



## AUCKLAND AIRPORT'S CROSS-SUBMISSION ON THE SECTION 56G REVIEW DRAFT WIAL REPORT 29 NOVEMBER 2012

### INTRODUCTION

1. In this cross submission, Auckland Airport responds to matters arising from airline submissions on the Commission's Draft Report on the section 56G Review ("**Review**") of WIAL ("**Draft Report**").
2. Auckland Airport supports the cross submission made by the NZ Airports Association.
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### EXECUTIVE SUMMARY

4. The airline submissions on the Draft Report focus on encouraging the Commission to:
  - (a) increase the magnitude of its finding that WIAL is earning excess returns;
  - (b) find other ways in which WIAL is performing inconsistently with the Part 4 purpose statement (for instance, lack of efficiency gains); and
  - (c) soften its findings that, in some respects, information disclosure ("**ID**") is effective (for instance, innovation).
5. Such an approach is consistent with a strategy to undermine the information disclosure Regime ("**ID Regime**"), in an effort to have it replaced by other forms of regulation. This also leads airlines to argue that ID has failed, often with inconsistent positions in different forums, essentially because the airlines believe there may be an advantage to them if there was another form of regulation. This goes well beyond the scope of the section 56G Review.
6. Auckland Airport believes that the obligation under section 56G was carefully framed to require the Commission to provide a progress report. It is unrealistic to expect to establish a new ID Regime and then, with that new regime in its infancy, to conclude that the new ID has failed, especially if that finding is based on imprecise modelling and assumptions regarding future pricing decisions.
7. Auckland Airport believes that ID is effective, and can be increasingly effective as it beds in over time.
  - (a) Early signs of a regime in its infancy suggest that it is working effectively in promoting outcomes consistent with the Part 4 purpose statement in a number of respects. While there are no doubt areas for improvement going forward, it is our view that there can and will be improvements and gains over time, particularly as the Commission's section 53(2)B summaries and analysis and the outcome of this Review provide airports with additional guidance.

- (b) As previously submitted, Auckland Airport considers that if potential concerns are exposed as a result of the Review, then this is evidence that the ID regime is working, by providing the transparency that incentivises conduct consistent with the Part 4 purpose statement.
8. Regarding the measurement of profits, key arguments made by airlines are:
- (a) to use the 50<sup>th</sup> percentile of the WACC range, on the basis that revenue from non-aeronautical activities offsets any need to allow for asymmetric risk; and
- (b) leased assets should be excluded from the analysis because they will lead to an under-estimation of excess profits.
9. Such an approach improperly invites the Commission to act inconsistently with the clear requirements of the Act:
- (a) Part 4 clearly establishes dual till regulation, consistent with the approach under the Airport Authorities Act 1966 ("**AAA**"), which has been in existence for many years prior to implementation of the ID Regime. Seeking to re-litigate its merit at this point in the process is clearly beyond the scope of the section 56G Review.
- (b) Leased assets are clearly within the definition of specified airport services, and there is no basis for differentiating them from other regulated assets when assessing returns.
10. Adopting a 50<sup>th</sup> percentile WACC is likely to dis-incentivise investment that benefits airlines and consumers in the long term:
- (a) it incentivises the likelihood of regulated WACC being below actual WACC and therefore creates a risk that airports will not be incentivised to invest in regulated assets beyond minimum requirements;
- (b) in some circumstances, the lowest cost investment for an airport is not the highest value input for the industry; and
- (c) airports operate as nodes in networks for airlines. Accordingly, there can be real value for airlines in how airports develop and operate within the network, and in particular, real value can be achieved when airports invest more rather than less in developing capacity to facilitate the operation of these networks.
11. In this cross submission we also address our concerns that:
- (a) although BARNZ correctly seeks to distinguish *ex post* and *ex ante* efficiency considerations, it improperly seeks adverse findings based on decisions made prior to the implementation of ID;
- (b) BARNZ seeks to undermine the effectiveness of consultation on capex under the AAA, despite previously accepting the constructiveness of such consultations;
- (c) the airlines are unwilling to attribute positive outcomes, such as in innovation, to the effectiveness of ID. Auckland Airport believes that an ID regime that preserves existing incentives is just as effective as a regime that provides new incentives; and

- (d) the section 56G Review framework could be clarified regarding the Commission's process for establishing the most appropriate WACC reference point for price setting.

12. The remainder of the cross-submission is structured to respond to issues arising in relation to:

- (a) the Commission's profitability assessment;
- (b) the Commission's efficiency assessment; and
- (c) framework concerns.

### **PROFITABILITY ASSESSMENT**

13. In this section, we respond to airline arguments that:

- (a) the 50<sup>th</sup> percentile of the WACC input methodology ("**IM**") estimate should be used to assess target returns;
- (b) the WACC IM estimate determined after prices are set should be used;
- (c) the WACC IM model is biased upwards;
- (d) profitability should be assessed based on revenue and costs paid by consumers;
- (e) leased assets should be excluded from the assessment; and
- (f) the Commission's modelling should be adjusted.

### **Use of the 75<sup>th</sup> percentile for assessing target returns**

14. In their submissions on the Draft Report, airlines advocate that the Commission should adopt the 50<sup>th</sup> percentile for assessing target returns. This argument is predicated on the assumption that:

- (a) the revenue earned by WIAL in its retail and car parking activities (and other non-aeronautical activities) provides sufficient incentives to innovate and invest in aeronautical activities; and
- (b) on this basis, the mid-point WACC estimate represents a more appropriate level of target return for airports, as there is no need to allow for asymmetric risk.

15. BARNZ articulates the argument in the following way:<sup>1</sup>

BARNZ notes that the complementary nature of the retail and car-parking activities occurring at airports has led many countries to treat airports as single till businesses, with aeronautical charges set after taking into account the non-aeronautical revenue earned by the Airport. Heathrow Airport is one of the most well-known examples. Regulation of New Zealand Airports is currently implicitly based on a dual till approach, whereby assets, costs and revenues are split between the different activities, with charges for aeronautical activities set in isolation from the tens (even hundreds) of millions of dollars able to be earned from the provision of car-parking and retail activities to airline passengers.

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<sup>1</sup> BARNZ *Submission by BARNZ on Commerce Commission Draft Report on how effectively information disclosure regulation is promoting the purpose of Part 4 in relation to Wellington Airport*, 30 November 2012 ("**BARNZ Submission on WIAL Draft Report**"), pages 10 - 11.

The fact that such a lucrative complementary revenue stream exists, means that it is not necessary for Airports to set charges at the 75th percentile WACC estimate in order to be incentivised to innovate and invest – the presence of the ability to earn additional revenue from provision of these complementary or ancillary services already provides additional incentive to Airports to invest in maintaining or adding aeronautical capacity. Any internal consideration by airports of the business case for adding additional aeronautical capacity (such as additional contact gates, hard stands or passenger processing capacity), will not only take into account the forecast aeronautical revenue to be earned from such investment, it will also consider the likely increase in retail and car-parking revenue from the additional passenger volumes. Airports fundamentally differ from other regulated businesses such as gas pipelines and electricity lines businesses in this respect.

BARNZ therefore considers that the Commission's analysis of the returns earned, and forecast to be earned by Wellington Airport (and all regulated airports) should utilise the mid-point estimate of the WACC range.

16. Auckland Airport believes BARNZ's argument to be misconceived. Part 4 of the Act clearly and expressly requires a dual till approach to regulation of airport activities, under which the Commission's task is to estimate an appropriate WACC for the regulated business. Only those services that fall within the definition of specified airport services are regulated, and the Commission's power to require disclosure of information regarding unregulated activities is severely limited (see section 53D of the Act).
17. Using the 75<sup>th</sup> percentile recognises the risk of the regulatory WACC estimate being below the true WACC. It makes no sense, in a dual till environment, to accept a greater risk of setting the regulatory WACC too low on the basis that the regulatory error will be compensated by revenue earned from non-regulated activities.
18. Despite these clear requirements, the airlines continue to seek single till outcomes under Part 4. In earlier submissions on the section 56G Review, Air New Zealand advocated that the Commission should analyse airport returns on the basis of a single till type approach:<sup>2</sup>

Air NZ submits that the current focus on a portion only of airports' businesses does not allow for a proper assessment of whether the purpose of Part 4 is being met. In many jurisdictions where effective regulation of airports is applied, prices for aeronautical services provided by airports are set after taking account of forecast revenues from non-regulated parts of the airport. In this way the overall return of the airport is taken into account when establishing prices for monopoly services. This reflects practice in competitive markets where a business owner, when assessing returns, will consider the overall performance of the business rather than the individual business units. Analysis of individual business unit performance will be important in ensuring that all are performing effectively but the overriding concern is the overall performance. Air NZ considers that the Commission must undertake such an analysis to properly understand airport performance, and require sufficient information to allow it (and other interested persons) to do so.

19. This argument quite properly failed to gain any traction with the Commission, and airlines now appear to be rehearsing the same argument in support of seeking the 50<sup>th</sup> percentile as a target return.
20. While advocating for a single till approach is not a novel argument, it is not an argument that was advanced by airlines during pricing consultation (except for consideration of how costs should be properly allocated in light of the dual till). Accordingly, Auckland Airport considers that it is inconsistent for BARNZ to encourage the Commission to revise its pricing reference point of the 75<sup>th</sup> percentile to the 50<sup>th</sup> percentile, when

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<sup>2</sup> Air New Zealand *Submission on section 56G Report Airport Services Process and Issues Paper* 29 June 2012, at paragraph 118.

BARNZ elected to apply the Commerce Commission's updated 75<sup>th</sup> percentile WACC estimate of 8.04 percent when considering the charges proposed in Auckland Airport's Revised Pricing Proposal.<sup>3</sup>

Therefore, in order to provide an absolutely reasonable yardstick for comparison, the BARNZ Represented Airlines have elected to apply the updated Commerce Commission's 75<sup>th</sup> percentile WACC estimate of 8.04 percent when considering the charges proposed by Auckland Airport.

21. In our view, advancing this argument during the section 56G Review is opportunistic, and more properly falls outside the section 56G Review, which, as clearly signalled by the Commission, is not a review of the dual till approach.

*Why adopting the 50<sup>th</sup> percentile is not rational from an economic perspective*

22. The Commission's rationale for adopting the 75<sup>th</sup> percentile estimate of WACC relates to the asymmetric risk of social consequences associated with estimation error - that is, it is better to err on the high side than the low side, as the welfare consequences of under-investment are worse than the consequences associated with over-investment.

23. In its submission on the Draft Report, BARNZ argues that the Commission need not concern itself about using the 75<sup>th</sup> percentile for this purpose in respect of airports, as the complementary revenue from commercial services will mitigate any concerns about the risks associated with under-investment. In our view, this is akin to arguing that the Commission should not overly concern itself as to whether it gets the WACC estimate wrong, as WIAL can cross-subsidise aeronautical activities from the commercial side of its business. However, this would be an ad hoc response that would blur the boundary between dual till and single till, without any appropriate analysis of the implications of doing so. Accordingly, the risk of regulatory error in relation to setting an appropriate target return for aeronautical assets is high, such that the risk of asymmetric social consequences remains.

24. The risks and implications of a lower WACC that would result if the Commission adopts the single till approach advocated by airlines include:

- (a) minimising capital investment, potentially at the expense of industry outcomes;
- (b) delaying efficient investment;
- (c) increasing congestion;
- (d) reducing regulatory certainty; and
- (e) reducing investment on the commercial side.

*Why use of the 50<sup>th</sup> percentile is not good in practice: it may dis-incentivise investment that benefits airlines and consumers in the long term*

25. As outlined in earlier submissions, Auckland Airport is concerned that adopting the 50<sup>th</sup> percentile creates a risk that airports will not be incentivised to invest in regulated assets beyond minimum requirements. It is important to note that in some circumstances, the lowest cost investment for an airport may not be the highest value input for the industry. In our view, the position adopted by the airlines fails to recognise that airport investment is often designed to meet the commercial interests of airlines. Airports operate as nodes in networks for airlines. Accordingly, there can be real value for airlines in how airports develop and operate within the network, and in particular, real value can be achieved

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<sup>3</sup> BARNZ Submission by BARNZ on Auckland Airport Revised Pricing Proposal on Behalf of the Airlines it has Authority to Fully Represent, 7 May 2012, at page 2.

when airports invest more, rather than less, in developing capacity to facilitate the operation of these networks.

26. The new terminal facility ("**NTF**") at Auckland Airport provides a useful and current example of capacity expansion. Logically, if the Commission's approach pushes airports towards lower returns, Auckland Airport would be incentivised to spend the least money possible when investing in infrastructure even where this might result in a potentially less efficient operating environment for airlines.

*There are significant risks if the Commission gets it wrong*

27. As discussed in our earlier submission and alluded to above, Auckland Airport is concerned that, if the Commission adopts the 50<sup>th</sup> percentile in assessing profitability, it increases the probability of setting a regulated WACC for regulated assets below true WACC, and therefore risks the following:
- (a) limiting opportunities to access capital markets;
  - (b) compromising New Zealand airports' competitiveness with our understanding of the approach taken by Australian airports, which seek higher returns than those set by the Commission's WACC existing estimate at the 75<sup>th</sup> percentile;
  - (c) de-prioritising aeronautical investment in favour of other investment where appropriate returns can be earned; and
  - (d) dis-incentivising investment in the short term, contrary to limb (a) of the Part 4 purpose statement. This is a risk which is exacerbated for large scale infrastructure investments in long-life assets, as required for airports.
28. In this context, and as discussed in our submission on the Draft Report, it is essential that the Commission adopt a "helicopter approach" to assessing airport returns in order to ensure it does not risk regulatory error. The risk of negative investment consequences which flow from a short-term return focus have been recently recognised by the Australian Productivity Commission, which stated that:<sup>4</sup>

Thus, for price-regulated industries, decisions by a regulator on the appropriate 'asset beta' can significantly affect the prices charged for those investments. However, there is no single 'correct' asset beta or market risk premium, and setting parameters that result in a lower-than-required WACC (and thus lower prices as the cost of capital feeds into the building blocks model) can result in inadequate or delayed investment, as investors seek higher returns elsewhere. For a regulator targeting a particular rate of return that it deems to be 'appropriate', the risks of over- or under-shooting the cost of capital are not symmetrical...

While rates of return may vary over time, a business must earn its WACC *on average* to make investment attractive. But if a regulator acts to curtail high rates of return, while ignoring periods of low returns, then the business will not earn the returns needed to attract investment funds. This movement by a regulator only against high returns is known as 'asymmetric truncation'.

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<sup>4</sup> Australian Productivity Commission *Economic Regulation of Airport Services*, 14 December 2011 (Inquiry Report no. 57), page 126-127.

**The appropriate WACC is the WACC estimate at the time that prices were set**

29. When WIAL set its prices in March 2012, the most recent WACC determination available was approximately 8 months old (8 July 2011). The Commission described its decision to use the 27 April 2012 determination for WIAL as follows:<sup>5</sup>

We consider that the most appropriate WACC to use in assessing Wellington Airport's forecast returns is the cost of capital closest to the time at which prices were set, and therefore have used as the basis for our assessment of returns for PSE2 the cost of capital determination dated 27 April 2012.

30. The Commission is silent in the WIAL Draft Report on the fact that this determination was made after WIAL set prices.
31. Auckland Airport released its pricing decision on 7 June 2012, but actually set prices based on the WACC estimate and price points on 20 May 2012. Therefore the two determinations surrounding the price setting event ("**PSE**") were the determinations dated 27 April 2012 and 30 July 2012. However, the estimates contained in these determinations were as at 1 April 2012 and 1 July 2012 respectively. As set out in Table 1 below, Auckland Airport's WACC estimate fell between these two determinations.

**Table 1: WACC Determinations prior and subsequent to Auckland Airport's PSE2**

WACC percentile	27 April Determination estimate	30 July Determination estimate
Mid-point	7.06%	6.49%
75 <sup>th</sup> percentile	8.04%	7.48%
75 <sup>th</sup> percentile adjusted for AIAL specific beta	8.44%	7.86%

32. If "closest to the time at which prices were set" refers to the date the determination was issued, then it is the 27 April 2012 determination that is relevant, irrespective of whether 20 May or 7 June is considered closest to the date prices were set. However, if "closest" refers to the date the estimate relates to, it would be the 30 July 2012 determination. The Commission has given no guidance about what "closest" means because either definition would result in the 27 April determination being used for WIAL.
33. In our view, the appropriate and principled WACC estimate for the section 56G Review relating to *ex ante* forecasts is the WACC estimate at the time prices were set. Alternatively, if one of the WACC IM determinations must be selected, then an airport's intention in setting prices should be measured against information it had available to it at the time of pricing. This means that WACC IM determinations after prices were set should not be used.
34. In relation to Auckland Airport's specific circumstances:
- (a) we note that both Auckland Airport and Substantial Customers were guided by the April WACC determination, which was a key reference point evidenced on Auckland's consultation record, and could not have conceivably been guided by future parameters.

<sup>5</sup> Commerce Commission *Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport: Section 56G of the Commerce Act 1986*, 2 November 2012 ("**WIAL Draft Report**"), paragraph 157.

- (b) there are transaction costs involved in resetting prices in response to updated WACC inputs, and marginal benefit given the uncertainty around estimating WACC. A sound process requires provision of a detailed reasons paper on the decisions and adequate notification time for airlines to update their systems for the new prices meaning it is not possible to price with WACC parameters as at the time of price changes becoming actioned.

### **Non-parameter bias**

35. Futures Consultants argues that the true WACC is biased upwards as a result of three out of four non-parametric uncertainties, and therefore concludes that the WACC is likely to be overstated.<sup>6</sup> We refer to and agree with the NZ Airports submission and UniServices report in response to this argument.
36. Auckland Airport is deeply concerned that economic theory and assumptions, which are not quantifiable, are seeking to further reduce an already commercially unrealistically low WACC estimate. We do not see how any airport could justify investment at a return lower than the 50<sup>th</sup> percentile of the WACC IM.

### **Assessing profitability on the basis of costs paid by consumers**

37. Airlines advocate that the Commission's analysis in its Draft Report on WIAL should be supplemented by an assessment of profitability on the basis of costs paid by consumers:<sup>7</sup>

BARNZ considers that the Commission's report also needs to disclose the impact of the over-charging by Wellington Airport in terms of how much additional revenue users will have to pay the Airport in charges as compared with what would be paid to enable the Airport to earn its midpoint cost of capital. This is the additional cost consumers have to pay as a result of the Airport targeting a WACC in excess of the level applicable in workably competitive markets.

38. Auckland Airport agrees that this analysis could be a useful supplement. In this regard, we note that the Airport Pricing Inquiry included analysis on a per passenger basis for key inputs such as operating expenditure (although overall analysis was not done on a per passenger basis until the Minister determined the overall impact of imposing control would be 35 cents per passenger).
39. We agree with CIAL's submission on the WIAL Draft Report that per passenger analysis is more meaningful than per movement analysis. Additionally, Auckland Airport considers that the public is interested in the extent to which prices increase or decrease in real terms relative to inflation.

### **Airlines argue that the Commission should assess excess revenue rather than excess profit**

40. BARNZ provides the following comment in its submission:<sup>8</sup>

However, this calculation does not provide an indication of the excess charges paid by airlines and the travelling public, which are necessarily greater due to the impact of tax, which because of its inclusion in the building blocks approach, uplifts the amount of revenue sought by the airport. Users not only have to meet the high cost of capital being targeted by Wellington Airport. They also have to meet the additional tax payable as a result of the increased profits. In addition, in the case of end use consumers, GST also has to be paid on the higher

<sup>6</sup> Futures Consultants Limited *The Commerce Commission's Draft 56G Report on WIAL: Comments on Selected Aspects*, 27 November 2012 ("**Futures Consultants Limited Report**"), page 3.

<sup>7</sup> BARNZ Submission on WIAL Draft Report, page 11.

<sup>8</sup> BARNZ Submission on WIAL Draft Report, page 11.

charges and is not able to be claimed back, which further increases the impact on consumers of the over-charging by Wellington Airport.

41. Essentially, airlines are requesting that rather than look at excess profits, the Commission look at excess revenue (which includes taxes).<sup>9</sup> This approach would require the Commission to quantify any surplus transfer away from consumers - even though:
- (a) part of the transfer is to the airports in the form of profits; and
  - (b) the other part is to the government in the form of tax.
42. Furthermore we note that for international services, where airports and airlines are GST registered, there is no GST impact on either airports or airlines. In accordance with the GST legislation, airports are required to charge GST as the services are being performed in New Zealand and can be claimed by the airline. However, for the transport of passengers, ie the airline charges to passengers, this does not incur GST. Accordingly, we believe it would be entirely inappropriate for the Commission to gross up profitability estimates for tax.

### **Leased regulatory assets**

43. Futures Consultants and the airlines argue that including leased assets in the profitability assessment results in an underestimation of excess profits.<sup>10</sup> In response, Auckland Airport notes the following:
- (a) ID Requirements do not allow airports to obscure returns simply because leased assets are excluded from the scope of services on which prices are set following consultation.<sup>11</sup> Typically, airports have removed leased assets from pricing consultation in a transparent manner.
  - (b) the Commission's role to monitor returns on *all* aeronautical assets within the definition of specified airport services.
  - (c) the scope of the price setting disclosure and the annual disclosures are as required by the ID Regime and were driven off the existing AAA definitions of regulated services.
  - (d) in this respect, the Commission has been entirely consistent with its requirement to evaluate the effectiveness of ID relative to the totality of regulated activities.
  - (e) given that leased assets are regulated assets, it makes no sense to attempt to categorise them by degrees of competition in the way Futures Consultants seeks to.

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<sup>9</sup> BARNZ Submission on WIAL Draft Report, at page 11; Air New Zealand *Submission to the Commerce Commission on the "Draft report to the Ministers of Commerce and Transport on how effectively disclosure regulation is promoting the purpose of Part 4 for Wellington Airport"*, 30 November 2012 ("**Air New Zealand Submission on WIAL Draft Report**"), at paragraphs 19-21.

<sup>10</sup> Futures Consultants Limited Report, page 5; BARNZ Submission on WIAL Draft Report, pages 12-13; Air New Zealand Submission on WIAL Draft Report, paragraphs 24-25.

<sup>11</sup> As set out at page 14 of Auckland Airport *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2012*, 2 August 2012: "As indicated in Part A of this Disclosure, the revenue requirement for the 2012 Pricing Decision did not include Other Regulated Activities, such as aircraft and freight activities and certain passenger terminal services, namely identified tenancies leases and collection facilities for duty-free goods. This is because the revenue from these activities is not recovered by way of Standard Charges. Auckland Airport's revenue requirement for Other Regulated Activities is instead determined through negotiation of individual leases and/or licences between Auckland Airport and individual customers based on market value."

44. Futures Consultants also argues that the fact that leased activities have historically earned a return below WIAL's targeted WACC suggests that the WACC target is excessive.<sup>12</sup> In effect, Futures Consultants is arguing that a sub-category of aeronautical assets provide a benchmark for the WACC on all aeronautical assets. Auckland Airport responds as follows:
- (a) In Auckland Airport's disclosures in some years the leased activities have earned above WACC returns due to the treatment of revaluations. Therefore the systematic difference Futures Consultants implies is not correct in all instances.
  - (b) Futures Consultants argument that leased activities should provide the benchmark could only be the case at a theoretical level if the leased activities carry the same systematic and/or asymmetric risk as all aeronautical activities.
  - (c) Generic leased areas are driven from a different demand function – that is, the property market, rather than actual passenger demand. Put another way, there is a distinct demand curve, and accordingly there is no reason to assume that the cost of capital on the leased assets forms a relevant benchmark for all aeronautical assets. This assumes that leased assets are far less specialised and/or sunk than aeronautical assets, which would have implications for riskiness of cash flows.
  - (d) The fact the historical returns on leased activities have been below WACC for WIAL could simply be an indicator that this market has been performing poorly, which aligns with our understanding of commercial reality.
45. In summary, Auckland Airport considers the Commission's approach is consistent with the requirement to consider the effectiveness of ID for all regulated activities.

#### **Commission's modelling framework**

46. In our submission on the Draft Report, Auckland Airport recommended the Commission amend the internal rate of return ("IRR") analysis slightly to enable more robust interpretation, as follows:
- (a) To separate the two and five year analysis in the following way:
    - (i) Two year *ex post* analysis, referencing the forecast IM compliant WACC at the time of the first PSE. As outlined in our submission on the Draft Report, Uniservices' analysis estimates the Commerce Commission compliant benchmark as at June 2007 was for a WACC range of 9.11 percent -10.09 percent.
    - (ii) Five year *ex ante* analysis, assessing the reasonableness of inputs and forecast returns against an assessment of what was a reasonable return at the time of price setting.
  - (b) While Auckland Airport accepts that all modelling requires assumptions, in our view, any conclusions that come out of a modelling exercise should properly include explicit acknowledgement of the assumptions that underlie modelling results, in order to make clear the limitations of the modelling used. This is a general point of principle rather than a specific criticism of the Commission's approach to modelling.

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<sup>12</sup> Futures Consultants Limited Report, page 5.

47. BARNZ's submission on the WIAL Draft Report criticises a number of the Commission's assumptions in its modelling on the basis that the Commission's estimates:
- (a) are conservative;
  - (b) favour WIAL; and
  - (c) should be assessed by reference to investment decisions taken prior to the implementation of the ID Regime.
48. Auckland Airport does not share the concerns articulated by BARNZ. In our view, modelling cannot, in isolation, provide clear answers to whether ID is effective in promoting the limbs of the Part 4 purpose statement. This is because assessing the effectiveness of ID requires an overall assessment of performance against all limbs of the purpose statement. Not all of the limbs can be solely captured by any sort of modelling or formulaic approach. Accordingly, we are concerned to ensure that the Commission's approach:
- (a) acknowledges that modelling is *one factor* for it to weigh in to its assessment, which cannot be determinative of effectiveness;
  - (b) is explicit about the assumptions that underlie it; and
  - (c) is principled and consistent across all regulated airports.

## EFFICIENCY ASSESSMENT

### Opex efficiency

49. BARNZ advocates for the Commission reaching separate conclusions regarding historical and forward looking opex.<sup>13</sup> In our view, this is in principle a reasonable argument. It is consistent with concerns raised in our previous submission regarding the limitations of a 7 year IRR analysis, on the basis that it conflates *ex post* and *ex ante* assessments.

50. However, BARNZ then invites the Commission to find that WIAL has failed to promote opex efficiency on the basis of its analysis of only 2 years of actuals.<sup>14</sup>

BARNZ considers that there is clear evidence that Wellington Airport has avoided sharing the benefits of economies of scale with consumers over the first two years of disclosure under Part 4 through its inefficient increases in operating costs... BARNZ therefore does not consider that the Commission's draft conclusion that it is unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers is valid. The Commission has failed to give sufficient weight to the evidence of reductions in operating efficiency at Wellington Airport over the first PSE...

51. BARNZ goes on to contradict itself elsewhere in its submission on the Draft Report where it argues that opex efficiency needs to be measured over the longer term.<sup>15</sup>

In BARNZ's opinion, it is the measurement of trends over time at each Airport which will provide the strongest evidence about whether efficient levels of operating expenses are being achieved.

52. The latter comments expressed by BARNZ, while inconsistent with its earlier comments, are consistent with the Commission's position that ID is more effective once trends are known and can be compared between airports.<sup>16</sup>

We expect that it will take a number of years for information disclosure regulation to be fully effective at promoting operating efficiency. That is because the effectiveness of information disclosure in this area is dependent on the availability of data to assess trends in expenditure, as well as to make comparisons with other airports. This information was not available at the time of consultation for PSE2.

53. In our view, this is the correct approach - where the Commission has focussed on whether ID is effective rather than whether there are adverse performance outcomes, which we note is an entirely different test to that required by section 56G.

54. Rather than focusing on comparing opex between airports, the Commission should focus on trends over time. As discussed by CIAL in its submission on the WIAL Draft Report, when assessing absolute levels of opex, and trends in opex at a particular airport, the Commission needs to be aware that trends in opex vary with the infrastructure life cycle. In the early years of a facility the focus is on capex, and levels of opex (for example, maintenance) are comparatively low. Toward the end of the life of a facility, opex will be more prominent. This dynamic needs to be factored into the Commission's assessments of the relative performance of airports that are at different stages of their infrastructure investment lifecycle.

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<sup>13</sup> BARNZ Submission on WIAL Draft Report, page 3.

<sup>14</sup> BARNZ Submission on WIAL Draft Report, pages 6 - 7.

<sup>15</sup> BARNZ Submission on WIAL Draft Report, page 3.

<sup>16</sup> WIAL Draft Report, paragraph B9.

55. Airport-specific factors also result in different levels of opex. In addition, there are a range of factors that might result in different levels of opex between airports, and these need to be considered. For example:
- (a) the business model applied – relative ratio of in-sourced to out-sourced services;
  - (b) the mix of international to domestic processing;
  - (c) the relative ratio of aeronautical to commercial activity, where shared fixed costs may be spread across a varying range of activities;
  - (d) whether there is a curfew or not; and
  - (e) the impact of events created by climatic variations (for example, snow or fog etc).
56. We note that the Commission has stated that there may be reasonable levels of opex efficiencies to be made in the industry given the current operating environment. We acknowledge that we continue to target cost efficiencies per passenger and the strong desire from airlines during consultation that efficiencies should be built into pricing.
57. However, we query the Commission's assumption that there may be reasonable levels of opex efficiencies in the industry. The accuracy or otherwise of this assumption will only become clearer following a time series of annual reviews.
58. We note literature summarised in the Australian Productivity Commission's 2002 Report which highlights that:
- (a) while there are economies of scale in the provision of runways, there are likely to be diseconomies in other areas, such as terminal facilities (passenger handling).<sup>17</sup>
  - (b) the extent of scale economies in overall airport operations depends on which effect dominates.
  - (c) difficulties in maintaining access between airside and landside facilities as airports expand also influence the overall degree of scale economies in airport operations.<sup>18</sup>
59. The Australian Productivity Commission concluded that, overall, economies of scale appear to be limited to airports with relatively low passenger numbers — with some analysts claiming that falls in average costs are exploited fully at about 3 to 3.5 million passengers per annum.<sup>19</sup>

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<sup>17</sup> Betancor, O. and Rendeiro, R. (1999) "Regulating privatized infrastructures and airport services" World Bank Policy Research Working Paper no. 2180, September 1999; Walters, A.A. (1978) "Airports: an economic survey" *Journal of Transport Economics and Policy*, vol. 12, no. 2, pages 125–160 (cited in Australian Productivity Commission *Price Regulation of Airport Services: Inquiry Report*, Report 19, 23 January 2002 at page 100).

<sup>18</sup> Starkie (2001) "A new deal for airports", in Robinson, C. (ed.), *Regulating Utilities: New Issues, New Solutions*, Edward Elgar Publishing, Cheltenham, United Kingdom; Starkie and Thompson (1985) *Privatising London's Airports*, Institute of Fiscal Studies, Report Series no. 16, London (cited in Australian Productivity Commission *Price Regulation of Airport Services: Inquiry Report*, Report 19, 23 January 2002 at page 101)

<sup>19</sup> Doganis, R. (1992) *The Airport Business*, Routledge, London; Doganis 1992; Salazar de la Cruz 1999. Salazar de la Cruz, F. (1999) "A DEA approach to the airport production function" *International Journal of Transport Economics*, vol. 26, no. 2, pp. 255–70. (cited in Australian Productivity Commission *Price Regulation of Airport Services: Inquiry Report*, Report 19, 23 January 2002 at page 101).

60. The Australian Productivity Commission also notes that larger airports may encounter decreasing returns to scale. Salazar de la Cruz (1999), for example, found that average costs may increase past 12.5 million passengers per annum (with constant returns between about 3.5 and 12.5 million passengers). This would imply that efficiency is still achieved beyond 12.5 million passengers since, at passenger numbers just beyond this number, one airport would still have lower unit costs than two airports serving the same total market.
61. The Australian Productivity Commission considered that although these results may not hold *precisely* for Australian airports (given differences in airport traffic and general economic and regulatory conditions), they are likely to be *indicative* of the situation in Australia. In our view, the same indications are likely to be true in the New Zealand context.

**Airlines argue that sharing efficiency gains requires single till price setting**

62. BARNZ argues that because WIAL does not set its prices consistent with a single till regime, it is therefore not sharing the benefits of efficiency gains.<sup>20</sup> In Auckland Airport's view, this is again a clear effort to inappropriately undermine the dual till. Auckland Airport has successfully been driving efficiencies in passenger processing. These benefits are shared with the airlines through the delay of the need for significant capital expenditure in the form of capacity enhancements. In our view, the only exercise within the scope of the section 56G Review is to analyse the arguments set out on cost allocation, as has already been done by the Commission.

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<sup>20</sup> BARNZ Submission on WIAL Draft Report, page 6.

## FRAMEWORK CONCERNS

63. In its submission on the WIAL Draft Report, the airlines attack the following:
- (a) the ability of the ID Regime to incentivise behaviour consistent with Part 4 outcomes;
  - (b) the ability of the AAA to influence airport capex decisions (and therefore innovation and investment) because of the 20 percent capex threshold; and
  - (c) the failure of ID to achieve the purpose of Part 4 immediately.
64. Auckland Airport addresses each of these arguments in turn below.

### Incentivising behaviour

65. In its submission on the WIAL Draft Report, Air New Zealand attacks the ability of the ID Regime to incentivise behaviour consistent with Part 4 outcomes:<sup>21</sup>

Given ... the Commission's conclusions in respect of WIAL's excessive profits and the inability to determine whether it is sharing efficiency gains, it is therefore clear that the current information disclosure regime has failed. The fact that WIAL proceeded to set the charges it did, notwithstanding the knowledge of the new Part 4 regime, highlights a fundamental lack of any sort of credible threat which, in theory, is supposed to lie at the heart of the airport pricing information disclosure regulatory regime. WIAL's unwillingness to acknowledge the relevance of the Part 4 regime to pricing demonstrates without any doubt the failure of the current regime. As the Commission itself notes, "if it is effective, information disclosure should have its greatest impact in promoting the profitability based objectives in s52A(1).

66. In our view, it is opportunistic of airlines to argue that the ID Regime is lacking a credible threat to incentivise airport behaviour. As articulated in our earlier submission, the ID Regime has contained a very clear threat of further and more heavy-handed regulatory intervention should ID be deemed ineffectual. This has been a factor that materially influenced our price setting consultation and decision.
67. This Review presents the first opportunity for airports to receive feedback from the Commission on their performance. Looking ahead, the summary and analysis reports that the Commission will prepare will provide additional valuable guidance and direction.
68. We think it is simply not credible to claim that the ID Regime is incapable of incentivising behaviour consistent with the Part 4 purpose statement where:
- (a) there has only been one PSE under the ID Regime. The ID Regime cannot realistically be expected to have achieved the level of change sought by the airlines in the time that it has been operating. This has been correctly recognised in respect of a number of limbs of the purpose statement where the Commission has concluded that it is too early to tell whether ID is effective.
  - (b) the WIAL Draft Report has in fact identified a number of areas where ID appears to be working.
  - (c) some of the targets sought by airlines in submissions on the section 56G Review are inconsistent with the Part 4 purpose statement.

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<sup>21</sup> Air New Zealand Submission on WIAL Draft Report, paragraph 7.

### AAA capex consultation

69. In its submission on the WIAL Draft Report, BARNZ argues that AAA capex consultation is ineffective.<sup>22</sup>

The second observation by BARNZ relates to comments made by the Commission on the effectiveness of the Airport Authorities Act requirement for airports to consult over significant capital expenditure. The Commission appears to have assumed that this requirement acts as a constraining factor on airports, preventing them from undertaking investment which does not have the support of users. It does not. The threshold for consultation over capital expenditure under section 4C of the AAA of the project cost being 20% or more of the cost of the regulated assets is now so high as a result of ongoing asset revaluations that it is only triggered extremely rarely. In fact, BARNZ is only aware of it being triggered once – which was the new terminal building at Christchurch Airport which is just being completed. The s4C capex consultation requirement was not triggered for The Rock or the RESAs at Wellington Airport or for Pier B or the new international arrivals area at Auckland Airport. Nor was it triggered for the now postponed first stage of the Northern Runway at Auckland Airport. The ongoing practice of asset revaluations has virtually rendered the requirement in s4C to consult over major capital expenditure projects nugatory and it certainly does not act as a constraining factor on airports in practice.

70. Auckland Airport is puzzled by the argument advanced by BARNZ. In fact, Auckland Airport has consulted with airlines in relation to all of the examples of capex projects cited by BARNZ in its submission on the WIAL Draft Report - that is, Pier B, the new international arrivals area and the Northern Runway.

71. We also note BARNZ has acknowledged Auckland Airport's practice of consulting on all significant investment decisions in its submission on the Commission's Discussion Paper on Regulatory Provisions of the Commerce Act 1986 on 16 February 2009.<sup>23</sup>

Despite the fact it is not required to do so under s4C of the AAA, AIAL nevertheless consults fully on all significant capital expenditure, and agreement has been able to be reached between AIAL and airlines over the need for, timing and design (although not the allocation of costs and assets or the impact on prices) of projects such as:

- The separation of arriving and departing passengers, which required the construction of a second level on the international pier
- The construction of a second baggage makeup hall so as to enable the installation of hold stow baggage screening equipment which was not possible to install in a working bag hall as busy as the bag hall at Auckland Airport
- The construction of the first two gates of, and a connector to, Pier B
- The construction of a new arrivals area for Customs processing of passengers (the first component of Stage 3 of the terminal – called 3A or 'early arrivals'.

Through consultation, AIAL also came to accept the position of the airlines that Stage 3B of the terminal (construction of a new MAF processing area for arriving passengers and a meeters and greeters hall) should not be accelerated and that construction should not commence until there was a clear need for it.

72. More recently, BARNZ acknowledged at the WIAL section 56G review conference that Auckland Airport consults well below the statutory threshold of 20 percent:<sup>24</sup>

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<sup>22</sup> BARNZ Submission on WIAL Draft Report, page 4.

<sup>23</sup> BARNZ Submission on the Commission's Discussion Paper on Regulatory Provisions of the Commerce Act 1986, 16 February 2009, pages 18-19.

<sup>24</sup> Section 56G Review Wellington Airport Conference transcript, 7 August 2012, page 11.

**MS COOPER:** BARNZ is not involved in the day-to-day operational issues at Wellington Airport, more aware of them really at Auckland, and I think at Auckland there's regular involvement through the AOC with airline participants where airlines are able to comment on the capital expenditure plans and the upgrade plans by the airport to a level which is considerably below the statutory threshold for consultation. So, I think that's a key point, that airlines value that sort of level of consultation for projects which are going to cost \$1 million or \$2 million as opposed to the statutory level, which I think is up to, gosh, \$60 million or \$70 million now.

73. As with our approach in price setting disclosures (where we provided additional information in order to assist understanding), Auckland Airport positively approaches consultation in accordance with the spirit of the AAA, and with a desire to engage with its customers rather than focusing on the precise statutory threshold.
74. In Auckland Airport's view, AAA consultation is effective. The NTF is a prime current example where Auckland Airport, having begun consultation, reconsidered its options as a result of a counter proposal put forward by Air New Zealand - the "southern option" - which is now also being optimised and fully considered by Auckland Airport with an open mind prior to conducting a further consultation process.

#### **Failure of Part 4 to achieve the Part 4 purpose statement**

75. Air New Zealand advances the position that ID has failed to achieve the purpose of Part 4. In its discussion of the sharing of efficiency gains, Air New Zealand notes that:<sup>25</sup>

The relevance of this aspect of information disclosure to profitability, and the failure of information disclosure regulation to influence WIAL's behaviour only serves to highlight the failure of information disclosure to achieve the purpose of Part 4.

76. However, this is not the correct test for determining the effectiveness of ID. Nowhere in Part 4, and certainly not in the language used under section 56G, is it suggested that the Part 4 purpose statement is something that is achieved (or not) in the short term. The core purpose is to promote the long term benefit of consumers. As correctly articulated by the Commission, regulation under Part 4 *promotes* outcomes consistent with the purpose statement, on an ongoing basis. The report under section 56G is a progress report only, and does not require a definitive view on whether ID has succeeded or failed.
77. In our view, ID is most certainly achieving the purpose of Part 4 in some areas, and in others may be characterised as establishing the foundation for continued improvement.

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<sup>25</sup> Air New Zealand Submission on WIAL Draft Report, paragraph 29.