WIAL Submission to the Commerce Commission on its s56G Draft WIAL Report

Executive Summary & Key Issues

30 November 2012

Executive Summary

Introduction

This document is part of WIAL's submission following the release by the Commerce Commission (Commission) of its draft s56G report for WIAL.

This document is intended to summarise WIAL's assessment of the Commission's draft report, its key issues and WIAL's response to these.

Findings of the Commission's Draft Report

The Commission's high level findings are set out below:

WIAL is innovating appropriately
WIAL is providing quality services
WIAL has an improved and efficient price structure
It is too early to tell whether investment is appropriate
It is too early to tell whether efficiencies are being achieved and being shared with customers and evidence is mixed
ID has not been effective in limiting WIAL's ability to extract excessive profits

WIAL is pleased that the Commission has recognised that WIAL is investing and innovating appropriately, providing high 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 (IMs) for WACC of 8.04% and asset valuation.

WIAL has forecast to make an 8.1% return for PSE2 on $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.

WIAL's return is in line with the Commission's WACC IM of 8.04%. However, WIAL acknowledges that the Commission has assessed its return for WIAL using its asset valuation IM which values land at Market Value Alternative Use (MVAU) whilst WIAL has based its return on land valued at Market Value Existing Use (MVEU). WIAL's forecast return using the Commission's asset valuation IM has been calculated by WIAL at 8.9%.

WIAL's Current and Forecast Pricing

WIAL's current pricing produces revenues below the Commission's regulatory benchmark. However, the Commission claims that WIAL is forecast to earn excessive profits in the future which equates to $19.7 million present value above the Commission's regulatory benchmark (equivalent to 72 cents/passenger). This difference in revenue over PSE2 is shown below:

$000	2013	2014	2015	2016	2017	Total
Revenue (present value)	(3,331)	3,926	4,062	6,172	8,853	19,683

Forecast Returns

WIAL's returns for PSE2 are based on forecasts. The forecast return is dependant on actual outcomes which will almost certainly be different to what has been forecast. WIAL considers that it can only be appropriate to assess returns on actual outcomes.

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De Facto Price Control

WIAL is concerned that it is being incorrectly assessed by the Commission as if it were under price control. WIAL has submitted previously at length that it is critical that the IMs are not seen as mandatory else the airports will be under defacto price control, not light handed regulation.

As a result, WIAL considers that the comparison of WIAL's pricing to the Commission's regulatory return under its IMs should be treated with consideration and caution and not be seen as a "bright line" to assessing returns above or below appropriate returns.

Main Reasons for Differences in Returns

The main reasons for the difference in profitability assessments by WIAL and those by the Commission, are since the Commission has:

- applied its IM for land valuation at MVAU ie excluding airport conversion costs;
- applied its IM for WACC, comprising an airport sector WACC of 8.04%;
- adjusted WIAL's forecast returns for a wash up in relation to the delay in construction of the "Rock" terminal building; and
- applied WIAL's forecast 2017 asset base as the terminal asset value in its 7 year IRR calculation.

Land Valuation

The Commission notes that the asset values used by WIAL under the IMs are "disconnected" from those used in price setting. As extensively submitted by WIAL, it considers that MVEU and current asset values are more reflective of a competitive market. These values have been historically applied by WIAL for financial reporting and pricing purposes.

WACC

WIAL confirms that its return should be assessed on its own WACC, and not an airport sector WACC. It is unquestionable that the three airports under the ID regime have different risk profiles and evaluating WIAL's forecasts against a sector WACC derived largely from an evaluation of Auckland Airport (AIAL) is prejudicial to WIAL.

Applying modest sensitivity adjustments to the Commission's WACC of 8.04% to recognise specific parameters for WIAL provides a WACC of 8.8%. This adjustment alone has a present value impact over PSE2 of $10.8 million.

Terminal Wash Up

WIAL considers that the treatment of this wash up is inappropriate and it is incorrect to add this on to WIAL's forecast revenues and create an inflated revenue forecast for PSE2. It was a commercial risk sharing arrangement which was undertaken prior to the ID regime and has already been reflected in WIAL's actual pricing for PSE2.

This is a material adjustment by the Commission (present value impact over PSE2 of $8.8 million). Excluding this adjustment the forecast return over PSE2 in the Commission's model is revised down to 8.75% and the present value of forecast revenue above the Commission's regulatory benchmark reduces from $19.7 million down to $10.9 million.

The treatment of such arrangements by the Commission in its profitability assessments will disincentivise WIAL from considering such arrangements in the future.

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Unforecast Revaluation Gains

WIAL considers that the Commission's evaluation of its return over the 7 year period is incorrect since it does not correctly recognise the derivation of the return.

Pricing for PSE1 was set on an ex ante basis with revaluation forecasts based on expert advice and a wash up arrangement. As a consequence, WIAL was exposed to both upside and downside risk. Actual revaluation gains exceeded forecast due to market circumstances not anticipated by WIAL or the airlines. For the Commission to incorporate these unexpected actual movements is inappropriate and inconsistent with a regime that it is intended to promote outcomes consistent with a competitive market.

Excluding these ex post unforecast revaluations, the Commission's assessment of WIAL's return for the 7 years reduces from 10.1% to 8.4%.

Summary of Adjustments

As noted above, there are a number of 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. The impact of these adjustments compared to the Commission's assessment of excess returns for PSE2 is 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**

Impact of Infancy of ID Regime on Behaviours

WIAL considers that the Commission does not appear to have fully considered the infancy of the ID regime and the consequent impact this has had on WIAL's behaviours, in particular the behaviours adopted by WIAL at the time of setting prices for PSE2.

WIAL undertook consultation for PSE2 in accordance with the AAA. Whilst the ID regime and IMs provided input to consultation, 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 advisors.

In addition, at that time the Air NZ and WIAL merits appeals were still to be heard and WIAL adopted a position in pricing consistent with its merits appeal.

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.

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.

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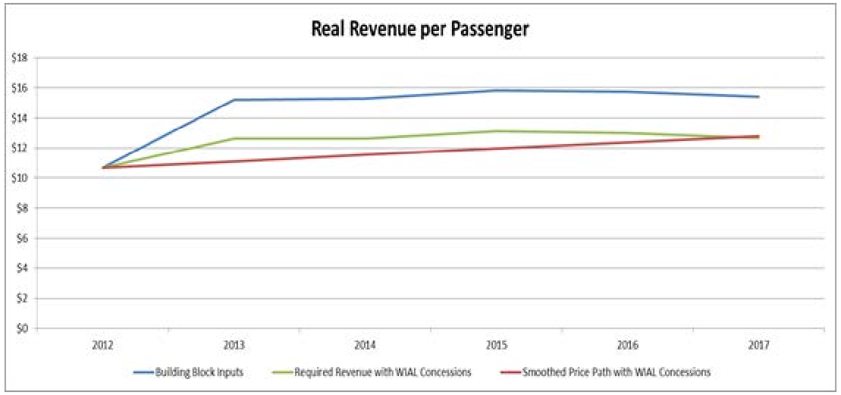
Consideration of WIAL's Pricing Behaviour for PSE2

WIAL prepared its building block model for PSE2 consultation with input from expert advisors, including valuers, economists and aviation 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.

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

The impact of the concessions and wash up on WIAL's revenue per passenger and the benefits of the smoothed price path over PSE2 are highlighted in the following graph:



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%.

Lack of Comment on Market Performance and Benchmarking

WIAL is concerned that the Commission's draft report to Ministers has omitted several fundamental aspects that are critical to any assessment of WIAL's performance. This includes:

- Market performance and WIAL's contribution to this;
- Benchmarking of airport pricing and performance.

Industry in Good Health

Any assessment of the effectiveness of the ID 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

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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 growth of 4.5% per annum 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 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.

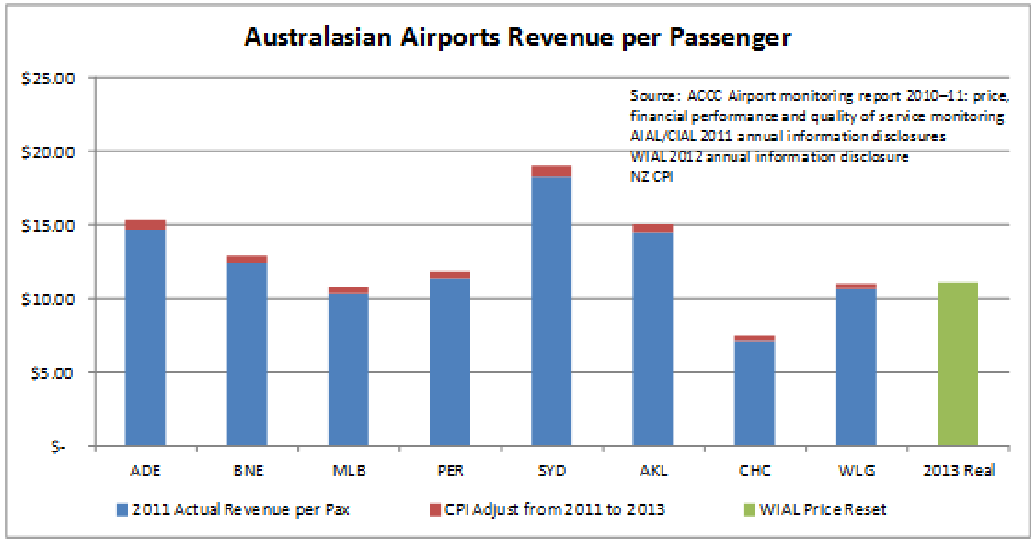
Airport Benchmarking

Australasian airport prices are among the lowest of the developed regions of the world. WIAL is among the lowest in Australasia and its aeronautical revenue per passenger is 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 shown below WIAL's own analysis of airport pricing in Australasia which shows that WIAL compares favourably with other airports.



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Ongoing Airline Disagreement

The Commission notes that there has been no reduction in the level of disagreement between the airlines and WIAL in relation to pricing outcomes and that if this does persist it cannot be confident that excessive prices will be limited at PSE3 or beyond.

WIAL is surprised by these comments and confirms that there will always be a natural supplier to customer tension between airports and airlines. Further to this, airports need to balance the needs of competing airlines who often have very different and conflicting requirements based on their business strategy and aircraft fleet configuration. Airports also need to make decisions for the longer term which may be at conflict with airlines and will need to anticipate and lead change.

In addition, 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.

Effectiveness of ID Regime

The Commission has been tasked with assessing the effectiveness of the ID regime. As a result, WIAL considers that the Commission will also need to assess the effectiveness of AIAL and CIAL. This will enable comparison of all three airports and enable Ministers to consider the overall effectiveness of the ID regime.

Light-Handed Regulation

WIAL notes that the new regime provides increased transparency of results and performance and will enable improved assessment between airports and also over time. Further to this the threat of potential increased regulation is treated as very real by WIAL.

WIAL has previously submitted work prepared by economists Sapare to the Commission regarding the worldwide trend for airports being towards commercial negotiations and agreements supported by light handed regulation. WIAL reiterates that whilst the ID regime is costly it supports a light handed disclosure regime which it considers provides the best long term outcome for consumers and passengers.

Concluding Comments

WIAL maintains its view that its forecast assessment of profitability is correct, and should be preferred to that of the Commission. WIAL has also identified in its submission a number of fundamental matters which it considers that the Commission must correct, in particular the treatment of the terminal wash up in PSE2 and its application of an airport sector WACC.

Equally the Commission's assessment depends on a number of unknowns, particularly traffic forecasts. Neither the Commission, or WIAL, or the airlines know what those figures will look like in the future.

Assessments for PSE2 and PSE3 are based on unknown events and hence there is no robust analysis of actual performance. At any time over the next 5 years WIAL could also reconsult on its airline pricing under AAA, develop new commercial agreements with airlines, or could consider commercial concessions for PSE3 which are unknown today.

In short, the ID regime needs more time in order for WIAL's actual performance and behaviours to be more accurately assessed.

Key Issues

Is WIAL Earning an Appropriate Economic Return Over Time?

Commission's Draft Findings:

- *ID provides an important benchmark*
- *Not effective in limiting ability to extract excessive profits*
- *Excessive returns due to revaluation gains, market value existing use land valuation and targeted high cost of capital*
- *Forecast excess returns over PSE1 $19.7 million at Commission's IM for WACC at 75th percentile*
- *No change in profitability targets for PSE1 and PSE2*
- *No reduction in airline disagreement and not confident that excess profits will not continue in PSE3 or beyond*

WIAL's Response:

Actual Returns

WIAL's current pricing is below the Commission's regulatory benchmark.

Forecast Returns for PSE2

WIAL is forecast to achieve revenues for PSE2 which equate to $19.7 million present value above the Commission's regulatory benchmark. However, this is dependant on actual outcomes which will almost certainly be different to what has been forecast. For instance, in order to illustrate the sensitivity of the outcomes a 1% reduction in traffic below forecast would reduce the present value of revenues by $2.1 million. This is only one of the many variables that will ultimately impact actual revenues.

The $19.7 million present value of forecast revenues above the Commission's regulatory benchmark is set out as follows:

$000	2013	2014	2015	2016	2017	Total
Revenue (present value)	(3,331)	3,926	4,062	6,172	8,853	19,683

WIAL reiterates that its future performance relies on achievement of forecasts. Furthermore, it relies on a precise measurement of asset valuation, WACC and other inputs to the pricing model which is impractical to achieve.

Forecast Returns for PSE3

WIAL is unsure why the Commission states that ID has the most impact on excess profits. In addition, WIAL is unclear as to why it concludes that more time is needed to assess certain aspects of Part 4, such as investment, but not for profits. This seems unusual given that WIAL's profitability has yet to be realised.

Assessments for PSE2 and PSE3 are based on unknown events and hence no robust analysis of actual performance.

Defacto Price Control

The Commission has acknowledged that a combination of alternative methodologies may yield similar outcomes.

However, as submitted by WIAL, prices should not be set as per IMs else this would be defacto price control. Furthermore, the reasonableness of pricing needs to be compared to the IM benchmark set by the Commission in conjunction with other components of Part 4, including incentives to innovate, investment , quality of service and efficiency.

Is WIAL Earning an Appropriate Economic Return Over Time?

Airport Specific WACC

The Commission's profitability assessment is based on applying its WACC IM. The Commission also notes that ID has had no impact on WIAL's targeted return and since WIAL disagrees over the key assumptions, it is unlikely that ID will have any impact going forward.

WIAL is surprised by these stark comments and reiterates that for pricing purposes (and consistent with competitive markets) it is critical that WIAL's own WACC be applied as opposed to an airport sector WACC. It is unquestionable that the three airports have different risk profiles and evaluating WIAL's forecasts against a sector WACC derived largely from an evaluation of AIAL is prejudicial to WIAL. Furthermore, it is expressly provided in the Commerce Act that airports are not required to apply the WACC IM for pricing purposes.

WIAL considers that in order to fully evaluate outcomes under ID the Commission must consider the use of airport specific WACCs and the sensitivity of this in its profitability assessments.

Applying modest sensitivity adjustments to the Commission's WACC of 8.04% to recognise specific parameters for WIAL provides a WACC of 8.8%. This amended WACC produces a forecast revenue above the Commission's regulatory benchmark of $8.8 million present value for PSE2. This adjustment has a present value impact over PSE2 of $10.9 million.

WIAL Cost of Debt

The Commission reports that WIAL's WACC for PSE2 is too high and notes that it should have fallen from PSE1 due to reductions in the risk free rate. However, it is important to note that WIAL's cost of debt increased during this time. During consultation, WIAL obtained external advice from its banks for WIAL's actual cost of debt. The total cost of debt, following inclusion of the debt premium advised by its banks, for PSE2 was 7.68%. This is virtually unchanged from WIAL's total cost of debt for PSE1.

Targeted WACC

WIAL confirms that it should only be assessed on actual returns and not its targeted WACC. Most companies target a WACC but only rarely achieve it.

Asset Valuation

The Commission notes that the asset values used by WIAL under IMs are "disconnected" from those used in price setting. As previously submitted by WIAL it considers that MVEU and current asset values are more reflective of a competitive market and have been historically applied by WIAL for financial reporting and pricing purposes.

However, WIAL notes that it is common for entities to have different asset values for financial reporting, regulatory and other purposes, each of which may be deemed to be more relevant for that legislation and purpose.

Is WIAL Earning an Appropriate Economic Return Over Time?

Revaluation Treatment – PSE1

The Commission has calculated WIAL's profitability for the 7 years since the start of the ID regime. The calculation includes WIAL's forecast 2017 asset base as the terminal value in the calculation. This calculation produces an IRR of 10.1%.

However, WIAL considers that the Commission's evaluation of this outcome is inappropriate and does not correctly recognise the derivation of the return.

Pricing for PSE1 was set on an ex ante basis with revaluation forecasts based on expert advice and a wash up arrangement. As a consequence, WIAL was exposed to both upside and downside risk. Actual revaluation gains exceeded forecast due to market circumstances not anticipated by WIAL or the airlines in consultation. To incorporate any unexpected actual movements is inappropriate and inconsistent with a regime that it is intended to promote outcomes consistent with a competitive market. The Commission needs to demonstrate that it has evaluated the treatment of the unexpected revaluation gains in a manner consistent with such markets.

By way of an example, a commercial property owner will not provide its tenants with rent increases or decreases based on unexpected ex post revaluation movements – this is a risk and reward of property ownership in a competitive market.

WIAL also highlights that it adopted a commercial arrangement for PSE1 which included a revaluation wash up for the airlines should actual revaluations vary to forecast. Whilst the terms were not met for PSE1, WIAL honoured this arrangement and included a concession of $14.5 million present value in the setting of prices for PSE2.

Revaluation Treatment – PSE2

WIAL further notes that in PSE2, and contrary to external valuation advice it received, WIAL agreed to adopt CPI at 2.5% pa for its revaluation forecasts in order to address this contentious issue in consultation.

WIAL is effectively taking all land valuation risk if the value of its assets changes by more or less than 2.5% pa over PSE2.

WIAL considers that these actions demonstrate commercial behaviours consistent with competitive markets and that it is inappropriate to treat ex post actual revaluation movements in an assessment of WIAL's profitability.

Is WIAL Investing Efficiently?

Commission's Draft Findings

- *Too early to tell whether investing efficiently*
- *Information on actual investment over PSE2 is necessary to form a conclusion*

Few airline concerns over PSE2 and forecasts appear prudent

Main issue is timing or alleged "gaming" of investment forecasts and price quality trade offs eg "Rock" and RESAs

WIAL's Comments

In WIAL's view the Commission has not fully evaluated the merits of the airline's submissions. Instead, in accordance with the comments set out below, WIAL considers that the Commission should be concluding that WIAL is investing efficiently.

Requirements of ID Regulation

The Commission appears to suggest that a role of ID should be to resolve airline concerns about WIAL's conduct. WIAL considers that this is not an objective of ID and that there will always be a natural supplier to customer tension in airline discussions:

- Airports need to balance the needs of competing airlines who often have very different and conflicting requirements, with different competitive objectives expressing different views on required investment;
- Airports also need to make decisions for the longer term which may be at conflict with airlines. Airlines may wish to take a short term approach to minimise prices rather than a longer term and an 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.

Nonetheless, WIAL reiterates that it considers that commercial agreements are desirable. WIAL's stated preference is to have commercial agreements in place with all its major airline customers.

Obligation to Consult

WIAL confirms that it consults on investment at levels much lower than the financial threshold set out in AAA and also in a manner consistent with best practice asset management:

- Consideration of long term planning requirements from development or updating 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, WIAL is currently consulting on its South West Pier development for $4.8 million which commenced in January 2011 and is still in progress. This evidences strong engagement and robust consultation with stakeholders on key projects.

Is WIAL Investing Efficiently?

- Ongoing operational design and functionality meetings with affected stakeholders as projects are undertaken;
- Following commencement of the new 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.

Further to the above, WIAL notes that there was little airline disagreement over its forecast capital expenditure for PSE2.

Airline Concerns of Over Investment and Price Quality Trade Offs

As a general premise the Commission comments 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. For example:

- The cost of the "Rock" investment fell within the range estimated by BARNZ.
- WIAL created additional tunnel width when constructing the Southern RESA at a cost of $2.7 million (from a total project cost of $24 million) to enable large aircraft to operate at WIAL. The incremental cost to construct separately at a different time would have been much larger and not in consumers' long term interest.

The price quality trade off issues identified by the Commission are at the margin within WIAL's pricing structure. Airlines did not respond to WIAL's economic rationale for its approaches, or WIAL's request for technical advice, during consultation and the specific issues were therefore not pursued.

WIAL considers that the price structure for PSE2 is appropriate, however WIAL also notes that the structure will evolve over time.

Timing of Investment

The Commission notes the airline's concerns that WIAL has incentives to inflate its forecasts and for actual spend to be lower than forecast. However, this is again an unsubstantiated statement. WIAL restates that the actual total capital spend over PSE1 was within 1% of forecast. In addition, excluding the Northern Pier development (which was subject to a wash up arrangement) the variance between forecast and actual capital spend on key projects for PSE1 represented an overspend by WIAL of $5.2 million as follows:

$000	2008	2009	2010	2011	2012
Other projects	(3,700)	7,600	(100)	800	600
Cumulative difference	(3,700)	3,900	3,800	4,600	5,200

Commercial Wash Ups

As noted above, WIAL had a wash up arrangement for the "Rock" terminal development in PSE1. WIAL has also put in place wash up arrangements for three large capital projects in PSE2 where WIAL has committed to a wash up should the projects be delayed by more than 12 months.

Increased Transparency

The new ID regime will increase transparency of investment by the airports. Furthermore, the new regime will promote the accuracy of forecasts which will require explanation of any material variances between actual performance and forecast.

Is WIAL Providing Services at the Quality Consumers Demand?

Commission's Draft Findings

- *ID appears to be providing a quality of services at a level that reflects consumer demands*
- *ID has had a positive impact on performance and conduct*

WIAL compares well versus other airports with its service quality similar or better to other airports in NZ and Australia, including the level of service interruptions

Airlines generally satisfied with quality of service

Main concerns are price quality trade offs eg air bridges, the "Rock" terminal development and RESAs

Passenger surveys improved since ID and improvement partly attributed to ID

WIAL's Comments

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

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 Airport Service Quality results are an important part of monitoring and maintaining service quality at WIAL, which are reported to its Board as part of its performance reporting.

Incentives to Address Service Quality

WIAL agrees with the Commission's comments that the capital expenditure consultation requirements under AAA are an incentive for WIAL to confirm customer service quality requirements while the Commission also comments that WIAL is obliged to meet health and safety requirements.

WIAL highlights that the regulatory and planning requirements are much more comprehensive than the Commission describes. In particular:

- Master Planning undertaken by WIAL must consider the long term capacity and service quality requirements for a variety of airport stakeholders.
- The AAA consultation requirements are 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 that service quality concerns are addressed. These issues are discussed in the more structured operational meetings that have been implemented to meet ID requirements.
- WIAL must meet stringent health and safety requirements to facilitate the ongoing operation of the airport and to maintain its operating certificate issued by the Civil Aviation Authority (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.

Is WIAL Providing Services at the Quality Consumers Demand?

Price Quality Trade Offs

WIAL has mentioned in the earlier section “Is WIAL Investing Efficiently?” that it considers that it is managing price quality trade offs appropriately.

ID is Having a Positive Impact on Service Quality at WIAL

WIAL confirms that 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.

Is WIAL Operating Efficiently?

Commission's Draft Findings

- *Unable to conclude on operating efficiency due to mixed evidence*

Increase in costs during PSE1 due to one off insurance and regulatory costs

(1% decrease during PSE1 excluding one off increases)

Costs per passenger forecast to decline in real terms over PSE2

Operating costs per passenger, and aircraft movement, are significantly below those at all other large airports in Australasia

WIAL's Comments

WIAL is perplexed that the Commission cannot conclude on the performance of WIAL due to mixed evidence.

WIAL is efficient, with the lowest costs per passenger of all reporting airports in Australasia. This efficiency keeps prices as low as possible, in spite of the Wellington Airport operation consuming a significant tract of highly scarce property within 10 minutes of the CBD of New Zealand's capital city. WIAL makes the following responses to comments made by the Commission.

Time Series of Data

The Commission states that there is not a sufficient long series of data to enable a conclusion to be formed. However, it has analysed information dating back to 2003 from information disclosures 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 shows costs per passenger decreasing from approximately $3.45 in 2003 to around $3.00 in 2012.

WIAL considers that this is a significant decrease in real costs which is after the inclusion of the significant real cost increases (primarily for insurance and regulatory costs) in recent years.

WIAL is also forecast to reduce real operating costs per passenger over PSE2.

Passenger Mix at WIAL

The Commission notes WIAL's comparative cost efficiency, however, it comments that it cannot be certain of the extent that this may be due to passenger mix.

WIAL agrees that each airport is different however if the Commission were to scrutinise its airport data further it is evident that several of the airports, including CIAL and Adelaide, are of a similar passenger size and mix to WIAL.

WIAL notes that its cost per passenger is approximately 30% below CIAL and 60% below Adelaide Airport.

WIAL considers that the above comments demonstrate its ongoing focus on and achievement of operating efficiencies.

Is WIAL Operating Efficiently?

Airline Disagreement

Much of the Commission's comments refer to airline challenges regarding WIAL's efficiency. However, it is important that the Commission confirm the facts and determine its own conclusions. WIAL states the following points:

- WIAL continues to be the lowest cost airport in Australasia on a cost per passenger basis.
- The Commission's 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 in real terms.
- 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 the airlines for scrutiny as part of consultation. WIAL responded to all questions raised by the airlines in respect of this consultation.

WIAL considers that these issues clearly demonstrate WIAL's achievements and commitment to maintaining an efficient operating cost base.

Do the Prices Set by WIAL Promote Efficiency?

Commission Draft Findings

- *ID has had a positive impact and current prices are more likely to promote efficiency than those previously in place*

Limited consideration to promotion of efficiency through pricing in PSE1

PSE2 includes optimal use of scarce resources to manage congestion and new price structures

ID has had a positive impact on outcomes and WIAL notes that one reason for this change was ID

WIAL's Comments

WIAL agrees with the Commission's comments regarding pricing efficiency. WIAL invested considerable efforts to try to ensure that an efficient price structure was implemented for PSE2. As part of consultation, WIAL contracted consultants Leigh Fisher and Sapere to undertake work to better understand airport pricing structures in place worldwide, and many of these findings were incorporated into WIAL's pricing for PSE2.

WIAL notes that the Commission 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. 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.

WIAL has responded below to comments raised by the Commission in relation to airline concerns.

Growth Incentive Scheme

WIAL considers that the Commission's analysis of the incentive scheme is unbalanced because it does not appear to recognise the risk that WIAL has taken with its forecast of strong traffic growth in PSE2. In particular:

- WIAL has accepted a higher risk for achieving the required passenger volumes and revenues than it was required to undertake.
- The incentive arrangement creates opportunity 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.
- WIAL has established an incentive arrangement that is publicly transparent, which has not previously been the case at WIAL or other airports in New Zealand.

WIAL disagrees with the airline comments that they are meeting the cost of the arrangement. The airlines are receiving lower charges of 43c per passenger than they would otherwise have received without the incentive scheme.

Is WIAL Sharing Efficiency Gains with Consumers?

Commission's Draft Findings

- *Too early to conclude whether any sharing of efficiency gains exist*

Limited evidence of historic or forecast efficiency gains

Unsure whether any efficiency gains reflected in prices for PES1 and PSE2

WIAL's Comments

WIAL is surprised by the Commission's comments that it has limited evidence of historic or forecast efficiency gains. Examples of such efficiencies are provided below.

Pricing Consultation

As part of consultation under the AAA, WIAL provides detailed capital and operating cost forecasts to its substantial customers. The cost forecasts are based on WIAL's most recent company budget with any real increases thereafter explained. This detailed transparency ensures that costs are being fully scrutinised, views exchanged and amendments made to forecasts. WIAL considers that this consultation provides a robust forum to discuss, challenge and share efficiencies.

Operating Cost Efficiencies

As set out earlier in the section "Is WIAL operating efficiently?", WIAL has clearly demonstrated that operating cost efficiency gains have been achieved since 2003 and are forecast to continue in PSE2 with a reduction in real operating costs per passenger.

Investment Efficiencies

As part of consultation with its stakeholders regarding capital investment, WIAL undertakes comprehensive engagement which ensures that efficiencies are achieved where ever possible.

WIAL has numerous examples of innovation that have resulted in the optimisation of assets and efficient investment. For instance, swing gates were developed for use at WIAL's main terminal, which enable the use of gates and baggage systems by both international and domestic passengers. This innovative design enables the optimum use and sharing of infrastructure. Similar efficiencies are being progressed by WIAL through use of its common user terminal. WIAL has also responded to airline requests and has put in place rear stair loading capability for aircraft which represents a cost efficient alternative to airbridges.

Airport Benchmarking

The comparability of WIAL's airport prices versus those charged by other New Zealand airports and overseas demonstrates that WIAL's charges are low compared to other Australasian and worldwide airports.

WIAL considers that the above comments demonstrate a significant sharing of efficiencies with its airline customers.

Is WIAL Innovating Appropriately?

Commission's Draft Findings

- *Limited impact of ID but not problematic since innovation levels appear appropriate and other incentives play a more important role*
- *Airports have incentives to invest*

WIAL's Comments

WIAL agrees with the Commission's findings in respect of innovations undertaken by WIAL and in particular the influence of ID regulation and other factors on innovation.

WIAL supports the airline comments referred to by the Commission that ongoing collaboration is important.