REVIEW OF INPUT METHODOLOGIES

SUBMISSION ON COMMERCE COMMISSION DRAFT DECISION

4 AUGUST 2016

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Introduction

1. The Commerce Commission ("**Commission**") has invited submissions on its draft decision released on 16 June 2016 ("**draft decision**") as part of its review of input methodologies ("**IM Review**") being undertaken pursuant to section 52Y of the Commerce Act 1986 ("**Act**").

2. In this submission we address matters that are particularly relevant to Auckland International Airport Limited ("**Auckland Airport**"). Our submission should be read in conjunction with the New Zealand Airports Association's ("**NZ Airports**") submission, which Auckland Airport is a party to and supports.

3. Auckland Airport's contact for matters regarding this submission is:

Adrienne Darling
Head of Economic Regulation and Pricing, Auckland Airport
Ph 09 255 9090
adrienne.darling@aucklandairport.co.nz

Executive Summary

4. Auckland Airport supports the Commission's intent to promote:

   (a) flexibility in the application of Information Disclosure ("**ID**") regulation; and

   (b) the provision of transparent and sufficient information for interested parties to assess performance.

5. Auckland Airport remains committed to ensuring its disclosures provide a clear and accurate picture of its performance. In turn, we welcome the Commission's commitment to undertake meaningful assessment of airport performance over time, which will require it to fully engage with the reasons and explanations we provide for our decisions.

6. On issues that have specific application to Auckland Airport, our views are as follows:

   (a) **Asset revaluation:** We support the proposed amendment to the input methodologies ("**IM**s") to allow airports to apply either CPI-indexation or an un-indexed approach to asset revaluation for information disclosure. This will provide additional flexibility for airports to disclose capital recovery consistently with their pricing approaches.[1]

   (b) **Adjustment to the regulatory asset base ("RAB"):** We think the focus should be on arriving at the best position for disclosure of the opening RAB at the start of PSE3. We encourage the Commission to provide flexibility to allow Auckland Airport to adopt any of the options proposed in the draft decision to disclose the impact of its revaluation approach since the start of the ID regime. This is a topic that could usefully be considered further in the proposed technical consultation phase.

   (c) **Assets held for future use:** We support the Commission's proposed solution for the disclosure treatment of any airport charges associated with assets held for future use. The draft decision will support an airport's ability to make efficient pricing decisions following consultation with substantial customers, and to explain the impact of these decisions to interested parties. In this way, the Commission's proposal provides clear transparency while avoiding the risk that efficient price signals are wrongly diagnosed as excessive profits.

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[1] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 216.3.

Asset revaluations

Problem definition

7. The Commission considers that its profitability assessments may not be the best reflection of an airport's effective return if airports use asset revaluation approaches for disclosure that do not align with their pricing decisions. This is particularly relevant to Auckland Airport, given that:

   (a) it has not been revaluing a subset of regulated assets for pricing purposes since 2007;

   (b) the new regime set the regulatory value of assets as at the start of ID, set the rules for how assets should be revalued for disclosure purposes going forward, and drew a line under anything that had happened before that time;

   (c) since that time, the IMs have required Auckland Airport to index its disclosed RAB in annual disclosures; and

   (d) Auckland Airport's RAB has therefore been rolled forward from the start of ID in a way that does not reflect its approach to revaluations in pricing over that time.

8. Although the Commission accepts that either indexing or not indexing can be consistent with implementing NPV=0, the challenge is that targeted profitability can be assessed on a different basis from actual profitability.[2] That is because:

   (a) the information an airport discloses about its price setting event must be consistent with the approaches the airport applied to its forecasts when setting prices;[3] whereas

   (b) the information an airport discloses on an annual basis must be consistent with the revaluation approaches set out in the IM Determination (that is, it must be IM compliant).

9. As the Commission is aware, Auckland Airport has sought to address this issue in previous disclosures by explaining the impact of our practice not to revalue on our annually disclosed return on investment. We also took steps to explain the moratorium and its effect on prices in the price-setting disclosure published after prices were set in 2012.

The proposed solution

10. As we understand it, the intent of the draft decision has three key parts:[4]

   (a) Amend the RAB roll-forward provisions in the IM to give airports the ability to apply the same revaluation approach they have adopted in price setting to the disclosed RAB going forward. In practice, this will require airports to apply either CPI-indexation or an un-indexed approach when rolling forward the value of individual assets in the RAB (with the ability to revalue land at MVAU on a periodic basis) in a way that is consistent with their pricing approach.[5]

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[2] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 200.

[3] Airports Information Disclosure Determination 2010 (Commerce Commission Decision 715, 22 December 2010), clause 2.5 and Schedule 18.

[4] If we have misunderstood the intended effect of the Commission's decision, we would appreciate discussing this with Commission staff at the earliest opportunity.

[5] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 214.

(b) Require Auckland Airport to adjust its current RAB values by removing or otherwise accounting for "disclosure-only" revaluations that have occurred since the establishment of the initial RAB.[6] The Commission has identified several methods that could be used to disclose this adjustment, but indicates a preference to require Auckland Airport to restate its RAB.

(c) Require retrospective disclosure of an adjusted/restated RAB for each of the last five disclosure years.[7] This would effectively require Auckland Airport to retrospectively disclose how the initial RAB would have been rolled forward if the new revaluation provisions in the IM had been in place from the start of ID.

11. In summary, our views are as follows:

(a) Auckland Airport supports the decision to allow airports to index or not index the RAB on a forward-looking basis (eg from the 2017 disclosure year and/or PSE3). Our position is subject to the proposed ID requirements allowing us to reflect the revaluation approach that has been taken in pricing, which may differ within an asset category as defined by the Commission. This will allow us to adopt a disclosure approach going forward that aligns with the revaluation approach in pricing.

(b) We accept that some adjustment to Auckland Airport's current RAB value will be appropriate to show the impact of "disclosure-only" revaluations between the date of the initial RAB and the point at which the new IMs take effect (essentially the start of PSE3). The issue is how to best achieve that adjustment in a transparent and efficient way. As we discuss below, we think it is too early to identify a single best method. In our view, the better approach is for the Commission to provide Auckland Airport with the ability to use any of the options (outlined at para 16 and 17 below) that it has identified in its draft decision.

(c) We are struggling to see the benefit in providing retrospective disclosure of what the RAB would have been for each year in PSE2 if "disclosure-only" revaluations were excluded (as per the transitional schedule 24). We have considerable doubts about the value of seeking retrospective annual precision for historically disclosed information at a year-on-year level. Instead, we think the key focus should be on getting the right disclosure starting point for forward-looking analysis.

Revaluation / indexing of the disclosure asset base going forward

12. Subject to the proviso we discuss below, Auckland Airport supports the Commission's draft decision to allow airports to index or not index assets for disclosure purposes on a forward-looking basis.

13. Auckland Airport agrees with the Commission's views that:[8]

(a) Both indexed and un-indexed approaches to rolling forward the RAB are consistent with allowing interested persons to assess whether airports are limited in their ability to earn excessive profits, consistent with section 52A(1)(d) of the Act (one limb of the Part 4 purpose).

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[6] By "disclosure-only" revaluations, we mean any revaluations that have been applied to an asset in Auckland Airport's RAB for information disclosure purposes between the establishment of the initial RAB and the point at which the new IMs (allowing non-indexed approaches for disclosure purposes) take effect, where that asset is part of Auckland Airport's moratorium on revaluations for pricing purposes.

[7] We understand this is to take place via the proposed transitional schedule (schedule 24), which requires Auckland Airport to insert restated information for the disclosure year ended 30 June 2016 as well as the four prior disclosure years.

[8] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 216.

(b) By ensuring that the ID RAB revaluation approach reflects the approach used in pricing (including the ability to revalue land at MVAU on a periodic basis), the transparency of returns is improved, and the risk that airports will have to restate asset values in the future is reduced.

14. The proviso to our support is that the ID requirements must allow the disclosure RAB to align with our pricing revaluation approach. On this point:

(a) Auckland Airport initially understood that the Commission's proposed solution was to require airports to apply the same indexing approach to an entire asset category.[9] This statement is consistent with the proposed drafting of clause 3.7(6) of the IM, which applies revaluations at the asset category level.

(b) As Auckland Airport's moratorium does not apply to all assets within each asset category, this interpretation would be problematic because some assets within an asset category are indexed while others are not.

(c) We now understand that the Commission is aware of this, and that its disclosure rules are intended to provide the ability to transparently disclose this approach. Auckland Airport asks that the Commission clarifies that this is the case in its Final Decision by:

(i) Amending clause 3.7(6) so that it allows different indexing approaches to be applied within each asset category; and

(ii) Confirming that airports should disclose aggregate details on revaluations (actual and forecast) at an asset category level. We accept that this would require airports to include a summary explanation that informs interested parties where different indexing approaches are adopted within an asset category.

Addressing the impact of “disclosure-only” revaluations on the current RAB

15. Changing the IMs will allow the disclosure asset base to be rolled-forward consistently with the revaluation approach in pricing going forward. The key issue then becomes how to address the impact of “disclosure-only” revaluations for Auckland Airport between the start of the ID regime and the point at which the new IMs take effect.

16. The draft decision presents three potential options to address and disclose the impact of ”disclosure-only” revaluations for Auckland Airport over this time:

(a) Restatement of RAB values, through either full restatement of the asset base at an individual asset level, or the use of alternative methodologies with equivalent effect.

(b) Use of the carry-forward mechanism to disclose the impact of Auckland Airport’s revaluation approach.

(c) Use of a "pseudo-asset" mechanism to provide a one-off adjustment to Auckland Airport's asset values.

[9] This interpretation emerged from the Commission’s statement that: “We propose that an airport be required to provide information on the approach used by it to revalue assets (ie, indexation or non-indexation) and the forecast value of revaluation at an asset category level.” (see Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), paras 235.1 and 235.2). The Commission proposes to include a definition of "asset category" within the IM Determination to match the definition in the ID Determination - namely: land; sealed surfaces; buildings and infrastructure; and vehicles, plant and equipment.

17. Although the Commission has expressed a preference for restatement, we would value the Commission providing Auckland Airport with the flexibility of the options it has identified. In our view, all can provide transparency and ensure robust profitability assessments over time. Taking each in turn:

    (a) **Restatement (including through the use of alternative methodologies with equivalent effect):** Restatement of the RAB as at the start of PSE3 to remove any revaluations since the start of ID may be a transparent option, but will be the most onerous from a compliance perspective. We are currently exploring with a system developer how practical it is to automate an update of the circa 60,000 assets comprising the RAB to exclude “disclosure-only” revaluations and to provide a clear reconciliation.

        Auckland Airport appreciates the Commission's acknowledgment of our concerns with the complexity and cost associated with any restatement attempt at an individual asset level.[10] We therefore support the draft decision to allow Auckland Airport to restate its current RAB using alternative methodologies with equivalent effect (subject to our views on the evidential threshold required, as discussed below).

    (b) **Carry-forward:** In our view, the carry-forward mechanism considered by the Commission has considerable merit. We see the carry-forward mechanism as operating in a similar way to the Commission’s proposed pseudo-asset mechanism. That is, the RAB would be indexed (or not) in accordance with the new IMs going forward. The carry-forward would be used to disclose and account for the value of the “disclosure-only” revaluations between the start of ID and the start of PSE3 (ie, those that were required under the old IMs).[11]

        Auckland Airport understands that the carry-forward mechanism is not the Commission's preferred approach because it may be perceived as a "temporary" adjustment only.[12] We strongly believe that any transparency concerns, including any concerns about the adjustment being perceived as temporary, could be addressed through an explanation of how the carry-forward adjustment is made up. The Commission is already planning to require this explanation.

        In addition, it is plausible that the moratorium may not be a permanent adjustment to asset values. Should that prove to be the case in the future, we agree with the Commission that the carry-forward mechanism could be used to reflect any unwinding of the moratorium over more than one pricing period.[13]

    (c) **Pseudo-asset:** The “pseudo-asset” proposal should be preserved.[14] We think it has the right intent - ie focussing on an adjustment to get the right starting point for forward-looking analysis, instead of requiring historic restatements.

        The Commission has suggested that this pseudo-asset would have a negative value defined as being equal in value terms to the impact of unwinding the moratorium, and could either be depreciable or non-depreciable. In our view, the value that the pseudo-asset should represent is the amount by which the RAB should be reduced to account for the impact of Auckland Airport’s revaluation approach since the initial RAB was established. In other words, the value of the “disclosure-only” revaluations since that time.

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[10] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 230.

[11] It may also avoid the potential complexity associated with the pseudo-asset approach, and have the advantage of not requiring the Commission to establish a separate set of rules to introduce a further mechanism.

[12] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 241.

[13] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 425.

[14] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 313.

We agree that this could potentially provide Auckland Airport with a transparent option to disclose the impact of its revaluation approach on its RAB, and would be worthy of further discussion during the technical consultation phase (eg whether it should be depreciable).

18. To conclude, we think the Commission should refrain from mandating one option for addressing the impact of Auckland Airport's "disclosure-only" revaluations on its current RAB. This is because:

    (a) We have not yet formed a view about how we will deal with "disclosure-only" revaluations in pricing for PSE3, or commenced discussions with our substantial customers on this important issue in any depth. Nor have we fully explored what system changes would be possible to implement a change to the current disclosure approach.

    (b) Depending on the outcome of those discussions and investigations, restatement of RAB values as at the start of PSE3 to remove any revaluations since the start of ID may be a transparent option, if it is practical and best aligns with the approach that is taken to the starting asset base for pricing. However, it may prove to be more transparent for Auckland Airport to use one of the alternative solutions.

    (c) We are not seeking to game the system. We intend to provide clear transparency about the impact of our "disclosure-only" revaluations on the RAB, so that this can be factored into forward-looking assessments of our profitability. We intend to act consistently with our past commitments in future pricing decisions, and to transparently disclose those decisions, so that interested parties can understand what we have done.

    (d) But, we cannot say whether it is possible or practical to precisely restate our RAB value to strip out "disclosure-only" revaluations back to the start of the ID regime. It might be, but we are still investigating the system changes that would be necessary to implement this approach. We also cannot say that this restatement is going to be the best or most transparent way to determine the right RAB starting point for profitability assessment for PSE3 onwards. It might be, but this will depend on the approach that we take in pricing.

    (e) In short, we think it is too early to narrow down the disclosure options that are available. We think restatement (including through the use of alternative methodologies), the carry forward mechanism, and the pseudo-asset mechanism could all be workable and transparent, and that it is too early to prejudge which will be the most transparent in practice.

19. As we were evaluating the options put forward by the Commission, we have also considered the interaction with the Commission's IRR model. In particular, it is not clear to us whether the closing asset base for the IRR should be the closing pricing asset base (as the Commission has proposed) or the forecast RAB as at the end of the relevant pricing period. It is also not clear whether this may differ depending on the option taken to account for "disclosure-only" revaluations. We would value discussing this issue with Commission staff before the Commission makes a final decision on the inputs for its IRR analysis.

Evidential threshold for alternative methodologies with equivalent effect

20. As discussed above, we support the intention behind the proposed solution to allow alternative methodologies with equivalent effect. However, we think the proposed

evidential requirements in the draft decision are likely to prove problematic in practice. The Commission states that:[15]

> In applying an alternative methodology, an airport would also have to comply with additional information disclosure requirements that would require an airport to: [...] provide evidence the methodology has equivalent effect.

21. It appears that the proposed evidence is certification by a senior manager under Schedule 23. Proposed clause 3.13(2)(a) also appears to impose a requirement that the alternative methodology must have an equivalent effect.[16]

22. It is not clear to us how an airport could provide evidence or certify that an alternative methodology has an equivalent effect on the valuation outcome without actually knowing the valuation outcome of applying the IMs. In order for an airport to know that an alternative methodology has an equivalent effect, it would, logically, need to apply the IMs to ascertain what effect it has. Clearly, this would defeat the purpose of allowing the use of alternative methodologies with equivalent effect.

23. Instead, we consider that the focus of the ID requirements should be on requiring airports to provide:

    (a) A description of the alternative methodology that has been used (currently proposed by the Commission);

    (b) An explanation of the reasons for the application of the alternative methodology (currently proposed by the Commission); and

    (c) An explanation of why the airport believes the alternative methodology will have an equivalent effect (not currently proposed by the Commission).

24. We consider that this information should be sufficient to give interested parties the ability to understand how the alternative methodology has been applied, and to assess whether it is likely to have an equivalent effect. We do not believe separate certification is required.

25. If the Commission remains of the view that separate certification by a senior manager is warranted, then in our view it is critical for the certification to retain the proposed qualifications "having made all reasonable enquiry" and "to the best of my knowledge", to make it clear that it is not an absolute requirement to certify that there is an equivalent effect.

Assets Held for Future Use

Problem definition

26. The Commission believes that it may be difficult to assess the impact that revenues associated with assets held for future use have on the expected profitability of regulated airport services.[17] That is because the current disclosures may not provide sufficient transparency if airports were to include revenues associated with assets held for future use in a future price setting event.

The proposed solution

27. The Commission's draft decision proposes that:

[15] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), paras 308, 308.4.
[16] We have some concerns from a legal and technical perspective with the way proposed clause 3.13 of the IM Determination is drafted, which will be addressed in NZ Airports' submissions.
[17] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 439.

(a) "total regulatory income" will now exclude "assets held for future use revenue";[18] and

(b) all revenue associated with assets held for future use, including revenue that may be factored into standard charges, is separately disclosed by either:

(i) including that revenue as part of a new, forward-looking assets held for future use schedule in price-setting disclosures; or

(ii) using the carry-forward mechanism to clearly identify the impact and intention of the interim revenues.

28. We understand that these changes would also be reflected in the annual disclosure templates, so that revenue associated with assets held for future use is excluded from total regulatory income and disclosed separately on both a forward and backward-looking basis.

29. Auckland Airport supports the Commission's proposed solution. In particular, it is positive that airports will be able to separately disclose revenue associated with assets held for future use to reflect their pricing intent without this distorting the assessment of target returns when compared to the RAB.[19] We also agree with the Commission's proposal to provide for two alternative solutions, with an airport retaining the flexibility to adopt the solution that best mirrors their pricing scenario. As noted above, we encourage the Commission to provide this same flexibility in relation to disclosure of the impact of Auckland Airport's revaluation approach.

30. This enhanced transparency is consistent with the Commission's objectives for the IM review and, in turn, better enables airports to explore efficient pricing options with airline customers.

31. We also support the Commission's proposed revision of clause 3.11 by making it clear that net revenue is to be subtracted from the carrying value of the asset, rather than gross revenue. We note that:

(a) We agree that the clause 3.11(6)(c) will achieve this objective by defining net revenue as net of operating costs and tax. However, for the formula to be correct, it requires an opening bracket to ensure the tax adjustment applies to revenue and operating costs, as follows:

> *(revenue derived from the excluded asset (other than tracking revaluations) – operating costs incurred in relation to the excluded asset)* (1-corporate tax rate)*

(b) We also recommend that the wording in clause 3.11(2) and 3.11(6)(c) be consistent. That is, both sections should refer to either "net after tax revenue" or "net revenue" (provided the formula for calculating "net revenue" is corrected as described above).

(c) We have also endeavoured to check the accuracy of the new information disclosure calculations by using historic data. We welcome the review of this by the Commission and recommend the following changes:

(i) Collapsing the line forecast revenue and operating costs into net revenue to align with the definition of net revenue in the IM, which would then need to flow into the ID determination.

[18] Commerce Commission "Draft amendment to the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010" (22 June 2016), page 43.

[19] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 454.

(ii) The addition of a line for transfer to works under construction, previously provided for.

18(ix): Assets held for future use cost and base value

		FY13	FY14	FY15
	Assets held for future use opening cost—previous year	198,082	216,070	235,334
plus	Forecast holding costs	16,787	18,312	19,944
less	Forecast assets held for future use revenue	(1,201)	(951)	(1,138)
plus	Forecast assets held for future use operating costs			
plus	Forecast assets held for future use additions	–	1	1
less	Forecast assets held for future use disposals	–	–	(0)
	Assets held for future use forecast closing cost	216,070	235,334	256,417
	Initial base value	145,885		
plus	Opening tracking revaluations	25,873		
	Opening base value	171,758	170,559	179,076
plus	Forecast assets held for future use revaluations	(1,199)	8,517	743
	Closing base value	170,559	179,076	179,819
	Tracking revaluations	24,674	33,191	33,934

Assumptions and justifications of on assets held for future use charges

We have attempted to review this schedule by running FY13-FY15 disclosure information through it.
Note:
a) Initial base value was calculated by backing out closing FY12 Tracking Revaluations / Opening FY13 Tracking Revaluations from the Opening FY13 Base Value. We value feedback on whether our interpretation is correct.
b) In completing this we had to collapse transfer to works under construction (provided in the seperate file) into additions. Suggest it be made a separate line, for clarity.

Assets held for future use and land conversion costs

32. The clear understanding at the time the IMs were developed was that airports would be entitled to earn a full return on assets held for future use, including the costs of holding land. This means that tracked holding costs must be able to enter the RAB when the asset held for future use is eventually commissioned.

33. At the April profitability workshop, Auckland Airport indicated there may be an unintended error in the current IM that prevented holding costs from entering the RAB at the time the asset held for future use is commissioned.

34. After a further review of the IM determination, we no longer understand this to be the case. We understand that holding costs can be included in the RAB as a non-land asset (as a land conversion cost) at the time of commissioning. This is consistent with the Commission's clearly expressed view that holding costs can be included in the RAB once the asset held for future use is commissioned into use. We indicated this updated view to the Commission by email following the workshop.[20] Our updated view has been reinforced by the IM Report, which states that holding costs are included in land conversion costs.[21]

35. However, the Commission has invited further submissions on the issue. To clarify that no amendment to the IM is required, our interpretation of the IM as it stands is set out below:

(a) When an Asset Held for Future Use becomes a Works Under Construction, its cost is calculated in accordance with clause 3.11(2), but is split into two components (see clause 3.11(5)):

(i) Cost of land = The base value of the land (its original MVAU value as at 2010 plus tracking revaluations since then)

(ii) Cost of property due to the incursion of land conversion costs = Holding costs – net revenue – tracking revaluations

(b) This means that the base value of assets held for future use increases with revaluations, but does not increase with holding costs. Instead, holding costs are tracked separately and transferred to works under construction as a separate cost to the land itself, and treated as the "cost of property due to the incursion of land conversion costs".

[20] Email and attachment from Emma Rae (Senior Advisor, Auckland Airport) to Jo Perry (Senior Analyst, Commerce Commission) raising issues with assets held for future use (4 May 2016), section C.
[21] See paras 167 to 171.

(c) "Real property to the extent due to land conversion costs" is included in the definition of non-land assets. When the asset held for future use is ultimately commissioned (after becoming a works under construction), the holding cost component – now defined as a land conversion cost asset – is commissioned into the RAB as a non-land asset. Clause 3.9(f) provides for the cost of an asset held for future use (which includes holding costs) to be calculated in accordance with clause 3.11 at commissioning, as set out above.

(d) The definition of excluded asset (which defines "property due to the incursion of land conversion costs" as an excluded asset) only applies to the initial RAB, and serves to exclude past land conversion costs – not those incurred in the future.

(e) This is consistent with the Commission's clearly stated intention at the time the IMs were established – which was that an airport was entitled to fully recover the cost of land held for future use, including holding costs. As set out in the IM Reasons Paper:

> Treatment of future development land
>
> 4.3.74 Land is to be excluded from the RAB unless it is currently used in the supply of specified airport services. This means that land being held or developed for future use—i.e. future development land—will not be included in the initial RAB.[214] Airports can nevertheless expect to be able earn a full return on and of the costs incurred in holding and developing this land without profits appearing excessive, provided it is eventually commissioned for use to supply airport services. This land will therefore enter the RAB once demand is sufficient to justify expansion of the Airport – not before.

(f) It is also consistent with the Commission's intention that future land conversion costs – ie those incurred by airports after the date of the initial RAB – would be included in the RAB going forward. As recognised by the Court in the merits review judgment:

> [935] In very general terms, the Airports asset valuation IM means that costs incurred in the past when converting land into a form suitable for use to provide airport services (ie land conversion costs) do not form part of initial RAB values. Such costs do become part of those values when incurred in the future. Again, there is no issue with that future treatment. The appeal here is against the exclusion of past land conversion costs.

(g) Finally, this is consistent with the scheme of the IMs, which make provision for land-conversion costs not in the initial RAB – supporting the interpretation that these costs can be included in the RAB once commissioned:

> (2) Physical asset life means, in the case of-
>
> (a) a **fixed life easement**, the fixed duration or fixed period (as the case may be) referred to in the definition of **fixed life easement**;
>
> (b) property to the extent due to the incursion of **land conversion costs**-
>
> (i) in the **initial RAB**, its remaining physical service life potential determined by an **airport** as on the first day of the **disclosure year** 2010; and
>
> (ii) not in the **initial RAB**, its physical service life potential determined as of its **commissioning date** by an **airport**;

36. We would welcome the Commission's confirmation of our interpretation.

Pricing Assets

Problem definition

37. Standard aeronautical charges typically relate to a subset of total regulatory activities. However, the ID regime and the current price setting disclosure requirements cover the

full regulated business. The Commission believes that this distinction has impacted on interested persons' ability to assess an airport's targeted return.[22]

38. The Commission has helpfully clarified that it is interested in the asset base airports use to set prices,[23] and that the issue is not about the treatment of leased assets.[24] However, as we discuss below, we are not yet sure that the draft decision fully grasps this distinction.[25]

The proposed solution

39. The Commission is proposing to add a new ID schedule reflecting airports' targeted returns based on pricing assets, and to require airports to explain any differences in profitability based on the pricing asset base compared with the RAB.[26]

40. Although we support improved transparency in the price setting event disclosures, we have significant reservations about this proposal. We are not convinced that the solution is consistent with the Commission's decision-making framework, which seeks to reduce compliance costs, other regulatory costs or complexity.

41. It is unclear to us how the proposed solution will allow an interested party to more effectively assess whether the purpose of Part 4 is being met. Instead, the proposal risks adding further layers of analysis and complexity for interested parties that is not materially helpful for that assessment.

42. However, if the Commission continues with its proposed solution, it is critical that the ID requirements allow airports to disclose a pricing asset base and revenue for ID purposes that reflects their pricing approach. We note that:

(a) It is likely that each airport could take a different approach to how it develops its pricing model for setting standard aeronautical charges. Although the goal is to set unit prices for common use assets, the scope of assets included in that model may vary slightly depending on how each airport approaches licensed or leased areas (eg licensed check in areas). The important point of principle is that a consistent approach is taken to all building blocks for the same scope of services when forecasting the pricing asset base.

(b) For example, Auckland Airport has previously included the assets and operating costs associated with some leased and licenced areas in its pricing model, and offset the corresponding revenue against the revenue requirement used to generate standard charges.

(c) Additional cost and complexity will arise if the Commission seeks to define pricing assets for ID purposes in a way that prevents airports from disclosing how they have established their pricing asset base in practice. It will also be important that Schedule 19 provides flexibility for airports to disclose the revenue that has been included in the pricing model, even though this revenue may not stem from standard charges set as part of the pricing consultation.

(d) If Schedule 19 is to be introduced, Auckland Airport supports NZ Airports' proposed amendment to the Schedule to add an additional line to capture lease or license revenue that has informed an airport's price setting. We are

[22] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 501.
[23] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 497.
[24] As it was characterised earlier in the IM review process, see eg: Commerce Commission "Input methodologies review - Airports profitability assessment - Workshop 2 - Summary of views expressed" (16 June 2016), Attachment C, para 43.
[25] As suggested at para. 502. Assets are included in the pricing asset base (they are not separately identified and excluded), but revenue from those assets is also included in the pricing model (eg deducted from required revenue).
[26] Commerce Commission "Input methodologies review draft decisions: Airports profitability assessment" (16 June 2016), para 514.1, 514.2.

working with NZ Airports to identify any further concerns with the relevant definitions in the proposed ID amendments.

WACC, target returns and asymmetric social costs

43. Auckland Airport supports NZ Airports' submission on the Commission's estimate of its regulatory WACC. In this submission, we expand on the way we understand the Commission intends to use its WACC estimate to assess our upcoming pricing decision.

44. When setting prices, Auckland Airport's target return is informed by a number of factors:

(a) First, we seek to estimate the forward-looking cost of capital for Auckland Airport for the term of the pricing period. Although this process draws guidance from the generic regulatory WACC, we also seek to understand (including through expert advice, and the views of our substantial customers):

(i) the nature and extent of systematic risk faced by Auckland Airport, and how this may differ to the generic industry-wide assumptions in the regulatory WACC; and

(ii) where it may be appropriate to adopt different approaches to other parameters to reflect an efficient and commercially realistic cost of capital for Auckland Airport, for example:

(aa) our estimation of the value of dividend imputation to our shareholders; and

(bb) our average debt term to maturity of issuance.

(b) Second, we seek to understand the target return that will be required over the pricing period. For Auckland Airport, this is not a mechanical process of simply plugging our WACC into our pricing model. Rather, we seek to balance this technical estimate of our capital costs with:

(i) our view of the appropriate return that is necessary to incentivise investment in aeronautical infrastructure over the pricing period, given the quantum of investment, risk profile and other key features of our projected capital programme;

(ii) an assessment of the prospect of Auckland Airport's average debt costs moving materially either up or down over the pricing period;

(iii) our response to feedback from substantial customers through the consultation process, including any support by customers for discretionary quality investments where Auckland Airport may have limited financial incentives to invest;

(iv) any other risks that we foresee over the pricing period that may impact on consumers or otherwise affect our ability to invest to meet consumer demands; and

(v) an understanding of how the unit charges derived from this target return compare to relevant market benchmarks for Auckland Airport.

45. In some situations, this balancing process may result in Auckland Airport targeting a lower return than its WACC estimate (as was the case for PSE2). In other circumstances, this evaluation may result in Auckland Airport targeting a higher return than its WACC estimate, consistent with Professor Yarrow's view that the expected rate

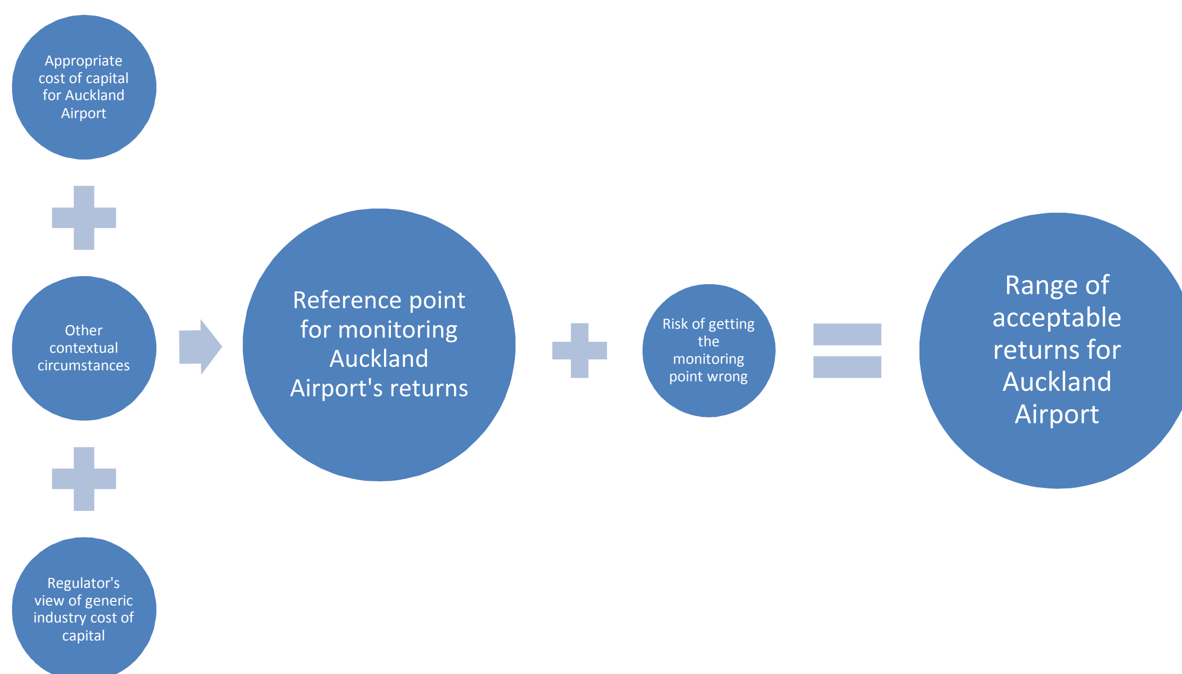
of return for a business will typically be higher than its cost of capital on an ex ante basis.[27]

46. We also note that estimating the WACC for a business and determining an appropriate return are two exercises that necessarily involve comparison and judgement, as the Commission is aware from its own experience. Although we will provide explanation for the approaches that we ultimately take, and will explain to interested parties where these views are informed by expert evidence, we trust that the Commission will recognise that it is never possible for this evidence to provide an exact answer.

47. In any event, our key point is that our target return can and will differ from the mid-point regulatory WACC for a number of reasons, including (but not limited to) the fact that we are likely to develop an airport-specific WACC estimate to inform our pricing decision.

48. We are therefore encouraged that the Commission has indicated that it will take a broader approach to profitability assessment in the future, and will engage with the airport-specific and wider factors that have informed our target return. As we interpret the draft decision, we understand that the regulatory WACC is just one part of the information set that the Commission will refer to as part of future assessments, and we strongly agree that is the right approach.

49. We think this relationship can be summarised in the diagram below:



50. As will be apparent from this diagram, we do not think that it is appropriate for a regulator to ignore the risk that it may wrongly assess an airport to be earning excessive profits, when that may not be the case, and to ignore the potential impact of this risk on pricing and investment. The ID regime has already shown that the regulator's reference point for assessing airport profitability has a material impact on the airports' behaviour and conduct, and can cause airports to reset their target returns at a lower level to conform with the regulator's view of what is acceptable.

51. We accept that the Commission is proposing to take a broader approach to profitability assessment going forward, and is not seeking to constrain airport returns to its WACC

[27] See Professor George Yarrow "Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector", published February 2016.

estimate. This is how we understood the regime was intended to operate. But it does not eliminate the fact that the regulatory regime, taken as a whole, introduces regulatory risks – including the risk that returns may be depressed and investment may suffer to the detriment of consumers over the long term.

52. For this reason, we think the Commission would be wrong to dismiss the relevance of asymmetric social costs for the airport sector, and would be wrong if it ignored this framework concept when assessing airport profitability. We do not think it is sufficient for the Commission to brush this well-established regulatory principle to one side because of a "hunch" that under-investment is unlikely to be a problem and a simplistic assertion that airports' unregulated businesses will mitigate against under-investment in all circumstances.

53. As discussed in NZ Airports' submission, we do not believe the Commission is on strong evidential ground when it makes these statements. As noted by NZ Airports, the risks of underinvestment, although different in nature to other industries, are real and significant. While the costs of underinvestment do not result in sudden and dramatic black-outs, for example, long-term and fundamental degradation of our essential infrastructure is a realistic possibility.

54. Overseas experience (including from the United Kingdom and Australia) provides strong evidence that capacity and quality concerns are very real for the airport sector, and can have material impacts on outcomes for passengers over the medium and long term. As in the case of terminal and runway capacity in London, resolving service degradation and capacity issues that have built up over time can be an extremely lengthy process, and there is often no "quick fix" in the absence of additional investment – often lumpy investment with long planning and construction lead-times.[28] In recent times, the Australian regulator has consistently called attention to service quality and capacity issues across the major Australian airports, and has continued to express its view that investment is not taking place at a sufficient pace to keep up with growth and customer demands – in an environment with the same theoretical incentives (dual till environment, consultation with airline customers, and light-handed regulation) which the Commission assumes will mitigate any risk of under-investment for New Zealand's regulated airports.[29]

55. These overseas experiences resonate with us. We face considerable pressure when spending capital and the risk of under-investment is real. We will seek to set our target return in a way that attempts to avoid that risk over the next five years, and to explain to the Commission and interested parties why we believe our target return is appropriate and delivers great long-term outcomes for consumers. But the Commission cannot ignore the fact that we set prices against the threat of further regulation, and that this threat has a material impact on the decisions that we make.

56. For this reason, as well as engaging with the airport-specific and contextual circumstances we put forward to support our target return, the Commission must remain alive to the fact that regulation introduces asymmetric social consequences, and we strongly believe that this concept remains highly relevant to assessing airport profitability.

57. Finally, we endorse the submissions put forward by NZ Airports disputing the relevance of the dual till to the assessment of airport returns. Any relationship between incentives to invest arising from unregulated airport activities is far more complex than the Commission appears to recognise.

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[28] See Dr Harry Bush and John Earwaker "Evidence relating to the assessment of the WACC percentile for Airports" (report prepared for NZ Airports), 21 August 2015, page 7.

[29] As discussed in Auckland Airport "Response to Commerce Commission's Emerging Views on the WACC Percentile for Airports", 16 March 2016, at paras 42-46.