BARNZ CROSS-SUBMISSION TO SUBMISSIONS MADE ON THE COMMERCE COMMISSION'S SECTION 56G ISSUES PAPER RELATING TO AUCKLAND AIRPORT

9 November 2012

Section 56G requires the Commission to *'report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services'.* It is against the outcomes specified in section 52A that the Commission must assess the effectiveness of information disclosure in terms of whether or not, or the degree to which, it has promoted the section 52A purpose.

BARNZ notes that the Commerce Commission has structured its draft report on Wellington Airport under the outcomes section 52A identifies, asking:

- Is [the] Airport operating and investing in its assets efficiently?
- Is [the] Airport innovating where appropriate?
- Is [the] Airport providing services at a quality that reflects consumer demands?
- Is [the] Airport sharing the benefits of efficiency gains with consumers, including through lower prices?
- Do the prices set by [the] Airport promote efficiency?
- Is [the] Airport earning an appropriate economic return over time?

BARNZ has therefore organised this cross-submission to the submission made by Auckland Airport utilising the same headings and order as adopted by the Commerce Commission in its draft Wellington Report.

This cross-submission is made on behalf of:

- The 'international-only airlines'[1] which BARNZ has written authority under s2A of the Airport Authorities Act 1966 to represent during consultation over charges with Auckland Airport, in its entirety.
- The Air NZ Group, in relation to all matters other than comments on the level of the domestic passenger charge and the need to review the airfield MCTOW curve.

[1] These are the airlines which had authorised BARNZ under section 2A of the AAA to represent them in consultations with airports under section 4B and 4C of the AAA. As at the 7th of June when AIAL set its charges these airlines were Air Calin, Air Pacific, Airwork, Air Tahiti Nui, Air Vanuatu, Cathay Pacific Airlines, China Southern Airlines, Emirates, EVA Airlines, Fieldair Holdings/Air Freight, Korean Air, LAN Airlines, Malaysia Airlines, Virgin Australia, Singapore Airlines, Tasman Cargo Airlines and Thai Airways International.

Is Auckland Airport Investing in its assets efficiently*?*

BARNZ has acknowledged in its main submission that it considers the capital expenditure Auckland Airport included in the financial model on which it has set charges in the second PSE is both reasonable, and is more efficient than the expenditure which was forecast in the first price setting event, where concerns were held by airlines over the early construction of the first stage of the Northern Runway and the proposed construction prior to the Rugby World Cup of a large arrivals processing area upstairs extending across the forecourt and into the car-park.[2] The only contentious issue which BARNZ is currently aware of with regards to forecast projects is the concern held by the Cargo Terminal Operators that there is no secure road from their cargo premises to the airside apron where cargo is loaded onto aircraft. Consultation continues in relation to the location and design of a new terminal facility for domestic operations, with the outcome as yet unknown.

BARNZ considers that for Airports, the mid-point WACC estimated by the Commerce Commission provides more than sufficient incentive for the Airport to innovate and invest and there is no need to allow a higher WACC for *ex ante* modelling as the Commission has permitted for electricity line and gas pipeline businesses. This is because, not only do Airports receive a return on and of the aeronautical capital invested, they also earn significant retail and car-parking revenue from passengers passing through the Airport. In 2012 Auckland Airport earned $166m from its retail and car-parking revenues or 39% of revenue earned by the Airport. Retail and car-parking activities contributed 46% ($153m) of Auckland Airport's after tax profit.[3] The Airport has indicated that it earns approximately $19 in retail and car-parking revenue for every international passenger passing through the Airport.[4]

The use of a 75th percentile WACC, or the 9.16% WACC targeted by Auckland Airport, would both create a very real risk that the Airport is over-incentivised to invest.

Is Auckland Airport operating its assets efficiently*?*

In its submission BARNZ raised concerns over the 27% increase in per passenger operating expenses at Auckland Airport over the last pricing period, from $3.86 per passenger in 2007 to $4.89 per passenger in 2012.[5] Over this period passenger volumes increased by approximately 19%, suggesting no economies of scale were achieved by the Airport. Operating costs are forecast to remain relatively constant on a per passenger basis over the next five years. BARNZ considers that there are serious questions over the efficiency of Auckland Airport's operating costs as at the commencement of the pricing period.

BARNZ does not accept the statement by Auckland Airport that its operating cost forecasts are conservative.[6] In BARNZ's view, the 2012 base year upon which Auckland Airport forecast its costs

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[2] Refer responses to questions 4.1 and 4.3 in BARNZ 18 October 2012 Submission.
[3] Refer Auckland Airport Annual Report for year ended 30 June 2012, at page 55. Note some of the figures referred to at page 8 of BARNZ's 18 October 2012 submission were 2011 figures from page 56 of AIAL's Annual Report, and therefore understated the level of retail revenue.
[4] Refer Auckland Airport Annual Report for year ended 30 June 2012, at page 107.
[5] Refer responses to questions 4.2 and 4.4 in BARNZ 18 October Submission.
[6] Refer page 82 of Auckland Airport Submission on the s56G Process and Issues Paper.

for the next pricing period, is not an efficient starting point. Rather, it incorporates some extremely large increases in operating costs which occurred in the preceding few years, and therefore provides the Airport with the ability to make efficiency improvements in the near term and retain the resulting savings. While BARNZ acknowledges that one of the outcomes of a fixed allowance for operating expenses is the creation of an incentive to improve efficiency due to the supplier being able to retain any cost savings achieved during the pricing period, this system also creates a perverse incentive for suppliers to increase operating costs in the final year or two of a pricing period (or defer or bring forward maintenance into the final year of a pricing period) so as to forecast costs going forward from a higher starting point and therefore enable 'savings' to be achieved during the early years of the new pricing period for the benefit of the supplier.

Is Auckland Airport innovating where appropriate?

As outlined in section 5 of BARNZ's 18 October Submission on the Issues Paper, there is a significant level of comfort among the BARNZ represented airlines over Auckland Airport's degree of innovation and current willingness to respond to airline led innovation.[7] While this is seen as being attributable to a focus by Auckland Airport management on innovation and improvement rather than as directly resulting from information disclosure regulation, information disclosure regulation is not seen as having harmed the incentive on the Airport to innovate.

Is [the] Airport providing services at a quality that reflects consumer demands?

As outlined in section 6 of BARNZ's 18 October Submission on the Issues Paper, there is a significant level of comfort among the BARNZ represented airlines over the quality of terminal and airfield facilities and services and the current responsiveness of the Airport to matters of quality raised by airlines. However, BARNZ represented airlines did express a desire for improved facilities for staff working at the airport. In addition, BARNZ notes that the Air Cargo Council and Cargo Terminal Operators have a different perspective with respect to the quality of cargo facilities.

Is [the] Airport sharing the benefits of efficiency gains with consumers, including through lower prices?

In its submission Auckland Airport has noted that it is sharing actual and expected efficiency gains with consumers, including through lower prices. In particular, the Airport refers to the recent reduction in charges per international passenger.[8]

While appreciated, and welcomed, by the international only airlines BARNZ represents, BARNZ does not agree that the recent reduction to average international charges was due to efficiency gains being shared with consumers. Rather, the reduction to average international charges was due to the

[7] BARNZ notes that the Air Cargo Council and Cargo Terminal Operators have a different view with respect to the willingness of the Airport to innovate in relation to cargo facilities.
[8] Refer para 475 of Auckland Airport Submission on the s56G Process and Issues Paper.

cessation of the previous practice of direct costs associated with the domestic terminal being met through the international PSC charge. As the domestic PSC was introduced at the beginning of the new pricing period, the purported justification for retaining international charges at their previous levels disappeared.

The reduction in average international passenger charges in FY13 amounted to 58 cents per passenger. The increase in average domestic passenger charges in FY13 was equivalent to $1.32 per international passenger.[9] This indicates that the Airport did not fully pass on the effect of this cross-subsidy ceasing. In 2007 consultation information indicated that the cross-subsidy of direct domestic costs amounted to approximately $1 per international passenger if overheads were excluded or approximately $2 per international passenger if overhead costs were included. The 58 cent reduction in the international passenger charge is thus directly attributable to domestic terminal charges now meeting the direct costs of domestic terminal services – and is not a result of the benefit of efficiency gains being shared with consumers.

BARNZ continues to hold the view that there is no evidence that the prices set by Auckland Airport reflect any efficiency gains. What gains the Airport has been able to make in some areas have just been absorbed into increased costs in other areas, with the result that the operating expenses reflected in prices going into the new pricing period are 27% higher per passenger than they were at the beginning of the first pricing period. This is despite the fact that a 19% increase in passenger volumes occurred over the same period.

Do the prices set by [the] Airport promote efficiency?

In the view of BARNZ represented airlines, the Airport receives a mixed score card on this question. On the one hand, it has to be acknowledged that there have been improvements in some areas, with aspects of the pricing structure adopted in the second PSE being more likely to promote efficiency than was previously the case under the old pricing structure. However, the BARNZ represented airlines consider that there is still some way to go:

- The introduction of a domestic passenger charge is considered to improve the efficiency of the charging structure. This was strongly supported by the BARNZ represented airlines during consultation, however these airlines consider that the level at which the charge has been set is approximately 10% too low, and while covering all incremental costs of domestic terminal activities, will not result in domestic activities making an appropriate contribution to common costs and overheads. The BARNZ represented airlines consider that domestic activities should be meeting at least 15% of terminal common costs and overheads.[10]

[9] Auckland Airport's Airline Pricing Investor Presentation, 7 June 2012, slide 6.

[10] This is based on domestic terminal floor space being 15% of total terminal floor space. An alternative would have been to use passenger volumes as a proxy, which would result in approximately 44% of terminal common costs and overheads being allocated to domestic activities. A 15% allocation of common costs (as was sought by BARNZ represented airlines) is therefore very favourable to domestic operators. Auckland Airport, however, did not even allocate this level of common costs to domestic terminal charges.

- The move to hourly based counter charges should provide improved pricing signals to airlines and ground handlers regarding the time counters are occupied (although staff costs meant that incentives already existed to ensure counters were used efficiently). However, this is a double edged sword, as, if airlines or ground handlers reduce the time check-in is open, or the number of counters which are open, too much, then this can create significant queues and congestion in the check-in area and ground floor.

- The termination of the Terminal Services Agreement creates additional incentives to improve efficiency in some ways, yet will also reduce the sharing of efficiency gains with airlines. The annual wash-up provision in the TSC Agreement was not liked by some airlines because they considered it diminished the incentive on the Airport to contain costs due to the ability to pass them on through the TSC. However, at the same time, other airlines valued the TSC because it enabled airlines to share in the benefits of increased volume through reduced unit charges for international terminal costs in years where significant growth occurred. The TSC was also a transparent mechanism for airlines to make price-quality trade-offs, with such decisions occurring regularly during each year on issues such as the level of after-hours engineering support or remote bussing support or the speed and degree at which refurbishment of air-side areas should occur. This mechanism for making regular price-quality trade-offs is now missing from Auckland Airport's pricing structure.

- At the conclusion of consultation, Auckland Airport advised BARNZ that it considers that the International Passenger Charge contributes to common airfield costs such as lighting, electricity networks, roading, rescue fire costs and storm-water. This view was not expressly articulated by Auckland Airport until the eve of its charges being set and is repeated at paragraph 386 of Auckland Airport's Submission on the Issues Paper. It is not considered appropriate or efficient by the international only airlines represented by BARNZ. BARNZ had understood that Auckland Airport was maintaining a MCTOW basis for its airfield charges as its advisor Estina recommended, and, if the BARNZ represented airlines had appreciated that the Airport intended to effectively supplement this with a per passenger charge on international passengers, then the response of the BARNZ represented airlines would have been that there should be a per passenger airfield charge in addition to the MCTOW charge for <u>all</u> passengers. A domestic jet passenger receives just as much benefit (and requires the same level of service) for runway lighting, rescue fire, storm-water and roads as an international jet passenger does.

- The continuation of the lower MCTOW charge for aircraft under 30 tonnes[11] does not promote efficient use of the airfield at busy times as it results in a lower per passenger charge for smaller aircraft, thereby potentially[12] incentivising the greater use of smaller aircraft rather than larger aircraft. The international-only BARNZ represented airlines consider that a standard MCTOW rate should apply to all aircraft, regardless of size. It is

[11] The MCTOW rate for aircraft under 30 tonnes is approximately 62% of the MCTOW rate for aircraft over 30 tonnes.
[12] It has to be acknowledged that market demand forces are also relevant to the size of aircraft deployed on particular routes.

acknowledged that Auckland Airport has undertaken to review its MCTOW pricing curve ahead of the next pricing event in 2017.

- Auckland Airport has removed the costs of undertaking its noise mitigation programme from airfield charges, instead indicating it intends capitalising them as an asset held for future use associated with the Northern Runway. BARNZ considers that this does not send efficient signals regarding the cost of operating the airport today. The noise mitigation programme, in BARNZ's view, is inextricably associated with current airport operations and is a cost incurred in the provision of specified airport services right now.

Is [the] Airport earning an appropriate economic return over time?

The calculation of the economic return earned by Auckland Airport is complicated by the Moratorium on asset revaluations adopted by the Airport in 2007 as it set its prices. The effect of this Moratorium is that:

- The asset base on which charges were set (which includes the 2006 revaluations, adjusted for subsequent investment, depreciation and allocation changes) is considerably lower than the disclosure asset base (where land was revalued in 2009 and 2011 and specialised assets indexed forward with CPI).
- The regulatory income forecast by the Airport in its financial pricing model is lower than the disclosure income because it does not include any income from revaluations.

In BARNZ's view it is extremely important that a consistent approach be taken to the income and the asset base when assessing the returns earned by an Airport:

- If the returns being measured are those forecast in the Airport's pricing financial model which were determined using the Moratorium asset base, then the asset base on which the level of profitability is to be assessed should also be the Moratorium asset base.
- If, on the other hand, the returns being measured include the revaluations incorporated within the disclosure statements, then the asset base on which the level of profitability is to be assessed should be the Disclosure asset base.
- It would not be appropriate to take the revenue from a building block model with the Moratorium asset base as its input with no forecast revaluations, and measure the profitability using the revalued Disclosure asset base.

BARNZ notes that there is not always consistency between the revenue being measured, and the asset base against which it is measured, in Auckland Airport's submission. For example, at paragraph 173 of its submission Auckland Airport alleges that the Information Disclosure under the Airport Authorities Act (AAA) shows that it earned returns of 4.5% in FY08 and FY09 and only 1% in FY10[13]. This comparison is not valid. The asset base adopted by Auckland Airport for the purposes

[13] In addition, BARNZ questions the validity of Auckland Airport's claim that it only earned a return of 1% return in FY10. This is only the case if the non-cash adjustment made by the Airport for the depreciation changes to buildings is treated as a loss. Auckland Airport earned $184m of revenue from aeronautical charges in FY10, which is $11m more than was earned in FY09 and $25m more than in FY08. The return

of the AAA disclosures was an MVEU valuation – which is significantly higher than the MVAU valuation the Airport used to set charges, and which BARNZ has acknowledged it considered was, on the whole, reasonable. Comparison with the higher MVEU valuation disclosed under the AAA will naturally understate the level of return actually earned.

Similarly, at paragraph 174 Auckland Airport compares its revenue excluding revaluations for FY11 (in other words the Moratorium based revenue) as against the Part 4 Disclosure asset base (which includes FY11 land revaluations and CPI indexing of specialised assets) and claims a 5.8% return. This is an inconsistent comparison. The valid comparison of the Moratorium based revenue is against the Moratorium asset base.

Of particular concern to BARNZ is Auckland Airport's indication that it intends to continue disclosing its returns this way – ie including and excluding revaluations. BARNZ considers that this has the potential to be highly misleading, as it will result in returns that exclude revaluations being compared against a revalued asset base. If Auckland Airport intends to supplement its disclosures, then it needs to be very careful to ensure that interested persons are not inadvertently misled. Any additional disclosure of returns excluding revaluations should be against an asset base which similarly excludes revaluations.

In the simplest terms, if one is measuring revenue which includes revaluations, then it should be compared against the revalued asset base. However, if one is measuring revenues which exclude revaluations, then it should be compared against the unrevalued (ie the Moratorium) asset base. It is completely inappropriate to measure returns which exclude revaluations against an asset base which includes revaluations.

The analysis undertaken by BARNZ during consultation, which was updated to reflect Auckland Airport's final pricing model and the Commission's 1 July 2012 WACC estimates, has excluded any actual or forecast revaluations and is based on the Moratorium asset base (which also excludes any revaluations post 2007). BARNZ's analysis has therefore taken a consistent approach to the revenue and asset base, with both excluding revaluations post 2007. This analysis indicates that:[14]

- At a mid-point WACC of 6.49% the charges set by Auckland Airport are likely to result in a post-tax NPV positive outcome to Auckland Airport of \$85m on its pricing asset base over the five years. This will result in airlines paying \$147m too much in charges over that period.
- At a 75th percentile WACC of 7.48%[15] the charges set by Auckland Airport are likely to result in a post-tax NPV positive outcome to Auckland Airport of \$45m on its pricing asset base

earned by the Airport in FY10 should be expected to be at a similar level to that of surrounding years. If the adjustments to building depreciation were truly fully treated as a loss in FY10, then one has to question why the Airport is now including the additional tax it has to pay on non-deductible building depreciation within the building block model on which charges are set, and ask whether the Airport is not recovering the effect of this change to tax laws twice over.

[14] Refer BARNZ response to question 3.5 at pages 11 to 17 of BARNZ's Submission on the Auckland Airport Section 56G Issues paper, 18 October 2012.

[15] Which the BARNZ represented airlines consider is too high as the substantial complementary retail and car-parking revenues able to be earned by airports as a result of the specified airport services they provide mean that there is no need to allow a return at the 75th percentile in order to incentivise investment.

over the five years. This will result in airlines paying $82m too much in charges over that period.

BARNZ considers that the more relevant figure is how much more airlines pay in charges (rather than the post tax NPV outcome to the Airport). The additional amount paid by airlines in charges is the figure which will ultimately impact on consumers in terms of the costs to them of travel or of air freight.

The Airport has indicated that its overall level of return targeted is 8.5%. However this is not evenly spread across all activities. Virtually all of the over-recovery is attributable to terminal activities, where the Airport's charges will result in a return in the vicinity of 11%. All of this excess terminal revenue comes from the terminal charges levied on international airlines on a per international passenger basis.

In the view of the BARNZ represented international-only airlines, Auckland Airport has set charges so as to earn excessive returns in relation to its international terminal activities. Charges for international services are being set significantly too high – both so that the Airport is able to meet some of the costs which should properly be met by other activities such as domestic terminal facilities and airfield facilities and so that the Airport can earn excessive profits.

Overall Conclusion

The BARNZ represented airlines consider that, in the case of Auckland Airport, while some of the purpose elements specified in Part 4 are being achieved (either by information disclosure or because of a pre-existing focus by Auckland Airport management on these matters), in other key areas information disclosure has not been able to effectively promote the outcomes sought under section 52A. Most significantly, the Airport has continued to set charges at a level which enables excess returns to be earned, indicating that information disclosure, by itself, is insufficient to promote the long term benefit of consumers.

Recapping the key questions which the Commission worked its way through in its draft report on Wellington Airport:

Question Posed Under section 52A	View of BARNZ Represented Airlines
Is Auckland Airport investing in its assets efficiently?	In the second pricing period, to date, yes.
Is Auckland Airport operating its assets efficiently?	Significant concerns are held over the efficiency of the 2012 operating costs which are used as the base on which opex is forecast for the second pricing period. Despite a 19% increase in passenger volumes over the previous pricing period, there was a 27% increase in per passenger operating expenses, which significantly exceeds inflation.
Is Auckland Airport innovating where appropriate?	In the second pricing period, to date, yes.

Is Auckland Airport providing services at a quality that reflects consumer demands?	In the second pricing period, to date, yes.
Is Auckland Airport sharing the benefits of efficiency gains with consumers, including through lower prices?	No evidence of the sharing of efficiency gains through lower prices has been seen. While such sharing was previously able to occur in relation to international air-side facilities through the TSC mechanism, this has now been discontinued by Auckland Airport.
Do the prices set by Auckland Airport promote efficiency?	The Airport receives a mixed score-card on this question: • The new domestic passenger charge, the removal of the pass-through element previously inherent in the TSC and the move to hourly based counter charges should all promote efficiency. • The continuation of a lower MCTOW rate for aircraft under 30 tonnes fails to send appropriate pricing signals regarding the efficient use of the airfield at busy times. • The non-inclusion of noise mitigation costs associated with current airfield operations and the top-up of airfield costs through international passenger charges both fail to send appropriate pricing signals to airfield users regarding the cost of using the airfield.
Is Auckland Airport earning an appropriate economic return over time?	The charges set by the Airport will result in airlines paying $147m too much in charges over the next five years, which will result in a NPV positive post-tax outcome of $85m to Auckland Airport at the Commerce Commission's latest mid-point WACC.

The purpose of Part 4 is to achieve outcomes which ensure that suppliers have sufficient incentives to invest and innovate and improve efficiency, while at the same time ensuring that suppliers share the benefits of efficiency gains with consumers (including through lower prices) and are limited in their ability to extract excessive profits from consumers.

BARNZ does not consider that information disclosure regulation under Part 4 has been able to effectively achieve this purpose in the case of Auckland Airport, which has continued to set charges containing substantial levels of monopoly profits.