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Regulation Branch
Commerce Commission
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Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport

Air New Zealand (Air NZ) appreciates the opportunity to make this cross-submission following the 26 February conference on the Commission's section 56G Review of Auckland Airport. Air NZ would be happy to answer any further questions the Commission may have regarding its views of Auckland Airport's performance and looks forward to the Commission's draft report for Auckland Airport.

It was evident at the conference that the Commission clearly appreciates the key issues with Auckland Airport's performance, namely the target level of return and Auckland Airport's intent with respect to valuations post the current pricing period and specifically its intentions with respect to treatment of revaluation gains. As highlighted in our initial submission on the s56G review of Auckland Airport:

> "Air NZ considers AIAL's second PSE clearly demonstrates that ID has been ineffective in promoting the purpose of Part 4. This is evident in AIAL's adoption of a WACC significantly in excess of the value determined by the Commission to be sufficient to ensure continued incentives to invest and in the continuing uncertainty around asset valuation methodologies."

This statement remains valid.

As with the review of Wellington Airport and consistent with Part 4 of the Commerce Act, the Commission is concerned with a number of areas of Auckland Airport's performance and behaviour, including quality, innovation and efficiency – in addition to profitability. During the course of this s 56G review process relating to Auckland Airport, including during the Conference itself, Air NZ has acknowledged the constructive approach of the Airport to engagement, innovation and quality – noting however that there is a need to provide for price-quality trade-offs given that customers are often far more focussed on price than quality at the highest level.

Air NZ submits however that the Airport's focus on these issues is not a result of information disclosure regulation but instead reflects its "business as usual" approach. Information disclosure may provide greater transparency of what the Airport does and how it does it but has not materially altered that behaviour.

Nevertheless, as the Commission stated in its Report to the Minister of Commerce on Transport on Wellington Airport:

> "The materiality of price-setting is clearly evident in the Explanatory Note to the Commerce Amendment Bill. The Explanatory Note indicates that the main area of concern with the information disclosure regime prior to Part 4 (ie, under the Airport Authorities Act 1966 (AAA)), was that it failed to constrain the exercise of substantial market power in setting airport charges. A key objective of the Part 4 information disclosure regime was to address this by protecting consumers from prices that would not be consistent with those in a workably competitive market."[1]
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> "Information disclosure under Part 4 should be particularly effective at highlighting concerns about excessive profits (and therefore prices), which heightens the credible threat of further regulation."[2]

Pricing outcomes are the key focus of the information disclosure regime and in this area information disclosure has seemingly had no impact on Auckland Airport's behaviour, with the Airport continuing to rely on its statutory authority under the Airport Authorities Act to price as it thinks fit. As highlighted in the Commission's review of Wellington Airport, information disclosure does not restrict the ability for airports to earn excessive returns and this potential remains open for Auckland Airport.

This is particularly the case given the Airport's valuation preferences as stated at the commencement of the pricing consultation (as set out in Air NZ's initial submission on the Auckland Airport s 56G review):

> "In respect of valuation, AIAL in its 14 September 2011 letter to substantial customers, stated:
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> > "Auckland Airport's position, on the basis of its review of relevant literature and professional advice, is that MVEU (or MVAU plus land conversion costs) is the appropriate methodology for valuing land assets." [3]
> >
> > And
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> > "Auckland Airport advocated to the Commerce Commission that a current ODRC valuation was a materially better methodology than an ODRC valuation based on

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[1] Commerce Commission, **Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport,** 8 February 2013, para. 1.8, p.10

[2] Ibid, para. 2.17, p.17

[3] AIAL 14 September 2011 Letter to Substantial Customers, First Information Pack Part B – Asset Valuation, p. 2

carrying values, derived from 30 June 2006 valuations rolled forward for additions, disposals and revaluations....

Auckland Airport has commissioned Opus to provide valuations as at June 2011 for specialised buildings and infrastructure.

The Opus valuations will be a crucial input for pricing purposes should Auckland Airport proceed with current valuations of specialised assets for pricing." [4]

And:

"Of particular concern however is the seeming continuing reliance by AIAL on advice from NERA in respect of revaluations:

"In terms of practical application for the upcoming price reset, it would be consistent with the principles we have outlined for Auckland Airport, starting from a current valuation for its specialised assets, to:

- Obtain unbiased forecasts of expected changes in value for those specialised assets over the pricing period, and treat any expected revaluations as income over that pricing period; and
- At the end of that pricing period, obtain unbiased revaluations of its specialised assets, with no wash-up... [5]

The same approach was advocated by NERA for land assets.[6]"

Therefore, in the absence of clarity from Auckland Airport as to what it means by "a principled approach" the Commission can only assume that the Airport will adopt the revaluation approach it stated its preference for at the commencement of consultation and which it is arguing for in the High Court as being "materially better" than the approach the Commission has determined as appropriate in the Input Methodologies. That is, the Airport will in 2017 move to value land assets at MVEU (or MVAU plus land conversion costs) and specialised buildings and infrastructure at an updated ODRC value, and will not treat revaluation gains as income. Air NZ considers that this outcome is a very real prospect and should be considered by the Commission.

In terms of whether the Commission should use an indexed or unindexed asset valuation in its IRR analysis, Air NZ considers that the key issue is consistency – if an indexed asset valuation is used, then any revaluations post 2009 need to be treated as income in the IRR calculation.

Air NZ also wishes to reiterates its concerns regarding the level of return characterised by Auckland Airport as appropriate. Auckland Airport has determined for itself that a target

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[4] Ibid

[5] NERA, Airport Asset Valuation Principles Auckland Airport, 13 September 2011, section 3.3, p.7

[6] Ibid, p.8

return at the 80^{th} percentile – above the top of the 25^{th} – 75^{th} percentile range determined by the Commission as appropriate – is justifiable[7]. As noted in Air NZ's 9 November 2012 cross-submission, the difference between Auckland Airport's self-determined "appropriate" target and the IM compliant WACC determined by the Commission on 31 July 2012 amounts to $33 million per annum of excessive charges payable by consumers.

Clearly Auckland Airport does not feel constrained by the current regulatory settings to price at a level consistent with what could be achieved in a competitive market.

As noted above, Air NZ would be happy to answer any further questions the Commission has regarding its views of Auckland Airport's performance and behaviour, and looks forward to the Commission's draft report for Auckland Airport.

Yours sincerely

John Whittaker
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[7] Notwithstanding AIAL then setting prices to achieve a return below this of 8.475%, even at this level the Airport is achieving returns some 13% higher than the top of the Commission's range and 31% higher than the 50^{th} percentile.