# WELLINGTON INTERNATIONAL AIRPORT LIMITED

## CROSS SUBMISSION

## FOLLOWING THE COMMERCE COMMISSION SECTION 56G REVIEW AIRPORTS CONFERENCE

**17 AUGUST 2012**

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## Executive Summary

1. This is Wellington International Airport Limited's (**"WIAL"**) cross submission following the Commerce Commission (**"Commission"**) Commerce Act (**"Act"**) Section 56G Review (**"Review"**) conference (**"Conference"**) held in Wellington on 7 August 2012.

2. WIAL appreciated the opportunity to engage directly with the Commission at the Conference.

3. WIAL understands that the Commission is seeking to form a view on whether the Information Disclosure Regime (**"ID Regime"**) is achieving its legislative purpose, and part of this assessment is to establish the impact on WIAL's behaviours, including the most recent consultation to establish new prices.

4. WIAL has demonstrated throughout its submissions during the Review that WIAL has provided comprehensive and high quality information disclosures to enable the purpose of the ID Regime to be met. This includes establishment of new systems and processes to enable the disclosure requirements to be met. WIAL has in fact demonstrated that it is seeking to maximise the benefits of the ID Regime by exceeding the mandatory requirements by:

   - establishing a more formal operational forum with airlines and other airport stakeholders aimed at achieving a collaborative decision making process for operational and service quality issues. This has been well received by all parties in addition to consideration of service quality and interruption issues required to be completed for preparation of annual information disclosures;
   - achieving greater transparency of its price setting (consultation) process than is required by the ID Regime though the publication of its consultation information; and
   - demonstrating in its consultation documents the consideration that it gave to the Input Methodologies (**"IM's"**) during the consultation and where WIAL implemented pricing approaches consistent with the IM's where appropriate.

5. WIAL has expressed its view that the IM's were required to be developed for the ID Regime but are not required to be applied in pricing under the Airport Authorities Act (**"AAA"**). Commissioner Duignan expressed a comment that the Commission recognises this. Nevertheless, the Commission has queried how the Review should be undertaken if the Commission could not consider the IM's.

6. WIAL does not suggest that the Commission should not consider the IM's but rather that they are utilised within the ID Regime in a manner that is complimentary with the existing AAA regime.

7. The Commission can achieve this by <u>evaluating the outcomes</u> achieved by WIAL within the ID framework, rather than focussing on individual inputs. This would enable the Commission to consider WIAL's achievement of the Part 4 purpose without seeking to substitute pricing inputs with the IM's, which WIAL considers would amount to de facto price control.

8. Given the commercial considerations that result from consultation with customers under the pricing framework, focussing on inputs can also lead to inadvertently misleading conclusions (e.g. confusing a WACC input with the actual or forecast return). WIAL has demonstrated over multiple pricing cycles that it genuinely seeks to achieve pricing outcomes that reflect the views of customers and does not simply adopt a formulaic approach.

9. The actual ex post outcomes shown in annual information disclosures must also be given substantial weight by the Commission. As previously reported, WIAL's actual returns within the ID and IM framework were well below WIAL's weighted average cost of capital ("**WACC**") at 6.16% and 6.91% respectively for the 2011 and 2012 years.

10. In addition, WIAL has calculated its returns since the commencement of the ID Regime until the end of the current pricing period i.e. financial years 2011 to 2017. The return over this 7 year period (comprising 2 years of actual returns and 5 years of forecast returns) is 6.88% based on an MVEU asset base and 8.21% based on an MVAU asset base.

11. WIAL also notes that contemplation of the IM's relates to only one aspect of the Part 4 purpose statement and the Commission is required to consider all components of the purpose. It was evident at the Conference that Air New Zealand Limited ("**Air NZ**") and BARNZ have few concerns with WIAL's service quality and innovation achievements (despite their written submissions). Comments concerning WIAL's investment programme were also generally supportive, with issues raised representing a small proportion of overall planned investment.

12. The Commission should also give regard to the commercial behaviours of WIAL (and the engagement of its customers) in setting prices, both commercially and during the price setting process. These behaviours are demonstrated in the following initiatives.

   - <u>Commercial agreements</u>. These have been negotiated with a number of airlines and include win-win specification of factors such as growth, risk, quality and price, and will generally result in higher growth targets (which benefit the entire community and economy).This is an approach that WIAL would like to extend to Air NZ but has been frustrated by Air NZ's lack of willingness to engage and apparent preference for Government intervention over commercial negotiation. WIAL notes that airlines generally have been moving away from reliance on Government intervention in supplier relationships and is concerned that Air NZ's Government ownership may be a factor in its preferences.

   - <u>Incentive arrangements.</u> WIAL has included incentives in its pricing schedule for the new period. The arrangement reduces the average charge for all passengers from the commencement of the pricing period due to the adoption of strong growth forecasts. WIAL however bears the risk that the growth will not be achieved and will underperform its required revenue forecast if the growth is not achieved (due to the reduced prices).

   - <u>Wash up arrangements</u>. The terminal and revaluation wash up arrangements from the previous period were one way risk sharing arrangements for specific events. That is, WIAL gave away upside risk while retaining downside risk. There were no such arrangements for other factors that occurred during the previous pricing period which were adverse to WIAL. The result in the previous period was that WIAL honoured wash-up arrangements, despite the fact that overall returns have been below WIAL's cost of capital.

13. A further consideration for the Commission is the cost to consumers of airport services in New Zealand compared to indications from international benchmarking. New Zealand Airports Association (**"NZ Airports**") commissioned Airbiz Limited to provide a report which peer reviewed the benchmarking analysis BARNZ provided to the Commission. The Airbiz report, which will be provided with the NZ Airports cross submission concludes that New Zealand international airport charges are below average for the sample of

airports referred to by BARNZ. Furthermore charges for domestic services are between a quarter and a half of the charges for domestic services in Australia.

14. The presentation by Kieran Murray from Sapere Research Group at the conference showed that information disclosure regulation of airports is considered an effective form of regulation in Australia, the United Kingdom and Europe. WIAL considers this endorses the application of the ID Regime in New Zealand.

15. WIAL therefore wishes to work collaboratively with the Commission, and other stakeholders, to continue to enhance the effectiveness of the ID Regime in New Zealand. In WIAL's view this will be achieved by:

    - The publication of further information disclosures that will enable interested persons to evaluate the performance of the New Zealand airports over time as contemplated by the Act.
    - The Commission undertaking reviews of the airport information disclosures and providing its views on how effectively the airports are achieving the Part 4 purpose statement and areas where the Commission may have concerns about the airport behaviour.
    - Airports having an opportunity to respond to the Commission's concerns including consideration of whether changes are appropriate to alleviate any concerns the Commission may express from time to time.

16. The combination of consultation and commercial agreements under the AAA regime and public transparency of airport outcomes under the ID Regime, provides airports with the framework to provide the most efficient long term outcomes for consumers and enable the risks associated with heavy handed regulation to be avoided.

## Introduction

### *Approach for this Cross Submission*

17. This is WIAL's cross submission following the Commission's Section 56G Review conference held in Wellington on 7 August 2012.

18. This cross submission should be read in conjunction with the earlier submissions and cross submission made by WIAL during the Review.

19. It is also separate to the submission and cross submissions made by NZ Airports which were prepared with input from and are fully supported by WIAL.

20. This cross submission is structured into parts:

    - Part A - WIAL comments on a number of significant issues that it considers warrant further information being provided to the Commission.
    - Part B – WIAL comments on the questions/ issues published by the Commission following the Conference.

### *WIAL Contact Details*

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

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## Part A – Significant Issues

### *Influence of ID Regime on Airport Behaviour*

22. WIAL understands that the Commission is seeking to assess the impacts of the ID Regime by reference to identifiable changes in airport behaviour.

23. WIAL considers that it is important however to understand its historic and ongoing long term behaviours to consider whether appropriate behaviours were already being demonstrated prior to the ID Regime. It is also important to reiterate that it is a matter of public record that the increased regulatory oversight of airports in Part 4 was not based on evidence of there being a problem in the industry and included consideration of the untested views of one party.

24. Notwithstanding this, WIAL considers that the ID Regime provides a forum for these behaviours to be clearly demonstrated in a more transparent, consistent and comprehensive manner than occurred prior to commencement of the regime.

25. WIAL demonstrated in its cross submission its preferred approach to pricing under the AAA regime, namely commercial agreements. Most significantly WIAL has implemented commercial agreements with airlines that facilitate growth and enable consumers to receive the benefit of this in both the short and the long terms through lower unit price.

26. Air NZ also acknowledged at the Conference that they did not have significant service quality or innovation concerns. WIAL considers that this further demonstrates that appropriate behaviours have historically occurred in these areas under the AAA regime.

27. WIAL also notes that there was little disagreement between WIAL and Air NZ and BARNZ regarding the capital expenditure forecasts submitted during consultation for the period 2012-2017. WIAL also continues to be the lowest cost per passenger airport in Australasia.

28. There has in fact been no robust evidence presented to WIAL that shows that its behaviour is, or has been, inappropriate and consequently it is therefore difficult to identify specific areas of behaviour "correction". Given the unusual circumstance of additional regulation being introduced without a specific issue being identified that required change, WIAL believes the Commission should be looking at positive historic and on-going behaviour rather than only seeking to identify changes.

29. The Commission Chair sought comment at the Conference on the influence of the ID Regime on the price setting process. The Chair summarised the Air NZ and BARNZ comments by commenting that *"So, this new regime did nothing to reduce the level of cost negotiation, it did nothing to reduce the level of dispute that might have arisen between the parties? [1]"*. WIAL notes that the BARNZ and Air NZ positions are factually incorrect, and represent gaming of the process to press for further regulatory intervention without producing any evidence of its need or benefits.

30. WIAL has submitted at length, and transparently shown through publication, the extent of cost information provided and the relatively narrow range of issues contested in pricing consultation. These outcomes are in part related to the ID Regime and the consistency of many of the pricing parameters with the IMs, and also to the already effective consultation process under the AAA.

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[1] Conference Transcript page 121, lines 14-16

31. To the extent there is an implication that WIAL has retained and inappropriately exercised market power, WIAL has submitted extensive evidence of its genuine consultation approach such as the commercial concessions made. WIAL also notes that Air NZ has significant countervailing market power as the dominant airline in the market, as WIAL's major customer and as the majority Government-owned national carrier (with extensive lobbying, marketing and legal resources and close interaction with Government at all levels). As such, WIAL notes that any inference that there has been no change in market power may be a result of WIAL having always had limited market power in dealings with Air NZ given its position of strong countervailing power.

32. In addition, WIAL has submitted previously that Air NZ and BARNZ seem set on a path of increased and heavy handed regulation. Whilst this strategy is still being pursued there is no incentive for BARNZ or Air NZ to indicate or attempt to achieve a reduction in dispute (real or otherwise). The previous success of a gaming strategy to increase regulation without the Government testing either the merits of the claimed problem or the benefits of additional regulation will be encouraging for Air NZ. WIAL is concerned that the clear evidence of commercial approach being preferable and achievable may be overlooked because of the overwhelming influence of Air NZ and the noise it has created over many years.

33. However, the intent of the ID Regime is to provide sufficient information to enable an assessment of WIAL's performance in achieving the Part 4 objectives. WIAL has shown its support for the increased transparency and the publication of high quality information to demonstrate its performance in a number of ways:

- WIAL made its AAA consultation information public to allow detailed scrutiny of the consultation process by interested parties.
- WIAL has not only implemented the operational forum meetings to allow service quality requirements in the annual information disclosures to be met but has further developed and expanded this process to achieve a much greater level of ongoing collaborative decision making between WIAL, the airlines and other key stakeholders.
- WIAL has established new information databases to capture the information required to enable publication of service quality information in annual disclosures and, importantly, is also using this information for discussions with stakeholders in the operational forums referred to above.
- As part of the introduction of service quality measurement and reporting, WIAL adopted the Airport Service Quality ("**ASQ**") surveys. These are reported and discussed at the monthly operational meetings and also form part of WIAL's Board scorecard reporting.

34. More specifically WIAL's disclosures, and processes to achieve these, have resulted in a significantly improved opportunity for interested persons to assess WIAL's achievement of the Part 4 objectives. We demonstrate this in the following table:

| **Part 4 Objective** | **Disclosures by WIAL** | **Increased Benefit for Interested Parties** |
|---|---|---|
| Incentives to innovate and invest | • Master plan that establishes WIAL's long term investment vision<br>• Price setting disclosures that demonstrate WIAL's | Only the first of these items was public prior to the ID Regime.<br>Additional information provides considerably more detail on |

| Part 4 Objective | Disclosures by WIAL | Increased Benefit for Interested Parties |
|---|---|---|
| | medium term planning<br>• Annual disclosures that show accountability for achievement of forecasts<br>• Consultation exchanges between WIAL and airlines on establishment of medium term forecasts | the rationale for medium term planning.<br>Explanations provided by WIAL on how actual performance may vary from forecast and why. |
| Incentives to improve efficiency and service quality | • Price setting disclosures that demonstrate WIAL's medium term planning<br>• Annual disclosures that show service quality outcomes<br>• Annual disclosures that show WIAL and stakeholder interaction to address service quality on an ongoing basis | None of this information was previously available to non-airline interested parties (Air NZ has commented that it received all the information that it required[2])<br>Benefits of information disclosure will develop over time as a history of performance is available |
| Share with consumers the benefits of efficiency gains including through lower prices | • Price setting disclosures that demonstrate WIAL's medium term planning<br>• Annual disclosures that show accountability for achievement of forecasts<br>• Consultation exchanges between WIAL and airlines on establishment of medium term forecasts | WIAL has provided extensive comment in its consultation material that allows interested persons to evaluate:<br>• The pricing benefits for consumers from the new pricing structure, including the published incentive arrangement<br>• WIAL's commitment to achieving reduced costs per passenger over the pricing period |
| Limited in ability to extract excessive profits | • Price setting disclosures that demonstrate WIAL's medium term planning<br>• Annual disclosures that show accountability for achievement of forecasts<br>• Consultation exchanges between WIAL and airlines on establishment of medium term forecasts | WIAL's consultation material provides extensive comment and financial information.<br>The annual disclosures allow review of WIAL's actual performance within the IM framework (further comment is provided in the section below). |

35. Clearly there is extensive information available to interested parties that was not available prior to the ID Regime and WIAL has sought to further increase the benefits of the disclosures by publishing the recent consultation information.

36. WIAL considers that it is critical that it can continue to seek development of commercial agreements with airlines which has proven to be possible under the AAA regime.

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[2] Air NZ – Submission to the Commerce Commission on s 56G report – 29 June 2012, paragraph 143

37. WIAL considers that the comments above show that the AAA and ID Regimes can be complementary but with the ID Regime enhancing the public transparency of actual and forecast performance.

38. WIAL notes that it is challenging to form a definitive view of its performance over time under the ID Regime. However, WIAL believes that consideration of the evidence and facts currently available show that the ID Regime *is* making a difference and the purpose of the Act is being achieved. Naturally, further evidence of the benefits of the ID Regime will emerge over time.

***Consideration of ID Regime without Input Methodologies***

39. At the Conference the Chair posed the question of how the Commission could carry out its task under s 56G if it cannot consider input methodologies[3]?

40. WIAL notes that this is already demonstrated in Australia, under its regulation of airports where IMs have not been established within the monitoring regime.

41. The Australian regime incorporates two separate components for their largest airports:

- Annual monitoring of annual information disclosures by the Australian Competition and Consumer Commission including:
  - Review of changes in financial and service quality performance from previous periods;
  - Comparison of outcomes from the monitored airports; and
  - Consideration of whether airports have inappropriately exercised market power in any of the monitored services.
- Periodic reviews of the effectiveness of the monitoring regime by the Australian Productivity Commission. The Productivity Commission considers whether the airport outcomes are within reasonable bounds, including the use of international benchmarking, whether the ACCC has demonstrated that inappropriate use of the market power has occurred and evaluates whether alternative forms of regulation could provide a more effective outcome than a monitoring regime.

42. The Australian regime provides a clear example of how airport outcomes may be considered without the requirement for a regulator to engage in the price setting process and commercial discussions between the airports and airlines.

43. However WIAL also appreciates that the Commission has been required to establish the IM's and consequently must give consideration to how they should be applied in consideration of the effectiveness of the ID Regime. We comment on this below.

***Adoption of IM's and Evaluation of Performance***

*Adoption of IMs in Pricing*

44. WIAL has provided earlier comment on why it considers that the IM's have been established for use in the ID Regime but are not required to be applied in price setting under the AAA consultation. Commissioner Duignan confirmed that the Commission is cognisant of the role of the IM's when he commented that *"We do not ourselves sort of tie that directly to use of the IMs but, then again, we have to recognise that we've put a lot of*

[3] Question 16 of Questions/issues arising from the Wellington Airport conference held on 7 August 2012

*effort into the IMs so they do represent a judgement that is relevant. So, it's not the test, as we see it is not whether the airport is observing the IMs but the overall outcome[4]."*.

45. In contrast, Air NZ and BARNZ continue to claim that the ID Regime is ineffective because WIAL has not adopted the specific input IM's. WIAL submits that the Air NZ and BARNZ position is simplistic and misguided and WIAL supports the primary focus being on outcomes to determine effectiveness of the ID Regime.

46. Although application of the IM's is not required for pricing under the AAA, WIAL has provided considerable comment in its consultation material, the price setting event disclosure and earlier substantive and cross submissions on how it gave consideration to the IM's in consultation. WIAL's most recent summary of its view was provided in the cross submission on the process and issues paper as follows[5].

> *"62. In summary, we reiterate that WIAL has not disregarded the ID Regime and notes the following;*
>
> - *The Act requires IMs to be developed for the ID Regime as monitored by the Commission.*
> - *WIAL has published clear and accurate disclosures in accordance with the Commission's Determinations.*
> - *WIAL applied IMs in its recent consultation under the AAA in a number of areas and consulted fully on the reasons why it was not considered appropriate to do so in a couple of specific areas.*
> - *The IMs are not mandatory for price setting under the AAA, and this is not their intended purpose, else airports would be subject to price control on a de-facto basis, contrary to Parliament's intent.*
> - *Parliament specifically determined retention of the AAA price setting provisions.*
> - *WIAL applied, through consultation, a number of commercial concessions to its price setting that materially offset the net impact of variations from the application of IMs – demonstrating that net outputs need to be considered and not selective inputs. "*

47. It is clearly evident that WIAL gave extensive consideration to the IM's during its price setting process.

*Use of IM's in Section 56G Review*

48. WIAL appreciates that the Commission is seeking to understand how the IM's can be recognised in its Review. The Commission posed the following question:

> *"Interrelationship between ID, s 56G reports and CC's IMs? How can the Commission carry out its task under s 56G if it cannot consider input methodologies?"*

49. WIAL is not suggesting that the Commission should not consider the IM's in the Review; the fundamental issue is how they are applied.

50. As commented above the Commission agrees that the IM's are not required to be applied in pricing established under the AAA. This means that:

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[4] Conference Transcript page 59, lines 23-28

[5] WIAL Cross Submission to the Commerce Commission Section 56G Process and Issues Paper, 20 July 2012, pages 11-12

- The Commission should not seek to establish its own calculation of required revenue by substituting pricing inputs derived from the IM's for those applied by the airports.
- The Commission must recognise that if it were to take this approach it would be effectively applying a de facto price control calculation and the commercial arrangements or concessions applied by the airport would need to be excluded.

51. Revenue expectations and pricing established under the AAA follow an extensive consultation process and produce outcomes from a combination of financial inputs and commercial decisions. They are interrelated so any changes to individual inputs or decisions cannot be assumed to change the revenue and pricing outcomes.

52. This does not diminish the ability of the Commission to consider WIAL's actual or forecast performance in the Review. In annual information disclosures WIAL's revenue and cost outcomes (Annual Information Disclosure Schedule 2) are assessed against an asset base and cost of capital established by application of the IM's (Annual Information Disclosure Schedule 1).

53. If WIAL's actual revenue, from actual pricing, produces a regulatory profit within the ID framework that varies from the cost of capital IM then the Commission has the opportunity to evaluate this outcome.

54. Fundamentally the AAA consultation decisions that have led to the revenue outcome do not impact the Commission's ability to make this assessment. For example, similar required revenues may be derived from the following two different approaches:

| **Pricing Item** | **Airport X (using IM's)** | **Airport Y (using AAA commercial approach)** |
|---|---:|---:|
| Assets | 1,000 | 1,100 |
| Cost of Capital | 8% | 9% |
| Return on Capital | 80 | 99 |
| Operating Costs (included tax and depreciation) | 50 | 50 |
| Commercial concessions including wash ups | 0 | (25) |
| Required Revenue | 130 | 124 |

55. Evaluation of both outcomes produce similar required revenues and it is therefore evident that the Commission should not be concerned with the pricing inputs and commercial decisions made under the AAA; it is the outcome from the pricing process that should be considered under any assessment by the Commission.

56. During WIAL's consultation it was cognisant that the Commission would make this assessment, and that this is the framework for annual information disclosure. It therefore provided strong input to WIAL's final pricing decision.

57. WIAL also wishes to emphasise however that this should only be one input to the Commission's assessment of performance and the Commission should also consider other market aspects such as:

    - Economic circumstances and whether the Commission's WACC determinations appropriately reflect these;
    - Commercial behaviour in respect of agreements between airports and airlines;

- Market changes that may cause variations from forecasts; and
- Comparability of New Zealand airport achievements compared to international market experiences.

This list is illustrative only and is not purported to be an exhaustive list..

*WIAL's Forecast Financial Performance*

58. WIAL has commented in its submissions and at the Conference that it has not sought to achieve its WACC in the 2012-2017 pricing period.

59. In considering the outcomes from its pricing decision WIAL calculated the returns it would achieve from utilisation of both the WIAL and IM valuation approaches for land. This produced the following outcomes for the pricing asset base (excluding LUMINS):

| **Calculation of WIAL MVEU Return** | | | | | | |
|---|---|---|---|---|---|---|
| | | **2013** | **2014** | **2015** | **2016** | **2017** |
| ***Forecast Revenue Statement from WIAL's Pricing*** | | | | | | |
| Required Revene from Pricing | | $60,303 | $65,686 | $71,918 | $78,706 | $85,850 |
| Other Income | | $205 | $210 | $215 | $221 | $226 |
| Operating Costs | | ($16,638) | ($16,068) | ($17,721) | ($18,103) | ($18,415) |
| Depreciation | | ($12,847) | ($13,510) | ($15,441) | ($16,704) | ($17,298) |
| Revaluations | | $10,927 | $11,270 | $11,914 | $12,206 | $12,268 |
| Tax | | ($8,827) | ($10,543) | ($11,669) | ($13,366) | ($15,262) |
| **Annual Regulatory Return** | | **$33,123** | **$37,045** | **$39,216** | **$42,960** | **$47,369** |
| | | | | | | |
| **Asset value including Land at MVEU** | | **$456,145** | **$476,032** | **$495,062** | **$502,242** | **$503,602** |
| | | | | | | |
| **Annual return** | | **7.26%** | **7.78%** | **7.92%** | **8.55%** | **9.41%** |
| | | | | | | |
| ***Calculation of Return for Period to Achieve NPV=0*** | | | | | | |
| **Forecast Return** | **8.13%** | 8.13% | 8.13% | 8.13% | 8.13% | 8.13% |
| Target Regulatory Earnings | | $37,086 | $38,703 | $40,250 | $40,834 | $40,945 |
| Surplus/(Deficit from Forecast Earnings) | | $3,964 | $1,658 | $1,034 | ($2,126) | ($6,425) |
| Discount Factor | | 108.13% | 1.17 | 1.26 | 1.37 | 1.48 |
| Discounted Surplus/(Deficit) | | $3,666 | $1,418 | $818 | ($1,555) | ($4,346) |
| **Net Present Value for Period** | | **$0** | | | | |

| **Calculation of CC Return** | | | | | | |
|---|---|---|---|---|---|---|
| | | **2013** | **2014** | **2015** | **2016** | **2017** |
| ***Forecast Revenue Statement from WIAL's Pricing*** | | | | | | |
| Required Revene from Pricing | | $60,303 | $65,686 | $71,918 | $78,706 | $85,850 |
| Other Income | | $205 | $210 | $215 | $221 | $226 |
| Operating Costs | | ($16,638) | ($16,068) | ($17,721) | ($18,103) | ($18,415) |
| Depreciation | | ($13,469) | ($13,497) | ($15,425) | ($16,302) | ($16,945) |
| Revaluations | | $9,474 | $9,769 | $10,378 | $10,634 | $10,667 |
| Tax | | ($8,658) | ($10,557) | ($11,689) | ($13,500) | ($15,387) |
| **Annual Regulatory Return** | | **$31,217** | **$35,543** | **$37,675** | **$41,657** | **$45,996** |
| | | | | | | |
| **Asset value including Land at MVAU** | | **$398,548** | **$416,360** | **$433,902** | **$439,562** | **$439,752** |
| | | | | | | |
| **Annual return** | | **7.83%** | **8.54%** | **8.68%** | **9.48%** | **10.46%** |
| | | | | | | |
| ***Calculation of Return for Period to Achieve NPV=0*** | | | | | | |
| **Forecast Return** | **8.92%** | 8.92% | 8.92% | 8.92% | 8.92% | 8.92% |
| Target Regulatory Earnings | | $35,559 | $37,148 | $38,713 | $39,218 | $39,235 |
| Surplus/(Deficit from Forecast Earnings) | | $4,342 | $1,605 | $1,038 | ($2,439) | ($6,761) |
| Discount Factor | | 1.09 | 1.19 | 1.29 | 1.41 | 1.53 |
| Discounted Surplus/(Deficit) | | $3,986 | $1,353 | $803 | ($1,733) | ($4,410) |
| **Net Present Value for Period** | | **$0** | | | | |

60. The calculations show that WIAL's expected income from pricing is the same while the asset base in the latter approach has been adjusted to reflect the MVAU valuation for land under the IM. The valuation of other assets has not been adjusted in accordance with the IMs however the total difference in the non land asset values is less than $1 million which does not have a material impact on the return.

61. The latter calculation illustrates therefore the outcomes that WIAL would expect to report under annual information disclosures during the pricing period if all forecasts were to be exactly met.

62. Importantly the comparison of these two outcomes further demonstrates that the Commission does not need to consider the commercial decisions that were included in the determination of WIAL's forecast revenue. The outcomes can be assessed within the ID and IM framework irrespective of the decisions that led to the forecast revenue being established.

63. Clearly however assessing forecast performance is fraught with uncertainty as WIAL also carries the risk of considerable uncertainty during the pricing period from variations in traffic volumes and other financial inputs.

64. Note that if the above outcomes are illustrated for all specified airport services (included in Schedule 18 of the price setting event disclosures ) the returns fall slightly to 8.04% and 8.74% respectively.

*WIAL's Actual Financial Performance*

65. WIAL's outcomes for its 2011 and 2012 financial years were prepared within the ID framework following application of the IM's, and are shown in the following table:

| | **ID Post Tax Return on Investment** | **Return on Investment Excluding Revaluations** | **Commission's 75th %ile Cost of Capital for WIAL** | **Shortfall in Revenue from Actual ROI below Commission WACC** |
|---|---|---|---|---|
| 2011 | 6.16% | 5.14% | 9.18% | $17.2m |
| 2012 | 6.91% | 5.44% | 8.73% | $10.4m |

66. It is clearly evident from the table that WIAL's actual performance assessed within the ID Regime is well below the Commission's cost of capital and has resulted in significant shortfalls in revenue of $17.2 million in 2011 and $10.4 million in 2012. Notably WIAL has not sought to recover these shortfalls in the 2012-2017 pricing period.

67. In addition, WIAL has calculated its returns since the commencement of the ID Regime until the end of the current pricing period i.e. financial years 2011 to 2017. The return over this 7 year period (comprising 2 years of actual returns and 5 years of forecast returns) is 6.88% based on an MVEU asset base and 8.21% based on an MVAU asset base.

*Wash Ups*

68. There was considerable discussion of WIAL's prior period wash up arrangements at the Conference. In WIAL's view there are several significant issues that were not given appropriate recognition in these discussions.

69. Most notably, the wash ups are commercial compromises. WIAL, or the other airports, are not obliged to provide wash up arrangements and in fact to do so for revaluation variations is at odds with economic advice received by WIAL during the 2007 consultation[6].

70. The wash ups were one way risk sharing arrangements. The wash ups are in respect of discrete items and provide a cap on the outcomes achieved by WIAL. WIAL still retained the risk that the outcomes could be adverse.

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[6] LECG, Response to valuation issues raised in BARNZ papers: Treatment of asset revaluation gains or losses, 12 February 2007

71. Dr Layton, for BARNZ, commented *"What these wash-ups are when they are reducing the price for the forward period is really a repayment of over recoveries in the previous period, so that they really should be applied back to adjusting that previous period[7]."*.

72. Taking a statement about "over recoveries in the previous period" in isolation of overall recoveries can give a misleading implication. There are other instances where WIAL incurred greater expenditure than forecast, such as the $2.5 million upgrade to baggage handling facilities and higher costs to complete the runway overlay of $5.5 million. WIAL has not been compensated for these unforecast capital items and are a clear illustration of the one way nature of wash ups.

73. If the Commission was minded to make adjustments in its assessment of future returns for specific wash up adjustments that are considered to have been past-period over-recoveries, WIAL believes the Commission would need to bring forward the overall under-recovery from the prior period into the return WIAL is targeting over time.

74. Also, the comment is incorrect in respect of the revaluation wash up. WIAL did not recover charges in respect of the asset base including unforecast revaluations during the pricing period and therefore no over recovery of revenue was achieved. These revaluations only affect the asset base for the subsequent pricing period, in this case 2012-2017, where WIAL's forecast revenues and charges will be reported and assessed within the ID and IM framework.

75. WIAL also does not agree that the arrangements for the 2007 were "murky" as described at the Conference. The terms were clearly documented in WIAL's 2007 consultation documents with a template calculation also provided. To demonstrate this the terms of the wash up provided to the airlines in the 2007 consultation are attached at Appendix 1.

76. WIAL also confirms that the revenue requirement used to determine prices for the 2012-2017 period incorporate the revaluation wash up ($24.9 million in nominal terms) and the Northern Pier "Rock" wash up ($20.9 million in nominal terms) from the prior pricing period.

***Economies of Scope and Sharing of Incentives***

77. WIAL commented at the Conference that it had not considered the impact of the incentive arrangement on the non-regulated activities because these activities were outside the scope of the ID Regime[8].

78. WIAL maintains that this is the correct approach however there is also clear rationale why an alternative approach would be inappropriate.

79. Firstly, the incentive scheme included in pricing produces lower prices for aeronautical services for all passengers. This was demonstrated in WIAL's consultation information [9] and is summarised in the table below:

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[7] Conference Transcript page 19, lines 22-26

[8] Conference Transcript page 97, lines 1-5

[9] WIAL Final Pricing Document, 1 March 2012, page 110

| Financial Year | FPD Forecasts | | | No Incentive Forecasts | | | Diff | | |
|---|---|---|---|---|---|---|---|---|---|
| | International | Domestic | Total | International | Domestic | Total | International | Domestic | Total |
| 2012 | 697,904 | 4,509,786 | 5,207,690 | 697,904 | 4,509,786 | 5,207,690 | 0 | 0 | 0 |
| 2013 | 707,096 | 4,586,071 | 5,293,167 | 707,096 | 4,531,311 | 5,238,407 | 0 | 54,760 | 54,760 |
| 2014 | 725,979 | 4,698,589 | 5,424,568 | 725,979 | 4,595,482 | 5,321,462 | 0 | 103,106 | 103,106 |
| 2015 | 774,532 | 4,820,690 | 5,595,222 | 745,612 | 4,670,438 | 5,416,050 | 28,920 | 150,252 | 179,172 |
| 2016 | 821,014 | 4,954,357 | 5,775,371 | 763,175 | 4,760,237 | 5,523,412 | 57,839 | 194,120 | 251,959 |
| 2017 | 837,192 | 5,111,092 | 5,948,283 | 779,352 | 4,872,804 | 5,652,156 | 57,839 | 238,288 | 296,127 |
| **Total 2013-2017** | **3,865,813** | **24,170,799** | **28,036,612** | **3,721,214** | **23,430,273** | **27,151,487** | **144,599** | **740,526** | **885,125** |
| **CAGR 2013-2017** | **4.3%** | **2.7%** | **3.0%** | **2.5%** | **1.8%** | **1.9%** | **1.4%** | **0.3%** | **1.1%** |

| | | FPD (with incentive) | No Incentive Alternative | Difference |
|---|---|---|---|---|
| Total (Net) Passengers (million) | Non-Incentive | 25.91 | 26.54 | (0.63) |
| | Incentive | 1.49 | N/A | N/A |
| | **Total** | **27.40** | **26.54** | **0.87** |
| Average Charge per Passenger (nominal) | Non-Incentive | $13.59 | $13.66 | ($0.07) |
| | Incentive | $6.96 | N/A | N/A |
| | **Average** | **$13.23** | **$13.66** | **($0.43)** |
| Total Revenue (million) | | **$362.46** | **$362.46** | **$0.00** |

80. WIAL has accepted the risk that the higher forecast volumes will be achieved, by lowering charges in advance by an average of 43 cents per passenger. In essence, WIAL has shared the benefits of prospective volume growth with its airlines in advance of the growth occurring. It is notable that during consultation, neither Air NZ or BARNZ had any issues with the passenger forecasts provided by WIAL

81. The counter factual scenario of prices established on the non-incentive based volume expectation would provide a greater probability that the passenger forecast would be achieved but also provide WIAL with greater upside potential as any increase in volumes would produce revenue derived from the higher price level. WIAL has given up this prospective benefit.

82. WIAL cannot conceive how this arrangement could reasonably have an impact on non-regulated services. The only way this could occur is if prices were reduced even further and an assumption made that WIAL would recover additional revenues from the non-regulated business to meet this cost however there is no rationale for this approach in WIAL's view.

83. WIAL is unclear on how the funding of the arrangement is being interpreted by Air NZ. At the conference Mr Whittaker commented that *"I think in terms of should the growth occur without the incentive being paid, then that incentive has been accounted as a cost of doing business for Wellington and revenue is being recovered to pay for that cost of doing business. So, in that case it would seem to me that's clearly a windfall gain for Wellington because it's putting in a cost of the incentive or the lack of revenue collected as a result of the incentive while collecting revenue to pay for it.*[10]"

84. For clarity. WIAL reiterates that the incentive arrangement works as follows:

[10] Conference Transcript page 97, lines 17-25

- WIAL has forecast higher passenger volumes than a non-incentivised scenario.
- WIAL has reduced the cost for all passengers, in comparison to a lower growth scenario. WIAL therefore receives reduced revenue from airlines carrying passengers on established services.
- There is no cost for the incentive arrangement. The airlines are paying lower charges.
- If the incentivised growth is achieved WIAL will receive reduced rate landing charges for the incremental growth, which will enable WIAL to achieve its forecast required revenue in total.
- If the incentivised growth is not achieved WIAL receives nothing and will not achieve its forecast required revenue.

85. Secondly, the non-regulated businesses comprise contestable markets where alternative options exist for the consumer and hence is subject to market competition. In addition, the spending is discretionary. This is the case for all non-regulated services, including car parking (where alternative modes of transport or drop off/pick up are available) and for retail and food and beverage facilities.

86. WIAL must also make separate investment and incur separate costs to generate revenue from these businesses.

87. WIAL also bears all the risk that forecasts will not be achieved due to economic events, airlines changing their scheduling or initiatives by competitors of the non-regulated businesses. WIAL notes that for the four months of trading of the current financial year, its passenger numbers are currently below forecast. As a consequence, WIAL is currently not achieving its required revenue and is exposed to further downturns in passenger numbers.

88. Thirdly, the dual till model has been a long established model in New Zealand, and Australia. It has been recognised that the single model disincentivises airport investment in services for passengers and the well documented problems at Heathrow in the UK are evidence of this. The dual till model provides greater incentives for airports to invest, provide appropriate service quality to passengers and to seek growth in business volumes.

89. Airports are incentivised to increase passenger throughput and consequently the drivers for the regulated and non regulated services are very much aligned. Copenhagen Economics recognised this in their review of European airport regulation and commented:

> *"The resulting competitive pressures on airports have to be seen in the context of the economic nature of those businesses. Airport costs are largely fixed, partly a result of investment in infrastructure but also because of associated operating costs, including those on safety and security, which vary little with scale of traffic. This gives airports a natural incentive to attract traffic to defray those costs, an incentive which has been accentuated by the growing importance of commercial revenues e.g. from airport retail or car parking (now almost as important overall as aeronautical revenues). Airports are indeed two sided businesses, engaging in a commercial relationship with both airlines and passengers. The profitability of an airport is therefore crucially dependent on traffic volume as revenues increase in proportion to passenger numbers while costs increase more slowly because of the*

*high fixed cost element. Airports therefore have to respond to increased passenger and airline choice by competing to both retain and attract traffic.*[11]*"*

90. Finally the Commerce Act regulation applies to specified airport services and the section 56G review is tasked with assessing how effectively information disclosure promotes the Part 4 purpose statement for these services. As stated previously, WIAL considers that the section 56G review therefore does not enable the Commission to evaluate other services.

91. WIAL respectfully submits that if the Commission was minded to invest resources in seeking to identify the existence and impact of market power in relation to air travel outside the currently regulated services, it would likely find substantially greater public benefit in exploring the pricing of airfares on monopoly regional services operated by Air NZ.

***Asset Revaluations in Competitive Markets***

92. The treatment of revaluations was discussed at the Conference and in particular how revaluations were treated in the commercial property market.

93. WIAL wishes to clarify this issue given that reference was made to adjustments to yield[12] as mechanisms to recognise asset revaluations.

94. WIAL agrees that the use of these mechanisms are likely to influence the rental expectations established by commercial property owners however WIAL notes that:

    - Expected yields on commercial property vary and are influenced, among other things, by the expected valuation growth in property values. Property owners establish expected yields to enable negotiation of forward looking rental contracts. Commercial property owners do not, however, consider the rental or valuation performance for a previous rental period and provide rebates to tenants if actual performance exceeded expectation (or vice versa).

    - Long term rental contracts are common for property tenancies. The contracts provide for rents to be adjusted within a lease period typically by way of reference to market rates (perhaps on a 3 or 5 yearly cycle). WIAL is not aware of any commercial property contracts that provide for rental levels to be reviewed to adjust for variations from prior property valuations.

95. At each price reset WIAL considers expected revaluations in the same way as the commercial property market in that the expected cash yield for the future pricing period is established <u>after</u> allowance for expected revaluation gains.

96. A revaluation wash up mechanism such as that provided by WIAL in relation to the previous pricing period is in fact a departure from competitive property market behaviour. These mechanisms have transferred some of the benefits of WIAL's property ownership through to customers, while protecting them from the downside risk of property ownership. WIAL considers that this demonstrates the effectiveness of the AAA regime in fostering reasonable behaviours.

[11] Copenhagen Economics, Airport Competition in Europe, June 2012, page 4

[12] Conference Transcript page 28, lines 28-32

***Land Valuation***

97. WIAL commissioned Telfer Young to prepare a land valuation in accordance with the requirements of Schedule A of the IMs. Telfer Young's valuation reports have been published as part of its information disclosures and available for review by interested persons.

98. Telfer Young's valuation as at 31 March 2011 formed part of the asset base applied in pricing and was consulted upon with WIAL's substantial customers. Telfer Young instructed Boffa Miskell to undertake an alternative use master plan for the airport site and established this as the base for the land valuation. This alternative use master plan considered feedback from WIAL's substantial customers and their valuers and advisors and consequently the plan and valuation were amended during consultation. This is documented in the published consultation material. As stated at the Conference, the final valuation represents a valuation upon which arbitration has already been undertaken.

99. The fundamental difference in the valuations between Telfer Young and BARNZ's advisers is the land use assumptions and particularly the proportion of land used for commercial purposes. This main difference was confirmed by BARNZ's valuers Property Advisory Limited at the Conference[13].

100. BARNZ's advisers proposed that the dominant use would be low density residential housing. As submitted in consultation, WIAL's valuers do not agree that this is credible given the scarcity of land in Wellington's southern suburbs and that it would not be the highest and best alternative use of the land as required by the IM.

101. This residential allocation also drives the realisation period and whilst Telfer Young's adopted realisation period is shorter at 7 years, the absorption rate for residential use for both WIAL and BARNZ is the same at approximately 6 hectares per year.

102. Furthermore, WIAL has sought advice from Telfer Young following the Conference and a copy of their letter is attached at Appendix 2. In this letter Telfer Young have commented that they gave consideration to the views expressed by BARNZ's advisors but that its final valuation ultimately reflects the most probable alternative use of the land and the associated highest valuation in accordance with the IMs. The Commission can confirm this from a review of Telfer Young's valuation report.

103. BARNZ's valuation adviser commented at the conference that the normal process to resolve differences between valuers is by arbitration[14]. WIAL reiterates that it has already submitted to voluntary arbitration with the airlines concerning the appropriate valuation methodology to be applied for pricing and the final outcome of this arbitration has been dismissed by the airlines. This is a further example of the long-running gaming behaviour of Air NZ – who agreed to a binding arbitration and then, having lost, returned to seeking regulation as an alternative to commercial and market mechanisms.

104. During the Conference the Commission also requested the parties to provide comment on possible amendments to the valuation IM that could result in the differences between the airport and airline advisers being narrowed. WIAL has also sought advice from Telfer Young on this matter.

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[13] Conference Transcript pages 51-52, lines 30-34, 1-3

[14] Conference Transcript page 49, lines 23-27

105. In summary, Telfer Young have reconfirmed that they consider their recommended valuation represents the highest and best alternative use of WIAL's land holding and that they "*do not consider there is any realistic way in which the methodology and its application can be more tightly specified."* A copy of the comments provided by Telfer Young for this cross submission is attached at Appendix 2.

106. WIAL considers that Air NZ and BARNZ are trying to "low ball" the land valuation in the hope that the Commission will consider an arbitrated outcome. WIAL has fully considered the advice from Telfer Young and considers that it reflects the appropriate valuation for land.

107. WIAL confirms that it has adopted the land valuation recommended by WIAL (using an airport developer WACC in the calculation of conversion costs) in its financial statements. These have been prepared in accordance with International Financial Reporting Standards and externally audited by the accountancy firm KPMG.

108. WIAL notes that the Commissioner Duignan commented *that "I don't think that an arbitration - I mean in this particular area of the two valuers, I don't think our sort of role extends to managing an arbitration of that.*[15]*"* WIAL agrees with this statement and would be concerned if the Commission took an alternative view and considers that if this did occur it would:

- Reduce the benefit of WIAL seeking commercial agreements with airlines;
- Diminish the incentive for airports to promote competition as different airline commercial objectives influence their support for investment, innovation and pricing approaches.
- Provide even further incentive to "game" the consultation process. As BARNZ commented at the Conference they consider "negotiate/arbitrate" regulation should be introduced. Whether this was implemented in a de facto or regulated manner it would not change the fact that the airlines would have no incentive to accept any proposal put forward by WIAL but would benefit by submitting "low ball" valuations.

109. WIAL reemphasises its view that the Commission's role is to assess the outcomes from the pricing process and to consider whether airports are achieving the Part 4 purpose statement.

***Price Quality Trade Off***

110. The two specific issues where price quality trade-offs were proposed by the airlines in consultation were for airbridge and baggage handling facilities. WIAL has explained in its cross submission on the process and issues paper why it did not consider it appropriate to establish separate charges for these facilities in the recent consultation[16].

111. There were two other issues raised at the Conference that WIAL considers it appropriate to provide further comment.

112. Firstly, Mr Whittaker for Air NZ suggested that while passengers desire a good quality of facilities at airports they may be less inclined to agree to quality improvements if they were also asked whether they would meet the cost of them[17]. WIAL notes that Air NZ's

[15] Conference Transcript page 50, lines 13-16

[16] WIAL Cross Submission to the Commerce Commission Section 56G Process and Issues Paper, 20 July 2012, page 25

[17] Conference Transcript page 15, lines 1-13

statement does not represent its actual experience. During the considerable debate over the increase in charges required to pay for WIAL's main terminal building which opened in 1999 WIAL commissioned AC Nielson to undertake a survey of passengers to obtain their views on paying an increase in charges for a new terminal. This survey reported that passengers were willing to pay an additional $4 in charges to pay for the new terminal development, with 96% of the passengers surveyed indicating that they were willing to pay this charge. This clearly demonstrates that passengers are willing to and want to pay for quality facilities.

113. Secondly, Commissioner Duignan queried[18] whether the choice of airbridge or rear stair disembarkation from jet aircraft is an area where passengers could be provided a price/quality trade off in terms of the facilities they used.

114. This is not an ideal example for an airport to comment upon. WIAL considers the service quality experienced by passengers while boarding and de-planing an aircraft to primarily be the responsibility of airlines and their ground-handlers. Airlines will balance the benefits of a fast turnaround (and therefore aircraft utilisation) against the demand impact of any imperfect experience. Airline competition should deliver a satisfactory overall outcome.

115. In this context, the provision by WIAL of stairs (at the request of multiple airlines) was done in the context of providing airline customers with their desired service levels and options rather than WIAL engaging directly with travellers.

116. It is evident that inefficiencies could result for the airlines and WIAL from establishment of a discreet airport charge for means of disembarkation and consequently it is difficult to contemplate how this could be justified.

117. This is similar to the proposal for a separate charge for baggage handling facilities. WIAL could not identify how the complexities of introducing such a charge could be resolved and invited the airlines to provide advice on to enable WIAL to consider it further. No advice was received prior to WIAL establishing its current charging schedule and the separate charge did not proceed. WIAL notes that this does not preclude the airlines from proposing the introduction of new charges in future periods and WIAL would consider the economic rationale for any such proposals.

***Cost of Capital***

118. Commissioner Duignan queried whether WIAL considered the anomaly in the Brennan-Lally model, which results in WACC increasing as leverage is increased, when it adopted a WIAL specific leverage of 40% in its WACC [19].

119. WIAL confirms that it has consistently adopted a 40% leverage target for over 10 years. Furthermore, it considers that this leverage is reasonable for a company such as WIAL. By contrast the leverage in the IM has been determined from a sample of airports operating in difference countries and jurisdictions and, most importantly, with different ownerships structures. Fundamentally, WIAL highlights that a number of the airports in the sample are publicly owned and funded.

120. WIAL considers that it is unquestionable that actual application of the 17% leverage for the three main airports in New Zealand is uncommercial and unrealistic.

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[18] Conference Transcript page 16, lines 15-22

[19] Conference Transcript pages 66-67, lines 31-34, 1-8

*Comparability of Charges*

121. WIAL is aware that NZ Airports commissioned a review by Airbiz of the comparative airport charge information provided to the Commission by BARNZ. WIAL has reviewed and provided input to the Airbiz report before it was finalised by NZ Airports.

122. The Airbiz review very clearly demonstrates the New Zealand airport charges are not high from comparison to international airports. This is consistent with the Leigh Fisher information WIAL provided in its substantive submission.

123. The additional work that Airbiz performed to compare New Zealand airport domestic charges with those by Australian airports is also telling with Airbiz concluding that average New Zealand airport charges are between one quarter and one half of those at Australian airports.

124. WIAL is aware however that its charges are relatively high in the New Zealand context and wishes to provide commentary to the Commission the reasons for this:

- Location of WIAL close to the Central Business District (CBD) and the scarcity value of land in the Wellington region, which both result in comparatively high land values.
- Efficiency benefits for passengers of the total cost of travel from/to WIAL compared to other airports less conveniently located. For instance the travel cost and time required for passengers travelling between Wellington airport and its CBD are considerably lower than those for passengers at other airports. Passengers consequently receive a considerable efficiency benefit from WIAL's location.
- The comparative quality of facilities.
- Intensity of use of facilities. WIAL has the highest volume of passengers processed per hectare of land in Australasia by a considerable margin.
- The higher construction cost of new aeronautical investment at WIAL due to "brownfields" construction requirements on a congested and small airport site.
- The aircraft mix operating at an airport. For instance, airports with wide body aircraft services charging on a MCTOW basis obtain a greater proportion of revenue from passengers carried on larger aircraft because the weight per passenger is higher than on single aisle aircraft. This disadvantages WIAL due to the absence of such long haul wide body aircraft.
- The basis under which charges are struck at each airport which may in part be influenced by airport ownership structures. For example, Air NZ has expressed concern that the regional airports will seek to apply the Commission's cost of capital IM and raise their charges. This may result in an increase in regional airport charges and indicates that regional airports may not currently be charging an appropriate return. Regional airports are typically wholly owned by local councils which often do not the same commercial requirements as mixed ownership airports.

125. As set out in the Airbiz report endeavouring to compare charges is a complex area which should be undertaken with care to ensure underlying differences are identified and adjusted for where required. The Airbiz report should provide the Commission with further understanding and perspective of Australasian and wider international airport charges and enable it to conclude that consumers utilising New Zealand airports are receiving airport services at a relatively low cost.

## Part B –Commission's Questions/Issues

126. WIAL has set out its responses to the Commission's questions below. In addition to the questions posed directly to WIAL, we consider it appropriate to also provide certain comments on the other questions for consideration by the Commission.

Q1: Air NZ to provide examples of 'excess'/'over-investment" in quality at Wellington Airport.

127. WIAL does not agree that there has been over investment at Wellington Airport. Airlines have different commercial motivations which influence their position on new investment. Airlines will typically not support investment that foster competition and airlines can also have different views of the quality of facilities that is required by passengers. In particular, incumbent and dominant airlines will oppose new investment that increases the likelihood of new airline competition.

128. For example, WIAL received support for the projects discussed below from Qantas and Pacific Blue during consultation on the projects.

129. Air NZ have previously made comment on the following investments and as a result we have provided the following comments for the Commission's information:

- Southern Runway End Safety Area (**"South RESA"**)

  The total cost of the RESA was approximately $23.5 million. The bulk of this cost was required to construct a tunnel at the Southern end of the runway to enable the RESA to be constructed over the public road.

  There were two aspects of this project that Air NZ disagreed with:

  - $2.1 million to extend the taxiway for aircraft to access the runway at the end to utilise the full runway area for take-offs. Air NZ did not require the full runway length for take offs for A320 aircraft and consequently did not support this expenditure. Other airlines operating B737-800 wished to utilise the full take off length and the stubway was therefore constructed. In the absence of the stubway these aircraft would have had to access the runway at an earlier point, taxi to the end of the runway, and then turn 180 degrees to enable take off. This would have introduced considerable inefficiency to runway operations which WIAL did not consider was appropriate.

  - $2.7 million to extend the clearway width on the Western side of the tunnel. WIAL constructed the South RESA safety enhancement to maximise the runway declared distance which is considered was the appropriate approach for a responsible certified airport operator. WIAL did not engineer the South RESA to deal with the occasional disrupt/diversion situation but to preserve the maximum potential long term viability of the facilities at a time when it is clearly the most cost effective means of achieving it

- Northern Runway End Safety Area (**"North RESA"**)

  WIAL initial proposed an option for the North RESA at a cost of $21 million but amended this to a lower cost option at $9 million following consultation with the airlines. A lower cost option was available that would have resulted in the operational length of the runway being shortened and Air NZ support this while Qantas and Pacific Blue did not. If the runway had been shorted Qantas and Pacific Blue would have had to reduce available seating capacity on their aircraft (i.e. couldn't sell all the available seats because of weight restrictions) for trans-Tasman services which would have reduced the commercial viability of the services. WIAL did not agree that this was appropriate and therefore proceeded with the option that preserved runway operating length.

- Northern Pier "Rock" Redevelopment

  WIAL received comment from Air NZ and BARNZ on the terminal development during consultation. WIAL provided the following comments in its Revised Pricing Proposal:

  > *"BARNZ commented in their response that "The Rock was an extraordinarily complex and expensive project. BECA, WIAL's Project Engineers, issued a media release describing it as an 'enormously complex' engineering design which 'stretched the ingenuity of BECA's structural team to the full. Questions of optimisation also need to be addressed."*
  >
  > *It is unquestionably true that this was a complex project however this arose from the challenges of completing a brownfields development rather than any suggestion of over design. In particular the project needed to accommodate:*
  >
  > - *Ongoing 24 hour, 7 day a week operations;*
  > - *Four different building structures;*
  > - *Multiple seismic structures;*
  > - *Three different levels; and*
  > - *An unusual footprint dictated by what was left over after operational requirements were met and all driven by WIAL's confined (and efficient) site.*
  >
  > *These challenges therefore created the complexity around meeting border agency and security requirements, Obstacle Limitation Surface (OLS) requirements and working next to airside operations.*
  >
  > *The actual build used simple and low cost materials and reused existing building components where possible (e.g. ceiling, plant etc). The works were extensively value engineered throughout the project to minimise cost.*
  >
  > *WIAL accepts that the profile of the building is not traditional, however the shape of the building was driven by the available footprint available. The roofline, while different, did not add a substantial cost to the project. For instance WIAL has already advised BARNZ that the cost of the copper for the roof was $259,000 and it will need little maintenance over its life. The building provides an appropriate level of amenity and space for passengers.*
  >
  > *Notwithstanding, WIAL does not believe that 'optimisation' translates to 'cheapest possible' as could be inferred from the BARNZ comment.*

*Wellington Airport is a capital city airport and a gateway to and from New Zealand. Appropriate levels of quality and amenity can be better taken from the approaches taken by customers, the region and commercial entities. Wellington is a vibrant city that prides itself on style. Air NZ, as the airport's largest customer, has a strong brand based on quality and innovation, with features such as the fitout of the new 777-300ER aircraft being a good example. In this context, WIAL considers the development to be innovative, cost-effective and in keeping with its stakeholders' expectations. Winning nine awards, including the Transport category at the prestigious World Architecture Festival in Barcelona, is a credit to the team responsible for the development and not evidence of somehow being 'suboptimal'.*

*Comments from the competition judges for the Registered Master Builders Commercial Project of the Year, which WIAL also won, are telling:*

*"This extremely complex build was executed to perfection, resulting in a truly sensational building and environment to be in," the judges said. "The Rock was a difficult build because of its complexity, shape and detailing. The site was restrictive, as the existing international airport terminal had to continue to operate while building took place. The outside of the building is quite radical and different, but when you go inside it is functional and has a great feel about it. The interior space is a welcoming and enjoyable place to be."*

*WIAL also notes BARNZ's verbal comment, referred to in a letter from WIAL to BARNZ, that the cost of the building should be $24 million to $29 million when compared to the $39 million planned by WIAL. The $39 million in fact included all civil works and air bridges undertaken in conjunction with the construction. The value of the building assets capitalised in WIAL's asset register, which includes capitalised finance costs, was $28.3 million which fits within the range noted by BARNZ.*

*In WIAL's view the total cost of the building construction fell within an acceptable range, as commented by BARNZ, particularly when recognising the complexities involved in the project. WIAL considers that no reasonable basis exists for it to consider optimisation of the construction costs incurred.*[20]"

130. In addition, despite the comments made by Air NZ at the Conference, there was little disagreement between WIAL and Air NZ and BARNZ regarding the capital expenditure forecasts submitted during consultation for the period 2012-2017. The single outstanding issue of disagreement relates to $3.5 million of expenditure retained in the period to address compliance issues with WIAL recognising the risk that the Civil Aviation Authority (CAA) will change the compliance standards following adoption of international ICAO standards.

[20] WIAL Revised Pricing Proposal, 22 November 2011, pages 48-50

| | |
|---|---|
| Q2: | Are there other quality measures that could be included in Part 4 ID requirements? If so, please provide examples. - WIAL |

131. WIAL is not aware of any quality measures that could be included in the current disclosure requirements.

132. We also highlight that the participants in the Conference did not identify any areas of concern in respect of quality.

133. WIAL has commented in its submissions that further time should be given to enable the ID Regime to become fully established before changes are considered.

134. WIAL therefore submits that changes to the current service quality reporting requirements are not required at this time.

| | |
|---|---|
| Q3: | How does WIAL get the 8.9% return using the Commission's IMs? How does calculate the 8% return that it has referred to in its submissions? |

135. Refer to paragraphs 57 to 63 above.

| | |
|---|---|
| Q4: | Which published cost of capital estimate should the Commission use as a basis for its profitability assessment – the March 2011 or the April 2012 estimate, and what adjustments may be necessary? - All |

136. WIAL has submitted previously that it considers that its return should be assessed based on its own actual cost of capital. The reasons for this have previously been submitted upon and are not repeated in this submission.

137. Notwithstanding this, it is well known that the calculation for the cost of capital requires considerable judgment and uncertainty and WIAL reiterates that identifying a single point measure at a specific point in time has considerable risk. Short term factors can also lead to conclusions being reached that may not be appropriate for longer term outcomes.

138. An example exists in respect of the market risk premium (**"MRP"**) input to the Commission's cost of capital calculation. The Commission advised in the IM Reasons Paper that a premium in the TAMRP was appropriate due the global financial crisis[21].. The Commission also concluded that the crisis was nearing an end and therefore the MRP would fall back to the long term level of 7% which was used in the Commission's 2012 WACC determination. It is now evident that the global financial concerns have not abated and consequently the additional 0.5% margin on MRP should still apply using the Commission's initial rationale.

139. In addition, the debt premium is a further WACC variable where consideration needs to be given to market circumstances. WIAL's price setting disclosure[22] shows that WIAL applied a debt premium derived from the Commission's cost of capital approach, but adjusted for a BBB+ rated company. By contrast, during consultation ANZ National Bank Limited advised WIAL that the debt margin that would have been payable by WIAL

[21] Commerce Commission Input Methodologies (Airport Services) Reasons Paper December 2010. Page 265

[22] WIAL Price Setting Event Disclosure for the Pricing Period 1 April 2012 to 31 March 2017, pages 31-32

was considerably higher than that derived from the Commission's approach (3.24% compared to 1.97%).

140. If these approaches had been applied the Commission's 2011 and 2012 WACC Determinations would clearly have produced higher outcomes.

141. WIAL confirms that during consultation for the period 2012 to 2017, the latest available WACC determination issued by the Commission was that published in March 2011. As a consequence, this provided the most current information available from the Commission.

142. However, as noted above it is important that assessments are not based on a particular point in time. As a result, WIAL considers that the Commission should consider the cost of capitals in both the 2011 and 2012 determinations and also identify whether other factors exist, such as in respect of MRP or risk free rate, or where it is appropriate for WIAL to apply different cost of capital assumptions in pricing from the Commission's information disclosure cost of capital, that could also have led to different WACC outcomes.

143. In WIAL's view the Commission should consider these matters and form a conclusion on the reasonableness of WIAL's forecast returns without being required to undertake specific fixed point calculations that are typically for an alternative regulatory mechanism such as price control.

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| Q5: Should the Commission use the midpoint or the 75th percentile in its ex ante assessment of profitability? |

144. The airports submitted on this issue during the consultation process to develop the IM's. Extensive comment was provided by Uniservices Limited in their report for NZ Airports on the IM Draft Reasons Paper. We refer the Commission to this report.

145. We note the conclusion expressed in the report in respect of the WACC range was:

> *"In summary:*
>
> - *The appropriate range for the WACC should be wider than the Commission's interval estimate. The Commission's range only attempts to recognise parameter error. If the Commission does, however, adopt the 75% percentile as its basis for the upper estimate of WACC, it should construct an interval for that estimate as shown by van Zijl (2007); and*
> - *For the purpose of assessing profitability the Commission's view that a starting point for any assessment is its mid-point or 50th percentile estimate (IM Draft Reasons Paper, para. 6.12.) is not appropriate. This fails to recognise asymmetry of social consequences and model error due to factors such as asymmetric risks and other market frictions.*[23]"

[23] Uniservices, Comments on the Commerce Commission's Approach to estimate the Cost of Capital in its Input Methodology Draft Reasons Paper, 12 July 2010, page 46

146. WIAL notes that the Commission is aware of the risks in establishing cost of capital from its comments on application of the cost of capital determinations. In the April 2012 determination the Commission commented:

> *"the context in which the WACCs will be used (75th percentile estimates of the WACC are used when considering default and customised price-quality paths, while a midpoint and range is determined for information disclosure)* [24] *"*

147. WIAL agrees with the Commission's view that a range should be established however as indicated by the Uniservices advice the range should not commence at the 50th percentile.

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| Q6: Should the MVAU methodology be more tightly specified? If so, in what way? - All |

148. Refer to paragraphs 96 to 108 above. A response to this question by WIAL's valuers Telfer Young is also attached in Appendix 2.

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| Q7: General observations on how ID is working. - All |

149. WIAL considers that this question should be addressed in two parts.

150. Firstly, is appropriate airport behaviour incentivised by the complementary nature of the AAA and the ID Regime? WIAL provided comment on this issue in its cross submission on the process and issues paper. In particular WIAL commented on certain significant achievements in achieving competitive market outcomes for consumers. These achievements were in the following three areas:

- Achievement of commercial agreements.
- Fostering of competition.
- Price setting behaviour and commercial compromise.

151. The ID Regime provides the appropriate mechanism for these achievements to be demonstrated over time.

152. WIAL also notes that the commercial behaviours have also produced low airport cost outcomes for consumers.

153. Secondly, do the information disclosures meet the section 53A purpose of information disclosure regulation *"to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met."* WIAL provided considerable comment in its substantive submissions on the process and issues paper on the achievement of this objective and we highlight certain comments below.

154. In its substantive submission WIAL commented:

> 274. *"WIAL has increased the depth and breadth of the information it discloses under the new ID regime. This includes:*
>
> - *Information on service quality achievement;*

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[24] Commerce Commission, Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10, 27 April 2012, page 4

- *Information on asset capacity and utilisation;*
- *Information on long term capital expenditure planning, which should be considered in conjunction with WIAL's 2030 Master Plan;*
- *Information on WIAL's financial outcomes;*
- *Information demonstrating the rationale for the pricing calculations and approaches adopted by WIAL;*
- *WIAL supplemented the above requirements of the ID Regime by publishing all key consultation documents, including expert reports and airline responses to WIAL's pricing information, on its website.*

275. *The assessment of the effectiveness of the ID Regime against the purpose statement for Part 4 of the Act will require a suitably long time-series of information to cater for variations in returns, demand and costs. With that said, some initial comments in respect of the performance of WIAL in meeting the purpose statement for Part 4 of the Act are:*

    - *WIAL is presently targeting an overall level of return on investment below its company specific WACC, which was an outcome of the commercial concessions made during the most recent pricing consultation process. While rates of return may vary over time, a business must earn its WACC on average to make ongoing investment attractive.*
    - *WIAL is investing in the replacement, upgrade and addition of new assets through development of its apron and terminal facilities to meet expected increases in demand.*
    - *WIAL is seeking to achieve improvements in service quality that reflects consumer demands through the terminal enhancements that will improve passenger amenity.*

276. *WIAL is innovating and seeking efficiency gains from the ongoing design of capital expenditure projects to seek increasing efficiencies in utilisation of the airport site while forecasting reductions in real operating costs per passenger, which are already the lowest in Australasia.*

277. *Assessment of actual performance in terms of efficiency gains, sharing those gains with consumers, and the assessment of profitability, needs to be made over a longer timeframe than is currently available under the ID regime.*

278. *WIAL's actual prices were determined following a comprehensive consultation process and involved commercial compromise. WIAL's future profitability will be dependent on a range of factors, including: actual outturn costs for the operation of the airport, and capital and maintenance projects; actual funding costs; actual passenger numbers (and market factors that drive consumption of the services).*

279. *We believe that, over time, the information disclosed by WIAL will be sufficient to allow interested persons to assess the performance of airports against the Purpose of Part 4 of the Act.*[25]*"*

155. WIAL has consistently expressed the view that the ID Regime needs to be given an opportunity to realise its full benefits and allow airport outcomes to be considered over time.

156. With respect to actual returns, in 2011 and 2012, WIAL's actual returns were below its own, and the Commission's cost of capital. Further to this, WIAL's forecast returns for the 2012-2017 pricing period are below its cost of capital. As noted earlier, WIAL's prices are not excessive as demonstrated in the Airbiz benchmarking report prepared for NZ Airports.

157. These outcomes, together with the comprehensive information disclosures that have been made, clearly demonstrate that the AAA price setting and ID regimes are complimentary and are producing appropriate outcomes for consumers.

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| Q8: | What impact does the allocation of the food hall into aeronautical assets have on opex? - WIAL |

158. Characterisation of the central terminal hall as a "food hall" is incorrect. WIAL notes that only one of the activities passengers undertake in this area is the consumption of food purchased from the retail outlets. As can be observed, passengers utilise this space to wait for flights and hence the area should be recorded as a shared or common use asset.

159. WIAL allocated forecast terminal building costs for the 2012-2017 pricing period by share of building value from the 2011 asset valuation. The total terminal building value in the final pricing model was $106 million and total terminal operating costs in the base year prior to allocation were $4.541 million. Transferring the asset value from dedicated commercial use to common use transfers approximately 76.4% of the area's value to the aeronautical asset base. This equates to an allocation of operating costs of $3.469 million to aeronautical usage.

160. The value of the transferred central hall assets was approximately $3 million of which 75% is included in aeronautical assets. If this were excluded the allocation factor for aeronautical costs would have fallen to 74.8% and the allocated operating costs reduced to $3.397m i.e. a reduction of $72,000.

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| Q9: | The $3.5 million of expenditure still in this period – was that a reasonable outcome from your point of view or do you still feel that that expenditure isn't actually required in this pricing period? - BARNZ |

161. WIAL currently operates its aviation activities under a number of dispensations granted by the CAA. The CAA is in the process of reviewing Civil Aviation Rule (**"CAR"**) 139 (the civil aviation regulations under which WIAL operates). The CAA's Notice of Proposed

[25] WIAL Substantive Submission, 6 July 2012, page 51

Rule Making (NPRM[26]) confirms that International Civil Aviation Organisation (**"ICAO"**) Annex 14 standards will be included into CAR 139 as appendices. During the submission process CAA confirmed that WIAL would have to apply for dispensations once the revised rule came into force. Noting CAA's desire to become compliant with ICAO standards it is probable that any future dispensation granted to WIAL would also include a transition period to achieve full compliance.

162. WIAL's considered view that the dispensations will progressively be reduced over time and its position to consequently allow for a prudent and modest forecast for compliance expenditure in this pricing period is an appropriate approach.

163. The majority of the $3.5 million capital expenditure works are to improve or achieve compliance for Code C aircraft and above:

- Part of Calabar Road falls within the 300m strip (required for precision approach airports such as Wellington) and taxiway wing tip clearance for Code E aircraft. The relocation of Calabar Road achieves runway strip compliance for precision approach by Code C and above aircraft and provides compliant Code E wingtip clearance. The relocation of Calabar Road requires the purchase of certain houses and a provision of $1.5 million has been forecast for this purpose..
- $1.9 million has been allowed for installation of jet blast deflectors and to strengthen the existing subway. Jet blast deflectors on Cobham Drive are required to enable the removal of the 60m roll forward on take-off on runway 16 for Code D and E aircraft. The subway strengthening will ensure on-going structural integrity for larger aircraft and ensure the subway meets new building standard earthquake resilience. This capital expenditure is a modest investment to ensure the current facilities can be utilised by all aircraft types that are presently using the airport.

164. In addition to this expenditure WIAL has forecast expenditure of $1.9 million to overlay the taxiway. This is required as the last overlay was undertaken in 2002. The existing taxiway to runway separation is 106.7m. It is therefore not compliant with Code C (168m for instrument), Code D (176m for instrument), and Code E (182.5m instrument and 107.5 non-instrument) requirements.

165. During the next taxiway overlay it is proposed that the taxiway centreline be moved 0.8m further away from the runway to improve compliance for Code C, D and E aircraft for instrument conditions and achieve compliance for Code E under non-instrument conditions.

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| [26] **630 ICAO – Part 139 review (8/CAR/3)** | To amend the Rules so New Zealand is compliant with ICAO standards, where differences were identified by the ICAO safety oversight and security audits in late 2006.<br>**Project Start Date: Nov 2007** | ▪ Processing submissions.<br>▪ RIS development in process. | **Public Consultation**<br>▪ Preparation of Summary of Submissions<br><br>**Next Milestone:** Draft final rule to MoT<br>**Expected Delivery Date:** Dec 2012 |

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| Q10: | What impact will the incentive scheme have on investment and revenues for the non-aeronautical activities? – WIAL |

166. Refer to paragraphs 76 to 83 above.

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| Q11: | WIAL noted that the runway congestion charges are likely only to have an impact on nine-seat aircraft. What impact do airlines think the congestion charges will have on the availability of nine-seat services at peak times? |

167. WIAL considers that the airlines are likely to comment that nine seat aircraft will be discouraged from landing during peak periods. However, this is in fact the outcome that WIAL is endeavouring to achieve from the introduction of a congestion pricing approach. WIAL wishes to avoid a situation where, for example, a larger aircraft carrying a greater number of passengers cannot land in the peak period because the smaller aircraft occupies a landing slot. Allocative efficiency will be enhanced if the maximum number of passengers benefit from use of a scarce landing slot.

168. WIAL wishes to re-emphasise the basis for the congestion charges that have been established by WIAL for the pricing period:

- The economic rationale for congestion charging suggests that a fixed charge should be applied to all aircraft utilising the runway during peak periods.
- WIAL has not applied a fully fixed charge approach as its intent for this pricing period is to send a modest signal to airline customers regarding runway congestion.
- Congestion charging is being introduced gradually during the pricing period and does not commence until the second year of the pricing period and gradually increases from this year.
- For example a fixed charge of $20 (in addition to the charges per tonne and passenger) is introduced in the second year of the pricing period increasing to $80 by the end of the pricing period. This level of fixed charge is modest even for a nine seat aircraft in the first year it applies. However, it will have a more significant impact on smaller aircraft as the fixed charge increases over time.

169. As previously submitted, it must be noted that the congestion charging does not increase WIAL's revenue in total as any increase in revenues from higher charges in peak periods is offset by lower revenues and charges in off peak periods. That is, it is a zero sum total equation.

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| Q12: | What benefits would the provision of further information on costs and revenue for non-aeronautical services provide? |

170. WIAL is unclear how the publication of other information on the unregulated activities will assist the Commission to monitor the regulated activities which is the requirement contained in section 53D of the Act. WIAL would be concerned if other price or performance information, beyond that already made public, was required to be published for the unregulated services that WIAL provides in competitive markets.

171. In particular:

- Section 53D(2) provides that consolidated information may only be required if it assists the Commission to monitor compliance with information disclosure requirements applying to regulated goods or services.
- Section 53D(3) provides that the Commission may require consolidated financial information for unregulated services and this is required, and provided, in Schedule 8 of the annual information disclosures.

172. The Act therefore does not provide the option for information on non-regulated services to be included in information disclosure unless it is necessary to achieve the regulatory requirements for regulated services. WIAL notes that this question is derived from consideration of the sharing of efficiency benefits. WIAL has provided comment on the scope of regulation as it relates to the sharing of incentives in this submission at paragraphs 84 to 90 above.

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| Q13: | We discussed the extent of runway capacity issues. To what extent are there capacity constraints for parking and check-in desks at WIAL, and could alternative market mechanisms (other than congestion charging) be used to manage this capacity? |

173. WIAL is not using congestion charging to manage capacity constraints in parking and check in facilities and is applying a market based mechanism to establish a charge for these services.

174. WIAL has introduced time based charging to encourage efficient airline use of the facilities with pricing established from reference to other airport charges for these services. WIAL's rationale to introduce time based charging for each of these services is slightly different to that for the runway.

175. WIAL has limited land available for aircraft parking gates and development of further gates requires a lengthy period of consultation, planning and construction and will have high costs of construction (due to the "brownfields" nature of construction at WIAL). WIAL is therefore seeking to encourage efficient use of the existing gates by charging airlines where aircraft remain at the gates for longer than an efficient aircraft turnaround period. That is, there is no charge for aircraft that disembark then board aircraft and depart within the standard turnaround times. WIAL is therefore seeking to maximise the use of its existing facilities by incentivising airlines to occupy aircraft gates only for the time that is necessary.

176. The capacity of check in facilities is sufficient for existing customers but the previous fixed licence arrangements precluded WIAL from being able to provide check in facilities to an alternative or new airline seeking use of the facilities. WIAL does not consider that it is efficient if it has to turn other airlines away because it cannot provide check in facilities when they are not being utilised by the existing scheduled airline operators.

177. A time based approach therefore enables WIAL to ensure that facilities can be made available for other users and avoid the requirement for construction of additional check in facilities to accommodate other users. It also prevents airline customers with licence agreements providing dedicated check in facility use from inhibiting prospective competitor use of the facilities. For example, if an airline wished to operate a trans-Tasman service with a wide-body aircraft they would require as many as 9 check-in

counters depending upon the carrier and the nature of the service offered. In the previous fixed licence user check-in environment WIAL would have been unable to accommodate this growth without incurring the additional cost of constructing new facilities. However, with the ability for airlines to share facilities under a pay by the hour system, the complementing peaks and troughs relating to the different timings of services provide the ability to accommodate growth during the times in which existing services do not require check-in counters.

178. WIAL also notes that this income is part of the total required revenue and therefore any increase in revenue forecast from these services was offset against the total revenue requirement before landing and terminal charges were established.

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| Q14: How should airports treat the cost of litigation? |

179. Litigation costs are unfortunately one of the operating costs facing WIAL. In forecasting its operating costs it considered that there was a strong likelihood that such costs would be incurred and consequently it was reasonable that they be included in the operating cost forecasts.

180. This assumption was based on past precedent. WIAL has incurred litigation costs in past years with Air NZ in particular over outcomes from consultation and pricing. WIAL has appropriately defended its actions where Air NZ filed proceedings, or has issued proceedings where Air NZ has withheld payment.

181. WIAL has appropriately defended its position in each of these instances and it considers that the costs are an appropriate cost of WIAL's regulated business.

182. For the Commission's information many of these costs have historically not in fact been recovered by WIAL as litigation has commenced after prices have been reset and WIAL has not sought to reclaim these costs from future prices.

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| Q15: What do airports expect would be in the Commission's s 53B summary and analysis reports? |

183. WIAL considers that the 53B summary and analysis reports would provide the opportunity for the Commission, airports, airlines and other interested parties, to work together to ensure that airports continue to meet the Part 4 purpose statement. The Commission's reports will assist this process by:

- Providing the airports with the Commission's views on how information disclosures may be modified and improved;
- Providing an objective view of airport performance and achievement of the Part 4 objectives;
- As future disclosures are prepared this will provide greater clarity to the airports, and other interested persons, as to how airports performance will be assessed and considered by the Commission. This will enable airports, shareholders and investors, to develop greater understanding and consequently improved confidence to commit to future investment programmes; and

- Advising areas where the Commission may be concerned that airports are not meeting the Part 4 purpose statement

184. WIAL would then have the opportunity to provide further explanation to the Commission in respect of any concerns raised by the Commission or modify behaviour where appropriate.

185. For example:

- If the Commission's concerns were in respect of the content of the information disclosures, or in respect of WIAL's service quality achievements WIAL would have the opportunity to respond immediately to the Commission's concerns.

- If the Commission's concerns were in respect of WIAL's financial outcomes and therefore were influenced by pricing WIAL could consider whether a new AAA price setting process should be commenced, or future action in the following pricing period should be considered. Commercial agreements that WIAL had in place, or maybe developed since, would likely also influence future outcomes and respond to any concerns raised by the Commission.

186. WIAL also notes the discussion at the Conference around prospective WIAL action should the High Court findings in the Merits Review result in changes (or not) to the IM's.

187. As noted above concerning the Commission's section 53B report, WIAL would have to consider prospective actions that were available to it by taking into account all of the information that was available at that time. WIAL would likely have the benefit of the High Court findings, the Commission section 53(B) reports, actual performance from a greater number of information disclosures including cumulative performance over a number of periods. WIAL would have to consider all of this information before it could consider whether short or long term pricing action was necessary (with WIAL always being cognisant of the ongoing reporting of its performance within the IM framework, whether as initially determined by the Commission or as amended by the High Court).

188. A collaborative approach will ensure that airports continue to meet the Part 4 objectives while preserving the benefits of light handed regulation as highlighted in the report by Sapere Research Group, which was provided with WIAL's cross submission on the process and issues paper.

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| Q16: | Interrelationship between ID, s 56G reports and CC's IMs? How can the Commission carry out its task under s 56G if it cannot consider input methodologies? |

189. WIAL considers that ID, s56G reports, the IMs and AAA have a strong interrelationship. As noted earlier, WIAL considers that the Commission can carry out is s56G review despite IMs not being required to be applied in price setting.

190. We have provided further comment in paragraphs 47 to 56 of this cross submission.

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| Q17: | How should airports treat the cost of Part 4 judicial review and merits appeals litigation? |

191. As noted above in question 14, where it is probable that costs will be incurred, WIAL has forecast these as part of consultation.

192. At the time the cost forecast was prepared for pricing, it was expected that the merits and judicial review would proceed and consequently the costs have been included in the forecast. These costs were expected to be incurred as part of the regulated business.

## Appendix 1 – Terms of 2007 Revaluation Wash Up

<u>Extract from WIAL 2006/07 Pricing Consultations with Airlines – Final Pricing Proposal – 9 May 2007- pages 49-51</u>

While recognising reservations as to both the practicality and theory of the BARNZ proposal, WIAL reiterates that it is not averse to a wash-up. On this occasion and to address the specific circumstances of this time, WIAL proposes an alternative wash-up mechanism for this upcoming pricing period (2007 – 2012). WIAL believes that this mechanism specifically addresses the erroneous claim raised by BARNZ adviser, Dr Layton (NZIER), that WIAL was deliberately understating forecast growth in asset values in the absence of a wash-up in order to achieve unexpected valuation gains in the future.

The alternative mechanism is described below (using land as the illustration).

- WIAL's valuation at 31 March 2006 is the commencing valuation.
- WIAL's revaluation forecasts will be retained in the pricing model. WIAL reaffirms the appropriateness of these assumptions following a further review which has been undertaken by its valuers.
- WIAL will provide the airlines with a pricing credit in the next pricing period (2012-2017) in the event that its forecasts differ from revaluation outcomes (in accordance with asset valuations undertaken by WIAL's valuers using the same valuation methodologies as in the 2006 Valuation), working as follows:
    - ✈ If the compounding growth rate (CGR) in actual valuation movements between 30 June 2007 and the date of the valuation used for the next pricing period is more than 2.5% pa but less than 6.4% pa, WIAL will credit the airlines in the next pricing period the difference between its forecast and the actual outcome.
    - ✈ WIAL assumes valuation risk if actual revaluations are less than 2.5%pa. compounding – i.e. WIAL takes the downside risk.
    - ✈ If actual valuation movement is greater than 6.4%pa compounding, WIAL retains the net gains over 6.4% pa - i.e. WIAL takes the marginal upside benefit beyond that forecast by BARNZ.

WIAL offers the same procedure with civil works/buildings valuations; albeit with 5.0%pa. and 5.5%pa. bands (reflecting WIAL's assumption in the pricing model and BARNZ proposed growth rate). Albeit, the wash up calculation would reflect the total outcome from all asset categories.

In short, WIAL will credit airlines in the next pricing round (2012 – 2017) to the extent of forecasts proposed by the airlines in this consultation. Airlines bear no downside risk.

WIAL notes that the starting asset values used in the pricing model are actually the values adopted on 31 March 2006. For purposes of this wash-up mechanism and to ensure that that mechanism properly matches the next pricing period, the starting values as at 30 June 2007 would be adjusted by applying WIAL's forecast growth rate in asset values (eg: 2.5% pa for land) to the values as set on 31 March 2006. WIAL would then determine finishing wash-up benchmark values for 31 March 2012 by applying compound growth rates from 30 June 2007. Those finishing wash-up benchmark values will then be compared to actual valuations at that time. The wash up arrangement is illustrated in Appendix 9.

Under this procedure WIAL's finishing valuation for the purposes of the wash-up will be the next period starting valuation for price setting for that period. The valuation will be the subject of consultation for the next pricing period as will the spreading of any credit due from this wash-up mechanism.

Since there is no liability for airlines under this arrangement, no formal agreement is required between the airlines and WIAL for this proposal to operate. WIAL believes that it would prove difficult to secure satisfactory contractual commitments from each of the current airlines, or any new operators that commence at WIAL over the next five years, to underwrite potential future liabilities that may arise from a full "unders and overs" wash-up.

WIAL considers that its proposal leaves some valuation risk with WIAL, which it considers is appropriate, while assuaging the airline concerns raised through this consultation that WIAL is deliberately understating its forecast valuation movements.

Appendix 10 from WIAL 2006/07 Pricing Consultations with Airlines – Final Pricing Proposal – 9 May 2007

| Adjusted Wash Up Start Up Value at 1 July 2007 | Annual Increment | Value 31/03/06 | No of Years of Revaluation | Adjusted Value at 01/07/07 |
|---|---|---|---|---|
| Adjusted start up value for wash up | 2.50% | 129000 | 1.25 | 133,044 |

| Base Parameters | Average Revaluation Increment per Year | Opening | No of Years of Revaluation | Forecast Value At End of Period |
|---|---|---|---|---|
| | | $000 | | $000 |
| WIAL Land Revaluation Assumption | 2.50% | 133,044 | 4.75 | 149,600 |
| BARNZ Land Revaluation Assumption | 6.40% | 133,044 | 4.75 | 178,635 |

| Scenario #1 Actual revalution < 2.5% pa | Average Revaluation Increment per Year | Opening | No of Years of Revaluation | Forecast Value At End of Period |
|---|---|---|---|---|
| | | $000 | | $000 |
| Actual outcome | *1.00%* | 133,044 | 4.75 | 139,483 |
| WIAL Loss during pricing period - not recoverable | | | | -10,118 |

| Scenario #2 Actual revalution > 2.5% pa but < 6.4% pa | Average Revaluation Increment per Year | Opening | No of Years of Revaluation | Forecast Value At End of Period |
|---|---|---|---|---|
| | | $000 | | $000 |
| Actual outcome | *4.00%* | 133,044 | 4.75 | 160,289 |
| Credit to be applied to airlines in next pricing period | | | | 10,688 |

| Scenario #3 Actual revalution > 6.4% pa | Average Revaluation Increment per Year | Opening | No of Years of Revaluation | Forecast Value At End of Period |
|---|---|---|---|---|
| | | $000 | | $000 |
| Actual outcome | *8.00%* | 133,044 | 4.75 | 191,760 |
| Total Valuation Uplift Above WIAL forecast | | | | 42,159 |
| Credit to be applied to airlines in next pricing period | | | | 29,035 |
| Value able to be retained by WIAL | | | | 13,124 |

## Appendix 2 – Telfer Young Advice on Valuation Input Methodology