perspective of operating expenses as well as from the perspective of capital costs.

With respect to operating costs, the issue mirrors that raised by BARNZ in section 4 above. Prior to the previous pricing period, when Wellington Airport was maintaining per passenger operating costs at a constant real level, economies of scale were being achieved in the level of operating expenses. However, the Airport now appears to have lost this focus on efficiency, with the result that per passenger levels of operating expenses have significantly increased in real terms per passenger. The Airport is no longer achieving any economies of scale in relation to its level of operating costs, despite history showing that they do indeed exist when the right focus is applied to managing costs.

With respect to capital costs, if one has a fixed asset base with large sunk costs, then as throughput increases, one would expect the unit charge to decrease. However, Wellington Airport's approach of regularly revaluing its assets, and not treating any un-forecast revaluations as income for the purposes of setting charges, means that economies of scale have not been passed onto consumers, despite the 29% increase in passengers at Wellington Airport which has occurred over the last ten years.

Overall, there is no evidence that the benefits of economies of scale are being passed onto users. Rather Wellington Airport has imposed substantial increases, with the charges payable by airlines increasing from \$10.70 per passenger in FY12 to \$14.43 per passenger in FY17. This represents a 35% increase in charges per passenger over five years. On average this equates to a 6.2% increase per annum per passenger. Any economies of scale which exist are being retained by Wellington Airport.

Does the AAA place any limitations on the pricing behaviour of Airports?

Mr Fitzgerald made a series of remarks at pages 107 to 108 of the Transcript suggesting that the Airport Authorities Act created a pricing structure of what he variously described as a level of 'maximum allowable revenue (refer lines 17 to 20 page 107), a 'fixed maximum' (lines 30-31, page 108) or 'constrained revenue'.

Similar remarks were repeated later at page 123 of the transcript where Mr Fitzgerald suggested that processes exist under the AAA to address situations where the Airport's conduct is demonstrably unreasonable.

This is a vast exaggeration of the legal situation existing under the AAA. Section 4A of the AAA gives Airports the right to set charges as they think fit, subject to the requirement that substantial customers must be consulted with first. The most recent judicial pronouncements on the charge setting powers airports hold under the AAA by the High Court and by the Court of Appeal²⁰ have held that there is no limitation in the AAA preventing airports from setting charges which contain monopoly profits, and that allegations that charges contain monopoly profits is not a reason on which the charges set by an airport can be judicially reviewed on the grounds of unreasonableness.

Thus, there is no 'fixed maximum' or 'constrained' level of revenue under the AAA. Judicial review for unreasonableness of airport charges on the grounds that they have been set at a level which contains monopoly profits is not currently available under New Zealand law.

There is therefore a very real risk that peak pricing can be used in the future as a mechanism to extract excessive profits.

The common terminal charge for domestic and international passengers

Wellington Airport has departed from its long standing approach of allocating space within the terminal between domestic and international activities, with space common to both (such as the check-in hall, baggage handling system and airside baggage make-up area) allocated proportionally between the two activities. Instead the Airport is treating the entire terminal as common – despite the fact that international aircraft do not use the domestic Southwest Pier and despite the fact there are significant international only facilities in the Northern Pier.

Attachment 9 contains a plan of the Terminals provided by the Airport to BARNZ during consultation with the gates marked for the Commission's reference.

When the terminal development of the Northern Pier was consulted on with BARNZ during the 2006/2007 pricing consultation the project was divided into a two key stages so far as aeronautical facilities were affected:

- Stage 1C concerned the redevelopment of the Southern face (ie domestic side) of the Northern Pier (what was then used by Qantas and Pacific Blue and is currently predominantly used by Jetstar). As described in Wellington Airport's August 2006 Information Package, this involved the addition of a new gate and air bridge, refurbishment of an existing air bridge, reconfiguration of the domestic lounge to improve passenger flows for international passengers and provides for domestic use of international gates. It related to gates 21, 22 and 23/24. Stage 1C was forecast to cost \$12.7m. Plans for these alternations and additions were provided to airlines during consultation.
- Stage 2 was forecast to cost \$38.8m and was described at page 39 of WIAL's Final Pricing Proposal dated 9 May 2007 as being a development that **'relates to WIAL's international business only'**. At this time the project was known as the IPT Development – the international passenger terminal development. WIAL had adopted the position that it was

²⁰ *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98.

not required to consult on this project under section 4C of the AAA capex consultation provisions because it did not exceed the 20% of asset value trigger contained in the AAA. In response to airline concerns over the incomplete consultation on the design of the space, namely the lack of disclosed designs, plans or cost estimates, the Airport recorded in its Final Pricing Proposal that 'the terminal would be subject to an optimisation exercise in 2012 which would address ... whether there was excessive floor area ... Number of gates ... Over-design (finishes/architectural premium)'. This has not occurred.

It is only more recently that Wellington Airport has started characterising The Rock as a common terminal facility. This was never the basis on which consultation occurred surrounding its development in 2006 and 2007. BARNZ fundamentally rejects the assertion by Mr Fitzgerald that The Rock development was designed from day one to be multi-use. As the Airport clearly stated in its own consultation documentation from 2007, when the decision was made to proceed with this development, and when the Airport was 'consulting' with airlines over it, the project '**relates to WIAL's international business only**'.

BARNZ acknowledges that Stage 1C of the works, affecting gates 21, 22 and 23/24, is predominantly domestic, but with capacity for gates to swing between international and domestic use.

Gate 25 at the end of the pier could easily be utilised as a swing gate serving both international and domestic aircraft, without domestic passengers needing to access international only areas. As such BARNZ considers that it would be appropriate for the costs of this air bridge to be allocated between domestic and international activities in proportion to its likely use. However, it is only the air bridge and the corridor leading to it which would be used by domestic passengers, not the international facilities of The Rock.

To use gates 26 through 29 for domestic operations would be extremely disruptive and costly due to the much higher security standards and requirements for a 'sterile' space. Moreover, the majority of the Northern Pier comprises MAF facilities, Customs facilities, duty free shops, Aviation Security screening and international departure lounges. BARNZ has serious doubts as to whether Avsec and the CAA would permit domestic passengers to use these spaces. If this was permitted, the time (and cost) subsequently required to 'resterilise' the space would likely render its domestic use totally impracticable.

It is extraordinary for the Airport to be treating the entire international space at the Northern end of the Terminal as common space. It flies in the face of the actual use of that space and it flies in the face of the reason for the development of this space – which was to provide additional international passenger facilities.

BARNZ notes that Wellington Airport has provided no evidence of the level of domestic use of the international gates in The Rock or of the level of domestic use of the international lounges and processing space. BARNZ submits that this is because the evidence simply does not support the Airport's treatment of this space as common.

In BARNZ's view there is a real question as to whether the common passenger terminal charge set by Wellington Airport of \$5.25 per passenger will result in international passenger charges meeting the incremental costs of Wellington Airport providing international terminal facilities, as opposed to the

Airport simply being a domestic only Airport. Wellington Airport's consultation material has disclosed that the assets directly associated with the international processing space in the terminal are valued at \$32.7m.²¹ Assuming a 20% return (for WACC, tax, depreciation and operating costs), then charges of approximately \$9 per passenger are required to meet the incremental costs of this purely international space. This is without any account being taken of common processing space such as the baggage sortation system or thoroughfares in the main terminal building.

Cost allocation vs efficient pricing

Commissioner Begg identified that it appeared there was a distinction between what she characterised as a cost allocation approach being applied by the airlines, and an efficient pricing approach being adopted by the Airport as the basis for the charges it has set, and requested comment on these different views.

BARNZ has many members, all with different interests and levels of activity. There are some airlines which operate freight only operations, and do not use the passenger terminals. There are other international only members, such as Virgin Australia and Qantas. There is an airline which only operates domestic services out of Wellington Airport – namely Jetstar. Finally, there is an airline that operates both domestic and international passenger services at Wellington Airport – namely Air NZ.

In assessing the reasonableness of the pricing proposals provided by Wellington Airport (and indeed Auckland and Christchurch Airports as well) BARNZ endeavours to adopt a neutral position between the interests of the different categories of airlines. The primary focus of BARNZ is on the overall level of required revenue which is justifiable. The objective basis which BARNZ uses to analyse the reasonableness of the proposed revenue levels and charges is cost allocation. Otherwise, BARNZ would be drawn into making value judgments setting off the interests of one category of member as against another, which would be highly inappropriate.

The approach adopted by BARNZ begins with the allocation of costs to the airfield, international passenger activities and domestic passenger activities. BARNZ then looks for a reasonable basis on which common costs can be allocated, which might variously adopt factors such as the share of directly allocated terminal space, passenger volumes, aircraft movements, directly allocated costs or FTEs etc. BARNZ believes that this approach provides its members with an objective basis on which each airline can then individually assess the reasonableness of the charges proposed by the Airport in question.

Through the application of this approach BARNZ has come to the view that the common terminal charge at Wellington Airport will cause terminal charges paid by international passengers to be below the incremental costs of providing international terminal facilities at Wellington Airport, and is therefore likely to result in domestic terminal charges subsidising the cost of providing international terminal facilities at Wellington Airport.

²¹ WIAL Initial Pricing Proposal, 18 August 2011, Appendix 8, page 113.

Impact of ID Regulation on Airport Behaviour re price setting

The Commission has sought feedback on whether information disclosure regulation has influenced the behaviour of Wellington Airport in how it sets its prices.

BARNZ has not seen any evidence that Wellington Airport has been influenced by ID Regulation, the Input methodologies determined by the Commission, or the forthcoming section 56G review by the Commission.

Wellington Airport has simply continued with its previous approach of setting charges as it thinks fit under its power to do so, as contained in section 4A of the AAA.

BARNZ's views on WIAL's behaviour in this regard were set out in further detail at pages 22 to 23 above, and also at pages 33 to 34 below.

The relevant counterfactual

The Chair noted at the beginning of the last session of the Conference that when the Commission reports back to the Ministers that it will need ‘to make an assessment of two worlds – one with and one without Information Disclosure Regulation, and see what, if any, difference has occurred as a result of that.’

BARNZ notes that the comparison should be between a world with information disclosure under the AAA (which was what was previously the case prior to the Airports inclusion in Part 4) and a world with information disclosure regulation under Part 4 of the Commerce Act. It is inconceivable that the Government would move airports to a situation of no information disclosure requirements at all. The counter-factual therefore should not be a situation of no information disclosure requirements.

Moreover, information disclosure regulation under Part 4 must necessarily include all elements of information disclosure regulation under Part 4, namely:

- The annual requirements to disclose information
- The input methodologies specified by the Commission
- The monitoring and analysis reports to be prepared by the Commission under s53B

Thus the factual and counter-factual with respect to information disclosure regulation should be described as follows:

The previous situation	The current situation
<ul style="list-style-type: none"> • Airports subject to Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 • Information disclosure requirements designed and administered by the MOT • The ability for the Secretary of Transport to issue guidelines existed under the AAA but this never occurred • Differing interpretations by Airports of matters such as subvention payments, asset inclusion, cost allocation etc • No annual or regular monitoring or review by the MOT • No information on quality and very limited information on levels of service • Disclosure of valuation reports 	<ul style="list-style-type: none"> • Airports regulated under Part 4 of the Commerce Act with the form of control being Information Disclosure Regulation • Information disclosure requirements designed and administered by the CC • Input methodologies developed by the CC regarding asset valuation, asset inclusions, cost allocation, tax and treatment of revaluations when preparing the information disclosures • A standard format for the disclosures, with increased detail, and greater consistency between airports • Annual monitoring and analysis by the CC • Increased information on quality and service standards • Disclosure of valuation reports • Disclosure following price setting events, including disclosure of forecasts

The most significant change between the previous situation of information disclosure under the AAA and information disclosure under Part 4 of the Commerce Act is the presence of the input methodologies determined by the Commission. The presence (or absence) of these input methodologies is vital when characterising the counter-factual.

Has Wellington Airport's behaviour been influenced by Part 4 information disclosure?

In its Reasons paper which accompanied the Input Methodologies determined for Airports, the Commission stated that information disclosure 'can influence suppliers' behaviour by making their performance in supplying regulated services more transparent'.

BARNZ has not seen any evidence that the move from information disclosure under the AAA to information disclosure regulation under Part 4 of the Commerce Act, including the input methodologies developed by the Commerce Commission, and the prospect of this review under section 56G, has had any impact or influence on Wellington Airport's behaviour:

- The Airport has continued to apply the MVEU valuation methodology it has always done
- The Airport has continued to only treat forecast revaluations as income when setting charges²², leaving substantial un-forecast revaluations (in this case of \$63m) included in the asset base on which charges were set, without those un-forecast revaluations being treated as income for the purpose of setting charges, thus breaching the FCM principle
- The Airport has continued to apply its inputs when calculating the cost of capital, and has even increased some inputs since it last set charges, resulting in a WACC estimate of 9.5%, which substantially exceeds the Commission's mid-point estimate of 7.06% for Airports
- The Airport has not been limited in any way in its ability to extract excessive profits. It has set what independent analysts have described as 'eye-watering' increases in charges which equate to an increase of 6.2% per annum for every passenger for five years. Charges per passenger will increase from \$10.70 in FY12 to \$14.43 in FY17. The Airport's aeronautical revenue will increase by approximately 9% per annum for the five years of the pricing period from \$56m in FY12 to \$86m in FY17. Overall BARNZ estimates that airlines will end up paying \$99m more in charges to Wellington Airport than would be the case if revenue requirements had been determined applying the Commerce Commission input methodologies and principles. The return to the Airport over the FY08 to FY12 pricing period has been in the vicinity of 11% to 12% per annum²³, depending upon whether committed wash-ups are treated as income in the pricing period in which the Airport receives the revenue or the pricing period in which the committed credit is applied. The forecast return to Wellington Airport depends upon the asset valuation methodology adopted. At the PAL MVAU valuation of land, Wellington Airport is forecast to earn a return of 10% to 11% per annum²⁴, depending upon whether committed wash-ups are treated as income in the pricing period in which the Airport receives the revenue or the pricing period in which the committed credit is applied.

²² Other than a relatively small wash-up provision which affected \$14.5m of revaluations out of \$131.8m.

²³ Refer Attachment 2

²⁴ Refer Attachment 3

The Airport has not demonstrated any behavioural change as a result of it being subject to information disclosure regulation under Part 4 of the Commerce Act. Rather, as expressed by the Chairman, it has *gone down the path of the way it has thought about these issues under the AAA with the Information Disclosure Regime really having no immediate impact.*²⁵

Instead the Airport has continued to rely heavily upon the right it has to set charges as it thinks fit under the AAA and, while it has engaged in a consultation process, for the majority of the time the outcome appeared to be a foregone conclusion with the Airport simply moving through a process, making pre-orchestrated changes in a few instances from highly unsustainable opening positions to positions that were merely 'unreasonable'.

The level of dispute or disagreement between BARNZ and Wellington Airport has not diminished at all compared with previous consultations. The cost of consultation was much the same for BARNZ as it has been on previous consultations, with the key issues remaining unresolved and still in dispute.

Wellington Airport has consulted with airlines over charges six times since the introduction of the obligation to consult substantial customers prior to setting charges. Other than on the first occasion immediately post the corporatisation of the Airport, in BARNZ's view Wellington Airport has in all other consultations provided airlines with sufficient information to enable the airlines to be properly informed and to make meaningful responses on the proposed charges. Therefore while the level of information provided by Wellington Airport during consultation cannot be criticised, this is not due to the Airport becoming subject to information disclosure regulation under Part 4 of the Commerce Act. There has therefore not been any behavioural change in terms of the level of information provided to airlines.

The one change is that the Airport is no longer placing confidentiality restrictions around its consultation information, and has instead made it available on its web-site for all interested persons. The extent to which this can be attributed to the influence of information disclosure under Part 4 or not is unclear. It may simply be that the Airport has taken a more mature approach to confidentiality, as a result of the number of consultation processes it has undertaken.

Mr Fitzgerald noted that the information disclosure regulation had resulted in the differences being isolated with clarity existing over their scope. With all due respect the same differences have existed between BARNZ and Wellington Airport in the 2002, 2007 and 2012 pricing consultations. There has always been clarity over the differences. The same issues considered by the Commission and submitted on by the parties during the process for determining the input methodologies and information disclosure requirements during 2009 to 2011, and in this Conference under the section 56G Review, were considered by the Commission, and submitted on by the same parties, in the Airport Price Inquiry in 2000 to 2002.

The issues have long been clear. That has not changed. The Airport has long determined them in its favour using its power to set charges as it thinks fit under the AAA. That has not changed.

In the case of Wellington Airport's pricing behaviour nothing has changed.

²⁵ Section 56G Conference Transcript, 7 August 2012, page 55.

Sapere has presented a partial summary of airport regulation in Australia and the United Kingdom to the Commission.

BARNZ is somewhat puzzled by why the Airports have undertaken this work in the context of the section 56G Review which concerns *how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services*²⁶

Regulatory outcomes and conclusions in Australia and the United Kingdom are, with respect, outside the jurisdiction of the section 56G Review being undertaken by the Commission, which must necessarily be focused on the specific statutory environment of the New Zealand Commerce Act, that is on the information disclosure regulation of Airports which exists under Part 4 of the Commerce Act, and whether that promotes the purpose of Part 4 of the New Zealand Commerce Act.

A stark example of the difference in the statutory environments is exemplified by the approach of the Australian Productivity Commission to claims of excessive pricing, which the Australian Productivity Commission has communicated it will only entertain where the excessive pricing is shown to affect community welfare, or the economy of Australia as a whole. This approach stems from the terms of reference from the Australian Government to the Productivity Commission when requesting it to review the economic regulation of airports in Australia. The Productivity Commission has colourfully remarked that *‘while distributional issues are ‘front and centre’ for [airlines and airports], the Commission’s focus is on outcomes for the Australian community.’*

By contrast, in New Zealand under Part 4 of the Commerce Act, distributional issues are ‘front and centre’ for the Commerce Commission, with one of the four key outcomes required under Part 4 being the promotion of outcomes which limit the ability of suppliers to extract excessive profits.

In any event, BARNZ also observes that the Sapere report has over-emphasised the role of information disclosure in the regulation of airports overseas. For instance, in Australia, information disclosure is only one very small cog in a complex regulatory regime which encompasses:²⁶

- Annual information disclosure by the Airports to the ACCC in accordance with the information disclosure requirements specified by the ACCC.
- Annual monitoring reports of the disclosed information by the ACCC.
- The imminent introduction of the ‘show cause’ process designed to act as a quick ‘mini-inquiry’ by the ACCC if monitoring discloses any *prima facie* concerns which warrant investigation.
- The ability of the ACCC to undertake a price inquiry.

²⁶ See the detailed description of the regulatory environment surrounding Australian Airports in Chapter 3 of the Productivity Commission Report #57 – The Economic Regulation of Airport Services, 14 December 2011.

- The ability of users to request that essential facilities be declared by the National Competition Council under Part IIIA of the Competition and Consumer Act 2010. This has been used previously with respect to freight facilities at several airports and domestic facilities at Sydney and is currently being considered for jet fuel facilities at Sydney as well.
- Regular programmed five yearly references by the Government to the Productivity Commission for a systems wide review of Airport Regulation.
- A history of price control having been initially imposed for the five years immediately following the privatisation of the main Airports.
- The ability of a Minister to make an Airport subject to price notification requirements by Ministerial Gazette. This means that the ACCC must be notified of any proposed price increases, and has the ability to object (or not) to the proposed price increase, although its objection is only of 'moral suasion' and not of binding legal effect. Sydney Airport aeronautical charges for regional air services are currently subject to price notification requirements.
- The Government having retained ownership of the Airport land and retained residual powers under the lease conditions, concerning a number of matters, key examples being requiring airports to hold regular Community Consultation Groups, Ministerial approval requirements for Airport Master Plans as well as of any major development costing more than \$20m, and restrictions on the ability of the Airport to refuse access to airlines. The Productivity Commission described the lease provisions as effectively providing the Government 'with an ongoing element of control over privatised airports'.²⁷
- Annual review by the Department of Infrastructure and Transport to monitor airport operators' compliance with lease conditions.

To endeavour to characterise regulation of airports in Australia as primarily comprising information disclosure and monitoring with potential for services to be declared is simplistic. As outlined above, the strands of airport regulation are substantially greater and more sophisticated with the prospect of further regulation being significantly more credible, not least of all due to the regular ongoing reviews by the Productivity Commission and the Government retaining significant influence by virtue of its role as lease holder of airport land.

²⁷ Ibid at page 23.