POST AUCKLAND AIRPORT SECTION 56G CONFERENCE SUBMISSION

15 March 2013 (Redacted information revised 22 March 2013)

Public Version - Commercially confidential information the subject of a Confidentiality Deed Between Auckland Airport and BARNZ which is the property of Auckland Airport has been deleted

The BARNZ Represented Airlines acknowledge and appreciate:

- Auckland Airport's willingness to innovate
- The level of quality in Airport facilities provided to passengers and the reliability and quality of the specialised aeronautical facilities used by the airlines at Auckland Airport
- Auckland Airport's receptiveness to airline needs regarding investment, innovation and quality levels
- The level of engagement Auckland Airport undertakes in relation to major capital investment projects and the fact that, for the most part, the Airport times its investment to coincide with the need for additional capacity.

However, these outcomes are not seen as being attributable to information disclosure regulation under Part 4. Rather, Auckland Airport has always been very focused on these matters, as acknowledged by BARNZ in the 2001 hearings by the Commission into airfield pricing.

Information disclosure regulation by itself, has failed to produce any material improvement in relation to the outcomes listed in section 52A.

It has not resulted in Auckland Airport sharing the benefits of any efficiency gains with consumers. In fact, the removal of the TSC Agreement significantly reduced the ability of airlines to share in the benefits of both economies of scale and economies of scope relating to activities in the international terminal.

Most significantly, information disclosure regulation does not place any limit on the ability of an Airport to earn excessive returns. This is seen both in Auckland Airport's decision to set charges on international terminal activities so as to target an 11% return on that aspect of its business, and in the fact that the Airport is not precluded from moving to reset prices in 2017 using a MVEU

valuation of its land and a new ODRC valuation of its specialised assets, without treating any of those actual revaluations as income in the charge setting process.

Auckland Airport's clearly stated preference, as conveyed to airlines at the beginning of the pricing consultation, is for it to revalue its land using MVEU with a new ODRC valuation of specialised assets and to only treat forecast revaluations as income for the purposes of setting charges, with any unforecast revaluations being retained by the Airport. This is also the position Auckland Airport advocated to the Commerce Commission during the input methodology setting process, and is the position the Airport is currently putting forward in the merits review process being undertaken by the High Court. It would leave the Airport retaining the benefit of all valuation uplifts since 2006. This approach would result in the NPV = 0 rule being materially breached and significant excess returns and windfall profits being extricated by the Airport.

That such an outcome is permissible under Part 4 information disclosure regulation clearly demonstrates that by itself, information disclosure regulation is not able to effectively limit the ability of airports to extract excessive returns.

Responses to Questions Posed by the Commerce Commission

1. An indication of the difference between the different inputs to the alternative land use valuation plan to determine the market value alternative use valuation of Auckland Airport land.

The key differences identified by BARNZ's valuation and town planning advisors in their reports prepared to date on the Auckland Airport 2011 MVAU valuation were the amount of commercial or non-residential land included in the development mix and the likely time for the development to occur and be sold.

BARNZ has sought further advice from Zomac Planning Solutions, Market Economics and Property Advisory Ltd (PAL) on these issues, as well as a full valuation report from PAL. Their reports are attached.

Amount of commercial space

Auckland Airport's planning advice provided by Common Ground included 74.1 ha of commercial space, which Common Ground translated to 518 841 m2 of commercial gross floor area (GFA) in its table of development outcomes on page 23 of its alternative use report. Common Ground included 'over 500 000m^2 commercial GFA for mixed use development' as one of its stated key outcomes.

The advice which BARNZ received from Market Economics and Zomac Planning Solutions was that this was significantly too much commercial space, with Market Economics advising that 204 000 to

264 000m^2 of commercial GFA would be the sustainable commercial space for the population expected under the MVAU scenario.[1] Market Economics considered that Common Ground had overstated how much commercial use there would be on Auckland Airport land under an MVAU scenario by around two to two and a half times. Market Economics and Zomac Planning Solutions have both confirmed to BARNZ that they continue to consider the 518 841m^2 of commercial GFA included by Common Ground to be substantially over-stated.

However, Colliers, which undertook the valuation for Auckland Airport, have advised in cross-submissions that they applied commercial land on a net land area basis, and not on a gross floor area basis within the precincts. Thus Colliers explained that they treated 259,841 square metres of commercial space as a net land area, (ie 25.9841ha) rather than a gross floor area.

Clearly, there is a fundamental inconsistency between the Common Ground alternative land use plan (which includes over 500 000 square metres of commercial gross floor area as a key outcome) and the Colliers valuation report which treats this as a net land area.

BARNZ's advisors have re-examined the need for non-residential space on a net land area basis, converting the Market Economics' gross floor areas to net land areas. This exercise has highlighted that on a land area basis, there is a large degree of conformity between Colliers and the BARNZ advisors on overall non-residential land requirements. This is because the land requirements for schools are significantly greater than for other non-residential activities. In fact, BARNZ advisors agree with Colliers that the Colliers' land use mix may not allow sufficient land for the long term schooling requirements of the development.

There still remains a significant difference between Common Ground and the BARNZ advisors on gross floor area non-residential requirements. However, as Colliers have indicated that they did not adopt the Common Ground gross floor area requirements within their valuation (instead treating the units as a net land area), this difference does not affect the overall outcome of the 2011 valuation exercise.

Time required for the development to be completed

Colliers have adopted a 17 year development horizon for the completion of the development and its sell-down. This includes 12 months for obtaining planning approval, development and construction.

Market Economics have provided further advice on this question.

They advise that plan change processes are taking up to two years to complete at the present time. In addition, time for development of infrastructure, earthworks and roading construction needs to be allowed for after planning permission is obtained. Therefore they confirm their earlier advice that three years should be allowed for obtaining planning approval, development and construction.

The Common Ground development plan assumes sales of approximately 1000 dwellings per annum. Market Economics point out that this would account for 9.3% of Auckland Region growth during that period. Therefore, the 1000 sales per annum are considered to be an optimistic rather than realistic

[1] Market Economics, Auckland Airport Alternative Use Review, December 2011, page 19.

assessment of growth. Market Economics have examined recent developments in the South Auckland area (namely Dannemora, Stonefields and Flatbush) and confirm that they consider that estimated sales of 800 dwellings per annum are reasonable. This represents a sales period of 20 years.

In total therefore, Market Economics consider that a likely timeframe for completion of planning, development, construction and sales would be 23 years.

Overall valuation outcome

During the Conference, the Commission requested that BARNZ obtain a quantifiable indication of the differences between the advice BARNZ has received on the appropriate inputs to the alternative land use plan and the development, and that which Auckland Airport's valuation is based upon. As a result of this request, BARNZ commissioned Property Advisory Ltd to undertake a valuation of the Auckland Airport land, in further of the Peer Review work undertaken to date and provided to the Commission in previous submission rounds.

Property Advisory have advised that in their opinion the MVAU valuation of Auckland Airport's RAB land is $491.5m. This equates to approximately $560 000 per ha (excluding seabed) across the RAB and land held for future development. The valuation report from Property Advisory, incorporating expert advice from Market Economics and Zomac Planning Solutions, is attached.

The Property Advisory valuation of $491.5m compares with the Colliers' valuation outcome of $563.1m, which is $71.6m or 14.6% higher. Colliers advised that their concluded value represents approximately $675 000 per ha over the land forming the RAB and land held for future airport development, approximately $115 000 higher per ha.[2]

However, as BARNZ has previously observed there is a lack of clarity over precisely what MVAU per ha value was adopted by Auckland Airport in its FY11 disclosures:

- As noted above, the Colliers valuation concludes by noting a $675 000 per ha value over the RAB and future development land (excluding seabed, coastal margin and commercial land).
- Auckland Airport's FY12 Annual Report records that the rate per ha for airfield land prior to the addition of holding costs is $1 020 000 per ha.[3]
- BARNZ's reading of the valuation rates adopted by Colliers is that the 2011 MVAU rates average $797 000 per ha for RAB land and $448 000 per ha for land held for future use.

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[2] Colliers Valuation Report – Market Value Alternative Land Use, Auckland International Airport, June 2011, page 33

[3] Auckland Airport Annual Report for the year ended 30 June 2012, page 72, note 11 to the financial statements.

2. *How much of the total route development costs is the amount that BARNZ Represented Airlines feel should not be included in charges?*

The short answer is the $10m[4] of route specific development costs over the five year pricing period.

Auckland Airport forecast approximately [ ] of known, budgeted and committed route development costs[5] in its financial modelling. Of this, [ ] relates to what is termed 'business unit route development costs' and [ ] to 'route specific development activities'. The business unit route development costs have been allocated approximately [ ] to aeronautical activities and approximately [ ] to non-aeronautical activities. The [ ] of route specific development activities have been allocated wholly to the aeronautical cost centre.

The [ ] business unit route development costs relates to costs such as the budget for the route development team, negotiation of air services agreements, visa streamlining programmes and general promotion of New Zealand and Auckland as a destination. The BARNZ Represented Airlines accept the aeronautical business meeting a portion of these business unit route development costs, provided that the non-aeronautical activities also meet an appropriate share, in reflection of the fact that passenger growth also directly benefits the retail and car-parking activities undertaken by the Airport. Auckland Airport moved in its final pricing decision to share those costs between the two sides of the business, with the aeronautical side meeting just over 60% of these costs, which resolved the allocation of [ ] of the forecast business unit route development costs.

The [ ] forecast 'route specific development activities' however remains in contention. These costs relate to marketing activities undertaken by, for or with individual airlines, relating to specific routes or destinations which may only be served by one airline. Including this kind of airline specific and airline targeted marketing costs in the cost base on which charges to all users are set, means users will be charged for costs which they do not directly benefit from.

In BARNZ's view, Auckland Airport's approach of including the costs of specific marketing commitments made to individual airlines is inconsistent with ICAO charging principles, which note that when determining the cost base for airport charges, aircraft operators should not be charged for facilities and services they do not use or which are not in general use (refer para 30 (ii) and (iii) ICAO Document 9082). BARNZ notes that the Regulatory Service for Brussels Airport Operation has ruled that commercial incentives to support airlines in their start-up or further development should not be allocated to the regulated aeronautical activities, as this would result in commercial advantages for some airlines being paid by all airlines.[6]

3. *The Asset base to be used in calculation of the IRR*

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[4] These were the figures advised to BARNZ in Auckland Airport's Reasons Paper in June 2012 as it set charges. Auckland Airport has just advised BARNZ that the precise figure is $9.35m.

[5] This excludes speculative, as yet unknown and uncommitted, marketing contributions to potential new entrants.

[6] Decision D-2010-02-LA which may be found at http://www.regul.be/sites/regul.be/files/bijlagen/Executive%20summary%20EN.pdf

The Commission devoted a significant segment of the conference day to the question of what inputs it should use in its assessment of Auckland Airport's IRR. The Commission was interested in what opening asset base should be adopted, what closing asset base should be applied and what impact the Moratorium on asset revaluations should have on the Commission's assessment.

What should the Commission take as the opening base valuation? What role should the Moratorium valuation have?

Given the central role of the opening and closing asset base valuations to the IRR calculation, and the fact that (to date) Auckland Airport has not committed to any particular approach to use in FY17 as it resets its prices, BARNZ considers that the Commission needs to undertake several scenarios in its analysis. The Airport's statements during consultation and in the s56G process provide clear guidance as to the options the Airport considers are before it. The Moratorium valuation approach should feature as one of those scenarios. However, so too should a closing asset base comprising a revaluation of land using MVEU and specialised assets using ODRC as this is:

- Auckland Airport's stated preliminary view for charge setting
- The approach advocated by Auckland Airport to the Commerce Commission in the development of the input methodologies
- The approach submitted by Auckland Airport to the High Court to be materially better than any other approach
- The valuation methodologies adopted by Auckland Airport in its financial reporting valuations.

The three scenarios BARNZ considers that the Commission should measure the IRR for are:

- A Moratorium opening and closing asset base
- Input methodology compliant opening and closing asset bases (with or without indexing between 2009 and 2012 as discussed below)
- A Moratorium opening asset base and a closing asset base with an MVEU revaluation of land and an ODRC revaluation of specialised assets.

Should the opening asset base be based on an unindexed roll-forward of the 2009 RAB?

In BARNZ's view, consistency between the asset base and the treatment of revaluations is key. Only revaluations (including indexing of assets) which have been treated as income in the charge setting process should be included in the opening asset base in the IRR.

In the present case, Auckland Airport has not treated any of the indexed roll forward of the RAB as income for the purpose of setting charges. Hence, when the Commission is comparing the outcome of Auckland Airport's pricing decision against an input methodology compliant approach, then either

an unindexed asset base excluding revaluations post 2009 should be used, or if an indexed asset base is applied, then the revaluations post 2009 need to be treated as income in the IRR calculation. BARNZ discussed this issue, and the need for consistency between asset valuations and the treatment of revaluations, at pages six to seven of its 9 November 2012 cross-submission.

Of course, if the Commission is assessing the outcome of Auckland Airport's pricing decision against the asset base the Airport used to set prices (ie the Moratorium asset base), then no indexing is required and the opening asset base should be the Moratorium asset base.

4. Was the approach tabled by Auckland Airport in consultation on treatment of future revaluations consistent with the input methodologies?

At the commencement of consultation in September 2011 Auckland Airport outlined its preliminary view that it would revalue assets for pricing purposes with MVEU being 'the appropriate methodology for valuing land assets' and the Opus 2011 ODRC valuation of specialised assets being 'a crucial input', and that it would include forecast revaluations 'as income on a prospective basis'.[7]

A paper which Auckland Airport had commissioned by NERA was also provided, which expanded upon the view that only expected revaluation gains needed to be treated as income in the charge setting process to satisfy the NPV = 0 principle where a nominal WACC is used with revalued assets. This was referred to as a forward looking approach to applying the NPV = 0 rule.

In BARNZ's view the argument that only expected revaluations need to be treated as income, and not actual revaluations, allows suppliers to drive a carriage and four through the NPV = 0 principle.

Actual experience with airport pricing has shown that actual revaluations have exceeded forecast revaluations by hundreds of millions of dollars at the three airports. Between 2002 and 2009 BARNZ estimates that there were approximately $620m of revaluations to the pricing asset bases of the three airports, some $195m of which was treated as income in the charge setting processes and approximately $420m which were not.[8]

Since then, Wellington Airport has revalued its pricing assets by over $130m, with approximately half of those revaluations not treated as income in the charge setting process, by virtue of the 'prospective only' treatment of revaluations. Auckland Airport has revalued its runway, taxiway and apron assets by $60m, its infrastructure by $56m (not all of which is within the RAB or pricing asset bases) and its land by $403m (not all of which is in the RAB or pricing asset bases).[9] There were zero forecast revaluations contained in Auckland Airport's financial model when it set charges in 2007 and 2012.

[7] Letter Auckland Airport to substantial customers, 14 September 2011.

[8] Refer Appendix 1 to BARNZ Submission on Commerce Commission Input Methodologies (Airport Services) Draft Reasons Paper and Draft Determination, 12 July 2010.

[9] Auckland Airport Annual Report for the year ended 30 June 2012, page 70, note 11 to the financial statements.

At a conservative estimate, over the three airports there is now at least $600m of revaluations which have not been treated as income in the charge setting process which will fall within the assets used to provide aircraft landing and passenger terminal services.

Through not treating these revaluations as income in the charge setting process, but setting charges off the revalued asset base using a nominal WACC, airports are able to obtain windfall profits as a result of the revaluations – profits which result in the NPV = 0 rule being materially exceeded.

In BARNZ's view, the approach put forward by Auckland Airport of it only treating forecast revaluations as income on a prospective basis, and not treating actual revaluations as income, is not a principled approach. Nor is it an approach consistent with the input methodologies. However, it is an approach which is open to every airport as a result of airports remaining free to set charges as they think fit under the Airport Authorities Act.

It is an approach designed to enable an airport to retain windfall profits in excess of reasonable returns. That the airports remain free to adopt such as approach demonstrates with absolute clarity the ineffectiveness of information disclosure regulation, by itself, in limiting the ability of suppliers to extract excessive profits.

5. Assessment of rate of return calculated consistent with the input methodologies

The Commission was interested in whether the parties were able to prepare an assessment of the rate of return to be earned by Auckland Airport in a manner consistent with the input methodologies.

At the present point in time BARNZ does not have the information to be able to reliably undertake this calculation. This is because the focus during consultation was on the Moratorium pricing asset base, and therefore BARNZ does not know the value of the pricing asset base using the input methodologies. The Part 4 disclosures are of the full RAB, which is a wider group of assets than the pricing asset base. The RAB valuation would need to be allocated between the pricing assets and the non-pricing assets. While this is a simple matter for the runway, taxiway and apron assets, all of which relate to the pricing asset base, it is much more complicated for assets which straddle the entire business such as land, infrastructure and buildings.

If, in its post conference submissions Auckland Airport provides material which BARNZ is able to utilise in order to undertake this calculation, then BARNZ would be willing to respond to this question further, if that would be useful to the Commission.