

Input methodologies review

Amendments to input methodologies for airports land valuation

Final reasons paper for the airports fast track review

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Commerce Commission
Wellington, New Zealand

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1. Introduction

Purpose of paper

1. This paper sets out the reasons for our decisions on the amendments to the Airport input methodologies for application of the Market Value Alternative Use (MVAU) land valuation methodology.

Background

2. Specified airport services provided by Auckland International Airport Limited (AIAL), Christchurch International Airport Limited (CIAL), and Wellington International Airport Limited (WIAL) are regulated under Part 4 of the Commerce Act 1986 (the Act).
3. We determined the Airport input methodologies (IMs) in 2010. Our determination included IMs for the valuation of land assets.¹
4. In our reasons paper accompanying the Airport IMs, we explained our approach to undertaking land valuation using an opportunity cost concept.² The Airport IMs implementing the opportunity cost concept approach, by requiring the application of an MVAU methodology, were set out in Schedule A of the Airport IMs. The reasons for our approach, and how the opportunity cost concept was to be applied to land valuation for airports, were set out in our 2010 Reasons Paper.³
5. Regulated airports have undertaken two valuations, one in 2009 and another in 2011. In our review of valuations undertaken under s 56G of the Act, we noted broad differences in the land valuations between airports and airlines.⁴

¹ Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 (Decision No. 709, 22 December 2010).

² 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), paras. 4.2.18 – 4.2.19, 4.3.2 – 4.3.3.

³ 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), paras. 4.3.55 – 4.3.79.

⁴ For example, WIAL and BARNZ's valuations differed by approximately \$37 million – see "Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport" (Commerce Commission, 8 February 2013), para. F23.

Amendments are part of the IM review

6. Under section 52Y of the Act, we must review each input methodology no later than 7 years after its date of publication.
7. On 10 June 2015, we issued a Notice of Intention announcing the commencement of work on a review of IMs with the intention of reaching final decisions by December 2016. As part of that announcement, we explained our intention to consider certain amendments to the Airport IMs on a fast track timeframe.⁵
8. On 3 July 2015 we gave notice confirming our intention to fast track consideration of certain issues relating to the Airport IMs for land valuation for airports.⁶
9. The purpose of the fast track process was to consider amendments to the application of the MVAU land valuation methodology, including narrowing the potential range of airport land values derived under the requirements and updating the requirements to align them with current valuation standards and practices.
10. We decided to fast track the consideration of amendments to the MVAU land valuation methodology so that the amended IMs would be in place well in advance of the 2017 price setting events for AIAL and CIAL, given that airports may undertake a new MVAU valuation in accordance with Schedule A at any time.
11. The decisions set out in this paper and in the accompanying Airport IM amendments determination complete the fast track process we commenced for our review of the application of the airport land valuation methodology. The main review of Airport IMs, including the appropriateness of using MVAU for airports' land valuations, will be considered as part of the wider Airport IM review.

⁵ Commerce Commission, "Cover Letter for the Notice of Intention to commence a review of input methodologies" (10 June 2015).

⁶ Commerce Commission "Amended notice of intention – Input Methodologies Review" (3 July 2015).

How we have applied our decision-making framework

12. Our decision broadly follows the decision-making framework set out in our draft framework for the IM review, in which we proposed to focus on the following questions when reviewing our IMs:⁷
- 12.1 Is the policy intent behind the IM still relevant and appropriate?
 - 12.2 Is the current IM achieving that intent?
 - 12.3 Could the current IM achieve the policy intent better?
 - 12.4 Could the current IM achieve the policy intent as effectively, but in a way that better promotes s 52R or reduces complexity or compliance costs?
 - 12.5 Do changes to other IMs require any consequential changes to the IM in question for internal consistency or effectiveness reasons?
13. As we signalled in our process update paper, this fast track process was focused on how the MVAU land valuation methodology is applied, and is not a review of its appropriateness.⁸ Our decision does not therefore consider the continued relevance and appropriateness of the MVAU land valuation methodology (ie, whether the policy intent behind MVAU approach is still relevant and appropriate), though it does take into consideration the relevance and appropriateness of the current application of that methodology in respect of airport's land valuation.
14. The differing interpretations of the MVAU rules, and the wide differences in valuation identified in our s 56G reports and subsequent summary and analysis, highlighted the need for providing further clarity to the Airport IMs land valuation requirements.

⁷ Commerce Commission "Developing decision-making frameworks for the current input methodologies review and for considering changes to the input methodologies more generally – DISCUSSION DRAFT" (22 June 2015), Attachment A, para. 8.

⁸ Commerce Commission "Input methodologies review process paper – update on fast track amendments" (3 July 2015), para. 25. Our review of the appropriateness of using an MVAU methodology for land valuation will be considered as part of the wider IM review process following release of this decision.

15. Having reviewed the application of the MVAU land valuation requirements and decided which Airport IMs to consider changing, we have turned our minds to whether and how to change them, taking into consideration the status quo and solutions that might lie outside of the Airport IMs (such as the Airports ID determination⁹). In deciding what changes are appropriate, we have considered whether the changes:¹⁰

15.1 Promote the Part 4 Purpose in s 52A of the Act more effectively;

15.2 Promote the IM purpose in s 52R of the Act more effectively, without detrimentally affecting the promotion of the s 52A purpose;

15.3 Significantly reduce compliance costs, other regulatory costs or complexity, without detrimentally affecting the promotion of the s 52A purpose.

Process to date

16. On 3 July 2015 we issued an updated Notice of Intention on our proposal to fast track the review of the Airport IMs relating to land valuation.¹¹ Our process paper issued on the same day provided an explanation for the intended timing and process for the review and considering any potential amendments.

17. We signalled in that notice that our draft decision on the airport land valuation methodology Airport IM review and draft Airport IM amendments would be focused on:

17.1 Narrowing the potential range of airport land values that can be derived under the requirements, including removing potential compliance ambiguities; and

17.2 Updating the airports land valuation requirements so they align to the current valuation standards and valuation industry practices applying in New Zealand.¹²

⁹ Airport Information Disclosure Determination (Commerce Commission Decision 715, 22 December 2010).

¹⁰ Commerce Commission “Developing decision-making frameworks for the current input methodologies review and for considering changes to the input methodologies more generally – DISCUSSION DRAFT” (22 June 2015), para. 5.

¹¹ Commerce Commission “Amended notice of intention – Input Methodologies Review” (3 July 2015).

¹² In our process update paper, we also proposed considering when land valuation methodology amendments will apply. In our draft decision, we decided that a decision on when the land valuation methodology amendments must be applied to previous valuations should be considered through the ID determination amendment process. The ID determination amendment process is discussed in Chapter 5.

18. We also engaged Ernst & Young (EY) to make recommendations on potential amendments to the land valuation methodology, and to assist us in the Airports fast track process.
19. On 2 October 2015, we held a workshop with stakeholders, facilitated by EY, to better understand stakeholders' views on the factors that drive differences in valuation outcomes under the MVAU, and to identify possible changes to this methodology and its process.
20. On 10 November, we released our draft decision on the Airport IM review of the application of the MVAU airport land valuation methodology.¹³ Submissions were received from the Board of Airline Representatives New Zealand (BARNZ), the New Zealand Airports Association (NZAA), and WIAL. Cross-submissions were received from BARNZ, NZAA, and AIAL.

Scope of this paper

21. The amended MVAU land valuation requirements we have determined today will be required to be applied by any valuer undertaking a valuation for an airport.
22. In our draft decision, we advised that we expected to commence a separate process under s 52Q of the Act to consider changes to the Airports ID determination:
 - 22.1 That may be necessary or appropriate in order to give effect to any amendments made as part of this fast track Airport IMs review;
 - 22.2 Where, as part of this review, we have identified issues we consider it appropriate to address in the Airports ID determination rather than amend in the Airport IMs determination.
23. There are a number of matters which we consider may be appropriate to address through an amendment to the Airports ID determination, including:
 - 23.1 Whether to require an explanation and reconciliation of changes in subsequent valuations;
 - 23.2 Whether to require an explanation and reconciliation of differences between subsequent MVAU land valuations and the land value included in the RAB.
24. Our intention remains to make any airport Airports ID determination amendments in late 2016, so that the ID amendments are in place for the next price setting event.

¹³ Commerce Commission "Input methodologies review: Fast track review of input methodologies for the application of airport land valuation methodology" (10 November 2015).

Material released alongside this paper

25. In this paper we explain the results of our review and the reasons for our decisions on amendments to the Airport IMs for airport land valuation.
26. In addition, we have published alongside this paper an amendment determination which amends the Commerce Act (Specified Airport Services Input Methodologies) Determination 2010.¹⁴
27. The amendments include:
 - 27.1 Clarifying the requirements for the starting land zoning special assumption (see Chapter 2);
 - 27.2 Updating Schedule A to incorporate and reflect the latest International Valuation Standards and terminology used in those standards and clarifying the requirements by removing extraneous explanatory notes (see Chapter 3);
 - 27.3 Updating the information supporting the valuation required to be prepared and disclosed by the valuer in the valuation report (see Chapter 4).
28. The amendments will apply from the date on which notice is given in the New Zealand Gazette.

¹⁴ A consolidated version (which includes amendments made to the original input methodologies) is available on the Commerce Commission website: <http://comcom.govt.nz/>.

2. Treatment of rezoning costs

Purpose of chapter

29. The purpose of this chapter is to outline and explain the treatment of the costs of rezoning airport land in determining the MVAU.

Overview

30. Consistent with our decision in December 2010, airport land is to be valued on the basis of an opportunity cost approach, ie, its forward-looking alternative use value.¹⁵ In a workably competitive market, the value of land is likely to broadly reflect its opportunity cost.¹⁶
31. The conventional approach to determining opportunity cost would be to assess the value of the land net of costs of developing the land for its highest and best alternative use. ‘Development costs’ are the costs associated with moving the land to its highest and best alternative use in the event the airport was closed.
32. However, our decision in December 2010 included a special assumption in order to better promote the purpose of Part 4. In particular, the special assumption was that land is valued as notionally vacant and free of airport-related improvements, in order to mitigate the risk to investment incentives that would arise from deducting the costs of converting the land away from its current use as an airport.
33. Therefore, no deductions are required to be made for the costs (‘remediation costs’) associated with remediating the characteristics of land that are specific to the supply of airport services. In particular, in determining the MVAU of the land, it is assumed to be vacant and unencumbered by airport-related improvements.
34. Nevertheless, the input methodologies determined in December 2010 still required a valuer to take into account other development costs associated with redeveloping the land to its highest and best alternative use. For example, if the vacant land was developed into a shopping complex, before being sold, then the building costs would be deducted from the gross sale value that would be realised after the development was complete. Likewise, the cost of rezoning from one non-airport use to another would be deducted.

¹⁵ 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), para. 4.2.18.

¹⁶ 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), para. 4.3.55.

Decision

35. The amendments introduced through this fast track process are intended to clarify that the treatment of remediation costs also applies to the costs associated with rezoning airport land. In particular, in determining the MVAU of the land, it is assumed that airport zoning does not apply.
36. The treatment of rezoning costs can have a material impact on the valuation of airport land. For example, BARNZ's valuer has identified valuation differences of \$41 million compared to WIAL's valuer, of which rezoning cost differences were the primary contributor (approximately \$30 million).¹⁷

Reasons for decision and responses to submissions

37. This section explains the reasons for our decisions. In summary, in our view:
 - 37.1 The conventional approach to determining opportunity costs would be to assess the value of land in an alternative use net of costs of developing the land for its highest and best alternative use;
 - 37.2 Rezoning costs would be a material cost that an airport would have to incur in developing the land for its highest and best alternative use, and estimates suggest rezoning costs would be most material for Wellington Airport;
 - 37.3 However, no particular treatment of zoning costs is required by the reference in s 52A(1) to outcomes produced in workably competitive markets; and
 - 37.4 The approach favoured by BARNZ would run counter to s 52A(1)(a) to the extent that airports' incentives to invest in specified airport services are determinately affected by write-downs (relative to past valuations) that:
 - 37.4.1 Are not required by the reference to competitive markets in s 52A(1); and
 - 37.4.2 May therefore affect the extent to which airports have confidence that an appropriate approach will be maintained in future.

¹⁷ BARNZ "Feedback on Commerce Commission analysis of Wellington Airport's third price setting event" (8 May 2015), pg. 4.

38. Overall, therefore, we consider our decision is consistent with our approach in the 2010 IM reasons paper, and strikes the right balance between promoting incentives to invest (s 52A(1)(a)). In addition, the amendments will provide further clarity and certainty, consistent with s 52R of the Act.

Original rationale for applying an opportunity cost approach

39. As explained in our December 2010 reasons paper, an opportunity cost approach is consistent with promoting outcomes consistent with those produced in workably competitive markets. This aspect of our decision is not being revisited under this fast track process.
40. A consequence of our December 2010 decision was that we considered that the approach used by airports—known as Market Value Existing Use ('MVEU')—was not consistent in conceptual terms with an opportunity cost approach required under Part 4. This is because the MVEU approach is not intended to reflect the value of land in an alternative use, but rather the value of the land in its existing use (which is in the supply of a monopoly service).
41. The difference between an MVEU and an MVAU valuation was in some cases quite large. For example, WIAL had an MVEU valuation of \$273m in 2011. The underlying MVAU land value on which this MVEU valuation was based was \$141m. The difference between the two valuations was \$132m.

Implications of conventional approach to determining opportunity cost

42. As noted above, the conventional approach to determining opportunity cost would be to assess the value of the land net of costs of developing the land for its highest and best alternative use. Development costs are the costs associated with moving the land to its highest and best alternative use in the event the airport was closed.
43. Notably, however, the characteristics of airport land are affected by certain decisions made by an airport, and these decisions have a consequential impact on the opportunity cost of the land. For example, laying a runway is beneficial to consumers of specified airport services, but subsequent removal of the runway would be costly.
44. The reduction in the opportunity cost of airport land in these cases is attributable to the increased costs of remediating the characteristics of land that are specific to the supply of airport services. These remediation costs are therefore associated with a form of asset specificity.

45. As noted in December 2010, asset specificity means that the application of an opportunity cost approach can result in significant write-downs of asset values relative to those that had previously been considered acceptable for regulatory purposes. The opportunity cost of non-land investments, for example, is very low or zero.
46. Taken to the extreme, if remediation costs were sufficiently large, the opportunity cost of land could be assessed to be very low or zero if remediation costs were deducted. This would imply that very low returns would be justifiable under information disclosure regulation.
47. Consequently, and as explained further below, we decided in December 2010 not to deduct remediation costs, and to implement this decision we noted that the land was to be valued on the basis of being vacant and unencumbered by airport-related improvements. That is, the opportunity cost is the opportunity cost of the land when it is notionally vacant and unencumbered by airport-related improvements.
48. In an attempt to remove ambiguity on this point, we included a non-exhaustive list of remediation costs that were not to be deducted in determining MVAU.

Rezoning costs are a material type of remediation costs for Wellington Airport

49. The most material difference in valuations produced between BARNZ and airports under the current requirements is for WIAL, and it arises primarily as a result of differences in the treatment of rezoning costs. WIAL valuation is \$140m. BARNZ valuation is \$100m. Approximately \$30m of this difference is explained by differences in the treatment of rezoning costs.
50. The reason for the difference is that BARNZ consider that the input methodologies determined in December 2010 for land valuation require the conventional definition of opportunity costs, with the exception of the remediation costs specifically listed in the determination (which did not include rezoning costs). In addition, BARNZ consider that the conventional approach would be most consistent with promoting outcomes consistent with those produced in competitive markets.
51. However, WIAL considered that the input methodologies permitted an approach that would ignore all remediation costs, including rezoning costs, but WIAL nevertheless deducted some rezoning costs in determining their valuation. These rezoning costs relate to the costs of rezoning from one alternative use to another, rather than the costs of rezoning from airport use to an alternative use.

52. The approach adopted by WIAL since the Airport IMs were determined produces similar MVAU valuation outcomes when compared to the MVAU valuations disclosed prior to input methodologies being determined.¹⁸ Consequently, the input methodologies determined in 2010 did not result in a write up of MVAU valuations relative to past MVAU valuations. Rather, the Airport IMs permitted a continuation of practices that were previously considered acceptable for regulatory purposes.

Deducting remediation costs would be likely to affect investment incentives

53. In December 2010, the reason we did not consider that remediation costs should be deducted was to avoid a situation in which an airport would be penalised for decisions that have:
- 53.1 benefitted its consumers; but
 - 53.2 increased future remediation costs.
54. In reaching this decision, we considered that the primary justification for this approach was to avoid write-downs of valuations,¹⁹ which is more relevant when determining the initial valuation (ie, as at 2010) than it is for future valuations. This is because:
- 54.1 the treatment in future affects the time profile of returns that can be justified under information disclosure regulation (ie, an NPV neutral effect); whereas
 - 54.2 the initial treatment affects the discounted value of future payments to capital that an airport can expect to recover from the start of information disclosure regulation under Part 4.
55. The treatment of remediation costs set out in December 2010 is therefore consistent with the approach that applied to non-land, specialised assets. In particular, for non-land assets, we considered that one-off write-downs of existing regulatory values would be likely to be inconsistent with suppliers having appropriate incentives to invest, ie, s 52A(1)(a).

¹⁸ MVAU valuations have included: \$145m (2006), \$140m (2009), \$141m (2011).

¹⁹ 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), para 4.3.72, p. 91.

56. Therefore, for similar reasons as those set out in December 2010 for non-land assets, we disagree with BARNZ's argument that the initial treatment is irrelevant to investment incentives provided the approach in future is appropriate.²⁰ This is because the initial treatment may affect the extent to which airports have confidence that an appropriate approach will be maintained in future.

Write-downs not required to be consistent with outcomes in competitive markets

57. The reference to competitive markets in the Part 4 Purpose provides guidance on the appropriate approach, but it is not definitive, and is therefore insufficient to justify a write down of valuations. However, it is worth saying that, in our view, airports and airlines are both right that their approaches are consistent with promoting outcomes consistent with those in competitive markets, depending on the particular characteristics of the market in question.
58. As noted by Professor George Yarrow, the approach favoured by BARNZ could be considered consistent with promoting outcomes consistent with those in competitive markets:

The opportunity cost of land can be estimated gross or net of any relevant remediation costs. Prima facie, it seems most natural to take a 'net' approach, since it would be the disposal of the land (i.e. a land-associated event) that would 'cause' the costs to be incurred. On this basis, the opportunity cost of airport land would be assessed on an 'as is' basis; i.e. how much is this land worth if it is sold bundled with those parts of the existing assets than [sic] cannot be dismantled/removed at a profit.

²⁰ 2010 Airport Input Methodologies Reasons Paper (Commerce Commission, 22 December 2010), section 4.3, pp. 73-94.

59. Similarly, other parallels with competitive markets—particularly those with similar characteristics to those observed in regulated markets—would suggest that the approaches adopted by airports could also be consistent with promoting appropriate outcomes.²¹

Thinking about things ex ante, if a landlord leased ‘pristine’ land to an airport operator, it might be the case that (a) the landlord would insist on the site being restored to a reasonable condition at the end of the lease (a roughly comparable example here would be requirements to make good land after opencast mining operations, which might either be required by the landowner or as a matter of public policy in granting a licence), or (b), in the alternative, the rental payments would be higher, to compensate for any ‘end of tenancy’ costs to be incurred by the owner. The first option here (a) provides stronger incentives for the airport not to do things that would increase remediation costs. The acquisition of the land would therefore ‘cause’ a contingent liability in relation to remediation, which would be well defined in terms of a lease of specified length. Where, however, the operator of the airport owns the land, the contingency is subject to the control of the operator, and its value is likely to be rather lower (approaching zero – i.e. alternative use is remote).

60. We also note that an alternative approach with an equivalent effect would be to apply a conventional approach to determining the opportunity cost of land, but supplement this approach with recognition in the RAB value of rezoning costs. This approach would be consistent with the approach to assessing opportunity costs currently favoured by BARNZ, while also preserving the incentives that airports have to invest in airport services.
61. In addition, we note that under the input methodologies for services supplied by Transpower New Zealand, land would enter the RAB at its purchase price and would not generally be revalued under the unindexed roll forward approach. For Airports, although we revalue land, we also count all the upward revaluations as income (and vice-versa). So in many ways the approach for Airports is equivalent to using a historic cost approach except for the implied profile of capital recovery. And if we now decided to write down the value relative to past regulatory valuations, then the treatment of revaluations would imply that an airport would be able to justify higher revenue to offset the one-off devaluation.

²¹ Notably, in submissions prior to our decision in December 2010, the NZIER (on behalf of BARNZ) also considered that remediation costs could be considered akin to a contingent liability, and therefore did not need to be deducted in determining the initial RAB value

3. Schedule A and valuation standards

Purpose of chapter

62. This chapter outlines and explains the amendments to Schedule A of the Airports IM to reflect the latest valuation standards and to address repetition and potential ambiguities.

Our decision on the latest valuation standards

63. Our decision is to incorporate the latest valuations standards by reference into Schedule A of the Airport IMs.

Updated valuation standards

64. In our 2010 decision on the Airport IMs, we adopted the following (then-current) valuation standards:²²

64.1 IVS 2—Bases Other Than Market Value;

64.2 IVS 3—Valuation Reporting;

64.3 IVGN 1—Real Property Valuation; and

64.4 ANZVGN 1—Valuation Procedures Real Property.

65. The International Valuation Standards (IVS) were prepared by the International Valuation Standards Council (IVSC), an independent, not-for-profit organisation that produces and implements universally accepted standards for the valuation of assets. These standards were adopted by the leading New Zealand professional bodies, the Property Institute of New Zealand, and the New Zealand Institute of Valuers (NZIV).
66. The 2013 IVS included the deletion of “IVS2 Bases Other Than Market Value”, removal of the terminology “Bases Other than Market Value” from the IVS framework, and the replacement of “IVS 3 Valuation Reporting” with “IVS 103 Reporting”.
67. The updated standards were formally adopted by the Property Institute and the NZIV as of 1 January 2014. The updated standards are those applied by professional valuers in their professional capacity as registered valuers.

²² The valuation standards that must be applied by valuers for the purposes of MVAU valuations under the Airports IM determination were set out in Schedule A, clause A3(1).

68. In our process update paper of 3 July 2015,²³ we signalled that updating the airports land valuation requirements so they align to the current valuation standards and valuation industry practices applying in New Zealand was a key area of focus.²⁴
69. Consistent with our draft decision, we have adopted the following valuation standards:
- 69.1 IVS 101 – Scope of Work;
 - 69.2 IVS 102 – Implementation;
 - 69.3 IVS 103 – Reporting;
 - 69.4 ANZVGN 1 – Valuation Procedures Real Property.
70. In reaching this view, we were informed by the expert advice of EY. In addition, we have considered the extent to which we needed to specify the particular standards to be applied, taking into consideration that a professional valuer, acting in that capacity, is subject to a number of professional obligations as a result of their membership in professional bodies.
71. Furthermore, consistent with the draft decision, we have incorporated these standards by reference in accordance with the process set out in Schedule 5 of the Act. By incorporating these standards by reference, we have the ability to efficiently and effectively update the applicable standards should they change in the future.

Submissions on our draft decision

72. NZAA supported our draft decision to adopt the latest standards.²⁵ No other party submitted specifically on these proposed amendments.

²³ Commerce Commission “Input methodologies review process paper - update on fast track amendments” (3 July 2015), para. 23.

²⁴ In our process update paper, we also proposed considering when land valuation methodology amendments will apply. In our draft decision, we decided that a decision on when the land valuation methodology amendments must be applied should be considered through the ID determination amendment process. The ID determination amendment process is discussed in Chapter 5.

²⁵ NZAA “Review of Input Methodologies: submission on draft decision on land valuation methodology” (8 December 2015), para. 22.

Reasons for our decision

73. We consider that updating Schedule A to reference the latest valuation standards will ensure consistency with best valuation practice, and that the standards commonly used by a valuer are applied to the airport valuations. We consider that there would be a real risk of confusion or misapplication of the valuation standards if this matter were not clarified.
74. Consistent with the framework for the review, we consider that this solution best promotes the long-term benefit of consumers.
75. In addition, this change will promote the purpose in s 52R by making it clear what standards apply, and how and when new standards apply, to land valuation undertaken under Schedule A of the Airports IM determination.

How we have implemented our decision

76. We have given effect to our decision by updating the definition of “valuation and property standards”, which are now defined in clause A1 of Schedule A.
77. The updated definition also makes it clear that these standards are incorporated by reference.

Our decision on the MVAU definition and other clarifications of Schedule A

78. Our decision is to remove any inconsistencies in, and repetition between, and within, the Schedule A requirements, explanatory notes and reference statements.
79. Our decision is consistent with the draft decision, with the exception that market-based evidence for estimating the eventual gross realisations or estimated value of the land can only be used to the extent that the use is unaffected by the supply of specified airport services.²⁶

Potential ambiguities and repetition in Schedule A

80. Following our detailed review of Schedule A, it became apparent that there were a number of potential ambiguities between the content of the requirements, including explanatory notes and definitions, as well as material overlap and repetition between the contents of Schedule A and the referenced valuation standards. While it appears the parties have come to some common ground on the interpretation of the Schedule A requirements, explanatory notes, and standards, we considered that there remained a risk that these could create potential ambiguity going forward.

²⁶ This is in line with the requirements of the original Schedule A of the Airports IM determination where we precluded the use of land sales evidence that was affected by the supply of specified airport services.

Our draft decision

81. In our draft decision, we proposed amending Schedule A to remove any potential ambiguities between the requirements, explanatory notes, and definitions, and the referenced valuation standards and explanatory and guidance notes set out in the valuation standards. These changes included a proposal to remove the definition of MVAU set out in clause A2 of Schedule A of the Airport IMs.
82. In our draft decision we also proposed that market-based evidence that is affected by the supply of specified airport services can be used if it is adjusted to remove the impact of the supply of specified airport services.
83. EY recommended this change, noting that valuers often make adjustments to comparable sales for a range of factors such as location, access to infrastructure, land use and topography.

Submissions on our draft decision

84. BARNZ's key concern with this draft decision related to the removal of the MVAU definition and the set of principles for identifying the alternative use, which were included in Schedule A of the Airport IMs. It is BARNZ's view that the removal results in a loss of guidance in the Schedule A of what constituted an appropriate alternative land use.²⁷
85. BARNZ submitted that removing the definition of MVAU from clause A2 of Schedule A would remove one of the schedule's main guiding principles, and would reduce certainty. In particular, BARNZ was concerned that we had omitted the principle that the use must be one which is physically possible, appropriately justified, legally permissible and financially feasible.²⁸
86. BARNZ did not support our draft decision to allow the use of market-based evidence that is affected by the supply of airport services, even where it is adjusted to remove the impact of the supply of specified airport services. BARNZ submitted that it had been advised by its expert valuer that it is questionable how this can be achieved without it simply representing a subjective decision, resulting in reduced certainty over the appropriate valuation.²⁹

²⁷ BARNZ "Submission on Commerce Commission draft decision relating to fast track review of Input Methodologies for the application of airport land valuation methodology" (8 December 2015), page 9.

²⁸ BARNZ "Submission on Commerce Commission draft decision relating to fast track review of Input Methodologies for the application of airport land valuation methodology" (8 December 2015), page 9.

²⁹ BARNZ "Submission on Commerce Commission draft decision relating to fast track review of Input Methodologies for the application of airport land valuation methodology" (8 December 2015), page 9.

87. NZAA agreed with our draft decision to remove the definition of MVAU from the Schedule A. It is NZAA's view that a reintroduction of it would undermine our decision to remove unnecessary repetition and that the definition of MVAU remains incorporated throughout the Schedule A of the Airport IMs, in particular in the MVAU valuation steps a valuer must take.³⁰

Reasons for our decision

88. In relation to the definition of MVAU, we note that the term is no longer supported by the current IVS. We therefore do not consider the existing definition sufficient or appropriate, and may cause confusion to expert valuers.³¹
89. The definition of what constitutes an appropriate alternative land use remains integrated throughout Schedule A of the Airport IMs because it is now captured by the special assumptions and the definition of "highest and best alternative use" (HBAU).
90. The special assumptions are now set out in the amended clause A5 of Schedule A and must be used by a valuer in undertaking the MVAU. For example:
- 90.1 Clause A4(5) requires that the MVAU include relevant development costs, including construction costs, holding costs, and the developer's or investor's profit and risk (previously included in the definition of 'development costs' in former clause A2 of Schedule A);
- 90.2 Clause A4(6) requires that the MVAU exclude the costs of converting the land to an airport, and clause A4(7) requires that the MVAU exclude remediation costs (both of which were previously excluded by the definition of 'development costs').

³⁰ NZAA "Cross submission on draft decision on land valuation methodology" (18 December 2015), para. 28 (a).

³¹ Including the MVAU definition would also create repetition because it remains integrated in Schedule A as outlined in paragraphs 27 – 29.

91. While we have updated the definition of MVAU, we have not amended the definition of HBAU. That definition is set out in clause 1.1.4(2) of the Airport IMs, and provides:

T means the most probable use of **land**, which use-

- (a) is not the **supply of specified airport services**;
 - (b) is not a use to the extent that it is influenced by the **supply of specified airport services**;
 - (c) is physically possible;
 - (d) is appropriately justified;
 - (e) is legally permissible;
 - (f) is financially feasible; and
 - (g) results in the highest estimated value of the **land** in question;
92. However, it is evident from BARNZ submission that there was a concern we had proposed removing the existing definition of HBAU. Our review of submissions indicated that there was some confusion over whether HBAU or other existing definitions had been removed or changed.
93. In order to mitigate any future confusion, and to make Schedule A more accessible to valuers tasked with undertaking an MVAU valuation for airports, we have decided to move the key relevant definitions from clause 1.1.4(2) of the Airport IMs to Schedule A.
94. Having considered submissions, we consider that the proposed changes to the definition of MVAU, when taken together with the other updates to Schedule A, effectively maintain the status quo as to the components of the MVAU valuation and valuation process, while better reflecting how the valuer will undertake the MVAU valuation under the current IVS standards. These updates will continue to promote the purpose of s 52A, while also better promoting the purposes of s 52R by reducing the likelihood of confusion in the application of the requirements by expert valuers.
95. We also agree with BARNZ that allowing the use of market-based evidence affected by the supply of airport services would reduce certainty. In order to promote confidence in the valuation, and reduce the risk that independent expert valuers will arrive at different valuations based on such evidence, we have decided to leave the requirements unchanged from the original Schedule A where it precluded the use of market-based evidence that was affected by the supply of specified airport services.
96. There is no evidence that precluding the use of market-based evidence that was affected by the supply of specified airport services created any ambiguity in previous valuations.

How we have implemented our decision

97. We have made a number of amendments in order to give effect to our decisions, including:

- 97.1 Removing the explanatory notes, and where appropriate included them as a requirement;
- 97.2 Amending the wording of the MVAU definition to be consistent with the latest valuation standards, which is now set out in clause A1; and
- 97.3 Moving all definitions relevant to MVAU valuation under Schedule A to an updated clause A1, Interpretation.

4. Information supporting valuations

Purpose of chapter

98. This chapter outlines the amendments to Schedule A of the Airport IMs that are intended to enhance transparency in relation to the valuation and the valuer's report.

Our decision to provide additional direction to valuers

99. Consistent with the draft decision, we have amended Schedule A of the Airport IMs to provide additional direction on the information required to be included in the valuer's report in order to support the valuation. The additional information includes:
- 99.1 where material to the valuation, economic analysis to support the HBAU plan;
 - 99.2 other expert opinions obtained by the valuer, where the valuer is not suitably experienced or qualified to provide an expert opinion;
 - 99.3 information to support the value of rezoning costs included in the MVAU; and
 - 99.4 all material assumptions and special assumptions made in undertaking the valuation.

Use of experts and disclosure of assumptions and expert opinions

100. A lack of disclosure on key assumptions and how those assumptions were determined have, in the past, made it challenging for BARNZ and the Commission to assess valuations. The level of suitably qualified expert advice for certain key assumptions has also been questioned by BARNZ in the past.
101. Schedule A did not specifically set out that valuers were required to obtain expert opinion where they were not suitably qualified or to disclose all material assumption and special assumptions.

Economic analysis to support highest and best alternative land use

102. The level of economic analysis undertaken to support the HBAU plan within airport valuations has been a point of contention between the Airports and BARNZ to date, with BARNZ stating that additional economic analysis should have been undertaken to support previous WIAL valuations in particular.
103. Schedule A, including the IVS required to be applied for valuations under Schedule A, did not specifically set out whether valuers were required to undertake economic analysis to support the proposed alternative land use in its HBAU plan.

Disclosure of rezoning cost assumptions

104. The cost to rezone airport land and in particular the zoning starting assumption has been a significant factor in variations between valuations to date. Chapter 2 outlines how Schedule A has been amended to provide further clarification to how rezoning costs are to be determined.
105. Given the significance that rezoning costs can have on the variances in MVAU valuations we have also explicitly included a requirement to disclose, where appropriate, the assumptions used to determine the rezoning costs included in the MVAU valuation. The assumptions to be disclosed include, the likelihood, timing, and costs of moving from the zoning starting assumption to the zoning required for HBAU plan.
106. Schedule A, including the IVS required to be applied for valuations under Schedule A, did not specifically set out whether valuers were required to disclose assumptions used to determine the cost of rezoning.

Submissions on our draft decision

107. In our draft decision, we proposed updating Schedule A of the Airport IMs to include direction on the need to provide information supporting the MVAU valuation, including the requirement to undertake economic analysis to support the HBAU plan where appropriate, justify any changes from the special assumptions set out in Schedule A, and general requirements to provide sufficient and appropriate information to support the analysis and conclusions. These changes were reflected in proposed amendments to clauses A2, A3 and A4 of Schedule A.
108. In submissions on our draft decision, NZAA supported our proposal to amend Schedule A of the Airport IMs to provide additional direction on the information required to support the valuation assumptions.³² No other party submitted specifically on these proposed amendments.

³² NZAA "Submission on draft decision on land valuation methodology" (8 December 2015), paras. 24 and 25.

109. NZAA also recommended clarifying clause A5(1)(e) from the draft determination to make it clear that the likelihood, timing, and cost of moving from the zoning starting assumption to the zoning for the HBAU need only be calculated if the zoning is different.³³ They expressed concern that a valuer might feel compelled to make a cost and timing allowance in order to comply with this clause.³⁴
110. We do not consider that this clarification is necessary, as is made clear by the special assumptions in clause A3. In particular, subclause A3(3) requires the valuer to disclose how they determined the zoning and its likelihood, timing, and cost, even if these are zero. Clause A5 sets out the steps the valuer must take in the valuation report, and one of those steps is determining the likelihood, timing, and cost of moving to the HBAU zoning.

Reasons for our decision

111. We have amended Schedule A of the Airport IMs because Schedule A, including the IVS required to be applied for valuations under Schedule A, did not specifically set out where valuers were required to obtain expert advice or when to disclose significant assumptions and supporting opinions.
112. Our reasons for amending Schedule A of the Airport IMs to provide additional direction on the information required to be included in the valuer's report in order to support the valuation are consistent with EY's advice and recommendations that informed our draft decision.³⁵
113. We consider that this change will promote the Part 4 Purpose more effectively as it will increase the transparency of the analysis underpinning the MVAU, which will allow interested persons – including airlines – to assess its reasonableness. Making this analysis available will enable interested persons to assess whether airports are limited in their ability to extract excessive profits, without undermining airports' incentives to innovate and invest.
114. We also consider this change will promote the IM purpose in s 52R of the Act more effectively, without detrimentally affecting the promotion of the s 52A purpose, because it reduces any ambiguity within Schedule A of the Airport IMs.

³³ NZAA ""Review of Input Methodologies: submission on draft decision on land valuation methodology" (8 December 2015), para. 20.

³⁴ NZAA ""Review of Input Methodologies: submission on draft decision on land valuation methodology" (8 December 2015), para. 20.

³⁵ EY "Supporting paper for proposed amendments to Commerce Act (Specified Airport Services Input Methodologies) Determination 2010 Schedule A" (5 November 2015), page 4.

How we have implemented our decision

115. We have made a number of amendments to Schedule A to give effect to our decision. The additional direction we have provided in the requirements regarding the information that must be disclosed by the valuer includes:
- 115.1 Inserting a new requirement in clause A2(5)(d) that expressly requires the valuer to obtain the opinion of a suitably qualified expert on any material matter on which the valuer is not suitably experienced or qualified;
 - 115.2 Inserting guidance in subclauses A3(8) that require the valuer to disclose in their valuation report all key special assumptions made in the MVAU; and
 - 115.3 Inserting a new subclause A3(9) to make it clear that the valuation report must include or attach any expert opinion relied upon by the valuer in preparing the valuation report.
116. We also note that we are incorporating the IVS reporting standards (set out in IVS 103 – Reporting) by reference (in the definition of “valuation and property standards”, now set out in clause A1). Those standards set out the reporting requirements for valuations.

Attachment A: Further consideration of zoning issues

Purpose of attachment

117. This attachment sets out our responses to specific issues raised by BARNZ in its submission on zoning, as well as providing further information on how we have given effect to our decision on treatment of rezoning costs.

Zoning assumptions under the existing Schedule A methodology

118. In our summary and analysis of WIAL's third price setting event, we noted that there were different interpretations on the appropriate zoning starting assumptions for an MVAU valuation. We summarised our views as follows:³⁶

The information disclosure requirements do not expressly require that an MVAU land valuation should assume that the appropriate land zoning is in place. We have identified the relevant input methodologies on this subject as an area to review and potentially provide additional guidance or clarification as part of the input methodologies review. For the purposes of this summary and analysis, therefore, our view is that the valuation approach undertaken by Wellington Airport is consistent with the input methodologies to the extent the input methodologies prescribe a specific approach.

119. BARNZ submitted that Schedule A requires the valuer to take into account the costs of any changes necessary to rezone the land from its current use – ie, the provision of aeronautical services – to the zoning required for the HBAU.
120. BARNZ's view relied on the explanatory note in clause A9(b), which provides:

In undertaking an **MVAU** valuation, the **valuer** must ... have regard to designation, zoning and other district plan and legal requirements applying to the **land**

121. In addition, BARNZ noted that the explanatory note in A9(4) provides:

The **land** is likely to be designated or zoned for the various aeronautical activities of the **airport** owner. In addition to considering the likely alternative uses for the **land**, the **valuer** should also consider the likelihood of the designation being uplifted or **the** land rezoned, and costs (if any) likely to be involved in this.

122. BARNZ also noted that Darroch reached a similar view in its assessment of WIAL's 2009 and 2011 valuations, a report prepared for us by Darroch.

³⁶ Commerce Commission "Summary and analysis of Wellington Airport's third price setting event" (30 June 2015), para. A16.

123. In support of BARNZ's view, the Covec report argued that any zoning starting assumption other than its existing zoning is contrary to the concept of opportunity cost, and that the requirements in Schedule A must be interpreted in accordance with the opportunity cost concept. We have addressed the Covec arguments about our application of the opportunity cost concept in Chapter 2.
124. We have most recently considered BARNZ submissions on this issue in our summary and analysis of WIAL's third price setting event.³⁷ In our WIAL summary and analysis, we concluded that WIAL's approach to the MVAU land valuation was consistent with the Airport IMs for land valuation, to the extent they specified an approach:³⁸
- The approach to land valuation employed by Wellington Airport is consistent with the input methodologies for aspects of the land valuation where the input methodologies specify an approach. Therefore, the submissions on this topic have not changed our assessment of Wellington Airport's conduct in regards to profitability. We do not consider that Wellington Airport's MVAU land valuation fails to comply with the information disclosure requirements.
125. The clauses relied upon by BARNZ require that the valuer "have regard to" the current zoning of the land, and must "consider" whether the likelihood of the land being rezoned. Neither provision specifies what the starting zoning assumption should be for the purposes of the MVAU, only that the valuer take it into consideration.
126. In addition, clause A9 requires that the valuer value the land as notionally vacant, which is arguably at odds with assuming that the land carries the current aeronautical zoning or designation.
127. We therefore disagree with BARNZ's contention that our proposal is a fundamental change from the previous requirements. As we have explained above, we consider today's decision is consistent with our approach in the 2010 Airport IMs reasons paper, and strikes the right balance between promoting incentives to invest (s 52A(1)(a)) while limiting the ability of airports to extract excessive profits (s 52A(1)(d)). In addition, the amendments will provide further clarity and certainty, consistent with s 52R of the Act.

³⁷ Commerce Commission "Summary and analysis of Wellington Airport's third price setting event" (30 June 2015).

³⁸ Commerce Commission "Summary and analysis of Wellington Airport's third price setting event" (30 June 2015), para. A14.

How we have implemented our decision

128. Clause A4 sets out the special assumptions the valuer must take into account when undertaking the MVAU valuation. The special assumption set out in subclause A4(3) states that the starting zoning of land is the zoning that would be most likely to be in place if the airport did not exist, and must be consistent with the requirement in A4(2) that the land be valued as notionally vacant and clear of airport-related improvements.
129. Subclause A4(4) sets out the considerations the valuer must take into account in considering what zoning would be most likely to be in place if the airport did not exist. This zoning starting assumption may be consistent with the zoning for the HBAU where the HBAU is consistent with:
 - 129.1 the current use of the land under the current zoning (other than for aeronautical services, or zoning influenced by the presence of the airport);
 - 129.2 the current use of the land surrounding the airport;
 - 129.3 the zoning that applied prior to the land being zoned for the airport.
130. The requirement for valuers to include in the valuation the likelihood, timing and costs of moving from the starting land zoning to the zoning required for the development of the land in its HBAU is set out in subclause A3(2). Subclause A3(3) requires the valuer to set out how they determined the zoning starting assumption.
131. Under these provisions, where the zoning starting assumption and the zoning of the land in its HBAU are the same, the valuer would still need to set out in the valuation report the likelihood, timing, and costs (which would be zero) in the valuation report, and detail how they determined the zoning starting assumption.