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Final 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

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Foreword

To the Ministers of Commerce and Transport

This report presents our conclusions on how effectively information disclosure regulation under Part 4 of the Commerce Act 1986 (Act) is promoting the purpose of Part 4. Part 4 is designed to ensure that suppliers of regulated goods and services have similar incentives and pressures to suppliers operating in competitive markets.

This report fulfils our obligations under s 56G of the Act in relation to regulated airport services provided by Auckland International Airport Limited (Auckland Airport). We provided our report in relation to Wellington International Airport on 8 February 2013. We will provide you with our report in relation to Christchurch International Airport later this year.

Although each of the three airports have been subject to information disclosure regulation under the Airports Authorities Act 1966 (AAA) for many years, airports only became subject to information disclosure regulation under Part 4 of the Commerce Act on 14 October 2008, with the passing of the Commerce Amendment Act 2008. The Regulatory Impact Statement to the Commerce Amendment Bill 2008 indicated that the main area of concern with the information disclosure regime under the 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.

Our review has been able to conclude how effectively information disclosure regulation is promoting the purpose of Part 4 to date in some areas, even though the Part 4 information disclosure requirements (and the 'input methodologies' which underpin them) have only been in place a short time (since January 2011). This is because Auckland Airport has been required to provide both historic and forecast data, including the information used to set its charges last year. Submissions received as part of our review have also been informative.

Based on the charges that Auckland Airport set last year, our conclusion is that information disclosure regulation is limiting excessive profits. Auckland Airport targeted returns over the current five-year pricing period which, while above our assessment of a normal return, are not so high as to suggest that the airport would be expected to extract excessive profits. Our section 56G review for Auckland Airport has also found that innovation is appropriate and that the level of quality experienced by consumers at Auckland Airport reflects their demand. We also found information disclosure has resulted in improvements in the way Auckland Airport structures its prices.

The input methodologies we set, which are particularly relevant to our conclusion on Auckland Airport's expected profits, are under review by the High Court. When the Court's judgment is released, we will update you on whether or not that judgment causes us to change any conclusion in this report.

Executive Summary

X1 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our section 56G review for Auckland Airport has to date found that information disclosure is effective in some areas, including limiting Auckland Airport's ability to earn excessive profits. However, we are unable to conclude whether it is effective in other areas.

X2 Our overall impression is that although the regime has only been in place a short time, Auckland Airport has made a number of positive changes to a number of aspects of its approach from PSE1 to PSE2.

X3 Our conclusion is that information disclosure regulation at this time has been effective in limiting Auckland Airport's ability to extract excessive profits over time. In particular, for PSE2 Auckland Airport targeted returns within an 'acceptable range' (ie, the range of returns that we assess as limiting the airport's ability to earn excessive profits, while allowing it to achieve at least a normal return), based on a reasonable assessment of how, at that time, it considered the Commission might assess its performance.

X4 Auckland Airport set prices such that its expected returns over the whole of PSE2 is equivalent to a return of 8.0% when the information disclosure framework is applied, and taking into account its moratorium on asset revaluations. Although this target return is above our assessment of a normal return, it is just within the upper limit of an acceptable range of returns of 7.1% to 8.0%, and therefore supports our conclusion that information disclosure is effective in achieving the Part 4 purpose as regards profitability (s 52A(1)(d)).

X5 Our conclusion is that information disclosure regulation is also effectively promoting the Part 4 purpose in the following areas:

X5.1 Innovation (s 52A(1)(a)). Innovation levels at Auckland Airport appear to be appropriate and airlines consider that Auckland Airport facilitates airline-led innovation. Our review has found that information disclosure is effectively promoting incentives to innovate at Auckland Airport.

X5.2 Quality (s 52A(1)(b)). The quality of service provided by Auckland Airport generally reflects the demands of airlines and passengers, and Auckland Airport addresses matters of quality raised by consumers. Our review has found that information disclosure is effectively promoting incentives to provide services at a quality that reflects consumer demands at Auckland Airport.

X5.3 Pricing efficiency (s 52A(1)(b)). Information disclosure has had a positive impact on this outcome. Our review has found that prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. Auckland Airport has indicated that the requirement to transparently outline its pricing methodology in information disclosure has led to improvements in its pricing efficiency.

X6 We are unable to conclude on the effectiveness of information disclosure under Part 4 on some performance areas at this time.

X6.1 Operational expenditure efficiency (s 52A(1)(b)). Information on actual expenditure over a longer period of time is necessary before we can form a conclusion.

X6.2 Efficient investment (s 52A(1)(a)-(b)). Information on actual expenditure over a longer period of time is necessary before we can form a conclusion.

X6.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). It is too early to conclude whether there are any operational expenditure (opex) and capital expenditure (capex) efficiency gains that could be shared.

1. Introduction

Purpose of this report

1.1 This report contains our conclusions as to how effectively information disclosure regulation is promoting the purpose of Part 4 of the Commerce Act 1986 (Act) for Auckland International Airport Limited (Auckland Airport).

1.2 We have prepared our report after considering all of the submissions and cross-submissions received to date as part of our section 56G review, including following a conference held on 26 February 2013.

Our task under s 56G

We must review how effectively information disclosure is promoting the Part 4 purpose

1.3 Information disclosure regulation was put in place with effect from 1 January 2011 for airport services provided by Auckland International Airport (Auckland Airport), Wellington International Airport (Wellington Airport) and Christchurch International Airport (Christchurch Airport).[1]

1.4 Our task under s 56G of the Act is to report on how effectively information disclosure regulation is promoting the Part 4 purpose. The report must be made 'as soon as practicable' after any new price for airport services is set in or after 2012.

It is appropriate to carry out this review for Auckland Airport now

1.5 For the same reasons noted in our section 56G report for Wellington Airport, we consider it is appropriate to carry out this review now because Auckland Airport set new prices on 7 June 2012 for the 2013–17 pricing period (referred to as 'PSE2').[2] Auckland Airport has made two disclosures of annual information under information disclosure regulation as well as specific price setting event disclosures for PSE1 and PSE2.[3]

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[1] The regulated airport services are set out in s 56A(1) of the Act as 'specified airport services', and consist of aircraft and freight activities, airfield activities, specified passenger terminal activities. This is also referred to as aeronautical services in this report.

[2] PSE2 relates to the price-setting event which set out Auckland Airport's revenue requirements and prices from 1 July 2012 to 30 June 2017. PSE2 is also referred to as the '2013-17 pricing period' where '2013' means the disclosure year ending on the 30 June 2013, and '2017' means the disclosure year ending on the 30 June 2017. PSE1 relates to the price-setting event which set out Auckland Airport's revenue requirements and prices from 1 July 2007 to 30 June 2012 (ie, the 2008-12 pricing period).

[3] A price setting event occurs when an airport fixes or alters the price it charges for its regulated services following consultation. Airports are required to consult on their prices at least once every five years. Following the price-setting event, Airports must publicly disclose information on their forecast expenditures, assets, expected return and associated required revenues for the pricing period, as well as a

1.6 We do not consider it would be consistent with reporting 'as soon as practicable' to delay the review in order to wait for:

1.6.1 other information disclosures to be made in the future;

1.6.2 current Court appeals on input methodologies to be resolved; or

1.6.3 summary and analysis reports to be published under s 53B(2).

1.7 To wait for these events would likely result in the report being delayed for at least 2–3 years. Parliament clearly envisaged that the review would be made relatively soon after price setting, and did not require that we publish a summary and analysis report prior to carrying out the section 56G review.

1.8 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.[4] Our review has enabled us to conclude on how effectively this has been achieved to date.

1.9 We consider that the price setting event disclosure and other views and evidence relating to the price setting event provide sufficient information to carry out the section 56G review. Any limitations in our analysis or to the conclusions that we have drawn are explained in the relevant parts of this report.

1.10 If the airports' input methodology (IM) merits appeals relevant to our conclusions in this section 56G review succeed to a material degree, we will provide further advice to the Minister regarding how such outcomes impact on our section 56G reports.

How we are carrying out our task under section 56G

1.11 We consulted on our process and approach for the section 56G reviews for the three airports with all interested parties in May 2012. Submitters raised a range of issues which we responded to in a Process Update Paper on 27 July 2012.[5]

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ten year demand forecast. Airports are also required to provide information on their pricing methodology and the quality of service provided.

4 Refer to the discussion about the provisions in the Bill relevant to airports: Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 1.2.15 to 1.2.16 and paragraphs 1.2.19 to 1.2.23.

5 These reports and submissions are available on our website at http://www.comcom.govt.nz/section-56g-reports/

We are reporting separately for each airport

1.12 We consider that preparing a separate report for each airport is the most appropriate interpretation of the section 56G task. This is because each airport's price setting decisions have occurred at different times, and information disclosure regulation may be having a different impact across the three airports.[6]

We are following the same assessment approach and process for each airport

1.13 Although we will report separately, we are using the same assessment approach for each airport. This report only applies to Auckland Airport, although it refers to our earlier report on Wellington Airport where relevant. The framework for our review that we describe in Chapter 2 and Attachment A is relevant to the review of all three airports.

1.14 We are following the same process for all three airports, which includes consulting with interested parties on the issues arising for each airport's review and holding a conference for each airport before consulting on the draft report and publishing our final report. The process we have followed for Auckland Airport is summarised in Attachment A.

We have not considered whether other forms of regulation should apply

1.15 The scope of our review considers how effectively information disclosure regulation is promoting the Part 4 purpose only. We are not extending our report to include considering and recommending whether regulation other than information disclosure should apply to the airports, nor whether information disclosure should no longer apply.[7]

We have not considered whether the definition of regulated services should be changed

1.16 Some submitters to this process raised the issue of including recommendations to regulate additional services not currently regulated as specified airport services.[8] We

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6 Christchurch Airport set new prices on 24 October 2012 while Wellington Airport set new prices on 1 March 2012. The effectiveness of information disclosure regulation for Christchurch Airport will be considered in a separate report. The effectiveness of information disclosure regulation for Wellington Airport has been considered in our section 56G report for Wellington Airport published on 8 February 2013. This report is available on our website at http://www.comcom.govt.nz/section-56g-reports/

7 Air New Zealand submitted that parallel reviews (eg, Commission inquiry, Ministry of Economic Development review) should be undertaken alongside the section 56G review to consider other types of regulation. See Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraph 134. BARNZ submitted that s 56G gives the Commission scope to consider other types of regulation. See BARNZ "BARNZ responses to Commerce Commission questions relating to process" 28 June 2012, pages 4 to 5.

8 BARNZ "BARNZ responses to Commerce Commission questions relating to process" 28 June 2012, pages 4 to 5; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review" 29 June 2012, paragraphs 117 to 119.

do not consider that extending the definition of specified airport services under s 56A(1) is within the scope of our section 56G review, therefore we have not considered that issue within this review.

How we have set out our analysis and conclusions in this report

1.17 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. Our section 56G review for Auckland Airport has found that information disclosure is effective in some areas, including in limiting Auckland Airport's ability to extract excessive profits, and we are unable to conclude whether it is effective in some other areas.

1.18 The remainder of this report outlines how we have reached these conclusions and provides the reasons for our views.

1.18.1 Chapter 2 sets out the key elements of our approach to assessing how effectively information disclosure regulation is promoting the Part 4 purpose. Attachment A expands on this approach and issues raised in submissions on our interpretation of the relevant statutory provisions.

1.18.2 Chapter 3 then summarises our conclusions and the reasons why we have reached them. These conclusions are supported by further detailed analysis in Attachments B to I.

2. How we assess the effectiveness of information disclosure regulation for this review

Purpose of this chapter

2.1 In this chapter we explain our approach to assessing how effectively information disclosure regulation is promoting the Part 4 purpose for Auckland Airport. Our approach has:

2.1.1 examined the performance (historical and expected) and conduct (ie, behaviour) of Auckland Airport, both before and after the Part 4 information disclosure came into effect; and

2.1.2 assessed the extent to which this information disclosure has had an impact on Auckland Airport's performance and conduct.

2.2 We begin by explaining what outcomes are sought in the Part 4 purpose and how information disclosure under Part 4 can promote those outcomes. We then explain how we have undertaken our assessment, including the role that input methodologies have played. Further detail is included in Attachment A.

Information disclosure and the Part 4 purpose

The Part 4 purpose sets out our approach to the section 56G review

2.3 The purpose of Part 4 as set out in s 52A(1) of the Act is to:

> Promote the long-term benefit of consumers in [regulated markets] by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services:
>
> (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
>
> (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
>
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
>
> (d) are limited in their ability to extract excessive profits.

2.4 The outcomes produced in workably competitive markets that are relevant to regulated markets under Part 4 are those reflected in the regulatory objectives in (a)–(d) of the purpose. The focus of our section 56G review is therefore on considering how effectively information disclosure is promoting the outcomes reflected in the Part 4 purpose statement. We do this by considering the key performance questions in Table 2.1.

Table 2.1: Key performance questions to assess if the Part 4 purpose is being met

Key performance question	Relevance to the Part 4 purpose (s 52A(1))
Is Auckland Airport operating and investing in its assets efficiently?	(a) and (b)
Is Auckland Airport innovating where appropriate?	(a)
Is Auckland Airport providing services at a quality that reflects consumers demand?	(b)
Is Auckland Airport sharing the benefits of efficiency gains with consumers, including through lower prices?	(c)
Do the prices set by Auckland Airport promote efficiency?	(a) and (b)
Is Auckland Airport earning an appropriate economic return over time?	(d)

2.5 These performance areas are interrelated. In order to assess the effectiveness of information disclosure in promoting particular outcomes observed in workably competitive markets, it is appropriate to consider relevant outcomes in other areas. For example, in order to reach our conclusion on profitability we first considered some of the other areas of performance. This is because the appropriateness of an economic return may vary depending on a supplier's performance in other areas. Likewise, in order to assess whether a supplier is sharing the benefits of its efficiency gains we must first assess whether it has achieved any efficiency gains.

2.6 While it is appropriate for us to consider the interrelated outcomes, this does not mean we must reach conclusions in one area to draw conclusions in another. We are satisfied that the time series information available at the time of this review has been sufficient for us to reach the conclusions set out in Chapter 3. We consider we are able to reach conclusions on the effectiveness of information disclosure in limiting Auckland Airport's ability to earn excessive profits based on forecast information, but are not able to do so in the areas of operational expenditure efficiency and efficient investment.[9]

9 Our information disclosure reasons paper explains that forecast disclosures are intended to assist interested persons assess whether expected profits are excessive, and whether airports are planning to meet forecast demand and quality expectations of consumers in their investment decisions. Forecast disclosures also enhance the assessment of airports' historical performance because actual outcomes can be reconciled with forecast information. This informs the assessment of whether airports have incentives to improve efficiency (Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 5.4 to 5.7). Currently, such reconciliation cannot be undertaken for PSE2 given that no actual expenditure information for PSE2 has yet been disclosed.

2.6.1 The effectiveness of information disclosure in limiting excessive profits can be assessed based on whether we consider Auckland Airport is targeting excessive profits when setting prices.[10] This analysis uses Auckland Airport's own forecast information for PSE2.

2.6.2 In the area of operational expenditure efficiency, we consider an analysis of actual opex in PSE2 is required to form a conclusion on the effectiveness of information disclosure regulation. This is because Auckland Airport's forecast of its opex for PSE2 is unlikely to include all its expected future efficiency gains.[11]

2.6.3 As discussed in Attachment H, we consider that information on forecast capex for PSE2 at Auckland Airport does not provide the full picture needed to understand whether Auckland Airport is investing efficiently. Information on actual capex in PSE2 is required for us to make this assessment.[12]

2.7 Finally on this point, we note that:

2.7.1 concluding that good performance exists in some areas does not necessarily cancel out potential findings of poor performance in others;[13] and

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10 Suppliers with market power have incentives to target excessive profits when setting their prices. Auckland Airport has recently set prices for PSE2, so we are able to observe at this time whether it is targeting an excessive profit. This requires us to consider whether the forecasts used to determine prices are appropriate. Although we are unable to conclude on the effectiveness of information disclosure in some of the areas due to a lack of actual information, we consider that the forecast expenditure is reasonable. Auckland Airport may earn excessive profits in PSE2 if it reduces expenditure inefficiently below the forecast levels. However, as discussed in Attachment A, we consider the trigger for undertaking the section 56G review has been met. Further summary and analysis under s 53(B) will identify over time whether such behaviour is occurring.

11 We expect to observe the effectiveness of information disclosure in promoting incentives to improve opex efficiency through actual performance, rather than forecasts. Auckland Airport's incentives to improve efficiency are strongest once prices have been set, as any efficiency improvements will result in higher profits. We do not therefore expect its opex forecast to accurately reflect improvements in efficiency. In order for us to draw conclusions concerning opex in this report, we would need to have actual information available. Only two years of data since the implementation of information disclosure under Part 4 are available which is insufficient for drawing out conclusions in this area.

12 While we consider that information disclosure is promoting incentives for efficient capex planning, we consider that actual information on capex is required to conclude in this area as, once prices are set, a supplier has an incentive to inefficiently delay or reduce its actual capital expenditure to earn higher profits. Therefore the effectiveness of information disclosure regulation in this area cannot be observed without information on actual capex by a supplier under information disclosure regulation and following a price setting event. We do not currently have a sufficient time series of information on actual capex in PSE2.

13 It is unclear to us whether Auckland Airport was suggesting otherwise when it stated in its post conference submissions that "any minor issues that have been raised should be considered in proportion to the overall picture of airport performance, and should not outweigh the positive outcomes that can be

2.7.2 finding some evidence of progress in a particular performance area does not necessarily mean that the intended performance outcome has been achieved.

2.8 Auckland Airport argues that "if there is evidence that Auckland Airport may have sought a higher return in the absence of the WACC IM (and ID more generally), then it must be found that ID has been effective in limiting excess returns."[14] We do not agree that we can conclude that information disclosure is effective simply because it places some constraints on profit levels, and as a result prices are lower than they would otherwise be. This is because the airport might still be targeting an excessive level of profits. On the other hand, if information disclosure has provided incentives for the airport to target returns within an 'acceptable range' (ie, the range of returns that we assess as limiting the airport's ability to earn excessive profits, while allowing it to achieve at least a normal return), then we are able to conclude that the disclosure regime is effective in respect of profitability.

2.9 As discussed in Attachments E and F, for the purpose of assessing the effectiveness of information disclosure regulation, we consider an acceptable range for target returns to lie between the mid-point and 75th percentile estimate of the airport's cost of capital, because that is generally consistent with limiting the ability of the airport to earn excessive profits, while allowing it to achieve at least a normal return. As such, information disclosure would in most cases be seen as effective for expected returns that are targeted within this range. However, even such a conclusion would still require an exercise in judgement, for instance, if a clearly inefficient airport were to consistently target returns at, or close to, the 75th percentile.

2.10 A return that is expected to substantially exceed this range will be problematic and most likely seen as targeting excessive profits. However, where the return is only marginally above the range, this will not lead to an automatic conclusion that the supplier is targeting excessive profits. In such circumstances the Commission will have to exercise its judgement to take into account the context, and the airport's conduct in light of its reasonable expectations.

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observed". (Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraph 7(b)).

14 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraph 54. We note that NZAA disagrees with our reasoning to some extent: "evidence of progress in an area does amount to promotion of the purpose statement. Part 4 does not set out performance outcomes to be achieved. Indications of positive behaviour change or maintenance of previous positive behaviour are signs of the start of an effective ID regime, across all limbs of the purpose statement." See New Zealand Airports Association "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraphs 20(b) and paragraph 24(b). We disagree that this is the correct approach in analysing the profitability limb of the purpose statement, since the input methodologies offer a benchmark against which the assessment is made, as discussed above.

2.11 We do not agree with BARNZ's (Board of Airline Representatives NZ) argument that information disclosure can never be effective at limiting excessive profits, simply because information disclosure is not price control.[15] We recognise that airports can set prices as they see fit under the AAA. However, as discussed in Attachment A, Parliament intended that information disclosure would influence price setting by airports. In Auckland Airport's case, our conclusion is that information disclosure has done so, and done so effectively.

How information disclosure regulation can promote the Part 4 purpose

2.12 Information disclosure can directly promote the Part 4 purpose. It provides incentives to achieve outcomes consistent with those found in workably competitive markets in two main ways:

2.12.1 by providing transparency about how well a supplier is performing relative to other suppliers and over time; and

2.12.2 through the threat of further regulation.[16]

2.13 Greater transparency enhances consumers' countervailing power, provides owners with better information to help them govern their business more effectively, and incentivises management of regulated suppliers to improve their performance. Better information can facilitate comparisons with other regulated suppliers that may identify sources of best practice, or innovations that should be adopted. Requirements to disclose information may also generate useful information that would not have been collected in the absence of the disclosure requirements.

2.14 The threat of further regulation incentivises suppliers to ensure their performance is consistent with the desired outcomes from workably competitive markets. Part 4 requires the Commission to monitor and analyse the information that is disclosed by all regulated suppliers, including airports. Such analysis can help policymakers to identify whether regulation should be removed, or strengthened.

2.15 In this review we refer to the way that an airport responds to the incentives provided by information disclosure regulation under Part 4 (or by the information disclosure regime under the AAA prior to Part 4) as the airport's 'conduct'.

Relevance of information disclosure purpose (s 53A) to Part 4 purpose (s 52A)

2.16 Information disclosure regulation has its own specific purpose (s 53A). The purpose of information disclosure regulation is for sufficient information to be readily available to interested persons to assess whether the purpose of Part 4 is being met.

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15 BARNZ "Post Auckland Airport Section 56G Conference Submissions" 15 March 2013, page 8.

16 Including, for example, the incentives created by airports recognising that the Commission would be undertaking this section 56G review.

2.17 The task of the s 56G review, namely assessing how well information disclosure is promoting the Part 4 purpose, is different from assessing how well the information disclosure requirements we have set are meeting the purpose of information disclosure regulation under s 53A.

2.18 Nevertheless, the extent to which information disclosure requirements are meeting the s 53A purpose is relevant to our s 56G assessment. The more effective the disclosure requirements are in meeting the s 53A purpose of information disclosure regulation, the more likely it is that information disclosure is promoting the overall Part 4 purpose.

2.19 For instance, if the indicators disclosed in accordance with the information disclosure requirements are not providing a good measure of a particular area of performance, there might be relatively weak incentives for suppliers to change their conduct so that their performance becomes more consistent with the Part 4 purpose. Indicators of performance that are more effective in allowing interested persons to assess whether the Part 4 purpose is being met are also likely to provide stronger incentives on suppliers to act consistently with that purpose.

Suppliers have incentives other than those provided by information disclosure

2.20 Information disclosure regulation by itself is not expected to be the sole source of all the necessary incentives to promote the Part 4 purpose. Other features of Auckland Airport's operating environment also create incentives and external pressures to improve performance. For example, Auckland Airport:

2.20.1 has incentives to operate as a profit maximising entity. It therefore has an incentive to improve its efficiency and to innovate in order to maximise profits;

2.20.2 is subject to other regulatory requirements. For example, the AAA requires Auckland Airport to consult on large capex programmes with its major customers, and therefore encourages Auckland Airport to provide services at the quality consumers demand.[17] Auckland Airport is also subject to minimum safety and security requirements that impact on quality; and

2.20.3 sets its revenue requirement and prices for five-year periods in advance, using a 'building blocks' model.[18] This creates some self-imposed incentives

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17 Refer s 4C of the AAA.

18 Economic regulators often employ 'building blocks' models to assist in setting regulated price caps or revenue caps when implementing price-quality regulation. Each building block relates to a different type of cost facing a regulated supplier, and regulators aim to provide firms with an opportunity to recover an efficient level of these costs, including the cost of capital, over the forthcoming regulatory period. We use a building blocks approach to set regulated prices for regulated electricity and gas suppliers under Part 4. By choosing to use a building blocks model to set its revenue requirements for each price-setting period, Auckland Airport is replicating this kind of approach.

for Auckland Airport to achieve efficiency gains and outperform its expenditure forecast to earn higher profits.

The effect of information disclosure regulation will vary for the different outcomes

2.21 Our general approach when assessing performance against the Part 4 purpose statement is to assess each outcome in its own right, without specifically elevating one above another. We note, however, that:

2.21.1 we expect the potential impact of information disclosure will vary between the different outcomes sought under Part 4; and

2.21.2 we also expect the time it takes for information disclosure regulation to have an effect on each of the Part 4 outcomes to vary.[19]

2.22 We therefore expect information disclosure regulation to have a greater potential impact at this time on certain areas of performance. As a result, it is likely that we will be able to observe these impacts in our review and to draw stronger conclusions in those areas relative to others.

2.23 Given the incentives already in place, the most obvious additional incentives provided by information disclosure regulation are on Auckland Airport's ability to earn excessive profits, and on its sharing of efficiency gains with its consumers. This is because of the relatively weak incentives on Auckland Airport in these areas of performance without regulation. 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.[20] It is also the area of performance that is most likely to lead to more heavy-handed regulation if the desired outcomes are not being achieved. Incentives from the threat of further regulation are therefore likely to be strongest in this area.[21]

2.24 In contrast, for example, information disclosure regulation is likely to have a relatively weak impact on incentives to innovate at Auckland Airport. This is because other incentives play a more important role in driving innovation, for example, incentives to maximise profits.

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19 Attachments B to I outline our views on these matters for each area of performance.

20 This is particularly the case with information disclosure under Part 4 (compared to information disclosure under the AAA) because there are input methodologies that allow profitability to be assessed on a consistent basis across suppliers and over time, as well as providing a benchmark for assessing returns through the cost of capital input methodology.

21 Price-quality regulation is typically applied for the purpose of limiting excessive profits. It is unlikely that, for example, price control would be considered as a solution to improve innovation or quality of service if profits were not considered excessive.

2.25 It is not a concern if information disclosure has a relatively weak effect on incentives in some areas as long as there are other incentives on Auckland Airport to promote the outcomes sought under Part 4, or Auckland Airport is already performing well in these areas. Instead, it is important that information disclosure regulation preserves existing incentives and does not provide disincentives in these areas. The benefit of information disclosure in these circumstances is in allowing interested persons to assess whether these outcomes are being promoted.

2.26 We may therefore conclude that information disclosure is effectively promoting the purpose of Part 4 with respect to a particular area of performance, even if information disclosure regulation is having a limited impact on that outcome, on the basis that information disclosure is having as much of an impact as we reasonably expect it could have.

2.27 We expect the length of time it will take for information disclosure regulation to promote the different outcomes sought under the Part 4 purpose will also vary. In areas such as efficiency of expenditure and quality, information disclosure will have the greatest effect over time, as trends and comparative information become available to interested persons.[22] The effectiveness of information disclosure at limiting excessive profits can be seen more immediately. This is because:

2.27.1 Auckland Airport has set its revenue requirement, and therefore its expected profits, for the next five years; and

2.27.2 the input methodologies also provide us with a benchmark of the profitability that would be expected in a workably competitive market.

2.28 The conclusions we are able to draw in this report are based on the time series information available to the Commission at this point in time – ie, "as soon as practicable after any new prices are set for airport services in or after 2012".

2.29 Air New Zealand and BARNZ have both raised the issue that Auckland Airport may adopt a different approach in the future price setting events and that this precludes us in reaching our conclusions on profitability.[23]

2.30 As stated above, this report is based on the information available at this point in time and the conclusions are based on this time-specificity. We note that Auckland Airport has responded to this argument in its cross-submission on our Draft Report by stating that its comments regarding future behaviour are recorded in submissions

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22 Trends are important because there is not necessarily an immediate benchmark available to assess performance.

23 See Air New Zealand "Submission to the Commerce Commission on the 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" 31 May 2013, paragraph 37 and BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, paragraphs 2 to 3.

and available publicly, as well as stating that the Commission's task is to assess how effectively information disclosure is working at this point in time.[24]

2.31 Information disclosure cannot preclude changes in future behaviour, which is why a regular monitoring regime is also in place, which requires these section 56G reports, as well as on-going summary and analysis. We are able to draw conclusions now based on what we currently know, and we consider that the evidence available supports those conclusions. Specifically, we do not agree that binding future commitments (legal undertakings) by Auckland Airport are required before we can reach a positive conclusion. Moreover, we expect to do extensive summary, analysis and reporting once PSE3 prices are set.

2.32 We have acknowledged in this report those areas of performance where we need information over a longer period of time to reach a firm conclusion at this stage (for example, in the case of operating efficiency). Even in those areas where we can draw conclusions at the time of this review, we expect such conclusions may be re-tested through our summary and analysis process as more information becomes available over time.

How we have assessed the impact of information disclosure regulation

Is the Part 4 purpose being promoted by information disclosure regulation?

2.33 To understand how effectively information disclosure regulation is promoting the Part 4 purpose, we have assessed whether performance at Auckland Airport is consistent with the outcomes sought by the Part 4 purpose, and whether any improvements in performance are likely to be attributable to changes in conduct incentivised by information disclosure regulation.

2.34 In assessing performance we have asked ourselves the questions outlined in Table 2.1 above. The focus of some of the objectives in the Part 4 purpose is on suppliers having incentives. We consider the practical test of whether incentives are working to promote the long-term benefit of consumers is to consider actual performance in that area.[25]

2.35 In assessing whether information disclosure is effectively promoting the Part 4 purpose we have also assessed whether it has impacted on Auckland Airport's conduct. The choices and decisions made by Auckland Airport for its recent price setting event are the obvious example. Other areas of conduct are also of some relevance, for example, collaboration with airlines.

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24 See Auckland Airport "Section 56G Review of Auckland Airport: Cross-Submission on Commerce Commission Draft Report" 14 June 2013, paragraphs 25(b) and (d).

25 Where information disclosed by Auckland Airport relates to its forecast activities then the questions above have been considered in relation to whether performance is forecast to be achieved.

2.36 To assess how effectively information disclosure is promoting the Part 4 purpose we have therefore:

2.36.1 examined the performance and conduct of Auckland Airport, both before and after the Part 4 information disclosure came into effect; and

2.36.2 assessed the extent to which this information disclosure has had an impact on Auckland Airport's performance and conduct.

2.37 The one area where we have not undertaken a relative comparison of conduct and performance before and after the introduction of Part 4 information disclosure is profitability. The cost of capital set out in the input methodologies provides a benchmark against which to measure profits. Therefore we do not need to examine in any detail Auckland Airport's revenue requirements for the price setting period beginning prior to Part 4 (ie, PSE1). We explain how we have used the input methodologies below.

2.38 In our s 56G report on Wellington Airport, we used the term 'absolute standard (or benchmark)' to distinguish our profitability assessment, which compared expected returns for PSE2 to our cost of capital estimate (determined in accordance with the input methodologies), from the 'relative' assessment we undertook in other areas, which compared conduct and performance in those areas between PSE1 and PSE2.

2.39 In its post conference submissions Auckland Airport expressed the concern that a "benchmark" is not the same as an "absolute standard", and that the cost of capital input methodology:[26]

> is being treated by the Commission as the only acceptable return. We see this as contrary to the purpose of ID and to the understanding that we had at the time of price setting. We are also concerned that the Commission expects that airports will have instantly met this "absolute standard".

2.40 We did not intend the use of the term 'absolute standard' to imply our cost of capital estimate provides an immovable cap on what constitutes an acceptable return. Our cost of capital input methodology 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. We discuss in this chapter that a combination of alternative methodologies to our input methodologies may give a similar outcome in terms of limiting excessive profits, and that we will consider the application of such other methodologies in light of outcomes they produced in a specific case. In addition, to

[26] Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraph 63.

avoid possible confusion, in this report we have just used the term 'benchmark' to refer to our cost of capital estimate, and have not used the term 'absolute standard'.

2.41 Therefore, while we consider that our input methodologies do provide the appropriate benchmark for assessing performance, as well as our assessment of how certain building blocks (for example, asset valuation) should be specified to promote the Part 4 purpose, they do not provide the only legitimate benchmark for assessing performance in terms of the Part 4 purpose.

2.42 In its post conference submission the New Zealand Airports Association (NZAA) asserted that:[27]

> The Commission's analytical framework was not known until publication of the Commission's draft s 56G report for its WIAL review and this was after completion of the AIAL price setting event for PSE2. AIAL, and WIAL, therefore could not have contemplated outcomes calculated in the manner by the Commission's analysis. The Commission's approach of moving the goal posts is unhelpful and misleading.

2.43 As set out in this chapter and Attachment A of this report, the Commission has applied the requirements of Part 4 of the Act and the input methodologies in order to carry out the task required under s 56G. The input methodologies developed for airports came into effect in December 2010. Where the primary approach taken by the airport has materially differed from the input methodologies (as in the case of asset valuations), we have had to consider whether it is appropriate to vary our approach in order to make an appropriate assessment.

2.44 It is unclear how the Commission's application of the legislation under which this review is required to be carried out, and its input methodologies, in any way constitutes an approach of "moving the goal posts" that is "misleading". Auckland Airport appears to have been able to closely predict the outcome of the Commission's profitability assessment for PSE2, and has tailored its pricing approach for PSE2 in light of those expectations.[28]

The role of input methodologies in our assessment

Input methodologies provide a benchmark for assessing profitability

2.45 The input methodologies we developed for airports in December 2010 in relation to cost allocation, asset valuation, the treatment of taxation, and the cost of capital are intended to promote certainty as to the rules, requirements, and processes applying to information disclosure regulation. The input methodologies represent our best

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[27] New Zealand Airports Association "Section 56G Review of Auckland Airport: Post Conference Submission" 15 March 2013, paragraph 15.

[28] Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraphs 91 to 92.

assessment of how certain building blocks should be specified to promote the Part 4 purpose in these areas.

2.46 Airports are not required to apply the input methodologies in setting their prices although they must disclose information consistent with the input methodologies for information disclosure purposes. The input methodologies then provide an important tool which assists interested persons in assessing whether the purpose of Part 4 is being met.

2.47 We have found the input methodologies to be most relevant to the profitability assessment aspect of our review. This is because the input methodologies for asset valuation, taxation and cost allocation are inputs into profitability measures (including the calculation of the return on investment that airports must disclose for past years). Therefore, although the airports are not required to apply the cost of capital IM, it provides a basis for comparing what airports are earning against our view of the level of return that is appropriate for this type of business.

2.48 If the airport's prices are not fully aligned with our input methodologies we do not simply assume that this means that the Part 4 purpose is not being promoted.[29] Our assessment considers the extent to which the airport has departed from our input methodologies and how other factors shape such a departure.

2.49 Moreover, a combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

2.50 Our assessment has therefore considered the variations by Auckland Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on historical or expected performance. In particular, as is discussed in Attachment F, Auckland Airport has had a moratorium on revaluing its assets since 2007. We have taken this departure from the asset valuation input methodology into account to ensure that our conclusions about Auckland Airport's profitability are valid.

Where input methodologies are not available we have considered what would be expected in a workably competitive market

2.51 In some areas of performance it is more difficult to assess the impact information disclosure regulation has had on the actual performance of airports as there are no relevant input methodologies (for example, for pricing efficiency or quality) and changes in performance or conduct may be attributable to external factors. For those aspects of performance, our analysis takes into account events (for example, PSE2) and what we might expect to find in a workably competitive market. We have

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29 Nor do we accept that, if airports have taken and followed external professional advice, the Part 4 purpose is **necessarily** being promoted.

been largely reliant on submissions received from interested parties as part of this review to assess whether information disclosure regulation has had an impact on these areas of performance.

Information used to examine performance

2.52 We have relied on the information disclosed by Auckland Airport under Part 4 and the material provided by the parties during the s 56G consultation process to date to examine performance. Where relevant, we have also had regard to information disclosed under the regulatory regime in the AAA, and documentation shared between Auckland Airport and airlines during consultation on the recent price setting event.

2.53 As we acknowledged in Chapter 1, information disclosure regulation under Part 4 has only been in place with effect since 1 January 2011 and the time series of disclosed data is relatively short in some areas. Where we consider that more time is required in order to tell whether information disclosure is effective, or likely to be effective, in promoting an aspect of the purpose, we highlight that in this report.

3. Conclusions from our section 56G review

Purpose of this chapter

3.1 This chapter sets out our conclusions on how effectively information disclosure regulation is promoting the Part 4 purpose for Auckland Airport and the key reasons why we have reached those conclusions.

Summary of our conclusions

3.2 Our conclusions on the effectiveness of information disclosure vary between the different outcomes sought under Part 4. As summarised below, our section 56G review for Auckland Airport has to date found that information disclosure is effective in some areas, including limiting Auckland Airport's ability to earn excessive profits. However, we are unable to conclude whether it is effective in other areas.

Summary of conclusions in each performance area

3.3 Our conclusion is that information disclosure regulation at this time has been effective in limiting Auckland Airport's ability to extract excessive profits over time. In particular, for PSE2 Auckland Airport targeted returns within an 'acceptable range' (ie, the range of returns that we assess as limiting the airport's ability to earn excessive profits, while allowing it to achieve at least a normal return), based on a reasonable assessment of how, at that time, it considered the Commission might assess its performance.

3.4 Auckland Airport set prices such that its expected returns over the whole of PSE2 is equivalent to a return of 8.0% when the information disclosure framework is applied, and taking into account its moratorium on asset revaluations. Although this target return is above our assessment of a normal return, it is just within the upper limit of an acceptable range of returns of 7.1% to 8.0%, and therefore supports our conclusion that information disclosure is effective in achieving the Part 4 purpose as regards profitability (s 52A(1)(d)).

3.5 Our conclusion is that information disclosure regulation is also effectively promoting the Part 4 purpose in the following areas:

3.5.1 Innovation (s 52A(1)(a)). Innovation levels at Auckland Airport appear to be appropriate and airlines consider that Auckland Airport facilitates airline-led innovation. Our review has found that information disclosure is effectively promoting incentives to innovate at Auckland Airport.

3.5.2 Quality (s 52A(1)(b)). The quality of service provided by Auckland Airport generally reflects the demands of airlines and passengers, and Auckland Airport addresses matters of quality raised by consumers. Our review has found that information disclosure is effectively promoting incentives to provide services at a quality that reflects consumer demands at Auckland Airport.

3.5.3 Pricing efficiency (s 52A(1)(b)). Information disclosure has had a positive impact on this outcome. Our review has found that prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. Auckland Airport has indicated that the requirement to transparently outline its pricing methodology in information disclosure has led to improvements in its pricing efficiency.

3.6 We are unable to conclude on the effectiveness of information disclosure under Part 4 on some performance areas at this time.

3.6.1 Operational expenditure efficiency (s 52A(1)(b)). Information on actual expenditure over a longer period of time is necessary before we can form a conclusion.

3.6.2 Efficient investment (s 52A(1)(a)-(b)). Information on actual expenditure over a longer period of time is necessary before we can form a conclusion.

3.6.3 Sharing the benefits of efficiency gains (s 52A(1)(c)). It is too early to conclude whether there are any operational expenditure (opex) and capital expenditure (capex) efficiency gains that could be shared.

How effectively is information disclosure regulation promoting the Part 4 purpose?

3.7 In the remainder of this chapter we set out how we have reached these conclusions. Further detail on our reasons and supporting analysis is provided in the attachments listed in Table 3.1.

Table 3.1: Attachments to this report

Innovation	B
Quality	C
Pricing efficiency	D
Profitability	E and F
Operational expenditure efficiency	G
Efficient investment	H
Sharing the benefits of efficiency gains	I

Information disclosure is limiting Auckland Airport’s ability to earn excessive profits

3.8 Our conclusion is that information disclosure regulation at this time has been effective in limiting Auckland Airport’s ability to extract excessive profits over time. In particular, for PSE2 Auckland Airport targeted returns within an 'acceptable range' (ie, the range of returns that we assess as limiting the airport's ability to earn excessive profits, while allowing it to achieve at least a normal return), based on a reasonable assessment of how, at that time, it considered the Commission might assess its performance. Auckland Airport's approach to setting prices for PSE2 was based on the input methodologies underpinning information disclosure, taking into account its moratorium on asset revaluations.

3.9 Auckland Airport set prices such that its expected returns over the whole of PSE2 is equivalent to a return of 8.0% when the information disclosure framework is applied, and taking into account its moratorium on asset revaluations. Although this target return is above our assessment of a normal return, it is just within the upper limit of an acceptable range of returns of 7.1% to 8.0%, and therefore supports our conclusion that information disclosure is effective in achieving the Part 4 purpose as regards profitability.[30]

3.10 Our own estimate of Auckland Airport's expected returns from 1 July 2012 over the remaining life of the assets (ie, for PSE2 and beyond) is 7.9%.[31] Like Auckland Airport's effective target return for PSE2, our estimate of expected returns also falls within the range of what we consider are acceptable returns (7.1% to 8.0%).

3.11 Information disclosure does appear to have had a direct impact on limiting Auckland Airport's ability to earn excessive profits. Auckland Airport explains that, at the time it set prices for PSE2, it "understood that the ID framework, including the IMs, was intended to impose disciplines on our pricing behaviour. Accordingly, the IMs, including the cost of capital IM, were a key reference point for our pricing decision in 2012." Auckland Airport made a number of changes to its approach to pricing from PSE1 to PSE2 to be more consistent with the new information disclosure requirements, including:

3.11.1 removing the land held for future use from its pricing asset base; and

3.11.2 targeting a lower cost of capital in response to submissions during the consultation process.[32]

Auckland Airport also agreed to continue its moratorium on asset revaluations during PSE2.

3.12 Our conclusion has been reached based on the assumption that Auckland Airport will continue its current pricing behaviour after PSE2, consistent with guidance Auckland Airport has provided during this review. BARNZ and Air New Zealand have identified a risk that the approach taken by Auckland Airport with respect to asset valuations in PSE3 and beyond may lead to Auckland Airport earning excessive profits at that time.

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30 Consistent targeting of returns at the upper end of the range would, in the case of an inefficient airport, still require consideration of whether excessive profits are being limited (refer paragraph 2.9).

31 This value is found when using end of year cash flow timings, which is consistent with current information disclosure requirements.

32 Auckland Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 16 March 2013, paragraph 203.

At the next price setting event we intend to closely monitor whether Auckland Airport acts consistently with the guidance it has given during this review.

Information disclosure is effectively promoting innovation

3.13 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Auckland Airport facilitates airline-led innovation, and the level of innovation at Auckland Airport appears to be appropriate. At this time, information disclosure does not appear to have an additional impact on incentives to innovate at Auckland Airport, but has not negatively affected existing incentives to innovate. As discussed in our report for Wellington Airport, where a supplier is already innovating appropriately, we would not expect information disclosure to have any material impact on innovation.[33] We therefore consider that information disclosure is effectively promoting incentives to innovate at Auckland Airport.

3.14 The key reasons for our conclusion are as follows.

3.14.1 The level of innovation at Auckland Airport appears to be appropriate.

3.14.2 Airlines generally consider that Auckland Airport facilitates airline-led innovation.

3.14.3 It appears that innovation at Auckland Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4.[34]

3.15 We expect that information disclosure regulation would have a limited impact on innovation because other incentives play a more important role in driving innovation. Auckland Airport has incentives to innovate so as to increase its profits and information disclosure does not appear to have negatively impacted on those incentives. Auckland Airport has suggested that its innovation activities are driven by core business drivers rather than information disclosure regulation under Part 4.[35] It

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33 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, paragraph B3.

34 At the conference for Auckland Airport, Air New Zealand stated that Auckland Airport "…were innovative prior to [the] Information Disclosure regime and they've remained innovative since". See Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 50.

35 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 49.

has however noted that information disclosure has resulted in greater transparency around the outcomes of its innovations.[36]

Information disclosure is effectively promoting the provision of quality at a level that reflects consumers' demands

3.16 Our conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Auckland Airport providing services at a quality that reflects consumer demands. Auckland Airport's overall conduct in this area is appropriate and, based on the available information, the quality of service provided to passengers and airlines reflects their demands. While the quality of service experienced by cargo operators has not reflected their demands to date, Auckland Airport has signalled it will review their concerns.

3.17 The key reasons for our conclusions are as follows.

3.17.1 Quality experienced by passengers at Auckland Airport is high and comparable with other New Zealand airports.

3.17.2 Airlines appear to be generally satisfied with the quality of service provided at Auckland Airport. This is based on submissions received as part of this section 56G review. Our analysis also supports this indicator.

3.17.3 The evidence available indicates that Auckland Airport facilitates improvements in quality or efficiency for services provided by its consumers (eg, airlines).

3.17.4 The New Zealand Air Cargo Council (NZACC) submitted that improvements in the quality of service its members experience are required. We understand that Auckland Airport will review the NZACC's specific concerns as part of its masterplanning, although it is unclear at this time whether this process will address the NZACC's concerns.[37] Furthermore, it is not clear whether the NZACC's members are willing to pay for the costs incurred outside of the masterplanning process for the improvements in the quality of service they experience.

3.17.5 Auckland Airport's conduct indicates it generally seeks to ensure quality reflects consumer demands. However, airlines have raised concerns with Auckland Airport's perceived unwillingness to enter into a service level

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36 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 50 to 51.

37 Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, Appendix 1.

agreement (SLA).[38] At this time, it is unclear why a SLA could not be agreed between parties.

3.18 Information disclosure regulation does not appear to have had a significant impact on the quality of service provided at Auckland Airport. While Auckland Airport has attributed changes to its fault diagnosis and management system, and an improved focus on reliability, to information disclosure, airlines consider that improvements in quality and conduct at Auckland Airport are a result of changes in management style and attitude.[39] Furthermore, there is limited evidence through the information disclosed at this time that quality has improved as a result of the introduction of information disclosure regulation. However, information disclosure has not negatively affected existing incentives to provide services at a quality that reflects consumer demands. Information disclosure may have had an impact on Auckland Airport's conduct in this area.

Information disclosure is effectively promoting pricing efficiency

3.19 Our conclusion is that information disclosure is effectively promoting efficiency of pricing. Auckland Airport appears to have given greater consideration to pricing efficiency in PSE2 relative to PSE1. Consequently, prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place. Auckland Airport has indicated that information disclosure regulation under Part 4 has led to improvements in the efficiency of its pricing.

3.20 Our analysis indicates that Auckland Airport's pricing methodology for PSE2 is likely to promote efficiency. For example:

3.20.1 Auckland Airport has introduced new charges and increased existing charges with the intention of ensuring the optimal use of scarce resources;

3.20.2 changes to the pricing methodology for PSE2 are likely to reduce the likelihood of cross-subsidisation relative to the PSE1 pricing methodology; and

3.20.3 Auckland Airport has made changes to its pricing methodology for PSE2 with the intention of improving price stability and certainty.

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38 SLAs are agreements between the airport and individual airlines that link charges to agreed service levels. Typically, as part of the agreement, the airport will rebate the airlines if the airport does not deliver the agreed service levels.

39 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 318; BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 39; Qantas Airways “The Qantas Group’s response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport” 24 October 2012, page 8.

3.21 Information disclosure has had a positive impact on this outcome. Auckland Airport has indicated that the requirement to transparently outline its pricing methodology in Part 4 information disclosure prompted discussions with airlines about its pricing methodology. These discussions led to a number of changes to its pricing structure, with the intention of improving the efficiency of prices.[40]

3.22 Additional changes to Auckland Airport's pricing methodology may further improve the efficiency of its prices (for example, further consideration of maximum certified take-off weight (MCTOW) charges for smaller aircraft).

It is too early to tell whether information disclosure is effectively promoting improvements in operating efficiency

3.23 We are unable to conclude whether information disclosure regulation is effectively promoting improvements in opex efficiency at Auckland Airport at this time. This is because we do not have a sufficiently long time series on actual operating expenditure to assess meaningful trends in opex at Auckland Airport since information disclosure regulation was implemented. Information on actual expenditure that is provided during PSE2 will assist in drawing conclusions on Auckland Airport's operating efficiency in the future.

3.24 The key reasons for our view on the effectiveness of information disclosure regulation in this area are as follows.

3.24.1 The evidence of improvements in opex efficiency at Auckland Airport since information disclosure regulation under Part 4 was implemented is mixed and inconclusive. Unit opex has both increased and exceeded the PSE1 forecast in 2011 and 2012, even when the unforeseen costs associated with Auckland Airport's route development activities are excluded. Although Auckland Airport has forecast unit opex to decline over PSE2, we would not expect forecast opex to reflect all expected future efficiency gains.

3.24.2 We do not yet have actual expenditure information for PSE2 to assess whether Auckland Airport has been able to achieve lower opex than forecast, and the reasons for any differences. This will be an important indicator of whether Auckland Airport is improving its efficiency and whether information disclosure under Part 4 is effective in this area.

3.25 We note that Auckland Airport does appear to seek to improve its operating efficiency. However, it is unclear whether this is a consequence of information disclosure regulation.

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[40] Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 416.

It is too early to tell whether information disclosure is effectively promoting efficient investment

3.26 We cannot conclude whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Auckland Airport at this stage as we do not have actual investment information for PSE2. However, information disclosure regulation appears to have promoted an efficient investment plan for PSE2. Submissions have commended the consultation process for capex that was adopted by Auckland Airport at the second price setting event.

3.27 The key reasons for our view on the effectiveness of information disclosure regulation in this area are outlined below.

3.27.1 Submissions have commended the consultation process that was adopted by Auckland Airport. This process gave airlines the opportunity to prioritise capex projects in PSE2, in contrast to PSE1. Auckland Airport's conduct in this area for PSE2 has led to airlines generally agreeing that the level and timing of investment planned for PSE2 is efficient based on the circumstances at the time.

3.27.2 We do not yet have a sufficiently long time series on actual capital expenditure to assess whether investment is being made in a timely and efficient manner.

3.27.3 It is not clear to what extent information disclosure has had an impact on the efficiency of Auckland Airport's planned investment and its conduct in this area. Auckland Airport considers that information disclosure has provided it with a useful reference point for expenditure forecasts for PSE2. It states that this has resulted in less disagreement between parties in consultation.[41] However, BARNZ and Air New Zealand consider that this improved conduct at Auckland Airport may also be due to other factors.[42] This indicates that information disclosure does not appear to have negatively affected existing incentives to plan efficient investment.

We are unable to conclude whether information disclosure is effectively promoting the sharing of efficiency gains with consumers

3.28 We are unable to conclude whether Auckland Airport is sharing the benefits of operating and investment efficiency gains with consumers and whether information disclosure is effective in this area. This is because there is limited evidence of historic

41 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraphs 277 to 279.

42 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 52 to 53.

efficiency gains at Auckland Airport that could be shared with consumers when setting prices for PSE2.

Attachment A: Regulatory Framework

Purpose

A1 This attachment sets out more detail on some of the matters covered in Chapters 1 and 2 of this report, including responding to relevant submissions. In particular, it sets out:

A1.1 the key statutory provisions applicable to the three regulated airports, and explains how these apply in the context of this current review. The key provisions relevant to this review are sections 52A, 53A and 56G set out in Part 4 of the Commerce Act 1986;

A1.2 the application of input methodologies to a section 56G review. The input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks should be specified to promote the Part 4 purpose. The input methodologies are a tool the Commission can use in its analysis of Auckland Airport's historic and expected performance;

A1.3 the relationship between information disclosure regulation under Part 4 and s 4A of the AAA. While airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. We do not consider that s 4A of the AAA is incompatible with the information disclosure regime as the two operate for distinct purposes. We also do not consider that Part 4 is subordinate to s 4A; and

A1.4 the scope, timing and process for the section 56G review. The substantive part of the Commission's task under s 56G is to assess "how effectively information disclosure regulation under this Part is promoting the purpose in s 52A in respect of the specified airport services". Section 56G provides that the trigger for the review is the setting of any new price "in or after 2012". This report is therefore an evaluation carried out by the Commission in accordance with s 56G. We consider that we are able to draw conclusions as summarised in Chapter 3 in this report at this point in time (that point in time being "as soon as practicable after any new prices are set …in or after 2012") based on the information available to us.

Key statutory provisions relevant to airports

A2 Specified airport services supplied by Auckland Airport, Wellington Airport and Christchurch Airport are subject to information disclosure regulation under subpart 11 of Part 4 of the Act. The subpart came into force on 14 October 2008 and prescribes:

A2.1 the scope of regulated services and the definition of 'specified airport services' (s 56A), which are defined as:

A2.1.1 aircraft and freight activities (s 56A(1)(a));

A2.1.2 airfield activities (s 56A(1)(b));

A2.1.3 specified passenger terminal activities(s 56A(1)(c)); and

A2.1.4 any other services that are determined by the Governor-General, by Order in Council made on the recommendation of the Minister, to be specified airport services (s 56A(1)(d));

A2.2 arrangements for transition from the previous regulatory regime, namely the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 to the new regulatory provisions under the Act (s 56F);

A2.3 when the provisions take effect and the statutory timeframes for making s 52P determinations specifying how information disclosure regulation applies to the regulated airports (s 56E); and

A2.4 monitoring responsibilities for the Commission, including a requirement to provide one-off reports to the Ministers of Commerce and Transport (s 56G).

A3 Each of the 'specified airport services' set out in clause A2.1 above is defined in detail in s 2 of the AAA. These definitions are quite broad and include non-exhaustive lists of the types of activity that are considered to fall within each of these categories.

A4 In accordance with s 56E of subpart 11 and subpart 4 of the Act, the Commission determined the "Commerce Act (Specified Airport Services Information Disclosure) Determination 2010" on 22 December 2010 (ID determination). The information disclosure determination sets out the information disclosure requirements applying to the regulated airports from 1 January 2011.

A5 Section 56G states that the Commission must review the information disclosed under the information disclosure requirements and report to the Ministers on the effectiveness of information disclosure regulation. We must do this as soon as practicable after a supplier sets any new price for a specified airport service in or after 2012. Under s 56G(1) the Commission must:

(a) review the information that has been disclosed by suppliers of specified airport services under subpart 4; and

(b) consult (without necessarily holding an inquiry) with interested parties; and

(c) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in s 52A in respect of the specified airport services.

Application of input methodologies to the section 56G review

Overview

A6 The input methodologies for regulated airport services provide a benchmark for assessing how effectively information disclosure regulation is promoting the purpose of Part 4 in a number of key performance areas, notably historic and forecast revenues and profits, and expenditure efficiency.

A7 As discussed in Chapter 2, it is accepted that there may be other avenues for promoting the purpose of Part 4 other than input methodologies. The purpose of setting the input methodologies is to promote certainty to regulated suppliers as to the tools the Commission will use in assessing the impact of information disclosure, such that s 52A(1)(a) to (d) occur. We set out our detailed views below.

Application of input methodologies to information disclosure

A8 We determined input methodologies for the regulated airport services on 22 December 2010. We applied those input methodologies in making our information disclosure determination for airports. The information required to be disclosed includes a wide range of historic and forecast information and performance measures, covering both financial and non-financial matters.[43]

A9 Auckland Airport is required to apply all of those input methodologies, except the cost of capital IM, when disclosing information under Part 4.[44]

A10 As is explained in the Airport Services Input Methodologies Reasons Paper, the matters covered by input methodologies in s 52T(1)(a) are most relevant to the disclosure of financial performance measures, as well as the financial statements and other information that supports those measures. The key historic financial performance measure airports must disclose is the annual return on investment (ROI), which measures the supplier's regulatory profit relative to the regulatory investment on which that profit has been earned.

Application of input methodologies to the section 56G review

A11 Auckland Airport is not required to apply the input methodologies when undertaking any task other than disclosing information under Part 4. For example, it does not have to apply the input methodologies when setting prices. However, Auckland Airport is required to disclose its forecast revenues and prices, and the actual methodologies it used in determining those revenues and prices.

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[43] Section 53C(2) sets out the types of information that we may require airports to disclose.

[44] Section 53F(1).

A12 It is the combination of disclosures of information based on input methodologies, and disclosures of actual and forecast information that the Commission uses in any assessment against the Part 4 purpose.

A13 The focus of the section 56G review is on the outcomes in s 52A(1). That focus informed the various questions on which we based our analytical framework, as discussed in Chapter 2. What we are interested in is assessing whether those outcomes are evident in Auckland Airport's performance or conduct.

A14 The input methodologies provide the Commission with a benchmark for assessing whether the objectives specified in s 52A(1) are being promoted. They are our assessment of how certain building blocks (for example, asset valuation) should be specified to promote the Part 4 purpose. As such, the input methodologies are a tool we can use in our analysis of Auckland Airport's historic and forecast performance.

A15 This approach is reflected in s 53F, which explicitly allows us to use input methodologies for our s 53B summary and analysis reports. As much of the analysis and assessment required to be carried out by the Commission under ss 53B and 56G overlaps, it is therefore also logical to use the input methodologies in the assessment required under s 56G.

A16 In its post conference submissions Auckland Airport generally agreed with our view that IMs are an appropriate basis for analysing airport's performance.[45] However, Auckland Airport did go on to note:

> Accordingly, we understood that we were not required to strictly apply the IMs in pricing, as ID regulation was seeking to understand our pricing and investment decisions, including our rationale and justifications for those decisions. We understood that the cost of capital IM, which is not required to be applied by airports for pricing or ID purposes, certainly fell into that category.

A17 Given that airports are not required to apply our input methodologies in setting their prices, where the airport is not fully aligned with our input methodologies we do not simply assume that this means that the Part 4 purpose is not being promoted. Our assessment considers the extent to which the airport has departed from our input methodologies, and how other factors shape such a departure.

A18 Both Auckland Airport and NZAA have expressed concerns that the Commission is applying the cost of capital input methodology to this review in a "bright line or price control" manner. However, as set out in Chapter 2, this is not the case.

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45 Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraph 58: "At the time prices were set, Auckland Airport understood that ID framework, including the IMs, was intended to impose disciplines on our pricing behaviour. Accordingly, the IMs, including the cost of capital IM, were a key reference point for our pricing decision in 2012. At the same time, we understood that ID regulation was intended to promote transparency around the decisions that we were making."

A19 As discussed above, airports are free to choose whatever methodology they like in undertaking their operations. What we are ultimately interested in is the outcome—for example, whether airports are limited in their ability to extract excessive profits. A combination of alternative methodologies to those contained in our input methodologies may yield a similar outcome in terms of limiting excessive profits in line with the Part 4 purpose.

A20 Finally on this point, we note that as discussed in Chapter 2:

A20.1 Concluding that good performance exists in some areas does not necessarily cancel out potential findings of poor performance in others.[46]

A20.2 Finding some evidence of progress in a particular performance area does not necessarily mean that the intended performance outcome has been achieved.[47]

A21 Our assessment has considered the variations by Auckland Airport from the input methodologies, the reasons why it has departed from them (if relevant), and the impact this has had on performance or expected performance. In particular, as is discussed in Attachment F, Auckland Airport has had a moratorium on revaluing its assets since 2007, and we have taken this departure from the asset valuation input methodology into account to ensure that our conclusions about Auckland Airport's profitability are not incorrect. We then took the results of that analysis and considered what, if any, impact information disclosure has had on the s 52A(1) outcomes.

The relationship between information disclosure regulation under Part 4 and s 4A of the Airports Authorities Act 1996

A22 Section 4A(1) of the AAA provides that an airport subject to that statute may:

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46 It is unclear to us whether Auckland Airport was suggesting otherwise when it stated in its post conference submissions that "any minor issues that have been raised should be considered in proportion to the overall picture of airport performance, and should not outweigh the positive outcomes that can be observed". Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraph 7(b).

47 In its post conference submission Auckland Airport states that: "When evaluating the effectiveness of ID, the Commission should not simply ask whether forecast returns exceed its WACC estimate. That is a price control approach. Rather, the key question is whether there is evidence that the WACC IM has influenced price setting decisions and, if so, how. Clearly, if there is evidence that Auckland Airport may have sought a higher return in the absence of the WACC IM (and ID more generally), then it must be found that ID has been effective at limiting excess returns". Auckland Airport "Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport" 15 March 2013, paragraph 54. To the extent that profitability remains clearly excessive, placing some constraints on profitability is unlikely to be sufficient in and of itself for satisfaction of the outcome sought under s 52A(1)(d).

> set such charges as it from time to time thinks fit for the use of the airport operated or managed by it, or the services or facilities associated therewith.

A23 However this right needs to co-exist with the new Part 4 regime, evidenced by the inclusion of s 4A(4) which provides:

> This section does not limit the application of regulation under Part 4 of the Commerce Act 1986.

A24 The AAA provisions relating to charges are primarily concerned with ensuring that the decision making process for airport pricing is clear. In that context s 4A clarifies that, while airports are required to consult with their major customers in accordance with the AAA, the final decision as to charges rests with the airports, and the consultation process does not have the ability to prevent airports setting charges as they think fit.

A25 However, information disclosure regulation, while being light-handed, is still intended to promote the overall Part 4 purpose as set out in s 52A. Parliament's intention behind the adoption of this regime was to introduce regulation that would, among other functions, have an impact on airport's prices. That is clear from the structure of Part 4 – all forms of Part 4 regulation including information disclosure regulation, are intended to promote the Part 4 purpose, which includes promoting outcomes such that suppliers are limited in their ability to extract excessive profits. Further, when referring to the section 56G review in its report on the Commerce Amendment Bill, the then Ministry of Economic Development (MED) stated:

> It is expected that the knowledge of an impending review (combined with robust information disclosure) will influence the price setting by airports.[48]

A26 MED's response to issues raised by the Commerce Committee on the Bill also went on to state:

> Officials remain of the view that the major airports should be covered in the Commerce Act. Considerations are: ...The major airports have strong natural monopoly characteristics. Absent effective regulation, airports are able to set prices as they see fit...
>
> ...Note however, that information disclosure, combined with annual analysis by the Commission and the requirements for a review, will impose some disciplines on pricing behaviour.[49]

A27 So while airports can set prices as they see fit, information disclosure is intended to have an impact on those prices. As such, we do not consider that s 4A of the AAA is

48 Ministry of Economic Development "Commerce Amendment Bill: Report of the Ministry of Economic Development", 4 July 2008, page 52.

49 Ministry of Economic Development "Commerce Amendment Bill: Response to issues raised by the Commerce Committee", 23 July 2008, pages 5 and 50.

incompatible with the information disclosure regime as the two operate for distinct purposes, or that the Part 4 purpose is subordinate to s 4A.

Scope, timing and process for the section 56G review

Scope of the review

A28 Under s 56G(1) the Commission must:

> (1) As soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service, the Commission must-
>
> (a) review the information that has been disclosed by suppliers of specified airport services under subpart 4; and
>
> (b) consult (without necessarily holding an inquiry) with interested parties; and
>
> (c) report to the Ministers of Commerce and Transport as to how effectively information disclosure regulation under this Part is promoting the purpose in section 52A in respect of the specified airport services.

A29 The substantive part of the Commission's task under s 56G is to assess "how effectively information disclosure regulation under this Part is promoting the purpose in s 52A in respect of the specified airport services".[50] This report is therefore an evaluation carried out by the Commission in accordance with s 56G.

A30 We have not carried out an assessment as to how effectively information disclosure is promoting the purpose of Part 4 relative to other types of regulation provided for under Part 4. In our view the wording of s 56G(1)(c) is clear: the scope of this section 56G review does not extend to considering and recommending to the Ministers whether regulation other than information disclosure should apply to the regulated airports. Consequently this report does not make any recommendations concerning changes to the current regulatory framework for Auckland Airport.

A31 In addition, we do not consider that extending the definition of 'specified airport services' under s 56A(1) is within the scope of the section 56G review. Section 56G is confined to the assessment of the information disclosure regime as it currently

[50] We note that Auckland Airport has argued in its submission on our Draft Report that information disclosure has been having a noticeable impact in constraining airport profitability because it has "provided considerable transparency of Auckland Airport's conduct and performance" and "resulted in Auckland Airport thoroughly justifying our decisions and the reasons behind them throughout consultation." See Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 122. We have discussed in Chapter 2 at paragraphs 2.12 to 2.15 the distinction between the purpose of information disclosure (s 53A) and the purpose of Part 4 (s 52A) and have set out how they are related. We further note that BARNZ has pointed out this distinction in response to Auckland Airport's submission in its cross-submission on our Draft Report, see BARNZ "Cross-Submission by BARNZ to Auckland Airport Submission on Commerce Commission Draft Report" 18 June 2013, page 6.

stands. Therefore we have not considered whether any additional services, not currently regulated as specified airport services, should be included in the definition of 'specified airport services'.

Timing of the review

The trigger for undertaking the section 56G review has been met

A32 Section 56G provides that the trigger for the review is the setting of any new price "in or after 2012":

> as soon as practicable after any new price for a specified airport service is set in or after 2012 by a supplier of the service.

A33 This is further confirmed by the wording of s 56(1)(c) which is a guide to the overall aim of subpart 11, namely:

> for a review of the new regime as soon as any new price is set in 2012 for specified airport services.

A34 We therefore consider that the trigger for reporting to the Ministers has already been met as Wellington Airport, Auckland Airport and Christchurch Airport have reset their prices in 2012.

A35 In its post conference submission Auckland Airport stated:[51]

> Auckland Airport continues to consider that ID regulation is in its infancy, and we expect that it will have a stronger impact on continuing improvement, conduct and performance over time, as more information is disclosed, clearer benchmarks are established, and ongoing monitoring and analysis reveals performance and behavioural trends....Even at this early stage, the evidence currently before the Commission demonstrates that each limb of the purpose statement is being effectively promoted...

A36 The conclusions drawn in this review reflect the level of data available. We consider that we are able to draw conclusions as summarised in Chapter 3 in this report at this point in time (that point in time being "as soon as practicable after any new prices are set …in or after 2012") based on the available data.

A37 However, we also acknowledge that the timing requirement of the section 56G review carries with it certain limitations as to the assessment being carried out. For example, the availability of a greater amount of time series data would enable a more robust assessment of some of the outcomes expected from the regime. While we are not persuaded that the benefit of more data overrides the wording of s 56G, we acknowledge that an outcome of conducting the section 56G review now is that

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51 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraph 8.

it is too early to draw conclusions about the effectiveness of the information disclosure regime in relation to some of the intended Part 4 outcomes.

A38 In its post conference submission Auckland Airport stated that:[52]

> Quality, innovation, capital expenditure and operating costs cannot be considered in isolation of each other or in isolation of overall returns, and many of these elements cannot be captured by modelling or numerical analysis....we continue to encourage the Commission to explore the interdependencies between the different limbs of the Part 4 purpose statement, and to reflect on how these interdependencies can be fully acknowledged in its analysis and conclusions.

A39 As discussed in Chapter 2, while we consider that the performance areas are interrelated, this does not preclude us reaching a conclusion on performance in one area without reaching a conclusion on performance in another. For example based on the evidence we were presented with, it is not necessary to conclude whether information disclosure is effective in the areas of operational expenditure efficiency, efficient investment and the sharing of efficiency gains in order to conclude whether Auckland Airport is expected to earn excessive profits.

A40 As discussed above, the Act requires us to undertake this review "as soon as practicable after any new prices are set…in or after 2012" (which rules out postponing the report until prices are set again in 2017). We consider that there is sufficient time–series information available to draw conclusions in certain areas, while not others. We will continue to analyse and draw conclusions on Auckland Airport's performance over time in our s 53B reports.

Process for the review

A41 The statutory process we must follow in undertaking this review is set out in paragraph A5 above. We have exceeded these minimum requirements and included various additional consultation steps. The process below has been adopted. We have:

A41.1 reviewed the information disclosed under Part 4 and the price setting consultation documentation;

A41.2 reviewed the information disclosed in consultation during this review process and in response to any requests for information under our information-gathering powers under the Act;

A41.3 published a Process and Issues paper and seek submissions and cross-submissions on the proposed process and scope of the review;

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[52] Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraph 7(b).

A41.4 published a preliminary issues paper for the Auckland Airport conference;

A41.5 held a conference for Auckland Airport prior to preparing a draft report to ensure that we have all the relevant information, and to test the issues and ensure we understand any differences of opinion;

A41.6 sought cross-submissions on material discussed at the Auckland Airport conference; and

A41.7 issued a draft report for Auckland Airport.

Separate reports for each airport

A42 We consider that preparing a separate report for each airport is the most appropriate interpretation of the section 56G task. This view takes into account that each airport's price setting decisions are occurring at different times, and that information disclosure regulation may be having a different impact across the three airports. This interpretation is also consistent with the trigger wording of s 56G which provides:

> As soon as practicable after any new price for a specified service is set in or after 2012 by a supplier of the service, the Commission must…

Information the Commission may consider in undertaking the section 56G review

A43 The Act does not contain any explicit limitations on information that we may take into consideration when conducting our analysis of the effectiveness with which the purpose of Part 4 is, or is not, being promoted. We note that the s 56G goes beyond a mere review of information disclosed, namely:

A43.1 it requires a review of the information disclosed (s 56G(1)(a)); and

A43.2 a report to the Minister comprising an assessment of how effectively the information disclosure regulation is promoting the purpose in s 52A (s 56G(1)(c)).

A44 The trigger for the review is the price setting event. To assess the effectiveness of information disclosure in promoting the purpose in that context, and also in the context of the wider airport sector performance, for example in terms of quality, the review explores a wider range of information than just the Part 4 disclosures.

A45 We have therefore reviewed the information disclosed by Auckland Airport, and have also sought further information in order to make a meaningful assessment of whether, and to what extent, information disclosure is promoting the Part 4 purpose.

Attachment B: Is information disclosure promoting appropriate innovation at Auckland Airport?

Purpose

B1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Auckland Airport has incentives to innovate (s 52A(1)(a) of the Act).[53]

B2 Innovation is about the discovery and use of new information, leading to the development of new goods or services, and/or more efficient production techniques.[54] Innovation is driven by the prospect of earning higher profits and a greater than normal return.

Conclusion

B3 Information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to innovation. Auckland Airport facilitates airline-led innovation, and the level of innovation at Auckland Airport appears to be appropriate. At this time, information disclosure does not appear to have an additional impact on incentives to innovate at Auckland Airport, but has not negatively affected existing incentives to innovate. As discussed in our report for Wellington Airport, where a supplier is already innovating appropriately, we would not expect information disclosure to have any material impact on innovation.[55] We therefore consider that information disclosure is effectively promoting incentives to innovate at Auckland Airport.

B4 The key reasons for our conclusion are as follows.

B4.1 The level of innovation at Auckland Airport appears to be appropriate.

B4.2 Airlines generally consider that Auckland Airport facilitates airline-led innovation.

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53 Our focus in this attachment is on innovations by Auckland Airport that are experienced by consumers. Innovations which affect the efficiency of Auckland Airport's expenditure (ie, which result in dynamic efficiencies) but which are not necessarily visible to consumers are implicitly considered in Attachments G and H.

54 Innovation is not the same as the adoption of industry best practice from New Zealand or overseas.

55 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, paragraph B3.

B4.3 It appears that innovation at Auckland Airport has been appropriate both before and after the introduction of information disclosure regulation under Part 4.[56]

B5 We expect that information disclosure regulation would have a limited impact on innovation because other incentives play a more important role in driving innovation. Auckland Airport has incentives to innovate so as to increase its profits and information disclosure does not appear to have negatively impacted on those incentives. Auckland Airport has suggested that its innovation activities are driven by core business drivers rather than information disclosure regulation under Part 4.[57] It has however noted that information disclosure has resulted in greater transparency around the outcomes of its innovations.[58]

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to innovate appropriately

B6 Auckland Airport has incentives to maximise its profits through improved performance, including through innovation.

How information disclosure can provide incentives to innovate

B7 Information disclosure regulation places relatively weak incentives on Auckland Airport to innovate appropriately due to the unique and unpredictable nature of innovation. Information disclosure regulation is likely to be most effective over time when combined with analysis of operational and capital expenditure as this will highlight where innovation may assist in achieving efficiency gains.[59]

How we have assessed whether Auckland Airport is innovating appropriately

B8 Our approach to assessing innovation for this review was to consider Auckland Airport's performance and conduct regarding innovation. We have looked at:

B8.1 evidence of innovation occurring at Auckland Airport, comparisons with innovation at other airports, and awards for innovation; and

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56 At the conference for Auckland Airport, Air New Zealand stated that Auckland Airport "…were innovative prior to [the] Information Disclosure regime and they've remained innovative since". See Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 50.

57 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 49.

58 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 50 to 51.

59 It may also highlight where innovations and best practice at other airports may be appropriate to adopt by an airport to improve operational and capital efficiency.

B8.2 whether Auckland Airport enables or facilitates innovation through collaboration.

B9 We have considered these indicators both before and after the introduction of information disclosure regulation to gain insights into the impact of information disclosure regulation on incentives to innovate.

Information used to assess whether Auckland Airport is innovating appropriately

B10 Our analysis is based on qualitative information from two main sources:

B10.1 information disclosed under Part 4; and

B10.2 submissions and other material provided to the Commission as part of this section 56G review.

Analysis of innovation performance and conduct

Is Auckland Airport innovating appropriately?

B11 The available evidence suggests that Auckland Airport has innovated appropriately, and continues to innovate appropriately. Qantas and BARNZ note that Auckland Airport leads other New Zealand airports in terms of innovation.[60] Although Auckland Airport is not considered to be at the forefront of airport innovation internationally, this is not considered to be a concern by BARNZ as Auckland Airport is able to benefit from lessons learned by adopting others innovations.[61]

B12 While the New Zealand Air Cargo Council (NZACC) submitted that "there is little or no innovation at [Auckland Airport]", it has not provided us with sufficient evidence of where it considered innovation was appropriate but not undertaken at Auckland Airport for us to change our conclusion.[62]

Does Auckland Airport’s conduct demonstrate that it has facilitated innovation?

B13 Overall, we consider that Auckland Airport has facilitated innovation. As discussed in our Wellington Airport report, facilitation of airline-led innovation is considered an important part of airports' conduct in relation to innovation.[63] The NZACC submitted

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60 Qantas Airways “The Qantas Group’s response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport” 24 October 2012, page 7; BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 36.

61 BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 36.

62 New Zealand Air Cargo Council “Submission to New Zealand Commerce Commission” 19 October 2012, page 3.

63 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, paragraph B16.

that innovations by airlines or cargo terminal operators within leased areas are required to be approved by Auckland Airport, and that this can be restrictive.[64] However, Auckland Airport is considered receptive to airline-led innovations. For example, Qantas submitted that Auckland Airport has supported the introduction of self-service kiosks in its terminals.[65]

64 New Zealand Air Cargo Council "Submission to New Zealand Commerce Commission" 19 October 2012, page 3.

65 Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 7. See also examples provided in BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, pages 36 to 37.

Attachment C: Is information disclosure promoting services at the quality consumers demand at Auckland Airport?

Purpose

C1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Auckland Airport provides services at a quality that reflects consumer demands (s 52A(1)(b) of the Act).

C2 We consider that quality is about consumers' experiences of regulated airport services, including comfort, timeliness and the availability of the service. Consumers include airlines, air cargo handlers, passengers and other users of Auckland Airport's aeronautical services.

Conclusion

C3 Our conclusion is that information disclosure regulation under Part 4 is effectively promoting the purpose of Part 4 in relation to Auckland Airport providing services at a quality that reflects consumer demands. Auckland Airport's overall conduct in this area is appropriate and, based on the available information, the quality of service provided to passengers and airlines reflects their demands. While the quality of service experienced by cargo operators has not reflected their demands to date, Auckland Airport has signalled it will review their concerns.

C4 The key reasons for our conclusions are as follows.

C4.1 Quality experienced by passengers at Auckland Airport is high and comparable with other New Zealand airports.

C4.2 Airlines appear to be generally satisfied with the quality of service provided at Auckland Airport. This is based on submissions received as part of this section 56G review. Our analysis also supports this indicator.

C4.3 The evidence available indicates that Auckland Airport facilitates improvements in quality or efficiency for services provided by its consumers (eg, airlines).

C4.4 The New Zealand Air Cargo Council (NZACC) submitted that improvements in the quality of service its members experience are required. We understand that Auckland Airport will review the NZACC's specific concerns as part of its masterplanning, although it is unclear at this time whether this process will address the NZACC's concerns.[66] Furthermore, it is not clear

66 Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, Appendix 1.

whether the NZACC's members are willing to pay for the costs incurred outside of the masterplanning process for the improvements in the quality of service they experience.

C4.5 Auckland Airport's conduct indicates it generally seeks to ensure quality reflects consumer demands. However, airlines have raised concerns with Auckland Airport's perceived unwillingness to enter into a service level agreement (SLA).[67] At this time, it is unclear why a SLA could not be agreed between parties.

C5 Information disclosure regulation does not appear to have had a significant impact on the quality of service provided at Auckland Airport. While Auckland Airport has attributed changes to its fault diagnosis and management system, and an improved focus on reliability, to information disclosure, airlines consider that improvements in quality and conduct at Auckland Airport are a result of changes in management style and attitude.[68] Furthermore, there is limited evidence through the information disclosed at this time that quality has improved as a result of the introduction of information disclosure regulation. However, information disclosure has not negatively affected existing incentives to provide services at a quality that reflects consumer demands. Information disclosure may have had an impact on Auckland Airport's conduct in this area.

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to provide services at a quality that reflects consumer demands

C6 As discussed in our report for Wellington Airport, the regulated airports have some incentives to provide quality that reflects consumer demands, aside from those provided by information disclosure regulation under Part 4 (discussed below).[69] As a commercial operator, Auckland Airport has incentives to provide quality at a level that consumers are willing to pay for to maximise profits. Auckland Airport is subject to other regulatory requirements, which also creates incentives in this area. For example, the Airport Authorities Act (AAA) requires Auckland Airport to consult on

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67 SLAs are agreements between the airport and individual airlines that link charges to agreed service levels. Typically, as part of the agreement, the airport will rebate the airlines if the airport does not deliver the agreed service levels.

68 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 318; BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 39; Qantas Airways “The Qantas Group’s response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport” 24 October 2012, page 8.

69 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, paragraphs C6 to C7.

material capex programmes with its major customers. This creates some incentives to understand the level of quality its consumers demand, and therefore may encourage Auckland Airport to provide services at the quality consumer demand. Auckland Airport is also obliged to meet safety requirements set by the Civil Aviation Authority (CAA), which requires a minimum level of quality.

C7 However, the approach airports take to setting prices (ie, for a five-year period in advance, using a building blocks approach), along with incentives to maximise their profits, may weaken their incentives to provide quality at the level consumers demand. For example, once prices are set for the pricing period, Auckland Airport may earn higher profits by reducing quality as it may reduce its expenditure. A regulated supplier that is targeting an excessive return also has an adverse incentive to over-invest in quality where it will result in higher capital expenditure, so as to earn higher profits.

How information disclosure can provide incentives to provide the quality consumers demand

C8 The public disclosure of information through information disclosure regulation can strengthen the incentives to provide services at a quality that reflects consumer demands, for example by requiring Auckland Airport to disclose the process it has put in place for undertaking operational improvement forums.

C9 We expect it may take some time for information disclosure regulation to be as effective as it can be in promoting the provision of services at a quality that reflects consumer demands. Significant quality improvements highlighted as necessary by consumers through information disclosure regulation may require a long lead time to implement if investment is required. The availability of longer time series of information on quality may improve its effectiveness, including during consultation at price setting events. Only limited information on quality was available through information disclosure at the time of consultation for PSE2.

How we have assessed whether Auckland Airport is providing quality at the level consumers demand

C10 There are usually many dimensions to the quality of a service and a single indicator will provide only an approximation to the overall quality of the service or services to which it relates. Different types of consumers may also demand different levels of quality. We have therefore examined a number of aspects of service quality at Auckland Airport experienced by different types of consumers.

C11 Our approach considers whether historic or forecast improvements to quality at Auckland Airport reflect consumer demands. We have considered evidence of:

C11.1 whether the quality of service being received by passengers at Auckland Airport reflects their demands;

C11.2 whether the aspects of service quality that are important to airlines and other substantial customers reflects their demands; and

C11.3 changes to Auckland Airport's processes and service quality following the introduction of information disclosure regulation.

C12 Our assessment of whether quality at Auckland Airport reflects consumer demands considers a number of aspects of quality, including the cleanliness and comfort of the airport, the reliability of different services provided by the airport and whether there is sufficient capacity to meet the demand of consumers. We have also considered whether Auckland Airport facilitates improvements in quality or efficiency for services provided by its consumers (eg, airlines).

C13 An assessment of whether quality reflects consumer demands implicitly includes an assessment of whether consumers are willing to pay for higher quality, or would prefer to pay less and receive a lower quality.

Information used to assess whether Auckland Airport is providing services at the level of quality consumers demand

C14 Our analysis is based on qualitative and quantitative information from:

C14.1 information disclosed under Part 4 and the AAA; and

C14.2 submissions and other material provided to the Commission as part of this section 56G review.

C15 The information provided to us as part of this section 56G review has been helpful as it has allowed us to hear directly from Auckland Airport's consumers on whether the quality they experience reflect their demands, taking into consideration the price-quality trade-offs. Information disclosure does not provide information on whether consumers are willing to pay for higher quality, whether they consider quality at Auckland Airport is too high or low, or whether quality is at the appropriate level given costs.[70] These price-quality trade-offs are largely addressed through consultation at the price setting events.

Analysis of Auckland Airport's quality performance and conduct

Is Auckland Airport providing services at a quality that reflects passenger demands?

C16 Auckland Airport appears to provide services at a quality that reflects passenger demands. This is evidenced by the high passenger satisfaction scores and similar passenger satisfaction scores to other New Zealand airports.[71] However, information disclosure does not appear to have a material additional impact in this area.

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[70] It does however provide information on the steps Auckland Airport has taken to elicit feedback from consumers on the quality they expect.

[71] We have not received any submission from passengers as part of this section 56G review to be able to consider passenger views on whether Auckland Airport is providing services at a quality that reflects

C17 Table C1 shows that passenger satisfaction at Auckland Airport since information disclosure regulation took effect is similar to passenger satisfaction at Wellington and Christchurch airports.[72] It also shows that passenger satisfaction at Auckland Airport is relatively high at between 4.0 and 4.2 out of a possible 5.

Table C1: Annual passenger satisfaction survey results for Auckland, Wellington and Christchurch airports (2011–12)

	2011		2012	
	Domestic	**International**	**Domestic**	**International**
Auckland	4.0	4.1	4.1	4.2
Wellington	4.1	4.0	4.1	4.1
Christchurch	3.9	4.1	4.1	4.2

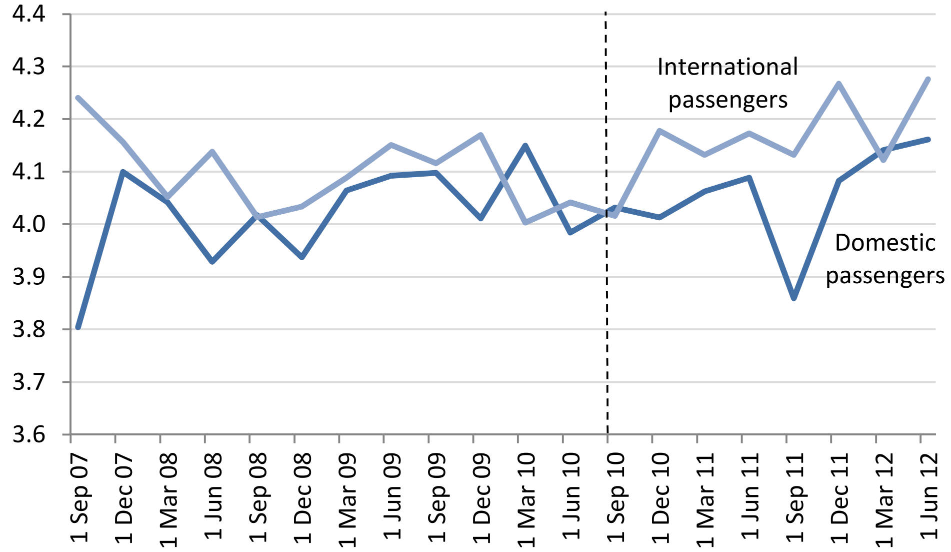
Sources: Auckland Airport, "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

C18 Table C1 shows that passenger satisfaction at Auckland Airport has increased since information disclosure regulation under Part 4 was implemented, but is broadly similar to the levels observed prior to information disclosure. The average score from the international passenger survey has increased since information disclosure regulation was implemented, from 4.0 in the first quarter of 2011 to 4.3 in the fourth quarter of 2012. At the same time, the average quarterly score from the domestic passenger survey has increased from 4.0 to 4.2.

passenger demands. We have therefore been reliant on evidence provided in information disclosure, as well as submissions on this issue by airports and by airlines.

72 Our analysis uses measures of passenger satisfaction from the Airport Service Quality (ASQ) quarterly survey programme run by the Airports Council International (ACI).

Figure C1: Quarterly passenger satisfaction survey results at Auckland Airport (2007-12)



Notes: Graph shows average survey score in each quarter. Graph does not start at 0 for readability. Dotted line indicates the first quarter of passenger satisfaction results reported in information disclosure.
Sources: Auckland Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Additional ASQ data provided in data request response from Auckland Airport, 21 December 2012.

C19 Auckland Airport has also highlighted that it was the recipient of the Skytrax award for the best airport in the Australia-Pacific region for the past five years.[73] This supports Auckland Airport's claim that it is providing services at a quality that reflects passenger demands.[74]

Does service reliability at Auckland Airport reflect consumer demands?

C20 An analysis of service reliability at Auckland Airport provides information about continuity of supply.

C21 Our analysis in Table C2 and Table C3 shows that Auckland Airport has a relatively high number and duration of interruptions for contact stands and air bridges.[75] It otherwise generally has a level and duration of interruptions within the range for Wellington and Christchurch airports, or lower. We have not received any

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[73] Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 96.

[74] However the Skytrax survey includes questions on non-aeronautical services as well as factors outside Auckland Airport's control. For example it includes questions on business centre facilities, public transport options and immigration. (See http://www.worldairportawards.com/main/methods.htm) It does not therefore only reflect quality experienced by passengers for regulated services.

[75] An interruption occurs if a service is withdrawn for 15 minutes or longer. Auckland Airport has attributed these relatively high interruptions in part to over-reporting (Explanation provided in data request response from Auckland Airport, 21 December 2012).

submissions to suggest that reliability at Auckland Airport does not reflect consumer demands, or that any of the reported increases in interruptions are of concern to the airlines. Airlines have noted that Auckland Airport has paid increasing attention to matters that affect service reliability in recent years, particularly interruptions to the availability of air bridges.[76]

Table C2: Normalised number of interruptions at Auckland, Wellington and Christchurch Airports (2011-12)

	2011			2012		
	Auckland	**Wellington**	**Christchurch**	**Auckland**	**Wellington**	**Christchurch**
Runway	0	0	1	0	0	0
Taxiway	0	0	0	0	0	0
Remote stands/ means of (dis)embarkation	0	0	0	0	0	0
Contact stands and air bridges	12	4	1	18	0	2
Baggage sortation system on departures	2	3	6	2	1	2
Baggage reclaim belts	0	0	1	1	0	1
On-time departure delay	0	0	0	2	1	N/A

Notes: Runway, taxiway, and stand and air bridge data reported per 10,000 landings. Outbound baggage sortation system data reported per million departing passengers. Baggage reclaim data reported per million arriving passengers. 2011 interruptions data shown here relates to interruptions caused by all parties. 2012 interruptions shown here include only interruptions where the primary cause is the airport. Differences in interruptions may also be due to varying approaches to recording interruptions at airports.

Table C3: Normalised duration of interruptions (minutes) at Auckland, Wellington and Christchurch Airports (2011-12)

	2011			2012		
	Auckland	**Wellington**	**Christchurch**	**Auckland**	**Wellington**	**Christchurch**
Runway	62	8	505	0	0	21
Taxiway	0	0	0	0	0	0
Remote stands/ means of (dis)embarkation	0	0	0	0	0	0

76 Air New Zealand “Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport” 19 October 2012, paragraph 74; BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 39.

Contact stands and air bridges	1,943	661	165	1,732	8	198
Baggage sortation system on departures	218	555	787	208	393	107
Baggage reclaim belts		0	168	97	0	209
On-time departure delay		0	0	88	2	N/A

Notes: Runway, taxiway, and stand and air bridge data reported per 10,000 landings. Outbound baggage sortation system data reported per million departing passengers. Baggage reclaim data reported per million arriving passengers. 2011 interruptions data shown here relates to interruptions caused by all parties. 2012 interruptions shown here include only interruptions where the primary cause is the airport. Differences in interruptions may also be due to varying approaches to recording interruptions at airports.

C22 We consider it too early to be able to assess meaningful trends in service reliability at Auckland Airport. Limited comparable information on service reliability is available prior to information disclosure. What information is available does not indicate any obvious change in performance in this area since information disclosure regulation under Part 4 was implemented.[77]

Does the utilisation of capacity at Auckland Airport reflect consumer demands?

C23 Utilisation of capacity is relevant to our assessment of quality because it can identify potential service constraints, indicating that a service is not available when required.[78]

C24 Our conclusion is that overall Auckland Airport appears to have provided capacity at a level that reflects consumer demands. Submissions received as part of this section 56G review have not indicated any aspects of service quality at Auckland Airport where they considered any service constraints were not being addressed in PSE1 or PSE2. Submitters have not indicated that they consider capacity will be inefficiently constrained in the future.

Does Auckland Airport facilitate improvements in quality and efficiency for services provided by its consumers?

C25 We consider that quality also includes actions taken by Auckland Airport which affect the quality of services provided by downstream suppliers and/or the ability of downstream suppliers to improve their efficiency. Many consumers of Auckland Airport's services are themselves providers of services downstream. For example, airlines use Auckland Airport's facilities and services to provide air transport services

77 Information on interruptions to runway, baggage, stand and air bridge services was disclosed under the AAA prior to information disclosure.

78 However, a service may be constrained as consumers may not be willing to pay for additional capacity. In this case, increasing capacity may not reflect consumer demands. Where capacity is constrained, a more efficient outcome may be to introduce congestion charging than to increase capacity.

to passengers. The quality of services provided by Auckland Airport may affect the service they are able to offer to their own consumers.

C26 Our conclusion is that Auckland Airport generally provides services that meet consumer demands such that these consumers are able to improve the quality of service they themselves offer, and/or to improve their own efficiency.

C27 Auckland Airport has provided a number of examples of how its behaviour has driven or facilitated efficiencies for downstream suppliers.[79] For example, it submitted that the installation of ground power units generates efficiencies and benefits for airline customers and that it has participated in a LEAN Six Sigma programme with its stakeholders.[80] We have not received any submissions from airlines that suggest Auckland Airport's behaviour in this area is not appropriate.

C28 However, the NZACC has raised some concerns with the quality of service its members have experienced at Auckland Airport. The NZACC submitted that improvements in the quality of service its member experience are required. Specifically, it requests a secure route to transport cargo from cargo terminal operator (CTO) premises to airside. All cargo is currently transported along a public road and, as a result, CTOs are required to employ security officers to prevent interference with cargo.[81]

C29 We understand that Auckland Airport will review the existing security arrangements as part of its masterplanning following the relocation of the domestic terminal.[82] At this time, it is not clear whether Auckland Airport's proposed masterplanning process will address the NZACC's concerns.

C30 We also note that it is unclear whether NZACC members are willing to pay any costs incurred outside of the proposed masterplanning process to improve the quality its members experience.[83] A consideration of whether quality reflects consumer demands implicitly includes a consideration of whether consumers would be willing to pay more (or less) for a higher (or lower) quality.

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79 Refer also to the discussion on whether Auckland Airport has facilitated innovation in Attachment B.

80 Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 216.

81 New Zealand Air Cargo Council "Submission to New Zealand Commerce Commission" 19 October 2012, pages 2 to 4.

82 Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, Appendix 1.

83 See New Zealand Air Cargo Council "Commerce Commission Questions from Conference" 14 March 2013. In response to a specific question on this matter, the NZACC submitted that it "does not know the costs of securing this route and it is doubtful that our members would be willing to pay for this given that airlines spend thousands of dollars annually to cover security costs to meet current CAA obligations".

Does Auckland Airport's conduct indicate that it seeks to ensure quality reflects consumer demands?

C31 Overall, Auckland Airport's conduct indicates that it seeks to ensure quality reflects consumer demands. However, airlines have expressed concerns about Auckland Airport's perceived unwillingness to enter into a SLA.

C32 Auckland Airport is considered to be responsive and pro-active in matters of quality raised by airlines, and to engage with airlines and understand their needs.[84] For example, it is engaging with Air New Zealand regarding refurbishment of the existing domestic terminal to enhance the service quality provided.[85] BARNZ notes that Auckland Airport is perceived to have a greater willingness to listen and is more open to airline input on matters of quality relative to PSE1.[86] While the NZACC submitted that "[Auckland Airport] does not seem interested in matters of quality raised by CTOs" and Auckland Airport acknowledged it has "dropped the ball" on matters of quality raised by the NZACC, we also observe that Auckland Airport has indicated that it has taken action to improve its conduct in this area by changing its person of contact with the NZACC.[87]

C33 The evidence available indicates that Auckland Airport has undertaken additional expenditure to address concerns about quality. For example, Auckland Airport launched a programme in 2012 to refurbish the international gate lounge, and has improved inter-terminal connections.[88]

C34 Auckland Airport's consultation on quality appears appropriate. Although quality is not explicitly consulted on as part of price setting events, Auckland Airport engages with airlines on quality issues through a number of forums. These include the multi-stakeholder Collaborative Operations Group and operational improvement forums to improve air bridge, baggage system and runway and taxiway performance.[89]

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84 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 39.

85 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 75.

86 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 41.

87 New Zealand Air Cargo Council "Submission to New Zealand Commerce Commission" 19 October 2012, page 3; Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 13.

88 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 312.

89 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 69.

However, Qantas and BARNZ have raised concerns with the lack of SLAs at Auckland Airport.[90] While Auckland Airport stated that it is open to negotiation of SLAs, it is not clear why parties were unable to implement a SLA.[91] The agreement of a SLA is an outcome that might be expected in a workably competitive market and there is some evidence that SLAs have been agreed at other airports.[92] Qantas has not responded to specific questions from the Commission on this issue. One of the expected outcomes of a SLA is that it provides incentives for the airport to provide services at an agreed quality standard. We note that, with the exception of the issue raised by the NZACC, no specific concerns about quality at Auckland Airport have been raised and, as discussed above, the level of quality experienced at Auckland Airport appears to generally reflect consumer demands.

90 Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 2; Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 11.

91 Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, paragraph 105. At the Auckland Airport conference, Auckland Airport indicated that it considers Auckland Airport should be subject to rewards as well as penalties as part of a SLA. It also noted that service levels are affected by the actions of other airlines, and may not necessarily be within the control of the airport. BARNZ stated that airports are unwilling to face financial penalties if service levels are not met. See Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 11 to 12.

92 See, for example, Productivity Commission (Australia) "Economic Regulation of Airport Services" (Productivity Commission Inquiry Report, No. 57, 14 December 2011), pages 205 and 377.

Attachment D: Is information disclosure promoting prices that are efficient at Auckland Airport?

Purpose

D1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Auckland Airport has incentives to set prices that promote efficiency (s 52A(1)(b) of the Act).[93]

D2 References to prices in this attachment relate to the charging structure at Auckland Airport and how Auckland Airport's total revenue requirement is collected from different services and consumers. This is set out in Auckland Airport's pricing methodology disclosed in information disclosure. This attachment does not consider whether Auckland Airport's target total revenue is appropriate. That is considered in Attachment E.

D3 Consistent with s 52A(1)(b), we have assessed whether the pricing methodology used by Auckland Airport is likely to result in prices that improve efficiency. We have therefore assessed Auckland Airport's pricing methodology for PSE2 relative to its PSE1 pricing methodology. Our analysis does not assess whether Auckland Airport's prices are fully efficient.

Conclusion

D4 Our conclusion is that information disclosure is effectively promoting efficiency of pricing. Auckland Airport appears to have given greater consideration to pricing efficiency in PSE2 relative to PSE1. Consequently, prices based on the pricing methodology for PSE2 are more likely to improve efficiency than those previously in place. Auckland Airport has indicated that information disclosure regulation under Part 4 has led to improvements in the efficiency of its pricing.

D5 Our analysis indicates that Auckland Airport's pricing methodology for PSE2 is likely to promote efficiency. For example:

D5.1 Auckland Airport has introduced new charges and increased existing charges with the intention of ensuring the optimal use of scarce resources;

D5.2 changes to the pricing methodology for PSE2 are likely to reduce the likelihood of cross-subsidisation relative to the PSE1 pricing methodology; and

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93 Section 52A1(b) states that the Part 4 purpose is to promote outcomes such that regulated suppliers "have incentives to improve efficiency".

D5.3 Auckland Airport has made changes to its pricing methodology for PSE2 with the intention of improving price stability and certainty.

D6 Information disclosure has had a positive impact on this outcome. Auckland Airport has indicated that the requirement to transparently outline its pricing methodology in Part 4 information disclosure prompted discussions with airlines about its pricing methodology. These discussions led to a number of changes to its pricing structure, with the intention of improving the efficiency of prices.[94]

D7 Additional changes to Auckland Airport's pricing methodology may further improve the efficiency of its prices (for example, further consideration of maximum certified take-off weight (MCTOW) charges for smaller aircraft).

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to set prices that promote efficiency

D8 Auckland Airport has an incentive to set prices that will result in higher demand and therefore higher profits. It therefore has some incentives to set prices that promote efficiency. However these incentives may be weakened by Auckland Airport's market power.

How information disclosure can provide incentives to improve pricing efficiency

D9 The increased transparency of Auckland Airport’s pricing methodology generated by information disclosure regulation may strengthen incentives to set prices that promote efficiency. Information disclosure regulation under Part 4 allows interested persons to understand the reasons for the pricing methodology adopted, and to assess the outcomes resulting from the methodology. This greater transparency may enhance consumers’ countervailing power. The disclosure of pricing methodologies can also provide examples of best practice from other regulated airports.

How we have assessed whether Auckland Airport’s prices promote efficiency for the purpose of this review

D10 Section 52A(1)(b) states that the Part 4 purpose is to promote outcomes consistent with outcomes in workably competitive markets such that regulated suppliers “have incentives to improve efficiency”. This includes productive, dynamic and allocative efficiencies.[95]

94 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 416.

95 Productive efficiency relates to the supply of goods or services at the lowest cost possible, while maintaining (or increasing) the quantity and quality of the good or service produced. Dynamic efficiency relates to decisions made over time, including investment and innovation, which improve productive efficiency. Allocative efficiency occurs when resources, goods or services are allocated to their highest value use.

D11 The prices set by Auckland Airport through its pricing methodology have an important role to play in improving efficiency. Consistent with outcomes observed in workably competitive markets, the prices set by Auckland Airport for each charged service should help ensure the efficient allocation of its aeronautical services and therefore its resources (allocative efficiency) and provide signals of where innovation and investment is needed at Auckland Airport to meet consumer demands (dynamic efficiencies).

D12 To assess whether Auckland Airport's prices promote efficiency, we have reviewed its pricing methodology for PSE1 and PSE2 against efficient pricing principles. This will allow us to understand whether information disclosure regulation has had any impact on its performance in this area.

Information used to assess whether Auckland Airport set prices that promote efficiency

D13 Our analysis uses quantitative and qualitative data from the following sources:

D13.1 information disclosed under Part 4 and AAA; and

D13.2 submissions and other material generated as part of this section 56G review.

Analysis of whether Auckland Airport's performance and conduct on pricing resulted in prices that promote efficiency

D14 The remainder of this attachment considers:

D14.1 the appropriate efficient pricing principles to assess Auckland Airport's pricing methodology against;

D14.2 the extent to which Auckland Airport's methodology for PSE2 addresses each of these principles relative to PSE1; and

D14.3 Auckland Airport's conduct in setting its pricing methodology during PSE2.

Efficient pricing principles

D15 We have assessed Auckland Airport's pricing methodology and subsequent prices against a number of principles that reflect the objectives of efficient prices.[96] These principles are discussed in more detail in the following sections.

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[96] These principles are consistent with the pricing methodology IM applicable to gas distribution and transmission businesses. See Commerce Commission "Input methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, Table 7.2. Similar principles are discussed in reports commissioned by airlines, Wellington Airport and Auckland Airport during consultation for the second pricing periods. See for example, Estina Consulting Limited "Aeronautical Pricing Methodology" 13 September 2011.

D15.1 Prices should be subsidy free.[97]

D15.2 As part of this, where a good or service is scarce, the price should ensure that the good or service is consumed by those that value it the most.

D15.3 Prices should have regard to consumers' demand responsiveness.

D15.4 Prices should enable consumers to make price-quality trade-offs or non-standard arrangements for services, where practical, to reflect the value they place on services.

D15.5 The development of prices should be transparent, and promote price stability and certainty for consumers, where demanded.

Prices should be subsidy free

D16 To be subsidy free, prices should be equal to or greater than incremental costs, and less than or equal to standalone costs.[98] We recognise there may be instances where it is not efficient for these criteria to be met.[99]

D17 Our conclusion is that Auckland Airport's pricing methodology for PSE2 is likely to better reflect the principle of being subsidy free than the methodology adopted for PSE1. This is because Auckland Airport has introduced a number of new charges and aligned existing charges to limit the likelihood of cross-subsidisation in PSE2, and has signalled that it will be further reviewing its charges to address concerns about cross-subsidisation of smaller aircraft by larger aircraft. Changes to its pricing methodology to limit cross-subsidisation include aligning the MCTOW rates for domestic and international jet aircraft and introducing a domestic passenger charge. BARNZ estimates that at the time charges were set for PSE1, there was a cross-subsidy of $1 per domestic passenger.[100] We consider that Auckland Airport has further limited the likelihood of cross-subsidisation occurring in PSE2 with the introduction of separate charges for transit passengers and for children.

D18 Airlines have raised concerns that larger aircraft are cross-subsidising smaller aircraft as these smaller aircraft pay a lower MCTOW charge for airfield services. However, it is not clear whether this is cross-subsidisation. BARNZ submits that lower weight

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97 Subsidy free prices are generally a necessary but not sufficient condition for efficient pricing.

98 The incremental cost is the cost of producing another service. The standalone cost is the cost that would have occurred if the supplier solely undertook that activity. See Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, paragraph 7.2.5 for further discussion on this issue.

99 For example, if the cost of collecting the information to ensure that the price charged to each individual consumer is subsidy free outweighs the benefits of setting prices that are subsidy free.

100 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 41.

aircraft may not meet their long run incremental costs while Qantas notes that aircraft less than 40 tonnes contribute only 5% of airfield revenue yet account for 42% of movements and 8% of landed tonnes.[101] However, as noted by parties at the Auckland Airport conference, it is not clear whether cross-subsidisation does occur in this area as it is an "extremely complex issue".[102] Auckland Airport has signalled its intention to review the cost drivers in this area for PSE3.[103]

D19 Given the low incremental costs of airport services, we consider it is unlikely that prices will be less than incremental costs at Auckland Airport during PSE2 and there is no evidence that the prices paid by consumers are more than standalone costs. However, based on the current pricing methodology, cross-subsidisation may occur in the future if there is congestion and use of aeronautical facilities is not otherwise efficiently allocated. This issue is discussed further in paragraph D23 below.

Price should ensure the optimal use of scarce resources

D20 Scarcity at airports may arise through congestion at facilities, and a lack of capacity where required. To understand whether Auckland Airport's prices promote the optimal use of scarce resources, we have examined whether Auckland Airport's prices are likely to allocate congested or scarce services efficiently to manage competing demands for limited capacity and resources.[104]

D21 Our conclusion is that Auckland Airport's prices for PSE2 are likely to better promote the optimal use of scarce resources at Auckland Airport relative to PSE1. Auckland Airport has introduced new charges and has also signalled that additional charges may be introduced in the future to manage congestion.

D22 Auckland Airport has introduced new charges and increased existing charges with the purpose of allocating scarce resources efficiently.

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101 BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 44; Qantas Airways “The Qantas Group’s response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport” 24 October 2012, page 8.

102 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 77 to 78.

103 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 366.

104 Where a service is scarce and demand for the service exceeds supply, prices can promote allocative efficiency by reflecting the opportunity costs of consuming the service. This will likely result in higher prices for those scarce resources and will help ensure that only those who benefit most from consuming the service will do so.

D22.1 Auckland Airport has introduced an hourly charge for common check-in facilities to encourage efficient use of the counter areas.[105]

D22.2 Auckland Airport has increased the parking charge for aircraft "to encourage a more efficient use of the apron". It has signalled that the charge will be used if needed to respond to inefficient use of resources.[106]

D23 Auckland Airport has indicated that congestion charges may be introduced in the future to send appropriate price signals and ensure the best use of assets, if required. At this time, it is unclear whether Auckland Airport's pricing methodology will ensure the efficient use of the runway if congestion arises in PSE2.[107] Auckland Airport currently considers it too early to introduce congestion charges and instead looks to airline and Airways processes and procedures to maximise use of the existing runway.[108] Airlines also generally consider it inappropriate to have congestion charging at this time and favour a 'toolbox' approach to managing any future congestion at Auckland Airport, including changes to their fleet, voluntary discussions with airlines to change schedules, collaboration with Airways and modifications to the existing runway as well as congestion charges.[109]

Prices should have regard to consumers' demand responsiveness

D24 In an industry with high fixed costs, such as airports, prices based on efficient incremental costs would under-recover the required revenues. Where this occurs, a possible efficient outcome would be to make up any shortfall by setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable (ie, Ramsey pricing principles).[110]

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105 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 74.

106 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 74.

107 Information disclosed suggests the runway may become congested in 2016 (ie, within the second pricing period). This is based on a disclosed runway capacity of 40 movements per hour, and a forecast busy period movement forecast of 41 in 2016. See Auckland Airport "Specified Airport Services Information Disclosure Requirements Information Templates for year ending 30 June 2012", Schedule 12 and Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 83. However, BARNZ considers these long term demand forecasts are over-stated. See BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, page 19.

108 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 82 to 83.

109 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 83 to 84.

110 This means that if the cost of serving each consumer group is the same, those consumers that are less responsive to prices are set higher prices than more price-sensitive consumers. For this to be efficient,

D25 Our conclusion is that Auckland Airport has considered consumers' demand responsiveness in its pricing methodology for PSE2, and that pricing efficiency in respect of this principle is therefore likely to have improved relative to PSE1.

D26 Unlike PSE1, Auckland Airport appears to have explicitly considered consumers' demand responsiveness when establishing its pricing methodology for PSE2. Variations in charges across different passenger groups for PSE1 do not appear to have been driven by different price sensitivities.[111] In PSE2, Auckland Airport notes it has allocated common costs to reflect differences in demand elasticity and consistent with the Ramsey pricing principles.[112] It is our understanding that this resulted in international passenger charges contributing a higher proportion to common airfield costs than domestic passengers.[113]

Prices should enable price-quality trade-offs

D27 Consumers may demand different levels of quality or quantity of service, for which they are willing to pay different prices. Where practical, consumers should therefore be able to make price-quality trade-offs. This may include the use of non-standard contracts or commercial agreements for individual consumers.

D28 Our conclusion is that there is no evidence at this time that Auckland Airport's pricing methodology for PSE2 better enables price-quality trade-offs than the PSE1 pricing methodology. This is not necessarily a concern if airlines and passengers are able to make appropriate price-quality trade-offs. Airlines have not raised any concerns with their ability to make price-quality trade-offs at Auckland Airport.[114]

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prices that adopt Ramsey pricing principles should increase output relative to a common price for all consumers.

111 Auckland Airport's pricing disclosure for PSE1 does not discuss how its prices have regard to demand responsiveness when explaining whether Auckland Airport's pricing methodology will lead to efficient prices. Instead, prices appear to have been set with the intention of ensuring prices are subsidy free. See Auckland Airport “Auckland International Airport Limited: FY08-FY12 Price setting Disclosure” 27 October 2011, page 33.

112 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 383; Auckland Airport “Auckland Airport’s Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012” 9 November 2012, pages 49 to 50.

113 BARNZ has questioned whether this is efficient. BARNZ submitted that many international travellers are as responsive to pricing signals as domestic passengers, and that international airlines consider their charges are higher than justified. (BARNZ “Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport” 31 May 2013, page 17).

114 For example, at the Auckland Airport conference, Air New Zealand stated that 'Auckland's pricing structure generally hasn't attempted to make price quality trade-offs. Our view is that overall those things are probably not very material and so we're comfortable with the structure that doesn't try to make them'. Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 85.

D29 Auckland Airport's standard charges for PSE2 do not allow for explicit price-quality trade-offs. In contrast, the charging mechanism for PSE1 did allow for such trade-offs, for example, by effectively reducing the average cost of consumers that used buses relative to those that used an air bridge.[115] Airlines have however valued their ability to make price-quality trade-offs as part of consultation on capex for PSE2. This is discussed further in Attachment H.

D30 The evidence available indicates Auckland Airport has enabled consumers to make price-quality trade-offs through other aspects of its pricing methodology.

D30.1 As in PSE1, Auckland Airport uses lease agreements and licences for consumers with specific asset requirements (for example, VIP check-in and VIP lounges) in PSE2.[116]

D30.2 Auckland Airport states that its pricing methodology allows for negotiations with individual airlines to reach agreement on variations from charged services, risk sharing and the term of agreement.[117] It noted that it is negotiating a commercial variation to its standard charges with an airline.[118]

The development of prices should be transparent, promote price stability and certainty for stakeholders, where demanded

D31 Auckland Airport appears to have set prices transparently, and to have had regard to price stability and certainty for stakeholders when doing so. For example:

D31.1 Auckland Airport has staggered the introduction of the international passenger charge for children to avoid price shocks;[119]

D31.2 Auckland Airport has abolished the Terminal Services Charge (TSC) in favour of a more certain and transparent approach to recovering costs associated with terminal access.[120] The TSC led to variability in prices as it resulted in annual wash-ups when actual costs and volumes differed from forecasts. BARNZ notes that while the removal of this charge reduces transparency, it

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116 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 31 March 2017" 2 August 2012, page 63.

117 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 31 March 2017" 2 August 2012, page 63.

118 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 404.

119 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 366.

120 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 74.

improves certainty and price stability for consumers.[121] Qantas also supports the removal of the TSC, while Air New Zealand notes that the removal reduces price variability.[122]

D32 It is not clear whether pricing efficiency in respect of the principles of transparency, price stability and certainty has improved relative to PSE1.

D33 Airlines have expressed concerns that there is uncertainty about Auckland Airport's approach to setting prices in PSE3.[123] However, we note that Auckland Airport has signalled the approach it may take to setting prices in PSE3 during consultation for this section 56G review.[124] We anticipate that this has reduced the uncertainty about prices at Auckland Airport in the future, although we also recognise it is not a binding commitment, as discussed in Attachment E.

Does Auckland Airport's conduct indicate that it seeks to improve the efficiency of its pricing?

D34 Overall, we consider that Auckland Airport's conduct in setting the pricing methodology for PSE2 shows that it seeks to improve the efficiency of its prices. For example:

D34.1 Auckland Airport commissioned an economic expert to advise it on efficient pricing principles;

D34.2 Auckland Airport has also indicated that further changes were made to its pricing methodology following consultation with the airlines, with the intention of improving the efficiency of its pricing;[125] and

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121 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 44.

122 Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 9; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 85.

123 Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 9; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 87; BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 45.

124 Auckland Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 16 March 2013, paragraph 38.

125 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 416; Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, pages 48 to 53.

D34.3 although not addressed as part of the second price setting event, Auckland Airport has indicated that it will review the cost drivers associated with the MCTOW curve for the third price setting event (PSE3) in response to concerns raised by airlines.[126] BARNZ has however expressed concern that this issue was not addressed during the consultation for PSE2.[127]

D35 We consider that Auckland Airport's conduct in this area has improved since the PSE1. Auckland Airport notes that "there was significantly more discussion of efficient pricing principles in the second PSE relative to the first PSE".[128]

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[126] Auckland Airport “Auckland Airport’s Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012” 9 November 2012, paragraphs 31 to 32.

[127] Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 78.

[128] Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 388.

Attachment E: Is information disclosure limiting Auckland Airport's ability to extract excessive profits?

Purpose

E1 This attachment contains our analysis and conclusions on how effectively information disclosure regulation is promoting outcomes consistent with those produced in competitive markets such that Auckland Airport is limited in its ability to extract excessive profits (s 52A(1)(d) of the Act).

E2 For the purpose of this section 56G review, 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. A supplier's profitability can be compared against the cost of capital to assess whether it is earning a reasonable economic return over time, or whether its profits are excessive.[129] Further discussion of our approach to assessing Auckland Airport's returns is provided in Attachment F.

Conclusion

Information disclosure is effective in limiting Auckland Airport's ability to extract excessive profits

E3 Our conclusion is that information disclosure regulation at this time has been effective in limiting Auckland Airport's ability to extract excessive profits over time. In particular, for PSE2 Auckland Airport targeted returns within an 'acceptable range' (ie, the range of returns that we assess as limiting the airport's ability to earn excessive profits, while allowing it to achieve at least a normal return), based on a reasonable assessment of how, at that time, it considered the Commission might assess its performance. Auckland Airport's approach to setting prices for PSE2 was

[129] We use 'returns' as the measure of airport profits. 'Normal returns' are the expected return that investors require to invest in a business with the given level of systematic risk. We consider the mid-point estimate of the cost of capital to provide the best estimate of a normal return, and to be the appropriate starting point for any assessment of airport profitability. However, we have also considered the 75th percentile cost of capital when assessing airport profitability. As is discussed in paragraphs F62 to F63, the 75th percentile cost of capital allows for the uncertainty of estimating the cost of capital and limits the potential asymmetric consequences of estimation error on investment. Targeting returns within this range will generally be consistent with limiting the ability of the airport to earn excessive profits, while allowing it to achieve at least a normal return--ie, it will be an 'acceptable range'. However, if a clearly inefficient airport were to target returns within this range, yet consistently at (or close to) the 75th percentile, that would still require a consideration of whether that airport is limited in its ability to earn excessive profits (refer paragraph 2.9). Returns marginally above this range are not on their own necessarily indicative of the 'excessive profits' referred to in the Part 4 purpose statement (ie, in s 52A(1)(d)). It may be appropriate to assess whether excessive profits are expected to be earned after consideration of other factors, including whether superior performance by the airport justifies earning a return above this cost of capital range (eg, see Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 1.2.2, 2.6.28 and 6.2.3.

based on the input methodologies underpinning information disclosure, taking into account its moratorium on asset revaluations.

E4 Auckland Airport set prices such that its expected returns over the whole of PSE2 is equivalent to a return of 8.0% when the information disclosure framework is applied, and taking into account its moratorium on asset revaluations. Although this target return is above our assessment of a normal return, it is just within the upper limit of an acceptable range of returns of 7.1% to 8.0%, and therefore supports our conclusion that information disclosure is effective in achieving the Part 4 purpose as regards profitability.[130]

E5 Our own estimate of Auckland Airport's expected returns from 1 July 2012 over the remaining life of the assets (ie, for PSE2 and beyond) is 7.9%.[131] Like Auckland Airport's effective target return for PSE2, our estimate of expected returns also falls within the range of what we consider are acceptable returns (7.1% to 8.0%).[132]

E6 Information disclosure does appear to have had a direct impact on limiting Auckland Airport's ability to earn excessive profits. Auckland Airport explains that, at the time it set prices for PSE2, it "understood that the ID framework, including the IMs, was intended to impose disciplines on our pricing behaviour. Accordingly, the IMs, including the cost of capital IM, were a key reference point for our pricing decision in 2012." Auckland Airport made a number of changes to its approach to pricing from PSE1 to PSE2 to be more consistent with the new information disclosure requirements, including:

E6.1 removing the land held for future use from its pricing asset base; and

E6.2 targeting a lower cost of capital in response to submissions during the consultation process.[133]

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130 This report uses a post-tax nominal cost of capital and post-tax nominal measures of returns unless otherwise stated.

131 This value is found when using end of year cash flow timings, which is consistent with current information disclosure requirements. The effect on expected returns of changing this and other assumptions is discussed below.

132 This conclusion contrasts with our conclusion that information disclosure has not been effective in limiting Wellington Airport's ability to extract excessive profits. Both Wellington Airport's own target returns (as well as our estimate of its expected returns) significantly exceed our estimated range of appropriate returns. Given the difference in conclusions at this stage, in this report we have taken the opportunity to contrast the results for Auckland Airport and Wellington Airport, and to explain the key differences in our analysis which reflect Auckland Airport's specific approach to setting prices (ie its moratorium on asset revaluations).

133 Auckland Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 16 March 2013, paragraph 203.

E7 Auckland Airport also agreed to continue its moratorium on asset revaluations during PSE2.

E8 Our conclusion has been reached based on the assumption that Auckland Airport will continue its current pricing behaviour after PSE2, consistent with guidance Auckland Airport has provided during this review. BARNZ and Air New Zealand have identified a risk that the approach taken by Auckland Airport with respect to asset valuations in PSE3 and beyond may lead to Auckland Airport earning excessive profits at that time. At the next price setting event we intend to closely monitor whether Auckland Airport acts consistently with the guidance it has given during this review.

How we have structured the analysis in this attachment

E9 The analysis in this attachment outlines:

E9.1 how we have assessed the effectiveness of information disclosure;

E9.2 Auckland Airport's expected profitability; and

E9.3 whether Auckland Airport's conduct indicates that they seek to earn a reasonable economic return over time.

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to limit excessive profits

E10 Without information disclosure regulation, Auckland Airport has weak incentives to limit excessive profits. Auckland Airport has market power and may therefore choose to set prices that result in excessive profits. The potential countervailing power of airlines and competition between airports for some routes may provide some incentives to constrain profits, but are not expected to significantly constrain Auckland Airport's market power.

How information disclosure can provide incentives to limit excessive profits

E11 As discussed in Chapter 2, information disclosure under Part 4 is intended to provide incentives for Auckland Airport not to extract excessive profits. The public disclosure of information on Auckland Airport's returns provides transparency about whether Auckland Airport is earning, or is expected to earn, a return that exceeds the Commission's estimate of returns earned in workably competitive markets (ie, the IM-compliant cost of capital estimate). This transparency, combined with the threat of further regulation, is expected to deter the regulated airports from setting prices that result in excessive profits.

We expect that the effectiveness of information disclosure should be able to be identified at this stage

E12 The effectiveness of information disclosure in limiting Auckland Airport's ability to extract excessive profits should be able to be identified at this time.[134] The input methodologies (IMs) applicable to information disclosure under Part 4 provide benchmarks against which to assess whether Auckland Airport's profits reflect the levels of profitability that could be expected in a workably competitive market.[135] The input methodologies were available to Auckland Airport at the time it set its prices for PSE2, and could therefore have influenced its conduct and performance at the time. Furthermore, we expect suppliers with market power to have an incentive to target excessive profits when setting their prices. As Auckland Airport has recently set prices for PSE2, we are able to observe at this time whether it is targeting an excessive profit.

How we have assessed whether Auckland Airport is earning excessive profits

E13 We have assessed whether information disclosure regulation is effectively limiting Auckland Airport's ability to extract excessive profits by examining the performance and conduct of Auckland Airport in relation to its expected returns.

E14 In assessing Auckland Airport's performance, we have calculated the return we expect Auckland Airport will earn based on the prices it set for PSE2 and its forecast passenger volumes and aircraft movements. We compare this expected return to the Commission's estimates of the cost of capital that would be expected for businesses with similar risk at the time prices were set.

E15 We have measured Auckland Airport's return using an internal rate of return (IRR) approach.[136] The IRR allows an assessment of returns across the remaining lifetime of the assets.

E16 In assessing Auckland Airport's conduct, we have considered the return that Auckland Airport might have expected the Commission to estimate based on

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134 This is discussed further in Attachment A.

135 Input methodologies for information disclosure under Part 4 of the Act allow profitability to be assessed on a consistent basis across suppliers and over time. A primary indicator of a benchmark level of normal returns achieved in a competitive market is provided by the cost of capital input methodology which estimates a supplier's WACC. By 'normal return' we mean the expected return that investors require to invest in a business with the given level of systematic risk. Given the uncertainty in estimating the WACC, the cost of capital IM not only requires the Commission to publish a mid-point estimate of the WACC, but also 75th percentile and 25th percentile estimates. Under the cost of capital IM and the information disclosure requirements, airports may also calculate and disclose the amount of any term credit spread differential (TCSD). Unless otherwise specified, our analysis has also allowed for estimates of the TCSD in calculations of returns. Under the cost of capital IM, our best estimate of a normal return comprises both the mid-point WACC estimate and an allowance for the TCSD (if any).

136 A discussion of why we have used an IRR methodology is provided in Attachment F.

information disclosed in accordance with the Part 4 information disclosure regime, taking into account Auckland Airport's moratorium on asset revaluations. This analysis helps us to understand whether Auckland Airport set prices knowing that the resulting profits would be excessive considering the Commission’s published framework for analysis (the IMs).

E17 Our conclusion on profitability was reached only after considering the other areas of performance relevant to this aspect of the Part 4 purpose, such as improvements to the efficiency of its operational expenditure. This requires us to take into consideration whether the forecasts used to determine prices are appropriate. Our analysis of these areas of performance is discussed in Attachments B, C, D, G, H and I. Given we do not have any significant concerns with performance in these areas, this attachment focuses on Auckland Airport’s expected return relative to our estimated cost of capital.

E18 Unlike many of the other aspects of performance set out in Chapter 2, our conclusion on whether Auckland Airport has been able to extract excessive profits does not require detailed comparison of performance prior to and subsequent to the introduction of information disclosure under Part 4. Instead, the cost of capital set out in the IMs provides a benchmark against which to measure performance. As such, our conclusions on the effectiveness of information disclosure regulation under Part 4 are not based on the returns achieved by Auckland Airport over PSE1.

E19 As discussed in Chapter 2, if an airport is expected to earn returns in excess of an acceptable range of cost of capital (ie, from the mid-point to the 75th percentile of the WACC estimate), this may not necessarily result in a conclusion that information disclosure is ineffective. If an Airport were expected to earn a return that is only marginally above the Commission's acceptable range of cost of capital, the Commission would apply a degree of discretion and exercise its judgment in assessing whether, given the overall context, the Airport is targeting excessive profits.

Information used to assess whether Auckland Airport is earning excessive profits

E20 Our analysis relies on:

E20.1 information disclosed under Part 4;

E20.2 information provided by Auckland Airport and other parties to the Commission as part of this section 56G review. This includes expert advice provided to the Commission on airport land valuation;[137] and

[137] We have consulted with Auckland Airport on the advice received from our airport land valuation expert and have considered Auckland Airport’s responses in drawing our conclusions.

E20.3 information made available by Auckland Airport as part of its consultation process for PSE2. Much of this information is not required to be disclosed as part of information disclosure regulation under Part 4.

Analysis of Auckland Airport's profitability performance and conduct

Will Auckland Airport's prices provide an acceptable economic return over time?

E21 Our analysis of Auckland Airport's expected performance indicates that its expected returns for PSE2 and beyond (ie, from 1 July 2012 over the remaining life of the assets) are likely to be 7.9% (when using end of year cash flow timings consistent with current information disclosure requirements). This estimate falls just within the range of what we consider are acceptable returns (7.1% to 8.0%).

E22 Further details on the assumptions used and approach taken to estimate and assess Auckland Airport's returns are provided below, along with sensitivity analysis.

The value of assets used to estimate Auckland Airport's return

E23 Auckland Airport's return is assessed relative to the value of its assets over time. Our estimate of the IRR therefore requires assumptions on the value of Auckland Airport's assets for regulated activities at the beginning of our period of analysis (the opening asset base) and at the end of the analysis period (the closing asset base).

E23.1 The opening asset base is the value of Auckland Airport's regulatory asset base (RAB) in 2009 as disclosed in information disclosure, 'rolled forward' to 30 June 2012 to take account of subsequent capital additions and disposals as well as depreciation (in the case of specialised assets). This opening value is consistent with the IM-compliant asset value disclosed at the start of Part 4 regime. It is also consistent with the effect of Auckland Airport's moratorium on asset revaluations since information disclosure under Part 4 began.[138]

E23.2 The closing asset base used in our analysis is estimated by 'rolling forward' the opening asset base to 2017 consistent with Auckland Airport's moratorium on asset revaluations, and assuming that this moratorium

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[138] The opening asset base now includes noise mitigation costs of $10.9m. The noise costs were included in Auckland Airport's asset base for pricing but were not included in our draft analysis of Auckland Airport's returns for the draft report as they did not form part of the disclosed RAB in 2012 (they were disclosed as work in progress). Auckland Airport has argued for the inclusion of these costs within the opening asset base (see Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013 page paragraphs 151 to 154). Similarly BARNZ agrees that these costs should be included in the asset base used for our analysis (see BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, page 18). The impact on including these costs is a reduction in Auckland Airport's expected returns of 8.0% (based on end of year cash flows) or 8.5% (based on mid-year cash flows) in the draft report, to 7.9% or 8.4% (depending on the cash flow timing assumptions) in this final report.

continues after 2017 (or that Auckland Airport adopts any alternative valuation approach that would have an equivalent effect on expected returns for PSE3 and beyond).[139] Like our profitability analysis for Wellington Airport, the closing value we have used reflects Auckland Airport's asset values at the end of PSE2 consistent with its pricing decisions for PSE2.[140] We recognise that if Auckland Airport were not to set prices after PSE2 consistent with this guidance, then the expected future returns for PSE2 and beyond would be significantly higher.

We have modelled cash flows at both year-end and mid-year

E24 Our estimate of returns (7.9%) is based on the assumption that cash flows (eg, staff wages, revenues received) occur at Auckland Airport at the end of the year. This is a conservative assumption consistent with the current information disclosure requirements, but does not reflect actual cash flows at Auckland Airport.

E25 We have also tested the impact of assuming cash flows will occur mid-year rather than at the end of the year.[141] This results in a higher estimate of the expected return for PSE2 and beyond of 8.4%. This represents the least conservative cash flow timing assumption, and is likely to result in an over-estimate of expected returns.

E26 When Auckland Airport set its prices for PSE2 it would not have expected us to undertake an assessment of its returns using a mid-year cash flow timing assumption. Therefore, although this higher estimate might better reflect Auckland Airport's expected profitability performance in PSE2, we have not placed any weight on it in drawing our conclusion on the effectiveness of information disclosure in limiting Auckland Airport's ability to earn excessive profits. That conclusion instead relies on our assessment of whether Auckland Airport was targeting an acceptable return (ie, its conduct), which is discussed in paragraphs E43 to E51 below.

Auckland Airport's expected return is compared to the mid-point and 75th percentile of the Commission's estimated cost of capital

E27 The IRR is compared to the Commission's estimate of the mid-point and 75th percentile cost of capital, as defined in the input methodologies. The mid-point estimated cost of capital is 7.1%, while the 75th percentile is 8.0%. We consider the mid-point cost of capital to be an appropriate starting point for any assessment of profitability for Auckland Airport while the 75th percentile cost of capital allows for

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139 The opening asset value has been 'rolled forward' from 2012 to 2017 for capital additions and disposals, and also for depreciation (in the case of specialised assets).

140 This is discussed further in paragraphs F31F29 toF35.

141 The expected post-tax return has been calculated using an assumption of end of year cash flows (except in the case of capital expenditure, which is assumed to occur mid-year). This is a conservative assumption as it is most likely that cash flows are likely to be spread over the year and will therefore occur on average earlier than the end of the year.

the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment.

E28 Our analysis uses the April 2012 cost of capital estimate as we consider it would have been reasonable for Auckland Airport to rely on this estimate when making its pricing decision. This is discussed further in Attachment F.

Sensitivity analysis

E29 We have tested a number of alternative scenarios for areas that have been identified by airlines as having greater risk, in particular the asset values used in our IRR analysis and Auckland Airport's passenger forecasts. We have not placed any weight on any of the results from our sensitivity analysis in forming our conclusion on the effectiveness of information disclosure in limiting the ability of Auckland Airport to earn excessive profits.[142] At this stage we have no reason to consider that the land valuations or passenger forecasts used by Auckland Airport in setting its prices for PSE2 are unreasonable and we consider that the assumption Auckland Airport will continue to price in a manner consistent with its current pricing behaviour to be the most likely expectation for future pricing behaviour. However, we consider it useful to highlight how sensitive our assessment of expected returns is to those factors.

E30 We have tested the impact if Auckland Airport does not continue its current pricing behaviour into PSE3 and beyond. This is in response to submissions from BARNZ and Air New Zealand that the approach taken by Auckland Airport with respect to asset valuations in PSE3 and beyond may lead to Auckland Airport earning excessive profits at that time.[143]

E30.1 If Auckland Airport were to value its land using a market value alternative use (MVAU) approach in 2017, recognise the revaluation of assets between 2009 and 2017 due to inflation but not treat these revaluations as income, its expected return for PSE2 and beyond could be as high as 10.6% to 11.2% (depending on assumptions about the timing of the cash flows).[144]

E30.2 If Auckland Airport were to recognise the revaluation of specialised assets between 2009 and 2017 due to inflation, value its land using a market value

[142] For more discussion on why we have not placed any weight on the results from our sensitivity analysis see paragraph F39.

[143] Further information on the scenarios selected is provided in paragraphs F31 to F35.

[144] There is another rationale for undertaking the returns analysis using an MVAU value for the land in the closing asset base for PSE2. If it is assumed that Auckland Airport could sell all of its land at market value (ie at MVAU) at the end of PSE2, given that information disclosure allows land to be revalued to MVAU, then our assumption that the moratorium will continue would result in an underestimate of excess returns if that sale occurred (eg, see "Lally advice on measuring excess returns", Appendix 19 of Commerce Commission, "Part IV Inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports", Final Report, 1 August 2002, page 511).

existing use (MVEU) approach in 2017 and not treat revaluations as income, its expected return for PSE2 and beyond could be as high as 11.4% to 12.0% (depending on assumptions about the timing of the cash flows).[145]

E31 We have tested the impact of a reduction in Auckland Airport's opening land valuation. A 10% reduction in the opening land value would result in an expected return of 8.7% or 9.2% (depending on assumptions about the timing of the cash flows).[146]

E32 We have also tested the impact of a change in Auckland Airport's passenger forecasts. Using BARNZ's alternative passenger growth forecasts would result in a return of 8.0% or 8.5% (depending on assumptions about the timing of the cash flows).[147]

Value and impact of excess returns earned by Auckland Airport

E33 We have quantified the monetary value of the ‘excess’ returns associated with our return estimates discussed above, including the impact on consumers (which are represented by ‘excess revenues’). Although some scenarios exhibit apparent excess returns (and excess revenues), we do not consider those results affect our conclusion that information disclosure regulation is effective in limiting Auckland Airport’s ability to earn excessive profits, because that conclusion depends on our assessment of Auckland Airport’s conduct (ie whether it is *seeking* to earn an acceptable return).

E34 We use the term ‘excess returns’ to refer to the amount of returns calculated to be above a particular value of the WACC (ie, the mid-point or 75th percentile, depending on the scenario, and given all the assumptions for that scenario). At our lower estimate of expected returns (ie, 7.9%) we would not anticipate that any excess returns, relative to the 75th percentile WACC, would be expected to be earned by Auckland Airport.[148]

E35 Despite an apparent finding of no excess returns for this scenario, an airport that is earning close to the 75th percentile of WACC would nonetheless be expected to earn

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145 The MVAU value at the end of PSE2 is proxied by indexing Auckland Airport’s 2011 MVAU value by Auckland Airport's forecast revaluation rate of 2.5% (as applied to leased assets). The MVEU value is proxied by adding the 2006 land conversion costs from the 2006 MVEU valuation, indexed to 2017, to this MVAU value. Land conversion costs have been indexed by historic CPI to 2012 and by Auckland Airport's forecast revaluation rate of 2.5% to 2017. As noted in paragraph F35 our analysis is intended to be illustrative of the potential risks if Auckland Airport adopts a different asset base for the pricing purposes in PSE3 from that indicated to us as part of this review.

146 This is discussed further in paragraphs F41 to F44.

147 This is discussed further in paragraphs F78 to F82.

148 As shown in Table E1, the expected excess returns for the lower estimate of expected returns are calculated to be slightly negative. This negative value is a result of the 7.9% expected returns being lower than the 75th percentile WACC of 8%.

'above-normal' returns. This is because the mid-point WACC provides our best estimate of the cost of capital.[149] However, as is discussed in paragraphs F62 to F63, the 75th percentile WACC takes into account the consequences on investment of WACC estimation error. Therefore, an expected return that is above the mid-point WACC, but lies below the 75th percentile WACC, is still within an 'acceptable range' (ie, it is consistent with limiting the ability of the airport to earn excessive profits), even though the airport is expected to earn 'above-normal' returns.[150]

E36 We estimate that the present value of excess returns (relative to the mid-point cost of capital) likely to be earned at Auckland Airport, based on our higher estimate of expected returns found using mid-year cash flows (ie, 8.4%), will be approximately $41.4 million for PSE2 and beyond. This is our estimate of the difference between the present value of the cash flows expected to be generated by Auckland Airport for PSE2 relative to the equivalent cash flows expected to be generated to recover the IM-compliant mid-point WACC (using mid-year cash flows).[151] We note that from a conduct perspective, using end of year cash flow timings is consistent with the IMs. Therefore the effectiveness of information disclosure regulation in limiting Auckland Airport's ability to earn excessive profits is not diminished by the excess returns expected under a mid-year cash flow scenario.

E37 Table E1 provides our estimate of excess returns for the PSE2 period and the period beyond that makes up the total excess returns earned over the remaining life of the assets. The value of excess returns is dependent on whether it is compared to the mid-point or 75th percentile WACC, and the assumed timing of cash flows.

149 When combined with the TCSD (if any).

150 As discussed above (paragraph 2.9), even such a conclusion would still require consideration of whether the airport is limited in its ability to earn excessive profits, for instance, if a clearly inefficient airport were to consistently target returns at, or close to, the 75th percentile.

151 The cash flow inputs for the calculation of excess returns for Auckland Airport are forecast revenue (excluding gain/loss on sale), less opex, less value of commissioned assets, plus cash received from disposals, less tax, less the term credit spread adjustment. The present value of this is compared to the present value of the same cash flow inputs generated from the use of the 2012 opening asset base and the Commission's cost of capital estimate.

Table E1: Estimated present value of excess returns at Auckland Airport ($m)

	Lower estimate[152]	Higher estimate
Excess returns from 2013 to 2017	-4.7	41.4
Excess returns beyond 2017[153]	n/a	
Total excess returns from 2013 over remaining life of assets	-4.7m	41.4

E38 We also estimate that Auckland Airport could earn as much as $72.1 million in 'excess revenues' over the five-year period of PSE2 (without discounting).[154] This is approximately 6.1% higher than the revenues required to earn a normal return, and is consistent with the scenario where expected excess returns are expected to be $41.4 million.[155] Unlike the estimation of excess returns, excess revenues are calculated on a pre-tax basis. The quantification of excess revenues helps to understand the impact on consumers because excess revenues represent the extent to which consumers are over-charged. Therefore, we have also calculated the excess revenues expected to be earned by Auckland Airport over PSE2.

E39 Table E2 provides the estimate of the excess revenues expected to be received from consumers for the PSE2 period. These values have not been adjusted to reflect the present value of this revenue, as the appropriate discount rate for consumers is not readily quantifiable.

152 Excess returns are presented in present value terms. This reflects the dollar value as at the start of PSE2, discounted by the relevant WACC estimate to reflect the time value of money. In workably competitive markets, firms expect to earn their cost of capital over time and would only be expected to earn higher than this as a result of superior performance. The estimate of excess returns earned by Auckland Airport is based on the cash flows expected to be generated by Auckland Airport as a result of the prices it set for PSE2, and accepting Auckland Airport's guidance about how it might set prices after PSE2.

153 Based on Auckland Airport's current pricing behaviour and the assurances Auckland Airport has made we regards to its likely future pricing behaviour, we do not, at this time, expect Auckland Airport to earn excess returns in PSE3 and beyond.

154 The estimation of excess revenues is based on the revenues required to generate a return based on the Commission's 75th percentile or mid-point of the cost of capital (depending on the scenario), and uses Auckland Airport's land valuation.

155 Auckland Airport's forecast revenues are less than the revenues required to recover the 75th percentile cost of capital.

Table E2: Excess revenues expected to be received by Auckland Airport over PSE2 ($m)

	Total revenue	Excess revenues
Forecast revenue based on PSE2 prices	1,258	
Forecast revenue required to achieve 75th percentile of Commission’s cost of capital	1,261	-3.6
Forecast revenue required to achieve mid-point of Commission’s cost of capital	1,186	72.1

Superior performance

E40 A return in excess of the Commission's acceptable range for the cost of capital is not on its own necessarily indicative of excessive profits. In a workably competitive market, a supplier may earn super-normal profits (at least in the short-term) as a result of superior performance (for example, achieving higher cost efficiencies than its competitors).

E41 Auckland Airport has submitted it is a superior performer with regards to its innovation, quality, consultation on capital expenditure and its route development activities.[156] For example, Auckland Airport has submitted that the award of best airport in the Australia-pacific region in the Skytrax awards for the past five years demonstrate that it is meeting passenger demands in a superior way.[157]

E42 Given that we have concluded Auckland Airport is targeting an acceptable return, we do not consider it necessary to come to a view on whether Auckland Airport is a superior performer as part of this review.[158]

Does Auckland Airport’s conduct indicate that it seeks to earn an acceptable economic return over time?

E43 Our conclusion is that Auckland Airport's conduct indicates that it seeks to earn an acceptable economic return:

E43.1 Auckland Airport has set prices for PSE2 in a manner that is within the range of an acceptable economic return, taking into account its moratorium on asset revaluations;

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156 Auckland Airport “Section 56G Review of Auckland Airport: Post-Conference Submission” 15 March 2013, paragraph 15.

157 Auckland Airport “Section 56G review of Auckland Airport : Submission on Commerce Commission draft report” 31 May 2013, paragraph 96.

158 We propose to engage with stakeholders at a later date to discuss our framework for assessing whether a supplier is a superior performer and to exploring more fully the distinction between an excess return and an excessive profit.

E43.2 Auckland Airport has targeted a lower cost of capital in response to submissions during the consultation process;[159] and

E43.3 Auckland Airport has removed land held for future use from the asset base used to set prices for PSE2. Its exclusion is consistent with the approach we consider is appropriate, as set out in the asset valuation IM. Auckland Airport also made changes to its allocation of costs for PSE2 in response to submissions.

Auckland Airport has set prices with the expectation that its return would not be inconsistent with the Commission's estimate of the cost of capital

E44 We have considered the forecast return that Auckland Airport might have expected the Commission to estimate from the start of the PSE2 period, given Auckland Airport's knowledge of the information disclosure requirements and the relevant IMs underpinning those requirements. No forward-looking indicator of returns is currently required to be disclosed under information disclosure regulation.

E45 Auckland Airport estimated that its forecast post-tax ROI ranges from 7.1% to 9.2% across the five years of PSE2.[160] This analysis uses the Commission's information disclosure framework and takes into account Auckland Airport's moratorium on asset revaluations.[161] It therefore excludes the effect of the revaluations that were only undertaken for disclosure purposes. In its post conference submission, Auckland Airport stated that it believed the Commission would acknowledge that any revaluation gains required to be disclosed under information disclosure were not realised through prices and did not form part of the effective return.

E46 We have assessed those forecast ROIs to be equivalent to an IRR over PSE2 and beyond of 8.0%.[162] We consider this to provide a reasonable estimate of the returns Auckland Airport might have expected the Commission to estimate had Auckland Airport's moratorium on asset revaluations been appropriately taken into account.

E47 Although our estimate of Auckland Airport's target returns for PSE2 (8.0%) is above our assessment of a normal return, it falls within the Commission's estimate of an

159 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraphs 24 to 25, 54 and 58.

160 Auckland Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 16 March 2013, paragraph 85(g).

161 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraphs 89 to 91.

162 Note that Auckland Airport does not cite this 8.0% value itself. We have derived the 8.0% return by solving for the target return that would generate an NPV of excess returns of zero for PSE2. Although Auckland Airport states that its target return for PSE2 was 8.475%, that value only relates to a subset of Auckland Airport's regulated activities (Auckland Airport "Cross Submission: Following the Commerce Commission Section 56G Review Airports Conference" 16 March 2013, paragraphs 85(h) and 91).

acceptable range of the WACC of between 7.1% and 8.0%, which supports our conclusion that information disclosure is effective in limiting Auckland Airport's ability to earn excessive profits.

Auckland Airport targeted a lower cost of capital in response to submissions

E48 Auckland Airport stated in its PSE2 price setting disclosure document that it considered an appropriate cost of capital to be 9.16%.[163] However, during the consultation process, and in response to submissions by airlines, Auckland Airport chose not to target this 9.16% return on the assets used to set prices (pricing assets), but rather to set prices using an effective return of 8.475%.[164] Auckland Airport's target return for PSE2 is significantly lower than its cost of capital estimate of 9.83% which it used to set prices in PSE1.

E49 Auckland Airport's target return of 8.475% for PSE2 only relates to pricing assets. As discussed above, we estimate that Auckland Airport's target return across all assets used to supply regulated services is lower (ie, 8.0%), suggesting that Auckland Airport's target return on its leased assets is lower than its target return on pricing assets.

Auckland Airport's approach to land valuation and cost allocation is consistent with the IMs

E50 Auckland Airport removed land held for future use from the assets used to set prices for PSE2, consistent with the asset valuation IM. This land was included in the asset base for PSE1.

E51 Auckland Airport has also made changes to its allocation of costs for PSE2 to reflect the views of its customers and the information disclosure requirements.

E51.1 It changed the allocation of the route development costs from an aeronautical cost base to a shared cost base during consultation.[165] This resulted in a lower forecast opex for the PSE2 period and consequently reduced charges.

E51.2 Auckland Airport also changed its approach to cost allocation of roads for PSE2. Air New Zealand submitted that Auckland Airport allocated a lesser proportion of the cost of roading to the airport precinct to the aeronautical cost centre.[166] This resulted in a small reduction to the value of the pricing

163 Auckland Airport "Auckland International Airport Limited: Price setting disclosure for the pricing period 1 April 2012 to 30 June 2017" 2 August 2012, page 27.

164 This return is for airfield and terminal activities only and does not include leased assets.

165 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 67.

166 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 67.

asset base, and therefore lower prices than if this allocation had not applied. This change has been attributed to information disclosure regulation under Part 4.

Attachment F: Supplementary material on our analysis of Auckland Airport's returns

Purpose

F1 This attachment contains further detail on our approach to assessing whether Auckland Airport is earning excessive profits discussed in Attachment E. It also addresses a number of key issues raised in submissions on our approach to assessing Auckland Airport's profitability.

Structure of this attachment

F2 The remainder of this attachment is structured as follows:

F2.1 paragraphs F3 to F12 discuss why we assess returns using the IRR approach and why we consider a five-year IRR assessment is appropriate;

F2.2 paragraphs F13 to F40 discuss how we have taken into account Auckland Airport's moratorium on asset revaluations in our IRR analysis;

F2.3 an explanation of why we have not used BARNZ's alternative Market Value Alternative Use (MVAU) valuation for Auckland Airport's land in our analysis is discussed in paragraphs F41 to F44;

F2.4 paragraphs F45 to F47 explain our assumptions on cash flow timings used in the IRR calculation;

F2.5 paragraphs F48 to F77 explain why we have adopted the mid-point and 75th percentile of our cost of capital published on April 2012 to benchmark Auckland Airport's expected performance;

F2.6 paragraphs F78 to F82 consider whether the demand forecasts used in Auckland Airport's building blocks analysis are reasonable;

F2.7 information on the airport activities included in our analysis of returns is provided in paragraphs F83 to F84;

F2.8 paragraphs F85 to F88 discuss the limitations of the information used in our analysis, including information relating to the issues discussed above; and

F2.9 paragraphs F88 to F90 discuss enhancements to the information disclosure requirements that may provide stronger incentives to limit excessive profits.

Use of the IRR to assess profitability[167]

The IRR estimates a return relative to the value of Auckland Airport's assets

F3 The value of Auckland Airport's regulatory assets provides an appropriate baseline against which profits can be assessed. In a workably competitive market, the value of a supplier's assets depends on their expected profits in the future which are themselves dependent on expected prices that are constrained by competition.[168] A monopoly service provider such as Auckland Airport is not subject to the same constraints on its prices and therefore its profits. Consequently, its unconstrained profits would not be an appropriate reference point for establishing an asset value against which to assess returns (or for setting regulated prices). Such an asset value would be based on, and could lead to, future monopoly pricing. We have set an IM for establishing the regulatory asset value of airports regulated under Part 4, including for Auckland Airport.[169]

We consider the IRR is a more appropriate measure than the ROI

F4 Our analysis of Auckland Airport's returns is based on its IRR. We have used the IRR, rather than estimating annual ROIs which would be consistent with information disclosure, as the IRR avoids some of the problems associated with the short term variability in returns.

F5 Information disclosure regulation under Part 4 requires airports to disclose an ROI. The ROI is an annual, single period profitability indicator which measures the airport's net income against its regulatory asset values at the end of each prior disclosure year. The ROI is intended to be comparable to the Commission's estimated weighted average cost of capital (WACC).

F6 Analysis of returns using the ROI for Auckland Airport could be distorted by the revaluation of assets at Auckland Airport. The ROI reflects any revaluation gain (or loss) that occurs in the year prior to the change in the asset value. This can result in a 'spike' in the ROI, which signals an expectation of higher (or lower) profits in the

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167 The IRR is the discount rate that results in the sum of net cash flows, discounted using that IRR, equalling the initial capital outlay.

168 For further discussion of this issue, see Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraphs 4.1.3 to 4.1.4; Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, paragraphs 4.1.3 to 4.1.4. Airlines can be expected to have some degree of countervailing market power over the Airports regulated under Part 4. However, Airports are only subject to information disclosure regulation, and that does not affect the right of Airports under the AAA to charge for specified airport services as they think fit.

169 IMs set out the rules, requirements and processes applying to the regulation of specified airport services. The purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of goods and services under Part 4. Key IMs include the setting of the initial value of the RAB and how the value of the RAB is rolled forward, the treatment of asset revaluations and the determination of the cost of capital.

future.[170] However, whether the reported returns actually eventuate depends on the extent to which the change in the asset value flows through into prices and revenues.[171]

F7 Unlike a ROI calculation, an IRR calculation does not rely on asset values in each year. Instead, it is based on the initial capital outlay, and the net cash flows associated with that investment. It therefore avoids the 'spikes' that can occur in the ROI.

Our analysis of the IRR uses an opening and closing asset value

F8 Information is not available to calculate the IRR over the lifetimes of all assets. Therefore, our analysis uses an opening and closing asset value, in addition to the net cash flows associated with the opening asset value (which is the deemed capital outlay at that time).

F9 Ideally, the closing asset value should represent the expected value of future net cash flows at that time (discounted by the WACC).[172] If the closing asset value is a good estimate of the present value of subsequent net cash flows, then the IRR will provide a good estimate of the returns on the opening asset value over the entire remaining lifetime of the assets.

F10 As discussed below, Auckland Airport has had a moratorium on revaluing some, but not all, of the assets it uses in supplying regulated services since 2007. The moratorium has been a key factor affecting our choice of the appropriate opening and closing asset values to use.

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170 A 'spike' in the ROI above the cost of capital as a result of a revaluation of assets indicates an expectation of higher profits in the future—but those higher profits have not yet occurred. Such a spike would also indicate that consumers have not yet received any compensation, through lower prices, to offset those expected higher profits. However, that expected level of profits will only fully eventuate if prices rise to the level implied by recovering the cost of capital on the revalued asset base (eg, Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd Decisions Paper" 30 October 2008, paragraph F.9). For example, during consultation on the asset valuation input methodology, Professor George Yarrow observed that a revaluation corresponds to a capitalisation of *future* cash flows (G. Yarrow, M. Cave, M. Pollitt and J. Small, *Review of Submissions on Asset Valuation in Workably Competitive Markets, a Report to the New Zealand Commission, Annex 2: George Yarrow – Response to Submissions on Individual Expert Reviews*, November 2010, paragraph 2.11).

171 If prices following the revaluation do not rise to the level implied by the revalued assets, the ROI measured at the point of revaluation may give a misleading view of returns. See Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, Appendix F.

172 Commerce Commission "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decisions Paper" 30 October 2008, paragraphs 190 to 193. The ROI, and the way it treats revaluations, is effectively a close approximation to an IRR calculated over only one year, with the revaluation reflected in the closing asset value.

Our IRR is based on the five-year period of PSE2

F11 A meaningful assessment of Auckland Airport's return should include a long-term assessment of returns (for example, an assessment of trends in returns or an average return over several years). We consider it important to examine returns over a number of years as a return in excess of the cost of capital (ie, an 'excess return') in a particular year is, on its own, not indicative of excessive profits. This is because costs can vary from year to year and income can be smoothed to reflect customer requirements. Furthermore, a short-term return that exceeds the cost of capital may simply reflect superior performance.[173]

F12 Consistent with the section 56G report for Wellington Airport, our preferred measure of expected returns over time for Auckland Airport is the five-year IRR for PSE2, which in Auckland Airport's case starts from 1 July 2012. The information available to us at this time would allow us to estimate the IRR from an earlier opening date than 1 July 2012. However, we consider that a five-year IRR provides a more useful indicator of Auckland Airport's conduct and performance in response to information disclosure, because returns achieved before July 2012 reflect pricing decisions made prior to the introduction of information disclosure. Even had Auckland Airport been making excess returns in PSE1, a decision not to immediately reset prices during PSE1 to account for the introduction of information disclosure could not necessarily be taken as an indicator of the ineffectiveness of the information disclosure regime.

Treatment of Auckland Airport's moratorium on asset revaluations

Asset values used by Auckland Airport's for pricing differ from those disclosed under information disclosure

Auckland Airport's moratorium on asset revaluations

F13 Auckland Airport introduced a moratorium on asset revaluations for pricing purposes in 2007. This moratorium applied during PSE1 and was in recognition of the fact that the treatment of asset revaluations had been a contentious issue during previous price setting events. The moratorium prevents changes in the value of specific assets (either due to new valuations being undertaken or indexation due to inflation) from being included in the asset base used to set prices. During the consultation process for PSE2, it was agreed that the moratorium would continue until at least 2017.

F14 The moratorium applies to assets used to set prices for PSE2, which are the land and specialised (non-land) assets associated with terminal and airfield activities. It does not apply to leased assets (ie, land and specialised assets associated with aircraft and freight activities). The leased assets are subject to revaluations over the forecast

[173] For further discussion of this issue, see Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraphs 3.23 and 3.25.

pricing period. Leased assets have been excluded from the price setting event, but still make up the assets included under information disclosure regulation.

Asset values disclosed by airports under information disclosure

F15 Asset values disclosed by airports under information disclosure must be disclosed in accordance with the IM for asset valuation. The asset valuation IM requires airports to establish an initial value of their RAB for the start of the Part 4 regime. This was determined from a new MVAU valuation for land assets used in supplying specified airport services (as at the last day of their 2009 financial year), plus the value of specialised assets used in supplying specified airport services disclosed under the previous AAA disclosure requirements (as at the same date).[174]

F16 The asset valuation IM also sets out how the 2009 initial RAB value must be 'rolled forward' for information disclosure purposes.[175] After 2009, the IM allows disclosed values for land to be revalued based on MVAU, although there is no obligation on airports to do so. In years where there are no MVAU revaluations for land, the IM specifies that disclosed values of land must be revalued based on the consumer price index (CPI-indexed) instead. The IM also requires the disclosed values of specialised assets to be CPI-indexed.[176]

F17 The IM also requires that revaluations due to CPI-indexation or to new MVAU valuations of land must be treated as income, and this is reflected in the way that disclosed ROIs must be calculated.[177] The IM does not set out any requirements for forecasting asset values, although information disclosure requires airports to disclose the forecast asset values they have used in their pricing decisions at each pricing event.[178]

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174 Commerce Commission “Airports Input Methodologies Reasons Paper” December 2010, page 62.

175 The 'roll forward' of an asset base means to determine its value in each year by reflecting changes in the asset base due to new assets, depreciation on existing assets, asset disposals, and changes in the allocation of assets between aeronautical (regulated) and non-aeronautical (non-regulated) asset bases. It also includes, where appropriate, the revaluation of assets resulting from inflation or new valuations being undertaken for land.

176 However, the effect of CPI-indexation may be fully or partly offset by the airport's choice of depreciation methodology. This is because the IM gives the airport the freedom to choose a depreciation approach other than the default of straight-line depreciation (provided disclosure of the change and its impacts are made). For more discussion on this issue, see Commerce Commission “Airports Input Methodologies Reasons Paper” December 2010, paragraphs 4.3.80 to 4.3.81.

177 For more discussion on this issue, see Commerce Commission “Airports Input Methodologies Reasons Paper” December 2010, paragraphs 2.8.13 to 2.8.17.

178 Commerce Commission “Information Disclosure (Airport Services) Reasons Paper” 22 December 2010, paragraph 5.17.

Asset values used by Auckland Airport for pricing

F18 As a result of the moratorium on asset revaluations, the asset values that have been used by Auckland Airport to set prices for PSE2 differ in a number of respects from the IM-compliant asset values disclosed under information disclosure.

F18.1 Auckland Airport was required to disclose an IM-compliant new MVAU valuation for the land in its initial RAB for 2009, although this value was not used for pricing purposes. This is because the moratorium on land revaluations continues from PSE1 and uses an approximation of the MVAU from 2006.[179]

F18.2 Auckland Airport chose to disclose an IM-compliant new MVAU valuation for land for 2011, although this value was not used for pricing purposes either, because the moratorium continued for PSE2.

F18.3 Auckland Airport has been required to disclose IM-compliant values for its specialised assets indexed from 2009 using the CPI. However, for pricing purposes the optimised depreciated replacement cost (ODRC) value disclosed under the AAA in 2006 is used as the basis of the value of specialised assets, and specialised assets have not been indexed since 2006.

Opening asset value for the IRR calculation

F19 The opening asset value used for our IRR calculations is at the beginning of PSE2 (ie, 1 July 2012) and differs from the RAB value disclosed for that year. The opening asset value used in our analysis is, however, consistent with both the IM-compliant RAB established at the start of the Part 4 regime, and with the effects of Auckland Airport's moratorium on asset revaluations since then. We have used this opening value to ensure that incorrect conclusions are not made about Auckland Airport's returns for PSE2 and beyond.

F20 Our opening asset value is the IM-compliant value of the RAB in 2009 disclosed under information disclosure, 'rolled forward' to 2012 in a manner consistent with Auckland Airport's treatment of asset values for pricing purposes. Capital additions and disposals since 2009, as well as depreciation for specialised assets, have been recognised, consistent with their treatment for pricing purposes. However, because

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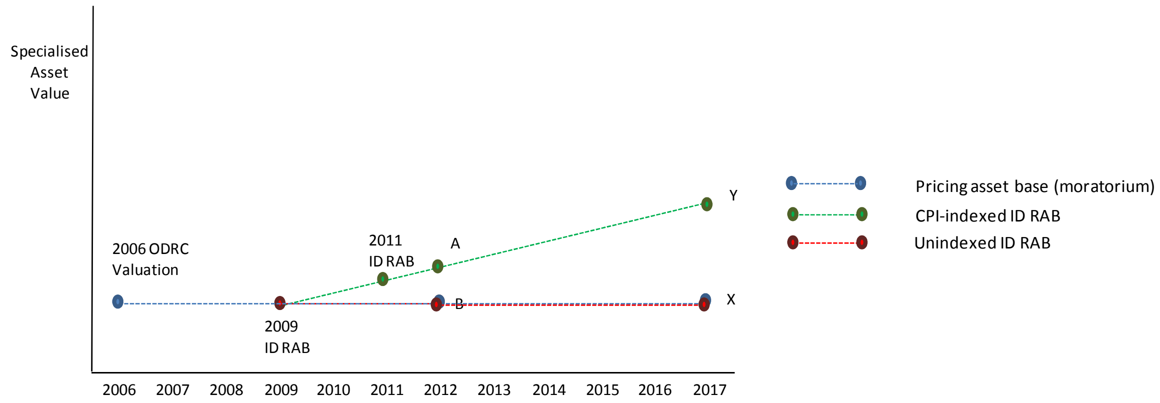
179 For PSE1, Auckland Airport actually used its 2006 market value existing use (MVEU) valuation for land with land conversion costs removed to set prices (ie, to approximate an MVAU valuation). Many past investments in the conversion of land for use as an airport will have already contributed to the market value of land in an alternative use. These costs will therefore already be reflected in a higher MVAU valuation than would otherwise have been the case (eg, levelled land is typically more valuable than unlevelled land). However, recognition of past investments relating to land conversion is appropriate in the RAB where the expenditure has been incurred relatively recently and would not be expected to affect the value of land in an alternative use. The IM-compliant asset base includes such investments, but they are recognised as specialised assets rather than land (eg, the seawall at Auckland Airport).

assets associated with Auckland Airport's terminal and airfield activities have not been revalued for pricing purposes since the start of the Part 4 regime, our analysis does not take account of the CPI-indexation of specialised assets and the new MVAU valuations of land that were undertaken by Auckland Airport for disclosure purposes only.[180]

F21 Figure F1 and Figure F2 below illustrate, in simplified form, the differences between the pricing and disclosure asset values relevant to the PSE2 pricing period, for specialised assets and land respectively.[181]

Figure F1: Specialised asset values for pricing and disclosure purposes



F22 In Figure F1 above, point A represents the value for specialised assets in 2012 as reported under information disclosure. Point A reflects that, under information disclosure, the value of specialised assets must be CPI-indexed from 2009.

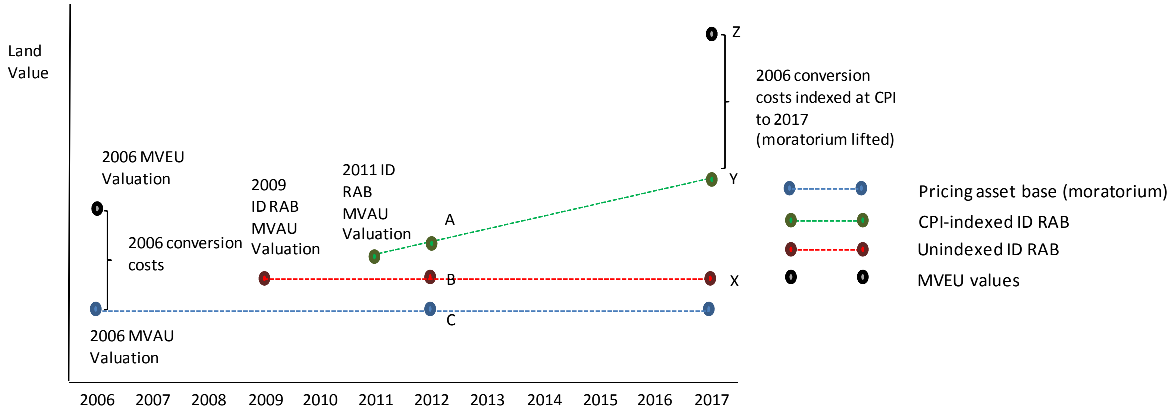
F23 Point B in Figure F1 represents the 2012 opening value of specialised assets used in our analysis. This is calculated by 'rolling forward' the IM-compliant RAB value for specialised assets in 2009 (labelled '2009 ID RAB') taking into account the moratorium. The IM-compliant RAB value in 2009 for specialised assets is also

180 Our analysis has recognised that only Auckland Airport's assets associated with aircraft and freight activities have been revalued for both disclosure purposes and pricing purposes (with revaluations treated as income). Assets excluded from the price setting event (ie, leased assets) are not subject to the moratorium and are therefore rolled forward in our analysis to recognise Auckland Airport's forecast revaluations. Due to the different revaluation treatment of pricing and leased assets we have ensured that the estimate of the opening asset value has had only the revaluations associated with pricing assets removed. The calculation of the opening asset value for PSE2 used in our analysis was provided to us by Auckland Airport.

181 As noted above, the scope of the assets used for pricing purposes is smaller than those used for disclosure purposes. Due to this difference in scope, we have had some difficulties in reconciling the asset values used for pricing and disclosure purposes, as is discussed in the last section of this attachment (from paragraph F85). However, for simplicity, the effects of this difference are not reflected in the figures. Also for simplicity, the effects of asset additions and disposals, as well as the depreciation of specialised assets, are ignored. Hence, unless there is an MVAU revaluation, or asset values are CPI-indexed, the asset values in the figures appear to remain constant.

consistent with the 2006 ODRC value of specialised assets ('2006 ODRC Valuation') 'rolled forward' from 2006 to 2009 consistent with the moratorium. This 'rolled forward' ODRC valuation is the value of specialised assets used by Auckland Airport to set prices for PSE2.

Figure F2: Land values for pricing and disclosure purposes



F24 In Figure F2 above, point A represents the value for land in 2012 as reported under information disclosure. Point A reflects that Auckland Airport chose to disclose a new MVAU valuation for land in 2011 ('2011 ID RAB MVAU valuation'), and from 2011 to 2012 information disclosure require this value to be indexed by the CPI.

F25 Point B in Figure F2 represents the 2012 opening value of land used in our analysis, which is found by 'rolling forward' the IM-compliant RAB for land in 2009 ('2009 ID RAB MVAU Valuation') taking into account the moratorium. The IM-compliant RAB value for land in 2009 differs from the land value used for pricing purposes. This is because Auckland Airport was required to undertake a new MVAU land valuation as at the start of the Part 4 regime. However, the value of land used by Auckland Airport for pricing purposes is not based on the 2009 MVAU valuation and instead 'rolls forward' its previous MVAU valuation from 2006 (labelled '2006 MVAU Valuation'), taking into account the moratorium.

F26 The selection of the opening asset value used in our IRR assessment for Auckland Airport differs from that used for our s 56G report for Wellington Airport. Our analysis of Wellington Airport's expected returns used the asset value disclosed by Wellington Airport under information disclosure as at 2012 as the opening asset value. This approach was appropriate for Wellington Airport because it was consistent with Wellington Airport's approach to setting prices and revaluing assets since the start of the Part 4 regime.

F27 In the case of Auckland Airport, it would not be appropriate to use the asset values disclosed under information disclosure after 2009 as it would overstate the value of the assets used by Auckland Airport to set prices. This would subsequently produce a misleading lower estimate of the returns expected to be earned by Auckland Airport for PSE2 and beyond and incorrect conclusions about excess returns.[182]

F28 Our approach of using an opening asset base for PSE2 that excludes revaluations on assets since 2009 also appears to be consistent with the forecast estimate of returns that Auckland Airport describes as its 'key reference point' when setting prices for PSE2. Auckland Airport explains that it believed the Commission would appropriately acknowledge the extent to which revaluation gains it was required to disclose:

F28.1 were not realised through prices;

F28.2 did not represent increases in the assets base on which charges were set; and

F28.3 were not part of the effective return for PSE2.[183]

Closing asset value for the IRR calculation

The closing asset value used in our conclusions reflects the expectation that Auckland Airport's future pricing behaviour is consistent with its current pricing approach

F29 As noted in the s 56G report for Wellington Airport, the closing value for our IRR analysis should represent the expectation of the airport's future cash flows, or the value of the assets likely to be used to set prices for PSE3 and beyond. Like our profitability analysis for Wellington Airport, the closing value we have used reflects Auckland Airport's asset values at the end of PSE2 consistent with its pricing decisions for PSE2.

F30 Our assessment of Auckland Airport's expected performance is based on the expectation the Auckland Airport's current behaviour with regards to the asset values are reflected in prices will continue (point X in each of Figure F1 and Figure F2 above). That is:

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182 All other things being equal, setting prices off an asset base that is not revalued will provide the same level of returns over the lifetime of the assets as setting prices off a revalued asset base, if all revaluations are appropriately treated as income for pricing purposes. However, the pricing profiles arising from the different valuation approaches will be different for each pricing period, although they will intersect over time. Pricing off an asset base that is not revalued provides greater upfront prices than pricing off a revalued asset base (where revaluations are appropriately treated as income). Because our assessment of returns is only part way through the life of Auckland Airport's assets, we would make incorrect conclusions about returns if our analysis did not recognise the impact of the moratorium on Auckland Airport's pricing profile over time. For example, see "Lally advice on measuring excess returns", Appendix 19 of Commerce Commission "Part IV Inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports", Final Report, 1 August 2002, pages 517 to 518; Commerce Commission, Gas Control Inquiry, Final Report, 29 November 2004, paragraphs 8.23 to 8.25.

183 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraphs 90 to 91.

F30.1 the moratorium on asset revaluations will continue beyond 2017;

F30.2 any land conversion costs will continue to be excluded from the asset base used to set prices; and

F30.3 land held for future use will continue to be excluded from the asset base used to set prices.

F31 In its post conference submission to this s 56G review, Auckland Airport has stated it has no intention of revaluing its assets base for pricing in PSE3 and that continuing the moratorium is a distinctly possible outcome, if customers support that approach.[184] It also states that if a revalued asset base were to be used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue target. This is consistent with the IMs and ensures that any revaluation gains to the airport are offset through and reduction in prices charged to consumers. We consider Auckland Airport's assurances provide the best indication of future performance at this time.

Sensitivity analysis

F32 The asset values used to set prices for PSE3 and beyond are an area of significant concern for airlines, given the original intention for the moratorium to end in 2017. In light of these concerns, we have also considered the impact of a different closing asset value being used, reflecting different pricing behaviour for PSE3 than PSE2. We have considered the impact of Auckland Airport changing its approach to pricing by:

F32.1 applying the input methodologies set by the Commission (which would reflect a fully indexed asset base from the beginning of PSE3), or

F32.2 by moving to the use of a market value existing use (MVEU) approach to land value (as argued by Auckland Airport in the High Court merits appeals of the input methodologies).

F33 In both cases we have assumed that Auckland Airport would not reflect the revaluation impact as a reduction in future revenue. These scenarios are consistent with BARNZ's arguments during the conference.[185] However, as noted in paragraph E29, we have not placed any weight on the results of this sensitivity analysis in forming our conclusion on the effectiveness of information disclosure in limiting the ability of Auckland Airport to earn excessive profits.

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184 Auckland Airport “Auckland Airport’s Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012” 9 November 2012, paragraphs 35 to 38.

185 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 35.

F34 We have estimated the expected return under a scenario where input methodologies are applied from 2017. The closing asset value used in this analysis is determined by 'rolling forward' the 2012 disclosed RAB to 2017 (point A in each of Figure F1 and Figure F2) using Auckland Airport's own estimate of revaluations on its CPI-indexed asset base for leased assets (point Y in each of Figure F1 and Figure F2).[186] The results of this analysis are presented in paragraph E30.1.

F35 To illustrate the expected return under the scenario where Auckland Airport adopts a MVEU land valuation, we have estimated the closing asset value by taking the IM consistent closing asset values discussed in the previous paragraph, and adding an estimate of land conversion costs in 2017.[187] The combined value equates to an estimate of the indexed MVEU valuation in 2017 (point Z in Figure F2). The results of this analysis are presented in paragraph E30.2. While BARNZ considers that the MVEU value used in our sensitivity analysis is understated, our analysis is intended to be illustrative of the potential risks if Auckland Airport adopts a different asset base from that indicated to us as part of this review.[188] It does not represent the maximum possible return that Auckland Airport might be able to achieve if a change in valuation approach were to be adopted.

Views of submitters on the appropriate asset values for the IRR calculation

F36 In its post conference submission, Auckland Airport submitted that its expected returns for PSE2 and beyond would be only 5.54%, if the same approach we applied to assess Wellington Airport's returns is used.[189] This estimate is based on using the asset valuation disclosed under information disclosure in 2012 as the opening value and the forecast pricing asset base in 2017 as the closing value.

F37 In its response to our draft report, Auckland Airport has continued to submit that we should use the asset valuation disclosed under information disclosure in 2012 as the opening asset value as this is the best estimate of the value of airport assets in a

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186 Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, paragraph 99(d)(ii). The CPI used is 2.5% In practice, Auckland Airport's own estimate of the 'roll forward' of its leased asset base uses 2.5% for land assets but substantially lower revaluation rates for buildings and plant.

187 We have estimated the land conversion costs in 2017 indexing the 2006 conversion costs from the 2006 MVEU valuation. The land conversion costs have been indexed using historic CPI rates for the period to 2012 and using Auckland Airport's own estimate of revaluations on its leased asset base of 2.5% for the period from 2013 - 17.

188 BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, pages 9 to 11.

189 In its post-conference submission, Auckland Airport had submitted that using the same approach as Wellington Airport would give an expected return of 5.74% (Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraph 98). Auckland Airport subsequently provided a revised IRR calculation, indicating an expected return of 5.54%, in: Auckland Airport "Auckland Airport IRR Calculation", 4 April 2013, page 2.

workably competitive market.[190] However, as noted in Chapter 2, a combination of alternative methodologies to those in our input methodologies may result in similar outcomes, and which are also consistent with those produced in workably competitive markets.[191]

F38 We do not consider it appropriate to use the asset values used by Auckland Airport to set prices as the opening value in our IRR analysis, as suggested by BARNZ.[192] The approach to valuing the asset base used for pricing purposes differs significantly across all three regulated airports, and does not therefore provide a useful reference for assessing an airport's return as part of this review.

F39 NZIER, for Air New Zealand, has submitted that it is not appropriate to disregard the sensitivity analysis undertaken in respect of the possible closing asset base used in our IRR analysis and that we should assign a probability of the likelihood of the scenarios to determine the expected value of the excess returns likely to be achieved by Auckland Airport. [193] This type of expected value analysis would be appropriate if this was to be the Commission's only opportunity to draw a conclusion regarding Auckland Airport's likely future returns. This is not the case. Our estimates of expected returns are based on our expectation of Auckland Airport's most likely future behaviour. If this expectation were to change, or if Auckland Airport's actual behaviour were to change when setting prices for PSE3 and beyond, we would continue to comment on the impact of this behaviour through summary and analysis or other advice to the Minister.

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190 Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 145.

191 Auckland Airport has stated that at the very least, the Commission should include a scenario in its analysis which incorporates the 2012 asset valuation disclosed in information disclosure as the opening IRR asset base (see Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 150). However, Auckland Airport does not state what it considers to be the appropriate closing asset base to use in this analysis. Given Auckland Airport's moratorium on asset revaluations for pricing purposes, we do not consider it appropriate to use the pricing asset base as the closing value in such a scenario, as this would mean opening and closing asset values would be determined on an inconsistent basis with respect to the treatment of asset revaluations. Therefore we have estimated the expected return using the asset values disclosed under information disclosure in 2012 rolled forward to 2017, either with no indexation (consistent with Auckland Airport's actual pricing behaviour) or with indexation applied at 2.5%, as the closing asset value. We estimate the expected returns using a closing asset base with no indexation to be 6.9% or 7.3%, depending on whether an end-year or mid-year assumption is made for the timing cash flows. The expected returns using a closing asset base indexed at 2.5%, and assuming Auckland Airport does not treat these revaluation gains as income, are estimated to be 8.6% or 9.1%, again depending on the cash flow timing assumption.

192 BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, page 6.

193 NZIER "Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport" May 2013, page 7.

F40 We have not tested the impact of removing 26.4 hectares of land from the RAB, as suggested by BARNZ.[194] BARNZ submits that this land, valued at approximately \$2.6m, has been determined by the Commission as not necessary for the provision of airfield services.[195] The removal of this land from the RAB will not have a material impact on our estimate of Auckland Airport's return. Furthermore, the land that the Commission previously concluded was not necessary refers to a significantly larger area than that BARNZ is objecting to.[196] Auckland Airport has removed the majority of this land from the RAB, but submits that the small amount retained is necessary for safety and process reasons.[197]

BARNZ's alternative MVAU land valuation

F41 BARNZ has questioned the plausibility of Auckland Airport's alternative land use plan used in its MVAU land valuation for 2011 as it contains an 'extraordinarily high' level of retail and commercial use.[198] An alternative land valuation commissioned by BARNZ resulted in an MVAU valuation which is 14.5% lower than the Auckland Airport MVAU valuation. Expert advice received by the Commission through the s 56G review process indicates that a range of 10% between valuations would be considered acceptable, but that a 15% variation would only occur in exceptional circumstances.[199]

F42 We have not tested the impact of using the BARNZ alternative land valuation as the opening value. The 2011 MVAU valuation challenged by BARNZ is not used by Auckland Airport for pricing purposes, and we do not know to what extent BARNZ's concerns might be relevant to the 2009 MVAU land valuation that forms the basis for our IRR analysis.[200] Furthermore, the BARNZ alternative valuation has, to date, not been subject to any external review procedures and we can make no comment on its appropriateness for compliance or any other purposes.

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194 BARNZ “Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport” 31 May 2013, page 13.

195 Commerce Commission "Part IV inquiry into airfield activities at Auckland, Wellington and Christchurch International Airports, 1 August 2002, paragraph 8.129

196 The Commission's comments were made in 2002 in relation to the eastern approaches and Wiroa Island areas which represent a much larger land area of approximately 211ha.

197 Auckland Airport “Section 56G Review of Auckland Airport: Cross-Submission on Commerce Commission Draft Report” 14 June 2013, page 38.

198 BARNZ “BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport” 18 October 2012, page 4.

199 Darroch, Letter re WIAL 2009 and 2011 valuations Wellington International Airport Limited Final Report 1 February 2013, page 2.

200 We provided Auckland Airport with the opportunity to respond to the alternative land valuation provided by BARNZ. This response can found in Auckland Airport “Section 56G Review of Auckland Airport: Response to specific matters raised in post-Conference Submissions” 12 April 2013.

F43 Our expert valuer's review of Auckland Airport's 2009 MVAU land valuation provides some assurance that Auckland Airport's 2009 MVAU is not an inappropriate base for our analysis. We have not yet formed a view on the compliance issues raised in the Darroch report.[201]

F44 We have assessed the impact of a 10% reduction in Auckland Airport's land valuation on Auckland Airport's return. This is because, at this stage, our expert valuer considers that Auckland Airport's 2009 MVAU is not strictly compliant, and that a variation of 10% between compliant valuations might not be unreasonable. The results of this analysis are presented in paragraph E31.

Cash flow timings assumed in our IRR calculation

F45 We have assumed cash flows occur at the end of each year, with the exception of capital expenditure. We have assumed that half of the capital expenditure forecast for each year of the regulatory period occurs at the beginning of that year, with the remaining half occurring at the end of the year. This gives rise to a conservative estimate of the IRR compared to using assumptions which attempt to better approximate the real timing of cash flows. It provides our lower estimate of Auckland Airport's expected returns.

F46 Consistent with our profitability analysis for Wellington Airport, we have also estimated returns for Auckland Airport based on the assumption that cash flows occur mid-year.[202] This represents the least conservative cash flow timing assumption. Our lower and higher estimates of Auckland Airport's expected returns are presented at paragraphs E24 to E25 of Attachment E.

F47 We do not agree with BARNZ and Air New Zealand's suggestion that our conclusions should be based on analysis that assumes cash flows occur mid-year.[203] Our conclusion is based on the assumption of year-end cash flows as this is consistent with the treatment of cash flows in information disclosure requirements. The use of mid-year cash flows to assess returns had not been signalled at the time Auckland Airport set prices. Therefore, we would not expect Auckland Airport to have had

201 Darroch "Review of land valuation methodology Auckland International Airport Limited", Final Report, 28 June 2013.

202 This is consistent with the approach more recently specified in the information disclosure requirements for electricity distribution and gas pipeline businesses. See Commerce Commission "Information Disclosure for Electricity and Gas Pipeline Businesses Final Reasons Paper" 1 October 2012, paragraphs E10 to E13. However, at the time that Auckland Airport set its prices for PSE2, it would not have been aware that we were considering measuring returns using an assumption about the timing of cash flows that was other than end of year.

203 See BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, page 12; Air New Zealand "Submission to the Commerce Commission on the 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" 31 May 2013, paragraph 26.

regard to this when setting its prices. We propose to consider enhancing the information disclosure requirements to better reflect the actual timing of cash flows.

Cost of capital and underlying assumptions

How we estimate the cost of capital

F48 The WACC estimates the percentage return on capital consistent with returns that may be achieved in a workably competitive market over time.[204] Under Part 4, we have published an IM for estimating the cost of capital for monitoring and analysing information disclosed by airports. We considered a range of analyses used by capital market practitioners to estimate the cost of capital.

F49 In this report we have stated all returns on a post-tax basis as this is consistent with analysis provided by both Auckland Airport and BARNZ, and is likely to be most familiar to most interested persons.[205]

Our analysis uses the April 2012 cost of capital estimate

F50 We consider that the most appropriate cost of capital to use when assessing Auckland Airport's forecast returns is the WACC estimate based on the IMs which was published on 27 April 2012.

F51 In reaching this view, we considered three possible WACC estimates calculated in accordance with the cost of capital IM:

F51.1 the April 2012 cost of capital determination;[206]

F51.2 a WACC estimated as at 21 May 2012, which was the last date Auckland Airport updated the market data prior to its 2012 pricing decision;[207] and

F51.3 the July 2012 cost of capital determination.[208]

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[204] Commerce Commission "Information Disclosure (Airport Services) Reasons Paper" 22 December 2010, paragraph 3.23.

[205] The cost of capital IM requires a vanilla nominal WACC and post-tax nominal WACC to be estimated and published for airport services for the purpose of information disclosure. The vanilla WACC is specified as the expected post-tax cost of equity capital and the expected pre-tax cost of debt capital, weighted by the respective proportion each represents of the total capital. The post-tax WACC is determined as the expected post-tax cost of equity capital and the post-tax expected cost of debt capital, weighted by the respective proportion each represents of the total capital.

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

[207] We have applied the cost of capital IM to estimate a WACC for Airports as at 21 May 2012. The risk-free rate is 3.08% and the debt premium is 1.96%, based on data for the period from 21 April 2012 to 20 May 2012.

F52 Post-tax WACC estimates as at these three dates are summarised in Table F1 below.

Table F1: Post-tax WACC estimates for airports based on the IMs (%)

	1 April 2012	21 May 2012	1 July 2012
25th percentile	6.08	5.70	5.51
Mid-point	7.06	6.68	6.49
75th percentile	8.04	7.67	7.48

Note: The fall in post-tax WACC estimates over the period from 1 April 2012 to 1 July 2012 was largely driven by reductions in the risk-free rate. As at 1 April the risk-free rate was 3.61%. The risk-free rate fell to 3.08% and 2.78% as at 21 May 2012 and 1 July 2012 respectively

F53 We consider that information available at the time of Auckland Airport's pricing decision should be used when estimating the WACC for assessing its profitability in this s 56G review. This approach is consistent with Auckland Airport's post conference submission, in which it argues that "…our intentions and conduct in setting prices should be measured against information available to Auckland Airport at the time of pricing".[209] In the case of the Wellington Airport s 56G report, a WACC estimated after the date which prices were set was used only because the previous WACC determination was in July 2011, several months prior to Wellington Airport's price setting decision. We also note using a later WACC did not disadvantage Wellington Airport.[210]

F54 In choosing between the 1 April 2012 and 21 May 2012 WACC estimates, we note that Auckland Airport could have made a reasonable estimation of the Commission’s cost of capital based on the IMs at the date that it finalised the market data for its pricing decision (ie, 21 May 2012). BARNZ has previously stated that “the Commission’s methodology has been specified sufficiently clearly in its Input Methodologies that interested parties (with access to sufficient expertise) are themselves able to update the WACC estimate”.[211] BARNZ also states that "it was widely and well understood by all parties that the Airport would be updating its cost

208 Commerce Commission "Cost of capital determination for information disclosure year 2013 for Transpower, gas pipeline businesses and specified airport services (with a June year-end) [2012] NZCC 20" 30 July 2012.

209 Air New Zealand “Post-Conference Cross-Submission on the Section 56G Review of Auckland Airport” 15 March 2013, page 20, paragraph 74.

210 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, paragraphs F31 to F35.

211 BARNZ “BARNZ Post Conference Submission on Wellington Airport Section 56G Revenue” 17 August 2012, page 21.

of capital, to reflect market changes in the cost of debt, as close as reasonably practical to when it determined charges." [212]

F55 Auckland Airport has acknowledged that it updated its WACC at the time of pricing, but the return was not used to set prices. [213] Auckland Airport states that it accepted a level of return lower than the updated WACC as a result of BARNZ's view that 8.04% was an appropriate level to assess the reasonableness of Auckland Airport's proposed prices. We also think it would have been reasonable for Auckland Airport to rely on the April 2012 WACC estimate when making its pricing decision given that this determination was published in relatively close proximity to the time of Auckland Airport setting prices.[214] Furthermore, the WACC estimated based on the IMs fell significantly over a short period of time in the lead-up to Auckland Airport's pricing decision, potentially leading to uncertainty around the appropriate WACC for this s 56G review.

F56 In the circumstances we consider that using the April 2012 WACC estimate is appropriate. We do not therefore agree with Air New Zealand's or BARNZ's submissions that our analysis should be based on the WACC estimate of 21 May 2012.[215]

We have assessed Auckland Airport's returns relative to the mid-point and the 75th percentile estimate of the cost of capital

F57 When assessing Auckland Airport's profitability we have used the mid-point cost of capital as the starting point, but also considered the 75th percentile cost of capital. This is consistent with the approach adopted in the s 56G report for Wellington Airport.[216]

F58 Air New Zealand has argued that the Commission should apply the 25th percentile for the following reason:

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212 BARNZ "Cross-Submission by BARNZ to Auckland Airport Submission on Commerce Commission Draft Report" 18 June 2013, page 9.

213 Auckland Airport "Section 56G Review of Auckland Airport: Cross-Submission on Commerce Commission Draft Report" 14 June 2013, paragraph 53.

214 In contrast, the most recent WACC determination for airports was published significantly in advance of Wellington Airport's price setting. When Wellington Airport finalised its prices in January 2012, the most recent IM WACC for airports was published in July 2011.

215 Air New Zealand "Submission to the Commerce Commission on the 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" 31 May 2013, paragraph 28; BARNZ "Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport" 31 May 2013, pages 15 to 16.

216 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, paragraphs F36 to F38.

> In fact, given that the IM is already significantly in favour of the regulated airport, a departure from the mid-point towards the 25th percentile would be justifiable, as it would balance the greater likelihood of over-compensation under the IM. Applying the 25th percentile - which the Commission has failed to do - sees excessive revenues balloon out to $153 million. This is simply too high a price for consumers to pay.

F59 Given that we are assessing profitability against an excessive standard, the 25th percentile is not relevant.

F60 We consider the mid-point cost of capital to be an appropriate starting point for any assessment of profitability for Auckland Airport. The Airport IM reasons paper states that "in assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (mid-point) on the range".[217]

F61 Using the mid-point is supported by the airlines. BARNZ submitted that "...the mid-point WACC estimate represents an appropriate level of target return for Airports and is more than sufficient to provide incentives to innovate and invest".[218] Air New Zealand submitted that "returns consistent with the WACC mid-point are an appropriate level of target return" and that "this represents a balance between the objectives of s 52A(1)(a) and (d)".[219]

F62 For the purpose of our review of how effectively information disclosure regulation is promoting the purpose of Part 4, we have also considered the 75th percentile cost of capital, in addition to the mid-point, to assess Auckland Airport's profitability. The 75th percentile cost of capital allows for the uncertainty of estimating the cost of capital and limits the potential asymmetric consequences of estimation error on investment. The analysis of Auckland Airport's profitability undertaken for this s 56G review is forward-looking and as such, it is important to allow for uncertainty about the cost of capital to ensure adequate incentives for investment are provided.

F63 In its submission on the draft report, NZIER submits that using the 75th percentile of WACC implies "a 74% probability that the Airport's forecast revenue will deliver excess returns".[220] We recognise that the 75th percentile implies an expectation of earning an 'above-normal' return, given the best estimate of the cost of capital is the

217 Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraph E11.2.

218 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 8.

219 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 155.

220 NZIER, Assessing the effectiveness of information disclosure, A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport, NZIER report to Air New Zealand, May 2013, p 4.

mid-point estimate.[221] However, given that the 75th percentile takes into account the consequences on investment of estimation error, consistent with s52(1)(a), we consider it acceptable to draw our conclusions about the effectiveness of information disclosure regulation by comparing expected returns to the 75th percentile, and not just to the mid-point.[222]

F64 The airports have submitted that a higher percentile should be used to assess returns as part of this s 56G review. Auckland Airport submitted that "using the 75th to 85th percentile for pricing purposes is entirely reasonable in the face of expect evidence that an increment of up to 1 percent should be applied to the Airport's WACC to account for asymmetric risk".[223]

F65 We consider that there is no compelling reason to move above the 75th percentile WACC in this case. 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).[224]

F66 Auckland Airport has not explicitly factored asymmetric risks into its cash flows.[225] However, given our 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.

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221 By ‘normal return’ we mean the expected return that investors require to invest in a business with the given level of systematic risk. Our best estimate of a normal return comprises both the mid-point WACC estimate and an allowance for the TCSD (if any). As explained in Attachment E, in this report we use the term 'excess returns' simply to refer to the returns calculated to be above the particular value of the WACC (eg mid-point or 75th percentile, depending on the scenario) given all the assumptions for that scenario. Therefore, if the analysis assumes the WACC value is at the 75th percentile, if expected returns equal that value then the analysis would result in a finding of no 'excess returns'. However, a finding of no excess returns will still require a consideration of whether excessive profits are being limited (refer Chapter 2).

222 We use a 75th percentile where we are administering price-quality regulation under Part 4. The 75th percentile WACC is used in that context to allow for the uncertainty of estimating the true cost of capital and in light of the direct consequences of estimation error on pricing and investment.

223 Auckland Airport “Auckland Airport’s submission on the Section 56G Review Process and Issues Paper 6 September 2012” 19 October 2012, paragraph 201.

224 Commerce Commission “Input Methodologies (Airport Services) Reasons Paper” December 2010, paragraph E12.1.

225 Auckland Airport “Section 56G Review of Auckland Airport: Post-Conference Submission” 15 March 2013, paragraph 76.

Differences between our cost of capital estimate and Auckland Airport's cost of capital estimate

F67 The parameters used by Auckland Airport to calculate its cost of capital estimate differ from those applied by the Commission. Auckland Airport has calculated a 75th percentile post-tax WACC of 8.88%.[226] Our April 2012 determination set a 75th percentile post-tax WACC of 8.04%.[227]

F68 Table F2 below summarises the key parameters used by Auckland Airport in calculating the cost of capital for PSE2. The parameters used by the Commission to set its April 2012 and July 2012 cost of capital determinations for Airports, as well as the 21 May 2012 estimate, are also included.

Table F2: Cost of capital parameters for Auckland Airport

Parameters	Commission's estimate of cost of capital 1 April 2012	Auckland Airport pricing decision 21 May 2012	Commission's estimate of cost of capital 21 May 2012	Commission's estimate of cost of capital 1 July 2012
Risk-free rate (%)	3.61	3.48[228]	3.08	2.78
Debt premium (%)	1.94	1.72	1.96	2.18
Debt issuance costs (%)	0.35	0.35	0.35	0.35
TAMRP (%)	7.00	7.50	7.00	7.00
Asset beta	0.60	0.65	0.60	0.60
Leverage (%)	17	30	17	17
Point estimate	50th - 75th percentile	75th - 85th percentile	50th - 75th percentile	50th - 75th percentile
Post-tax WACC (range)	7.06% - 8.04%	8.88% - 9.45%	6.68% - 7.67%	6.49% - 7.48%

Sources: Commerce Commission, "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10" 27 April 2012; Auckland Airport price setting disclosure, 2 August 2012; Commerce Commission, "Cost of capital determination for information disclosure year 2013 for Transpower, gas pipeline businesses and specified airport services (with a June year-end) [2012] NZCC 20" 30 July 2012.

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226 Auckland Airport "Price Setting Disclosure" 2 August 2012, page 23. Auckland Airport also used an 85th percentile estimate of 9.45%.

227 Commerce Commission "Cost of capital determination for information disclosure year 2013 for specified airport services (March year-end) and electricity distribution services [2012] NZCC 10" 27 April 2012, page 2.

228 The term of the risk-free rate used by Auckland Airport is seven years, compared to five years used by the Commission.

Consistent with the input methodologies, our estimated cost of capital does not include company-specific factors

F69 Auckland Airport submitted that "…it is important to take into account company-specific factors on a forward-looking basis for the entire pricing period…". The WACC used by Auckland Airport to set prices for PSE2 differs from the WACC IM in the following ways:[229]

F69.1 the term of the risk-free rate is seven years (compared to the five-year term specified in the IMs);

F69.2 the asset beta is 0.65 (compared to the IM benchmark of 0.60);

F69.3 leverage is 30% (compared to the IM benchmark of 17%); and

F69.4 the tax-adjusted market risk premium (TAMRP) is 7.5% (compared to 7.0% specified in the IMs).

F70 In setting the IMs, we considered the use of firm specific factors. For reasons set out in the IM reasons paper, we determined that a supplier which sets prices based on a higher estimate of its cost of capital than the actual cost at which capital is available in an industry cannot expect consumers to pay these higher prices.[230] Parties had extensive opportunities to submit on the IMs, and the final IM was our view of the best approach.

F71 As noted in the final s 56G report for Wellington Airport, the certainty intended by setting the IMs would be undermined if we made ad hoc adjustments to our published cost of capital estimates derived from IMs. We note, however, that while Auckland Airport is subject to company-specific risks, investors can diversify away such risks. The cost of capital reflects risk which investors cannot diversify away.

F72 Auckland Airport's expert, Dr Marsden, has argued that changes in pricing structure for PSE2 have increased the forward-looking systematic risk for Auckland Airport's aeronautical assets.[231] Exposure to systematic risk is measured by the asset beta. However, any potential increase in exposure to systematic risk faced by Auckland Airport has not been quantified. Further, it is not clear that Auckland Airport's pricing

229 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraphs 70 and 73.

230 Commerce Commission, "Input Methodologies (Airports) Reasons Paper, December 2010, paragraphs 6.2.2 to 6.2.7.

231 Specifically, Auckland Airport's forward-looking aeronautical prices have greater weighting towards passenger service charges. Uniservices "The Commerce Commission's Section 56G Review of Auckland International Airport Ltd: Asset Beta for Aeronautical Pricing and Treatment of Asymmetric Risk" 15 March 2013, pages 5 to 9.

structure is significantly different from the sample of 25 comparator airports used to estimate the asset beta in the cost of capital IM.

We consider our estimated cost of capital is commercially realistic

F73 Auckland Airport submitted that "there is a real risk that the theoretical position on WACC is diverging from business reality" and that "this will have a significant impact on whether Auckland Airport has the right incentives to invest and is able to attract the necessary capital to do so".[232] They pointed to:

F73.1 volatility in IM WACC estimates over short periods of time;

F73.2 a material disconnect between analyst reports and the Commission's WACC estimates; and

F73.3 a material disconnect between Auckland Airport's actual cost of debt and the Commission's estimate of the cost of debt.

F74 As discussed in the final s 56G report for Wellington Airport, we do not consider that additional reasonableness tests of our WACC estimate are required for this review.

F75 Volatility in IM WACC estimates reflects changes in the risk-free rate and debt premium over time. In the IMs we determined that using (more volatile) current interest rates is better than a long-term historical average because current rates will lead to estimated costs of equity and debt which more closely reflect changes in expectations in financial markets.[233] Having considered submissions, we decided that using current rates better achieves the Part 4 purpose.[234]

F76 Differences between the Commission's WACC estimate and market analyst's estimates appear to be largely driven by the use of a current risk-free rate compared to a longer term average.[235] The use of current (rather than historic) rates also explains any difference between Auckland Airport's actual cost of debt and the estimate based on IMs.

232 Auckland Airport "Section 56G Review of Auckland Airport: Post-Conference Submission" 15 March 2013, paragraph 72.

233 Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraph E4.11.

234 Commerce Commission "Input Methodologies (Airport Services) Reasons Paper" December 2010, paragraph E4.12.

235 For example, the Deutsche Bank WACC estimate for Auckland Airport (dated 21/02/2013) is based on a risk-free rate of 5% and the Macquarie estimate (dated 11/02/2013) is based on a risk-free rate of 4.5%. The 1 April 2012, 21 May 2012 and 1 July 2012 IM WACC estimates contained in Table F2 above are based on risk-free rates of 3.61%, 3.08% and 2.78% respectively. The most recent WACC estimate based on the IMs (as at 1 January 2013) used a risk-free rate of 2.96%.

F77 Market analysts will typically use a longer term risk-free rate, averaged over a long period, when estimating the WACC for Auckland Airport because they are seeking to estimate the company's value over the life of its assets and cash flows.[236] Our WACC estimate, on the other hand, is based on a shorter period to best match the risk-free rate for the five-year period over which we are analysing Auckland Airport's returns.[237]

Is Auckland Airport's demand forecast reasonable?

F78 In this section, our analysis focuses on whether Auckland Airport's demand forecast for PSE2 is appropriate. The demand forecast is an important determinant of the prices set by Auckland Airport, and through this, its actual profits.

F79 Based on submissions, we consider that Auckland Airport's overall demand forecast for PSE2 is unlikely to result in excessive profits. We also found that the demand forecast for PSE1 was also reasonable.

F80 Auckland Airport may have an incentive to under-forecast the demand used to derive its prices so as to earn higher profits. Prices are set by assuming a volume forecast for each charged service. These prices, combined with the volume forecast, should be set to recover only the revenue requirement forecast by Auckland Airport in its building block model. If volumes are then higher than assumed, Auckland Airport will receive higher total revenue and likely higher returns. However, higher volumes may also be a result of factors outside Auckland Airport's control, or due to superior performance in attracting additional passengers and aircraft over the regulatory period.

F81 Air New Zealand submitted that the passenger demand forecasts used by Auckland Airport to set prices for PSE2 reflect expectations of future demand, while BARNZ considers the forecast MCTOW growth is realistic.[238] However, Qantas consider Auckland Airport's passenger forecast to be conservative as it is below historic growth rates and BARNZ submitted that it considers an international growth forecast

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236 See the discussion at Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, pages 590-592, paragraphs H13.54 and H13.56. WACC estimates based on the IMs are updated for each regulatory period to reflect changes in interest rates.

237 Differences between investment bank estimates of the cost of capital (used in valuation reports) and cost of capital IM estimates are discussed in the IM reasons paper for EDBs and GPBs (in the context of valuations of Transpower commissioned by the New Zealand Treasury). See Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" December 2010, page 591, paragraph H13.56. The Forsyth Barr valuation of Transpower (dated 8 November 2011) is available here: http://www.comu.govt.nz/resources/pdfs/valuation-reports/tnz-vr-fb-11.pdf and the First NZ Capital valuation of Transpower (dated 31 October 2011) is available here: http://www.comu.govt.nz/resources/pdfs/valuation-reports/tnz-vr-f-11.pdf.

238 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 64; BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 34.

of 2.7% in 2013 is more appropriate than the 1.8% assumed in Auckland Airport's forecast.[239] We have tested the impact of using BARNZ's alternative growth forecast. The results from this analysis are shown in paragraph E32. BARNZ noted that in hindsight, Auckland Airport's forecast international passenger growth in 2013 was more accurate than its own.[240]

F82 BARNZ and Air New Zealand considered Auckland Airport's demand forecast for PSE1 was reasonable based on the information available at the time charges were set.[241] Actual passenger volumes were 3% lower than forecast overall, further indicating that Auckland Airport did not under-forecast demand in PSE1.

Activities included in our assessment of Auckland Airport's returns

F83 Our assessment of Auckland Airport's expected returns in PSE2 uses Auckland Airport's forecast revenues (and costs) for all of Auckland Airport's regulated activities. Table F3 shows Auckland Airport's total forecast revenue for the period which has been used in our returns assessment.

Table F3: Auckland Airport combined forecast revenue ($000)

	2013	2014	2015	2016	2017
Airport activity charges	206,082	219,890	231,353	242,856	254,562
Lease, rental and concession income	19,790	20,163	20,595	21,037	21,268
Total revenue	225,872	240,053	251,948	263,893	275,830

Note: The revenue from airport activity charges is not the same as that provided in Auckland Airport's pricing disclosure for PSE2. Instead, our analysis uses the revenue provided in the model used by Auckland Airport to set prices for PSE2.
Sources: Commerce Commission analysis of Auckland Airport "Auckland International Airport Limited: Price setting event disclosure", 2 August 2012; Auckland Airport pricing model airfield and terminal equalisation for PSE2.

F84 These forecast revenues differ from those reported by Auckland Airport in the pricing event disclosure, as Auckland Airport's pricing disclosure excludes the asset values and revenues from leased assets. The activities which involve leased assets are however included in the definition of specified airport services for the purpose of information disclosure regulation and have therefore been included in our analysis.

239 Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 7; BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 34.

240 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, page 64. Qantas did not suggest an alternative growth rate and we are not therefore able to quantify the impact of any other alternative demand forecasts.

241 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 66; BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 35.

Limitations of the information used in our analysis

F85 As noted in paragraph F27, the use of the 2012 information disclosure asset values (which include revaluations) as the opening value for our IRR analysis would not be consistent with the pricing asset values (which exclude revaluations). To be consistent with Auckland Airport’s moratorium, we sought to obtain from Auckland Airport the 'roll forward' to 2012 from the 2009 opening RAB for information disclosure that excludes revaluations on pricing assets. This information cannot be obtained from disclosures as there is no split between pricing and non-pricing assets for disclosure purposes. We were advised by Auckland Airport that an unreasonable amount of time would be necessary to reconstruct these values in detail. Auckland Airport has instead provided us with an estimate of these values which has been derived by removing from the 2012 disclosed values revaluations arising in 2010, 2011, and 2012.[242]

F86 We have attempted to reconcile the asset values provided to us by Auckland Airport, to ensure consistency between the asset valuations and the disclosed values under information disclosure, and also between the 2009 disclosed values for specialised assets and the values disclosed under the AAA.[243] We have not been able to fully reconcile these values and identification of all reconciliation issues can be found in the technical documentation supporting this report.[244] We do not consider these issues will give rise to any significant adjustments to the opening asset base used in our IRR analysis, and are therefore not material to our conclusions.

F87 For pricing purposes, Auckland Airport has assumed the seawall is part of its land assets and is not depreciated. The asset valuation IM recognises the seawall within Auckland Airport's specialised assets and depreciates this asset accordingly. To ensure consistency with Auckland Airport's approach to setting prices, we have

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242 The basis for the 2012 disclosed values for land is an independent MVAU valuation report prepared by Colliers dated June 2011 (and rolled forward one year), whereas the basis for the 2009 disclosed values is an independent valuation report, also prepared by Colliers, dated June 2009. The estimate provided by Auckland Airport does estimate the revaluation impact of the difference between the 2009 and 2011 valuations.

243 The information disclosure requirements do not require any reconciliation to be provided.

244 We have reconciled the 2011 disclosed land values to the 2011 Colliers MVAU report. We were unable to fully reconcile the 2009 disclosed RAB land values to the 2009 Colliers valuation, but the difference of $31.7m appears to relate to the exclusion of the seawall and to approximately $8.6m in allocation adjustments Similarly, there is a difference between the 2009 disclosed values of buildings (-$18.7m) from the values previously disclosed under the AAA regime (buildings was previously classified as two categories - buildings and services and infrastructure). Again, these differences appear to relate to the classification of the seawall, and allocation adjustments.

treated the seawall as a land asset in the opening asset value and, as such, have not depreciated this asset.[245]

F88 Our conclusion about the effectiveness of information disclosure in limiting the ability of Auckland Airport to earn excessive profits is not affected by the treatment of the seawall. If we had treated the seawall as a depreciable asset in our analysis (consistent with the IM), our estimate of Auckland Airport's expected return (using end of year cash flow timing) would reduce from 7.9% to 7.8%, largely due to a lower closing asset value.

Enhancements to the information disclosure requirements may provide stronger incentives to limit excessive profits

F89 As discussed in the s 56G report for Wellington Airport, incentives for airports to price consistent with the Part 4 purpose could be strengthened if each airport were required to disclose an indicator of its expected returns comparable to its cost of capital, along with the other information disclosed following a price setting event. Under the current disclosure requirements, after each price setting event airports must disclose information about how they have set their current and future prices. However, airports are not required to disclose an indicator of their expected returns for the relevant pricing period.[246] The inclusion of such an indicator would require additional information requirements than currently provided for under information disclosure, particularly information about the asset base expected to be used to set prices on an on-going basis.[247]

F90 The opening asset base for such a forward-looking profitability indicator should also reflect appropriate departures from input methodologies by airports, such as Auckland Airport's moratorium on asset revaluations, which has been reflected in its price setting decisions. Likewise, it would be appropriate that any indicator reflecting past returns also be consistent with the indexation, revaluation and depreciation decisions made by airports when they set their prices for the current pricing period, to ensure that incorrect conclusions about excess returns are not made. The asset valuation IM gives airports some flexibility in choosing the approach they take to valuing their assets. However, in future, it would be appropriate to ensure that this

245 We have adjusted the opening values by moving the value of the seawall ($23.0m) from infrastructure and buildings to land, consistent with Auckland Airport's pricing approach.

246 This indicator could be derived in the same way we have estimated expected returns in this section 56G review (ie, an IRR calculation that uses an estimate of the asset base expected to provide the basis for setting prices in the subsequent pricing period as the closing asset value).

247 Auckland Airport has stated that it does not consider these change to be appropriate (see Auckland Airport “Section 56G Review of Auckland Airport: Cross-Submission on Commerce Commission Draft Report” 14 June 2013, paragraphs 157 to 158). Any proposed changes to information disclosure requirements would be subject to consultation prior to implementation.

flexibility is only provided to ensure that the information disclosed applies the same assumptions underpinning prices (which can be set by airports as they see fit).[248]

F91 We also intend consulting on changes to the information disclosure requirements to better reflect the actual timing of cash flows. Our assessment of Auckland Airport's expected returns has focussed largely on a return calculated using an end of year assumption for cash flows. This is consistent with the assumption currently specified in information disclosure but provides conservative estimates of returns. Changes to this assumption would likely better promote the purpose of Part 4, and would be consistent with our approach to cash flow timing for the electricity distribution businesses and gas pipeline businesses regulated under Part 4.

[248] We also consider that requiring airports to disclose reconciliation between the asset values and other information used for pricing purposes, and the equivalent disclosure information, would assist interested persons in analysing disclosures.

Attachment G: Is information disclosure promoting improvements in operating efficiency at Auckland Airport?

Purpose

G1 This attachment summarises the analysis undertaken for this s 56G review to assess the effectiveness of information disclosure in promoting outcomes consistent with workably competitive markets such that Auckland Airport has incentives to improve operating efficiency (s 52A(1)(b) of the Act).

G2 Consistent with s 52A(1)(b), we have assessed whether Auckland Airport is improving its operating efficiency.

G3 Improvements in operating efficiency result from reductions in operational expenditure (opex) while maintaining (or even increasing) the quality and quantity of service provided as a result of improvements in managerial efficiency. Opex efficiency gains may also result from an increase in quantity or quality for no additional opex.

Conclusion

G4 We are unable to conclude whether information disclosure regulation is effectively promoting improvements in opex efficiency at Auckland Airport at this time. This is because we do not have a sufficiently long time series on actual operating expenditure to assess meaningful trends in opex at Auckland Airport since information disclosure regulation was implemented. Information on actual expenditure that is provided during PSE2 will assist in drawing conclusions on Auckland Airport's operating efficiency in the future.

G5 The key reasons for our view on the effectiveness of information disclosure regulation in this area are as follows.

G5.1 The evidence of improvements in opex efficiency at Auckland Airport since information disclosure regulation under Part 4 was implemented is mixed and inconclusive. Unit opex has both increased and exceeded the PSE1 forecast in 2011 and 2012, even when the unforeseen costs associated with Auckland Airport's route development activities are excluded. Although Auckland Airport has forecast unit opex to decline over PSE2, we would not expect forecast opex to reflect all expected future efficiency gains.

G5.2 We do not yet have actual expenditure information for PSE2 to assess whether Auckland Airport has been able to achieve lower opex than forecast, and the reasons for any differences. This will be an important indicator of whether Auckland Airport is improving its efficiency and whether information disclosure under Part 4 is effective in this area.

G6 We note that Auckland Airport does appear to seek to improve its operating efficiency. However, it is unclear whether this is a consequence of information disclosure regulation.

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to improve its opex efficiency

G7 Auckland Airport has an incentive to operate efficiently to increase its profits. This incentive is strengthened by Auckland Airport fixing its prices for a five-year pricing period. This gives Auckland Airport an incentive to improve efficiency so as to outperform the opex forecast in its building blocks model (ie, have lower actual expenditure than forecast) and earn higher profits.

G8 As discussed in our review of Wellington Airport, these incentives to operate efficiently are weakened because of Auckland Airport's market power. For example:

G8.1 Auckland Airport sets its prices, in part, based on its forecast of opex. Auckland Airport has an incentive to set this forecast above an efficient level so as to earn higher profits by outperforming this opex forecast without necessarily being efficient; and

G8.2 Auckland Airport may also have an incentive not to achieve efficiency gains in the last year of the pricing period. This results in a higher starting point than otherwise from which to forecast opex for the subsequent starting period.

How information disclosure can provide incentives to improve operating efficiency

G9 Information disclosure may strengthen Auckland Airport's incentives to operate efficiently. The public disclosure of information on historic and forecast opex provides transparency about how well Auckland Airport is performing relative to other suppliers and over time. Over time it can highlight if Auckland Airport has over-forecast opex for the purpose of price setting.

We expect that information disclosure would have had a relatively limited impact at this stage

G10 We expect that it will take a number of years for information disclosure regulation to be fully effective at promoting operating efficiency. That is because the effectiveness of information disclosure in this area is dependent on the availability of data to assess trends in expenditure, as well as to make comparisons with trends at other airports. The availability of this information potentially increases the countervailing power of consumers at Auckland Airport. This information was not available at the time of consultation for PSE2.

How we have assessed operating efficiency for the purpose of this review

G11 We have analysed whether information disclosure regulation is effectively promoting operating efficiency at Auckland Airport by examining:

G11.1 whether Auckland Airport has outperformed its opex forecast for PSE1, and the reasons for any over or under performance;

G11.2 the efficiency trend of Auckland Airport's historic opex expenditure. As part of this, we have examined historic trends in Auckland Airport's unit opex for the period 2006–12 and its unit opex relative to other airports; and

G11.3 evidence of forecast improvements in opex efficiency in PSE2, and Auckland Airport's conduct in establishing this forecast.

G12 Our analysis considers Auckland Airport's performance and conduct both before and after the introduction of information disclosure regulation to gain an insight into the impact of information disclosure regulation on promoting incentives to improve opex efficiency.

G13 To help understand the efficiency of Auckland Airport's opex, we have explored two unit opex measures: opex per passenger and opex per aircraft movement. We consider these are appropriate measures of Auckland Airport's unit opex as they are likely to reflect some of the drivers of Auckland Airport's variable costs.[249] Auckland Airport also sets a number of its prices on a per passenger or per movement basis.

G14 We do not have a sufficiently long time series of trends in actual opex data at Auckland Airport to conclude whether information disclosure regulation under Part 4 is effective in promoting improvements in operating efficiency. We expect to observe the effectiveness of information disclosure in promoting incentives to improve opex efficiency through actual performance, rather than forecasts. Auckland Airport's incentives to improve efficiency are strongest once prices have been set, as any efficiency improvements will result in higher profits. We do not therefore expect its opex forecast to accurately reflect improvements in efficiency. In order for us to draw conclusions concerning opex in this report, we would need to have actual information available. Since the implementation of information disclosure under Part 4, only two years of data are available which is insufficient for drawing out conclusions in this area.

G15 A disaggregated review of the different components of opex may provide further insights into whether Auckland Airport's forecast opex for PSE2 reflects improvements in efficiency. However, given the likely limited insights into the effectiveness of information disclosure regulation we do not consider the costs of requiring this information for the purpose of this review are appropriate. Furthermore, the specific concerns raised by airlines (discussed in paragraphs G35 to G38) will not have a significant impact on Auckland Airport's forecast opex.

[249] Changes in opex per aircraft movement may however also reflect changes in the size and capacity of aircraft.

G16 We expect that the availability of longer trends in time series information for opex for Auckland Airport and comparator airports in PSE2 through information disclosure, as well as information to assess differences between actual and forecast opex for PSE2 will better allow interested persons to assess whether Auckland Airport is improving its opex efficiency in PSE2.

Information used to assess opex efficiency at Auckland Airport

G17 Our analysis uses quantitative and qualitative data from the following sources:

G17.1 information disclosed under Part 4 and the AAA;

G17.2 information published by the Australian Competition and Consumer Commission (ACCC); and

G17.3 submissions and other material received as part of this s 56G review.

G18 All currency values in this attachment are expressed in real 2012 terms unless otherwise stated.[250]

Analysis of Auckland Airport's opex efficiency performance and conduct

Did Auckland Airport improve its operating efficiency in the first pricing period?

G19 There is no evidence of improving efficiency at Auckland Airport in PSE1. Unit opex has increased over PSE1 and at a faster rate than at Christchurch Airport, although at a slower rate than observed at Wellington Airport. Actual opex also exceeded forecast opex.

G20 However, we do note that much of the increase is related to the introduction of information disclosure regulation and the implementation of route development costs. The increased regulatory costs are to some degree affected by factors outside of Auckland Airport's control while route development costs may be an efficient cost if it attracts a sufficient increase in passengers in the future. This issue is discussed further in paragraph G37 below.

G21 To assess whether Auckland Airport has improved its operating efficiency during PSE1 we have compared actual and forecast opex during PSE1 and examined historic trends in unit opex at Auckland Airport as well as its unit opex relative to other regulated airports.

Comparisons between actual and forecast opex

G22 Auckland Airport's actual opex was higher that than forecast throughout PSE1, including following the introduction of information disclosure regulation in 2011. Auckland Airport has attributed this difference to route development and other

[250] We have calculated real values using the Statistics New Zealand consumer price index (CPI).

unforeseen costs. When these costs are excluded, actual opex in PSE1 more closely approximates forecast opex, although actual opex is still higher than forecast. However it is not clear that this is an appropriate comparison given that some of these unforeseen costs were within the control of Auckland Airport.

G23 Actual opex exceeded forecasts in PSE1 by 13% as illustrated in Figure G1 and Figure G2.[251] Auckland Airport has attributed much of this difference to unforeseen costs including:

G23.1 route development costs. These costs relate to marketing campaigns to attract new routes and airlines to Auckland Airport and accounted for over half of the difference. These costs were within the control of Auckland Airport;

G23.2 regulatory costs associated with the implementation of information disclosure. Based on our analysis, these account for approximately 17% of the difference and are likely to be within the control of Auckland Airport to some extent;[252] and

G23.3 repairs and maintenance expenditure, increases in the cost of cleaning contracts, and computer costs. These account for approximately 16% of the difference.[253]

Figure G1: Forecast and actual opex per passenger (2008–12)

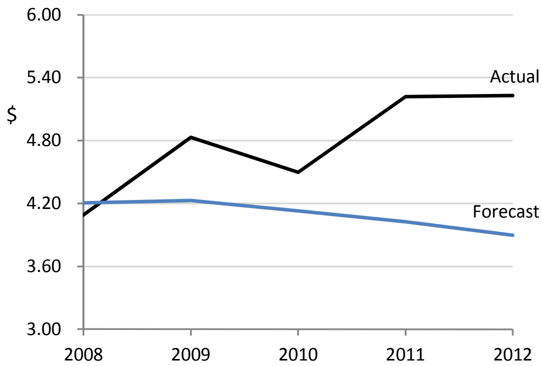
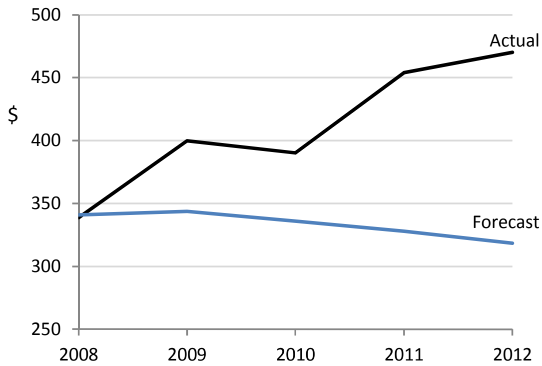


Figure G2: Forecast and actual opex per aircraft movement (2008–12)



Notes: Forecast and actual opex exclude aircraft and freight costs and leased areas as these were not included in the PSE1 forecast. Dollars shown are in real (2012) value.

251 Aircraft and freight costs and leased areas that were not included operating cost base for the first price setting event have been excluded from actual opex for comparability with forecasts.

252 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 239.

253 Auckland Airport "Response to Commission information request – 26 November 2012" 7 February 2013.

Sources: Auckland Airport "Identified Airport Activities Disclosure Financial Statements" 2008 to 2010; Auckland Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

G24 Actual opex exceeds forecast opex for 2011 and 2012 even when the unanticipated expenditure on route development activities is excluded. It is unclear to what extent the remaining variance is due to costs outside the control of Auckland Airport, or unanticipated costs that were efficiently incurred.

Historic trends in unit opex

G25 Figure G3 and Figure G4 shows that unit opex at Auckland Airport has varied over PSE1 (2007-12) but has trended upwards. There was a significant increase in opex per passenger in 2009 and 2011. This was due to a combination of increased operational costs and declining passenger numbers in these two years.

Figure G3: Actual opex per passenger (2006–12)

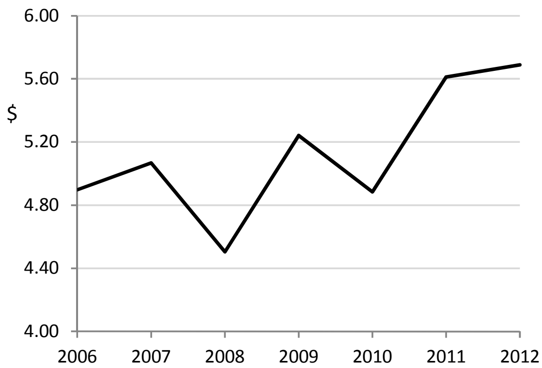
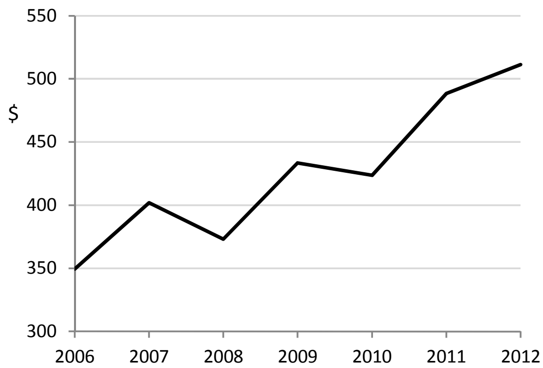


Figure G4: Actual opex per aircraft movement (2006–12)



Note: Figures include opex associated with aircraft, freight and leased areas. Dollars shown are in real (2012) value.
Sources: Auckland Airport "Identified Airport Activities Disclosure Financial Statements" 2006 to 2010; Auckland Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

Comparisons of unit opex between airports

G26 There is no evidence that Auckland Airport increased its operating efficiency in PSE1 when comparing its historical opex with other airports. Auckland Airport's unit opex increased at a slightly slower rate than at Wellington Airport during PSE1, as shown in Figure G5 and Figure G6. This is in contrast to Christchurch Airport which had declining opex up until 2010.

Figure G5: Indexed opex per passenger at Auckland, Wellington and Christchurch Airports (2006–12)

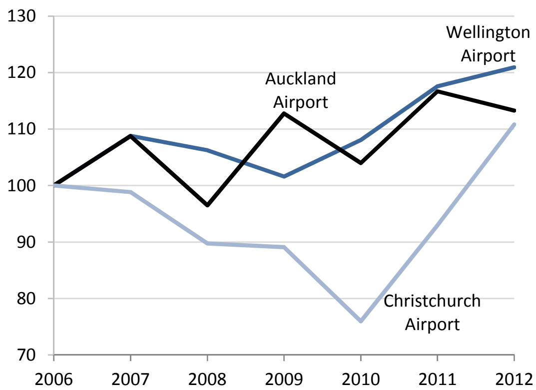
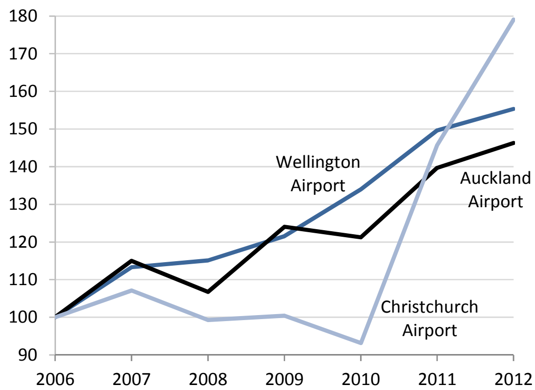


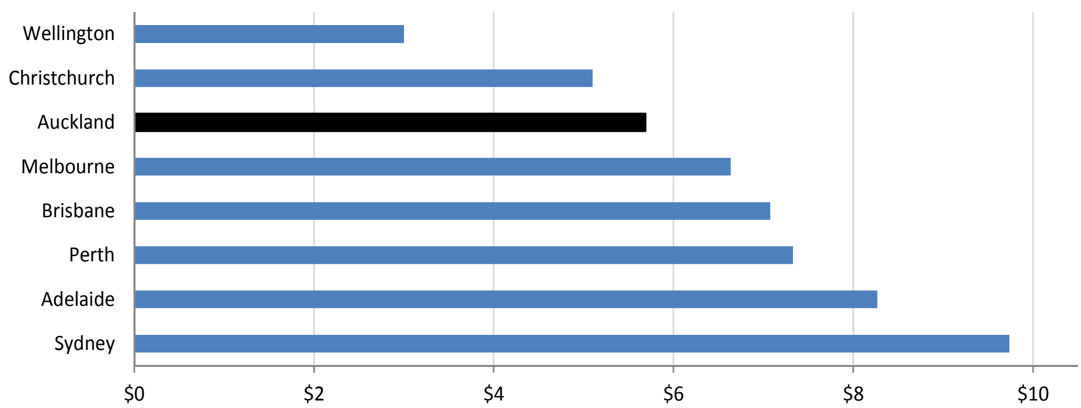
Figure G6: Indexed opex per aircraft movement at Auckland, Wellington and Christchurch Airports (2006–12)



Note: Graph shows differences in the rate at which unit opex has changed at the airports between 2006 and 2012. It does not represent differences in the level of unit opex.
Sources: Auckland Airport "Identified Airport Activities Disclosure Financial Statements" 2006 to 2010; Christchurch Airport "Identified Airport Activities Disclosure Financial Statements" 2006 to 2010; Wellington Airport "Identified Airport Activities Disclosure Financial Statements" 2006–10; Auckland Airport, "Specified Airport Services Annual Information Disclosure" 2011 to 2012; Christchurch Airport "Specified Airport Services Annual Information Disclosure"2011 to 2012; Wellington Airport "Specified Airport Services Annual Information Disclosure, 2011 to 2012.

G27 Our indicative analysis in Figure G7 and Figure G8 shows that Auckland Airport has higher unit opex relative to the other New Zealand regulated airports. This may be due to the relatively high proportion of international passengers at Auckland Airport. However Auckland Airport has lower unit opex than the regulated Australian airports. At this stage, due to a limited understanding and data on these differences, we cannot provide more detailed comparisons.

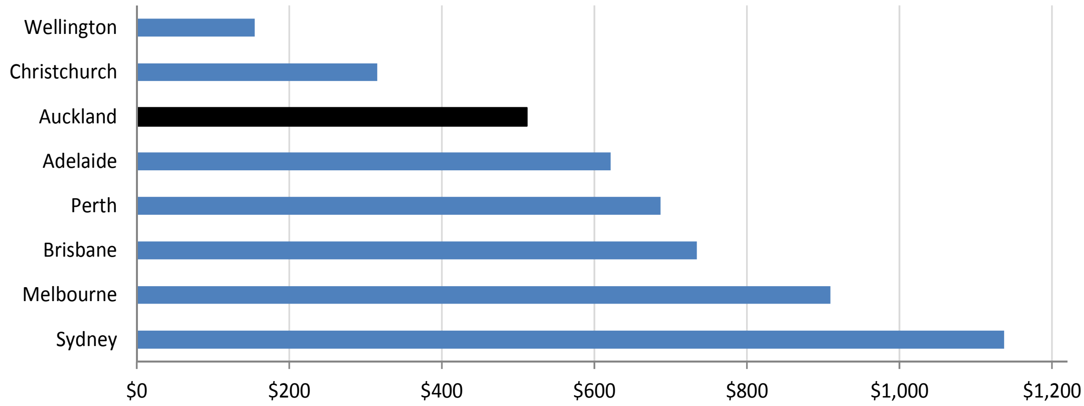
Figure G7: Opex per passenger (2012)



Notes: Australian currency converted to New Zealand currency based on a rate of $NZ1 = $A0.781.
Sources: Auckland Airport, "Specified Airport Services Annual Information Disclosure for year ending 30 June 2012"; Christchurch Airport "Specified Airport Services Annual Information Disclosure for year ending 30 June 2012"; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March

2012"; ACCC "Airport Monitoring Report 2011-12: Price, financial performance and quality of service monitoring", April 2013.

Figure G8: Opex per aircraft movement (2012)



Notes: Australian currency converted to New Zealand currency based on a rate of $NZ1 = $A0.781.
Sources: Auckland Airport, "Specified Airport Services Annual Information Disclosure for year ending 30 June 2012"; Christchurch Airport "Specified Airport Services Annual Information Disclosure for year ending 30 June 2012"; Wellington Airport "Specified Airport Services Annual Information Disclosure for year ending 31 March 2012"; ACCC "Airport Monitoring Report 2011-12: Price, financial performance and quality of service monitoring", April 2013..

Did Auckland Airport's opex forecast for the second price setting event indicate reasonable future efficiency gains?

G28 Auckland Airport's forecast suggests that the efficiency gains forecast for PSE2 may be reasonable, although airlines have raised concerns that the forecast starts from a historically high base.[254] Auckland Airport has forecast opex per passenger to decline in 2013 and continue to decrease over PSE2.

G29 To assess whether Auckland Airport's opex forecast for PSE2 indicates reasonable future efficiency gains, we have:

G29.1 considered forecast trends in unit opex at Auckland Airport, including relative to unit opex in PSE1. We would expect forecast opex to reflect some, but not necessarily all, expected future efficiency gains;

G29.2 benchmarked Auckland Airport's forecast unit opex in PSE2 relative to Wellington and Christchurch Airports' forecast expenditure in the same period. This provides an indication of whether any forecast efficiencies by Auckland Airport are appropriate;

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[254] BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 33; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 62.

G29.3 assessed whether any reductions in unit opex are due to economies of scale, and whether these economies are attributable to improvements in Auckland Airport's efficiency; and

G29.4 considered the views raised in submissions on this s 56G review.

Forecast trends in unit opex

G30 Figure G9 shows that opex per passenger at Auckland Airport is forecast to decline over PSE2 and by 2017 is expected to be less than 2010 levels. Figure G10 shows that opex per aircraft movement is also forecast to drop in 2013 and to remain flat over PSE2 at below 2012 levels. However, opex per aircraft movement is also driven by changes in aircraft size and capacity.

G31 Airlines have however raised concerns that the starting point for Auckland Airport's opex forecast for PSE2 is inappropriately high.[255]

G32 Much of the decline in opex per passenger over PSE2 is due to a reduction in route development costs over the period. Opex per passenger is still forecast to decline over PSE2 when route development costs are excluded from our analysis, and to be less than 2010 levels by 2017.

Figure G9: Opex per passenger (2008-17)

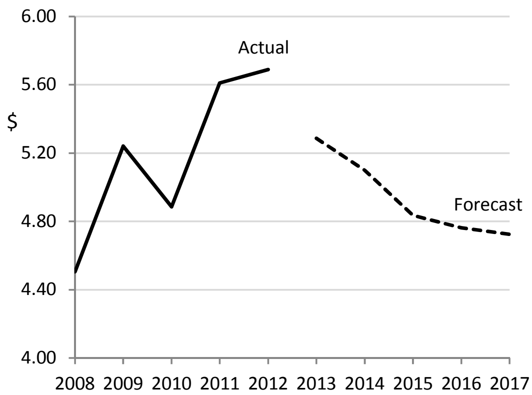
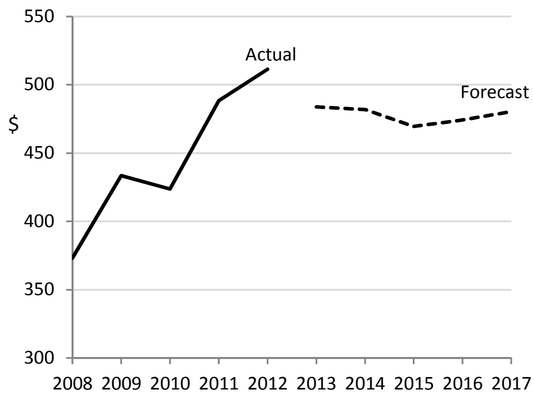


Figure G10: Opex per aircraft movement (2008-17)



Note: Dollars shown are in real (2012) value.
Sources: Auckland Airport "Identified Airport Activities Disclosure Financial Statements" 2006 to 2010; Auckland Airport "Specified Airport Services Annual Information Disclosure" 2011 to 2012.

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[255] BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 33; Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 62.

Comparison of forecast trends in unit opex

G33 Auckland Airport has forecast a similar decline in unit opex over PSE2 relative to Wellington and Christchurch airports, as shown in Figure G11 and Figure G12. This suggests that Auckland Airport's forecast reductions in unit opex may be reasonable. Although unit opex at Auckland Airport is higher over the whole period than the other two airports, as discussed above, it is not clear that such comparisons are appropriate.

Figure G11: Indexed opex per passenger at Auckland, Wellington and Christchurch Airports (2013-17)

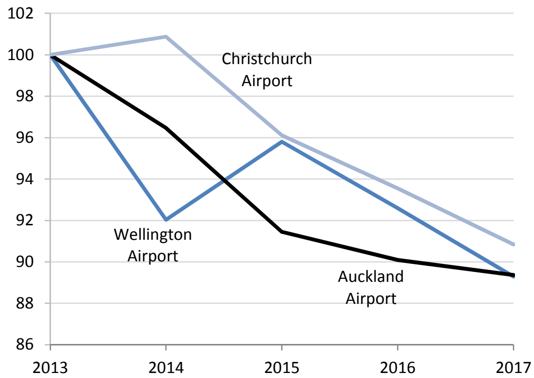
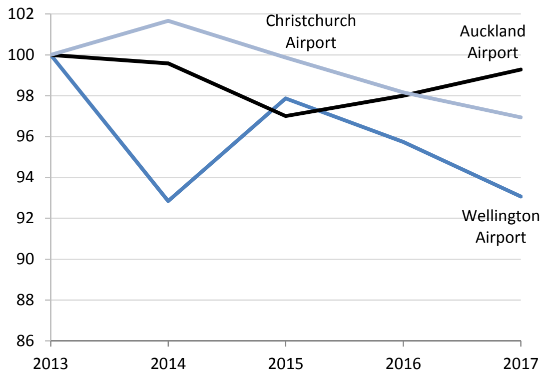


Figure G12: Indexed opex per aircraft movement at Auckland, Wellington and Christchurch Airports (2013-17)



Sources: Auckland Airport "Auckland International Airport Limited: Price setting event disclosure" 2 August 2012; Christchurch Airport "Christchurch International Airport Limited: Price setting event disclosure" 19 December 2012; Wellington Airport "Wellington International Airport Limited: Price setting event disclosure" 30 April 2012.

Economies of scale at Auckland Airport

G34 The reduction in Auckland Airport's forecast opex per passenger over PSE2 appears to be partly attributable to economies of scale. Auckland Airport's total opex is forecast to remain relatively flat over PSE2. However, opex per passenger is forecast to decline as a result of increasing forecast passenger numbers. Some of these economies of scale may be due to forecast increased demand resulting from Auckland Airport's route development activities, as discussed below. As such, these economies of scale may be, in part, attributable to efficiencies expected to be generated by Auckland Airport.

Concerns raised in submissions

G35 Airlines have expressed two main areas of concern regarding Auckland Airport's opex forecast for PSE2. These relate to route development costs and litigation costs associated with the information disclosure input methodologies.

G36 Airlines do not consider the inclusion of route development costs for specific airlines in the opex forecast for PSE2 is appropriate.[256] These costs relate to marketing activities to promote new international routes and airlines, with the intention of increasing passenger and aircraft volumes at Auckland Airport. BARNZ states that this cost is $9.35m, which accounts for 2.5% of total operating costs for PSE2.[257]

G37 We consider that some sharing of risk for route development costs is appropriate. This is because the route development activities may increase demand relative to a situation where these activities were not undertaken. Airlines may subsequently benefit from lower unit costs resulting from these increased volumes and economies of scale. Our analysis indicates that airlines may benefit from the forecast expenditure on route development in the long-term.[258]

G38 Auckland Airport has included litigation costs for a merits review against the input methodologies applicable to information disclosure regulation in its opex forecast for PSE2. Air New Zealand submitted that these costs should not be included as an aeronautical cost.[259] According to BARNZ, the litigation costs account for $4m over PSE2, which is approximately 1% of total opex forecast.[260] It is therefore unlikely that litigation expenditures on their own will have a significant impact on prices at Auckland Airport.

Does Auckland Airport's conduct indicate that it seeks to improve efficiency?

G39 There is some evidence to suggest that Auckland Airport does seek to improve its operating efficiency based on its conduct. However, it is unclear whether there has been any change in conduct since the introduction of information disclosure regulation. For example:

G39.1 Auckland Airport has led a "LEAN forum" with airlines and border agencies to identify initiatives to gain efficiencies from existing assets. According to Auckland Airport, these initiatives aim to optimise the use of its current

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256 Airlines accept the inclusion of route development costs which benefit all airlines in Auckland Airport's opex forecast for PSE2. See Commerce Commission, Transcript of Auckland Airport Section 56G Conference, held on 26 February 2013, pages 64 to 66.

257 BARNZ "Post Auckland Airport Section 56G Conference Submission" 15 March 2013, page 5.

258 We estimate that this would require international passenger volumes to increase by 1.1% to 1.4% per year during PSE2 as a result of Auckland Airport's route development activities, and for Auckland Airport to maintain these additional passenger numbers into PSE3. Auckland Airport has forecast growth in international passengers of 3.1% per year over PSE2. However, it is unknown what proportion of this forecast growth is due to route development. This analysis is based on all the route development costs that have been allocated to the aeronautical business.

259 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 62.

260 Based on information provided by BARNZ. See BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 30.

assets, mainly through faster processing of passengers for various terminal activities.[261] The LEAN forum was established in 2010, prior to the implementation of information disclosure regulation under Part 4;

G39.2 Auckland Airport's route development activities suggest it seeks to exploit economies of scale. Route development activities were first undertaken in 2010; and

G39.3 Auckland Airport introduced a "Fighting Fit" strategy in 2009, which included a workstream on cost efficiency.[262]

G40 Air New Zealand stated that Auckland Airport has maintained an adequate level of transparency with regard to engagement on its opex forecasts. [263] BARNZ notes that opex is difficult to engage on without detailed analysis by the airlines, but does not indicate that Auckland Airport has insufficiently consulted on its opex efficiency.

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261 Auckland Airport has provided the Commission several examples of initiatives that have been implemented. Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 195.

262 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 206.

263 Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 69 to 70.

Attachment H: Is information disclosure promoting incentives to invest efficiently at Auckland Airport?

Purpose

H1 This attachment summarises the analysis undertaken for this review to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive market outcomes such that Auckland Airport has incentives to invest and improve the efficiency of its investment (s 52A(1)(a) and (b)).

H2 Efficient investment is the investment in assets at the lowest possible cost over the lifetime of the assets, while delivering the required level of quality or output which is valued by consumers. The efficiency of an investment is assessed based on:

H2.1 the information available at the time the decision to invest was made; and

H2.2 the actual costs and delivery of an investment project once completed.

Conclusion

H3 We cannot conclude whether information disclosure regulation under Part 4 is effectively promoting efficient investment at Auckland Airport at this stage as we do not have actual investment information for PSE2. However, information disclosure regulation appears to have promoted an efficient investment plan for PSE2. Submissions have commended the consultation process for capex that was adopted by Auckland Airport at the second price setting event.

H4 The key reasons for our view on the effectiveness of information disclosure regulation in this area are outlined below.

H4.1 Submissions have commended the consultation process that was adopted by Auckland Airport. This process gave airlines the opportunity to prioritise capex projects in PSE2, in contrast to PSE1. Auckland Airport's conduct in this area for PSE2 has led to airlines generally agreeing that the level and timing of investment planned for PSE2 is efficient based on the circumstances at the time.

H4.2 We do not yet have a sufficiently long time series on actual capital expenditure to assess whether investment is being made in a timely and efficient manner.

H4.3 It is not clear to what extent information disclosure has had an impact on the efficiency of Auckland Airport's planned investment and its conduct in this area. Auckland Airport considers that information disclosure has provided it with a useful reference point for expenditure forecasts for PSE2.

It states that this has resulted in less disagreement between parties in consultation.[264] However, BARNZ and Air New Zealand consider that this improved conduct at Auckland Airport may also be due to other factors.[265] This indicates that information disclosure does not appear to have negatively affected existing incentives to plan efficient investment.

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to invest efficiently

H5 Auckland Airport has some incentives to invest efficiently. Auckland Airport sets its prices for a five-year pricing period. Setting its prices for a fixed period provides Auckland Airport with an incentive to invest efficiently so as to outperform the capex forecast in its building blocks model (ie, have lower actual expenditure than forecast), and therefore earn higher profits. Under s 4C of the AAA Auckland Airport is also required to consult on large capex programmes with its substantial consumers.

H6 As discussed in our review of Wellington Airport, some of these incentives to invest efficiently are weakened because of Auckland Airport's market power. For example:

H6.1 Auckland Airport has an incentive to set its capex forecast above an efficient level to justify higher prices through its building blocks approach. This allows it to then earn higher profits by outperforming this forecast without necessarily being efficient;

H6.2 Auckland Airport may choose to defer investment beyond the point at which it is efficient to invest so as to reduce its costs within the pricing period. Auckland Airport may also choose to forecast investment earlier in the pricing period than would likely occur. Where the timing of investment differs from the forecast used to set prices, Auckland Airport may earn higher profits; and

H6.3 under the building blocks model that it uses to set prices, Auckland Airport's prices are based on the size of its asset base. If it is targeting the recovery of an excessive cost of capital on its asset base, it may have an incentive to over-invest to increase the size of its asset base. This is because it could earn higher profits if the targeted cost of capital on that investment exceeds the economic cost of financing the investment. However, as discussed in Attachment E, our analysis suggests the Auckland Airport has targeted a return in PSE2 that is within our estimated range of acceptable returns.

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[264] Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraphs 277 to 279.

[265] Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 52 to 53.

How information disclosure can provide incentives to improve investment efficiency

H7 Information disclosure may strengthen Auckland Airport's incentives to invest efficiently. The public disclosure of information on historic and planned capex can provide transparency about how well Auckland Airport is performing relative to other suppliers and over time. Over time, it can highlight if Auckland Airport over-forecasts capex or forecasts capex to occur too early in the pricing period for the purpose of price setting.

H8 We expect information disclosure regulation will only become as effective as it can be, in terms of promoting efficient investment, over time. That is because the effectiveness of information disclosure is dependent on the availability of data to assess trends, and the opportunity for suppliers and consumers to react to the information disclosed. At the time of consultation for PSE2, only limited information on Auckland Airport's capex was available in information disclosure.

How we have assessed whether Auckland Airport is investing efficiently

H9 Our approach to assessing investment for this review is to consider Auckland Airport's performance and conduct regarding investment. We have looked for evidence of:

H9.1 the delivery of investment at lowest possible cost, without compromising quality or outputs and delivering the desired outcome. As part of this we have reviewed the actual and forecast capex of Auckland Airport in PSE1;

H9.2 planned under-investment and over investment; and

H9.3 planned and actual investment occurring at an appropriate time.

H10 We have also considered the conduct of Auckland Airport when planning, consulting on and delivering capital projects.

H11 Given that there is little concern from the airlines about Auckland Airport's capex forecast for PSE2, we have not undertaken a detailed review of its capex forecasts and supporting business cases. We did not consider the costs of undertaking such a review were appropriate to address relatively minor concerns with Auckland Airport's capex forecast for PSE2. Our analysis of the efficiency of Auckland Airport's capex therefore relies to a large extent on submissions received as part of this s 56G review.

Information used to assess whether Auckland Airport is investing efficiently

H12 Our analysis uses quantitative and qualitative data from the following sources:

H12.1 information disclosed under Part 4; and

H12.2 submissions and other material generated as part of this s 56G review.

Analysis of Auckland Airport's investment performance and conduct

Is Auckland Airport investing efficiently?

Does Auckland Airport deliver investment for an efficient cost?

H13 At this time, we do not have actual expenditure information for PSE2 to assess the effectiveness of information disclosure in promoting the efficient delivery of capex.

H14 We are unable to conclude whether Auckland Airport has delivered capex in PSE1 at an efficient cost. Some projects incurred higher costs than forecast. The actual costs of other projects were less than forecast, including the Northern Runway. However, it is not clear to what extent the forecast for these projects was appropriate.

H15 Auckland Airport's capex in PSE1 was 11% lower than forecast, partly due to the postponement and reprioritisation of projects. Table H1 shows that significantly less was spent on some specific projects than forecast. This includes the first stage of a new Northern Runway, which was postponed by Auckland Airport from 2009, and the airfield pavement rehabilitation program, which was reprioritised due to weaker economic conditions and lower aircraft movements. When excluding these two projects, actual capex is 13% higher than forecast.

Table H1: Forecast and actual capex at Auckland Airport (2008-12)

Program	Forecast ($m)	Actual ($m)	Difference from forecast ($m)	(%)
Expanded arrivals	41.7	41.2	-0.5	-1
Airfield pavements rehabilitation	39.8	14.0	-25.9	-65
Stage 1A (stands and connector)	36.5	47.0	10.5	29
Northern Runway (stage 1)	35.4	9.2	-26.2	-74
Domestic Terminal Building works	6.8	6.6	-0.2	-2
Meeters and greeters, forecourt management and emigration	17.1	21.8	4.7	28
Terminal Precinct	11.8	9.2	-2.6	-22
Pier B Hardstand (stage 2)	8.4	7.0	-1.4	-17
Engine run-up	8.0	0.0	-8.0	-100
Noise prevention	5.2	6.2	1.0	20
Other capex	44.6	65.5	20.9	47
Total	255.3	227.6	-27.7	-11

Note: Figures reported in $ million (nominal values).
Sources: Auckland Airport "Auckland International Airport Limited: FY08-FY12 Price setting Disclosure" 27 October 2011; Auckland Airport "Specified Airport Services Information Disclosure Requirements Information Templates for year ending 30 June 2012".

Is there evidence of planned under or over investment at Auckland Airport?

H16 There is no evidence of any planned under or over investment in Auckland Airport's capex forecast for PSE2. Airlines generally consider that the projects planned for PSE2 reflect an efficient level of investment and have taken into account the priorities of the airlines.[266] This appears to be due, in part, to the consultation on its planned investment in PSE2 undertaken by Auckland Airport.

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266 Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 63; BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 31; Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 52 to 53. Qantas submitted concerns regarding the $29m expenditure planned for the domestic terminal upgrade given its five year depreciation profile. See Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, page 6. BARNZ and Air New Zealand's understanding is that there

H17 The evidence available suggests Auckland Airport did not plan to under or over-invest in PSE1, with the potential exception of the planned investment in the Northern Runway as discussed below. Submissions have raised few other concerns with under or over investment at Auckland Airport in PSE1. Auckland Airport's reprioritisation of various projects planned in PSE1, as discussed in paragraph H19, may also indicate that it actively sought to avoid any under or over investment.

Is investment planned and undertaken at an appropriate time?

H18 Submissions generally agree that investment planned for PSE2 is taking place at an appropriate time. We are unable at this time to assess whether investment is subsequently undertaken at an appropriate time.[267]

H19 While airlines have concerns that investment was not planned for an appropriate time in PSE1, there is some evidence that Auckland Airport subsequently undertook investment at an appropriate time.[268] BARNZ considered that the planned investment in the Northern Runway in PSE1 was occurring ahead of time.[269] Auckland Airport subsequently postponed work on the Northern Runway as a result of the economic recession and increased aircraft size.[270] Airlines have not expressed any concerns regarding the efficiency of this reprioritisation of the Northern Runway or any other project that occurred in PSE1. We also observe that Auckland Airport's timing of actual capex in PSE1 did not deviate significantly from that planned in its forecast. This suggests that it did not systematically forecast capex to occur earlier in the regulatory period than the investment is likely to occur so as to earn higher profits. This was raised as a concern by airlines in relation to Wellington Airport.[271]

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would be a wash-up should the terminal upgrade have a longer asset life. See Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 55 to 56.

267 Qantas has expressed concern that Auckland Airport is proposing to delay projects associated with the new terminal. Auckland Airport has responded that the new terminal is scheduled to be completed on time. Qantas Airways "Submission on Commerce Commission Section 56G Draft Report relating to Auckland Airport" 31 May 2013, page 1; Auckland Airport "Section 56G Review of Auckland Airport: Cross-Submission on Commerce Commission Draft Report" 14 June 2013, paragraph 86.

268 Although Qantas has expressed concern that customers have paid for planned capex in PSE1 that never eventuated, and would effectively be charged for this capex again. See Qantas Airways "The Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport" 24 October 2012, paragraph 3.6.

269 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 31.

270 Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraph 47.

271 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, paragraph H18.

Does Auckland Airport's conduct reflect that it seeks to invest efficiently?

H20 There is evidence of an improvement in Auckland Airport's conduct for PSE2 relative to PSE1. Airlines consider that the consultation process adopted by Auckland Airport for PSE2 allowed constructive engagement and enabled the airlines to prioritise projects. For example;

H20.1 Air New Zealand states that the process undertaken by Auckland Airport in determining its capex priorities for PSE2 was robust, transparent, and inclusive;[272] and

H20.2 BARNZ states that the Auckland Airport's inclusion of airline priorities as a fundamental part of capex planning is a first for airports in New Zealand.[273]

H21 However both Air NZ and BARNZ consider that this improved conduct at Auckland Airport may also be due to factors other than information disclosure. Instead, they attribute it to maturation and a return to best practice.[274]

H22 The exclusion of the New Terminal Facility from forecast capex by Auckland Airport is evidence that it seeks to consult thoroughly with airlines on this major investment before including the terminal as a part of charges.[275]

[272] Air New Zealand "Submission to the Commerce Commission: Commerce Act 1986, Part 4 – Section 56G Review of Auckland International Airport" 19 October 2012, paragraph 63.

[273] BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 32.

[274] Commerce Commission, *Transcript of Auckland Airport Section 56G Conference*, held on 26 February 2013, pages 52 to 53.

[275] Auckland Airport "Auckland Airport's submission on the Section 56G Review Process and Issues Paper 6 September 2012" 19 October 2012, paragraphs 338 and 364e.

Attachment I: Is information disclosure promoting the sharing of efficiency gains with consumers at Auckland Airport?

Purpose

I1 This attachment summarises the analysis undertaken by the Commission to assess the effectiveness of information disclosure regulation in promoting outcomes consistent with workably competitive markets such that Auckland Airport shares the benefits of efficiency gains with consumers, including through lower prices (s 52A(1)(c) of the Act).

I2 In a workably competitive market, efficiency gains achieved by a supplier are likely to be shared with consumers over time through lower prices. Efficiency gains may also be shared through improvements to service quality or additional investment at no cost to consumers.[276] Our focus is on sharing efficiency gains made in the supply of regulated services. Some of these efficiency gains may arise as a result of providing regulated and unregulated services in combination (ie, economies of scope).

I3 To assess whether a supplier is sharing efficiency gains, an assessment first needs to be made of whether it is achieving efficiency gains. This is discussed in Attachments G and H.

Conclusion

I4 We are unable to conclude whether Auckland Airport is sharing the benefits of operating and investment efficiency gains with consumers and whether information disclosure is effective in this area. This is because there is limited evidence of historic efficiency gains at Auckland Airport that could be shared with consumers when setting prices for PSE2.

How we have assessed the effectiveness of information disclosure

Incentives on Auckland Airport to share efficiency gains with consumers

I5 Auckland Airport has weak incentives to share efficiency gains with consumers. Auckland Airport's decision to set prices using a building blocks model provides some incentive to share efficiencies by making it more transparent whether efficiency gains have been made and shared. However, although Auckland Airport is required to consult with its customers on pricing, its ability to set charges as it sees fit means

[276] Auckland Airport submitted that behaviour which drives efficiencies for consumers and passengers is also sharing efficiency gains. Auckland Airport “Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report” 31 May 2013, paragraph 216. We consider that this is an aspect of service quality and is discussed further in Attachment C.

it is unlikely to have strong incentives to promote the sharing of efficiency gains outcomes sought under Part 4.

How information disclosure can provide incentives to share efficiency gains

I6 Information disclosure can strengthen incentives to share efficiency gains by increasing transparency of whether efficiency gains have been made and allowing interested persons to assess whether these have been shared with consumers. If efficiency gains are not shared with consumers over time, then this can indicate that excessive profits are being earned. This may increase the likelihood of further regulation. However, the ability of information disclosure regulation to be effective in this area relies on Auckland Airport making or forecasting efficiency gains in the first instance.

I7 Information disclosure may potentially provide an incentive to share efficiency gains resulting from economies of scope through the cost allocation IM.[277] This implicitly requires common costs to be allocated between Auckland Airport's regulated aeronautical services, and its non-aeronautical services. The IM may help ensure that efficiency gains in common costs that are achieved through the joint supply of aeronautical and non-aeronautical services are shared with consumers of aeronautical services.

We expect that information disclosure would have had a relatively limited impact at this stage

I8 We expect information disclosure regulation will only become as effective as it can be in this area over time. This is because we expect information disclosure regulation to be as effective as it can be in this area at price setting events. This is when efficiency gains are most likely to be shared with consumers through the prices set and investments planned. However, the effectiveness of information disclosure is dependent, in part, on information on historic efficiency gains. Information on trends in Auckland Airport's expenditure was not available through information disclosure at the time prices were set for PSE2 to assess whether efficiency gains had been made and to thereby influence the prices set or investments planned.

I9 At this time we consider that information disclosure regulation has not provided any disincentives for making efficiency gains or sharing them with consumers.[278]

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[277] Economies of scope arise when it is less expensive to produce different types of goods or services together rather than separately.

[278] Our future summary and analysis reports on the information disclosed under Part 4 will likely consider the treatment of efficiency gains in considering profitability and may therefore have incentive effects in this area.

How we have assessed whether Auckland Airport is sharing efficiency gains for the purpose of this review

I10 Our approach considers whether any historic or forecast efficiency gains are being shared with consumers through lower prices. As part of this, we examined:

I10.1 whether prices set by Auckland Airport reflect efficiency gains achieved in previous pricing periods (ie, between period sharing);

I10.2 whether prices set by Auckland Airport reflect any forecast efficiency gains for the pricing period (ie, within period sharing); and

I10.3 whether Auckland Airport has any explicit mechanisms for sharing efficiency gains that are not forecast.

I11 We also considered whether efficiency gains have been passed on in improvements to service quality at Auckland Airport or investment in aeronautical assets, at no cost to consumers.[279] This would mean that these investments or improvements are not funded through the prices set by Auckland Airport during the price setting event.

I12 We have assessed whether Auckland Airport is sharing efficiency gains with consumers both before and after the introduction of information disclosure regulation. This provides insight into the effectiveness of information disclosure regulation in promoting the sharing of efficiency gains.

Information used to assess whether Auckland Airport is sharing efficiency gains

I13 Our analysis relies on information provided by Auckland Airport in its disclosures for PSE1 and PSE2, and our assessment of the efficiency of Auckland Airport's operational and capital expenditure discussed in Attachments G and H. We have also considered submissions received as part of this s 56G review on whether Auckland Airport has shared efficiency gains.

Analysis of Auckland's Airports performance and conduct

I14 We are unable to conclude whether prices set by Auckland Airport reflect efficiency gains achieved in previous pricing periods. As discussed in Attachments G and H, the evidence of whether Auckland Airport has achieved efficiency gains historically is inconclusive. Auckland Airport submitted that its efficiency initiatives have resulted in asset utilisation benefits. It suggests that consumers have benefitted through greater asset productivity in PSE1 and PSE2.[280] Auckland Airport has also submitted that forecast unit costs have reduced as a consequence of increase volumes resulting

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[279] For example, an airport may choose to share efficiency gains through investment in new lounge facilities without these being funded through the prices it charges for its services.

[280] Auckland Airport "Auckland Airport's Cross Submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012" 9 November 2012, paragraph 165.

from its route development initiatives undertaken in PSE1.[281] Prices may therefore be lower relative to prices if such efficiency initiatives had not been undertaken.

I15 Similar to PSE1, prices for PSE2 reflect the efficiencies included in Auckland Airport's expenditure forecasts. This is because the building block model used by Auckland Airport to determine the revenue requirement includes forecasts of operational and capital expenditure. Forecast efficiency gains that are included in these expenditure forecasts (including any economies of scale) will therefore automatically be reflected in lower prices through the revenue requirement. However, it is not clear to what extent any forecast operating efficiency gains for PSE2 are appropriate given the perceived high costs in the base year.

I16 Relative to PSE1, Auckland Airport has fewer explicit mechanisms for sharing efficiency gains that were not forecast. The TSC provided a mechanism in PSE1 for sharing any efficiency gains through an annual wash-up to reflect actual costs. This charge has been removed for PSE2. Although the removal of the TSC reduces the sharing of efficiency gains, it provides additional incentives to improve efficiency and, as discussed in Attachment D, may improve certainty and price stability.[282] As such, its removal appears to still be consistent with the Part 4 purpose.

I17 We are not aware of any examples of actual or planned improvements in quality or investment for aeronautical services at Auckland Airport that result from efficiency gains and were not funded through prices set for PSE2 or for PSE1.

281 Auckland Airport "Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report" 31 May 2013, paragraph 215.

282 BARNZ "BARNZ responses to Commerce Commission Section 56G Issues Paper relating to Auckland Airport" 18 October 2012, page 42; BARNZ "BARNZ Cross-submission to Submissions made on the Commerce Commission's Section 56G Issues Paper relating to Auckland Airport" 9 November 2012, page 5.