



**SECTION 56G REVIEW OF AUCKLAND AIRPORT
SUBMISSION ON COMMERCE COMMISSION DRAFT REPORT**

31 MAY 2013

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EXECUTIVE SUMMARY

1. Auckland Airport has implemented a change in culture through the course of the development of information disclosure ("**ID**") regulation which sees us much more heavily focussed on meeting customer needs and pursuing strategies that will boost the New Zealand economy. We are committed to further embedding the objectives of Part 4 of the Commerce Act 1986 into our corporate culture, values, policies and decision making. Throughout this process, our relationship with our customers continues to evolve and improve.
2. These changes have seen Auckland Airport transform from a company that builds infrastructure to a sales-led organisation focused on driving economic growth for the benefit of New Zealand through making journeys better.
3. Auckland Airport's commercial goals have positive consequences which deliver significant benefits for our airline customers, passengers, and the New Zealand economy. Our pricing vision of rewarding growth helps to drive:
 - (a) an increased choice of destinations for passengers, in addition to world-class quality services;
 - (b) tangible efficiencies and growth-based benefits for airlines; and
 - (c) greater travel and tourism benefits for New Zealand, including by helping to open up key source markets for tourism and trade opportunities.
4. Auckland Airport is very conscious of the responsibilities that come from operating within a regulated industry. These responsibilities were at the forefront of our mind when we set charges in 2012, and reflect the genuine commitment that we have to listening to, understanding, and meeting our customers' needs. We firmly believe that our pricing decision delivers great outcomes for New Zealand, and delivers significant benefits to both passengers and our airline customers while ensuring we earn a fair and reasonable return.
5. For these reasons, we welcome the Commission's draft conclusions that ID regulation is effectively promoting the Part 4 purpose statement at Auckland Airport in a number of areas. We are pleased that the Commission's draft report to the Ministers of Commerce and Transport ("**Draft Report**") has recognised that ID regulation is effectively:
 - (a) promoting incentives to innovate;
 - (b) providing incentives to provide services at a quality that reflects consumer demands;
 - (c) encouraging a pricing methodology that is improving and promoting pricing efficiency; and
 - (d) limiting Auckland Airport's ability to earn excessive profits.
6. At the same time, we consider the Commission's Final Report ("**Final Report**") can go further in some areas to more directly reflect Auckland Airport's positive performance and the current effectiveness of ID regulation. We consider the Final Report can and should recognise that Auckland Airport has created a five-year, forward-looking plan which effectively promotes all four limbs of the purpose statement.
7. This plan is complemented by our continuing commitment to actively considering and targeting innovation, efficiencies and improvements in quality across all areas of Auckland Airport's operation. In this way, we consider there is currently sufficient

evidence to support a conclusion that ID regulation is working effectively in its early stages across the full range of performance areas. Further, as more information is gathered over time, the effectiveness of the new ID regime will continue to develop and improve.

8. In the meantime, there are some aspects of the Draft Report that create uncertainty as to how Auckland Airport's future performance and behaviour will be assessed. We consider that the Final Report can proactively contribute to the ongoing success of the ID regime by presenting interested parties with a fuller picture of the complex nature of airport performance (and the complexities involved in assessing that performance).
9. Auckland Airport considers it is appropriate for the Final Report to:
 - (a) give more emphasis to exploring the relationship between the different limbs of the purpose statement;
 - (b) meaningfully acknowledge that assessing returns is not a precise science;
 - (c) acknowledge that the concept of "efficiency" can and should be broadly defined in an airport context;
 - (d) similarly, acknowledge that a broad approach demonstrates tangible efficiency gains and benefits which are being shared with consumers / customers; and
 - (e) expand the approach taken to superior performance.
10. Doing so will ensure that Auckland Airport can have confidence that we will be able to:
 - (a) target a fair return; and
 - (b) have incentives to outperform in a way that delivers real benefits for airlines and consumers;

without actual returns being incorrectly considered to be excessive in the future.

11. In particular, Auckland Airport has invested in developing our capability in a number of areas in order to increase the prospect of superior performance (including through increased demand in the future. It is important the Commission understands that we are working hard now to establish the key elements for future success - building our knowledge, experience, networks and momentum to increase the likelihood of successful and enduring incremental growth in the future (as a result of future initiatives).
12. Similarly, where Auckland Airport is currently demonstrating superior performance in a particular area (such as delivering superior quality while seeking normal returns), this performance should be fully recognised.
13. We expand on these points in this submission, which should be read together with the submission from the New Zealand Airports Association, which Auckland Airport supports.
14. Auckland Airport's contact for matters regarding this submission is:

Simon Robertson
Chief Financial Officer
Auckland Airport
Ph 09 255 9174
simon.robertson@aucklandairport.co.nz

SECTION 1: ASSESSING THE EFFECTIVENESS OF ID REGULATION

Key points:

- ID regulation provides a robust platform for monitoring airport performance over time. Although ID is in its early stages, it has had a significant and positive impact on Auckland Airport's behaviour and decision-making.
- Auckland Airport has embedded the objectives of Part 4 in its culture, raised awareness of detailed annual monitoring, and its price-setting disclosure reveals it has created a five-year, forward-looking plan which effectively promotes each limb of the purpose statement.
- ID regulation is working effectively in its early stages across the full range of performance areas.
- The complexities of airport performance should be fully recognised to ensure that a sophisticated and full picture is presented to interested parties. This is a key (potential) benefit of ID compared to other forms of regulation.
- It is important to build on the positive start for the new ID regime and ensure that ID continues to provide the right incentives going forward. The section 56G review can provide a positive contribution to the ongoing success of the regime.

The strength of ID regulation

15. The greatest strength of the ID regime is that it provides a robust platform for monitoring airport performance. The combination of forecast and historic disclosures required as part of ID regulation provides interested persons with information about the incentives that exist for airports to behave and perform in a way that promotes the long-term benefit of consumers, and how airports are responding to these incentives. As the Commission has previously noted:¹

An effective information disclosure regime provides transparency to interested persons on the performance of regulated suppliers, and provides an ongoing source of information so that trends can be identified and monitored over time.

16. As recognised by the Commission, placing information and analysis about regulated suppliers into the public domain can create incentives similar to those found in competitive markets. It does so by providing information to consumers and other interested persons to enhance their countervailing market power, providing better information to the owners of regulated suppliers, and providing increased incentives for regulated suppliers to improve relative and absolute performance.²
17. ID is particularly well-suited to complex businesses such as airports. It provides discipline by ensuring a full and diverse array of information is disclosed, so that interested persons can assess how airports respond to and balance the demands and objectives of the airport, airlines, passengers, stakeholders and other customers. In addition, ID regulation gives airports the flexibility to tailor their plans and decisions, with input from customers, to promote the long-term benefit of consumers. It avoids the very real risk that "command and control" type regulatory regimes will result in formulaic and blunt approaches that inhibit innovative and tailored behaviour and outcomes.

¹ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010 at paragraph 2.24.

² Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010 at paragraph 2.28.

18. The new ID regime encompasses broader financial performance measures than existed under previous disclosure regulation, and has introduced a range of non-financial performance information. As such, the quality, transparency and range of information available to interested parties has improved greatly, providing for a more effective and comprehensive assessment of airport performance.
19. The increased transparency under the new regime provides an opportunity to closely examine airport performance and assess an individual airport's circumstances, including its capacity challenges, capital requirements and growth and demand factors. This depth of information will allow a full and robust analysis of airports' incentives to invest and innovate, efficiency improvements, and quality and service levels, as well as checking that airports are setting prices in order to target a fair return over time.
20. Auckland Airport is keen to ensure that the section 56G review fully highlights the strengths of the regime in providing a wealth of information to interested parties to assess airport performance. The robust and thorough consultation process through this review, including well-informed submissions from airlines throughout, clearly demonstrates the transparency of performance that has been achieved.
21. Going forward, future disclosures will reveal a time series of data that will build up an even deeper picture of airport behaviour and performance outcomes, further cementing the regime's early success.

The impact of ID regulation for Auckland Airport

22. Although ID is in its early stages, it has had a significant and positive impact on Auckland Airport's behaviour and decision-making.
23. From Auckland Airport's perspective, there are already a number of identifiable benefits for consumers as a result of the implementation of ID regulation. These benefits further underscore the early effectiveness of the regime, as well as demonstrating that Auckland Airport has acted responsibly and responsively in continuing to align our conduct and performance with the desired regulatory outcomes under the Part 4 purpose statement.
24. In particular, we note the following:
 - (a) Auckland Airport's corporate culture has been influenced by the inclusion of airports in Part 4 of the Commerce Act, and we have taken active steps to increase awareness across the business of the limbs of the Part 4 purpose statement. Auckland Airport did not wait until the input methodology ("IM") and ID determination process was complete to begin a process of educating staff on the implications of ID regulation under the Commerce Act. Instead, we took a proactive approach following the enactment of the Commerce Act amendments in October 2008, which continued throughout the Commission's consultation on the development of the ID regime in 2009 and 2010.
 - (b) The quality and depth of our disclosures provides clear evidence that we are conducting ourselves in a manner that embraces the intent of ID regulation and the transparency and increased information base that underpins the success of the regime. In many cases our disclosures go beyond the requirements of the ID Determination in order to assist and enhance the understanding of interested persons.
 - (c) Auckland Airport and its substantial customers are closer in our understanding of each others' issues than ever before. Although this change was underway prior to the introduction of ID regulation, the new regime has helped deepen the understanding between us.

- (d) We take our pricing consultation obligations very seriously, and make it clear that we will approach all decisions with an open mind and consider all points of view. It is important to us that our pricing decisions are supported by robust reasoning, and are highly informed by feedback from our customers. ID had a positive effect on this consultation process in a number of ways:
- (i) The introduction of ID regulation has provided Auckland Airport and its airline customers with a common language and reference point through the IMs.
 - (ii) The scope of the differences between Auckland Airport and airlines has been reduced considerably. At the time of pricing, there was substantial alignment between Auckland Airport and its customers on demand forecasts, allocation of assets and expenses, asset valuations, capital expenditure assumptions, depreciation lives and taxation. The new ID regime has had a positive effect in this area.
 - (iii) The ID framework was very effective at ensuring we carefully and transparently disclosed our approaches and the rationale for those approaches. It encouraged us to expressly consider and to be more explicit about our modelling and decisions, as well as giving airlines a reference point to test those decisions. As such, it introduced further discipline and guidance to our pricing decisions.
- (e) The understanding and scrutiny that developed through the section 56G review process encouraged Auckland Airport to carefully consider and clarify its likely future approach to the treatment of revaluations, providing further information to interested parties on our intentions with regards to this issue.
- (f) Greater transparency of forecast outcomes has allowed interested parties, including the public, to understand how our expected performance matches and promotes the desired regulatory outcomes in the Part 4 purpose statement.
25. In our view, these results demonstrate that the ID regime is working as intended. In particular, ID regulation is fulfilling its key objectives by:
- (a) providing transparency around airport behaviour, decisions and performance;
 - (b) ensuring interested persons have access to increased amounts of high-quality information, prepared on a consistent basis over time; and
 - (c) facilitating more effective consultation processes between Auckland Airport and its airline customers.
26. Further (as previously highlighted by Auckland Airport³), BARNZ and Air New Zealand have positively acknowledged a number of aspects of our conduct and behaviour. For example:
- (a) Airlines have recognised that information disclosed by Auckland Airport has led to greater transparency and greater understanding of Auckland Airport's performance (as intended by the ID regime).⁴

³ See Auckland Airport *Cross-submission on the Section 56G Review Auckland Airport Process and Issues Paper*, 9 November 2012 at paragraphs 10-28.

⁴ Air New Zealand *Submission on Section 56G Review of Auckland Airport*, 19 October 2012 at page 7; BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 2.

- (b) BARNZ, Qantas and Air New Zealand have all recognised Auckland Airport's open, engaging and receptive approach, and its willingness to engage comprehensively with stakeholders in relation to innovation, improving operational performance and efficiency, and improving service quality.⁵ In particular, BARNZ has noted that Auckland Airport is considered to be "responsive and proactive" in relation to quality matters raised by airlines.⁶
- (c) Air New Zealand has recognised that (setting aside the level of charges), changes to Auckland Airport's pricing reflect efficient pricing principles, and have created a stronger link between the facilities that are used and the charges and revenues associated with those facilities.⁷
- (d) Similarly, BARNZ has acknowledged that the airfield MCTOW charges, airfield parking charges, international transit and transfer passenger charge and international check-in counter charges were all reasonable.⁸
- (e) BARNZ has acknowledged that the ID regime (through the presence of the section 56G review) did have an impact on Auckland Airport's approach to its cost of capital methodology and the target return sought by Auckland Airport.⁹
- (f) Air New Zealand and BARNZ have made positive comments about Auckland Airport's consultation philosophy, including our approach to capital expenditure consultation, which was positively endorsed by BARNZ,¹⁰ and described as "robust, transparent and inclusive" by Air New Zealand.¹¹
- (g) BARNZ has acknowledged that it considers the capital expenditure included by Auckland Airport in its aeronautical pricing model for PSE2 is both reasonable and is more efficient than the expenditure which was forecast in the first price setting event.¹² The method of consultation on capex has also been positively addressed by BARNZ as an example for others.¹³

27. The airlines, incorrectly in our view, do not consider these positive outcomes to be directly attributable to the ID regime. However, we continue to consider that, irrespective of whether the positive outcomes were "caused by" the ID regime, a regulatory regime which preserves Auckland Airport's incentives to engage in the above types of behaviour is a successful and constructive regime. We also believe that the ID regime is having an impact on everything we do, even if specific conduct cannot be directly attributed to ID. Importantly, we note that the regime and process has ensured that other airports are now aware of Auckland Airport's practices and we believe that may have a positive effect on the whole sector.

Assessing the effectiveness of ID regulation in its early stages

28. Auckland Airport believes the new ID regime is working effectively in its early stages. As discussed above, the incentives created by ID regulation (through increased transparency, access to information and active monitoring of disclosures) demonstrate that the regime is effectively working as it should to promote positive behaviour.

⁵ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 34, 35, 39; Qantas *Response to Section 56G Issues Paper Relating to Auckland Airport*, 24 October 2012, section 5; Air New Zealand *Submission on Section 56G Review of Auckland Airport*, 19 October 2012, page 17.

⁶ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 37.

⁷ Air New Zealand *Submission on Section 56G Review of Auckland Airport*, 19 October 2012, page 19.

⁸ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 12.

⁹ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 3.

¹⁰ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 30.

¹¹ Air New Zealand *Submission on Section 56G Review of Auckland Airport*, 19 October 2012, page 16.

¹² BARNZ *Cross-Submission on Auckland Airport s56G Issues Paper*, 9 November 2012, page 2.

¹³ See, for example, Commerce Commission *Christchurch Airport Conference Transcript*, 24 May 2013 at page 104 (line 22) - 105 (line 17), per Kristina Cooper for BARNZ.

29. The section 56G review has also sought to assess the appropriateness and reasonableness of airport behaviour and decisions. As such, the questions for the section 56G review have centred on whether Auckland Airport's conduct and performance is consistent with the outcomes in the Part 4 purpose statement.
30. When these questions are answered, it is clear that ID regulation is establishing the right incentives for Auckland Airport to effectively promote each limb of the purpose statement and, therefore, the long-term benefit of consumers. In particular, the new regime has been effective at encouraging Auckland Airport to make efficient, reasonable, and responsible decisions for the next five years.
31. In this respect, we encourage the Commission to fully recognise that Auckland Airport is forecasting performance that, together with its corporate culture, effectively promotes each limb of the purpose statement and delivers real benefit for New Zealand.
32. Accordingly, positive conclusions about Auckland Airport's forecast performance, and the incentives provided by ID regulation in its early stages (or the absence of negative incentives) can be made across all performance outcomes. In our view:
- (a) The section 56G review does not require the Commission to conclusively determine the effectiveness of ID regulation now (ie whether it has succeeded or failed). It calls for a decision about *how* effectively ID regulation is promoting the Part 4 purpose statement *at the current time*, recognising that ID regulation will continue to influence behaviour and performance over time.
 - (b) The incentives provided by ID regulation can be expected to improve as the regime continues to develop and more disclosures are made and analysed.
 - (c) However, Auckland Airport's decisions and forecast performance at the time of pricing demonstrate that the ID regime is currently working as effectively as could be expected, for all limbs of the purpose statement.
33. The Draft Report considers that it is "too early to tell" whether ID is effective in certain performance areas.¹⁴ However, in developing the ID framework, the Commission expressly noted that its requirements to disclose forecast price-setting information were specifically designed to assist interested persons to make *ex ante* assessments of:¹⁵
- the extent to which forecast profitability is excessive (through the comparison of forecast costs to forecast revenue);
 - the appropriateness of the scope and timing of capital expenditure in light of demand forecasts, consumers' willingness to pay and the quality expectations of consumers; and
 - Airports' intentions to improve efficiency and to share those gains with consumers (through lower prices and/or improved quality).
34. As such, Auckland Airport submits that the available evidence supports the following conclusions at this stage of the new ID regime:¹⁶
- (a) **Efficient investment:** Auckland Airport's forecast capital expenditure was efficient based on the circumstances at the time of pricing. The scope, level

¹⁴ Commerce Commission *Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport: Section 56G of the Commerce Act 1986*, 30 April 2013 ("Draft Report") at paragraph 3.7.

¹⁵ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010 at paragraph 5.11.

¹⁶ More detail on Auckland Airport's reasons for these conclusions is included in the remaining sections of this submission.

and timing of investment planned for PSE2 is efficient and appropriate in light of Auckland Airport's demand forecasts, consumers' willingness to pay for that expenditure, and the quality expectations of Auckland Airport's consumers.¹⁷ Ongoing disclosures will provide interested parties with information to assess how we respond to changing market conditions and stakeholder feedback in the delivery of Auckland Airport's investment over time.

- (b) **Operational expenditure efficiency:** Since the amendments to Part 4 of the Commerce Act, Auckland Airport has implemented a number of efficiency initiatives which are well aligned with the Part 4 purpose statement. Auckland Airport is actively seeking to improve its efficiency, and its pricing decision demonstrates an intention to improve efficiency over PSE2. Information on actual operating expenses will help to add to the picture over time, including identifying where efficiencies were achieved or where forecast improvements may have been too ambitious (resulting in a lower than forecast regulatory return).
- (c) **Sharing the benefits of efficiency gains:** Auckland Airport's performance demonstrates that it seeks to create a wide variety of efficiency gains, including through operational and process improvements that generate efficiencies for airlines and passengers. Efficiencies of scope and scale have been generated through Auckland Airport's route development activities (undertaken in PSE1 at no cost to consumers) which have stimulated incremental demand, mostly at off-peak times. These efficiencies have been shared with airline customers through increased passenger demand forecasts from FY13 and, therefore, lower prices over PSE2. These efficiencies have also delivered benefits for passengers through increased destination choice.

Additionally, Auckland Airport's forecast reductions in operating expenses have been built into prices for PSE2, resulting in an actual sharing in advance of forecast efficiencies through lower prices (whether or not those efficiencies actually eventuate).

35. Of course, actual performance will vary from forecasts. Auckland Airport will continue to seek to excel and to outperform its forecasts. Unforeseen circumstances will occur, consumer priorities will change, and market conditions and demand will fluctuate. These variations have the potential to be greater in an airport context than in other regulated industries. Ongoing disclosures and the Commission's monitoring and analysis reports will tell interested parties how effective ID regulation has been in providing the right incentives for Auckland Airport to behave responsibly and appropriately (including by outperforming its forecasts) across a pricing period, taking these factors into account.
36. Future price-setting disclosures will also tell interested parties about the incentives that transparency, information, and monitoring provide for Auckland Airport in its next price setting event.
37. This data will emerge through subsequent disclosures. There are obviously aspects of ID regulation which will continue to bed in (including the monitoring and feedback processes which will identify performance trends and encourage continued promotion of the Part 4 outcomes over time).
38. However, it is perfectly consistent with this framework to conclude that Auckland Airport has created a five-year, forward-looking plan which effectively promotes each limb of the

¹⁷ For example, the Draft Report notes that (at paragraph H17): "There is no evidence of any planned under or over investment in Auckland Airport's capex forecast for PSE2. Airlines consider that the projects planned for PSE2 reflect an efficient level of investment and have taken into account the priorities of the airlines."

purpose statement. In this way, ID regulation is working effectively in its early stages across the full range of performance areas.

The complexities of airport performance should be fully recognised

39. We continue to have reservations about how black and white some aspects of airport performance, particularly returns, are presented in the Draft Report. As discussed above, we consider the ID regime is designed to present a more sophisticated approach. We are concerned the Draft Report risks oversimplifying the complex aspects of airport performance that are, in many ways, the most important features to highlight for interested persons (including Ministers).
40. Auckland Airport is concerned the Draft Report risks side-stepping these issues in an attempt to present "an answer". In our view, this overlooks the fact that understanding the nature and relationship of the complex factors in play is likely to present a more sophisticated and useful picture of airport performance, increasing the understanding of interested parties over time.
41. We are concerned the Draft Report:
- (a) Does not fully highlight or reflect the interactions and relationships between different parts of airport performance for interested parties, who may not immediately recognise or understand the inherent links between factors such as returns, quality, capital and operating expenditure, efficiencies and innovation.
 - (b) Attempts to assess airport returns in a black-and-white manner that is not supported by the assessment tools that are available. The Draft Report continues to assign a level of precision to the weighted average cost of capital ("**WACC**") IM as a proxy for the appropriate return for an airport, which we consider creates risks of mistaken interpretations going forward. Estimating the appropriate level of airport returns is a complex area where more information and explanation is needed to avoid these risks.
 - (c) Takes a narrow approach to efficiency, equating "efficiencies" to a reduction in costs. A significantly broader approach is required in an airport context in order to fully reflect the diverse ways in which airport performance creates value, benefits and efficiencies for all parties in the airport value chain.
 - (d) Takes a similarly restrictive view of how efficiency gains may be shared with consumers. A broad approach is needed to recognise that the benefits of efficiency gains can flow to consumers in a multitude of ways beyond a reduction in price (and may be passed on through forecast efficiencies before those efficiencies are achieved).
 - (e) Adopts a narrow view of superior performance, and how that performance may be demonstrated. In particular:
 - (i) There is no reason why superior performance must result in an increase in demand or an increase in efficiency before it can be recognised under an ID framework.
 - (ii) The Commission appears to have an unrealistic expectation of the level and precision of evidence that must be provided by airports before it will accept that superior performance has occurred.
 - (iii) The possibility that all three airports are performing in a superior way in some performance areas (such as quality) cannot be dismissed.

42. We also consider the Commission's attempt to present "an answer" at this early stage has prevented it from making findings now on matters where the full picture will emerge over time (such as efficiency). We expand below.

The interaction between the limbs of the Part 4 purpose statement

43. The Draft Report suggests that the Commission will assess *all* analytical areas prior to assessing the effectiveness of ID in promoting one particular outcome. However, the Draft Report does not subsequently explain if or how the Commission has taken into account other limbs of the purpose statement when assessing airport performance. It still presents a picture of each limb being (artificially) considered in isolation.
44. In our view, a greater appreciation of the interdependence of the limbs of the purpose statement is required. Accordingly, we consider the Final Report should fully consider the interdependence of the limbs in making an assessment about the effectiveness of ID, rather than merely noting that there is an interrelationship. This will better reflect the statutory intent of the ID Regime and recognise the significant influence the Final Report will have on future price setting behaviour, for both airlines and airports.
45. We appreciate that doing so is not straightforward. Part 4 outcomes are variable and competing and are therefore necessarily interlinked. There is no single mechanism that determines how an assessment of airport returns can be adjusted to account for superior performance, quality levels (including where consumers may be enjoying higher quality that reflects their needs), innovative behaviour, and investments that deliver network or industry benefits. But, equally, it is clear that these relationships need to be actively considered and discussed before a conclusion can be drawn about airport profitability.
46. Similarly, there is no formula that can assess whether efficiency gains are being incentivised in a way that is proportionate to other limbs of the purpose statement. On the other hand, it is clear that efficiency gains should not be incentivised at the expense of service quality (including safety considerations), responsible investment in maintenance or additional capacity, or innovations which promote greater benefits for passengers and airlines than would flow from reduced operating expenditure.
47. For these reasons, Auckland Airport encourages the Commission to expressly acknowledge and consider the relationships between the limbs of the purpose statement in its Final Report. We are not suggesting the Commission needs to find "an answer". However, the process of exploring the nature of the relationships, and explaining the interlinking factors for interested parties, will ensure the Final Report presents a more sophisticated picture of the interaction between the Part 4 outcomes than simply stating the elements are related. The Commission's annual reviews will also allow for increasing sophistication in the consideration of these matters.

Assessing airport returns is not black-and-white

48. The Commission's use of the WACC IM in its analysis remains a key issue for Auckland Airport. Although the Commission has stated that its WACC estimate does not represent an "immovable cap" on the appropriate level of returns,¹⁸ it is difficult to understand when and how the Commission will move away from its estimate in any meaningful way. We are therefore struggling to balance the fact that:
- (a) on one hand, the Commission has stated throughout the Part 4 process that information disclosure is not price control, and that it will consider contextual factors and returns above its WACC estimate in some circumstances; but

¹⁸ Draft Report, paragraph 2.32.

- (b) on the other hand, the framework adopted in the Draft Report strongly suggests that any expected returns above the Commission's WACC estimate will be treated as evidence of excessive profits, unless airports can provide evidence of superior performance (which, as discussed further below, appears to be very narrowly defined and difficult to establish to the Commission's satisfaction) or explicit assessment of asymmetric risks.
49. The approach in the Draft Report appears to treat contextual factors as possible excuses or justifications for excess returns, and to suggest these factors will only be relevant in unspecified circumstances after a comparison to the Commission's WACC estimate has revealed excess returns. In Auckland Airport's view, this approach:
- (a) Risks presenting an overly simplistic picture to interested parties of the accuracy associated with the WACC IM and of the challenges associated with determining an appropriate level of airport returns. We consider the approach in the Draft Report risks the WACC estimate being misinterpreted as a black-and-white test for airport returns, regardless of the language the Commission uses to describe its WACC IM.
- (b) Creates considerable uncertainty going forward. For example, it is not clear what factors the Commission will take into account, when it will consider it is appropriate to do so, and how it will reconcile these factors with the outcome of its formulaic profitability analysis.
50. To illustrate the problem, we anticipate that airlines will seek to convince the Commission that it has miscalculated Auckland Airport's returns, that they should be increased by (say) 0.1 to 0.2%, and that this will provide clear evidence that excessive returns are being earned and ID regulation is ineffective. The truth is that the picture is far more complex, and that minor changes to the Commission's model will not change the fact that Auckland Airport is forecast to earn a reasonable return.
51. In our view, it is more appropriate for the Final Report to more expressly acknowledge that producing WACC estimates (including under the WACC IM) is not a precise science. Rather, it is important for the Final Report to present contextual factors as an important element of evaluating airport profitability and determining an appropriate return for airports, particularly in an information disclosure context.
52. This recognises the theoretical nature of the WACC IM and acknowledges that commercial considerations, expert evidence, business realities and the nature of the challenges that are faced by individual airports are an important and appropriate part of the fact set that airports use to set charges. Considering the WACC IM together with commercial expectations will provide more balance to a very theoretical WACC position.
53. In other words, putting the outcome of the WACC IM in context is a process that should take place *as part of* the way the WACC IM is applied by the Commission, rather than *after* that application.

The approach to "efficiency" and sharing of efficiency gains

54. A recurring theme throughout the Draft Report is the idea of efficiencies. Auckland Airport is concerned that the Commission has taken too narrow an approach to:
- (a) identifying what an "efficiency" may look like in an airport context; and
- (b) recognising the ways in which the benefits of efficiency gains can be (and have been) shared with consumers.

55. Airport services are considerably different to other regulated services. The facilitation of travel is quite different from the generation or transmission of electrons. As such, the notion of efficiency in the airport industry is far broader than the traditional approach that may be appropriate for other regulated sectors.
56. For example, in the electricity industry, an ultimate consumer will be predominantly (if not entirely) interested in two performance outcomes - reliability and price. Once reliability has reached an acceptable level, the usual benefit to consumers from efficiency gains will be a reduction in price.
57. In an airport context, it is important to remember that features such as convenience, time savings, quality and availability of services, and increased choice are key elements of value for passengers. Efficiencies of size, scope and processes can deliver tangible benefits in these areas through:
- (a) improved passenger processing times;
 - (b) faster and more reliable baggage handling;
 - (c) "smart" operations that meet the expectations of digitally savvy consumers;
 - (d) increased reliability and improved on-time performance of flights; and
 - (e) greater choice in destinations and greater availability of flights to those destinations.
58. Similarly, although price will always be important for airlines and cargo operators, airports can deliver value to these consumers in ways other than price reductions. For example:
- (a) decisions on capital expenditure (including the location, size, and other features of any new investment) can deliver considerable network efficiencies and advantages for airlines, often at no benefit (or even at additional cost) to airports;
 - (b) airport investments in growth-driving activities can deliver tangible flow-on benefits for airlines (directly and indirectly through the domestic network); and
 - (c) processing efficiencies and operational efficiencies can deliver cost savings for airlines and other stakeholders which will not be apparent from an analysis of Auckland Airport's operating expenditure.
59. In short, the airport environment is not simply about achieving efficiencies through reduced operating expenses, with those reductions then passed on to consumers. The nature of the airport industry means that a broader approach must be taken to the definition of "efficiency", how that concept is measured, and what the sharing of efficiency gains looks like in an airport context. In particular, it is important that the approach in the Final Report values and incentivises behaviours that create efficiencies for participants in the wider airport value chain (including airlines, ground handlers and Government agencies).
60. We provide more specific detail of the way the Final Report can recognise these issues in Section 8, which addresses the ways in which Auckland Airport is sharing the benefits of efficiency gains with consumers.

Superior performance

61. The Draft Report has given Auckland Airport an insight into the role that superior performance will play in the Commission's analysis of disclosed information. However, we have some reservations that the Commission's framework will not fully recognise when airports are a superior performer.
62. We are concerned that the Commission appears to be overlooking areas in which Auckland Airport's current performance indicates we are superior (at the same time as forecasting normal returns). We are also keen to ensure that the Commission and interested parties are fully aware of where Auckland Airport has invested in capability in key areas that are showing early signs of superior performance, and which indicate that superior performance might be expected over PSE2.
63. At this stage, it is very unclear what the Commission will consider to be "superior performance". The only current guidance available to airports is that the Commission considers no evidence of superior performance has currently been presented. Auckland Airport has some reservations that the Commission may have a narrow idea of what superior performance looks like, and an unrealistic expectation of the level and precision of evidence that must be provided by airports before it will accept that superior performance has occurred.
64. The Part 4 outcomes are, by their nature, broadly defined. As recognised by one of the Commission's experts in the IM consultation process:¹⁹
- Wisely, the NZ legislation does not require the Commission to *achieve* the *same outcomes/results* as would be produced by competition, but rather to *promote* rather *broadly defined* outcomes (which, to better avoid ambiguity, by explicitly distinguishing them from specific, precise, measurable outcomes, might better have been described as *tendencies*) that are *consistent* with those produced in competitive markets. These tendencies are then exemplified in terms of incentives and benefit sharing, not in terms of specific, well defined outcomes/results.
65. It should not be expected that these broadly defined outcomes can always be measured in precise or specific ways. Superior performance that cannot be measured by precise statistics is no less important or valuable to the long-term benefit of consumers. Similarly, it should not be expected that superior performance is always the result of a single decision or action. In our view, a vast multitude of small decisions can equally create an environment characterised by superior performance.
66. In this way, we encourage the Commission to take a broader view of what superior performance may be, and how that performance may be demonstrated. In our view, the Commission's monitoring and analysis may, in fact, play the most important role where superior performance can only be expressed in qualitative terms, or where there are difficulties in precisely comparing performance to a counter-factual (such as demand increases in response to route development activities). In our view, summarising and analysing the evidence of these types of behaviour, which are clearly beneficial to the long-term interests of consumers, is a key aspect of the Commission's task under the section 56G review (and its ongoing analysis over time).
67. We expand in the specific sections of this submission on areas where we consider the Final Report can consider superior performance in more detail. The purpose of doing so is not to "justify" above normal returns. In a situation where Auckland Airport is seeking normal returns, we consider that there is still scope to recognise aspects of Auckland Airport's superior performance (including where we are actively looking for ways to be superior in the future) in the Final Report.

¹⁹ Yarrow, G., *Review of Input Methodologies (Airport Services) Draft Reasons Paper*, June 2010, pp 5-6 (emphasis in original). This quote is mentioned by the Commission in: *Commerce Commission Input Methodologies (Airport Services) Reasons Paper*, December 2010 at paragraph 2.6.17.

The way forward for information disclosure

68. It is important to build on the positive start for the new ID regime and ensure that ID continues to provide the right incentives going forward. We consider the Final Report can make a useful contribution to the ID regime by:
- (a) ensuring that positive performance is fully recognised to preserve ongoing incentives to engage in that behaviour; and
 - (b) providing certainty that actual returns will not be incorrectly viewed as excessive.

Positive performance should be fully recognised

69. The section 56G review provides the first opportunity for the Commission to analyse and provide feedback about Auckland Airport's disclosed information. As such, it provides an indication of how our future behaviour and performance will be assessed. In doing so, the section 56G review process provides considerable information about how Auckland Airport's current conduct and performance is recognised and valued within the context of the ID framework. This information will shape how ID regulation incentivises appropriate behaviour and promotes outcomes consistent with the Part 4 purpose statement going forward.
70. For this reason, it is important to ensure that positive performance is fully recognised and valued within the ID regime. This is necessary to ensure that incentives exist to engage in that positive behaviour and seek to maintain and improve current performance levels going forward.
71. We are pleased that the Commission has recognised our positive behaviour in a number of areas of its Draft Report, and we are keen to see an increased recognition of our positive conduct. In particular, we consider there is scope for the Final Report to more expressly reflect that:
- (a) our innovative activities (including our route development activities) are delivering considerable benefits beyond a simple reduction in operating costs;
 - (b) the quality of our services is world-class, and our performance in the Skytrax World Airport Awards over the past five years demonstrates that we are providing a superior service that reflects passenger needs and expectations;
 - (c) our engagement approach on capital expenditure is a resounding example of the values that ID regulation intends to promote, through improved quality of information, quality of collaboration, and quality of consultation;
 - (d) we are sharing the benefits of targeted efficiency gains with consumers by including these efficiencies in the cost base from which prices have been set and not seeking to recover unforeseen costs from prior periods; and
 - (e) we are helping to *create* efficiencies for these parties (to the ultimate benefit of passengers, airline and other customers).
72. We hope that the Commission's findings in this regard can help provide useful guidance for future conduct for all participants. We expand in Sections 2 to 8 on how the Commission may fully reflect our positive performance across each of its seven assessment areas.

Assessing returns going forward

73. In order to keep delivering a high quality airport experience, it is important that Auckland Airport is able to target a fair return so that we can continue to meet the needs of current and future passengers and airlines. In particular, the prospect of a fair return is important to ensure that we can attract sufficient capital, both nationally and internationally, to fund future investment.
74. We are pleased the Commission's analysis has confirmed our strong belief that our forecast returns are reasonable. At the same time, although it is absolutely correct that ID regulation is effectively constraining our ability to make excess profits and that Auckland Airport has set prices to earn a fair and reasonable return going forward, we have some concerns with the way the Commission has reached that conclusion.
75. In particular, we continue to consider there are risks in a profitability analysis that focuses on the output of a technical calculation to determine whether ID regulation is effective. In our view, focusing on a modelling-based view is naturally prone to assumptions and errors, and does not fully reflect the broad picture of Auckland Airport's profitability or the long-term benefit that Auckland Airport is delivering for consumers and the economy. These concerns have introduced a risk that our fair return may be incorrectly considered to be excessive in the future.
76. In our view, there is a risk that future monitoring and analysis reports may consider our returns, which are fair and reasonable on an *ex ante* basis, to be excessive when analysed after the fact. For example:
- (a) As discussed above, we continue to have concerns that contextual factors relevant to the application of the WACC IM are not fully recognised under the Commission's analytical framework.
 - (b) The Commission will publish annual updates to its WACC estimates for airport services. This annual update is confusing in the context of returns set based on five year expectations in 2012 within a WACC range. There is currently no information about how these annual updates will be factored into assessments going forward of a pricing decision made at an earlier point in time.
 - (c) Auckland Airport's objective was to ensure that the forecasts used for pricing were reasonable, realistic and unbiased at the time pricing decisions were made. Going forward, Auckland Airport will appropriately strive to outperform its forecasts across all aspects of our pricing decision. This is an essential element of Auckland Airport's ambition for New Zealand's tourism industry.
 - (d) However, when actual results are assessed, there is no certainty that this appropriate and positive behaviour will be recognised as superior performance. Ensuring that incentives exist to outperform reasonable and robust forecasts is essential to the development of a successful ID regime which provides continuing incentives for efficient, innovative decision making in the long-term interests of consumers.
77. In order for the section 56G review to contribute to the ongoing success of the ID regime, Auckland Airport encourages the Commission to proactively address these concerns in its Final Report and to properly reflect the *ex ante* nature of the process.
78. In this way, Auckland Airport can go forward with confidence that its actual returns across PSE2 will be interpreted in a way that is consistent with the Commission's *ex ante* assessment, and which preserves incentives to outperform across the full range of performance areas.

SECTION 2: INNOVATION

Key points:

- Auckland Airport has been developing culture of innovation. This development has been complemented by ID regulation.
- Auckland Airport is innovating in ways that create efficiency gains by improving the efficiency of its operational and capital expenditure.
- However, successful innovation is not isolated to these types of improvements. Product, service and process innovations can drive significant benefits for consumers in other ways, which should be reflected in an ID framework.

ID Regulation is effectively promoting innovation at Auckland Airport

79. We agree with the Commission that ID regulation is effectively promoting innovation at Auckland Airport. In particular, we note that:
- Auckland Airport has a track record of innovative investments in airport and airfield operations and in customer service. Considerable efforts have been made to ensure our day-to-day decision making and performance at both management and grass roots level aligns with the Part 4 purpose statement.
 - Auckland Airport has strong communication with substantial customers in this regard and we support airline/customer driven innovation. We value our Airport partners' involvement in the identification and development of innovations through airport-wide initiatives to incentivise good ideas.
 - Similarly, Auckland Airport seeks to innovate and improve in ways that create value for our customers, as well as for stakeholders such as the ground handlers, Customs and the Ministry of Primary Industries Biosecurity division.
 - ID regulation has supplemented our existing innovative practices. It has reinforced the need to ensure that Auckland Airport is innovating appropriately at both a management and grass roots level. The ID regime has increased the transparency of our innovations in operation, and provided a welcome opportunity for airlines, passengers and other interested parties to assess Auckland Airport's culture of innovation.
80. We are keen to ensure that, going forward, our existing incentives to innovate are not undermined by ID regulation. A key risk in this respect is the uncertainty that innovation leading to efficiencies for Auckland Airport and our consumers may be wrongly diagnosed as excess returns. Further, it is also important to note that innovation, by its nature, will always involve some risk and may not always be successful.

A broader approach to innovation is necessary

81. In that context, we are also concerned that the discussion of innovation in the Draft Report appears to consider that the benefits of innovation are primarily linked to efficiency gains by improvements in operational and capital expenditure efficiency.²⁰ In our view, a broader approach is necessary in order to fully reflect the positive innovation activities undertaken at Auckland Airport.

²⁰ See, for example: Draft Report, paragraph B8.

82. There is no doubt that successful innovation can create efficiencies by reducing actual expenditure against forecast. It does so through implementing cost-saving measures and finding new ways to utilise existing assets (thus increasing capacity and delaying the need for further capital expenditure). Indeed, Auckland Airport is already innovating in this way. For example:
- (a) Under Auckland Airport's Fighting Fit strategy, we took part in an innovative initiative to join with a group of Australasian airports to achieve cost efficiencies in relation to Airport Owners and Operators Insurance, and to create a long-term relationship with an insurer new to the New Zealand market. As a result of this innovative approach, Auckland Airport's insurance costs are now lower than they were in 2006 (even though most parties seeking insurance would be experiencing significant increases in insurance costs).
 - (b) Auckland Airport has used Comprehensive Airport Simulation Technology ("**CAST**") to model, understand and communicate with customers in relation to the existing Domestic Terminal upgrade and the quality trade-offs required in the course of that upgrade.
 - (c) CAST simulation has also been used to better understand the capacity constraints and options for emigration processes, which has led to the deferral of capital investment. Through engagement with customers (including BARNZ), further operational solutions have been identified which will create significant capacity (such as segmentation of staff and passenger flows).
 - (d) A comprehensive review of the airfield pavement management system has been undertaken, which will lead to a migration from an individual system for the airport to a world standard for the monitoring, management and replacement of airfield slabs - a core airport asset.
 - (e) A carousel allocation tool has been developed in order to maximise the utilisation of baggage carousels and increase throughput on the existing carousels. This "Lean" initiative is currently being tested.
 - (f) Auckland Airport has worked and continues to work with our airline customers to review gate and stand policies to optimise gate usage and identify innovative operational efficiencies.
 - (g) Innovation is being used to generate sustainability efficiencies and energy savings. This includes innovative activities such as installing the largest solar voltaic panel array in New Zealand on the roof of the international terminal Pier B building, public recycling stations, a terminal energy efficiency programme, and improvements in water capture technology to reduce water use per passenger.
 - (h) Product innovations for non-regulated activities have had a positive impact on capacity constraints in Auckland Airport's regulated services. For example, the introduction of free car-parking for the first 10 minutes has reduced the need for increased forecourt space for passenger pick-up and drop-off, and has reduced pressure on terminal capacity.
83. However, the introduction of product, service and process innovations to improve departures, arrivals and border initiatives is a continuous process that can also:
- (a) reduce operational risk and enhance safety;
 - (b) increase reliability of both airport and airline performance;

- (c) improve capacity utilisation of terminal and airfield facilities;
- (d) result in initiatives which drive growth;
- (e) improve the quality of the airport experience and environment for passengers; and
- (f) create processing and operational improvements that deliver benefits for passengers, airlines and stakeholders.

84. Since the 2008 amendments to the Commerce Act, Auckland Airport has sought to educate all levels of our team on the objectives of the Part 4 purpose statement, and to adapt our behaviour to align with and promote those objectives. For example, during the development and implementation of ID regulation, Auckland Airport has:

- (a) As recognised by the Commission, recently introduced a world-first "Jackal" grass, specially developed by PGG Wrightson, containing a fungus that deters insects and, in turn, reduces bird activity near runways. This reduces the risk of bird strike for aircraft, which would be catastrophic for an airline.
- (b) Introduced Cat III technology to assist with airport operations in low-visibility conditions and significantly reduce the number of fog-related delays or cancellations for airlines. This also improves the potential passenger experience relative to a delay scenario.
- (c) As part of Auckland Airport's Every Minute Matters initiative, implemented an initiative identified by MPI Biosecurity for dis-insection of a plane upon landing, saving up to 10 minutes in the processing of each flight and assisting reliability, customer satisfaction, capacity utilisation and operational processes.
- (d) Ground power units were introduced in order to improve the energy efficiency of aircraft by removing the reliance on its auxiliary power unit. As a result, this generated a cost saving to the airlines and created environmental benefits. This innovation was originally hampered due to health and safety issues, which resulted in a re-design to alleviate the problem. The solution was a cable carrier termed the "crocodile", which enables the ground power unit to be connected to the aircraft with minimal manual intervention and an improved Health and Safety outcome. Further, the development of the crocodile interface has allowed aircraft to land with their auxiliary power units off. In total, this initiative is estimated to provide a \$5m fuel saving per annum across the fleet at Auckland. Air New Zealand has been the lead carrier throughout the development of this project.
- (e) Created a flexible design for stand configuration on Pier B which allows loading and disembarking from two levels of an A380 aircraft, or four smaller aircraft (Code C) at the same time.
- (f) Sought out innovative engineering techniques in the upgrading of the main runway to minimise the impact on airline operations and reduce the cost per square metre.
- (g) Introduced Advanced Passenger Display (in June 2010) which has assisted with resource allocation and capacity utilisation for Auckland Airport and border agencies.
- (h) Worked with Air New Zealand to introduce self-check in facilities. We continue to work with Air New Zealand to achieve their strategic target of 90% self-

service check-in, and more broadly to explore all avenues to optimise check-in in light of the growing presence of remote check-in options.

- (i) Introduced new Flight Information Display systems, supplemented by targeted gate announcements, to help reduce missed flights, with benefits for both passengers and airlines.
85. In addition, our innovative route development activities deliver considerable benefits for passengers, airlines and the New Zealand economy in terms of airline and route choice, facilitating environments conducive to competitive airline pricing, and driving inbound tourism growth. Further detail is provided in Section 7 of this submission.
86. Going forward, it is important that these types of innovations are fully recognised for the positive benefits they provide for consumers (including both passengers and airlines) and other stakeholders (which, ultimately, will also benefit consumers). Positive innovation in the interests of consumers is to be promoted and encouraged in all circumstances, not simply where it is linked to a narrow concept of cost reduction.
87. In order to do so, we encourage the Commission to recognise Auckland Airport's innovative behaviour more broadly in its Final Report.

SECTION 3: QUALITY

Key points:

- ID regulation is effectively promoting quality at Auckland Airport, which continues to be of a level that meets the demands of consumers.
- Auckland Airport continues to deliver superior quality performance, which we encourage the Commission to recognise in its Final Report.

ID Regulation is effectively promoting quality at Auckland Airport

88. Auckland Airport takes pride in the quality of our services for all airport users and in our engagement with substantial customers to ensure that quality requirements are appropriate from the perspective of consumers. Given the complexity of the environment we operate in, Auckland Airport continues to deliver a superior level of service for its price points.
89. The ID quality monitoring framework interacts with the continuous feedback loops that Auckland Airport has in place with our customers, and has improved our focus on reliability and fault diagnosis. This positive interaction leads to a focus on building understanding and finding practical solutions to resolve any service issues which arise.
90. As such, Auckland Airport agrees with the Commission's draft conclusions that:
- (a) Auckland Airport's conduct in this area is appropriate, and the quality of service provided to passengers and airlines meets their demands,²¹ and
 - (b) ID regulation has not negatively affected existing incentives to provide services at a quality that reflects consumer demands.²²
91. In addition, we support the Commission's acknowledgment that assessing whether quality reflects consumer demands includes a consideration of whether consumers would be willing to pay more (or less) for higher (or lower) quality.²³
92. As with innovation, going forward it will be important to ensure ID regulation does not undermine existing incentives to promote quality.

Auckland Airport is a superior performer

93. Auckland Airport continues to consider that we deliver superior quality performance today. In its Draft Report, the Commission states:²⁴
- ... our own analysis indicates that Auckland Airport provides a level of quality similar to both Wellington and Christchurch Airport and that this level of quality has remained at a similar level over time, which suggests it is not a superior performer in these areas.
94. The quality analysis measures included in the ID requirements are one measure of Auckland Airport's ability to provide services of the quality and range wanted and expected by consumers. These analytical measures demonstrate that Auckland Airport is providing services at a quality that reflects consumer demands. Auckland Airport's quality has consistently been rated "very good" in the ASQ survey results, which we

²¹ Draft Report, paragraph C3.

²² Draft Report, paragraph C4.5.

²³ Draft Report, paragraph C12.

²⁴ Draft Report, paragraph C5.

consider to be exceptional given our price point and the near-impossibility of achieving a quality rating of 5 out of 5 in the ASQ process.

95. In our view, the Skytrax awards demonstrate that Auckland Airport is doing so in a way which has been recognised to be superior. These awards are a very strong passenger service indicator, based on a global survey of over 12 million passengers who evaluate the traveller experience across 39 different airport service and product factors.
96. As the best airport in the Australia-Pacific region for the past five years, these awards show that we are meeting passenger demands in a superior way. Our continued success in these awards demonstrates that Auckland Airport is delivering quality in a way that is important and valuable to passengers and which they are willing to pay for.
97. The approach in the Draft Report indicates that these awards are not relevant to a finding of superior performance due to Auckland Airport's historically high quality results, and the Commission's quality analysis of Christchurch and Wellington Airport.
98. It is difficult to see that Auckland Airport's exceptional performance is somehow less valuable because we have had a historically high quality base, or because the other regulated airports in New Zealand also provide good quality services.
99. We acknowledge that Auckland Airport has been providing excellent quality services to passengers for some time, with continuing incremental improvements. In our view, this is not a barrier to a finding of superior performance. Similarly, New Zealand is in a fortunate position in that all three of its regulated airports are delivering high quality services, and have been for some time. Again, this is not a barrier to finding that Auckland Airport is a superior performer with regard to quality.
100. If quality standards drop going forward, the Commission and other interested parties will be quick to point out the decrease in quality, and adverse inferences may be made about Auckland Airport's performance. However, if current standards are maintained or improved going forward, the approach set out in the Draft Report suggests this continued positive performance will be treated as the expected standard.
101. We are therefore concerned that the approach in the Draft Report suggests that sustained superior performance may be mistakenly considered to be the "average supplier" standard. Auckland Airport works incredibly hard to ensure that we continue to provide world-class services of award-winning quality. To us, this is a key sign that we continue to meet consumer demands in an exceptional way.
102. The Commission also considers it is unable to conclude that Auckland Airport has demonstrated superior performance as:²⁵

It is also unclear whether Auckland Airport achieves appropriate price-quality trade-offs. This is an important factor when considering whether Auckland Airport's performance in this area is superior and might justify earning a return higher than our estimated cost of capital.

103. In apparent contrast to these statements, the Commission has noted elsewhere in its Draft Report that:
- (a) ID regulation has provided information on the steps Auckland Airport has taken to elicit feedback from consumers on the quality they expect,²⁶
 - (b) airlines have not raised any concerns with their ability to make price-quality trade-offs at Auckland Airport,²⁷ and

²⁵ Draft Report, paragraph C5.

²⁶ Draft Report, footnote 8, page 51.

(c) the evidence available indicates Auckland Airport has enabled consumers to make price-quality trade-offs through aspects of its pricing methodology.²⁸

104. It is clear that Auckland Airport's on-going communications and positive relationships with substantial customers will allow considerable input into the price/quality relationship throughout PSE2. In this respect, price quality trade-offs will continue to occur as feedback from various stakeholders during the course of the pricing period is considered as part of the decision-making process. In short, we recognise that price-quality trade-offs need to be made, and are conscious of the risks of under- and over-investing in quality.
105. In addition, Auckland Airport has provided a mechanism to adjust pricing in certain circumstances where airlines wish to substantially increase investments in quality over the pricing period.²⁹ For example, if there is agreement airlines can raise the quality levels by requesting us to invest in additional facilities.
106. In light of this evidence, we consider the Commission can appropriately conclude that Auckland Airport is a superior performer with regard to quality.

²⁷ Draft Report, D30.

²⁸ Draft Report, D32.

²⁹ Further detail is included in Auckland Airport *Submission on the Section 56G Review Process and Issues Paper*, 19 October 2012, paragraph 352.

SECTION 4: PRICING EFFICIENCY

Key points:

- ID regulation is effectively promoting efficient pricing at Auckland Airport. Auckland Airport's pricing methodology for the 2012-2017 pricing period is efficient and positive changes have been triggered by the ID requirements.
- Auckland Airport's demand forecast for PSE2 is reasonable and there is no evidence that Auckland Airport seeks to under-forecast demand. Similarly, the other forecast elements in Auckland Airport's pricing decision were efficient and reasonable at the time prices were set.
- The Commission's analysis is properly based on these reasonable forecasts, and the Commission has appropriately given no weight to alternative demand forecasts.

ID regulation is effectively promoting efficient pricing

107. The Commission has accurately concluded that ID regulation is effectively promoting efficient pricing at Auckland Airport. Auckland Airport agrees with the method the Commission has used to assess pricing efficiency and the progress that has been made in this performance area since the introduction of ID regulation. We are pleased the Commission has recognised that:
- improvements in the efficiency of pricing have taken place between PSE1 and PSE2;³⁰
 - Auckland Airport explicitly considered consumers' demand responsiveness when establishing our pricing methodology;³¹
 - Auckland Airport set prices transparently, and having regard to price stability and certainty for stakeholders when doing so,³² and
 - our conduct has demonstrated that we seek to improve the efficiency of our pricing.³³
108. As noted by the Commission, ID has had a positive impact on Auckland Airport's performance due to the requirement to transparently outline our pricing methodology. This operated as the trigger for Auckland Airport to give greater consideration to its pricing methodology and efficient pricing principles when setting charges in 2012.
109. In addition, we agree with the Commission's conclusion that the overall demand forecasts for PSE2 are generally reasonable.³⁴ The Commission has also concluded that Auckland Airport's demand forecasts for PSE1 were reasonable. On this basis, we consider that there is evidence to support a finding that Auckland Airport seeks to robustly forecast demand. We encourage the Commission to reflect this conclusion more expressly in its final report.
110. Further, we agree with the Commission that BARNZ' demand forecast should not form part of the assessment of Auckland Airport's performance. We reiterate that:

³⁰ Draft Report, paragraph D5.

³¹ Draft Report, paragraph D28.

³² Draft Report, paragraph D33.

³³ Draft Report, paragraph D40.

³⁴ Draft Report, paragraph D38.

- (a) the forecasts used by Auckland Airport to set charges accurately reflected expectations of future demand at the time prices were set;
 - (b) these forecasts were robust, reliable and based on independent data from Tourism Futures International ("**TFI**") and Airbiz, who specialise in forecasting for airport master planning and charging purposes;
 - (c) airlines were invited to contribute their own views of their schedules and demand directly to these independent consultants, so that a robust forecast could be built that included contributions from customers;
 - (d) BARNZ' demand estimate was based on analysis of historical averages, which was inferior to the data from TFI and Airbiz; and
 - (e) Air New Zealand has submitted that the passenger demand forecasts used by Auckland Airport to set prices for PSE2 reflect expectations of future demand.³⁵
111. In these circumstances, we query the value of incorporating BARNZ' alternative forecast as a sensitivity in assessing Auckland Airport's returns. In our view, the alternative position put forward by BARNZ does not have the necessary robustness to warrant inclusion in the sensitivity process. As such, we encourage the Commission to disregard the alternative demand estimate put forward by BARNZ in its Final Report.
112. Actual results will inevitably vary from forecast. We are concerned that it is easy, with the benefit of hindsight, for parties to focus on a one-sided analysis if demand turns out to be more than forecast (or, for example, operating expenses are less than forecast) and undertake no analysis where demand turns out to be less than forecast. In our view, sufficient acknowledgment needs to be given that:
- (a) Forecasting is a difficult process which Auckland Airport takes very seriously. We endeavour to reach reliable, robust forecasts at the time of pricing. For PSE2, Auckland Airport's forecast volumes were reasonable, appropriate and unbiased in the circumstances that existed at the time of pricing.
 - (b) Any *ex post* analysis does not change the fact the forecast was reasonable at the time of pricing. If demand increases by more than forecast, there is no reason to suspect that excess profits are being made. Similarly, any *ex post* analysis must acknowledge that Auckland Airport bears the risk if demand is less than forecast (as was the case in PSE1).
 - (c) Auckland Airport and its customers share the risk (on their respective businesses) that actual demand will differ, as they would in a workably competitive market.
113. As discussed elsewhere in this submission, we encourage the Commission to draw conclusions that the forecast elements in Auckland Airport's pricing decision were equally reasonable and efficient at the time prices were set.

³⁵ Air New Zealand Submission on Section 56G Review of Auckland Airport, 19 October 2012, paragraph 64.

SECTION 5: PROFITABILITY

Key points:

- ID regulation was a significant factor in Auckland Airport's pricing decision. Auckland Airport set prices to earn a fair and reasonable return on long-term investments, and we agree with the Commission that ID regulation is effectively limiting Auckland Airport's ability to earn excess profits.
- However, Auckland Airport considers that analysing the effectiveness of ID regulation requires a broader approach than comparing the output from a rate of return model to a theoretical WACC estimate.
- The appropriateness of airport decisions should be judged on the fact set at the time of pricing.
- The role of ID regulation in providing information, promoting transparency, and incentivising changes in conduct and outcomes over time is an important part of assessing the effectiveness of ID regulation.

Overview

114. Auckland Airport set prices after drawing guidance from the regulatory framework (including the IMs), expert advice, market and commercial circumstances, and feedback from our substantial customers. Our pricing decision sought to balance and promote the varying needs of our customers while ensuring that Auckland Airport would earn a fair and reasonable return over time.
115. ID regulation was a significant constraining factor in our pricing decision, and we agree with the Commission's conclusion that ID regulation is effective at limiting Auckland Airport's ability to earn excess profits. However, Auckland Airport has some remaining concerns with the way the Commission has carried out its analysis.
116. We agree with a number of features of the Commission's approach to assessing profitability. In particular, Auckland Airport considers that:
- (a) As recognised by the Commission, ID regulation is clearly a regulatory tool that is capable of limiting the ability of airports to earn excessive profits (although we do not agree that ID can be "more" effective in relation to this limb and/or have a more immediate impact than in relation to other limbs).³⁶
 - (b) The Commission has appropriately recognised that Auckland Airport made positive changes to our price setting approach for PSE2 which brought our target for returns within an appropriate range.³⁷
 - (c) The Commission has correctly concluded that an assessment of our pricing decisions should be based on the fact set at the time prices were set. As part of this assessment, the Commission has appropriately:
 - (i) acknowledged that BARNZ assessed Auckland Airport's charges at the 75th percentile of the Commission's WACC estimate (8.04%) at the time charges were set; and

³⁶ See Draft Report, paragraph E27.

³⁷ Draft Report, paragraph E9.

- (ii) referenced the April 2012 WACC estimate as part of the information set available to Auckland Airport at the time it set prices.
 - (d) The Commission's decision to place more reliance on the 75th percentile estimate of its cost of capital than on the 50th percentile estimate is appropriate (subject to the discussion of asymmetric risks below).
 - (e) Appropriate decisions have been made to disregard the airlines' speculative future assumptions involving revaluations on a market value existing use ("MVEU") and optimised depreciated replacement cost ("ODRC") basis. Although we do not consider it is appropriate for an analysis of current performance to make assumptions about future pricing decisions, we are pleased the Commission has adopted the best evidence of Auckland Airport's likely future behaviour.
 - (f) The Commission has correctly considered that BARNZ' alternative land valuation is not appropriate to use as the opening value in its internal rate of return ("IRR") analysis as it has not been subject to any external review procedures and no assessments have been made about its IM compliance.³⁸ In our view, it is not appropriate to have regard to airline alternative valuations that are not subject to the considerable scrutiny, auditing requirements and compliance obligations that apply to Auckland Airport's disclosed valuations.
 - (g) Similarly, the Commission's decision to give no weight to the results from its sensitivity analysis is appropriate and responsible given:
 - (i) the nature of the data and assumptions in the sensitivity scenarios in the Draft Report; and
 - (ii) the evidence that the approaches adopted by Auckland Airport in pricing (including the land valuation and demand forecasts) and Auckland Airport's disclosed valuations under the ID requirements are appropriate and reasonable.
117. We do not discuss these issues in any depth in this submission.³⁹ However, further discussion is needed on the following aspects of the Commission's analytical approach:
- (a) the approach to assessing the effectiveness of ID regulation in constraining airport returns;
 - (b) the use of the WACC IM as an estimate of "normal returns";
 - (c) the approach to the opening and closing asset bases in the Commission's IRR analysis; and
 - (d) the sensitivity assumptions in the Commission's analysis.

Assessing the effectiveness of ID regulation

118. The Draft Report states that:⁴⁰

We do not agree that we can conclude that information disclosure is effective providing it places some constraints on profit levels, and as a result prices are

³⁸ See Draft Report, paragraph F46.

³⁹ These issues are addressed in more detail in: Auckland Airport *Section 56G Review of Auckland Airport: Post-conference submission*, 15 March 2013.

⁴⁰ Draft Report, paragraph E26.

lower than they would otherwise be. This is because the airport might still be targeting an excessive level of profits.

119. This is correct, to some extent. However, it assumes that evidence of excess profits is readily available. Auckland Airport's view is that, in a scenario where there is considerable debate about how to assess whether forecast returns are excessive, the Commission is best to look at the available evidence that ID is having a limiting effect at the time that prices are set.
120. Accordingly, assessing how effectively ID regulation is promoting the profitability limb of the purpose statement requires an analysis of incentives, conduct and outcomes (as with each of the other limbs of the Part 4 purpose statement). To be complete, that analysis should be significantly broader than an approach centred on theoretical modelling.
121. As such, an approach that is based solely on a comparison of returns to the WACC IM does not fully acknowledge what "success" means for ID regulation. This is particularly the case when it was never intended by lawmakers that the Commission's WACC IM would be a hard target that airports must price to.⁴¹ The role of ID regulation in providing information, promoting transparency, and incentivising changes in conduct and outcomes over time is what must be assessed.
122. When these factors are taken into account, we consider that ID is having a noticeable impact in constraining airport profitability. This impact extends beyond that which can be captured by the results of the Commission's IRR modelling. In particular, ID regulation has:
- (a) Provided considerable transparency of Auckland Airport's conduct and performance. A wide range of information was put to substantial customers in Auckland Airport's pricing consultation, and substantial information has been provided through annual disclosures for the 2011 and 2012 financial years, as well as in the price-setting disclosure for PSE2.
 - (b) Resulted in Auckland Airport thoroughly justifying our decisions and the reasons behind them throughout consultation, in our price-setting disclosure, and through the section 56G review process. As such, ID has required us to be more explicit about our modelling, approaches and assumptions, and has given airlines a reference point to test those approaches. This is clear evidence that ID regulation is working as intended.
 - (c) Been very effective at highlighting the issues of main concern and promoting debate on these issues, which is a good thing. Continued debate to encourage understanding and appreciation of different parties' positions is a key factor in ensuring that Auckland Airport has incentives to limit its returns expectations.
 - (d) Influenced behaviour and outcomes in a number of key ways, including the target return falling from PSE1 to PSE2, price increases for PSE2 at less than the rate of inflation, and Auckland Airport's decision to follow ID guidelines in some areas where we have reservations with the IM approach.

For example, Auckland Airport has practical and economic reservations with the IM requirements to exclude the Northern Runway land from the regulatory asset base for disclosure purposes. However, we have taken efforts to respond to and manage within the regime as best we can while seeking

⁴¹ See, for example, Ministry of Economic Development *Report on the Commerce Amendment Bill*, 4 July 2008 at page 25.

ongoing dialogue on this key issue with our substantial customers and the Commission.

123. These types of constraints provide valuable information about how ID regulation is effectively limiting Auckland Airport's ability to earn excessive profits. All constraints on profitability are evidence that ID regulation is working to limit Auckland Airport's ability to earn excessive profits. Acknowledging these constraints as evidence of ID's effectiveness ensures that interested parties fully understand that ID regulation is intended to promote broadly defined outcomes over time, rather than requiring instant achievement of precise (yet debateable and contentious) standards.
124. As a result, while the Commission appears to be focussed on whether ID has effectively reduced profits to the level that would be allowed if price control applied, a robust report would instead focus on and fully acknowledge all of the ways ID has nevertheless placed constraints on profitability, consistent with the nature of ID regulation.
125. Further, given that estimating a reasonable return is an extremely contentious, imprecise and theoretical task, we encourage the Commission to focus on real world factors that are capable of being evidenced, such as those above.
126. We continue to encourage the Commission to reflect these considerations in its Final Report.

The WACC IM as an estimate of "normal returns"

127. In previous submissions, Auckland Airport has described our reservations with the prescriptive nature of the WACC IM and the way it is being used by the Commission. As previously discussed, we understood that the WACC IM provided guidance and a reference point to facilitate effective ID and consultation. We did not consider the WACC IM to provide us with an accurate estimate of the forecast level of return that was appropriate for Auckland Airport.
128. As noted in Section 1 of this submission, we appreciate that the Draft Report has acknowledged the WACC IM does not constitute an "immovable cap on what constitutes an acceptable return".⁴² The Draft Report goes on to state that the WACC IM:⁴³
- ... provides a range of estimates, rather than a single estimate. A departure in actual returns from within that range needs to be considered in context and, depending on the reasons for and size of the departure, may or may not lead us to conclude that excessive profits are being earned or are forecast to be earned.
129. However, the *application* of the WACC IM in the Commission's profitability analysis illustrates the difference in approach between Auckland Airport and the Commission. As such, we are keen to ensure the Commission fully understands Auckland Airport's position on this important issue.
130. The Commission's starting point is that the WACC IM is the appropriate level of returns for every airport, and it notes that contextual factors will be relevant in *some* circumstances. On the other hand, Auckland Airport considers it is necessary to put the WACC IM in context in *all* circumstances to provide interested parties with sufficient information about the nature of airport returns and the limitations associated with a strict application of the theoretical WACC model. In this way:
- (a) the Commission considers that contextual factors may justify actual returns that are above what the Commission considers to be "normal returns"; whereas

⁴² Draft Report, paragraph 2.32.

⁴³ Draft Report, paragraph 2.32.

- (b) Auckland Airport considers that contextual factors are necessary to understand what an appropriate range for "normal returns" may look like, on both a forecast and actual basis.
131. For example, Auckland Airport considers that forecast and actual returns above the WACC IM may be appropriately considered to be "normal returns" in light of:
- (a) observable market outcomes and investor expectations which may be inconsistent with the output of the WACC IM;
 - (b) business or industry circumstances that are relevant to airports in general and Auckland Airport in particular;
 - (c) economic conditions in New Zealand and globally; and
 - (d) the practical challenges that New Zealand's airports face in attracting sufficient capital to fund significant long-term investments.
132. Auckland Airport considers that the nature of the prescriptive WACC IM resulted in a lack of engagement from airlines on WACC issues in Auckland Airport's most recent pricing consultation. In our view, the current approach in the section 56G review encourages airlines to approach future pricing consultations with the expectation that airports must set forecast returns at the level of the then current WACC IM. We do not consider this to be the intent of the ID regime.
133. By acknowledging that the output of the WACC IM must *always* be considered in context, and providing examples of situations in which returns above the WACC IM will be considered to be "normal returns", the Commission can:
- (a) proactively contribute to the depth of understanding that all parties will bring to future pricing consultations;
 - (b) avoid a situation where airlines bring an entrenched view to the consultation table; and
 - (c) meaningfully distinguish ID regulation from a heavier-handed regulatory approach.

Airport-specific factors

134. Through the course of the section 56G review, it has become apparent that Auckland Airport and the Commission have different views on how capital markets work in practice.
135. Auckland Airport considers elements of the WACC IM are too theoretically based and the results of the WACC IM need to be benchmarked against achievable and observable capital market outcomes.
136. We remain concerned that, in an effort to establish an industry-wide asset beta (based on a sample of international airports) for disclosure purposes, the Commission has disregarded specific factors which may impact upon the non-diversifiable risk/asset beta for each airport in the section 56G review. We consider that Auckland Airport's cost of capital is under-estimated by the WACC IM, particularly if other market frictions and risk factors relevant to Auckland Airport were taken into account. The use by the Commission of the industry-wide asset beta when assessing Auckland Airport's returns fails to acknowledge a rational investor-required rate of return. To the extent that this rational investor-required rate of return is considered to be excessive, incentives to invest may be diminished.

Treatment of asymmetric risks

137. The Draft Report notes that:⁴⁴

In the IMs we decided not to make any adjustments to the cost of capital for asymmetric risk, but noted that it may be appropriate to deal with asymmetric risks through other means (such as adjustments to regulatory cash flows).

Auckland Airport has not factored asymmetric risks into its cash flows. However, given our draft conclusion that information disclosure regulation has been effective in limiting Auckland Airport's ability to extract excessive profits over time, other possible adjustments for asymmetric risk have not required closer examination.

138. Auckland Airport continues to consider that the lack of any adjustment for asymmetric risk under the Commission's IM approach will leave airports significantly exposed in the event of a catastrophic event. We remain concerned that the Commission's approach risks:

- (a) mistakenly assessing reasonable returns on an *ex ante* basis as excessive returns, because asymmetric risk is not provided for in its WACC IM or otherwise accounted for; and
- (b) creating considerable uncertainty as to when and how costs incurred in response to a catastrophic event can be recovered after the event.⁴⁵

139. We continue to encourage the Commission to consider ways in which it can reflect an allowance for asymmetric risk in its assessment approaches.

The timing of the WACC IM

140. Auckland Airport set its charges after drawing considerable guidance from our understanding of the regulatory framework and the application of the ID regime at the time prices were set. As the Commission has acknowledged, Auckland Airport considered that its forecast return was consistent with the Commission's published WACC estimate at the time prices were set, and was also consistent with the return expectations used by BARNZ (of 8.04%) when assessing the reasonableness of Auckland Airport's charges.⁴⁶ The Commission's published April WACC estimate was the key reference point used by substantial customers to assess Auckland Airport's charges.

141. For pricing purposes, Auckland Airport clearly signalled to substantial customers its intention to continue updating the parameters in its pricing model (including in Auckland Airport's WACC estimate) periodically. We also clearly signalled our intention to stop updating the parameters after a certain point for practical reasons, in order to make a pricing decision and provide adequate notice of that decision to its substantial customers. No feedback was received on Auckland Airport's proposal to do so, and no substantial customers requested that Auckland Airport update its WACC estimate closer to July 2012.

⁴⁴ Draft Report, paragraph F61-F62.

⁴⁵ See, for example, the Commission's Issues Paper on the Orion proposal for a customised price path, where the Commission's initial view appears to be that investors have had the opportunity to spread risk and it is therefore not clear whether Orion should recover costs incurred in response to the earthquakes (and, if there is to be any recover, in what proportion): Commerce Commission *Invitation to Have Your Say on Orion's Proposal to Change its Prices and Quality Standards: Issues to Explore and Consider*, 1 May 2013 at paragraphs 89 - 91.

⁴⁶ See Draft Report, paragraph E19.

142. At the Christchurch Airport conference (in response to submissions from BARNZ), Commissioner Duignan indicated that the updating of WACC estimates before pricing decisions may have implications for the way the Commission thinks about publishing its WACC updates.⁴⁷
143. However, this consideration would clearly be an ongoing process in which the Commission would wish to seek the views of airports, airlines and other interested parties. It would be inappropriate for the Commission to assess performance in its section 56G review against any newly developed principle.

The opening asset base

144. The Commission has elected to apply a formulaic IRR approach to the assessment of Auckland Airport's forecast returns. We continue to consider that, under the analytical structure established by the Commission, the appropriate opening asset base is the 2012 disclosed values of Auckland Airport's assets (as this is the IM compliant value).
145. In our view, the Commission's assessment framework is built on comparing forecast returns to the current value of an airport's assets as at the start of the pricing period. As such, the appropriate reference point for the Commission to use for its opening asset base is the Commission's view of the value of Auckland Airport's assets in a workably competitive market, as at the beginning of 2012. This is the IM compliant value.
146. The Draft Report notes that:⁴⁸
- ... profitability is measured as the returns achieved or expected by a supplier from its operations over time relative to the value of the assets employed in those operations.
147. The Commission has been clear that the asset valuation IM represents its best estimate of the value of airport assets in a workably competitive market. In our view, adjusting the disclosed opening IM value of Auckland Airport's assets for assessment purposes based on the pricing treatment of those assets before 2012 is in conflict with:
- (a) the basic theory of a regulated environment where asset values shed light on the appropriate level of costs that prices should seek to recover, rather than the other way around;
 - (b) the Commission's acceptance that 2012 is effectively the "start" of the ID regime, and that decisions made before this time cannot be considered as a product of ID regulation; and
 - (c) the separation between pricing and ID regulation.
148. We understand that the moratorium asset value used in pricing is different to the Commission's asset valuation IM. However, that is simply one of the building blocks used to reach a view on an appropriate return, and therefore prices. It does not determine the prices.
149. The Commission has been clear that its task is to assess outcomes, not inputs. As such, the Commission's role should simply be to assess the forecast regulatory revenues over PSE2 (which do not include revaluation gains) against its view of the regulatory asset base at the start of that period (ie the IM compliant asset value).
150. At the very least, the Commission should include a scenario in its analysis which incorporates the 2012 ID asset valuation as the opening IRR asset base.

⁴⁷ Commerce Commission *Transcript of Christchurch Airport Conference*, 24 May 2013 at page 58 (lines 25-26).

⁴⁸ Draft Report, paragraph E2.

Treatment of noise mitigation costs

151. The 2009 IM asset base the Commission has used as the starting point for its opening asset base in its IRR analysis excludes works under construction.
152. However, as clarified in Auckland Airport's post-conference submission, cumulative noise mitigation costs of \$10.9m were included in the pricing asset base on which charges were set for PSE2. These costs form part of disclosed works under construction in the 2012 information disclosures, and are not included in the Commission's opening IRR asset base:⁴⁹

PSE1

In PSE1, both operating and capital cost forecasts associated with noise were included in pricing. At the end of PSE1 the actual capital costs associated with the noise programme in PSE1 were \$10.9m. This was included in the closing asset base that was rolled forward to PSE2.

(m)	Input	2008	2009	2010	2011	2012	
Noise Trust costs	Forecast	0.3	0.3	0.3	0.1	0.1	
Capital costs for Acoustic Treatment	Forecast	2.5	1.1	0.9	0.4	0.3	
Acoustic treatment	Actual PSE1					6.2	
Acoustic treatment	Prior to PSE1	4.6					
						10.9	

PSE2

Noise trust operating costs of \$300,000 were included in the forecast operational expenditure for pricing in PSE2 (increasing at CPI over PSE2). Forecast capital costs associated with acoustic treatment of houses for PSE2 were excluded from pricing. These were not forecast to be very material in PSE2.

...

Auckland Airport understands that the airlines support the acoustic treatment costs incurred over the course of PSE2 being included in the PSE3 asset base, based on outturn costs.

153. Auckland Airport continues to recommend that the Commission's opening asset base should be increased to include acoustic costs incurred to date which are not reflected in the RAB values (\$10.9m), given BARNZ' preference for these to be included in the asset base on which charges were set. As noted by BARNZ at the conference:⁵⁰

... we consider it should be in the current asset base on which charges are currently being paid.

154. We have checked the pricing model and found that no depreciation profile was applied to this asset. The modelling adjustment required is therefore as follows:

	FY12	FY13	FY14	FY15	FY16	FY17
Acoustic treatment forecast in pricing asset base to be added to the asset base for IRR analysis	10.9	10.9	10.9	10.9	10.9	10.9

⁴⁹ Auckland Airport *Section 56G Review of Auckland Airport: Post-conference submission*, 15 March 2013, Section 8 (pages 34-35).

⁵⁰ Commerce Commission *Transcript of Auckland Airport Conference*, 28 February 2013 at page 58.

Sensitivity assumptions

155. Auckland Airport questions the need to include sensitivities which are based on assumptions that are not robust (such as a MVEU/ODRC valuation, a demand forecast which BARNZ has subsequently resiled from, or a reduction in Auckland Airport's land valuation⁵¹). However, we accept the Commission has taken a sensible approach in attempting to understand these sensitivities but concludes that they are of no weight in its analysis.
156. In addition, we consider the Commission can validly explore "upside sensitivities" such as an adjustment to cashflows as an allowance for asymmetric risks, and a 10% upwards adjustment to Auckland Airport's land values (which is an equally plausible option).

Proposed changes to information disclosure

157. The Commission has suggested that changes be made to the ID requirements going forward, in order to:
- (a) align the asset valuations disclosed under ID with the pricing treatment of those assets; and
 - (b) require airports to disclose an indicator of expected returns in future pricing disclosures that is in line with the Commission's approach in the section 56G review.
158. Auckland Airport does not consider these changes to be appropriate.

"Matching" disclosed values to pricing treatment

159. Requiring disclosed asset valuations for annual ID purposes to "match" the pricing treatment of those assets inappropriately blurs the distinction between pricing and information disclosure.
160. Land assets provide the clearest illustration of the issue in relation to the Commission's suggestion. For land assets, the Commission has been clear that the right incentives will be provided where disclosed asset values represent the current opportunity cost of those assets. In its IM Reasons Paper, the Commission stated:⁵²

The correct incentives to invest in land in future will be provided if Airports expect to be able to earn a return on any investment in land before profits appear excessive that is sufficient to compensate them for the costs of acquiring and holding onto that land. The cost of continuing to hold onto land acquired in the past is measured by the opportunity cost that the Airport incurs today by using the land to supply specified airport services (i.e. instead of using it to supply other services). Providing a signal to Airports that they will be consistently able to earn revenues that compensate them for the opportunity cost of holding land without profits appearing excessive is therefore the appropriate approach when valuing land under Part 4.

161. The treatment of land assets in pricing is a matter for consultation between airports and airlines when charges are set. It is not relevant to assessing the current opportunity cost of the land, and therefore is not (and should not be) relevant to the disclosed asset values.

⁵¹ We note for completeness that we continue to consider that Auckland Airport's land valuations in 2009 and 2011 are fully IM compliant. We continue to seek to understand the views of the Commission's expert valuer, and explain Auckland Airport's position, in this respect.

⁵² Commerce Commission *Input Methodologies (Airport Services) Reasons Paper*, 22 December 2012 at paragraph 4.3.57.

162. In addition, the suggested approach is circular, selective and asymmetric, and would result in a number of difficulties and inconsistencies. For example:
- (a) If airports include a different set of assets in the pricing asset base, does this alter the assets in the disclosed regulatory asset base? If so, this would be inconsistent with the application of ID to all regulated assets.
 - (b) If airports include additional assets in the pricing asset base (for example, if Auckland Airport agreed with its substantial customers to introduce a charging structure for the Northern Runway land, and to disclose those charges in accordance with the current disclosure rules on future use assets), would the value of this land be added to the regulatory asset base for disclosure purposes?
 - (c) If airports value land for pricing on a different basis to the Commission that results in a higher value than a current MVAU value, how would this be treated when disclosing valuations?
163. In short, the Draft Report's suggestion of an adjustment to the ID requirements to accommodate how revaluations were treated in pricing would, if it was done on a principled and consistent basis, actually require a fundamental readjustment to the asset valuation IM on a basis entirely inconsistent with the reasoning behind that IM.

Indicator of expected returns

164. Requiring airports to disclose an indicator of future returns in line with the Commission's IRR model will require airports to make assumptions about future pricing periods at the time of each pricing decision.
165. We understand the Commission considers this is necessary to be able to measure returns over the life of an airport's assets. However, requiring airports to disclose predictions about potential pricing decisions does not, in fact, give this information.
166. A better approach is to give the ID regime time to work to its full potential and produce the information set needed to properly draw conclusions about forecast and actual returns over time. This data will become available over time through annual disclosures and future pricing disclosures.

SECTION 6: INVESTMENT

Key points:

- Auckland Airport has created an investment plan that is efficient, reasonable and supported by airline customers.
- ID regulation has been effective in its early stages in promoting incentives for Auckland Airport to plan efficient and appropriate investment.

Auckland Airport's positive investment performance

167. Auckland Airport has a strong track record in investing to provide capacity. We undertake responsive, responsible and forward-thinking investment to ensure our continued contribution to the NZ economy. It is important that the ID framework is providing positive investment incentives and not discouraging our incentives to continue timely and appropriate investment that helps New Zealand's economy to thrive.
168. Auckland Airport supports the Commission's findings that:
- the evidence demonstrates Auckland Airport has effectively consulted on forecast capital expenditure with airlines for PSE2, and the consultation process adopted by Auckland Airport has been commended;⁵³
 - parties consider that the level and timing of planned investment for PSE2 is efficient based on the circumstances at the time of pricing;⁵⁴ and
 - there is no evidence of planned under or over-investment at Auckland Airport for PSE2.⁵⁵
169. In addition, we appreciate and endorse the comments we have received from our airline customers through the section 56G review. In particular:
- BARNZ has commented that our forecast capital expenditure represents efficient, sensible and appropriate responses to the areas of capacity constraint in current facilities, and makes sensible use of existing space.⁵⁶ Auckland Airport has also received feedback from BARNZ in support of its proposal to consult separately on the new terminal facility outside the process for setting standard charges.⁵⁷
 - Air New Zealand has noted that it considers Auckland Airport's capital expenditure forecasts for the second PSE to be reasonable, and the capital expenditure programme to be a good reflection of customer requirements during PSE2.⁵⁸
170. As discussed in our post-conference submission, Auckland Airport delivers an excellent service level in our engagement model with customers. We consider that Auckland Airport delivers a level of consultation that far exceeds our statutory obligations, and

⁵³ Draft Report, paragraph H4.2.

⁵⁴ Draft Report, paragraph H4.2.

⁵⁵ Draft Report, paragraph H17.

⁵⁶ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 29.

⁵⁷ BARNZ *AAA Consultation - Minutes from BARNZ presentation on the Revised Pricing Proposal*, 16 May 2012, page 2 and Air New Zealand *AAA Consultation - Minutes from Air New Zealand presentation on the Revised Pricing Proposal*, 16 May 2012, pages 1 and 2.

⁵⁸ Air New Zealand *Submission on Section 56G Review of Auckland Airport*, 19 October 2012, paragraph 63.

recent changes have been made to include airline priorities as a fundamental initial step in capital expenditure planning.

171. In our view, the importance of recognising our constructive and superior engagement with our airline customers cannot be underestimated. This is particularly important in the context of ID regulation, where promoting more effective consultation and engagement between airports and airlines was a key driving factor behind the introduction of the new regime.
172. In light of these positive findings, we encourage the Commission to revise its draft conclusion that it cannot conclude whether ID is promoting incentives to invest at Auckland Airport. As we have noted above, the Commission's ID framework was specifically designed to allow, among other things, *ex ante* assessments of the scope and timing of capital expenditure in light of demand forecasts, consumers' willingness to pay, and the quality expectations of consumers.⁵⁹

ID is effectively promoting incentives to invest in its early stages

173. Auckland Airport has a responsibility to consumers, Auckland and New Zealand to ensure long-term tourism infrastructure capacity for predicted growth is in place. This requires getting the right infrastructure in the right place at the right time, and investing in a manner that enables the flexibility needed to accommodate future changes.
174. In order to do so, Auckland Airport must have incentives to:
- (a) make efficient planning decisions in advance; and
 - (b) appropriately and efficiently implement those decisions (including adjusting those decisions in response to changing conditions or customer requirements).
175. As such, ID regulation should aim to promote both incentives for Auckland Airport to efficiently plan capital expenditure *ex ante*, while spending it efficiently *ex post*. Indeed, the ID framework is set up in a way that allows both these types of incentives (and the role of ID regulation in promoting those incentives) to be assessed. In this way:
- (a) forecast pricing disclosures will allow an assessment of the efficiency and appropriateness of Auckland Airport's planned investment; and
 - (b) ongoing annual disclosures will provide information about the delivery of investment over the course of a pricing period.
176. The Commission itself notes this distinction in the Draft Report,⁶⁰ but considers that information about both of these elements is necessary before it can draw a conclusion about the effectiveness of ID regulation.
177. In our view, information about the actual delivery of capital expenditure over PSE2 cannot change the fact that, at the time of pricing, Auckland Airport's planned investment was reasonable and efficient. Similarly, it cannot change the fact that ID regulation has already promoted the right incentives for Auckland Airport to efficiently plan investment.
178. As such, Auckland Airport considers the Final Report can conclude that ID regulation has been effective, and is currently promoting incentives for Auckland Airport to invest. This conclusion is supported by the evidence that:

⁵⁹ See Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010 at paragraph 5.11.

⁶⁰ Draft Report, paragraphs H2.1 to H2.2.

- (a) existing investment levels at Auckland Airport appear appropriate;
- (b) forecast investment is reasonable and efficient in light of demand forecasts, consumers' willingness to pay and the quality expectations of consumers;
- (c) there is no evidence of planned over or under-investment in Auckland Airport's capital expenditure forecast for PSE2; and
- (d) ID has not negatively affected incentives to plan efficient investment

179. The Commission can add to this conclusion through its annual monitoring reports as it receives information on the timing and quality of investment delivery over PSE2. In this way, the Commission can take the same approach as it has done for other performance areas such as innovation and quality - make a conclusion that ID is currently effective, and monitor that conclusion over time as actual results become available.

SECTION 7: OPERATING EFFICIENCY

Key points:

- In our view, ID regulation is effectively promoting incentives for Auckland Airport to operate its assets efficiently and seek to improve its operating efficiency.
- Auckland Airport is actively seeking to improve its efficiency, and is forecasting efficiency gains over PSE2. These forecasts allow the Commission to make an *ex ante* assessment of the impact of ID regulation on Auckland Airport's incentives to improve its efficiency.
- Auckland Airport's route development activities are an example of where we are already delivering strong outcomes for consumers, and are continuing to sow the seeds now for superior performance in the future.

ID regulation is operating effectively in its early days

180. In its Draft Report, the Commission considers that it is unable to conclude whether ID regulation is effectively promoting improvements in opex efficiency at Auckland Airport. In the Commission's view, information on actual expenditure that is provided during PSE2 will assist in drawing conclusions on Auckland Airport's operating efficiency.
181. The Commission has also noted that:
- there is some evidence through Auckland Airport's conduct that we seek to improve efficiency;⁶¹
 - Auckland Airport has forecast unit opex to decline over PSE2, which may indicate improved efficiency is planned;⁶² and
 - Auckland Airport does appear to seek to improve its operating efficiency (although the Commission considers it is unclear whether there has been any change in conduct since the introduction of ID regulation).⁶³
182. Although we agree that information on actual operating expenses will help to add to the picture over time, we consider the Final Report can draw more positive conclusions based on Auckland Airport's forecast performance. In our view, ID regulation is being effective now in a number of ways:
- ID regulation puts a spotlight on all areas of airport performance. This enables the numerous interactions to be considered together, which we think is an improvement from the previous ID regime. In this way, ID allows a meaningful discussion to occur on the relationships and trade-offs between operating costs, quality, innovation and investment. This meaningful discussion was not happening in the same way before ID regulation.
 - Since the amendments to Part 4 of the Commerce Act, we have implemented new initiatives which are well aligned with the purpose statement and have adapted forums to meet the requirements of ID regulation. We are committed to listening to and truly understanding the viewpoints of our customers about our operational practices through forums such as our Collaborative Operations

⁶¹ Draft Report, paragraph G4.

⁶² Draft Report, paragraph G5.2.

⁶³ Draft Report, paragraph G5.4.

Group. This group meets regularly and is made up of operations managers of Auckland Airport and its stakeholders from across the end-to-end airport process. The objectives of the group are to enhance active collaboration, real time communication and decision making. As a result, stakeholders at Auckland Airport have excellent opportunities to influence the operational efficiency of assets. ID regulation encourages and promotes our incentives to continue to engage positively with our consumers in this way.

- (c) Auckland Airport had highly efficient operating costs by world standards prior to the introduction of ID regulation under the Commerce Act.⁶⁴ Leigh Fisher's Airport Performance Indicators 2011 Report was provided to substantial customers in our Initial Pricing Proposal, and this research demonstrated that by international standards, Auckland Airport's cost efficiency is very good. In terms of operating costs, Auckland Airport ranked 45th lowest out of the total sample group of 50 airports.
- (d) Auckland Airport is actively seeking to improve its efficiency, and is forecasting efficiency gains over PSE2. The countervailing power of airlines during our pricing consultation resulted in opex forecasts which include targeted efficiencies over PSE2. These forecasts allow the Commission to make an *ex ante* assessment of the impact of ID regulation on Auckland Airport's intentions to improve efficiency and its decision to share the expected gains with consumers through lower prices (even if those expected gains do not eventuate).
- (e) The increased transparency and availability of information through ID regulation promotes incentives for Auckland Airport to maintain or improve its operating cost efficiency. Over time, ID will help to shed light on the forecast information, including identifying where efficiencies were achieved or where forecasts may have been too tight.

Lean initiatives

- 183. Lean Six Sigma is an approach to operational excellence focussed on building transformational change. It creates an organisational culture that focuses on the customer, uses fact based, data driven problem solving, and has an inherent inclination towards innovation.⁶⁵
- 184. Auckland Airport's Lean initiatives post-dated the development of the new ID regime, and represent a material change in the way Auckland Airport does business. The Lean programme was initially facilitated by an external consultant (Beca), but a staff member has since been trained to Black Belt level in 2010. This is necessary for Auckland Airport to ensure we have in-house resources capable of managing Lean Projects on an on-going basis. Training of further staff in this discipline is planned.
- 185. In 2011, Auckland Airport (described as "Airport X") was featured in a presentation by Beca Applied Technologies Ltd ("**Beca**") at the Project Management Institute of New Zealand conference as an example of the tangible benefits that Lean Six Sigma initiatives can produce in a service environment. A copy of Beca's conference paper is **attached** to this submission. As noted by Beca in that paper:⁶⁶

⁶⁴ Auckland Airport *Submission on the section 56G Review Process and Issues Paper*, 19 October 2012, paragraphs 492-497.

⁶⁵ Beca Applied Technologies *Lean Six Sigma in a Service Environment: Applying a Unique Project Management Framework*, PMINZ National Conference 2011.

⁶⁶ Beca Applied Technologies *Lean Six Sigma in a Service Environment: Applying a Unique Project Management Framework*, PMINZ National Conference 2011, page 1.

Lean Six Sigma is an established management approach to achieving operational excellence and it can do more than simply improve processes. It can help leaders discover opportunities far beyond operations, and create organisations that have an inherent inclination towards innovation.

186. As recognised by Beca, the implementation of this approach at Auckland Airport has allowed different stakeholders to establish a common vision of enhancing the passenger experience, which has led to systematic reviews of a number of important processes (including the provision of flight information, queue times, and waiting times for baggage claim).⁶⁷

187. Using the goal setting framework of the Lean Six Sigma approach:⁶⁸

... root cause analysis is combined with statistical analysis to identify which factors are contributing to the big efficiency "leaks" which come from delays, defects and variations in any given process. This value-added approach has been demonstrated in [Auckland Airport's] Lean Six Sigma programme, where the team has successfully applied this framework to help improve operational efficiency, enhance the overall passenger experience, reduce costs and implement a continuous improvement programme in day-to-day operations.

188. As discussed in the **attached** letter from Ministry of Primary Industries Border Clearance Services, this approach creates process improvements and clear benefits for airport stakeholders. As noted in the letter:⁶⁹

The Lean process continues to be the avenue for process improvement and MPI appreciates this initiative as it has enabled many changes at Auckland Airport to occur in a timely manner through a structured process with clear objectives and benefit realisation.

189. We also **attach** a February 2012 presentation which summarises the Lean Six Sigma programme at Auckland Airport.

190. The following table demonstrates the efficiency impact of the Lean initiatives that Auckland Airport has implemented throughout the development and implementation of the ID regime. As discussed in Section 1 of this submission, it is not always possible to precisely quantify how broadly defined outcomes such as "increased efficiency" are being promoted. For this reason, we consider that the qualitative evidence provided in this table is informative and valuable for interested parties (including the Commission) when assessing the effectiveness of ID regulation. Qualitative evidence will also highlight how efficiency gains can be broader than a reduction in operating costs for Auckland Airport.

Auckland Airport's Lean efficiency initiatives

Initiative	Timing	Detail	Improvement
Arrivals APD	Jun 2010	Advanced passenger displays developed to inform key stakeholders and border agencies with arriving passenger volumes which is updated when a passenger checks in at their origin. This assists border agencies with resourcing according to passport type.	Frontline border control staff (and airport operations staff) are better informed on passenger volumes, which has improved resource management. This in turn means more passengers can be processed under the same terminal footprint.

⁶⁷ Beca Applied Technologies *Lean Six Sigma in a Service Environment: Applying a Unique Project Management Framework*, PMINZ National Conference 2011, page 2.

⁶⁸ Beca Applied Technologies *Lean Six Sigma in a Service Environment: Applying a Unique Project Management Framework*, PMINZ National Conference 2011, page 4.

⁶⁹ Ministry of Primary Industries letter to Auckland Airport, 30 May 2013, page 2.

Initiative	Timing	Detail	Improvement
Way-finding improvements in bag hall	Jun 2010	Way-finding improvement is an on-going activity as configuration changes are introduced.	Improved bag claim information displays and relocated monitors and wayfinding signs into central locations in the bag hall to improve flows and minimise congestion at the entrance to the hall by carousel 1.
Exit facilitation	Oct 2010	MAF is collating feedback and data on queue management, capacity management and passenger flows. They are systematically implementing associated changes to improve secondary screening process. A number of process improvement initiatives at international arrivals were introduced - direct exit for AU/NZ low risk passengers, passenger segmentation, roving profilers, digital screens, multi-language signs, improved signage and way-finding.	Achieving faster passenger processing times without major terminal redevelopment.
Local control stations for bag claim arrivals		Equipped frontline baggage handling agents with local control station and changed associated process.	Help optimise allocation of carousels, which deferred the need to add new infrastructure (ie new carousels).
Flight Information Display System ("FIDS") screens upgrade	Nov 2010	Large Split Flap board decommissioned and replaced with banks of 2x 42 inch FIDS screens and a 1x screen with clock opposite each entry door in the check in area as well as airside.	Improved visibility of flight information by providing critical information at every entry so passengers have equal opportunity to see and use these on entry regardless of which door they come through.
Check-in zoning	Nov 2010	Check-in area split into 5 zones A-E to assist navigation and wayfinding. Large wayfinder signs in the check-in area hang in each zone to help passengers identify the area they need to head to. A zone will be displayed on check-in FIDS displays.	Improved visibility and sight lines with large signs making for easy identification of zones to assist passengers to find their correct check-in area. This is much easier than looking for numbers above each counter.
FIDS messaging review	Jun 2011	Full holistic review of FIDS – eg message content, presentation of information, timing offsets, robustness and stability. Area specific messaging tailored to provide the right information at the right time in the passenger journey. eg. Landside check-in displays different information to landside first floor messages and airside message on departures.	Improved flight information displays to help achieve on time performance and getting passengers to the right place at the right time – effectively optimising the use of the existing infrastructure.
Carousel extension and related works	May 2011	A number of initiatives to resolve issues experienced in the arrivals baggage hall, including: extending the reclaim area on the carousel; install spill guards, install roller doors on the entry and exit points.	More efficient service to customers and improved passenger experience. It also allowed Carousel 5 to become A380 capable.
Improved Baggage Tracing Unit ("BTU")	Jun 2011	Improved BTU facility through relocation and process improvement. Worked with the ground handlers and border agencies to deliver this.	Resulted in more effective and efficient processing of unclaimed baggage without requiring new infrastructure to house this facility.
International transit & transfer screening point upgrade	Aug 2011	Project to improve transit/transfer passenger journey by increasing the queue area, improving flows through the space and delivering flight information and messaging relevant to the transit/transfer passengers.	Delivered improved layout and passenger flow through the screening point. Increased queue footprint inside and immediately outside the room. Dynamic wayfinding screens and information monitors display in multi-language to

Initiative	Timing	Detail	Improvement
			help the non-English speaking travellers.
Immigration Hall – column mounted screens and local PA system	Sep 2011	The scope included installing a local PA system and column mounted LCD screens in the Immigration Hall playing a welcome video including Customs declaration information and Biosecurity declaration reminders.	Improved passenger facilitation, in particular during RWC. Utilizing any wait time in queue to re-enforce declaration messages to arriving passengers.
MAF configuration and process changes	April 2012	MAF continues to systematically make configuration changes to their functional areas. <ul style="list-style-type: none"> Layout changes to increase queuing space into search area Wall installed to prevent odours drifting into direct exit lanes and effectively optimise the use of dogs as verification step in this process. 	Improved passenger flows into secondary screening x-ray and search areas. Less congestion and impact on All passports lanes and assessment desks. Better use of dogs in exit lanes. More centralised flow of exiting passenger.

191. Auckland Airport has maintained the positive momentum and improvements generated by its Lean steering, governance and working groups through our Collaborative Operations Group.
192. ID regulation plays an important role in these processes, through the transparency it provides and the increased information set it produces for Auckland Airport, our consumers, and our stakeholders about the effectiveness of our efforts to drive efficiencies. Further, as the Commission has recognised throughout the section 56G review, ID regulation is effective where performance is already positive in a particular area and ID regulation preserves the incentives for airports to maintain that positive performance.

Operating expenses in PSE1

193. As part of its assessment of the effectiveness of ID regulation, the Commission has examined whether Auckland Airport improved its operating efficiency in PSE1. The Commission makes a comparison between actual and forecast operating expenditure, and discusses Auckland Airport's unforeseen costs over PSE1. These costs include Auckland Airport's route development costs, regulatory costs associated with the implementation of ID regulation, and repair and maintenance costs.
194. Auckland Airport encourages the Commission to clarify in its Final Report that these costs were not included in pricing in PSE1, and were not passed on to consumers. Indeed, as discussed further below, route development costs incurred in PSE1 have generated increases in economies of scope and scale and increases in demand that have created significant benefits for consumers (at no cost for those consumers).
195. In addition, Auckland Airport will continue to invest in route development activities in PSE2 above the level of these costs that have been included in pricing, given the significant benefits that can be generated from these activities for Auckland Airport, passengers, airlines and the New Zealand economy.

The way forward for ID regulation and operating efficiency

196. Although Auckland Airport is committed to continually striving for cost efficiencies, it is increasingly difficult to achieve efficiencies off an already highly efficient base. Going forward, there may be a diminishing ability to squeeze out incremental efficiencies against this cost base.

197. In addition, the complexity of the business environment continues to evolve in practice, and passenger expectations continue to change. Auckland Airport must keep up with these changing demands. In these circumstances, operating expenditure is a key example of where different aspects of airport performance cannot be considered in isolation, and where increased efficiency does not necessarily mean reduced operating costs. For example, BARNZ has recognised that:⁷⁰

Since the introduction of the service monitoring and on-time performance monitoring measures in the information disclosure requirements the Airport Facilitation Committee is provided with quarterly reports on interruptions. It has also been observed that there is a better response to interruptions to air-bridge availability, with engineer availability having been increased. This has resulted in additional cost, but the operational benefits are valued by airlines.

198. Going forward, we encourage the Commission to examine:
- (a) the full picture available to evaluate the efficiency of ID regulation in incentivising operating expenditure;
 - (b) whether our operating cost base is efficient given the nature of Auckland Airport;
 - (c) the numerous ways in which Auckland Airport can deliver efficiencies in a broader sense than reduced operating costs (for instance, electing to incur higher repairs and maintenance costs may efficiently defer significant capital expenditure investment); and
 - (d) how the ID regime can recognise and incentivise behaviours that lead to efficiencies for consumers and the airport industry (we expand on this in the following section of this submission).

Route development costs and superior performance

199. Route development initiatives are not just about a route and an airline. These activities involve a complex system of interdependences throughout the value chain, delivering benefits for passengers and airlines, and creating tourism and trade opportunities.
200. In the Draft Report, the Commission considers that:⁷¹

While Auckland Airport submitted that its route development initiatives are an indicator of superior performance in PSE1, it is not clear to what extent this has led to increases in demand that might justify earning a return that exceeds our cost of capital. Auckland Airport also submitted that its engagement with stakeholders and investment in a Lean Six Sigma process has delivered superior outcomes. However it has not quantified the impact of these activities on its expenditure in PSE1 to demonstrate that superior efficiency performance was achieved.

201. We think that this represents an overly narrow view of how superior performance can be measured, especially when our efforts to boost demand were running against the impact of the global financial crisis (outside of our control), which was reducing demand. In other words, in certain market conditions superior performance may be needed to earn normal returns while providing a world-class service. Conversely, if superior performance does lead to higher than forecast demand and returns, the Commission's current approach leads to uncertainty that these returns may incorrectly be viewed as excessive.

⁷⁰ BARNZ *Response to Section 56G Issues Paper Relating to Auckland Airport*, 18 October 2012, page 37.

⁷¹ Draft Report, paragraph G6.

202. We consider that Auckland Airport's route development activities are a clear example of efficiencies in action. These activities have already demonstrated great outcomes for consumers, and our ongoing efforts in this area are targeted towards superior performance in the future.

203. In our view, it is important for the Final Report to recognise the areas in which Auckland Airport's superior performance is delivering "early wins" in terms of efficiency benefits, and benefits for airlines, passengers, tourism, and trade. We also encourage the Commission to understand the effort that Auckland Airport invests into these activities, which may very well mean that superior performance is demonstrated over PSE2 and beyond.

Current performance

204. In particular, our route development activities focussing on the Chinese market have been particularly successful. These initiatives have involved developing our China strategy and the critical success factors to promote NZ as a destination to the Chinese market. Our approach has included initiatives in China, through the web, and marketing within New Zealand to operators who need to make the connection with Chinese wholesalers if passenger growth targets are to be met. Auckland Airport has demonstrated its ability to achieve success in driving growth in the right market at the right time. This does not simply happen by accident.

205. By way of example, the box below demonstrates the significant effort that is necessary to drive sustainable growth in a market, using Auckland Airport's recent initiatives in the Chinese market as a case study.

Route development in action: China case study

Calendar 2009

- *Comprehensive study of China undertaken*
- *Six market airline visits were made, with four Chinese carriers approached each time*
- *More than 20 proposal updates were made to potential airlines for the China to Auckland market*
- *Auckland Airport entered joint ventures with trade partners in China to lift New Zealand's tourism profile in the Chinese market*
- *Auckland Airport engaged with Tourism New Zealand to facilitate supporting investment*

2010

- *Auckland Airport establishes its network in China of wholesales and agents to promote "NZ only" travel products*
- *Develop products for semi free independent traveller ("FIT") and customized mini group travel segments*
- *Auckland Airport develops Luxury New Zealand website, social media heavily used to promote New Zealand as a "luxury destination"*
- *Auckland Airport engages with Immigration New Zealand and broader stakeholders on the importance of simplifying the visa process to facilitate travel by Chinese nationals*
- *Organised China Southern high level visit to encourage more visa support from the New Zealand government. Immigration NZ places an immigration officer in Guangzhou – a customer centric approach to visa issues.*
- *Discussions with China Southern, Tourism Australia, Brisbane Airport on business case for services*
- *Auckland Airport and Tourism New Zealand undertook joint venture promoting NZ in China (and supporting direct services)*
- *China Southern announces new 3x weekly indirect service to New Zealand (Guangzhou-Brisbane-Auckland), after numerous market visits.*
- *Following strong agent support for NZ, China Southern drops plans to start services via Brisbane and announces Auckland direct 3x weekly service*

2011

- *First charter service (by a wholesaler) from China (Guangzhou-Auckland) during Chinese New Year*
- *China Southern commenced Guangzhou-Auckland 3x weekly direct service*
- *Within six months of commencing operation Guangzhou-Auckland services increase to a daily service*
- *Discussions with Ministry of Foreign Affairs and Trade, Tourism New Zealand, Air New Zealand and indirect carriers to develop programs in Shanghai and Beijing*
- *Auckland Airport invited to join discussions with Ministry of Transport and Chinese authorities on renegotiation of New Zealand / China air-rights. Air rights are expanded to three times daily each way (from once daily each way)*
- *In-market research and profitability analysis to monitor performance*

- Meetings with local government and regional tourism authorities to build understanding of the value and impact of the Chinese market to influence priorities
- Domestic itineraries extended through heavy development program with trade of Queenstown itinerary
- Auckland Airport organised several media familiarisations to China, to build up New Zealand outbound to China demand
- Utilised influential figures from Chinese market to build NZ profile for inbound travel (eg "travel with movie star")
- Auckland Airport organised and hosted a series of cultural training / workshops for the travel industry in Auckland, Rotorua and Queenstown, to increase likelihood the travel industry would become "China Ready"

2012

- Auckland Airport launched "Asia Competition" to seek partners to work in the Chinese market
- Auckland Airport launched *Ambition 2020* project targeting Asian markets
- Auckland Airport co-operation with Weibo (largest social media platform in China) to promote NZ, with a series of activities carried out in the digital environment including competitions, questionnaires and games
- Tourism New Zealand and Auckland Airport discuss China leisure product market structure failure, incubating the premium kiwi partnership program with Tourism New Zealand supporting then driving
- Auckland Airport offer Tourism Marketing Asia Fund to identify best practice in NZ industry and stimulate market interest
- Together with China Southern, Auckland Airport hosts a Mega familiarisation of 200 Chinese agents

2013

- FIT focused website is built to assist conversion – www.xinxilanlvcheng.com
- Asian summit – Auckland Airport gathers Asian travel airline and marketing experts for new Asia Industry Summit and invites NZ tourism industry. Conference materials developed and sponsored by Auckland Airport available on www.ambition2020.co.nz
- Weibo Travel App launch – Auckland Airport first Airport in world to partner with Weibo
- Joint venture with luxury travel clubs and travel agencies to attract premium travellers
- Auckland Airport hosts intensive China-ready workshops
- Auckland Airport signs a new Memorandum of Understanding with China Southern Airlines
- Auckland Airport recognised at 2013 Chinese Luxury Travel Awards

206. In this way, Auckland Airport's route development activities in PSE1 show strong signs of superior performance. Our performance in this area has led to recognition within the industry of our innovative and superior approach to driving growth, and to tangible benefits for airlines and passengers. In particular:

- (a) Auckland Airport's route development activities are recognised amongst the best in their class. Auckland Airport received a highly commended award at the Routes Airport Marketing Awards in 2012, the only airport in Australasia to be acknowledged that year. We have won four awards of this type in the last three years.
- (b) A research presentation on a review of China's outbound travel market, prepared by an independent research agency based in Copenhagen, describes the development and launch of our Luxury New Zealand Network as a "best practice" example for developing a travel market.⁷²
- (c) We estimate that at least 10.8% of FY12 volumes are associated with initiatives Auckland Airport has been involved in as part of its route development programme. Further, many of these routes have contributed to good growth in off-peak services (such as China Southern) which has provided better utilisation and efficiency of existing assets.

207. As will be discussed in Section 8 of this submission, we consider the benefits and efficiencies produced by route development activities in PSE1 have been shared with consumers (both through the value Auckland Airport's behaviour has delivered for consumers, and through the PSE2 pricing decision).

Setting the stage for future success

⁷² Wonderful Copenhagen Research and Development *Review of China's Outbound Travel Market 2013: Perspectives for Scandinavian city tourism*, January 2013 (available at: http://www.visithelsinki.fi/sites/visithelsinki.fi/files/files/Tutkimukset/chinavia_-_review_of_chinas_outbound_travel_market_2013_-_final.pdf)

208. We consider that our route development activities in PSE1 and PSE2 have established the groundwork for continuing superior performance in this area.
209. For example, Auckland Airport is currently undertaking a similarly innovative approach to build awareness in order to stimulate additional demand from Indonesia. To date, there has been a three year incubation process of in-market initiatives, including development of online channels, enhancement of New Zealand itineraries in Indonesia, use of celebrity endorsements and market visits with government agencies and key industry players.
210. Auckland Airport has invested in developing our capability in this area in order to increase the prospect of superior demand in the future. It is important the Commission understands the effort that Auckland Airport is investing in this area to proactively stimulate growth. Auckland Airport is not waiting for growth to come. Instead, we are establishing the key elements for future success - building our knowledge, experience, networks and momentum to increase the likelihood of successful and enduring incremental growth in the future.

SECTION 8: SHARING OF THE BENEFITS OF EFFICIENCY GAINS

Key points:

- Auckland Airport is committed to sharing the benefits of efficiency gains with consumers.
- We encourage the Commission to assess Auckland Airport's current sharing behaviour as well as the evidence of Auckland Airport's intentions to share efficiency gains with consumers over PSE2.
- When this approach is followed, it is clear that ID regulation is effectively promoting the sharing of the benefits of efficiency gains.

ID regulation is currently promoting the sharing of benefits with consumers

211. Auckland Airport is committed to sharing the benefits of efficiency gains with consumers through lower prices, reductions in operating costs as efficiencies are achieved, and constraining price increases. We consider the evidence before the Commission supports a conclusion that Auckland Airport is already doing so.
212. We do not agree that information on actual efficiency gains over PSE2 is required for the Commission to conclude that ID regulation is currently effective in its early stages. As noted previously by the Commission, the forecast disclosure requirements allow interested parties to make *ex ante* assessments of airports' intentions to share efficiency gains with consumers.⁷³ We encourage the Commission to do so for Auckland Airport.
213. In particular, Auckland Airport's charges for PSE2 include forecast efficiency gains through reductions in operating expenditure and forecast increases in demand as a result of committed route development activities. Airport charges for PSE2 have reduced on the basis of these forecasts, meaning that airlines are *actually* benefitting in pricing from *forecast* efficiencies and forecast demand increases. As such, Auckland Airport's pricing decision demonstrates a clear *intention* to share efficiency gains with consumers and a corresponding reduction in *actual* prices (even if those forecast gains do not eventuate).
214. Actual efficiency gains through changes in Auckland Airport's pricing methodology have also been passed through to consumers through a price reduction in international charges and virtually flat revenue growth per passenger overall.
215. Further, the benefits that were created by Auckland Airport's route development activities in PSE1 are a clear example of where the benefits of efficiency gains (such as the scale advantages delivered by increased off-peak services) have already been shared with consumers. In this way, there is already clear evidence that Auckland Airport has shared the benefit of the efficiencies of scope and scale generated by our route development activities in PSE1. For example:
- (a) Incremental volumes as a consequence of route development initiatives undertaken in PSE1 have been included in the baseline forecast and have reduced the forecast unit cost applicable for pricing in PSE2.
 - (b) The reduction in international charges in FY12 is due, in part, to the proactive stance Auckland Airport has taken to encourage carriers to consider new

⁷³ Commerce Commission *Information Disclosure (Airport Services) Reasons Paper*, 22 December 2010, paragraph 5.11.

routes and to consider Auckland and New Zealand as a destination which should be at the top of their list.

- (c) These activities were not performed at the time of the PSE1 price-setting forecast and so the costs were not recovered in pricing for PSE1. All volumes associated with committed routes delivered during PSE1 are included in demand forecasts for PSE2. This means that airlines have received 100% of the benefit of the increased volumes associated with route development, at a fraction of the cost.
- (d) At the time of price-setting for PSE1, the forecast prepared by Tourism Futures International anticipated significantly higher volumes than transpired. Auckland Airport's proactive route development function during the global financial crisis has meant that today's passenger volumes are much better than they might have been and charges are accordingly lower than they would have been without this function. Had the programme not been a corporate priority, a unit price reduction for international services would not have been possible at the commencement of PSE2.

216. Further, we encourage the Commission to acknowledge that behaviour which drives efficiencies for consumers and passengers is itself a sharing of efficiency gains. In this way:

- (a) Day-to-day efficiencies in service quality, innovation and proactive identifying and responding to stakeholder issues allow us to deliver tangible benefits to airlines, border agencies and passengers through reduced delays and increased convenience.
- (b) Efficiency benefits have been shared with airline customers where our innovations deliver significant cost savings to airlines with little direct benefit to Auckland Airport. For example, Cat III lighting, the installation of ground power units, and Auckland Airport's efforts to work collaboratively with Airways and airlines on flight approaches have created efficiencies and benefits for our airline customers with little direct benefit for Auckland Airport.
- (c) Processing improvements have been hugely successful in increasing efficiencies, with the benefits of those efficiencies shared with passengers through reducing passenger processing times. For example, our Lean Six Sigma work has delivered or enabled the delivery of Advanced Passenger Display, more flexible baggage allocation processes, and Smartgate processes for arrivals and departures. These have enabled world class and efficient passenger processing of departing and arriving passengers as they move through the border process.

We **attach** a letter from Ministry of Primary Industries Biosecurity to this submission, which lists the stakeholder benefits that some of these initiatives have delivered. As we discuss elsewhere in this submission, we consider that the Final Report should fully recognise where Auckland Airport's behaviour creates efficiencies and benefits for key airport stakeholders.

- (d) Consumers have benefited (and will continue to benefit) from the efficiencies of scope and scale generated by our route development activities. Our expenditure in this area in PSE1 has delivered real benefits to consumers in choice, improved connectivity to other destinations and ultimately through increased demand that results in lower aeronautical charges than would otherwise be the case.

217. As with other limbs of the purpose statement, we consider the evidence before the Commission supports a conclusion in the Final Report that:
- (a) the current level of benefit sharing at Auckland Airport appears appropriate;
 - (b) Auckland Airport is sharing forecast efficiency gains with consumers through lower prices and increased value;
 - (c) ID regulation is not negatively affecting Auckland Airport's incentives to share efficiency gains with consumers; and, therefore
 - (d) ID regulation is effective in its early stages at promoting the sharing of the benefits of efficiency gains at Auckland Airport.

The way forward for ID regulation

218. Going forward, we consider it is important to ensure the ID regime recognises and values behaviours that lead to efficiencies for the industry where there is little or no gain for Auckland Airport. For example, investment can be delivered in a way that creates network and industry-wide benefits, but may result in higher capital investment or operating costs for Auckland Airport. In this way, the most efficient option for the industry and for airlines will not necessarily be the lowest cost option for Auckland Airport.
219. Care must be taken to ensure that the correct incentives are in place for Auckland Airport to work with our airline customers and stakeholders to maximise benefits for the aviation industry and respond to our customers' key drivers and operational requirements. If incentives to invest are appropriate, a higher cost option might be optimal where that means a positive industry outcome can be achieved and industry efficiencies created. Auckland Airport is keen to see the ID framework recognise and value these types of efficiencies and how they can represent appropriate sharing behaviour.