WELLINGTON INTERNATIONAL AIRPORT LIMITED'S

SUBSTANTIVE SUBMISSION

TO THE COMMERCE COMMISSION

IN RELATION TO ITS

DRAFT REPORT TO THE MINISTERS OF

COMMERCE AND TRANSPORT ON HOW

EFFECTIVELY INFORMATION DISCLOSURE REGULATION IS

PROMOTING THE PURPOSE OF PART 4 FOR

WELLINGTON INTERNATIONAL AIRPORT LIMITED

30 NOVEMBER 2012

Table of Contents

Introduction

Approach for this Cross Submission

1. This is Wellington International Airport Limited's ("**WIAL**") substantive submission on the draft report to the Ministers of Commerce and Transport on how effectively Information Disclosure ("**ID**") Regulation is promoting the purpose of Part 4 for WIAL (**"Draft Report"**) issued by the Commerce Commission (**"Commission"**) on 2 November 2012.

2. This submission is separate to the submission made by the New Zealand Airports Association (**"NZ Airports"**) which was prepared with input from and is fully supported by WIAL.

3. This submission is structured into two parts:

    - Part A – WIAL comments on a number of significant issues that it considers warrant emphasising for the Commission's further consideration.

    - Part B – WIAL provides more detailed comment on the Draft Report. These comments are provided for each of the Attachments contained in the Draft Report.

WIAL Contact Details

4. WIAL will be pleased to provide any further information required in support of this submission. Our contact person is:

Martin Harrington
Chief Financial Officer
Wellington International Airport Limited
PO Box 14175
Wellington

DDI: 04 385 5105
Mobile: 021 625 284
Email: mharrington@wellingtonairport.co.nz

Part A - Key Issues with the Commission's Draft Section 56G Report

Introduction

5. WIAL is pleased that the Commission has recognised in its Draft Report that WIAL is investing and innovating appropriately, providing quality services and has introduced an improved and efficient price structure. However, it is concerned that the Commission considers that WIAL is forecast to earn excessive returns above the Commission's regulatory benchmark based on its input methodologies ("**IM**") for weighted average cost of capital ("**WACC**") of 8.04% and asset valuation.

6. WIAL has forecast to make an 8.1% return on the $500 million of assets employed in its aeronautical business. WIAL considers that this is a fair rate of return given the inherent volume and other risks associated with the market for aviation and the ID regime will effectively monitor this return over the long term.

Key Issues

7. WIAL has a number of significant issues with the Commission's approach to the evaluation of WIAL's conduct and performance as described in the Draft Report.

8. In particular, WIAL is concerned that the Commission:

   - Has reverted to a de facto price control approach in assessing WIAL's profitability;
   - Has not appropriately evaluated WIAL's commercial concessions adopted in its pricing consultation for the pricing period from 1 April 2012 to 31 March 2017 ("**PSE2**") and certain outcomes in its assessment model, namely:
     - Terminal or "Rock" wash up – impact of current treatment $8.77 million present value;
     - Adoption of an airport specific WACC for WIAL – prospective impact of current treatment $10.8 million present value;
   - Has not considered the infancy of the ID regime and its consequent impact on WIAL behaviours. Specifically, it has not considered the behaviours adopted by WIAL at the time of setting prices when the price setting was being undertaken in accordance with the Airport Authorities Act 1966 ("**AAA**"). WIAL considered ID as a non-price control regime, and consequently was entitled to base its pricing on methodologies different to the IMs where there was sound reason to do so;
   - Has assessed outcomes for the pricing period from 1 July 2007 to 31 March 2012 ("**PSE1**") which are inappropriate since these represent decisions and behaviours made prior to the introduction of the ID regime;

- Has included unforecast revaluation gains in PSE1 and apportioned these to 2011 and 2012 without appropriately evaluating the contribution of the unforecast gains to the Commission's assessment of the returns for these years;
- Has included WIAL's pricing asset base as the closing asset base in PSE2 and its 7 year internal rate of return ("**IRR**") calculation and concluded that this will be used as an input to WIAL's future price determinations, and will consequently result in excess returns being earned in the pricing period commencing on 1 April 2017 ("**PSE3**") and beyond. It is inappropriate for the Commission to conclude that WIAL will earn excessive profits based on a forecasted 2017 asset value which may not eventuate and an expectation of WIAL's future pricing behaviour;
- Has not appropriately considered the complementary requirements for ID regulation, namely innovation, investment, efficiency, service quality and profitability;
- Has not provided the Ministers with relevant market information to enable them to consider WIAL's achievement of the overall objective in Part 4, including any assessment of market performance (and WIAL's contribution to this) or comparison of airport pricing between the main airports or worldwide;
- Has not given due regard to WIAL's commercial behaviours or the appropriate outcomes from those behaviours;
- Expresses conclusions that the effectiveness of ID Regulation is reflected in ongoing airline disagreements when this is not what the Commerce Act ("**Act**") requires, nor is it not unexpected and nor does the Commission seek to evaluate the merits of the airlines positions.

9. We comment in Part A on these issues before addressing the detailed comments in the Commission's Draft Report.

Commission has undertaken a defacto price control approach and not appropriately evaluated outcomes for its assessment

10. The Commission has undertaken an ex-post price control review of WIAL's financial performance for PSE2 and for the seven years until the end of PSE2.
11. The Commission has expressed a conclusion on WIAL's performance for the period based on the ex-post outcomes (assuming PSE2 outcomes will equal forecast).
12. WIAL has several significant concerns with the Commission's approach to this analysis.

Evaluation of Commission's Assessment Model for PSE2

13. WIAL has reviewed the Commission's financial model for PSE2 and does not have any comment to make on the approach undertaken within the model

(following the Commission's resolution of several errors in the first version of the model issued on 2 November 2012).

14. WIAL is concerned however with two key issues in respect of the Commission's use of the model:

- The inclusion of the terminal wash up in PSE2 produces a material impact on the Commission's assessment. WIAL considers that this is inappropriate for several reasons and we comment in detail in the comments below and in Attachment I.
- The Commission's evaluation of outcomes illustrated by the model. WIAL comments further below.

Treatment of Terminal Wash Up

15. The Commission amends WIAL's forecast by excluding recoveries on the terminal development from PSE1 and adding these to PSE2.

16. WIAL strongly disagrees with this approach. By making these adjustments the Commission is:

- Creating forecast revenues and regulatory earnings that do not represent WIAL's forecast earnings in PSE2.
- Creating a revenue forecast that varies from the definitions of revenue contained in the ID Determination (further detailed comment is provided in our comments at Attachment I).

17. The Commission should not be amending WIAL's forecasts but evaluating the outcomes that arise from them. WIAL's commercial behaviours over a period of time are combined with pricing inputs to produce the forecasts as a set of total outcomes, not discrete components that can be disaggregated.

18. The terminal wash up was a commercial concession proposed by WIAL during consultation in 2006 for PSE1 and was in advance of the ID regime. WIAL considers that the Commission's treatment of the terminal wash up arrangement will produce a significant disincentive for WIAL to consider such arrangements in the future.

19. The inclusion of the terminal wash up represents a material impact on the Commission's analysis and should be excluded from the Commission's model. The present value of this adjustment for PSE2 is $8.77 million and amends the Commission's IRR return for PSE2 to 8.65% and for the 7 years to 9.83%.

20. This produces the following amended outcomes:

Output from Model	WIAL Amended Outcomes ($000)	Commission Revised Calculations Model ($000)
NPV of WIAL cash flows	126,502	135,273
NPV of Commission cash flows at 75th percentile	115,590	115,590
Difference in NPV cash flows	10,912	19,683
IRR for PSE2	8.65%	9.14%
IRR for 7 year period of ID regulation	9.83%	10.10%

Commission's Evaluation of Outcomes from Assessment Model

21. The Commission expresses its conclusion that WIAL is earning excess profits as if these are realised or actual outcome. This is clearly not correct.

22. There are considerable uncertainties for WIAL in forecasting for the five year pricing period and also by the Commission in analysing the outcomes by application of the IM's. The Commission needs to give further consideration to sensitivities that affect the forecast outcome.

Sensitivity from Passenger Forecast Variations

23. WIAL's passenger numbers for the financial year commencing on 1 April 2012 are currently below forecast.

24. It does not require a material change in passenger numbers to create a significant change in WIAL's forecast profitability.

25. For example if passenger numbers were above or below forecast by 1% for PSE2 the net present value ("**NPV**") of WIAL's cash flows for the period would change by $2.13 million.

26. A small difference in a forecast assumption can therefore have a significant impact on forecast profits for the period.

Cost of Capital

27. The Commission's evaluation of the PSE2 cash flows is derived from application of the Commission's WACC IM. WIAL appreciates that this was the Commission's intention in developing the IM and publishing the WACC determinations.

28. The Commission further notes that it has used the 75th percentile in its analysis because this provides some allowance for uncertainly in the WACC calculation. WIAL agrees with this approach by the Commission.

29. However in evaluating the materiality of variations between WIAL's forecast outcomes and outcomes calculated by the Commission under the IM

framework the Commission must consider whether there are reasonable factors that can account for the variations.

30. In particular the Commission's WACC IM has been derived by the Commission for the three airports (WIAL, Auckland International Airport Limited ("**AIAL**") and Christchurch International Airport Limited ("**CIAL**")), with the Commission's separate WACC determinations for WIAL reflecting the different timing of WIAL's accounting balance date rather than any other consideration.

31. It is unquestionable however that the three airports have different risk profiles and consequently evaluating WIAL's forecast outcomes solely against a sector WACC derived largely from evaluation of AIAL's business model is prejudicial to WIAL.

32. We also note that the Commission considers expected rates of return should have fallen since PSE1 because risk free rates have fallen. This is an incorrect conclusion because the total cost to obtain funds from external markets, and the risks inherent in the financial markets due to the global financial crisis, mean that expected returns have not in reality fallen. We provide further comment in Attachment I.

33. The Commission should therefore be considering appropriate modifications or sensitivities to its own assumptions that WIAL considers will demonstrate that the difference between WIAL's forecast cash flows and those from application of the IM framework is not inappropriate.

34. For instance, WIAL has modified the Commission's IMs for certain parameters in the table below. Even these modest changes increase the WACC for evaluation of WIAL's outcomes from 8.04% to 8.8%.

Variable	**Commission to Consider Revisions to WACC IM for Evaluation of WIAL Outcomes**	**Commission WACC IM Determination**	**Comment**
Asset beta	0.65	0.6	WIAL does not have the same diversification of airline customers as other airports.
Debt premium	2.35%	1.94%	WIAL is rated BBB+ and does not have scale of AIAL or public ownership of CIAL to justify A- rating. 2.35% is the Commission's own assumption for BBB+ EDB's in 27/04/12 determination.
Market risk premium	7.5%	7.0%	Global financial uncertainties remain.
Mid-point post tax WACC	7.80%	7.06%	
75th percentile post tax WACC	**8.80% (WIAL estimate not calculated from model)**	**8.04%**	

35. The impact of this change in WACC is material to the Commission's analysis and should be considered in its analysis of returns. The present value of this adjustment to the Commission's NPV for PSE2 would be $10.80 million.

36. WIAL notes the reference by the Commission to the different WACC parameters adopted by WIAL for pricing and those supported for the merits appeal. WIAL confirms that the differences arose because the WACC's are being established for different purposes. The pricing WACC is WIAL specific while the WACC subject to the merits appeal is for the airport sector.

Summary of PSE2 Model Assessment

37. As noted above, there are a number of methodologies and treatments that materially impact the profitability and return assessments undertaken by the Commission. WIAL considers that the Commission should re-evaluate its assessments based on these different treatments.

38. A summary of adjustments compared to the Commission's assessment of excess returns for PSE2 are shown below.

Impact on Present Value of Returns	**$000**
Commission's assessment of excess profits for PSE2 per Draft Report	$19,683
Less adjustment for terminal wash up treatment	($8,772)
Less adjustment for WACC sensitivities	($10,797)
Adjusted excess profit difference	**$114**

39. Furthermore, this calculation does not include an allowance for prospective variations from forecast such as that illustrated for passengers above.

40. WIAL also notes that part of the consultation for PSE2 comprised a charge for noise mitigation activities at the airport. Whilst these charges have been set for PSE2, WIAL is currently consulting with Air New Zealand Limited ("**Air NZ**") and the Board of Airline Representatives of New Zealand Inc ("**BARNZ**") with a view to putting in place a longer term commercial agreement. This will impact any assessment of forecast ex-ante returns by the Commission and demonstrates the willingness of WIAL to progress such commercial discussions under the current regime.

41. In WIAL's views the Commission's conclusion on the achievement of excess profits needs to be modified to:

- Exclude the terminal wash up adjustment from PSE2.
- Recognise the uncertainties implicit in undertaking 5 year ex-ante forecasts.
- Recognise the sensitivity of forecast outcomes to changes in forecast assumptions, e.g., passenger volumes.
- Reflect variations in WIAL's WACC from the Commission's WACC IM.

42. Appropriate consideration of these factors shows that the difference from the Commission's assessment under the IM framework is within a reasonable margin of uncertainty and does not substantiate a conclusion that WIAL is forecasting to earn significant excess profits in PSE2.

Ex-ante consultation versus ex-post review in 7 year IRR analysis

43. WIAL has several concerns with the Commission's 7 year IRR calculation and the Commission's evaluation of the outcome from this calculation. WIAL believes that the Commission ignores several critical factors:

- The Commission's 7 year IRR analysis includes outcomes from PSE1 pricing decisions that were made prior to development of the ID regime. The Commission has not given consideration to what the appropriate regulatory WACC may have been at the commencement of PSE1.
- The failure to recognise the impact of unforecast revaluation gains on the calculation and the implications of this; and
- Inclusion of WIAL's pricing asset base as the closing asset base in PSE2 which the Commission considers will produce excess returns being earned in PSE3 and beyond.

PSE1 Pricing Decision Predated Information Disclosure

44. By combining the analysis of PSE1 and PSE2 into a 7 year analysis, the duration of the ID regime, the Commission is combining an ex-post and ex-ante assessment of WIAL's actual and forecast outcomes.

45. The Commission has not recognised that pricing decisions for PSE1 were made prior to commencement of the ID regime and should also be evaluated against return criteria that were established at that time. The Commission compares the outcome from its 7 year IRR return to its current WACC IM in paragraph H93 which is incorrect for PSE1. A WACC established from applying the Commission's methodology in 2007, when WIAL set PSE1 prices, would be higher than the outcome from the Commission's 2012 WACC determination for WIAL.

46. This illustrates the difficulty that exists when the Commission is establishing regulatory WACC's annually, while the airports establish return expectations (not necessarily WACC) at the commencement of new pricing periods.

47. The Commission needs to ensure that its analysis reflects the timing of airport pricing decisions.

Unforecast Revaluation Gains

48. The Commission does not appear to recognise the distinction between WIAL's ex-ante price setting process and the Commission's ex-post review.

49. WIAL prepared robust ex-ante forecasts for PSE1 following consultation with airlines under the AAA. The forecasts reflected professional advice, WIAL's views and responses received from the airlines.

50. Variations from forecasts inevitably occur over a five year period with some of those variations due to WIAL or airline actions and some of them due to market factors that were not expected by either party.

51. Recognition of the variations in future pricing periods is not required by the AAA but may be subject to commercial arrangement such as the wash ups established by WIAL.

52. The most material variation from forecast for PSE1 was for land revaluations. The land revaluations exceeded both WIAL's and the airlines expectations. The Commission has concluded as a result that WIAL will earn excess profits for the 7 year period since ID was introduced and will continue to earn excess profits in the longer term. However, the Commission's conclusion is inappropriate on a number of levels:

- The revaluations were generated because of market events not expected by WIAL or the airlines. They did not arise because of inappropriate conduct by WIAL. The Commission should recognise therefore that the revaluations were due to competitive market outcomes.
- Property owners in competitive markets do not reduce or increase future cash flow expectations because of unexpected revaluations in a previous rental period. Therefore it is incorrect for the Commission to express the comment that WIAL has not appropriately accounted for the revaluation gains[1].
- The Commission comments in the Draft Report that "*Over time, the impact of the revaluations will become apparent under information disclosure as elevated profit levels to the extent that the revaluations flow through into the revenues collected from customers by Wellington Airport*[2]". That is revaluations only impact consumers when they are reflected in prices.

  WIAL will therefore only receive the full benefit of the unexpected revaluations from PSE1 if it prices on the revalued asset base going forward. Consequently to conclude that WIAL earned excessive profits in PSE1 due to unrealised asset revaluations is incorrect.

Closing Asset Base

53. The Commission then concludes that WIAL will earn excessive profits in the long term because it will continue to price off the revalued asset base. This comment is premature for two reasons.

54. Firstly, there is no certainty as to what the 2017 asset base will be. The forecasted asset base includes provision for annual valuation increases of 2.5%, based on expected CPI movements. If the valuation increases do not occur a much lower asset base would arise.

[1] Draft report paragraph H5.3
[2] Ibid paragraph H65

55. If this were to occur WIAL's asset base would be $486.1 million. Assuming all other forecast outcomes were achieved this would reduce the 7 year IRR calculated by the Commission from 10.10% to 8.76%. This represents a material reduction in the Commission's IRR calculation.

56. Secondly, this Section 56G Draft Report is the first feedback WIAL has received on how the Commission will apply the ID Regime and which requires further consideration by the Commission as set out in this submission.

57. WIAL will be required to consult on charges to apply for PSE3, and beyond, and at that time will have to consider all available information, including airline views and the Commission's reports.

58. WIAL also has the option to review its pricing at any time, including prior to PSE3, if it wishes. The ID Regime requires the Commission to analyse WIAL's results as they occur and this will allow the Commission to conclude on WIAL's long term pricing approach.

59. While the IRR calculation reflects the Commission's objective for the calculation the Commission needs to supplement this with explanation of the factors above rather than forming a long term conclusion now which is based on the Commission's presumption that the forecast asset base will be achieved and assumptions of WIAL's future pricing conduct.

Commission has not considered the infancy of the ID Regime

60. The Commission has not considered the behaviours adopted by WIAL at the time of setting prices for PSE2. This was undertaken at a time when the Air NZ and WIAL merits appeals were still to be heard and WIAL adopted a position in pricing consistent with its merits appeal.

61. Further, whilst the ID regime and IMs provided some guidance, WIAL considered that in a regime where the price setting provisions of the AAA were expressly retained and that ID is a non-price control regime it was entitled to base its pricing on methodology different to the IMs where there was sound reason to do so. This was undertaken with advice from WIAL's independent experts.

62. At that time, there was also no guidance from the Commission as to how it would assess the effectiveness of the ID regime. The first clear expression by the Commission on the new regime has only now been issued in its Draft Report.

63. As a consequence, WIAL considers that it is important that the Commission considers and assesses these points. Whilst the Commission's IMs were known at that time of setting prices for PSE2 and were an important consideration for pricing, WIAL's behaviour and conduct was based on its own assessment of the ID regime at that time.

64. WIAL accepts that the Commission is expressing some concerns regarding potential future outcomes which it will need to consider in relation to its future monitoring role.

65. Such an approach is consistent with WIAL's view that the Section 56G review and Section 53B reports are an important tool for the Commission to provide guidance on matters of concern. These are an important part of the process (which includes resolution of the merits review proceedings) to develop a mature ID regime, where clear expectations for performance are established and the right incentives are provided over time.

Commission has not provided the Ministers with sufficient information to enable them to consider achievement of Part 4

66. WIAL is concerned that the Commission's Draft Report has omitted several fundamental aspects that are critical to any assessment of the ID regime.

67. Part 4 of the Act provides that:

> *"The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services —*
>
> > *(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
> >
> > *(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
> >
> > *(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
> >
> > *(d) are limited in their ability to extract excessive profits."*

68. In WIAL's view a complete report to the Ministers of Commerce and Transport must provide them with a view on the performance of the aviation market in New Zealand and the performance of airports within New Zealand and worldwide before the specific analysis of WIAL can be assessed.

69. Provision of the market assessment is a critical part of this evaluation because it will provide the Ministers with a full understanding of the market and whether consumers are being well served, whether there are areas of concern to be addressed and the risks that exist if regulation of the airport sector is changed.

70. Without this context it will not be possible for the Ministers to make an informed decision.

71. WIAL therefore identifies several key market performance indicators that the Commission should present in its report to the Ministers.

Key Market Performance Indicator	Issues for the Commission to Consider
What are the critical factors to consider for the long term interest of consumers?	• What are the drivers of travel decisions for consumers? • How critical is the role of airports in travel decisions? • What is the role of airports in providing long term benefits to consumers? • Are airports operating efficiently and at an appropriate quality of service?
Are passenger numbers growing?	• Is the market growing? • Are airports demonstrating appropriate commitment to the achievement of market growth?
Is appropriate airport infrastructure being provided?	• Are airports continuing to develop infrastructure to accommodate market growth? • Is there significant evidence of material under or over investment?
How do the charges New Zealand consumers pay for airport services compare to the wider aviation market?	• How do the three main New Zealand's airport charges compare and how do they compare internationally? • Is it likely that consumers travel choices are being impacted by New Zealand airport charges? • Are commercial agreements being achieved between airports and airlines?

72. Considerable information has been presented to the Commission throughout the process to develop the ID Regime on these issues.

73. WIAL submits that the Commission should undertake its own independent evaluation of this for presentation to the Ministers, however to assist the Commission we provide WIAL's high level view below.

74. **Industry in Good Health**

Any assessment of the effectiveness of the regime should consider the wider effectiveness and performance of the market, which WIAL considers is in good health. WIAL has been active in this by encouraging a vigorous air transport market, as evidenced by the following:

- Strong investment which fosters airline competition and facilitates passenger growth;
- Incentive agreements with most major airlines that have operated at WIAL;
- Ground breaking in providing published incentive agreements;
- Promotion of ongoing passenger growth;
- Commercial concessions and arrangements being a part of pricing consultation, including one way asset and revaluation wash ups;
- Good quality services;
- Lowest cost airport in Australasia;
- Low pricing in Australasia and worldwide.

75. **Competitive Tension**

WIAL considers that it is critical in any assessment of the effectiveness in promoting "outcomes consistent with competitive markets" that such matters are considered and assessed. The existence of incentive agreements with airlines should be strong evidence in themselves of market competition working well.

WIAL earns 40% of its revenue from non-aeronautical activities. This creates an important incentive and a market driven constraint on the ability to raise aeronautical prices above appropriate levels. High aeronautical prices deter or at best delay the onset of new capacity and this affects non-aeronautical revenues directly. WIAL is actively incentivised to keep prices low, and further to reach commercial agreements with airlines to encourage capacity addition. This activity lowers unit costs for all carriers over the long term.

In addition, compared to AIAL and CIAL, WIAL has relatively suffered with regards to trans-Tasman growth over the last decade as predominantly all growth has come from Emirates, other wide body aircraft and Virgin Blue as a new entrant. WIAL has physical limitations on its capacity to accept wide body aircraft services, but not withstanding these limitations has had average annual growth of 4.5% compared to AIAL's 5.9% and CIAL's 3.7% since 2000. WIAL has made up for its physical limitations with aggressive marketing and incentive campaigns.

Over the last decade a number of airlines have come and gone from the domestic market, including Ansett, Qantas NZ, Origin Pacific and Pacific Blue. Maintaining a competitive market in these circumstances has been WIAL's paramount priority. Airport objectives are very much aligned with the airlines in the drive to increase passenger throughput and undertake this as efficiently as possible and at an appropriate level of customer service.

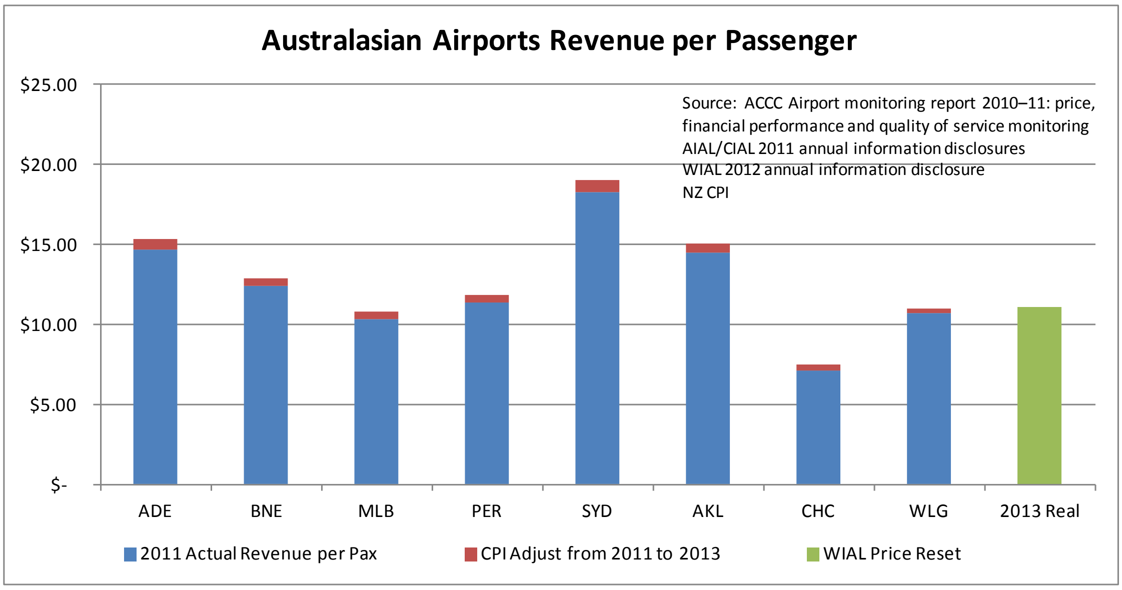
76. **<u>Airport Benchmarking</u>**

Australasian airport prices are among the lowest of the developed regions of the world. WIAL's airport prices are among the lowest in Australasia and its aeronautical revenue per passenger is in between AIAL and CIAL.

The Australian Productivity Commission published its review of Australian Airports in 2012 and this highlighted that New Zealand airport pricing was in the lowest quarter of worldwide pricing.

WIAL considers that the Commission must consider the performance of WIAL compared to other airports, being at least AIAL and CIAL but ideally to airports worldwide. It is this analysis that will help determine whether WIAL's charges are indeed appropriate.

As previously submitted to the Commission, we have detailed below WIAL's own analysis of airport pricing in Australasia which shows that WIAL compares favourably with other airports.



77. Importantly however the Commission must present this information to ensure that Ministers are not being asked to evaluate the performance of WIAL as an individual airport in a vacuum and without wider context.

Commission has not appropriately recognised WIAL's commercial behaviours

AAA

78. The AAA requires New Zealand's large airports to consult with its substantial customers before setting prices at least once every five years, unless agreement is reached to set prices for a longer period.

79. The AAA also requires the large airports to consult on substantial capital expenditure projects.

80. The consultation process requires extensive amounts of forecast information to be presented to airlines with in depth exchanges of views between the parties on the forecast information before prices are set by the airports.

81. Much is made of the provision in the AAA that prescribes that airports can set charges *'as they see fit'* however, WIAL considers that an objective evaluation of its published consultation process and the comparability of WIAL's, and other New Zealand airport's charges, clearly demonstrates that the AAA regime has resulted in low airport charges in New Zealand.

82. As the Commission is aware, WIAL sought to enhance the transparency of the consultation process by publishing the consultation documents on its website during the consultation to set prices for PSE2. This was undertaken to better inform interested persons as to the extent of consultation required under the AAA, the commercial behaviours exhibited by airports and the behaviours of both parties.

Effectiveness of ID regulation should not be assessed on whether disagreement still exists with airlines

83. The consultation process established by the AAA does not require negotiation or agreement to be reached with airlines but it provides an important foundation for airports to continue to invest and develop their businesses for the benefit of airlines and consumers.

84. However, in its Draft Report the Commission repeatedly expresses concern over WIAL's conduct because agreement was not reached with the airlines.

85. WIAL notes that the Act does not contain a requirement that the purpose of Part 4, ID regulation or this section 56G review is to facilitate agreement between airports and airlines.

86. WIAL does wish to establish commercial agreements with airlines, and WIAL has stated previously that it is WIAL's preference to put in place commercial agreements with its airline customers. However, within the context of this review WIAL is concerned that the Commission appears to have introduced this disagreement as a key factor, when it is not required, and even more fundamentally, does not undertake an evaluation of the merits of the airline disagreements.

87. WIAL submits that the Commission must give further consideration to the comments in the Draft Report concerning the views of airlines on WIAL's consultation and performance and undertake its own evaluation of the issues involved. In doing so the Commission needs to recognise that:

    - Individual airlines can have different strategies and provide WIAL with contrasting opinions on some issues, particularly investment where incumbent airlines may not support investment that facilitates increased competition. Clearly WIAL is then required to identify long term solutions that best benefit all parties and is in the best long term interest of consumers.

- Airports and airlines have different asset profiles which can lead to different pricing objectives. Airlines can take a shorter term view than airports concerning investment whereas airports must take a long term view for investment. Airports have little opportunity to reduce capacity when markets fall while airlines have this flexibility with their aircraft fleets.

- There is no incentive for airlines to agree to pricing established by airports. Air NZ and BARNZ have agreed to few components of consultation, let alone consultation outcomes overall. Unfortunately, airlines can continue to disagree with consultation proposals for no other reason than not wanting to suggest that they consider airport conduct appropriate.

88. WIAL submits that it is inappropriate for the Commission to conclude that a change in WIAL's conduct is required due to a difference of airline views with WIAL's positions when the Commission has not undertaken an evaluation of the issues. These matters are addressed more fully in Part B of this submission.

WIAL's commercial conduct

89. The Commission analyses WIAL's performance over PSE1 and PSE2 but shows little regard for the approaches taken by WIAL beyond the price setting provisions in the AAA. The Commission in fact dismisses WIAL's comments about its commercial behaviours[3].

90. The Commission should recognise that WIAL has exhibited appropriate commercial market behaviours which:

- Are discretionary in respect of price setting. The revaluation and terminal wash up arrangements established in PSE1 and revaluation forecast and asset wash ups in PSE2 provide a clear demonstration that WIAL has undertaken consultation in a commercial manner and sought to meet airline concerns on issues where warranted.

  The pricing incentive arrangement in PSE2 similarly results in WIAL accepting financial risk that traffic growth figures will be achieved through the reduction of charges for all passengers from the commencement of the pricing period. WIAL considers that incentivising airlines to achieve strong growth or establish new routes is the most effective way of delivering long term benefits to consumers.

- Has resulted in long term commercial arrangements with airline customers outside the consultation pricing process. WIAL seeks to develop agreements with airlines that provide a 'win-win' for them and WIAL and most fundamentally seek to facilitate airline competition at WIAL which delivers sustained growth in passengers and provides clear benefits to consumers in the long term.

[3] Draft report paragraph H15

91. A key factor in prior consultations is how variations from consultation forecasts are addressed. In both the noted arrangements from PSE1, WIAL retained the risk of adverse events while provided the airlines with the benefit of positive variations from forecast.

92. The opportunity for commercial negotiation remains outside of the AAA process and WIAL is willing at all times to consider agreements with airlines that are beneficial for both parties.

Part B – Detailed Comment on Draft Report

Attachment A: Regulatory Framework

> ***WIAL's Recommendation***
>
> Further time is required before a complete evaluation of WIAL's performance can be undertaken and before conclusions can be reached on the influence of the ID Regime.

Introduction

93. WIAL broadly agrees with the Commission's discussion of the Regulatory Framework in Attachment A.

94. There are aspects of the discussion that WIAL considers require further elaboration and we comment on these below.

Application of Input Methodologies

95. WIAL agrees that it is appropriate for the Commission to utilise the IM's as the basis for analysing WIAL's financial performance.

96. WIAL further agrees that the outcomes from the application of its pricing determinations will then be compared to outcomes arising from the Commission's analysis using the IM's.

97. However WIAL also submits that the Commission must recognise in its evaluation of the regime that the IMs remain subject to merits appeal. The fact that the prospect for change of the methodologies remains should lead the Commission to be less definitive in its conclusions and recognise several different future pathways are possible.

98. WIAL has significant concerns regarding the Commission's comment in paragraph A23 that:

    "Our assessment has therefore considered the variations by Wellington Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance".

99. The purpose of Part 4 seeks promotion of outcomes consistent with outcomes in workably competitive markets in the long term interests of consumers. As a result, the assessment of WIAL's achievements within the context of the entire purpose statement is critical, rather than the Commission's current approach which has been to assess the four sub-objectives directly.

100. This requires consideration of a much wider range of factors than is indicated in this comment from the Commission. While the Commission will consider variations from the IM's it should also be considering:

- Performance of the market and whether airport conduct is contributing to the market outcomes. Relevant questions are set out in Part A of this submission.
- The commercial conduct of airports in establishing consultation and pricing outcomes.
  - Are the airports providing comprehensive information based on sound advice to airlines for pricing consultation?
  - Are the airports responding to feedback from airlines by making changes to consultation forecasts?
  - Do airports consider risk sharing arrangements with airlines to mitigate consultation concerns?
- Commercial market reasons for varying from IM's.
  - Are there airport specific characteristics which reasonably result in different inputs including asset valuations and airport specific WACC assumptions?
  - In respect of forecast performance, are there appropriate factors that mean some variation from IM's is appropriate and reasonable?
  - When conducting ex-post analysis of outcomes, an evaluation of whether variations may have been caused by inappropriate price setting behaviour or are reflective of competitive market outcomes?

101. We address these issues in respect of the Draft Report for WIAL in this submission.

Role of the AAA

102. The Commission describes the AAA requirements and comments at paragraph A28 that:

> *"The AAA provisions relating to charges are primarily concerned with ensuring that the decision making process for airport pricing is clear. In that context section 4A clarifies that, while airports are required to consult with their major customers in accordance with the AAA, the final decision as to charges rests with the airports, and the consultation process does not have the ability to prevent airports setting charges as they think fit."*

103. WIAL considers that the Commission is not recognising the significance of the consultation requirement under the AAA. Consultation requires airports to:

- Provide comprehensive financial forecast information to well-resourced and expert substantial customers for review.
- Consider feedback from the substantial customers and modify building block inputs and forecasts as appropriate.
- Consider political and regulatory implications of pricing strategies.

- Consult on proposed investments.
- Consider the requirements of all airline customers to facilitate competition in the aviation market.

104. WIAL's consultation for PSE2 took over 12 months with numerous meetings and exchanges of significant levels of information. The combination of all of the above matters provides substantial countervailing power to the airlines and ensures that airports establish pricing that is reasonable and can be justified.

105. The impact of the AAA consultation requirements can be evaluated by reference to prices charged by airports in other jurisdictions. The NZ Airports submission post the WIAL conference provided a report from Airbiz Limited (**"Airbiz"**) comparing New Zealand airport charges compared to other jurisdictions[4]. This further developed the comparative charges information provided to the Commission by BARNZ.

106. The Airbiz report clearly shows that New Zealand airport charges are not high in comparison to international standards and in particular, domestic charges are low compared to Australia which has a similar regulatory environment. In particular the Airbiz report concluded that:

> *"The BARNZ analysis shows that New Zealand international airport charges are below the average of a sample of international airports. The analysis was consistent with other recent analysis undertaken for Auckland and Wellington airports and information provided to the Australian Productivity Commission in its recent inquiry into the economic regulation of airport services.*
>
> *Airbiz's comparison of New Zealand airport domestic charges demonstrates that average domestic New Zealand airport charges are between half and a quarter of average Australian domestic charges."*

107. The role of the AAA consultation requirements is significant and has not provided New Zealand airports with the unfettered right to set charges at inappropriate levels.

108. Australasian airport prices are among the lowest of the developed regions of the world. WIAL's airport prices are among the lowest in Australasia and its aeronautical revenue per passenger is in between AIAL and CIAL.

109. The Commission must give due regard to this in its consideration of WIAL's performance.

Timing of Section 56G Review

110. WIAL made considerable submissions to the Commission concerning the process for the Section 56G review. We do not repeat these comments in this submission however recognition of the timing of the Section 56G review of WIAL remains relevant.

[4] Airbiz Limited, Peer Review, BARNZ Analysis of New Zealand Airport Charges, 17 August 2012

111. Completion of the review so soon after introduction of the ID Regime has meant that the Commission has been unable to reach a conclusion in respect of some of the objectives in Part 4.

112. Section 53B of the Act requires the Commission to *“publish a summary and analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated suppliers, their relative performance, and the changes in performance over time.”*

113. Clearly the Commission has not yet been able to undertake some aspects of the required reporting, even within the context of the WIAL Section 56G review, such as evaluating the relative performance of WIAL to other airports.

114. These issues demonstrate that further time is required before a complete evaluation of WIAL’s performance can be undertaken and therefore conclusions can be reached on the influence of the ID Regime.

Attachment B: Is Wellington Airport operating efficiently?

WIAL's Recommendations

- Conclusion B3 should be amended to recognise that WIAL is operating efficiently and has significantly reduced its costs per passenger over a long period of time.
- Conclusion B5.1 should be amended to note that WIAL achieved improved efficiency in its operating costs for PSE1 excluding certain unforeseen and uncontrollable items (mainly insurance and regulatory costs).
- Conclusion B5.2 should be amended to recognise that WIAL has a much lower cost base than other airports and consequently increases such as insurance and regulatory costs will have a disproportionate increase.
- Conclusion B5.4 should be amended by inclusion of a comment that the Commission has considered the points of disagreement raised by the airline submissions and the facts do not support the airline's views.
- Conclusion B5.6 should be amended to indicate that a comparison to similar sized Australasian airports, for passenger volumes and passenger mix, demonstrates the operating efficiency achieved by WIAL.

Introduction

115. WIAL is perplexed that the Commission cannot conclude on the operating efficiency of WIAL due to mixed evidence.

116. WIAL is efficient, with the lowest costs per passenger of all reporting airports in Australasia.

117. This efficiency keeps prices as low as possible, in spite of the airport operation consuming a significant tract of highly scarce property within 10 minutes of the central business district of New Zealand's capital city.

118. The Commission has undertaken a detailed analysis of WIAL's operating expenditure outcomes and notes the following:

- WIAL's operating costs for PSE1 were above forecast, while noting WIAL's explanations for significant factors beyond WIAL's control that resulted in the cost increases.
- WIAL is forecasting a reduction in operating costs per passenger for PSE2.
- WIAL's operating costs per passenger, and aircraft movement, are significantly below those at all other large airports in Australasia.

119. However despite the clear evidence of WIAL's comparative cost efficiency to other airports, and long term history of cost management, the Commission identifies reasons why it cannot conclude that WIAL is operating efficiently.

120. These reasons include:

- There is not a sufficient long series of data to enable a conclusion to be formed on the effectiveness of ID;
- While noting WIAL's comparative cost efficiency the Commission comments that it cannot be certain of the extent that this may be due to the passenger mix at WIAL (i.e., lower proportion of international passengers than at other airports);
- The airlines have challenged WIAL's ongoing commitment to cost efficiency;
- The airlines have noted some specific examples where they disagree with WIAL's approach, albeit that the Commission notes these areas are not material.

121. We comment on each of these areas below.

Time Series of Data

122. The infancy of the ID regime means that it is not possible for sufficient actual data to be available for this review using disclosures made under the ID regime.

123. However the Commission analyses information dating back to 2003 from IDs under the AAA regime which shows that costs per passenger have declined significantly since 2003 albeit that they increased in the period 2009 - 2012. The Commission's own analysis in Figure B1 of the report shows costs per passenger decreasing from approximately $3.45 in 2003 to around $3.00 in 2012. It is unquestionable that this is a significant decrease in real costs which is after the accommodation of the significant real cost increases in recent years.

124. WIAL also notes that the Commission also considers costs by aircraft movement. Average costs per aircraft movement have increased however this is a function of changes in airline fleets where an upgauging of aircraft means that increased numbers of passengers are carried on larger aircraft. This has been a trend in the New Zealand, and other markets in recent years and is expected to continue for some years yet. Consequently the cost measure by aircraft movement is distorted. WIAL considers that the most appropriate measure to assess operating cost efficiency is cost per passenger and BARNZ has also indicated that this is the appropriate cost measure[5].

Passenger Mix at WIAL

125. When comparing WIAL's costs to other Australasian airports the Commission comments that *"This may indicate that Wellington Airport is relatively efficient. It may also be due to the differences in its operational circumstances, for example, differences in the international passenger ratio, which means*

[5] BARNZ responses to Commerce Commission questions relating to Wellington Airport 28 June 2012, page 15

Wellington Airport could have lower expenditure without being more efficient. At this stage, due to limited understanding and data on these differences, we cannot provide more detailed comparisons".[6]

126. WIAL agrees that each airport is different however if the Commission were to scrutinise the Australian Competition and Consumer Commission ("**ACCC**") report, that it has used for the airport comparative data, and New Zealand airport disclosures, it is evident that some of the airports are not materially different in passenger mix than WIAL. For example:

	International Passengers		**Domestic Passengers**		**Total Passengers**
	000	**%**	**000**	**%**	**000**
WIAL	655	13	4,480	87	5,135
CIAL	1,488	26	4,287	74	5,775
Adelaide	563	15	3,105	85	3,668

127. These airports are reasonably close in size to enable a reasonable conclusion to be formed with WIAL's cost per passenger approximately 30% below CIAL and 60% below Adelaide.

128. WIAL also notes that a substantial share of airport costs will not be different for international and domestic passengers, for example all costs associated with the airfield, and consequently WIAL submits that the Commission should not overemphasise differences in passenger mix.

Airline Views on WIAL's Cost Efficiency

129. At paragraph B28 the Commission refers to the BARNZ submission *"it considered an efficient level of opex for PSE2 would be equivalent to opex per passenger in 2007. This level appears to be based on the information available at the time of consultation, rather than a detailed consideration of what an efficient level of opex is"*.

130. WIAL agrees with the Commission that the BARNZ conclusion was not based on an informed consideration of what an efficient level of costs should be at WIAL. Rather BARNZ sought to adopt a relatively low point in respect of historic costs and project this forward without any regard for the significant real cost increases faced by WIAL since that time. Clearly this approach is not reasonable.

131. WIAL notes that BARNZ was in fact provided with considerable information on WIAL's operating costs both for PSE2 and earlier consultations. The BARNZ high level approach was not due to any limitation in the amount of information available to them during consultation.

[6] Draft Report paragraph B22

132. The Commission comments at paragraph B33 that airline submissions *"have suggested that Wellington Airport's conduct does not indicate it seeks to improve efficiency"*. In WIAL's view the Commission's role is to look through and test these statements and form its own view on WIAL's conduct. The facts do not support the airline submissions and this is demonstrated by the Commission's analysis and comment in the Draft Report:

- WIAL continues to be the lowest cost airport in Australasia on a cost per passenger basis.
- The Commission comments at paragraph B16 that its own analysis shows that WIAL's general operating costs (excluding the specific unforeseen items) fell by 1% in PSE1.
- WIAL is forecasting operating costs per passenger to fall in PSE2.
- WIAL's costs per passenger have fallen markedly when a longer time series of data is considered as shown by the Commission's own analysis.
- WIAL provides considerable cost commentary and financial detail to its airlines for scrutiny as part of consultation. WIAL responded to all questions raised by the airlines in respect of this information.

133. WIAL considers that this analysis and commentary clearly demonstrates WIAL's achievements and commitment to maintaining an efficient operating cost base.

Areas of Specific Disagreement with WIAL Costs

134. These are noted in paragraph B32 of the Draft Report and we comment on these below.

135. The Commission appears to be indicating that the items noted may not be justified or that WIAL's expense efficiency is compromised because the airlines disagree with these items.

136. The Commission comments that *"The airlines submitted that the increased opex as a result of the three additional employees to provide gate allocation services is not appropriate.[7]"* This comment is not correct and it is Air NZ only that is disagreeing with WIAL assuming responsibility for the gate allocation function. BARNZ confirmed this in commenting that the other airlines supported WIAL assuming this function.

137. This is an issue where Air NZ has different competitive objectives than the other airlines operating at WIAL. If Air NZ were to retain the gate allocation function it has the option to allocate itself priority for gates where congestion occurs. It also requires competing airlines to provide Air NZ with advice of their forecast aircraft movements which creates the opportunity for Air NZ to gain considerable competitive advantage.

[7] Draft Report paragraph B32.1

138. By assuming this function WIAL can ensure that all airlines receive an appropriate entitlement to aircraft gates. This will become increasingly important as congestion of gates increases in peak periods.

139. It is important that the Commission recognises that airlines may have different commercial objectives and that analysis or comment by the Commission is not unduly influenced by the view of one airline.

140. The airlines disagree that expected litigation costs incurred in respect of the regulatory regime should be included in forecast operating costs. WIAL commented on the rationale for the inclusion of these costs in its cross submission following the WIAL conference. Fundamentally the costs are directly incurred by WIAL in the management of its regulated activities and consequently are appropriately included in the costs for this business.[8]

Summary

141. The Commission has undertaken an analysis of WIAL's historical and forecast operating costs as well as comparing WIAL's costs with other airports in Australasia.

142. The analysis shows that WIAL has in the past, and is striving to achieve in the future improving operating cost efficiency demonstrated by lower operating costs per passenger.

143. WIAL has accommodated a substantial increase in passengers in the past decade with costs falling markedly on a per passenger basis. WIAL has therefore achieved operating cost efficiency gains through reducing unit costs per passenger while at the very least preserving the quality of services provided to passengers. WIAL is also forecasting costs per passenger to fall in PSE2. WIAL submits that the facts demonstrate that WIAL has achieved, and is forecasting to achieve, operating cost efficiencies. As a result, WIAL considers that the Commission should amend its conclusions to reflect these efficiencies.

[8] WIAL Cross Submission Following the Commerce Commission Section 56G Review Airports Conference, 17 August 2012, page 33

Attachment C: Is Wellington Airport investing efficiently?

> **WIAL's Recommendations**
>
> WIAL submits that the Commission should amend its conclusion in paragraph B3 to conclude that WIAL's actual performance in PSE1, and the available evidence for PSE2, show that ID, and the preceding regulations, promote efficient investment at WIAL

Introduction

144. The Commission has analysed WIAL's capital expenditure performance during PSE1 but refrains from concluding whether ID regulation is effectively promoting efficient investment principally because of timing concerns raised by the airlines.

145. In WIAL's view the Commission does not appear to have fully evaluated the merits of the airline submissions and consequently the Commission's draft conclusion is not correct.

146. We comment below on several specific issues addressed in the Draft Report.

Requirement of ID Regulation

147. WIAL is concerned that the Commission seems to suggest at paragraph C6 that a role of ID should be to resolve airline concerns about WIAL's conduct. There is no suggestion anywhere in Part 4 of the Act that indicates that this is an objective for ID regulation.

148. Adoption of this objective could in fact result in investment inefficiencies or deficits. These could result from:

- Airlines with different competitive objectives expressing different views on required investment or conflicting requirements.
- Airlines taking a short term approach to minimise prices rather than a long term efficient asset management approach that WIAL must consider to facilitate ongoing passenger growth.
- Other than required investment for their own specific requirements there is little incentive for airlines to agree in consultation and the prospects of agreements will diminish if the airlines believe the Commission will seek to resolve differences.

149. WIAL is not submitting that agreements are not desirable. Far from it - WIAL's preference is to have commercial agreements in place with all major airlines operating at WIAL.

150. WIAL submits that where disagreements may exist, and the Commission wishes to include these issues in its analysis of WIAL's performance, the Commission must evaluate the issues and reach its own conclusion as to whether WIAL's conduct in respect of investment has been appropriate.

151. We comment further below on specific examples that illustrate WIAL's concerns.

Obligation to Consult

152. The Commission notes at paragraph C7 that WIAL is required to consult with its substantial customers on large capital expenditure programmes under section 4C of the AAA. This is correct, however, in practice consultation is considerably more comprehensive than the statutory obligation. This consultation involves investment at levels much lower than the financial threshold set out in the AAA and is in a manner consistent with best practice asset management.

153. The consultation undertaken includes:

- Consideration of long term planning requirements from development or review of Master Plans.
- Presentation of detailed forecasts, and supporting comment, for pricing periods to airlines during pricing consultation. This enables the airlines to review all forecast capital expenditure, not just large projects.
- Separate presentations and engagement with airlines, and other affected stakeholders, on the requirement for and design of larger projects. For example, the current correspondence and meetings with regard to the proposed $4.8 million South West Pier terminal development.
- Operational design and functionality meetings with affected stakeholders as projects are undertaken.
- Following commencement of the ID Regime operational forum meetings with airlines, and other stakeholders, to evaluate asset and service performance including consideration of whether investment is required by WIAL to rectify areas of concern.

154. There is in reality an ongoing dialogue between WIAL and airport users to ensure that projects are required, are delivered with minimum impact on ongoing operations and provide the best solution for all airport users.

Airline Concerns of Over Investment

155. As a general premise the Commission comments in paragraph C8.3 that WIAL has an incentive to over invest to maximise the size of its asset base. However there is no evidence that WIAL has behaved in this manner.

156. The Commission then notes three specific projects in paragraph C17 where the airlines have expressed disagreement with WIAL's capital expenditure. While the Commission has also recorded brief responses from WIAL in respect of each of the projects the Commission does not provide its assessment of whether it considers WIAL's approach is inappropriate for these projects. We comment briefly on each below.

The “Rock” Terminal Expansion

157. As noted by the Commission the cost of “The Rock” terminal expansion fell within the cost range estimated by BARNZ. This demonstrates that WIAL did not over invest in this project as previously submitted by the airlines.

158. The Commission also referred to a BARNZ submission which claims that an additional $5 million was spent on the Runway End Safety Area (“**RESA**”) to accommodate aircraft that are not likely to operate at WIAL. The BARNZ submission is factually incorrect and WIAL has provided comment on this in its earlier submissions.

RESA’s

159. For clarity, WIAL confirms that the total amount of disputed expenditure was $4.8 million.

- Of this amount $2.1 million was incurred to construct an additional stubway so that aircraft could taxi directly to the newly extended Southern end of the runway prior to take off. In the absence of this expenditure aircraft operated by Pacific Blue and Qantas would have had to enter the runway at an earlier point, taxi to the runway end, and then execute a 180 degree turn prior to take off. Clearly this would have compromised efficient use of the runway. This expenditure was supported by both Pacific Blue and Qantas.

  This expenditure was not supported by Air NZ because the A320 aircraft operated by Air NZ on trans-Tasman services could operate off a shorter runway length and did not require the additional stubway. It was however noticeable that as soon as the facility was available it was also used by Air NZ.

  The fundamental issue is that Air NZ had rational competitive reasons to disagree with this expenditure because the operations of Qantas and Pacific Blue would have been compromised without it and the co-existing North RESA investment.

  WIAL considered it critical that this investment was undertaken to facilitate the operations of its airline customers.

- The remaining $2.7 million was incurred to ensure the South RESA tunnel width met technical specifications to enable aircraft larger than the Code C aircraft usually operated by the airlines for scheduled services to land. A small number of such aircraft land every year including those operated by the airlines established at WIAL. A critical issue however was that to defer this expenditure until another time would have resulted in considerable inefficiencies in undertaking the deferred tunnel construction and a substantially higher cost to achieve this. WIAL’s view was, and remains, that this incremental cost at the time of the RESA construction was justified.

Taxiway Compliance

160. WIAL submits again that the BARNZ submission in respect of the forecast taxiway works in PSE2 does not withstand scrutiny.

- WIAL demonstrated in its consultation documentation that the majority of the expenditure was required for the operation of current Code C aircraft and that the New Zealand Civil Aviation Authority ("**CAA**") were expected to seek to reduce the level of dispensations granted to airports over time.
- Nonetheless WIAL accepted the airline submissions that there was some uncertainly as to exactly what might be required by the CAA in the future and consequently the largest proportion of the expenditure was deferred until the next pricing period to enable confirmation of the regulatory requirements and further consultation to be undertaken with airlines.
- The Commission states that this expenditure accounts for 15% of capital expenditure in PSE2 suggesting that the disagreement relates to all expenditure in the forecast taxiway works however this is not correct.

  The 15% component includes reconstruction of the Airport Fire Station which is required irrespective of the taxiway compliance issues.

  WIAL's Final Pricing Document ("**FPD**")[9] shows that the capital expenditure subject to disagreement for PSE2 was $5.291 million for airfield engineering compliance works. The FPD also provides further comment[10] demonstrating that this forecast included $1.854 million for overlay of the taxiway which will be required in any event due to wear and tear. The remaining compliance expenditure is therefore $3.437 million which represents approximately 5% of the total aeronautical capital expenditure for PSE2, and less than 1% of WIAL's aeronautical asset base.

  WIAL notes that the Commission also notes that the compliance works account for 14% of the forecast capital expenditure for PSE3. This is correct however this expenditure remains subject to confirmation of the CAA compliance requirements and further consultation with airlines. No commitment has been made to undertake this expenditure.

  WIAL commented that it considered the PSE2 forecast to be a prudent level of investment to respond to the expected increase in regulatory requirements.

161. WIAL considers that it had rational and robust reasons to undertake or forecast to undertake the particular expenditures queried by Air NZ and BARNZ. Furthermore, for the reasons explained above, WIAL can demonstrate that it is focussed on ensuring that its investment programme is efficient.

[9] WIAL FPD page 81
[10] Ibid pages 82-83

Timing of Capital Expenditure

162. Following airline submissions the Commission analysed the time profile of capital expenditure during PSE1. This analysis was of the key projects undertaken by WIAL during PSE1. The Commission's analysis can be summarised as below:

Variance between forecast and actual capex for PSE1					
	Year Ending				
	2008	**2009**	**2010**	**2011**	**2012**
	$m	$m	$m	$m	$m
Northern Pier including the Rock	-10.0	-16.4	9.8	17.7	0.8
Cumulative difference	*-10.0*	*-26.4*	*-16.6*	*1.1*	*1.9*
Other projects	-3.7	7.6	-0.1	0.8	0.6
Cumulative difference	*-3.7*	*3.9*	*3.8*	*4.6*	*5.2*

Note: Negative numbers show actual expenditure below forecast

163. This table shows that expenditure was indeed delayed for the Northern Pier development however for other projects the changes in timing from forecast were not significant. The analysis in fact shows that WIAL incurred expenditure of $5.2 million above forecast for these projects.

164. The total variance represents an overspend of approximately $6.2 million on the total forecast. However WIAL notes that it was also able to defer some other capital expenditure with the net result being that WIAL's actual aeronautical capital expenditure, excluding asset transfers, was within 1% of the total forecast for PSE1.

165. The Commission has omitted to note in its analysis that WIAL included a wash up arrangement in respect of the terminal project. This meant that any benefits WIAL obtained from the delay of this project were to be returned to the airlines in a future pricing period.

166. The Commission notes in paragraph C20 that WIAL has implemented a wash up arrangement in respect of three large building works in PSE2. WIAL notes that again there is no advantage to be gained by WIAL delaying these projects.

167. WIAL notes that following modifications of its original forecasts for the reasons noted above, there was little airline disagreement over its forecast capital expenditure for PSE2 during consultation.

168. When these facts are considered collectively it is clear that WIAL has not sought to derive, nor obtained, benefit from delaying investment.

Summary

169. The Commission's draft conclusion is that it is too early to form a conclusion on whether ID may be effectively promoting efficient investment at WIAL. The

Commission comments that this is principally due to concerns raised by the airlines over the timing of WIAL's actual investment.

170. WIAL considers that it has demonstrated above that evaluation of the airline submissions does not support their view that WIAL has undertaken any material over investment nor has it benefitted, or is it seeking to benefit, from delayed investment.

Attachment D: Is Wellington Airport innovating appropriately?

WIAL's Recommendations
WIAL agrees with the Commission's findings.

171. WIAL agrees with the Commission's findings in respect of innovations undertaken by WIAL and the influence of ID regulation on this. WIAL also agrees with the airline comments referred to by the Commission that ongoing collaboration is important.

172. In paragraph D10 the Commission notes Air NZ's proposal for separate charging for passengers using the baggage system. WIAL considers that this is a price/quality trade off issue and has provided comment on this matter in Attachment G of this submission.

Attachment E: Is Wellington Airport providing services at the quality consumers demand?

WIAL's Recommendations
WIAL agrees with the Commission's findings.

Introduction

173. WIAL agrees with the Commission's findings in respect of the impact of ID regulation on the provision of service quality.

174. The quality of service at WIAL compares well against other airports both in New Zealand and overseas. WIAL was voted the best airport in Australasia at the 2011 World Travel Awards and its terminal facilities have received numerous accolades from around the world. The quarterly ASQ results are an important part of monitoring and maintaining service quality, which are reported to WIAL's Board as part of its performance reporting.

175. The quarterly reporting of ASQ results and improved operational meetings are contributing to an improvement in service quality at WIAL. In addition the new ID requirements will provide increased transparency of performance going forward.

176. The Commission also makes several comments in the Draft Report that we consider warrant further clarification or comment.

Regulatory Incentives to Address Service Quality Requirements

177. WIAL notes the Commission's comments in paragraph E5 and agrees that the AAA capital expenditure consultation requirements are an incentive for WIAL to understand customer service quality requirements while the Commission also comments that WIAL is obliged to meet health and safety requirements.

178. However the regulatory and planning requirements are much more significant than the Commission describes. In particular:

- Master Planning undertaken by WIAL must consider the long term capacity and service quality requirements for the airport's customers and other key stakeholders.
- The AAA consultation requirement is not limited to major capital expenditure projects. The pricing consultation enables airline consideration of all forecast operating and capital expenditure. While service quality may not be a specific topic of pricing consultation it is considered in discussions on expenditure.
- To ensure ongoing efficient airport operations WIAL must communicate continuously with airlines and other key stakeholders to ensure short term service quality concerns are addressed. As problems are identified longer term solutions may be required. These issues are now discussed in the

more structured operational meetings that have been implemented to meet ID requirements.

- WIAL must meet detailed, comprehensive and stringent technical and health and safety requirements to facilitate ongoing operation of the airport and to maintain its operating certificate issued by the CAA. The CAA requirements require a major commitment to service quality that is reflected in the processes required to ensure facilities are developed and maintained to a high quality. A good example is the runway where compromises cannot be made.
- The new ID requirements provide increased transparency of actual performance over time.

Requirement for Additional Capacity

179. WIAL is perplexed at the Commission's comment in paragraph E21 that "*submissions received as part of this 56G review have not indicated any aspects of service quality at Wellington Airport where they considered service was constrained, and where they required additional capacity."*

180. WIAL does not agree that service improvements are not required. The areas in question are highlighted in WIAL's ASQ survey outcomes and WIAL has planned capital works in PSE2 to address these areas. In particular we refer to gate lounges and wash room facilities for domestic passengers. The Commission also refers to Air NZ's submission that improvements in quality are required for regional airline customers in paragraph E25 of the Draft Report.

181. WIAL is currently consulting with Air NZ on the design of the required terminal improvements.

WIAL's Conduct

182. WIAL notes that matters included in this section of the Draft Report have been addressed elsewhere in this submission. Nonetheless WIAL wishes to emphasise the key issues to be considered.

183. At paragraph E24 the Commission notes that Air NZ disagrees with WIAL assuming the gate allocation function and that it is not cost efficient. WIAL notes that other airlines support WIAL assuming responsibility for this function. The Commission must consider whether an airline may have its own commercial objective which leads to a submission in its own interest, but which is not in the interests of all customers. This is the case with gate allocation.

184. At paragraph E25 the Commission comments that quality enhancements made by WIAL appear to have been demanded by consumers with the exception of the extent of the investment in "the Rock" and the RESA's. We have commented in detail on these projects in our comments on Attachment C above however we repeat that:

- The Commission should evaluate the commercial basis for airline submissions to enable it to reach its own conclusion.
- The Commission should recognise WIAL's objective to ensure capital investment is efficient and will meet long term user requirements. Short term curbing of major projects may incur a much higher subsequent cost if deferred.
- The Commission should also consider the materiality of issues where airlines may be expressing disagreement. Prudent management by WIAL may require initial expenditure to ensure that the risk of longer term curbing of services through the ability to meet developing regulatory requirements is mitigated. An example is the compliance expenditure addressed in our comments in Attachment C.

Attachment F: Is Wellington Airport sharing efficiency gains with consumers?

WIAL's Recommendations

- WIAL has demonstrated that efficiency gains have been achieved in the past and are forecast in PSE2. The draft conclusion in paragraph F5.1 should be deleted.
- As part of its consultation requirements, WIAL provided detailed cost forecasts to its substantial customers for PSE1, PSE 2 and earlier consultations. This full transparency ensured that costs could be scrutinised. In each case cost forecasts have commenced with the most recent budgeted year with any real increases provided for then explained. This has continued to result in a reduction in average costs per passenger which reflects the inclusion of efficiency gains in cost forecasts. Paragraph F5.2 should be amended to reflect this.
- WIAL has provided specific examples of investment efficiency benefits for consumers and consequently the conclusion in paragraph F5.3 should reflect this.
- Finally, the Commission has measured operating costs efficiency gains at WIAL and conclusion F5.4 should be amended.

Introduction

185. WIAL is surprised that the Commission concludes in paragraph F5.2 of its Draft Report that it is not clear that efficiency gains have been shared with consumers when it also comments that expenditure forecasts included in pricing reflect historical efficiency gains.

186. Similarly at paragraph F5.3 the Commission concludes that there is no evidence that WIAL is sharing efficiency gains from investment and in particular from increased output.

187. A relatively high level analysis of several key indicators shows that WIAL has delivered reduced costs to passengers while increasing productivity over a long period of time. This is evidenced by the accommodation of substantially increased passenger volumes with reducing average cost per passenger and greater intensity of use of facilities while quality has been preserved to provide increased efficiencies for the benefit of consumers.

188. These efficiencies can be evaluated from trends in historical data.

Incentive to Share Gains with Consumers

189. The Commission diminishes the influence of the AAA consultation regime. At paragraph F7 the Commission states that *"However, although Wellington Airport is required to consult with its customers on pricing, its ability to set charges as it sees fit means it is unlikely to have strong incentives to promote the sharing of efficiency gains outcomes sought under Part 4."*

190. The Commission's conclusion that the AAA does not provide incentives to share efficiency gains is not evidenced by the comparability of the prices charged by New Zealand airports with other jurisdictions. New Zealand airport charges are below average for international passengers and markedly below Australia for domestic charges[11].

191. The transparency of WIAL's consultation information on operating expenditure, the rebasing of expenditure in each consultation to reflect earlier period reductions in costs per passenger and the exchange of views with airlines, including amendments being made to the forecasts, during consultation demonstrate that the AAA regime does incentivise WIAL to minimise its cost forecasts and share efficiencies with airlines.

192. WIAL is also incentivised to seek efficiency gains for capital expenditure projects and seeks to achieve these. This is evidenced through innovation in expenditure undertaken, such as increasing use of the terminal as a common user facility, swing gates to enable the use of gates and baggage systems by both international and domestic passengers and rear stair loading capability for aircraft which is a cost efficient supplement to air bridges.

Illustration of Efficiencies Shared with Consumers

Operating Cost Efficiencies

193. The Commission's own analysis of operating costs in Attachment B shows that WIAL has achieved a considerable reduction in operating costs per passenger since 2003. The Commission also recognises that WIAL is forecasting a reduction in real operating costs per passenger in PSE2.

Investment Efficiencies

194. It is difficult to illustrate WIAL's achievements in this area from an analysis of financial outcomes however there are several qualitative examples that demonstrate that efficiencies have been achieved and passengers have received benefit. These include:

- The only significant change to the terminal footprint since the current main terminal building opened in 1999 is "the Rock" development. Since the terminal opening passenger numbers have increased by over 40% so clearly increased efficiency has been achieved for terminal utilisation.
- As identified above WIAL has, and will, increasingly develop the terminal as a common user facility which enables deferral of major development works for the terminal.
- WIAL has also commented previously on development of the RESA's. WIAL fundamental objective for these projects was to achieve maximum utilisation of the WIAL land footprint for runway services. In essence runway operating length was preserved which enabled Pacific Blue and

[11] Airbiz Limited, Peer Review, BARNZ Analysis of New Zealand Airport Charges, 17 August 2012

Qantas to achieve more efficient use of their aircraft, and consequently preserve airline competition. In the absence of this approach airline capacity would have been significantly constrained.

- WIAL has been able to meet increased security requirements in recent years by altering its existing terminal footprint and consequently avoid the requirement for significant expansion or redevelopment of its facilities.

195. In addition to the above examples, WIAL notes that it has demonstrated its investment efficiencies by undertaking strong asset management disciplines.

- Undertaking incremental capital expenditure projects which have therefore obviated the need for more significant capital expenditure and larger capital expansions.
- Seeking to ensure WIAL's facilities can accommodate changing airline aircraft operating requirements which enable passenger growth to be facilitated within the current airport footprint.

Cost Savings from Finance Costs

196. WIAL is unclear why the Commission addresses this issue in paragraph F6 when noting that this topic is not related to an efficiency gain. WIAL addresses this issue in its comments on Attachment I.

Airport Benchmarking

197. WIAL considers that the comparison of WIAL's airport prices versus those charged by other New Zealand airports and overseas shows that WIAL's prices are low. This should provide benefits to the airlines operating at WIAL and evidence the sharing of efficiency gains.

Summary

198. WIAL considers that it has demonstrated both the past and forecast sharing of efficiency gains with its airline customers and consequently submits that the Commission should reconsider its draft conclusions.

Attachment G: Do the prices set by Wellington Airport promote efficiency?

WIAL's Recommendations

WIAL agrees with the Commission's view that the price structure implemented for PSE2 should lead to improvements in efficiency.

However, WIAL submits that the Commission should amend its view in paragraph G41 where it comments that *"the airlines have expressed a number of concerns with Wellington Airport's pricing methodology during consultation, and that these concerns have not been addressed."*

WIAL gave full consideration to the airline proposals during consultation but ultimately did not consider they were appropriate or justified. The Commission's comment should be amended to reflect this assessment.

Introduction

199. WIAL agrees with the Commission's conclusion that the price structure implemented by WIAL for PSE2 should lead to improvements in operating efficiency. WIAL invested considerable efforts to try to ensure that an efficient price structure was implemented for PSE2. As part of consultation, WIAL contracted external consultants Sapere and Leigh Fisher to undertake work to evaluate airport pricing structures in place worldwide and to make recommendations concerning an efficient price structure for WIAL. Many of these findings were incorporated into WIAL's pricing for PSE2.

200. However, WIAL does not agree with the Commission's comments that further improvements to promote pricing efficiency could be required in future periods due to airline disagreement over aspects of the pricing structure for PSE2.

201. Whilst WIAL agrees that enhancement of efficiency can occur over time and that ongoing development of the pricing methodology may lead to further efficiencies in later pricing periods, WIAL confirms that it gave full consideration to airline comments during consultation for PSE2.

202. The Commission has not set out its assessment of the concerns that airlines have expressed in their submissions. We comment on the specific examples raised in the Draft Report below.

Incentive to Under-forecast Demand

203. In paragraph G7 the Commission comments that the *"…profit maximising objective also creates adverse incentives to earn excessive profits through the pricing methodology. For example, Wellington Airport may use an unrealistically low demand forecast when setting its pricing methodology…"*

204. WIAL notes that its traffic forecasts were based on advice from its external consultants Booz and Co. These forecasts were provided to airlines during consultation and were available for scrutiny and challenge.

205. WIAL notes that the traffic forecasts for PSE2 were considered by the airlines to be reasonable. At paragraph G36 the Commission comments that forecasts for PSE2 were unlikely to result in excessive profits for this reason.

206. However in the same paragraph the Commission comments that the airlines disagreed with the forecast for PSE1 and noted that actual passenger numbers exceeded WIAL's forecasts. The Commission then further comments that it recognises that the higher volumes could have arisen from factors outside WIAL's control.

207. WIAL considers that this is another area that requires the Commission to fully evaluate the submissions made by the airlines rather than presuming that any disagreement indicates a valid concern. In the consultation for PSE1 the airlines queried WIAL's assumption of 0% growth in the domestic market for the year 2008 (with forecasts for subsequent years anticipating that market growth would recommence). WIAL's forecast was derived from its analysis of available airline capacity, from Air NZ and Qantas, at that time and the prospects of growth being achieved by these airlines in 2008. Upon receipt of the airline submissions during consultation, WIAL sought information from the airlines on their future capacity plans which would facilitate market growth in 2008. No information was provided.

208. Consultation was completed in June 2007. In August 2007, Pacific Blue announced that they were intending to commence domestic services in New Zealand and this occurred in November 2007. WIAL was not aware of Pacific Blue's plans until their public announcement and could not have anticipated this in its consultation forecast. The surplus domestic passengers above forecast in PSE1 were primarily due to the Pacific Blue market entry. WIAL notes that Pacific Blue's subsequent withdrawal from the market in 2011 then resulted in the WIAL forecast for 2012 being achieved in that year, that is the forecast was not exceeded for this year. Growth provided by the other airlines was in line with WIAL's forecast.

209. With regard to international passenger growth, actual traffic was close to forecast until 2012 when further growth resulting from the Air NZ and Virgin Blue Alliance eventuated. Again this growth could not have been contemplated when the forecast was prepared.

210. WIAL considers that it is clear that WIAL's forecast for PSE1 was appropriate and reflected the information that was available to it at the time the forecast was prepared.

Cross Subsidisation

211. The Commission considers the existence of cross subsidies within WIAL's pricing structure and refers in paragraph G19 that cross subsidisation of 19 seat aircraft is possible in peak periods if long run incremental costs were to be considered. WIAL notes that its pricing methodology for PSE2 is intended to introduce pricing as a mechanism to manage forecast congestion and that this

has been introduced gradually in the second year of PSE2 to mitigate price shocks that could arise for some groups of passengers following transition from the PSE1 pricing approach. Further consideration will need to be given to whether stronger congestion management pricing signals will be required in future pricing periods.

212. In paragraph G20 the Commission lists several areas where airlines consider that cross subsidisation may occur in PSE2. WIAL gave consideration to these issues during consultation and we note the following:

- Airlines submitted that separate terminal costs should be established for international and domestic passengers. WIAL considered it more appropriate to transition from the separate charge that was applied in previous pricing periods to a consistent charge for all passengers. WIAL's change in approach reflects its expectation that the use of the terminal assets will change with the Northern Pier that was previously used exclusively for international passengers being increasingly used for domestic services. This will enable WIAL to defer development of significant capacity enhancement to discreet domestic passenger facilities.

  The Commission notes that WIAL's expert advisers recommended a separate charge for domestic and international passengers. In making this recommendation, WIAL's advisers were not aware of WIAL's strategy to increase common use of the terminal and consequently did not factor this into their recommendations.

- The Commission refers to a submission from Air NZ that domestic transfer passengers may cross-subsidise domestic non-transfer passengers. This was not raised by Air NZ in consultation and was therefore not considered by WIAL at that time. However WIAL notes that:
  - This is not a charging system that is employed in any other airport that WIAL is aware of.
  - WIAL is unclear as to how separate charging could be developed as there is no efficient or transparent means for WIAL to be able to identify transfer passengers.
  - The distinction of where particular transfer passengers should incur a charge would depend on the extent to which those passengers used the terminal facilities, which in turn would depend on how long passengers were required to wait for their flights.
  - The Commission and industry representatives discussed the reporting requirement for domestic transfer and transit passengers in development of information disclosure and disclosure templates. It was agreed at that time by all participants, including Air NZ, that reporting of domestic transfer and transit passengers would not be

required in ID because of the complexities in measurement. The Commission accepted these comments and deleted this reporting requirement from the ID templates.

- WIAL agrees with the BARNZ submission that airfield charges are anomalous for international and domestic charges. As the Commission notes this is due to transitional arrangements from the previous pricing structure where distinct charges were established for international and domestic passengers. WIAL seeks to mitigate this anomaly during the progression of PSE2 as the amended pricing structure is introduced.
- Finally BARNZ submits that the Maximum Certified Take Off Weight ("**MCTOW**") tonnage rate for aircraft above 100 tonne implemented by WIAL does not reflect the cost of the additional services received by those aircraft. WIAL commented that these aircraft pay a much higher total charge than small aircraft. Additionally this also may provide some counter balance to the cross subsidisation of small aircraft in congested periods.

213. WIAL wishes to reemphasise that none of these issues impact the level of forecast revenue to be recovered by WIAL. These reflect differences of view on aspects of the pricing structure to achieve the forecast revenue. WIAL has endeavoured to ensure that the PSE2 pricing methodology has sound economic foundations and seeks to promote the efficient use of its facilities.

Price Quality Trade Offs

214. WIAL accepts that price quality trade-offs should be considered where it is feasible to do so, the costs of developing any new charging mechanisms is justified and a sound economic basis exists for establishment of separate charges.

215. None of the issues raised by the airlines withstand this scrutiny although WIAL is willing to discuss options in the future should circumstances change.

216. As commented earlier, the Commission must evaluate the disagreements raised by the airlines. In respect of the issues noted in the Draft Report:

- WIAL is not aware of a technical means that would allow charges to be established for bags that use the baggage sortation system. WIAL sought advice from the airlines during consultation and no solution was provided; Challenges include:
  - o WIAL can count bags on the system for outgoing baggage but does not have a means of distinguishing bags by airline.
  - o WIAL does not have a means to count incoming baggage or to distinguish the airlines where common use of a baggage reclaim belt occurs.

- WIAL is unclear whether these issues could be resolved and the cost of doing so.

- WIAL discontinued the separate air bridge charge applied in PSE1 because WIAL is unable to provide alternate gate facilities for jet aircraft if an air bridge were not used. That is, an aircraft would still have to occupy an aircraft gate with an air bridge even if it were not used. WIAL therefore does not have the option to provide this price quality trade off in a manner that would preserve the air bridge availability for other users.
- Separate charging for the extra RESA tunnel width for larger aircraft introduces a much wider consideration for the charging of airport infrastructure. That is, should discrete parts of the infrastructure be charged to different airlines or aircraft types? This would require analysis of which parts of the airfield and terminal were used by which airlines and require significantly more complex asset and cost management. It would also introduce conflict with WIAL's objective to maximise efficient utilisation of the facilities and to achieve efficient long term investment. WIAL does not consider these conflicts are justified. In this particular instance the cost involved is approximately $2.7 million of investment with little ongoing maintenance cost.

217. WIAL does not agree with these examples of prospective price quality trade-offs for PSE2. However the AAA regime requires WIAL to consult on pricing methodology each time charges are set and therefore will require WIAL to give further consideration to these issues for future pricing periods.

Volume Growth Incentive Arrangement

218. WIAL considers that the Commission's analysis of the incentive arrangement is unbalanced because the Commission does not appear to recognise the compensating risk that WIAL is taking with its forecast of strong traffic growth in PSE2.

219. The Commission notes WIAL comment that its traffic forecasts would be lower in the absence of an incentive scheme. This is correct and is based on traffic forecast advice received from Booz & Co. Consequently it is unquestionable that charges would be higher if the lower traffic forecast were applied without an incentive scheme.

220. The Commission's analysis is correct in that WIAL could receive additional revenues if the traffic forecasts are achieved and payment of the incentive is not required However, WIAL has also accepted a greater risk that the traffic forecast will not be achieved and consequently required revenue will not be achieved. Furthermore WIAL does not expect to meet its traffic forecasts without having the incentive arrangement in place.

221. The Commission does not appear to be recognising the commercial behaviour evidenced by WIAL and the potential long term benefit for consumers. In particular:

- As commented above, WIAL has accepted a higher risk for achievement of required revenues than it was required to.
- WIAL has established an incentive arrangement that is publicly transparent, which has not previously been the case with such arrangements at WIAL or other airports in New Zealand.
- The incentive arrangements create opportunities for all airlines to benefit from increasing passenger numbers and new services.
- If the arrangement is successful in incentivising new growth it will benefit all passengers in the long term as revenue requirements will be spread over a higher passenger base in future pricing periods.

222. WIAL also suggests that the Commission should be mindful of the commercial objectives of airlines making submissions. It is not in the interests of incumbent operators for competition to be increased at airports and consequently airport initiatives to achieve this outcome will be rationally opposed by these operators.

223. It is clear that WIAL is endeavouring to promote passenger growth and consequently generate outcomes that are in the long term interests of consumers and consequently meet the Part 4 purpose.

224. Airline comments that they are meeting the cost of the arrangement are also factually incorrect. The airlines are receiving reduced charges for all passengers from the commencement of the pricing period as WIAL demonstrated in its FPD

Summary

225. WIAL appreciates that the Commission recognises that it has sought to improve the efficiency of its price structure in PSE2.

226. However, contrary views expressed by the airlines must be evaluated before the Commission concludes whether airline views have not been addressed in consultation. WIAL gave full consideration to the airline comments during consultation for PSE2 but did not consider they were appropriate or justified. As a result, WIAL considers that the Commission’s commentary should reflect this assessment.

Attachment H: Is Wellington Airport earning an appropriate economic return over time?

WIAL's Recommendations

The Commission concludes that ID regulation has not been effective in limiting WIAL's ability to extract excessive profits. However, WIAL considers that there are a number of key issues that the Commission should reassess which will lead it to amend this conclusion in its final report.

The most significant areas for the Commission to reconsider are:

- The Commission has undertaken an ex-post price control review of WIAL's financial performance for PSE2 and for the 7 years until the end of PSE2 without undertaking an appropriate evaluation of the outcomes from its analysis;
- The Commission has not considered the infancy of the ID regime and its consequent impact on WIAL's behaviours. Specifically, it has not considered the behaviours adopted by WIAL at the time of setting prices for PSE2 when the price setting was being undertaken in accordance with the AAA. WIAL considered ID as a non-price control regime, and consequently was entitled to base its pricing on methodology different to the IMs where there was sound reason to do so;
- The Commission has not appropriately evaluated WIAL's commercial concessions adopted in its pricing consultation for PSE2 and certain outcomes in its assessment model, namely:
    - Terminal or "Rock" wash up – impact of current treatment $8.8 million present value;
    - Adoption of an airport sector WACC – impact of current treatment $10.8 million present value;
- The Commission has assessed outcomes for PSE1 which are inappropriate since these represent decisions and behaviours made prior to the introduction of the ID regime;
- The Commission has included WIAL's pricing asset base as the closing asset base in PSE2 and its 7 year IRR calculation and prematurely concluded that this will produce excess returns being earned in PSE3 and beyond;
- The Commission contends that there has been no material change in WIAL's approach to profitability targets and similar rates of return were targeted in PSE1 and PSE2. WIAL confirms that it relied on professional advice in establishing its WACC for both PSE1 and PSE2. In addition, its forecast return for PSE2 was lower than its WACC, being a forecast return of 8.1% using a market value existing use ("**MVEU**") land valuation or

8.9% using the Commission's market value alternative use ("**MVAU**") land valuation. Furthermore, the Commission has not given due weight to other WACC factors that compensate for the reduction in risk free rates between PSE1 and PSE2.

- The Commission should not be assessing the existence of disagreements with airlines to conclude on the effectiveness of ID regulation. The airlines will often have little or no incentive to agree with airports while airlines can have different competitive strategies which means common agreement is not always possible. The Commission needs to evaluate the stated disagreements to determine its own views based on the requirements of the Part 4 objective.

Introduction

227. WIAL has significant concerns about how the Commission has evaluated the outcomes from its financial modelling of WIAL's historical and forecast outcomes. In WIAL's views the Commission:

- Does not appropriately analyse WIAL's historical performance;
- Does not give appropriate regard to WIAL's commercial conduct during consultation and in fact effectively dismisses this;
- Alters WIAL's financial forecast inappropriately and in a manner that is not consistent with the ID Determination; and
- Does not give due regard to why it may be appropriate for WIAL's outcomes to vary from that produced by applying the IM's.

228. The Commission's review of financial outcomes has replicated a price control approach and WIAL considers that this exceeds the requirement of ID regulation. While the Commission's approach is reasonable to illustrate comparison of WIAL's forecast outcomes to those derived from application of the IM's, WIAL considers that the Commission's evaluation of variations between the IMs and WIAL pricing approaches is incomplete.

229. Furthermore the Commission has also expressed a conclusion on its view of WIAL's prospective pricing behaviour beyond the current PSE2 pricing period which is inconsistent with the requirements of this review and with the requirement for ID regulation.

230. In this section WIAL addresses the Commission's analysis in Attachment H of its Draft Report and the Commission's evaluation of the outcomes from this.

Impact of ID Regime on WIAL's Behaviours

231. As noted previously in this submission, WIAL considers that the Commission has not appropriately assessed the behaviours adopted by WIAL at the time of setting prices for PSE2. This was undertaken at a time when the Air NZ and

WIAL merits appeals were still to be heard and WIAL adopted a position in pricing consistent with its merits appeal.

232. Further, whilst the ID regime and IMs provided some guidance, WIAL considered that in a regime where the price setting provisions of the AAA were expressly retained and that ID is a non-price control regime it was entitled to base its pricing on methodologies different to the IMs where there was sound reason to do so. This was undertaken with advice from WIAL's independent experts.

233. At that time, there was also no guidance available from the Commission as to how it would assess the effectiveness of the ID regime. The first clear expression by the Commission on the new regime has only now been issued in its Draft Report.

234. As a consequence, WIAL considers that it is important that the Commission considers and assesses these points. Whilst the Commission's IMs were known at that time of setting prices for PSE2 and were an important consideration for pricing, WIAL's behaviour and conduct at the time was based on its own assessment of the ID regime at that time.

235. WIAL accepts that the Commission has subsequently identified some concerns regarding potential future outcomes which it will need to consider in its future monitoring role. Such an approach is consistent with WIAL's view that the Section 56G review and its Section 53B reports are a valuable opportunity for the Commission to provide guidance on matters of concern. These are an important part of the process (which includes resolution of the merits review proceedings) to develop a mature ID regime, where clear expectations for performance are established and the right incentives are provided over time.

236. As a result, whilst the Commission can compare WIAL's forecast returns to those under its IMs, it is important that the above matters are considered in the Commission's assessment of WIAL's behaviour and potential future behaviour now that the Commission is providing feedback to WIAL and the other airports on its assessment of the ID regime.

Profitability Targets in Price Setting

237. The Commission compares the cost of capital established by WIAL for PSE1 and PSE2 in Table H6 and concludes in paragraph H43 that WIAL did not change its pricing behaviour because WIAL's targeted WACC did not fall following the reduction in risk free rates. The Commission then further comments in paragraph H44 that WIAL's WACC estimate has been increased and is higher than the IM.

238. WIAL considers that the Commission's evaluation of cost of capital is limited and ignores several important considerations.

- WIAL's WACC adopted for pricing is a specific cost of capital for WIAL recommended by its external advisers Sapere. They were tasked to identify a WACC recommendation for WIAL after considering its specific company characteristics. It is unquestionable that the three airports will have different risk profiles and that WIAL's WACC will differ from the other airports subject to regulation, namely AIAL and CIAL, and also from the Commission's assumptions for the airport sector WACC.

- In providing advice to WIAL, Sapere analysed the asset beta data collected by the Commission and used to establish the airport sector beta to provide their recommendation for a WIAL specific WACC. While this has increased above previous pricing periods it reflects the fact that WIAL is subject to greater risk than the other airports and consequently it is appropriate for WIAL's beta to be higher than the single beta adopted by the Commission for all three airports subject to ID regulation.

- The Commission is correct that risk fee rates have reduced between PSE1 and PSE2 however the Commission ignores the fact that the cost of securing debt has increased markedly at the same time.

- For example:

	PSE2 Cost of Debt Based on Bank Recommendation	**Cost of Debt Component Targeted by WIAL in PSE2**	**Cost of Debt Component Targeted by WIAL in PSE1**
Risk free rate	3.90%	3.90%	6.16%
Debt premium	3.24%[12]	1.89%	1.50%
Debt issue costs	0.54%	0.54%	Included in debt premium
Total Cost of Debt	**7.68%**	**6.33%**	**7.66%**

During consultation, WIAL obtained external advice from ANZ Limited for WIAL's actual cost of debt. As shown in the table above, the total cost of debt, following inclusion of the debt premium advised by ANZ Limited, for PSE2 was 7.68% which is virtually unchanged from WIAL's total cost of debt assumption for PSE1.

However, WIAL highlights that for PSE2 it actually adopted a concessionary position in its pricing and adopted a cost of debt based on the Commission's approach to setting the debt premium, albeit that WIAL adopted a debt premium for BBB+ rated companies.

- WIAL is rated BBB+ by Standard & Poor's and cannot source funds at the cost of debt set out in the Commission's IM which is based on AIAL's rating of A-. WIAL is not rated A- principally because it does not have the scale of AIAL or the full public ownership of CIAL, and consequently has a higher debt premium than the Commission's allowance.

[12] WIAL FPD page 51

239. The Commission adopted 7.0% as an appropriate long term level for the tax adjusted market risk premium ("**TAMRP**") but accepted that it was appropriate to increase this to 7.5% to recognise the impact of the global financial crisis. The international financial environment remains unstable and consequently WIAL does not consider that the TAMRP has fallen.

240. Importantly while WACC is an input to WIAL's pricing calculation, it is not the return that WIAL is seeking in its future cash flows and its forecast return over PSE2 is below its WACC.

241. The Commission has seemingly ignored the above factors which WIAL considers provide reasonable explanations for the variation in WIAL's forecast performance from the Commission's assessment using the IM's. The Commission has instead rigidly applied its own financial assessment which replicates a price control approach. This approach is prejudicial to WIAL and the Commission should evaluate the impact of these factors before forming any conclusions on WIAL's actual and forecast profit performance.

Were Profits Excessive Prior to Information Disclosure?

242. WIAL does not disagree with the Commission's approach to the analytical calculations published in tables H8 to H13 to demonstrate WIAL's return for the 2011 and 2012 years (with the exception of the treatment of wash ups which is addressed as a separate section below).

243. We comment on several key issues concerning the Commission's assessment of the results from the calculations below.

Accuracy of Calculations

244. While the analytical approach is reasonable the Commission has made several errors in its analysis. These are:

- Table H12 revaluation income – the Commission has calculated this for the pricing asset base only rather than for all regulated assets.
- Table H12 revaluation wash up – the wash up has no tax consequences and therefore should not be tax adjusted.
- Table H12 pricing asset investment value – the actual for 2012 is the Regulatory Asset Base ("**RAB**") from the 2012 annual information disclosure. The Return on Investment ("**ROI**") including revaluations should not be assessed against this asset base because it does not include the revaluations. The ROI should be assessed against the WIAL asset base values.
- These issues are also incorrect in table H13.

245. We reproduce tables H12 and H13 below with the above items corrected in the calculations.

Reproduced Table H12: Comparison of Forecast vs. Actual Performance 2012 Adjusted for Revaluations

	Forecast 2012 ($000)	**Actual 2012 ($000)**	**Actual 2012 including terminal wash up ($000)**
Pricing profit (excluding revaluations)	21,344	29,727	28,093
Revaluation income	71,986	147,048[1]	147,048
Pricing profit (including revaluation)	93,330	176,775	175,141
Impact of revaluation wash up	N/A	14,500	14,500
Adjusted pricing profit (including revaluation and interest tax shield adjustment)	93,330	161,035	159,401
Pricing asset investment value	351,404	496,113	496,113
Target return/ ROI including revaluations	26.6%	32.5%	32.1%

Note 1: Calculations provided at Appendix 1

Reproduced Table H13: Assessment of ROI in 2011 and 2012 including revaluation/terminal wash up

	2011 ($000)	**2012 ($000)**
Aeronautical revenue	50,686	54,737
Regulatory profit	24,351	28,093
Revaluation income	29,410	29,410
Impact of revaluation wash up	2,900	2,900
Adjusted regulatory profit (including revaluation and interest tax shield adjustment)	49,465	53,363
Asset investment value	483,884	496,113
Target return/ ROI including revaluations	10.2%	10.8%

246. The revised calculations do not change the outcomes in any material way but we provide them to the Commission for the benefit of accuracy. We comment further on these returns in the following section.

Commission's Evaluation of Ex-Post Revaluation Outcomes

247. WIAL notes that the Commission has adjusted WIAL's annual disclosures for 2011 and 2012 which reported returns of 6.2% and 6.9% respectively. The Commission has applied an ex-post assessment of actual revaluations achieved by WIAL in PSE1 and included an apportionment of the revaluation gains to 2011 and 2012. This apportionment has the impact of increasing

WIAL's returns on WIAL's asset base to 10.2% and 10.8% (as corrected above).

248. The Commission's analysis effectively suggests that WIAL's behaviour was inappropriate although the Commission calculates that excessive profits were generated without evaluating the following matters:

- The basis of consultation which involves forecasts of various parameters (usually for the next 5 years);
- WIAL's forecasting behaviour in consultation, which involved reliance on external advisors and ultimately a revaluation wash up arrangement for PSE1;
- How the variation in asset valuations arose; and
- How these would be treated in competitive markets.

249. WIAL correctly included forecast revaluations in its pricing calculations for PSE1. WIAL sought advice from expert valuers on prospective asset valuation increases for the pricing period. Recommendations were received from Telfer Young for land and buildings and Opus International Consultants for civil works. Due to the sensitivity of land valuations WIAL then sought additional advice from Wareham Cameron.

250. WIAL proposed the recommended valuation increases to the airlines in consultation and the airlines proposed alternative recommendations. The relative positions were:

Revaluations % per annum	**WIAL**	**Airlines**
Land	2.5%	6.4%
Buildings and civil works	5.0%	5.5%

251. WIAL did not consider the airlines' land valuation movement credible and decided to retain the forecast land value movement recommended by Telfer Young and Wareham Cameron.

252. However in response to airline submissions that WIAL was under forecasting the valuation movements to seek windfall gains WIAL implemented a risk share wash up arrangement where the airlines would receive credit for valuation gains that exceeded WIAL's forecasts up the level of the airline forecasts. This was a voluntary commercial approach undertaken by WIAL.

253. If a wash up occurred under this arrangement it was to be reflected in lower expected revenues for the next pricing period.

254. WIAL's consultation conduct was therefore robust where independent professional advice was obtained as the foundation for forecasts, and WIAL adopted a commercial risk sharing arrangement in the event that valuation gains varied from forecast.

255. The actual revaluation gains for land exceeded forecast. While the terms of the wash up arrangement were not met, WIAL honoured the arrangement and reduced expected cash flows for PSE2 to reflect the wash up arrangement.

256. Revaluation gains above the wash up level were subsequently included in the asset base for pricing by WIAL which is consistent with competitive property market behaviour. For example, commercial property landlords do not increase or reduce future rental cash flows because property valuations for earlier rental periods varied from their expectations.

257. The Commission is therefore not evaluating WIAL's performance in accordance with the purpose statement which seeks to achieve *"outcomes consistent with workably competitive markets".*

258. WIAL considers that the Commission should amend its evaluation of the historical returns to recognise WIAL's consultation conduct and recognise that inclusion of the total revaluation gains in the asset base for pricing is consistent with competitive market behaviour.

Pricing Impact of Revaluation Gains

259. In paragraph H5.3 the Commission comments that *"We consider the excessive profits are attributable to Wellington Airport's use of its own asset valuation methodologies to revalue assets without accounting appropriately for the resulting revaluation gains"*.

260. WIAL is unclear on how the Commission can comment that WIAL has not accounted appropriately for revaluation gains.

261. If the Commission's view is that WIAL should be applying an ex-post pricing adjustment in future pricing periods for all unexpected revaluation gains then the Commission would be expecting behaviour that is not consistent with how competitive markets operate. Furthermore this suggests that the Commission is distinguishing variations from revaluation forecasts from all other forecast variations. There is no economic rationale for the different treatment.

262. The revaluations will only affect consumers to the extent they flow through prices over the long term. WIAL has made the decision to include the full updated asset valuation for pricing in PSE2, albeit that the outcomes are mitigated by other commercial factors detailed below.

263. WIAL agrees with the Commission's statement in paragraph H65 that *"Over time, the impact of the revaluations will become apparent under information disclosure as elevated profit levels to the extent that the revaluations flow through into the revenues collected from customers by Wellington Airport (as our analysis for PSE2 and beyond demonstrates later in this attachment).*"

264. The Commission further explains the impact of revaluations in paragraph I12 when it states:

“Revaluing assets complicates the assessment of returns. The ROI reflects a revaluation gain (or loss) in the year prior to the change in asset value. This can result in a ‘spike’ in the ROI which simply signals an expectation of higher (or lower) profits in the future. However, whether the reported returns actually eventuate (and any gains or losses associated with them) depends on the extent to which the change in the asset value flows through into prices and revenues”.

265. The critical reference in this point is that the returns from revaluations only eventuate when they impact prices and revenues. This contrasts with the Commission’s comment that WIAL has inappropriately accounted for revaluation gains.

266. WIAL is concerned that the Commission shows through its analysis of WIAL’s historical performance that it is confusing WIAL’s financial reporting outcomes with assessment of its pricing outcomes that impact consumers. WIAL submits that the two are distinct and should be considered as follows:

- WIAL is required to undertake asset revaluations including land valued at MVEU and other assets at optimised depreciated replacement cost (“**ODRC**”) periodically for financial reporting purposes.

  WIAL has elected to utilise these asset values as an input into the calculation to establish required revenue, and prices, in conjunction with a number of other financial inputs and commercial decisions.
- The Commission’s role is to evaluate the outcomes from WIAL’s pricing consultation and evaluate the reasonableness of this within the IM framework that the Commission has established.
  - The Commission evaluates WIAL’s actual and forecast cash flows as it has done in its assessment for PSE2;
  - The Commission assesses the returns that the forecast cash flows produce compared to an asset base valued in accordance with the IM requirements;
  - It is the cash flows that impact consumers, not historical revaluation gains which should be disregarded as acknowledged by the Commission in the comment above *“whether the reported returns actually eventuate (and any gains or losses associated with them) depends on the extent to which the change in the asset value flows through into prices and revenues.”*
- The actual revaluation gains for PSE1 ended up being above forecast and produced returns within the building block model that were higher than anticipated. However, clearly these revaluations had no impact on consumers in PSE1.

- By contrast WIAL's cash revenues for PSE1 were below the revenue levels that would have been required to achieve the Commission's WACC within the evaluated within the ID framework. The Commission confirms this in paragraphs H57 and H58 but then seeks to explain why this outcome is of concern due to the existence of revaluations.
- WIAL considers that this may demonstrate the Commission's misinterpretation.
    - o WIAL's cash flows are the product of a collection of inputs and market circumstances and for PSE 1 these cash flows, as shown in WIAL's annual disclosures, were below the levels required to generate a return consistent with the Commission's WACC determinations. This reflects the outcome for consumers.
    - o The Commission then seeks to demonstrate that the true returns were actually higher because of the unexpected revaluation gains and yet these had no impact on consumers and were recognised in PSE1 for financial reporting purposes only.

267. WIAL confirms that it has the opportunity to reconsider this matter in establishing prices for PSE3 and beyond with full awareness that the divergence of its outcomes from the Commission's IM based calculations may increase, and be subject to ongoing scrutiny from the Commission.

Are Expected Profits Expected to be received after PSE2?

268. The Commission comments further in paragraph H78 that *"We do not know what asset value Wellington Airport will use as the basis for setting prices beyond PSE2, or whether there will be any wash ups associated with any revaluations. However, at this point in time we consider it is reasonable to assume that, at the very least, Wellington Airport expects to set prices for PSE3 and beyond by pricing off its current forecast of the closing asset value for PSE2."*

269. WIAL considers that it is inappropriate for the Commission to prejudge WIAL's pricing behaviour for future pricing periods. Information disclosure regulation has only been in place for a very short period of time and the Commission's evaluation of outcomes from the regime has only been advised to airports for the first time in its Draft Report on WIAL. To conclude that the Commission's evaluation will not be considered and responded to by airports in the future is unrealistic and premature.

270. WIAL considers it is inappropriate for the Commission to speculate on what may happen for PSE3. In particular, when recognising that:

- The Commission should not conclude that the outcomes for PSE2 are inappropriate following correction of the terminal wash up treatment and consideration of WIAL specific factors that lead to a more appropriate return benchmark than the WACC IM.

- WIAL may implement commercial agreements with airlines during the pricing period that lead to changes in the expected financial outcomes for WIAL.
- WIAL has to re-consult on prices during or at the end of PSE2 and at that time will have to consider WIAL's actual performance, economic conditions at the time, submissions from the airlines and the then current regulatory requirements, including conclusion of this Section 56G review and the summary and analysis reports that are to be prepared by the Commission in respect of published disclosures.
- WIAL will have actual results for PSE2, prepared several years of annual information disclosures and received ongoing engagement with the Commission in terms of its evaluation of performance over the pricing period.
- WIAL's forecast asset base for 2017 may not eventuate.

Reasons for Excess Profits – Terminal Wash Up

271. The Commission concludes that its assessment of excess profits are due to WIAL adopting an MVAU plus conversion costs land valuation and a targeted cost of capital of 9.51%.

272. However in reaching this outcome the Commission has also chosen to adjust WIAL's forecast revenues for the terminal wash up and consequently analysed cash flows for PSE2 that;

- Inflate WIAL's PSE2 revenue forecast; and
- Will not be consistent with the Commission's IMs and consequently will also not be consistent with what will be disclosed in WIAL's annual information disclosures.

273. WIAL disagrees strongly with how the Commission has treated the terminal wash up (and we comment on the specific reasons for this in our comments on Attachment I).

274. The table below shows the outcome that is produced following amendment of the Commission's model for the terminal wash up.

Output from Model	**WIAL Amended Outcomes $000**	**Commission Revised Calculations Model $000**
NPV of WIAL cash flows	126,502	135,273
NPV of Commission Cash flows at 75th percentile	115,590	115,590
Difference in NPV cash flows	10,912	19,683
IRR for PSE2	8.65%	9.14%
IRR for 7 year pernod of ID regulation	9.83%	10.10%

Reasons for Excess Profits – Targeted WACC

275. WIAL reiterates that it did not target a return of 9.51% for PSE2 and the Commission has not given appropriate regard to the overall package of pricing decisions that WIAL made.

276. WIAL considered the returns that would be generated from its ex-ante forecasts when it set prices for PSE2. These returns are founded on the pricing asset base only (not the assets for total specified services) and are derived from the net cash revenue plus revaluations that WIAL has forecast for PSE2. These forecast returns were 8.1% with land valued at MVEU and 8.9% with land valued at MVAU.

277. WIAL considers that the Commission's dismissal of its commercial approach to pricing for PSE2, which resulted in reduced revenue forecasts, is of significant concern and appears to confirm that the Commission is taking a defacto price control approach to its assessments.

278. Furthermore as we have commented earlier in this submission the Commission has not given regard to WACC sensitivity adjustments that would appropriately recognise differences for WIAL from the airport sector WACC IM.

279. If the Commission were to consider the prospective sensitivity adjustments noted by WIAL earlier in this submission it would produce the following outcome for PSE2.

Output from Model	**WIAL Amended Outcomes $000**	**Commission Revised Calculations Model $000**
NPV of WIAL cash flows	135,273	135,273
NPV of Commission Cash flows at 75th percentile	126,387	115,590
Difference in NPV cash flows	8,886	19,683
Change in NPV	(10,797)	
IRR for PSE2	8.80%	9.14%
IRR for 7 year pernod of ID regulation	9.92%	10.10%

Consideration of WIAL's Pricing Behaviour for PSE2

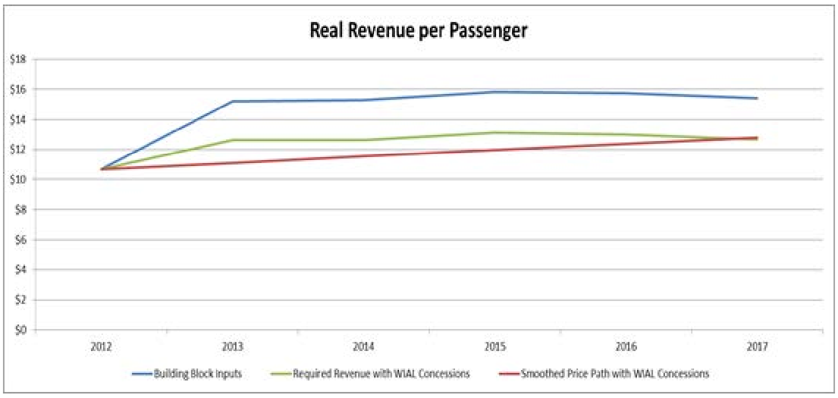
280. WIAL prepared its building block model for PSE2 consultation with input from expert advisors, including valuers, economists and traffic consultants. In setting the revenue price path, WIAL implemented a number of commercial concessions and wash ups which resulted in the PSE2 revenue being $93.0 million below that produced by the building block model. These concessions included:

- WACC concessions with respect to WIAL's own WACC and the WACC applied for an airport developer (which reduced the MVEU land valuation);

- Revaluation wash up from PSE1, which whilst it was not applicable under the terms of the wash up arrangement in PSE1, WIAL decided to apply this commercial concession in PSE2 being $14.5 million;
- Smoothed price path which results in WIAL only achieving its required revenue (adjusted for commercial concessions) in the final year of PSE2.

281. In addition to the above, WIAL applied a reduction in revenue relating to the "Rock" wash up for $20.9 million.

282. The impact of the different revenue paths on the real revenue per passenger and the benefits of the smoothed price path over PSE2 are highlighted in the following graph:



283. The revenue price path applied by WIAL after the above concessions and wash up comprises a $93.0 million reduction on its building block inputs for PSE2 and an effective forecast return on assets of 8.1%.

Airline Disagreement

284. WIAL is concerned that the Commission is basing conclusions on WIAL's consultation conduct on whether agreement is reached with airlines on pricing without an evaluation by the Commission of the airline views.

285. As noted in Part A of this submission, WIAL's experience with consultation is that airlines have little or no incentive to agree to anything other than discrete investments required to support their own business. In addition, airlines can continue to disagree with consultation proposals for no other reason than not wanting to suggest that they consider airport conduct appropriate.

286. In addition, WIAL also has instances of airlines agreeing to dispute resolution processes and commercial approaches implemented by WIAL in response to their submissions only for the airlines to subsequently ignore these outcomes.

287. Some examples of disagreements are:

- WIAL submitted to independent arbitration in 2003 regarding its asset valuation methodology which all parties agreed would be binding. This arbitration ultimately supported the MVEU and ODRC methodologies applied by WIAL. Subsequent to the arbitration the airlines have chosen to ignore the outcome and continue to submit the methodologies were inappropriate. A clear example of WIAL endeavouring to reach an appropriate commercial solution.

- Airlines have disagreed with WIAL's traffic forecasts to varying degrees in past consultations but have never provided WIAL with any information to corroborate their views.
- Airlines can each have different strategies and provide WIAL with contrasting opinions on some issues, particularly investment where incumbent airlines may not support investment that, for example, facilitates increased competition. In such instances WIAL is required to identify long term solutions that provide the best benefit for all parties and passengers.
- Airports and airlines have different asset profiles which can lead to different pricing objectives. Airlines will often take a shorter term view than airports concerning investment whereas airports must take a long term view for significant investment increments. In addition, airports have little opportunity to reduce capacity when markets fall while airlines have more flexibility, including via changes in their aircraft fleets. In such instances, WIAL is required to identify the most appropriate solution in the long term interest of passengers.

288. The Commission needs to ensure that airline disagreement is not seen as a reason to view the current regime as broken. Instead it is important that it form its own view on WIAL's consultation process by reviewing the consultation material that has been published. WIAL considers that its consultation was conducted in a comprehensive and professional manner. Airline views were given considerable regard and detailed explanations provided where WIAL disagreed with the airlines.

Commercial Agreement

289. The opportunity for commercial negotiations is always available for airports and airlines and WIAL confirms that it currently has, or has had, agreements with all of the major airlines operating at WIAL.

290. WIAL is willing to undertake commercial agreements with airlines that produce benefits for both parties and its stated preference is for such agreements with its airline customers.

291. WIAL also notes that it is currently discussing the noise mitigation activities consulted upon for PSE2 with Air NZ and BARNZ. WIAL and these parties are negotiating a commercial agreement that would replace the existing noise levy charges established for PSE2. WIAL notes that it proposed a commercial agreement during consultation for PSE2 which was not resolved at that time. However WIAL is hopeful that a long term commercial agreement can be reached on these charges.

Summary

292. The Commission concludes that ID regulation has not been effective in limiting WIAL's ability to extract excessive profits. WIAL considers that for the reasons set out above, the Commission should reconsider its evaluation and ultimately lead it to amending this conclusion in its final report.

Attachment I: Supplementary Material on Profitability

293. We comment on specific items in this attachment.

Treatment of cash and non-cash wash ups

294. The Commission has modified WIAL's pricing forecasts by increasing WIAL's forecast revenues for PSE2 through addition of an allowance for the terminal wash up, while deducting an allowance for this revenue in its 2011 and 2012 analysis.

295. By undertaking these adjustments the Commission creates a hypothetical situation that does not reflect the returns that WIAL has, and is forecast to, earn over PSE1 and PSE2. WIAL considers that this treatment is inappropriate and results in analysis by the Commission which misrepresents WIAL's actual and forecast revenues in PSE1 and PSE2.

296. WIAL is concerned by the misleading nature of the Commission's treatment of the terminal wash up arrangements that WIAL entered with airlines during PSE1. As the Commission is aware, WIAL set its charges in PSE1 at a level that included collecting revenue needed for the development of The Rock within a certain timeframe. The arrangement entered into at the time included specific provision for a wash up in PSE2 if the project was not completed as scheduled. That wash up arrangement was triggered, and WIAL proceeded to set its charges in PSE2 on the basis of a reduced revenue forecast, in order to compensate airline customers. For both PSE1 and PSE2, WIAL was entitled to set charges as it thought fit, but did so only after extensive consultation with airlines. The terminal wash up arrangement reflected a commercial concession to airlines and was lawful. In PSE2, WIAL fulfilled its PSE1 terminal wash up arrangement on its terms, and prices have been set on the basis that less revenue is required from charges in this period.

297. The Commission's decision to move the revenue reduction to PSE1, and correspondingly create an inflated revenue forecast for PSE2, does not reflect WIAL's lawful commercial arrangements either before or after the introduction of Part 4 ID regulation. The Commission is, in 2012, assuming a downward change to the revenue received by WIAL for PSE1, and a corresponding upwards change to the revenue requirements for PSE2 (which have already been consulted on and set).

298. The Commission has in its analysis retrospectively assumed a change to the basis on which prices for each of PSE1 and PSE2 were set by WIAL as a matter of fact. It has then conducted its profitability assessment on the basis of the changed figures. But the Commission's retrospective rearrangement of the basis for WIAL's price setting in PSE1 and PSE2 effectively sets WIAL up for the appearance of earning excess profits to the level of the inflated revenue forecast. This cannot have been the intention when requiring the Commission to conduct a review of the effectiveness Part 4 ID regulation. The Commission's analysis does not reflect WIAL's pricing behaviour either before or after Part 4,

and it does not reflect regulatory disclosures. In WIAL's submission it should be corrected to do both.

299. As noted above, WIAL considers that the Commission's adjustment means that its forecast revenue in the Draft Report does not comply with its ID Determination. WIAL is required to report its annual revenues pursuant to the ID Determination, The ID Determination defines revenues as:

> *"**airport activity charge** means revenue earned by an airport in relation to a specific charge or group of charges, other than lease, rental and concession income. In determining how charges are disclosed, consideration must be given to the charging structure outlined in the pricing methodology disclosed in accordance with clause 2.5(1);*
>
> ***net operating revenue** means*
>
> *(a) in all instances other than related party transactions, the total of airport activity charges, other operating revenue, and lease rental and concession income;*
>
> *(b) in relation to related party transactions, net operating revenue (as determined in accordance with paragraph (a)) from related parties;*
>
> ***other income** means any income received from the provision of specified airport services that is not captured by total operating revenue or gains / (losses) on asset sales;*
>
> ***other operating revenue** means revenue earned by an airport business in relation to specific charges relating to a regulated activity, which has not been separately disclosed as an airport activity charge or lease, rental and concession income. Other operating revenue must not exceed 10% of net operating revenue;"*

300. None of these definitions provide for recognition of items that will not be earned by WIAL in the relevant year.

301. As noted earlier, should the Commission retain its approach then it is likely that WIAL will be disincentivised to consider such arrangements in the future.

BARNZ return calculations

302. The Commission notes in paragraph 36 that it has referred to the BARNZ analysis of returns and invites submissions from others on the BARNZ approach.

303. WIAL notes that BARNZ's analysis includes all revaluations (forecast and unforecast) as income in the same manner as the Commission in its own draft calculations.

304. BARNZ has estimated a variety of numbers in its calculation and it therefore does not have the same precision as the Commission's data.

305. WIAL has therefore not considered the BARNZ calculation in any detail and considers that it is more appropriate to respond to the Commission's analysis.

Unreconciled information

306. WIAL was concerned to read the Commission's comments at paragraph I44 that infer that there was a lack of transparency in the WIAL data. WIAL has attempted to provide comprehensive information disclosures, published its consultation documents and responded in detail to all queries from the Commission. WIAL treats its disclosure responsibilities extremely seriously. With respect to the specific items noted by the Commission, WIAL responds below.

307. The Commission comments that it could not reconcile the $62.5 million of disclosed revenue shown on page 12 of Price Setting Disclosure with the $60.3 million disclosed on page 45. The difference is forecast revenue for the LUMINS noise mitigation activity. WIAL comments on page 48 that this revenue was forecast using a stand-alone building block model.

308. The Commission comments that it was unable to reconcile the 31 March 2011 MVAU of $141 million to the $85.4 million disclosed in the Price Setting Disclosure WIAL cannot find any reference to the $85.4 million in the disclosure document so is unable to comment further at this stage. WIAL notes however that the MVAU land values reported in the 2011 and 2012 annual disclosures were $119.2 million and $121.4 million respectively. The $85.4 million reference would appear to be incorrect.

309. The Commission appears to confuse the valuation of WIAL's total land holding with the allocation of the land holding for information disclosure reporting. The land valuation comprises WIAL's total landholding that is available for long term airport services. The valuation of the land area currently used for commercial purposes must then be deducted from the total valuation. These analyses were set out in WIAL's consultation documents and valuation reports. WIAL notes that this reconciliation is always prepared when a new valuation is undertaken.

310. WIAL has endeavoured to ensure that its published information is transparent and complete. WIAL is willing to continue to work with the Commission and respond to its queries as required.

Cost of Capital

311. The Commission states in paragraph I72 that it *"considered what range of WACC would be appropriate when determining the 'normal' return for Wellington Airport.*"

312. The Commission concluded in paragraph I74 that:

> *"Typically the Commission would use a 75th percentile WACC as an upper boundary of the range in contexts where it is administering price control. The 75th percentile WACC is used in these contexts to allow for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment."*

313. WIAL agrees with the Commission's assessment and the rationale for using the 75th percentile for its analysis of WIAL.

314. However the Commission should be giving regard to other WACC factors in evaluating the variations in WIAL's forecasts from those undertaken by the Commission in the ID framework.

315. In its analysis the Commission uses the WACC IM that it has established for the three airports subject to ID regulation.

316. It cannot however be ignored that all three airports do not have the same cost of debt nor the same risk characteristics. WIAL considers that in order to fully evaluate outcomes under ID regulation the Commission must consider the use of airport specific WACCs, which airports use when they set prices and that this should be evaluated in its assessment of profitability.

317. WIAL is not submitting that the Commission should use WIAL's WACC in its analysis but rather should consider the impact or sensitivity analysis of this in its assessment of WIAL's performance and the impact of differences in cost of debt and other parameters between airports.

318. For example, WIAL has modified the Commission's IMs for certain parameters in the table below. Even these modest changes increase the WACC for evaluation of WIAL's outcomes from 8.04% to 8.8%.

Input	**Commission WACC Determination 27/04/12**	**Revision for Evaluation of WIAL's Financial Outcomes**
Risk-free Rate before Tax	3.61%	3.61%
Debt Premium	1.94%	2.35%
Debt Issue Costs	0.35%	0.35%
Market Risk Premium	7.0%	7.5%
Leverage	17.0%	17.0%
Beta (Asset)	0.60	0.65
Investor Tax Rate	28%	28%
Cost of Debt	5.90%	6.31%
Cost of Equity		
Beta (Equity) = BetaA/(1-Lev)	0.72	0.78
RFR.BT*(1-Ti)+BetaE*TAMRP	7.7%	8.47%
Mid Point Post Tax Weighted Average Cost of Capital	**7.06%**	**7.80%**
75th percentile	***8.04%***	***8.80% (estimate)***

319. In this example provided by WIAL it recognises appropriately that:

- It is not realistic for WIAL to have a cost of debt equal to an A- rating based on AIAL's business model. WIAL has applied the Commission's

BBB+ assumption for EDB’s in the table although this still represents well below the actual cost of funding of WIAL.

- The global financial crisis remains a major issue and continues to impact the cost of available funds. The Commission should continue to recognise this as it agreed was appropriate in 2009 and allow an additional margin on its assumption for the longer term TAMRP.
- WIAL clearly must have a higher business risk than AIAL given such matters as its exposure to a small number of large customers and the absence of diversification that the long haul sector provides at AIAL, and to some extent CIAL. WIAL’s amendment above therefore reflects an adjustment that the Commission may consider more realistic rather than directly adopting WIAL’s beta as recommended by Sapere.

320. WIAL illustrates the outcome of this revised WIAL specific WACC in its comments on the Commission’s model.

Appendix 1: Commissions Calculation of WIAL's Returns for PSE1

The Commission's calculation was undertaken for assets included in the pricing asset base only. WIAL has reproduced the calculations for the entire regulated assets base which are shown below:

	Wash up Calculations			PSE1 BB Model		Closing 2012 Value per PSE2 BB Model		
				Open. + Reval	Closing	**PSE2**	**Less Capex**	**PSE2 2012**
	2006	**2007**	**2012**	**2012**	**2012**	**2012**	**+ Deprec in 2012**	**Revals Only**
Land	143,068			161,868	161,869	208,921		
Land Total	143,068			161,868	161,869	208,921		208,921
Specialised building assets	74,300			98,728	108,469	129,244	4,501	133,745
Civil works	65,638			94,396	130,836	130,314	3,256	133,570
Total	283,006			354,992	401,174	468,479	7,757	476,236

Forecast revaluations to 31 March 2011	**Per PSE 1 model**		**Revaluations in excess of PSE 1 forecast to 31 March 2012**		
Land	18,800		Land		47,052
Specialised building assets	24,428		Specialised building assets		25,276
Civil works	28,758		Civil works		2,734
Total Revaluation over PSE 1	71,986				75,062
			Revaluation from PSE 1 Model		71,986
			Total revaluations		147,048