AUCKLAND AIRPORT'S SUBMISSION ON THE SECTION 56G REVIEW PROCESS AND ISSUES PAPER 6 SEPTEMBER 2012

Overview

1. Prior to the introduction of information disclosure ("**ID**") regulation under Part 4, Auckland Airport had committed itself to a strategy of growth and efficiency that would promote the long term benefit of our consumers, and which would contribute to New Zealand's economic productivity. Auckland Airport believes that what benefits our consumers and the New Zealand economy also benefits our business. Under the Airport Authorities Act 1966 consultation process, we disclose extensive amounts of information to substantial customers regarding our proposed approaches to pricing, and we believe we are responsive to this feedback. Accordingly, prior to the introduction of ID regulation under Part 4, we were aware of the need to ensure our pricing models provided efficient outcomes.

2. The introduction of ID under Part 4 must be viewed in that context. In Auckland Airport's view:

   (a) Although our approach to pricing and consultation remains similar in many respects, there is no doubt that ID is having an impact on our performance. The input methodologies ("**IMs**") and ID requirements have established guidance and benchmarks that have heavily influenced and brought further discipline to our pricing decisions. There is strong pressure for us to conform to outcomes produced by the IMs;

   (b) For various reasons elaborated on in this submission, it is difficult to measure the quantitative impact of ID. At this early stage of implementation a qualitative assessment is required, focussing on whether ID has provided the right incentives to promote outcomes consistent with the purpose statement over time; and

   (c) The Commission should therefore carefully assess the full story told by our disclosures to date and provide a balanced report to Ministers. Auckland Airport has spent considerable time and effort preparing its disclosures to allow interested persons to fully understand all aspects of its performance under the purpose statement. We accept that there will be room for improvement on some matters, but we also expect that positive aspects of our performance will be fully acknowledged.

3. We believe that ID is the right form of regulation for airports, and that the regime established by the Commission will effectively promote the purpose statement over time. It will do this by providing a greater amount of information, prepared on a consistent basis, for interested persons to assess performance over time. We view the section 56G Report as an opportunity to further enhance the regime in that respect.

4. The Commission will be aware that Auckland Airport nevertheless has some concerns regarding the current ID framework. We have appealed some aspects of the IMs because we are concerned that they create a very real risk of efficient performance being misdiagnosed as being inconsistent with the Part 4 purpose statement.

5. This submission does not revisit those matters in any depth. However, we have raised matters regarding IMs (eg land held for future use) when it is relevant to our desire to continue to work with the Commission to further develop an ID regime that provides greater regulatory certainty.

Development of a strategy to benefit customers and the national economy

6. Auckland Airport is owned and operated by Auckland International Airport Limited and, although it is one of New Zealand's largest listed companies, it is a relatively young company. The introduction of ID regulation under Part 4 is a significant milestone in our history.

7. Auckland Airport is now New Zealand's primary gateway to the world. It is widely recognised as one of New Zealand's vital infrastructure assets. It acts as a key hub in the movement of significant numbers of people and volumes of goods into and out of Auckland and New Zealand.

8. It is located on around 1500 hectares (including land held for future development). In addition to its aeronautical activities, a large variety of retail shopping and other services are located on Auckland Airport's land, many of which support its aeronautical activities.

9. We believe that corporatisation was a critical step towards establishing an airport responsive to the demands of consumers. The Airport Authorities Amendment Act 1986 paved the way for corporatisation. It allowed the Crown and local bodies to form and own shares in airport companies and transfer assets to them. In 1987, an Establishment Board concluded that Auckland Airport could be run on commercial grounds and that a company structure would be more appropriate than a state owned enterprise.

10. Following the passage of the Auckland Airport Act 1987, Auckland International Airport Limited was incorporated and commenced trading in 1988. The government retained a 50 percent shareholding, and the remaining 50 percent of shares were allocated to 29 local body councils in Auckland.

11. Key milestones in Auckland Airport's shareholding from that point include:

    (a) The Local Government Amendment Act 1989 reduced the number of local FWI body shareholders from 29 to 7, with increased proportional shareholdings for the remaining councils.

    (b) Papakura City Council sold its shares to the Crown in 1990, giving the Crown a 51.6 percent shareholding.

    (c) Infratil Investments Limited became the first external shareholder by purchasing Rodney District Council's shareholding in 1995.

    (d) In 1998 the Government sold its shares through an IPO and Auckland International Airport Limited was listed on the New Zealand Stock Exchange. Listing on the Australian Securities Exchange followed in 1999.

12. Now, following the restructuring of Auckland governance, Auckland Council through Auckland Council Investments Limited (22.4 percent) is the only remaining local body shareholder.

13. Although Auckland Airport has provided critical local, regional and national infrastructure throughout its history, it considers that its corporatised structure best enables a high quality infrastructure to be provided efficiently, which best serves the national interest.

14. Auckland Airport is an important driver of the productivity of New Zealand's economy. As the international gateway to both New Zealand and New Zealand's economic engine-room Auckland city, Auckland Airport is one of New Zealand's most important infrastructure assets providing substantial jobs, contributing around $14 billion to the economy and catering for four million visitors to New Zealand each year. Auckland

Airport also facilitates a wide range of economic activity in Auckland and New Zealand as a whole, by enabling the movement of goods and people.

15. Auckland Airport recognises the importance of its role as New Zealand's major gateway to the world and its key role in New Zealand tourism. Auckland Airport provides the first and last experience for approximately 70 percent of international travellers to and from New Zealand. This affords a unique opportunity to influence the views of New Zealand through the eyes of millions of tourist and business travellers. Auckland Airport is focused on making further improvements to the passenger experience.

16. For example, a key strategy of Auckland Airport's is working with the relevant border agencies (in particular, MAF, Immigration and Customs) to ensure the 'uniquely kiwi' approach is translated into a friendly, smooth and hassle-free experience for arriving and departing passengers. Auckland Airport's investment in our marketing support programme is designed to work with airline and industry partners to assist the growth of affluent visitors from high value markets that will deliver value to our airline customers, develop strong investment opportunities for the industry, improve profitability and deliver greater value.

17. Auckland Airport has also been a leader in promoting and driving growth in tourism by significantly investing in route development, which has resulted in airlines introducing new international capacity to Auckland Airport. Successes of Auckland Airport such as these are shared by New Zealand tourism and by the airlines serving New Zealand, through increased passenger numbers.

Investment programme

18. Auckland Airport makes considerable investments to ensure its continued contribution to the New Zealand economy. We believe that our natural incentives to invest should be encouraged by regulation, particularly when it is for the benefit of passengers. For example:

(a) From 2005 to 2009 Auckland Airport embarked on a programme of substantially developing its aeronautical facilities and services. This included a range of projects such as runway rehabilitation and widening, substantial work on the international terminal, renovation of the domestic terminal, property developments and pier works.

(b) The International Terminal Project involved the 3A expansion project, the Pier B project, the First Floor (arrivals) Expansion and the First Floor departure redevelopment project. This was completed in 2011 at a total cost of $191.7 million.

(c) In 2010 Auckland Airport invested $54.29 million in capital expenditure. This included aeronautical investments of $12.256 million including airfield concrete slab replacement and noise mitigation of houses and schools.

(d) In 2007 Auckland Airport also began the new Northern Runway stage one development before the project was put on hold.

(e) For the first PSE in the period from FY08 to FY11, $183 million was invested in regulated activities.

(f) The airport has invested approximately $80 million in the 2012 financial year on a range of projects including, property, aeronautical, retail, and car parking and infrastructure.

(g) Auckland Airport is also currently consulting on capital expenditure under the Airport Authorities Act 1966 ("**AAA**") regarding building a New Terminal Facility ("**NTF**").

19. However, we recognise that as an entity facing limited competition, it is important that our performance is subject to rigorous scrutiny. Among other things, it is appropriate to check that we are not over investing or have the ability to earn excess returns on a sustained basis. On the other hand, regulation must not chill our incentive to continue timely and appropriate investment that helps New Zealand's economy to thrive.

The Review is an important step in the development of the ID Regime

20. In that context, Auckland Airport is proud of its historic performance. It has now committed to further embedding the objectives of Part 4 of the Commerce Act ("**Act**") into its company culture, values, policies and decision making.

21. The section 56G Review ("**Review**") has the potential to be an important foundation for the success of the new ID regime. It provides the first milestone for the Commission to provide guidance on what the information disclosed has indicated about Auckland Airport's performance during the time period relating to the disclosure. It will also provide a platform to assist the understanding of Auckland Airport's future disclosures, together with guidance on how we might modify or improve aspects of our behaviour and/or disclosure going forward. Accordingly, the Review itself will contribute to the ongoing effectiveness of ID regulation in promoting and incentivising outcomes consistent with the Part 4 purpose statement.

22. Throughout our first information disclosure and price setting consultation, Auckland Airport has been committed to making comprehensive disclosures in a manner that at a minimum, fully complies with the framework and guidance provided by Parliament and the Commission. Indeed, on a number of occasions our disclosures have gone beyond the requirements of the schedules to the ID Determination ("**Schedules**"), with a view to assisting and enhancing the understanding of interested persons and ensuring the ID regime operates as intended.

23. For instance, during the second price setting event ("**PSE**"), Auckland Airport provided its substantial customers with additional tables of information in order to assist the airlines with isolating the difference between all regulated services and the scope of services that were the focus of the pricing consultation process. This was about enhancing understanding and helping the ID regime work, and is evidence of our commitment to embracing the spirit and intent both of ID regulation under Part 4, and the Commission's interpretation and approach in implementing it.

24. Auckland Airport is committed to the current review of the regime's effectiveness (from which the Commission will report to the Ministers of Commerce and Transport) and to ensuring that the new regime is given sufficient time to be fully tested. Looking ahead, we are similarly dedicated to future disclosures being made in alignment with the requirements, spirit and intent of the ID Regime, and informed by the Review's findings and the Commission's ongoing guidance through its annual analysis and summaries of information disclosed.

Assessing performance

25. In its Process and Issues Paper, the Commission queried which aspects of Auckland Airport's performance and conduct it should focus on in carrying out the Review, and how it might go about assessing effectiveness. As correctly noted by the Commission:[1]

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

26. Section 56G now requires the Commission to undertake a one-off Review to assess the effectiveness of ID in promoting the Part 4 purpose statement. The purpose of Part 4 of the Act (against which effectiveness is to be assessed) is set out in section 52A(1) - that is, to promote long-term benefit to consumers in markets where there is little or no competition by promoting outcomes that are consistent with identified outcomes produced in competitive markets.

27. In our view, in order to properly assess the effectiveness of the regime in promoting the purpose statement, there needs to be a thorough examination of the disclosure record over a meaningful period of time. The ID Regime covers historical financial information, quality performance measures, forecasts of total revenue requirements, pricing methodologies, prices and other key statistics. Additionally, the PSE disclosures require Auckland Airport to disclose its pricing methodology to enable interested persons to understand and assess its consultation on both a procedural and substantive basis.

28. Throughout its disclosure and consultation processes, Auckland Airport has closely considered the Commission's IM Determination and ID Determination. Although Parliament did not intend for the Commission's IMs to regulate pricing decisions, Auckland Airport has taken the approach that the Commission's methodologies provide a useful and important point of reference for it to consider when setting its prices. In doing so, the IMs have provided a sound discipline in requiring any departures to be justified. Accordingly, in determining the effectiveness of the operation of the ID regime in meeting the four limbs of the Part 4 purpose statement, Auckland Airport believes that the IMs are a relevant consideration.

29. While inputs are relevant and are necessarily linked to outputs, we believe it is ultimately outcomes that are the primary and determinative measure of whether performance and behaviour are consistent with the Part 4 purpose (as is the case in workably competitive markets which the regulatory regime aims, at a high level, to emulate). Accordingly, we believe that it would be appropriate for the Commission to reflect on matters that were central to our decision making process, beyond a pure building block approach, such as the following:

    (a) Expert advice that supports taking a different approach on points of economic principle (for instance, Auckland Airport's proposed Weighted Average Cost of Capital ("**WACC**") was based on the Commission's WACC methodology, but has in some key respects departed from the generic industry WACC for ID purposes to estimate an Auckland Airport specific WACC for pricing purposes).

    (b) Commercial practice which takes into account observable market outcomes which are inconsistent with implied economic incentives or outcomes. For example, the exceedingly low cost of debt implied by the Commission's methodology, relative to Auckland Airport's actual cost of debt. At the same time Auckland Airport has a sound reputation for raising debt efficiently, and its

[1] Commerce Commission, *ID Reasons Paper,* 22 December, paragraph 2.24.

leverage ratio has been relatively stable over time (despite theoretical incentives to raise leverage under the Brennan-Lally model).

(c) There have been instances where BARNZ[2] and/or Air New Zealand have specifically requested that Auckland Airport departs from the Commission's ID IMs. For example,

As a result, the asset valuation is a lower valuation than would be applicable under the Commission's market value in alternative use ("**MVAU**") and specialised assets valuation methodology).

(d) Business or industry circumstances relevant to airports in general and Auckland Airport in particular; economic conditions in New Zealand and globally; and commercial and investment decisions informed by competition concerns and economic growth. For example, the retention of a significant land bank for the expansion of critical national infrastructure to accommodate future growth in tourism and trade demand. Auckland Airport has endeavoured to apply the Commission's IMs but has now formed the conclusion that pure application of the Future Use concept will be commercially unacceptable.

Impact on Auckland Airport to date

30. In reflecting on the effect of the ID Regime to date, we have concluded that ID has had an impact on Auckland Airport in two key ways:

(a) In establishing regulatory reference points via the IMs, the Commission has brought further discipline to our pricing practices. Where Auckland Airport considered it appropriate to adopt approaches consistent with the Commission's methodologies, Auckland Airport has done so. Where Auckland Airport has departed from the Commission's approach, Auckland Airport believes it has been clear to its substantial customers on its reasons for doing so. At the very least, Auckland Airport believes it has adopted approaches that are aligned with the spirit of the Commission's regulation, so that the resources invested in the ID process are leveraged for the benefit of all stakeholders. Accordingly, the Commission's own view of the inputs that it believes are consistent with promoting the Part 4 purpose have been the key points of reference for our pricing proposal, have been carefully considered by Management, Board, and experts, and have provided a framework for discussions with our airline customers. This has introduced significant additional discipline to our pricing practices.

(b) Auckland Airport has recognised that our performance will be closely scrutinised and measured against the purpose statement. In making our disclosures and conducting our pricing consultation, the prospect of poor feedback resulting from that scrutiny and measurement was a highly relevant consideration (indeed, one possible adverse outcome of ID regulation is the potential for under investment or delayed investment due to a constraining of management and board decision-making).

31. Auckland Airport has a long history of providing high quality services incorporating continued development of facilities and identification of operating efficiencies. ID complements Auckland Airport's historical achievement by providing a structured platform in which achievements can be assessed by the public and non-airline stakeholders, who previously did not have access to consultation information. Auckland Airport believes that there are a number of instances where we have made progress as a result of the ID regime, including:

[2] References to BARNZ in this submission are references to BARNZ represented airlines.

(a) ID has been a helpful reference point which has reduced the volume of disagreement between the parties for some building block elements. At the time of the first PSE, both opex and capex forecasts included in pricing were significant issues for our airline customers. However, neither were significant issues during the consultation for the second PSE.

(b) ID has provided greater transparency of forecast outcomes, which will be assessed for consistency with the Part 4 purpose statement. Although variations from forecasts inevitably occur, Auckland Airport's objective was to ensure that there was no systematic bias in the forecasts at the time of the PSE.

(c) ID has created a formal, standardised record of performance and a comprehensive record of the PSEs that will enable a consistent record of performance to be disclosed on a year to year basis. Auckland Airport is confident that the monitoring of annual performance and transparency of forecast outcomes and the basis of pricing has and will continue to contribute to a greater long-term understanding of airport pricing and performance.

(d) The ID price setting disclosure has provided a clear reference point for the Commission's requirements for information to be disclosed following the PSE, which has in turn influenced the structure and emphasis placed on advancing issues through the consultation process. For example, in the first PSE the prospect of introducing a domestic charge was raised but not supported by the airlines, nor advanced. However for the second PSE further time was spent on this matter and the introduction of a new charge for domestic passengers was implemented. Where Auckland Airport has made departures from the IMs in pricing, these have been carefully explained and have been made based on feedback from substantial customers and sound economic principles. Departures have also been made by embracing an important objective and advantage of ID regulation - that is, knowledge of the relevant commercial environment and informed and autonomous investment decision-making (which includes a broad range of factors such as stimulating competition in downstream markets (including airlines) and stimulating and accommodating economic growth across the region and country as a key infrastructure provider).

(e) Auckland Airport's disclosures have provided substantial information to enable interested persons to understand and form a view on Auckland Airport's performance, as intended by the new regulatory regime. Although Auckland Airport has received very little feedback in relation to its first annual disclosure, it is hopeful that the additional disclosures it has made have provided some new information to interested parties which was not previously available.

(f) Auckland Airport has generated efficiencies and shared the benefit of those efficiency gains with consumers. Auckland Airport continues to be one of the lowest cost airport operators in the world. Over the past seven years Auckland Airport has:

(i) Introduced a number of Lean Six Sigma Service ("**LEAN**") initiatives which have increased either the quality or capacity of existing investment;

(ii) Seen significant reductions in corporate costs (such as shareholder costs and PR costs);

(iii) Reduced its reliance on hireage of plant and equipment; and

(iv) Passed through efficiencies to international passengers in the form of reduced unit prices from July 2012.

32. Auckland Airport's disclosures in the ID Schedules have reported comprehensively on the extent to which Auckland Airport is benefiting consumers. Although it is not possible to attribute all of those outcomes to the new ID regime, they are consistent with its purpose and assist with painting a broader picture of our approach to our disclosures.

33. In our view, the new ID reporting regime is a significant improvement on previous reporting requirements, as it encompasses broader financial and non-financial performance measures, and provides for a more effective and comprehensive assessment of regulated services. The increased transparency of the new regime provides better means for explaining an airport's individual circumstances, in particular capacity constraints and capital requirements.

34. The following provides an overview of what our disclosures tell interested persons about the extent to which Auckland Airport is promoting the purpose statement objectives.

Identifying and implementing innovations (Schedules 6, 11, 12, 13, 14, 15)

35. The introduction of technologies and innovation to improve departures, arrivals and border initiatives is a continuous process that can increase the propensity to travel and increase the available capacity of existing infrastructure, thus deferring capital expenditure on new infrastructure until it is needed. Successful innovation serves several purposes:

(a) It leads to operational improvements (as outlined in Schedule 15);

(b) It improves capacity utilisation of terminal and airfield facilities (as outlined in Schedules 12 and 13);

(c) It potentially increases reliability of performance, safety and initiatives to drive growth (as outlined in Schedule 11); and

(d) It can reduce actual expenditure against forecast expenditure (as outlined in Schedule 6) by finding new ways to utilise existing assets, increase capacity and delay the need for further investment.

36. Auckland Airport has a history of innovation in airport and airfield operations and in customer service. For example, the Auckland Airport 'Blue Coat' ambassador programme that we initiated has been copied by many airports around the world, and is frequently cited in Airport Service Quality ("**ASQ**") surveys and customer research as a source of satisfaction (as outlined in Schedule 14).

37. Innovations can also improve operational risk:

(a) Auckland Airport recently introduced a world-first 'Jackal' grass, especially developed by PGG Wrightson, containing a fungus that deters insects, and in turn, reduces bird activity near runways; and

(b) A harbour-side location means that Auckland Airport has needed to find innovative ways to manage risks associated with extreme weather and tidal conditions. Auckland Airport was the first airport in Australasia to introduce Cat III technology to assist with airport operations in low-visibility conditions and significantly reduce the number of fog-related delays or cancellations for airlines.

38. Airport partners are involved in the identification and development of innovations through airport-wide initiatives to incentivise good ideas. A recent initiative implemented by Auckland Airport, dubbed 'Every Minute Matters', produced a number of ideas, including a winning idea from MAF Biosecurity, which identified a smarter way for 'disinsection' of a plane upon landing. This idea saves up to 10 minutes in the processing of each arriving flight which helps with:

(a) Reliability;

(b) Customer satisfaction;

(c) Capacity utilisation; and

(d) Operational improvements.

39. Product innovations for non-regulated activities, but which have an impact on our regulated services, include the following:

(a) The introduction of free car-parking for the first 10 minutes, which has reduced the need for increased forecourt space required for passenger pick-up and drop-off, and has reduced pressure on terminal capacity; and

(b) The Auckland Airport Emperor Lounge opened in late 2011, complementing a number of existing airline operated lounges that are located at Auckland Airport, providing greater choice for partner airlines and for passengers.

40. An important service innovation from the first PSE was the removal of the international departure fee, which was replaced with a passenger service charge that is levied on the airlines. Consumer feedback for many years was unequivocal that having to pay a separate departure fee at the airport resulted in a poor experience. This Auckland Airport initiative has since been followed by Christchurch International Airport Limited ("**CIAL**") and Wellington International Airport Limited ("**WIAL**").

41. Airfield innovations include the following:

(a) Apron lighting, for low visibility conditions.

(b) Ground power units, to improve energy efficiency of aircraft.

(c) To be A380 capable, gate 15 and 16 in the Pier B building have been specially fitted with two Multi Aircraft Ramp System ("**MARS**") air-bridges, which are able to disembark or load both levels of the aircraft. These also provide the unique ability to service two A380s or four smaller aircraft at the same time.

(d) To ensure New Zealand was A380 ready, Auckland Airport upgraded the main runway, adding a 7.5m asphalt strip down each side. While this runway rehabilitation was underway, the taxiway was converted to a runway to allow operations to continue. Certain innovative engineering techniques were employed for the first time in New Zealand to allow for sections of widened runway to be poured in a way that minimised impact on airline operations.

42. Operational efficiency has been enhanced by recent Auckland Airport innovations, including:

(a) The introduction of Advanced Passenger Display, which has assisted with resource allocation and capacity utilisation. This provides border agencies and Auckland Airport with advanced information on the nationality breakdown of arriving passengers.

(b) Operation Kingfish, which saw Auckland Airport work with Air New Zealand to introduce self-check facilities at international check-in. Auckland Airport has innovated in assisting passengers to get to the gate in time for flights, with new Flight Information Displays, supplemented by targeted gate announcements, helping to reduce the number of missed flights.

(c) In the last year, with the growing ubiquity of smart mobile devices, and the rise of digitally savvy consumers who want individualised products and services on demand, the concept of a 'smart' airport has also become a proxy for innovation at Auckland Airport. As part of our research, Auckland Airport is assessing how consumers in the near-future will travel, and the experience they expect along the way.

43. Innovation is being used to generate sustainability efficiencies and energy savings:

(a) The Leadership in Engineering and Environmental Design ("**LEED**") accredited Pier B international terminal has the largest solar voltaic panel array in New Zealand on the roof of the terminal, with 300m^2 of solar panels providing much of the energy for the building.

(b) Public recycling stations have been installed at Auckland Airport since 2008. There are ten in the international terminal and five in the domestic terminal for plastic, cans and glass. Auckland Airport also provides facilities for tenants to recycle their waste. In total, over 400 tonnes of waste from the terminals is recycled, which gives a recycling rate of around 25 percent.

(c) A terminal energy efficiency programme was initiated in 2010.

(d) Improvements in water capture technologies have reduced the water use per passenger to 0.049 cubic metres in 2011 (down from 0.055 cubic metres the year before). Rainwater is collected and piped to a rainwater reclaim tank farm. Approximately 4000m^3 of rain water is collected annually and recycled for use in the air-conditioning cooling towers.

Having an appropriate incentive to invest

The investment context

44. In general, airports are one of the few infrastructure sectors in New Zealand that do not have a significant sector-wide infrastructure deficit. That said, airport infrastructure is hugely capital intensive and long-lived, and it is essential for New Zealand that airports continue to have appropriate incentives to provide the capacity necessary to ensure there are no growth constraints and to facilitate our country's ambitions to grow trade and tourism.

45. Auckland Airport is an economic growth engine for the Auckland and New Zealand economies, generating thousands of jobs and driving millions of dollars' worth of tourism and trade activity. It handles more than 230,000 tonnes of airfreight annually worth $12.5 billion; contributes around $19 billion annually to the national economy and $10.7 billion to the Auckland economy (13.7 percent of New Zealand's GDP). Projected to grow faster than the rest of the economy, the importance of Auckland Airport in New Zealand's economic activity will continue to grow. Auckland Airport's goal is to enhance this economic contribution as much as possible. With that in mind, it is taking steps to increase productivity by investing in the following:

(a) Smart airport infrastructure.

(b) Air-service development, and in conjunction with our key stakeholders, initiating and promoting programmes to attract more tourists and trade to New Zealand. Auckland Airport is heavily focused on growing tourism, travel and trade for the benefit of Auckland and New Zealand. Gaining better air connections to high-growth markets is essential for New Zealand's economic growth agenda – there is a strong link between air services, market access and economic growth. Notably, many of the opportunities exist at off-peak times and therefore create limited incremental cost and thereby improve asset utilisation.

How Auckland Airport plans its investment

46. Masterplanning is an effective tool for facilitating the integrated planning of infrastructure investment. By evaluating a range of future layout options for the airport, masterplanning provides information on those options that provide the greatest value, the costs to achieve them and the pathway for implementation. In doing so, masterplanning for the future considers factors such as demographics, population growth, tourism growth, aviation trends, the economy, the regulatory framework, globalisation, technology, resource constraints, security, environmental responsibility, community and stakeholder input.

47. A second runway to the north and parallel to the existing southern runway has long been part of the Auckland Airport master-plan and will, in time, be essential to accommodate forecasted long-term tourism and trade growth. Construction work on the Northern Runway commenced in 2007. This was temporarily paused in 2009 to better match timing of delivery of the Northern Runway with demand slowed by economic conditions and upgrading of aircraft sizes. In July 2010 the suspension of construction was extended for several more years, following extensive consultation with the airline industry and a review of capacity management. That review identified more innovative means of managing peak-time capacity on the existing southern runway, meaning it could handle expected growth for longer than earlier envisaged. Additionally, although passenger volumes are growing again, the growth trend is less than anticipated when construction of the Northern Runway began. The eventual recommencement of construction of the Northern Runway will be demand-driven relative to the capacity of the existing southern runway and terminals.

48. A long-term planning vision of an integrated terminal infrastructure served by two runways, surrounded by a vibrant airport business district, and well connected with the city, remains central to the airport's thinking. With growth in passenger and freight transport, changing aircraft types, and associated aircraft movements, Auckland Airport is now confronting capacity constraints, particularly in the domestic terminal. These constraints will only become more acute as more of the larger A320 aircraft replace smaller B737 aircraft on domestic routes. The highest priority for the short to medium-term horizon is to address the capacity constraints in the existing domestic terminal and to find a pathway for enabling the future benefits for passengers and New Zealand resulting from improved integration of terminals.

49. Auckland Airport has a responsibility to Auckland and New Zealand to ensure long-term tourism infrastructure capacity for predicted growth is in place. Achieving this responsibility requires optimising dynamic efficiency (getting the right infrastructure in the right place at the right time) and investing in a manner that enables the flexibility needed to accommodate future changes and shifts.

50. A major development programme, which saw more than half a billion dollars invested in new infrastructure over several years, came to a conclusion in the late 2000s. Since then, the main emphasis has been on maximising the efficiency of this investment by improving utilisation of airport assets. But as passenger numbers, aircraft movements and freight volumes continue to grow, capacity constraints will develop.

51. In particular, capacity in the domestic terminal is becoming increasingly constrained. Accordingly, in consultation with our stakeholders, we need to carefully and appropriately invest to ensure that Auckland Airport is able to meet expected demand and underpin growth within the region.

52. The nature and large scale of some of the capital investment that will be required to accommodate demand growth at Auckland Airport, and the relatively shallow capital pools available in the country, means that we must be able to raise capital and attract funding from a wide range of sources. Access to global capital is therefore critical to our ability to invest.

53. A key consideration for the Board in making the pricing decision, was that an appropriate return on investment is required to enable Auckland Airport to source suitable funding from capital markets. This is particularly important because Auckland Airport competes for that capital with other Australasian commercial airports. This is discussed further in our answer to question 3.1.

54. The very long-term realities of airport planning and development mean we must continue to hold land for future airport expansion for extended periods. However, the current regulatory framework implies that it is unacceptable for airports to reflect the holding costs for such land assets in their charges to airlines, meaning that this land would generate no return to airport shareholders until such time as it becomes operational. As New Zealand's foremost airport, which represents a vital part of the country's transport, tourism and trade infrastructure, Auckland Airport must ensure it has the capacity to cater for the needs of future generations by retaining this land. This is a national responsibility we cannot, and do not wish to avoid. However current regulatory settings mean our shareholders are bearing the cost associated with safeguarding future New Zealand aviation capacity, with considerable uncertainty as to whether this cost may be recovered.

55. Incentivising investment for the Northern Runway is crucial in the context of the development of New Zealand's tourism industry.

56. Options were put forward during consultation to signal the cost of supply for a Northern Runway. The options were based on the Commission's "Future Use" methodology. Auckland Airport is concerned that the Commission's methodology may not deliver commercially acceptable outcomes for the airlines in the future due to the step change in pricing implied by it. At present, alternative land use options exist, but Auckland Airport continues prudently to hold significant areas of land for future aeronautical purposes rather than selling or developing the land for other commercial use. However, this landholding provides no current cash return, and future aeronautical returns remain uncertain. In the second Price Setting Disclosure, Auckland Airport noted that further dialogue is required to develop the certainty needed to enable investment in a Northern Runway. Auckland Airport considers that the section 56G Review is a good forum in which to advance understanding of the issues and elaborates on this further in question 3.

Providing services of the quality and range required by consumers (Schedule 14 and 15)

57. Schedule 14 of the disclosure statements reports on passenger service indicators, which are one measure of Auckland Airport's ability to provide services of the quality and range wanted and expected by consumers. The operational improvement indicators outlined in Schedule 15 also serve to highlight work that improves customer satisfaction.

58. Auckland Airport uses a number of methods to understand and improve the quality of services required by customers and to assess customer satisfaction. These include:

(a) Membership of the global ASQ service rating system. Outlined in more detail in Schedule 14, ASQ is a customer satisfaction analysis and benchmarking programme. Average survey scores for the year showed slow but steady improvement from a high base.

(b) The World Airport Skytrax Awards are a strong passenger satisfaction indicator. For the last four years, Auckland Airport has been voted the best airport in Australia Pacific in the World Airport Skytrax awards, and was named in the top 10 airports in the world in 2009, 2010 and 2011.

(c) The Best Service in Australia Pacific award in 2009 and 2012. These annual awards are based on a global survey that included over 12 million voters in 2012, evaluating traveller experiences across 39 different airport service and product factors - from check-in, arrivals and transfers through to departure at the gate.

59. Auckland Airport also undertakes regular qualitative and quantitative market research that assists in understanding consumer needs and preferences. The quality and range of products and services across the business has been expanded, including terminal amenities and passenger processing. This offers choice and encourages supplier innovation and competition to help grow the size of the overall market.

60. Research also indicates that consumers expect a certain quality of airport environment, or ambience:

(a) In 2011, Auckland Airport completed a major refurbishment of the international departures area including an expansion of airside and emigration processing space and a reduced space landside. This has helped Customs and Aviation Security to increase processing speed, and has assisted airlines by reducing the incidence of passengers missing flights.

(b) The refurbishment also had a particular focus on using design to enhance the passenger experience. The quality of the refurbishment was recognised in August 2011, being awarded the Supreme Winner at the national Red Retail Design Awards, which promote excellence in design.

(c) A pre-Rugby World Cup 2011 ("**RWC**") refresh of the arrivals experience included a review and upgrade of way-finding for international arriving passengers, making it easier for passengers to find their way around. This also had the effect of improving capacity utilisation (outlined in Schedule 13) and the passenger satisfaction indicators (outlined in Schedule 14).

61. Auckland Airport is also seeking to improve terminal access for the disabled and for the mobility reduced. In late 2010, an Access Audit was undertaken for both the International and Domestic terminals by the Disability Resource Centre, with a number of best-practice initiatives already completed and underway following the recommendations of that audit.

62. Air-service development initiatives have continued with the aim of driving market growth and increasing consumer choice. Auckland Airport has invested significantly in international air-service development to stimulate and accommodate targeted tourism and trade growth and to benefit consumers through an increase in air-service competition and an expansion of destination options. Opportunities to invest in domestic and regional air-service development that benefits consumers through increased competition and choice are more limited, due to the smaller market scale.

63. Improved physical access to the airport is important to consumer satisfaction. Auckland Airport has worked with transport agencies and operators to increase choice in airport transport options and improve the road and forecourt layouts to improve ease of use and increase safety. This has, to date, resulted in an increased frequency of bus services, an award-winning car-pooling system, and strong participation in council initiatives to identify and protect transport routes for a future rapid transit network option.

64. Consumers increasingly expect that organisations meet their responsibilities and obligations to care for the community and the environment. Auckland Airport has the largest noise mitigation programme in New Zealand, designed to reduce noise impacts and meet our obligations to the community. The Auckland Airport Community Trust has now distributed over $2 million in funding to community initiatives within the airport noise contours. In 2011 Auckland Airport gained 'Silver' status in the international Earthcheck sustainability benchmarking programme, and was the only organisation in New Zealand nominated in every category of the Sustainable 60 awards. Using a range of energy harnessing or energy saving-related initiatives, there are continued improvements across all key measures, including Co2 and water use per passenger.

Generating efficiencies and sharing the benefits of those efficiency gains with consumers (Schedules 6, 11, 12, 13, 14 and 15)

65. Schedules 12 and 13 of the disclosures report on the ability of Auckland Airport to maximise utilisation of the passenger terminal and the aircraft and apron facilities to drive efficiencies for passengers and airlines. Information that is included in Schedules 11, 14 and 15 will be influenced by the benefits that are gained through better efficiency. Achievements in operational efficiencies have continued across the terminal and airfield. These include the following:

(a) The extension of SmartGate into international departures.

(b) Continued collaboration with our airport partners on expanded Lean Six Sigma efficiency work.

(c) The further development of Smart Border initiatives. Smart Border is Auckland Airport's description for the group of technology and efficiency initiatives that, when completed, can effectively 'submerge' the trans-Tasman border processing experience for travellers, making it as close to a domestic journey as possible, while preserving sovereign border integrity in terms of immigration, customs and bio-security needs. Auckland Airport works constantly with relevant border agencies (in particular, MAF, Immigration and Customs) using Lean Six Sigma methodologies to drive a better experience – the success of which was particularly evident during the RWC. This is an on-going process as we strive to improve our levels of service and the passenger experience. The results of the Lean Six Sigma work are reflected in Schedules 12, 13 and 15. In particular, in line with Schedule 15, there have been operational improvements in passenger processing times. SmartGate self-service border kiosks were advocated for, trialled and first introduced at Auckland Airport, speeding up the Customs process for eligible New Zealand and Australian passport holders. Time and convenience are a strong proxy for value for a passenger.

(d) Self-service check-in kiosks are now available for domestic travel with Jetstar and for both domestic and trans-Tasman travel with Air New Zealand.

(e) In addition, Auckland Airport supported the introduction of risk-based bio-security screening, increasing the likelihood of detecting bio-security risks and speeding up MAF bio-security screening times significantly.

66. There has been a focus on procurement efficiency. Auckland Airport has successfully reduced the number of suppliers from over 5000 to fewer than 1500, generating operational efficiencies, greater economies of scale and reduced supplier management cost.

67. Auckland Airport has also completed a review of its capital sourcing strategies and capital allocation/productivity. In improving the discipline and efficiency of the sourcing and allocation of capital, cost pressures on the balance sheet have been reduced, and there is more informed and more accurate decision-making on potential expenditure (as outlined in Schedule 6).

68. By tightly controlling capital expenditure and making every dollar count, there is an emphasis on innovative thinking and better utilisation of existing assets (as outlined in Schedules 12 and 13). Changes were made over the year to the domestic and international terminal forecourts to ease congestion, facilitate better traffic flow and make provision for more public transport. Ahead of the RWC, Auckland Airport also invested in a revamp of the international terminal arrivals experience, particularly the airside arrivals corridor and the landside public arrivals hall, and in an update of signage at both terminals.

69. As well as having a strong growth focus, Auckland Airport has strived to disconnect costs (including capital expenditure) from passenger volume growth to help drive down unit costs and reduce pressures on pricing. Reliability of core regulated services has been very high, and compares well with international airport performance. Auckland Airport believes the best measure is to calculate reliability of these core services as a percentage of available time. For example, the overall availability of the runway, including a significant and unusual outage in late 2010 caused by cabling works commissioned by Airways, was over 99.9 percent.

70. Auckland Airport has shared the benefits of these efficiencies with consumers through:

    (a) Lower prices through facilitating volume growth;

    (b) Low cost and capital inputs to pricing calculations as efficiencies are achieved; and

    (c) Constraining price increases.

71. All of this has been achieved while also delivering good to very good passenger experience outcomes, as detailed in the service quality section of this submission.

Earning a fair and reasonable return on the investments made

72. As outlined in Schedule 1 of the disclosures, Auckland Airport believes that return on investment should be measured over a period of time rather than at a single point in time. As this is the first disclosure under the new ID regime, it should form the first of a series of data on return on investment.

73. While new airport facilities deliver benefits to New Zealand tourism and trade, Auckland Airport acknowledges that providing this new infrastructure will represent a significant investment that will affect airport charges. It is conscious of the challenging environment some airlines currently face, and the Asia-centric growth that other airlines are experiencing. Such concerns must be balanced with the requirement to invest in infrastructure, in a staged, fit-for-purpose and highly efficient way to best meet New Zealand's interests.

74. Historically, Auckland Airport has earned conservative returns on investment. As outlined in earlier information disclosures, the last three years of return on average

assets after tax but before interest were 1.0 percent (2010), 4.5 percent (2009) and 4.5 percent (2008), based on the methodology adopted at the time and excluding any revaluations.

75. Auckland Airport also has a history of reviewing investments in response to changing demand conditions. For example, in recognition of evolving market conditions, and in order to carefully optimise delivery with market need, work on the Northern Runway was halted and reduced to preservation works only.

76. Auckland Airport has also demonstrated its 'skin in the game', by electing not to implement a scheduled price increase at the height of the global financial crisis ("**GFC**"). In July 2009, in recognition of the extraordinary conditions being experienced at that time by our airline customers, Auckland Airport deferred a scheduled increase in landing charges, effectively waiving $2.7 million of revenue over a nine month period. There was a return to the scheduled pricing arrangement in March 2010. In the second PSE, Auckland Airport has increased the use of pricing per passenger and therefore increased the exposure of Auckland Airport to market fluctuations.

Assessment challenges

77. Schedule 1 reports on the actual return on investment compared to an estimate of WACC for the year ended 30 June 2011. The commentary provides further information to interested parties on key considerations when interpreting the disclosed return. The three main considerations relate to:

(a) The difference in timing and time horizon, between the setting of a five year forward looking WACC for pricing, versus updating a WACC annually for ID;

(b) Interpretation of the return on investment for ID, which includes asset valuations, in the context of Auckland Airport's price setting in 2007 which contained a moratorium on asset revaluations; and

(c) The exclusion of land held for the future second runway and inclusion of aircraft and freight activities in the regulated asset base.

Apples and pears

78. As prescribed by the ID Determination, the WACC comparatives provided in Schedule 1 are the Commission's estimates for the year ended 30 June 2011 using inputs determined as at 1 July 2010. The 'previous price setting event' relevant to these disclosures occurred in 2007, and the WACC used for that pricing used inputs determined at that time. This meant that the WACC used for pricing purposes is very different to the WACC now being used to benchmark the subsequent outcomes of the previous pricing decision. For June 2011, the WACC estimated for ID by the Commission was 8.06 percent, as shown in Schedule 1 of Auckland Airport's disclosure. However, prices were set some five year prior. Applying the Commerce Commission's WACC methodology, but using the inputs applicable at the time of the previous price consultation, would have resulted in a mid-point (50th percentile) post-tax WACC estimate of 9.11 percent (for 2007).

79. When making ex post assessments using annually calculated WACCs, it will be critical to ensure that performance is fully contextualised, and the reasons for any deviation between return on investment and WACC are fully understood. We acknowledge that, with the pricing period as it is, pricing is fixed for 5 years and this may result in what appears to be Auckland Airport earning rents if the WACC moves downward over the time period. Whilst this might be revealed by comparison to an actual WACC calculation in ID, we consider it is crucial that parties recognise that this does not necessarily indicate the exercise of market power. Equally, if WACC rises during the pricing period,

resulting under-recovery in any given year is not an indicator that the airport is failing to ensure it earns a normal return over time. The fact that WACC moves around year to year reinforces the need to do any ex post analysis over a long period of time.

Effect of moratorium

80. In 2007, Auckland Airport consulted with its substantial customers on how to treat asset revaluations. Based on an Australian Productivity Commission decision and with the support of the airlines, the price path for FY08 to FY12 included a moratorium on asset revaluations (through to 2017) to avoid the short-term variances it may produce and remove this contentious element from the pricing decision. Therefore, no revaluation gains were included in the calculation of Auckland Airport's regulatory profit used to calculate return on investment during the pricing period. On the other hand, the intention was that there would be no alleged windfall gains from revaluations when prices were set in 2012.

81. In contrast, the Commission is measuring the return on investment by including revaluations in the calculation of Auckland Airport's regulatory profit used to calculate return on investment. Each is a valid approach if consistently applied. However, the Commission's approach includes revaluations as income even though the pricing decision in 2007 did not include these increases in the asset base between 2007 and 2012.

82. Auckland Airport's reported return on investment set out in the disclosures ended 30 June 2011 incorporates the revaluation gains. To illustrate the impact, the unrealised non-cash revaluation gains of $75.4 million represent over half of the company's reported return on investment for the year ended 30 June 2011. Excluding these would lower the post-tax return on investment estimates for the year ended 30 June 2011 to 5.8 percent. This compares with a post-tax WACC range of 9.11 percent to 10.09 percent at the 50th to 75th percentiles, calculated using the Commerce Commission's methodology and the parameters applicable when the price path was set.

83. To compare FY11 with FY10, the 2010 financial year did not include any market revaluation gains on land, although it did include $17.7 million of CPI valuation adjustments on land, plant and equipment. Auckland Airport's estimated post-tax return on investment for the year ended 30 June 2010 is 7.3 percent including the 2010 CPI revaluation, and 5.8 percent excluding it. This compares with the same post-tax WACC range of 9.11 percent to 10.09 percent at the 50th to 75th percentiles applying the Commission's WACC methodology at the time prices were set.

Establishing an appropriate estimate of WACC

84. Auckland Airport considers it is important that an appropriate return on investment is achieved to enable Auckland Airport to source suitable debt and equity funding from global capital markets. Auckland Airport also considers that a precise return cannot be calculated and that the WACC must be considered within an appropriate range.

85. In the most recent pricing decision, Auckland Airport has not adopted some aspects of the Commission's industry-wide WACC as it believes that it is necessary and appropriate to consider company-specific WACC matters on a forward-looking basis for the entire pricing period.

86. In this regard, at no stage during the IM consultation process did we understand that the Commission considered that its WACC IM was being developed for the purpose of being applied by Auckland Airport in pricing decisions - albeit Auckland Airport did follow an approach that was broadly consistent with the principles underlying the WACC IM.

87. The main difference in perspectives between Auckland Airport and substantial customers in the second PSE was whether the Commission's IM for ID ought to be applied for pricing. Auckland Airport provided expert advice and detailed explanation of each of the WACC parameters. Auckland Airport also requested that substantial customers explain why Auckland Airport should adopt an industry-wide WACC for a pricing decision specific to Auckland Airport. No reasons (other than simply because the Commission's WACC should be applied) have been forthcoming and, as a result, Auckland Airport has not been persuaded that applying all aspects of the Commission's industry-wide WACC set for ID purposes is appropriate for pricing.

88. Auckland Airport's final decision was informed by analysis and reports by Professor Alastair Marsden of Uniservices and its experience in debt and equity markets. The basis for this decision is provided in Section 2.2.3 of the Price Setting Disclosure and key points are discussed further in response to question 3.

89. We also ask the Commission to consider theoretical approaches relative to practical and empirical evidence specific to Auckland Airport. Particular areas we highlight for the Commission to consider are:

(a) Whether a 17 percent leverage ratio is realistic;

(b) Whether the implied cost of debt under the IM is realistic;

(c) The impracticality of matching the debt structure to the regulatory period;

(d) The balance of evidence and views on the market risk premium;

(e) The appropriateness of making some account for firm specific factors in the asset beta for pricing purposes; and

(f) Whether it is realistic to assume no asymmetric risks, in particular Type I asymmetric risks?

90. As part of the IM process, Auckland Airport became aware of the theoretical incentive to raise leverage under the Brennan-Lally model. Auckland Airport has not contemplated increasing leverage in order to exploit this theoretical advantage. The company's leverage ratio has been very stable averaging 27.5 percent over the last two years, and 28.8 percent over the past five years. If Auckland Airport was inclined to change its leverage to 17 percent, this would not represent an efficient capital structure, as such a structure would be considered by many investors to be a lazy balance sheet offering restructuring potential. However the facts are that Auckland Airport's leverage is not influenced by the perceived incentives provided by the IM, but by treasury policies, and its capital structure is entirely independent of the pricing consultation processes.[3] No substantial customers suggested that Auckland Airport should adopt a 17 percent leverage ratio.

[3] Auckland Airport holds a monthly Treasury Management Committee ("**TMC**") meeting with members including management and treasury operational team from Auckland Airport and independent treasury advisors to discuss current domestic and global economic and financial trends, treasury performance, funding and hedging arrangements and treasury policy reporting and compliance. A formal annual review of the treasury policy is performed to amend the policy if required to meet market best practice, and to review the target credit rating and ratios, the hedging parameters and the funding parameters, with any changes to the treasury policy requiring Board approval. In addition, a semi-annual report is presented to the Board reporting treasury results against treasury policy. A treasury report is provided to the Board on a monthly basis, a summary of Auckland Airport's debt position including borrowing facilities, bonds, commercial paper, money market, interest rate swaps and interest rate options including hedging profile and compliance with hedging parameters, funding parameters, counterparty credit limits and other treasury policies.

Implied cost of debt

91. Auckland Airport also highlighted to substantial customers that one observable WACC parameter – the cost of debt implied under the IM, was implausibly low in Auckland Airport's view. As at April 2012, the implied cost of debt (at the 50th percentile) under ID for the airport industry was 5.9 percent pre-tax. At that time, Auckland Airport's weighted average debt cost was 6.52 percent pre-tax. Auckland Airport does not consider that the theoretical debt cost of funds calculated in the WACC model represents a commercially viable debt funding rate for an entire debt portfolio. Substantial customers did not respond specifically to Auckland Airport's points raised in relation to the artificially low debt cost implied by the model. Auckland Airport is confident that it has an efficient debt portfolio and therefore believes that the Commission's WACC methodology is too conservative. This may be due in some part to the unprecedentedly low yields being experienced in certain countries for government bonds.

92. Auckland Airport has since asked Bancorp to benchmark the efficiency of Auckland Airport's debt costs to substantiate whether its cost of raising debt is unreasonably high as implied by the WACC IM. (A letter is **attached** from Bancorp as **Attachment 1**). Based on a sample of companies operating in the infrastructure space and/or were regulated they conclude:[4]

> The average cost of funds ranged from 7.5 percent to 6.58 percent for 2010/2011 and 7.47 percent to 6.47 percent in 2011/2012. AIAL has the lowest cost of funds in 2010/2011 and second lowest in 2011/2012.

Risk terms

93. Auckland Airport does not consider it is efficient or feasible to match its debt structure to the aeronautical pricing period. The implicit requirement under the IM to match the term of the Airports' debt to the price review period is inconsistent with prudent treasury management and the commercial imperatives to spread debt across time periods. It would also require the Airports on day one of the five year period, to:

(a) Accurately assess the markets used to source debt during the five year period;

(b) Assess the amount of debt required (despite variable capital expenditure and passenger volumes driving different outcomes); and

(c) Determine the exact dates for refinancing with all debt refinancing due on the same day.

94. Auckland Airport agrees with Uniservices advice that:

(a) Prudent commercial and treasury management would not be to have all debt finance maturing on the same day (ie the price review date or end of a current regulatory period);

(b) Interest rate swaps are not commercially realistic mechanisms by which the Airports can completely manage their interest rate risk; and

(c) Insufficient allowance is made by the Commission for the cost of any interest rate swaps.

95.

[4] Bancorp, Letter from Bancorp to Auckland Airport, 2 October 2012.

Commission's view that companies with an average debt tenor greater than five years should be properly compensated for the increased costs.

96. Bancorp also note in their letter that:[5]

> No regulated organisations managed interest rate risk to align with a regulatory reset period. This is consistent with what we have observed as market best practice in Australia. Queensland Treasury had historically attempted to manage the debt of state owned entities to the various regulatory cycles but we believe it has abandoned this approach given the material funding and hedging execution risks faced. NSW Treasury has consistently managed interest rate risk for regulated state owned entities on a portfolio basis. Analysis completed by TCorp in 2008/2009 that we were party to concluded that fixing all debt to the regulatory cycle could impose up to 50 basis points (0.50%) on interest rate swap costs alone.

TAMRP

97. Auckland Airport acknowledged that the Commission's most recent estimate of WACC in January 2012 suggested a TAMRP of 7 percent was appropriate, ending the temporary application of a 7.5 percent premium due to the GFC.

98. Auckland Airport requested Uniservices to provide a thorough analysis and summary of the current industry views on the appropriate market risk premium.[6]

[5] Bancorp, Letter from Bancorp to Auckland Airport, 2 October 2012.
[6] Uniservices April 2012 Report: Comments on March 2012 submissions by the Airlines and update on specified parameter inputs into the Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland Airport.

Asset beta

101. Auckland Airport sought advice from Uniservices on the appropriate asset beta for Auckland Airport's pricing. An asset beta of 0.65 has been adopted (rather than the Commission's industry beta of 0.60) based on expert advice from. Uniservices replicated the Commission's analysis for the WACC IM, but as at August 2011, as **attached** as **Attachment 2.** Auckland Airport also notes that the Commission estimated a corporate asset beta for Auckland Airport of between 0.75 and 0.79. Auckland Airport considers that an asset beta for the regulated side of the business of 0.65 consistent with the sample outcomes, yet more reflective of Auckland Airport's risk profile. We draw attention to the Commission that Auckland Airport's new price structure has a higher risk, than its previous price structure, with a substantially reduced cost pass through element.

Other considerations for a reasonable return

102. We note that Auckland Airport building blocks pricing model has made no allowance in its cashflows for asymmetric type risks such as SARS, volcanic activity, terrorist activity etc. This is a consideration that should be recognised in setting a reasonable return.

103. Auckland Airport's Board and Management continue to hold significant concerns in respect of Auckland Airport's ability to earn a fair return on investments made under a monitoring regime which excludes assets efficiently held for future expansion. The value of the land held for future use, using the Commission's valuation methodology, is recorded at $178 million as at 30 June 2011.

104. Airports are land intensive businesses, and land available and owned by Auckland Airport, adjacent to existing airport infrastructure, is key to Auckland Airport delivering the future aeronautical growth needs of Auckland and New Zealand. As part of its pricing decision, Auckland Airport has highlighted the fact that the IM for future use assets is entirely impractical and commercially challenging.

105. Auckland Airport considers that some insights in relation to whether a reasonable return is provided to Auckland Airport comes from comparisons of Auckland Airport charges with other airports. Auckland Airport has procured a number of reports in this regard.

106. The report by international aviation consultants, Jacobs, was conducted in September 2010 and reviewed international charges. According to Jacobs, Auckland Airport's international aeronautical charges were at the time "middle of the pack", just below the average of the 20 airports serviced by Air New Zealand that handle more than 500,000 international passengers a year. A report by Australasian aviation consultants, Airbiz, was conducted in August 2010 and reviewed our domestic charges. The Airbiz report found that Auckland Airport had amongst the lowest domestic charges in Australasia. These competitive charges have been achieved while providing excellent levels of service, as indicated by being named the best airport in Australia Pacific for four years running.

Room for improvement of performance

107. Although Auckland Airport is proud of its success stories, we accept that there will be some instances where we can do better in the future both in terms of performance, ID and pricing consultation.

108. The focus of pricing consultation is directed in part by questions raised by substantial customers and the nature of feedback. Substantial customers identified a few areas, late in the consultation process, which they indicated required further review. For example, in response to the Initial Pricing Proposal

Such an exercise has the potential to take more than a year and therefore was not possible during the most recent PSE. However based on this feedback, Auckland Airport has agreed to prioritise this in the lead up to the next price consultation.

109. While Auckland Airport was fully committed to running a consultation process consistent with the legislative and regulatory framework, we accept that the Commission's Review may provide additional guidance on how we might improve going forward, particularly given that the regime is in its infancy. However, in our view, any identified problems/deficiencies should be taken as a sign of ID working. Put another way, the identification of problems will allow us to improve our behaviour, which is evidence that ID is working as intended.

110. We have given careful consideration to whether an ID regime can be properly held to be effective where an aspect of airport behaviour is considered to result in an outcome that may be contrary to one of the limbs of the Part 4 purpose statement. The Commission's characterisation of the ID Regime in the ID Reasons Paper has been useful in this regard:[7]

> ...placing information and analysis about regulated suppliers into the public domain is about creating incentives similar to those found in workably competitive markets by providing:
>
> - information to consumers and other interested person, about the extent to which efficiency gains have been shared with consumers through lower prices or other means (consistent with section 52A(1)(c)). Doing so is likely to enhance consumers' countervailing market power, which may result in excessive profits being limited (consistent with section 52a(1)(d)), and may facilitate consumer engagement with regulated suppliers about the desired level of service quality (consistent with section 52A(1)(b));
>
> - better information to the owners of regulated suppliers. For example, information disclosure may allow comparison with suppliers in other areas. This may facilitate effective governance and help owners identify opportunities for value-enhancing trade in assets used to supply regulated services (e.g. consolidation of businesses), management contracting and so on, thereby promoting incentives for improved efficiency, including efficient investment and innovation (consistent with section 52A(1)(a) and (b)); and
>
> - increased incentives for the management of regulated suppliers to improve relative and absolute performance, consistent with section 52A(1)(a) and (b).

111. The Commission goes on to recognise that ID regulation is not about directly seeking to *influence* outcomes, (which is what one would expect from a price control regime), but is properly about *exposing* them:[8]

> However, the Commission considers that it is important to distinguish this influence from the purpose of information disclosure as provided for in section 53A of the Act. While some incentive effects will flow from any information disclosure regime, the Commission's information disclosure framework has been developed to ensure that sufficient information is readily available to interested persons to assess whether the purpose of part 4 is being met.

112. Consistent with the views of the Commission, it is our view that ID regulation was never intended to categorically and immediately prevent the occurrence of outcomes inconsistent with the Part 4 purpose statement. Even a more heavy-handed regulatory

[7] Commerce Commission, ID Reasons Paper, 22 December paragraph 2.28.
[8] Commerce Commission, ID Reasons Paper, 22 December, at paragraph 2.29.

regime cannot absolutely prevent against such outcomes. Indeed, a key reason why price control is imposed as a last resort is due to the risk of regulatory error and adverse outcomes. The analysis in the Regulatory Impact Statement ("**RIS**") on the Commerce Amendment Bill acknowledges this, and advice in the Cabinet paper on the Commerce Act Review suggests that the Minister might decide not to impose price control on the basis that:[9]

> ...the new public benefits (overall efficiency) were negative (the benefits of regulation in terms of efficiency gains did not outweigh the costs) and benefits to consumers were relatively low (at only about 40 cents per passenger).

113. Accordingly, the overarching goal of ID regulation is transparency, which is about *exposing* outcomes inconsistent with the Part 4 purpose statement and promoting better outcomes over time, not *preventing* those outcomes.

Room for improvement of ID

114. As a result of our experience to date, we believe the current ID regime has significant strengths. These include stronger regulatory discipline, greater transparency in methodologies of pricing and other aspects of Auckland Airport's behaviour and making a greater volume of quality information available to interested parties.

115. Auckland Airport acknowledges that there will be opportunities for improvement to ID regulation as the regime beds in over-time, and welcomes the Commission's guidance in contributing to a more effective ID Regime going forward.

[9] Cabinet Paper, Commerce Act Review - Airports 2007, at paragraphs 16 to 18.

1.1 Has information disclosure had any impact on Auckland Airport's performance and in understanding Auckland Airport's performance relative to the first PSE, and why?

116. Auckland Airport has identified a number of instances where Information Disclosure ("**ID**") regulation has had an impact on our performance:

(a) Whilst Auckland Airport maintains that the elements of the Part 4 purpose statement are sensible parts of any business strategy and therefore have been core elements of Auckland Airport's strategy, Auckland Airport's leadership team has emphasised to staff the need to align Auckland Airport's strategy and vision with the Part 4 purpose statement. This means day to day decision making must demonstrate efficiency, innovation, investing and providing services of a quality demanded, reasonableness of returns and a sharing of benefits. Accordingly, staff are aware of the increased scrutiny of outcomes by the Commission. In many instances, performance at the ground roots level will have been aligned with the purpose statement. However ongoing explicit monitoring provides a further motivator to staff and a feedback loop to support continuous improvement.

(b) The reference points established by the input methodologies have brought a further discipline to our pricing decision-making. The IMs have been our starting point for consideration of inputs into our pricing decisions, and are a continuing reference point. Where we have considered it appropriate, we have adopted approaches consistent with the Commission's methodologies. Where we have departed from these, we have done so on the basis of sound economic principles, expert advice and/or commercial and investment expertise, in a manner that we believe is consistent with the spirit of the Commission's methodologies. Further, we have been clear and transparent with substantial customers about the reasons for doing so.

(c) A less tangible impact on our performance in the second PSE, is that the heightened scrutiny of our performance has required us to think even more carefully and cautiously about whether our proposed approaches to pricing and investment are appropriate. It is open to the Commission to consider whether or not this is in fact a positive impact of ID Regulation. For example, over the long term, the Commission may observe that it has a chilling effect on board investment decisions, in the face of greater regulatory risk.

(d) We believe that the understanding of our performance will have improved under the second PSE (relative to the first PSE), due to the impact of ID. The first PSE occurred prior to the new ID regulatory regime when detailed disclosure was not required. The new ID regime has now required Auckland Airport to publish a comprehensive record of the first PSE. It logically follows that this comprehensive record, which included commentary to enhance understanding, will have increased interested parties' understanding of that event. We have also now made full disclosure regarding the second PSE, which should mean that interested persons now have a fuller understanding of our performance for both PSEs. In saying this, we note that substantial customers already have a full understanding of our performance given the comprehensive consultation processes that occur before prices are set.

117. In conducting the Review, it will be open to the Commission to consider whether higher level disclosure principles would result in better outcomes than prescriptive disclosure Schedules. Auckland Airport has not formed a view either way. However, when making our disclosures, where we have thought that the way in which we presented information

in the Schedules may have detracted from understanding our performance, we have provided supplementary material or commentary to assist with more fully understanding the information disclosed. In doing so, we have looked behind the Schedules to the intent of the regulatory regime, to embrace the spirit of ID regulation. Put another way, we have sought to bridge the mismatch between pricing and annual information disclosure, by communicating transparently with airlines. Some examples of Auckland Airport doing so include:

(a) Adding a set of tables in the second PSE to assist airlines' understanding of the reconciliation of their subset of information in pricing consultation, to the PSE disclosure (Table A);

(b) Adding in the FY11 annual disclosure commentary on the implied returns, including revaluations versus excluding revaluations as agreed in pricing (Schedule 1); and

(c) In Schedule 13 in the report on Capacity Utilisation Indicators,10 we have provided additional commentary where explanations are required in order to distinguish between notional and practical capacity.

118. Auckland Airport appreciates why the Commission seeks to compare the first and second PSEs in order to assist it with determining whether ID is having an 'impact' on performance and understanding performance. On one level, it is an obvious comparison of two worlds - that which existed when information disclosure operated under the AAA, with that which exists in a world with information disclosure regulation under Part 4. However, Auckland Airport believes there are limitations with such an approach, namely:

(a) ID is not meant to have an immediate impact on performance. As recognised by the Commission in the ID Reasons Paper, transparency and monitoring promotes change *over time*, rather than having an appreciable effect on Airports' behaviour immediately.[11] Accordingly, more than one PSE will need to occur under the new regime in order for a proper assessment to be made of whether the transparency and monitoring objectives are working as intended. In this regard, we note that a PSE event itself (together with the Commission's commentary on it through its annual summaries and analysis of disclosures) may influence a subsequent PSE by virtue of the publicity it generates (be that positive or negative). These aspects of ID simply cannot be seen until there has been more than one PSE under the new regime; and

(b) If the Commission were to conclude that there was no material change in performance and understanding of performance between the two PSEs, one very reasonable inference that could be drawn by the Commission is that performance was appropriate before ID regulation under Part 4. In that regard, it is instructive to remember that ID was not introduced to remedy any identified problem regarding airport performance, but was introduced as the preferred option for strengthening the existing information disclosure regime under the AAA, in order to enhance transparency regarding performance, so that performance could be more readily understood and monitored.[12] Put another way, if there is no identifiable change in actual performance between the two PSEs, it does not logically follow that ID regulation is ineffective, particularly in the context of the absence of a clearly articulated problem with performance in the first place.

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[10] Auckland Airport, Commerce Commission, Specified Airport Services Information Disclosure Requirements Information Templates, 17 May 2012.
[11] Commerce Commission, ID Reasons Paper 22 December 2010, page 17, at paragraph 2.24.
[12] Cabinet Paper, Commerce Act Review - Airports, 2007, at paragraphs 36 and 39 and Commerce Commission, ID Reasons Paper 22 December 2010, page 17 at paragraph 2.25.

1.2 Has information disclosure had any impact on the effectiveness and scope of consultation as part of Auckland Airport's second PSE relative to the first PSE, and why?

Effectiveness of consultation

119. Broadly speaking, ID Regulation has impacted positively on the effectiveness of consultation by providing a common regulatory reference point for the second PSE. Information disclosure has played a more significant role in the second PSE relative to the first PSE, primarily because ID under Part 4 (as opposed to ID under the AAA) has an established set of IMs and information requirements.

120. This is in contrast to the prior period, when the conclusions of the Airports Price Inquiry provided some reference points for airports and airlines, but were not binding for ID and did not cover all regulated activities. There were a number of limitations with the guidance provided by the Airports Pricing Inquiry, including:

(a) A lack of consensus regarding particular methodologies. For instance, the choice of asset valuation methodology was an area on which the views of the Commissioners and their experts were divided;[13]

(b) Only some activities were subject to the inquiry, which therefore did not cover the full range of regulated airport activities. Accordingly, issues particular to the terminal were not specifically addressed; and

(c) While the Commission ultimately recommended price control of selected goods and services for Auckland International Airport, the Minister of Commerce decided not to implement heavier-handed regulation on the grounds that the high regulatory cost of price control would outweigh any benefits. Accordingly, the Minister clearly did not agree with all of the Commission's findings.

121. Therefore, at the time of the first PSE, there were no agreed and universal set of reference methodologies for ID.

122. Conversely, ID regulation under Part 4 has provided greater guidance (by way of a set of IMs and ID requirements) than previously existed.

123. As a result of this guidance, Auckland Airport believes it now has a clearer understanding of the Commission's view for monitoring and therefore did not actively seek out new regulatory precedents in Australia (which Auckland Airport did do in the first PSE). In our view, generally speaking, this has meant that substantial customers have also had a comparatively clearer understanding of the Commission's view for monitoring.

124. In our view, an increase in understanding of the Commission's view for monitoring by both airlines and Auckland Airport has in many respects assisted consultation, particularly because the parties to the consultation had a common regulatory reference point from which it was clearly understood that departures would need to be justified. As discussed earlier, Auckland Airport did in practice feel compelled to justify any departures from the IMs to its substantial customers, including the basis on which those departures were made, and the material on which it relied to justify the departure.

125. As reference methodologies are more firmly established for the most recent PSE, the areas of concern have reduced considerably. In this respect, we note that the Government's intention in the Explanatory Note to the Commerce Amendment Bill that

[13] Commerce Commission, Part IV Inquiry into Airfield Activities at Auckland, Wellington, and Christchurch International Airports, 1 August 2002, at page 327.

IMs "...provide better information to guide consultations and between airlines and airports and pricing decision" and "...remove much of the contention under the current regime" has in our view been met.[14]

126. For those matters that remain contentious (such as WACC and asset valuation), it was not possible to reach common ground while the merits review proceedings were alive. Parties to those proceedings have genuinely and strongly held views on which methodology best meets the purpose statement, and it is difficult to see how either side could have compromised on those positions before those proceedings were concluded. The exception to that position is where Auckland Airport adhered to a more favourable position (from customers' perspective) determined during the last PSE (i.e. retaining the revaluation Moratorium).

127. Once the merits review proceedings are concluded and the IMs finally settled, we expect that they will have a further impact in future PSEs in terms of reducing points of contention and guiding parties towards common ground.

Scope of consultation

128. On reflecting on the second PSE, the increased scope of Auckland Airport's disclosures under the new disclosure requirements impacted on the scope of consultation. As noted above, Auckland Airport took a fresh approach to its consultation process. This was certainly driven and influenced by the advent of the ID regime, which set out the Commission's expectations of minimum information to be disclosed through the ID Determination Schedules.

129. In some areas, Auckland Airport considers that the Price Setting Disclosure is valuable in summarising the record of events as at the time of pricing. This record can be used as a useful reference point throughout the pricing period (as staff change) and as Auckland Airport moves into the forthcoming pricing period. Auckland Airport also provided the draft price setting disclosure to those parties which had most actively participated in the process, to ensure that the public disclosure was considered an appropriate and fair record from their perspective.

130. During consultation, Auckland Airport proposed to continue our practice of focusing the consultation on standard services provided within the Airfield and the Terminal. In this respect, the revenue requirement for the 2012 Pricing Decision did not include Other Regulated Activities, such as aircraft and freight activities and certain passenger terminal services (such as identified tenancies, leases and collection facilities for duty-free goods). This is because the revenue from these activities is not recovered by way of Standard Charges. Auckland Airport's revenue requirement for Other Regulated Activities is instead determined through negotiation of individual leases and/or licenses between Auckland Airport and individual customers, based on market value.

131. In this respect, Auckland Airport did not expand its consultation process to perfectly align with the ID scope. We did this because in our view, the scope of services consulted on has evolved following feedback in early price setting events, and is uncontroversial and broadly accepted as the right scope of activities for the aeronautical pricing consultation.

132. Auckland Airport also provided additional information to help customers understand the scale of difference between all services and the scope of services that were the focus of the pricing consultation process.

133. Auckland Airport believes that ID has had a positive impact on the scope and structure of consultation in some areas. For example:

[14] Regulatory Impact Statement, Commerce Act Review - Airports, 2007, page 28, at paragraphs 34 and 35.

(a) Capital consultation: was more structured and aligned to the information disclosure requirements for the Price Setting Disclosure, to ensure all assumptions were clearly captured and tested at the time of the PSE; and

(b) Operating cost consultation: followed the structure set out in ID, which proved to be an effective format for consulting on this topic.

Greater emphasis on price efficiency in the consultation process

134. ID has also promoted greater emphasis on price efficiency in the second consultation process relative to the first. In the knowledge that Auckland Airport was required to make a disclosure on the efficiency of prices, in the second PSE Auckland Airport engaged Estina Consulting to write a report that addressed the following:

(a) Key considerations for determining efficient prices;

(b) The basis for assessment (including economic references);

(c) Measurement techniques; and

(d) Recommendations for Auckland Airport to consider, together with further recommendations as to why the recommendations were most likely to result in efficient prices).

135. Customers engaged constructively on the report, with the result that the report and feedback from substantial customers materially influenced our final decisions on pricing structures designed to promote greater efficiency. Accordingly, in our experience, the external advice from Estina Consulting and feedback from substantial customers was highly valuable - particularly in stimulating a greater level of internal discussion regarding price efficiency and price structure in the second PSE than occurred in relation to the first PSE.

Shorter and more constructive consultation process

136. Another signifier of enhanced effectiveness was that the consultation process conducted regarding the second PSE was significantly shorter and more constructive than the previous consultation process. In our view, the pre-consultation process and consultation process for the first PSE were protracted and heated, extending from August 2004 to June 2007, taking almost three years to complete. At the completion of the process, judicial review was threatened by the airlines and there was a volume of negative media commentary from Air New Zealand regarding Auckland Airport's pricing.

137. In contrast, the second PSE was conducted between August 2011 and June 2012. Whilst still a significant period for a consultation process, it was materially shorter than for the first PSE. Prior to the consultation, Auckland Airport looked afresh at its consultation process, streamlining the process and structuring it in order to significantly align with the Commission's ID requirements that were known to all parties prior to the PSE.

1.3 What aspects of performance and conduct should we focus our efforts on for this review for Auckland Airport?

140. There are a number of aspects of Auckland Airport's performance and conduct that we would like to draw to the Commission's attention. However, as a general response, we encourage the Commission to take a broad-based approach to consideration of performance and conduct. That is, the Commission should fully consider all aspects of performance and conduct relevant to assessing the extent to which the purpose statement is being promoted, and not unduly focus on points of remaining contention between airports and airlines.

141. Auckland Airport believes that it is doing many things well, which should be fully acknowledged in the report, alongside any findings that there is room for improvement.

Quality of disclosures and the spirit in which they were made

142. In our view, the quality of the disclosures we have made provides clear evidence that we are conducting ourselves in a manner that embraces the spirit and intent of ID regulation. Rather than strictly adhering to the requirements of the Schedules in a manner that would have ensured base minimum compliance, we have sought to ensure that the information we disclose assists understanding to the fullest extent possible.

143. Auckland Airport recognises that in some instances, the current information is difficult for some interested parties to understand. In support of our goal of promoting the fullest understanding possible, Auckland Airport provided additional disclosures to bridge the gap between the often technical information disclosed, and interested persons' understanding of it. For example, in our Annual Disclosure we explained the key area of difference between Auckland Airport's approach to pricing and the Commerce Commission's approach to ID regarding the treatment of revaluation gains and how this affects the interpretation of the return on investment in Schedule 1.

144. Auckland Airport also provided an executive summary in our Annual Disclosure, structured against five core themes derived from the purpose statement. In doing so, Auckland Airport demonstrated commitment to better explaining (through its disclosures) how its performance is consistent with and relates to the purpose statement. Consequently, we believe that there is a sound starting basis of information available to the Commission to assess the extent to which the objectives of the Part 4 purpose statement are being promoted.

Constructiveness of consultation

145. As part of this Review process, Auckland Airport has provided the full record of our consultation process to the Commission on a confidential basis. In our view, this record clearly demonstrates that we approached consultation with an open mind and used the consultation process constructively to better inform and influence our pricing decisions.

146. When appearing before the Auckland Airport Board on 16 May 2012 Auckland Airport's Price Setting Disclosure reflects that BARNZ Represented Airlines made the following acknowledgement regarding our process and the quality of our consultation:[17]

[15] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, at page 36.
[16] Norm Thompson, Air New Zealand, AAA Consultation - Minutes from Air New Zealand presentation on the Revised Pricing Proposal 1.45pm, 16 May 2012, at page 1.
[17] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, at page 36.

> Mr John Beckett, on behalf of BARNZ Represented Airlines confirmed that the BARNZ Represented Airlines considered that Auckland Airport's consultation process had been constructive and had enabled good dialogue between the parties.

147. Mr. Beckett's views expressed to the Board align with our experience of the consultation process. In particular, we were left with the impression that while there was not absolute concurrence or agreement at the end of the consultation, the airlines felt that they had been listened to and the effectiveness and scope of the second PSE markedly improved upon experiences during the first PSE.

148. We also note that views of substantial customers included a broad spectrum of contrasting priorities and characteristics. That is, our substantial customers did not share the same views on all matters for very sensible reasons relating to their various business models/interests. In this context, it is our view that the level of consensus that was achieved during the consultation process was significant. Further, we believe that the substantial common ground that was achieved by the end of the process is testimony to the fullness and robustness of Auckland Airport's consultation process - that is, our responses to requests for further information and our willingness to consider customer feedback, increased mutual understanding and resulted in movement of positions:

(a) There was considerable feedback on the demand forecasts during the initial stage of consultation

(b) As a result of feedback in the first stage of consultation (pre Initial Pricing Proposal) in the Initial Pricing Proposal, Auckland Airport:

(i) Agreed to continue with the Moratorium approach to asset valuation; and

(ii) Excluded the Northern Runway land from the pricing asset base.

(c)

(i) Proposed to extend consultation on the ITF project and to set an investment charge at a later date. As a consequence, the ITF capital expenditure was excluded from the Revised Pricing Proposal;

(ii) Reviewed the baseline operating costs for FY12 from budget to forecast, and ensured all one-off costs were excluded;

(iii) Revised the International Terminal Building ("**ITB**") space allocation rule; and

(iv)

(d) In the Final Pricing Decision, as a result of feedback on the Revised Pricing Proposal, Auckland Airport:

(i) Removed Taxilane Two from the forecast. Following this adjustment, in the Final Pricing Decision there was no opposition to the international terminal capital expenditure programme;

(ii) Shared the business as usual route development costs, based on feedback in the Revised Pricing Proposal and strong feedback to the Board;

(iii) Revised the ITB forecourt asset allocation;

(iv) Resiled from its proposal to introduce an Annual Variable Charge ("**AVC**"); and

(v) Staged the introduction of the passenger charge to 2-11 year olds.

Pricing decision

149. Wellington Airport's pricing decisions appear to have been a central point of focus in the Review process to date. In this regard, we note that in its submission on the WIAL Review Process and Issues Paper, BARNZ advocated that pricing decisions should be a key focus of the Commission's consideration.[18]

150. Auckland Airport made a number of changes to its proposed pricing structures throughout the consultation process in response to matters and concerns raised by airlines. While some differences in opinion between Auckland Airport and substantial customers remained at the time of our final pricing decision, we are confident that we genuinely considered all feedback with an open mind and ultimately struck an appropriate balance between competing variables in our final pricing decision.

151. In this regard, we note that full agreement would not have been practical in any event, as substantial customers had different views on points of detail.

152. The volume of materials, matters and issues traversed during any pricing consultation on a five year forward looking basis is vast. This was certainly the case in Auckland Airport's aeronautical pricing consultation. In reviewing Auckland Airport's conduct, it is our view that the Commission should consider whether the priority matters raised by customers in consultation were considered by Auckland Airport (and we are confident that the record will show that they were genuinely considered in what was a fulsome consultation process). In our view, it would be disadvantageous and ultimately misleading to focus on a small number of points of remaining difference, particularly if any of these points of difference were not raised by airlines during consultation.

[18] BARNZ, Submission on Process and Issues Paper Section 56G Review (WIAL), 29 June 2012, at page 3.

157. At the highest level, only two of these concerns relate to building block assumptions for the pricing period:

(a) WACC; and

(b) Route development.

158. Accordingly, it is implicit that during the consultation process, demand forecasts, operating costs (excluding route development), asset valuation (including depreciation) and tax had significantly progressed to being discussions on points of detail and not of substance.

[19] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 36.

Auckland Airport's leadership position

161. Auckland Airport is a responsible corporation which seeks to take leadership positions within the industry and takes its regulatory responsibilities seriously. More so than ever in the current economic climate, New Zealand needs companies which are prepared to lead and take (necessary, informed and calculated) risks to build New Zealand's economy.

162. As the international gateway to both New Zealand and New Zealand's economic engine room, Auckland City, Auckland Airport is one of New Zealand's most important infrastructure assets:

(a) Auckland Airport provides thousands of jobs for the Auckland region.

(b) We are the country's second largest cargo 'port' by value, contributing around $14 billion to the economy.

(c) We cater for over 1.8 million visitors each year, which is 70 percent of New Zealand's international travellers.

163. Auckland Airport has a significant influence on New Zealand's economy in two key respects:

(a) Auckland Airport's operation as a major business in Auckland, sustaining substantial employment and providing a range of services to the air transport sector, travellers, exporters and importers; and

(b) Auckland Airport facilitates a wide range of economic activity in Auckland, and New Zealand as a whole, by enabling the movement of goods and people. The airport handles a substantial share of import and export goods moving to and from other regions. The flow of export goods supports businesses that manufacture, service and transport them, just as the flow of imported goods supports businesses that use, transport and distribute these. Similarly, the flow of international and domestic travellers through the airport support significant service business activity.

164. Auckland Airport has been a leader in promoting and driving growth in tourism by significantly investing in route development, which has resulted in airlines introducing new international capacity to Auckland Airport. Successes of Auckland Airport such as these are shared by New Zealand tourism and by the airlines serving New Zealand, through increased passenger numbers. In this regard, we note that each international visitor generates around $2,500 for the New Zealand economy.

165. Auckland Airport's role (and how investment facilitates this role) is an important backdrop against which its conduct should be measured and assessed. Put another

[21] Norm Thompson, Air New Zealand, AAA Consultation - Minutes from Air New Zealand presentation on the Revised Pricing Proposal 1.45pm, 16 May 2012, page 1.

way, calculated risk-taking investment is required for initiatives like Auckland Airport's route development function.

166. Any chilling effect on the board's investment decision-making has significant risks that may compromise benefits to the long term unit cost of delivery as well as existing and further significant indirect benefits to the Auckland and New Zealand economies. Since the ID regime was introduced, even the threat of further regulation (in contrast to actual further regulation) has had negative consequences for Auckland Airport, including:

(a) Reduced shareholder appeal, because some investors have declined to invest in Auckland Airport due to perceived regulatory risk;

(b) Suppressed credit ratings relative to performance; and

(c) Greater uncertainty regarding earning a return on land set aside for aeronautical purposes.

167. Investment decisions have significant impacts for our stakeholders and the broader economy. Accordingly, in consultation with our stakeholders, we need to carefully and appropriately invest to ensure that Auckland Airport is able to meet expected demand and underpin growth within the region. With strong passenger and freight growth projected, and with more than 40 year old existing domestic terminal infrastructure nearing the end of its useful life and providing ever lessening levels of service, Auckland Airport needs to begin investing carefully now to ensure long-term tourism infrastructure capacity is in place at the right time, and to ensure that out-dated assets do not negatively impact on New Zealand's reputation.

Revenue and profitability

168. In undertaking its review of revenue and profitability, we recommend that the Commission focuses its efforts on:

(a) Carrying out a thorough review of the ID record and the pricing consultation records that Auckland Airport has now provided to the Commission;

(b) Assessing revenue and profitability relative to the overall level of service provided by Auckland Airport;

(c) Understanding overall performance and conduct in price consultation and Auckland Airport's consideration and action in respect of views raised in consultation;

(d) An appropriate cost of capital range for Auckland Airport for pricing; and

(e) Assessing how returns can be monitored over time in relation to including or not including annual revaluations. This recognises that both Auckland Airport and the airlines have 'agreed' to a moratorium following strong requests for this by airlines.

3. Is Auckland Airport earning an appropriate economic return over time?

169. The Commission has re-phrased this question since putting it in the WIAL process paper as: '*is WIAL earning excess profits*'?

170. Although Auckland Airport welcomes the recognition that the assessment must be made 'over time', it remains unclear what time period the Commission is focused on. Auckland Airport believes that the appropriate focus is forward looking from the point that regulation commenced. Given the inherent uncertainties in predicting future revenue, this assessment must be approached with caution.

171. Further, we note that the relevant question under section 52A is whether regulated airports are *limited in their ability* to extract excessive profits. This is not the same as asking whether excess profits are being earned or whether Auckland Airport is earning an appropriate return. This supports our view that snapshot assessments of returns are inappropriate, and the better approach is to consider whether Auckland Airport is limited in its ability to extract excessive profits on a sustained basis over time.

172. On an *ex ante* basis, Auckland Airport expects to earn an appropriate economic return. Over the PSEs these were:

(a) An after-tax forecast return of 9.83 percent from FY08 - FY12; and

(b) An after-tax forecast return of 8.475 percent for the 2013-2017 pricing period.

173. The Commission must also recognise that forecasts do not always eventuate. While Auckland Airport's forecast returns for the first PSE were 9.83 percent, we failed to achieve these, primarily due to the negative impact on demand of the GFC and other adverse events. Auckland Airport has in fact earned conservative returns on investment. As outlined in information disclosures under the AAA, in the last three years returns on average assets after tax but before interest were 1.0 percent (2010), 4.5 percent (2009) and 4.5 percent (2008), based on the methodology adopted at the time and excluding any revaluations.

174. It will be difficult to form a conclusive view on an *ex post* basis regarding returns over the first PSE and second PSE. For example:

(a) In 2007, Auckland Airport consulted with its substantial customers on how to treat asset revaluations. With the support of the airlines, the price path for FY08 to FY12 included a Moratorium on asset revaluations to avoid the short-term variances it may produce. Accordingly, no revaluation gains were included in the calculation of Auckland Airport's regulatory profit used to calculate return on investment during the pricing period. The ID regime therefore creates some distortion between when returns are measured from when they are earned. However, Auckland Airport has under-earned relative to the expected or target return under the first PSE.

(b) Therefore, the ID disclosures should be interpreted with caution as these include $75.4 million of unrealised non-expected revaluation gains (as the IMs require revaluations to be included in the roll forward of the asset base and treated as income, even though there have been no revaluations for pricing purposes). This represents over half of Auckland Airport's disclosed return on investment for the year ended 30 June 2011. Excluding these would lower the post-tax return on investment estimates for the year ended 30 June 2011 to only 5.8 percent.

(c) Paradoxically, it may have been easier for interested parties to understand forthcoming *ex post* returns analysis under the second pricing period if we had abandoned the Moratorium and our asset base had therefore been aligned with ID. To enable parties to better understand *ex post* returns, Auckland Airport proposes to disclose in two ways i.e. including and excluding revaluations.

(d) On occasion, Auckland Airport has also delayed major investments or scheduled increases in prices that would have been factored into forecast returns at the time when prices were set. Recent examples include our investment in the Northern Runway, which was delayed in recognition of evolving market conditions, and in order to carefully optimise delivery with market need.

(e) In July 2009, in recognition of the extraordinary conditions being experienced at that time by our airline customers, Auckland Airport deferred a scheduled increase in landing charges, effectively waiving $2.7 million of revenue over a nine month period. There was a return to the scheduled pricing arrangement in March 2010.

(f) When assessing returns, we accept that the Commission will need to consider the appropriateness of *ex ante* forecasts, although we remain of the view that they are the most important measure. In terms of actual performance there will be a number of valid drivers of deviation from forecasts to actuals. In this respect, we highlight to the Commission that forecasting is subject to significantly more variation in the airport industry than in many other regulated utilities, due to the discretionary nature of the decision to travel.

(g) Auckland Airport is also concerned that the Commission's IM that requires assets held for future use to be excluded from the regulatory asset base ("**RAB**"), has the potential to undermine Auckland Airport's ability to earn an economic return on this land over time. Our concern is specifically in relation to land held for the future use of the Northern Runway which is discussed further in response to question 3.11.

3.1 What is an appropriate level of target return for Auckland Airport, and why is the level appropriate?

The WACC IM is not an appropriate measure of returns

175. Airline submissions on the WIAL consultation have argued that the estimate of WACC established by the Commission's IM should be the target rate of return for each airport.

176. Auckland Airport disagrees, for the following key reasons:

(a) The Commission's estimate of a benchmark industry-wide WACC is not an appropriate target for each airport, which will have differing characteristics;

(b) The Commission's annually adjusted estimate of WACC misaligns with returns that are a product of a five yearly forward looking price setting process, where the WACC is 'locked in' at the commencement of the period;

(c) The Commission's approach reduced MRP on the assumption that the GFC was nearing an end. This was not a correct assumption; and

(d) The Commission's allowance for debt costs is not realistic compared to the actual cost of debt of a range of firms.

177. An annual estimate of WACC should be used with a great deal of caution to measure returns because:

(a) WACC is only one building block among many that determine required revenues for airport services.

(b) Planning horizons are extremely long, and investment is large and lumpy. There could be various adjustments made to the forecast price or return profile. For example, where a large infrastructure investment is made in year 1, customers may request charges increase over time rather than a full return being imposed when the asset is commissioned. Measured against the Commission's WACC, there will be under recovery in early years, and over recovery in later years. An example is Pier B, part of Auckland's international terminal expansion.

(c) Prices are set for five years using the airport's then current estimate of WACC. For example, the WACC consulted on by Auckland Airport when setting aeronautical prices for FY12 covered the five years starting in FY08. The Commission's WACC estimate for FY12 that is compared to actual FY12 return on investment in the FY12 disclosure statements covers the five year period starting in FY12. The periods therefore misalign by four years. Accordingly, prices will appear excessive if the risk free rate (and hence regulated WACC) drops during the pricing period (eg under the new regime the Commission's WACC estimates have been 8.06 percent (2010), 7.56 percent (2011) and 6.49 percent (2012)).

(d) Auckland Airport will also be subject to demand/supply shocks. That is, if actual demand is greater/less than forecast (noting the difficulty of forecasting in the context of the GFC), recovery will be greater/less than predicted.

178. In essence, the Commission should be cautious in using an annually updated five year forward looking rolling estimate of WACC to measure returns that are a product of a five year WACC estimate that is estimated at the time of pricing, as well as demand forecasts and other commercial adjustments, all 'locked in' at the commencement of the five year pricing period. We understand from the Commission's submissions in the merits review proceedings that it recognises that if return on investment is higher than the Commission's estimate of WACC, then there could be many valid reasons for this, such that it may not be an indicator of excess returns.

179. Auckland Airport also cautions against its own estimate of a WACC range being equated to its target rate of return. Auckland Airport recognises that WACC is one of the few primary issues of contention between it and substantial customers. In light of current economic conditions and in recognition that there has been some disagreement in this area, Auckland Airport priced below the lower end of its estimated WACC range, and set standard charges that are forecast to result in an effective return on investment of 8.48 percent. This effective forecast return on investment is close to the Commission's industry-wide estimate of WACC as at the time prices were set, and is not the same as Auckland Airport's estimate of WACC.

180. In that context, we note that Auckland Airport released its 2012 pricing decision on 7 June 2012. The last Commission estimate of WACC for Auckland Airport specifically before this date was issued on 8 July 2011, with a mid-point of 7.56 percent and a 75th percentile of 8.54 percent. The last Commission airport WACC estimate issued before Auckland Airport's pricing decision was specifically for WIAL, issued on 1 April 2012, with a mid-point of 7.06 percent and 75th percentile of 8.04 percent. On 31 July 2012 following the PSE, the Commission determined a mid-point of 6.49 percent and 75th percentile of 7.48 percent for Auckland Airport.

181. The volatility over short periods of the WACC estimate produced by the IM further demonstrates the difficulty in seeking to use the WACC IM to identify an appropriate target return for each of the years during the five year period, when for pricing the WACC is only estimated once at the commencement of the pricing period.

The WACC IM is also not an appropriate target for Auckland Airport

182. Although Auckland Airport followed the WACC IM in many respects, overall the estimate produced by the WACC IM is not an appropriate target for Auckland Airport for pricing purposes. We have not at any stage understood the Commission's position to be that its industry-wide estimate of WACC for ID monitoring purposes should be applied by individual airports in their pricing decisions without first considering whether there are company-specific factors that warrant departure from the Commission's estimate for monitoring all three airports.

183. In its submissions in the merits review proceedings, the Commission considered that the WACC IM provided a point of reference which would give a basis for comparison with the actual methodologies used by the airports, and would allow interested parties to evaluate the airports' own assessments of their cost of capital. The Commission noted that the presence of the WACC IM would encourage airports to be explicit about the assumptions and rationales used in their own modeling, and give interested parties some information for testing the airports' own assessments. This supports our understanding that Auckland Airport may use company-specific factors in estimating its WACC for price-setting purposes. Doing so is not linked to any exercise of market power - it is simply a natural part of producing Auckland Airport's own assessment of its WACC (supported by its expert advice), which may then be assessed by interested parties, and considers that *de facto* price control was not the intent of the IMs in a light-handed regulatory environment.

184. As carefully explained and reasoned throughout its pricing consultation process, Auckland Airport has not adopted the Commission's industry benchmark estimate of WACC in its entirety.

185. We believe it is important to take into account company-specific factors on a forward looking basis for the entire pricing period, while at the same time checking the estimate against relevant international trends and benchmarks. Auckland Airport provided an opportunity for substantial customers to explain why Auckland Airport should adopt, without adjustment, the industry-wide WACC for a pricing decision specific to Auckland Airport, despite its understanding that the Commission never intended for it to be applied in such a manner. No explanation was provided and therefore Auckland Airport was not persuaded that applying the Commission's industry-wide WACC set for ID purposes in its entirety was appropriate for its pricing decision.

186. That said, the WACC IM did provide a template for Auckland Airport's WACC estimate, and any departures from the WACC IM were carefully considered and followed independent expert advice. In summary, and as explained further below, Auckland Airport believes that on the small number of parameters where it adopted a different approach:

(a) It was in respect of a parameter where airport specific factors are relevant, and where it did not understand the Commission to be expecting the benchmark established for ID purposes to be followed without question. Asset beta is a key example. That said, Auckland Airport also took care to ensure that evidence for Auckland Airport was not inconsistent with a broader sample of airports.

(b) The alternative approach was consistent with the underlying rationale for the Commission's position. For example, in the context of the WACC estimate in

the real world, the term of the risk free rate should not over or under compensate the regulated entity.

(c) Expert advice was that on a matter of judgment, there were legitimate grounds for adopting an alternative approach - such as TAMRP. In this context, it is relevant that the calculation of WACC for a particular portion of a company is subject to variables that require expert assessment, judgment and estimation. As acknowledged by the Commission in the IM Reasons Paper:[22]

> There are many complex, technical issues in developing a methodology for determining the cost of capital.

187. The following table summarises Auckland Airport's WACC range and the key WACC parameters that Auckland Airport has adopted in its 2012 Pricing Decision:

***Table A**: Aeronautical pricing WACC parameters*

	Aeronautical pricing WACC for FY13-FY17 pricing period
Risk-free rate	3.48%
Tax-adjusted market risk premium	7.50%
Company tax rate	28%
Debt premium	1.72%
Debt to debt plus equity ratio	30%
Asset beta	0.65
Nominal after tax WACC range (75th - 85th percentile range)	8.88% - 9.45%

188. Auckland Airport's approach is consistent with the WACC IM, except that:

(a) A seven year term of the risk-free rate has been adopted (between the Commission's five year term and Uniservice's recommended 10 year term), as a highly pragmatic and practical solution to recognise the conflicting views on the term of the risk free rate and in addition to better match the term of the risk free rate to the average original debt maturity of Auckland Airport's debt. The weighted average original debt maturity of drawn debt for both 30 June 2012 and 30 Sept 2012 is 6.8 years.

(b) An asset beta of 0.65 has been adopted (rather than the Commission's industry beta of 0.60) based on expert advice from Uniservices. Uniservices replicated the Commission's analysis for the WACC IM, but as at August 2011, as **attached** as **Attachment 2**. Auckland Airport also notes that the Commission estimated an asset beta for Auckland Airport of between 0.75 and 0.79, and that Auckland Airport's new price structure has a higher risk with a substantially reduced cost pass through element. This new structure is based on requests from some substantial customers for greater risk sharing, together with our view that we will be faced with increased systematic risk going forward beyond that indicated in any historic regression analysis and/or based on historical fundamental risk factors.

(c) Auckland Airport's leverage is based on its average corporate leverage, with a small upwards adjustment for the regulated business (in much the same way as the asset beta has had a downwards adjustment because of the Commission's view that the regulated side of the business is less risky than the commercial side). The regulated side of the business requires an upward adjustment to leverage to account for its ability to service more debt and to provide for a more optimal capital structure.

(d) A market risk premium of 7.5 percent has been adopted based on empirical research by Dimson *et al* 2011,[23] and in recognition that the impacts and effects of the GFC have not ceased with the ongoing sovereign debt issues occurring in Europe.

189. A WACC range of between the 75th and 85th percentile has been adopted on the basis that, for pricing purposes, asymmetry of social consequences (i.e. the social costs of rates of return being too low so that Auckland Airport will not have incentives to invest, are greater than the social costs of returns being higher in the short term) and the existence of asymmetric risks and model error provide strong grounds for departing from the Commission's 75th percentile for pricing purposes (or 50th percentile as the starting point for monitoring purposes). Accordingly, in its final building blocks calculation, Auckland Airport referenced a point-estimate of 9.16 percent at the mid-point of the range between the 75th and 85th percentile.

190. However, as noted in response to question 3.4, the point estimate WACC of 9.16 percent results in a negative NPV outcome of 25.4 million in the second PSE. The effective post-tax WACC that results in a forecast NPV of $nil in the second PSE is 8.475 percent.

Asymmetric risk

191. Auckland Airport understands the Commission's view to be that, for pricing purposes, the 75th percentile should be used to establish the point-estimate of WACC.

192. In Auckland Airport's view, the WACC IM does not sufficiently account for model error and asymmetric risk, and this is an additional factor that needs to be considered in pricing. As Auckland Airport submitted throughout the consultation on the WACC IM, an increment of up to 1 to 2 percent for pricing purposes should be added to the estimate of WACC to account for such risks. Uniservices provided advice to Auckland Airport at the time of pricing that an increment of up to 1 percent was appropriate. This more conservative position reflected that (among other things) Auckland Airport has a different profile to other airports, and that the WACC was for pricing purposes rather than monitoring.

193. Auckland Airport is subject to the following types of asymmetric risks:

(a) Type I: risks that are generally unrelated to the day-to-day operation of a business, and arise through infrequent events that could produce large losses (SARS, terrorist attacks, volcanoes, climate change); and

(b) Type II: risks that derive from asset stranding/redundancy.

194. The Commission has acknowledged the existence of such risks. Moreover, while in the case of ID the Commission may provide an allowance for accelerated depreciation in the case where assets may become stranded or redundant, this may not be practical in the real world, where prices are set in consultation with the airlines on a five yearly basis.

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[23] Dimson, E., Marsh, P. Staunton, 2011 and M. Equity Premia Around the World, London Business School, Chapter in book "Rethinking the equity risk premium", edited by P. Brett.

195. Another possible approach, as suggested by the Commission, is for Auckland Airport to incorporate such risks into its forecast operating costs, such as by way of a self-insurance 'premium'. This appears to be the Commission's preferred approach, although it is unclear.[24]

196. In this respect, Uniservices has previously advised of three potential mechanisms to deal with Type I asymmetric risks, namely:[25]

(a) Determination of an actuarially-fair insurance premium and modelling this cost into the cash flows under any building blocks approach;

(b) Adding an increment to the WACC; or

(c) *Ex post* protection - that is, when, or if, the adverse event occurs the cost is reimbursed by the customer.

197. For convenience, the following discussion of those options has been extracted from Uniservices' report:[26]

> Actuarially-fair insurance premium
>
> Assessment of the level or quantum of adjustment for asymmetric risks is difficult. Commercial third party insurance to cover asymmetric risks is often not available and even where available is typically much more expensive that an "actuarially-fair" premium charge.
>
> In this regard Boyle (2002) (quoting Froot, 1999) notes that reinsurers often require substantial risk premiums to ensure against catastrophe risks. Boyle (2002) also notes in 1996 Berkshire Hathaway sold $1.05 billion of reinsurance to the California Earthquake Authority. The probability of Berkshire Hathaway having to pay anything under the reinsurance policy was estimated at 1.7%, but the premium was $113 million - 6.3 times the expected loss. That is, according to the theory of the CAPM that provides a return for systematic or non-diversifiable risk only the premium should have been less than $17.85 million.
>
> Increment to cost of capital
>
> In our view more common commercial practice is to add an increment to the discount rate as opposed to providing for asymmetric risks in the 'cashflow' expectations. This recognises modelling any asymmetric risks in the expected cashflows is often not well understood or accepted in practice.
>
> Ex-post protection
>
> In respect of ex-post protection, assets owned by regulated firms typically have long expected asset lives and any contract for ex-post protection would need to be binding on the parties (including the regulator) and of long-term duration.
>
> For Airports ex-post protection does not appear a realistic option given the potential for changes in the airlines that operate at each Airport. Future passengers would also be required to meet the cost of a past event.

198. Auckland Airport agrees with Uniservices that the burden of proof for the existence and quantum of any asymmetric Type I risks should not fall solely on the provider of the regulated services. However, it is irrefutable that the earthquake in Christchurch has impacted on traffic at Christchurch, Auckland and Wellington Airports. The Chilean ash cloud also negatively affected scheduled services to Auckland. While we acknowledge

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[24] Input Methodologies Reasons Paper, December 2010, at paragraph E12.12.
[25] Comments on the Commerce Commission's Approach to Estimate the Cost of Capital, 2 Dec 2009, page 54.
[26] Comments on the Commerce Commission's Approach to Estimate the Cost of Capital, 2 Dec 2009, pages 65 to 66.

that the appropriate adjustment does involve some degree of judgement, we consider that it is inappropriate for the Commission to assume that asymmetric Type I risk is zero on the basis that the size of any adjustment could not be precisely quantified.

199. Auckland Airport considers that incorporation of an allowance for asymmetric risk in the WACC is a simpler and more commercially realistic approach. Auckland Airport does not currently incorporate any self-insurance premium into its forecast operating cost, and is not aware of any airports that operate a self-insurance scheme. Auckland Airport does not consider that such a scheme is practical or commercially prudent. Auckland Airport's building block pricing model has excluded an allowance in the cash flows for asymmetric type risks.

200. In its report on the appropriate WACC for aeronautical activities of Auckland Airport in October 2011, Uniservices also advised that:[27]

> In our view the recent information disclosure regime in NZ and the potential threat of price monitoring and/or price control poses some restraint on AIAL. It also exposes AIAL to asymmetric risks. This may occur if the Commerce Commission were to seek to impose price control or other penalties where ex-post returns were considered to be too high but with no compensation if ex-post returns were below expectations.

201. Accordingly, Auckland Airport believes that its approach of using the 75th to 85th percentile for pricing purposes is entirely reasonable in the face of expert evidence that an increment of up to 1 percent should be applied to the Airport's WACC to account for asymmetric risk. We did not separately add an increment for asymmetric risk and model error, which means our estimate of WACC was more conservative than what expert advice reasonably allowed for.

202. In summary, Auckland Airport did not establish a single point estimate of WACC to apply for pricing but rather established an estimated target range and evaluated the forecast building block outcomes, including the forecast revenue required, within this range. Throughout its consultation process, Auckland Airport updated market parameters. The final target return for the 2012 Pricing Decision was based on market data as at 21 May 2012.

Auckland Airport's estimate of WACC is appropriate

203. In the final price setting decision it was acknowledged that following the aeronautical price setting consultation, an efficient estimate of WACC remained one of the few areas of material difference between Auckland Airport and its substantial customers. Auckland Airport considered it prudent to price below WACC and therefore set its standard charges at a level that would result in an effective forecast return on investment of 8.475 percent on those assets that were included in its standard charges. This represented a forecast negative NPV of $25.4 million relative to Auckland Airport's point estimate WACC of 9.16 percent over the pricing period.

204. Auckland Airport believes that its estimate of WACC is appropriate for the following reasons:

WACC Range

(a) It is consistent with the Commission's regulatory practice to use a WACC estimate of at least the 75th percentile for pricing purposes, to account for asymmetry of social consequences or the social costs of rates of return too low that mean Auckland Airport will not have incentives to invest.

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[27] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, page 29.

Although Auckland Airport has not added a separate increment, it believes some allowance for model error and asymmetric risk should also be recognised, especially in circumstances where it has not included "self-insurance" premiums or third party catastrophic risk insurance as an operating cost.

Cost of Debt

(b) As noted in the introduction, one observable WACC parameter - the cost of debt implied under the IM, was implausibly low in Auckland Airport's view. As at April 2012, the implied cost of debt (at the 50th percentile) under ID for the airport industry was 5.9 percent pre-tax. At that time, Auckland Airport's weighted average debt cost was 6.52 percent pre-tax. Auckland Airport does not consider that the theoretical debt cost of funds calculated in the WACC model represents a commercially viable debt funding rate for an entire debt portfolio. Auckland Airport is confident that it has an efficient debt portfolio, as referenced by Bancorp (**attached** as **Attachment 1**), and therefore believes that the industry WACC methodology is too conservative.

Term of the Risk Free Rate

(c) A seven year term for the risk free rate is consistent with the principles underlying the Commission's decisions for the WACC IM and the establishment of the Term Credit Spread Differential ("**TCSD**") (discussed below), which is that regulated entities with a debt maturity profile of longer than five years should be appropriately compensated in the WACC estimate. It is also less than the 10 year period advocated during the IM consultation process as a suitable industry benchmark and recommended by expert advisors. A five year term has little relevance to the commercial realities of providing airport services, and the Commission's suggestion that interest rates can be matched to the five year period is simply not feasible from a commercial perspective.

The Term Credit Spread Differential

(d) In its IM Reasons Paper the Commission has recognised a TCSD.[28] This reflects that some regulated suppliers issue debt with an original period to maturity greater than five years (the price review period) to manage their exposure to re-financing risk. This applies to Auckland Airport. As acknowledged by the Commission, prudent management of re-financing risk by issuing debt with a long period to maturity is in the long term interests of consumers. Therefore, where a regulated supplier actually issues debt with an original period to maturity greater than five years, and the weighted average original period to maturity of its debt portfolio is also greater than five years, the Commission considers that an allowance for the additional debt premium is appropriate.[29]

(e) The Commission has explained that in the context of setting an industry benchmark WACC, the TCSD is a solution to the problem of ensuring that entities with a debt maturity profile of less than five years are not over-compensated, while those with a maturity length of over five years can be appropriately compensated. While Auckland Airport understands this principle,

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[28] Commerce Commission, Input Methodologies Reasons Paper, December 2010, at paragraph E5.16.

[29] Commerce Commission, Input Methodologies Reasons Paper, December 2010, at paragraph E5.17. In this respect Lally (2007, page 80) notes that failure of the firm to match its duration of debt to the regulatory cycle: "... lead to cash flows to equity holders whose net present value will tend to be negative, and will also inflict interest rate upon equity holders." See Lally, M., 2007, Regulation and the term of the risk free rate: Implications of corporate debt, Accounting Research Journal 20, 2, pages 73 – 80.

it believes that the TCSD will not provide full compensation as intended, because of the number of interest rate swaps involved.[30]

(f) But perhaps more importantly for price setting purposes, following the approach required by the TCSD is simply not feasible. The debt management approach implied by the Commission in its IM Reasons Paper would require that Auckland Airport, amongst other things:

(i) Enter *into swaps so that the effective term for all debt was the end of the five year* reset date;

(ii) Expose itself to unacceptable interest rate risk at the price reset date; and

(iii) To make adjustments to their swaps so that they always matured five years after the annual WACC setting date.

(g) In Auckland Airport's view:

(i) Prudent treasury policy would not have all interest rate swaps maturing on a price review reset date. That is, the Commission's 'theoretical' arguments to justify using a risk free rate and debt profile to match the term of the regulatory review period would 'require' the firm to adopt a treasury financing policy that does not accord with prudent treasury management in the 'real world' and expose the firm to unacceptable interest rate risk; and

(ii) It would not be practical or commercially prudent for a firm to adopt a theoretical hedge strategy to match the term of its debt to the 'regulatory review period', where under the approach in its IM Determination the Commission determines a rolling annual WACC, with the risk free rate and cost of debt also revised on an annual basis.

(h) Moreover, in respect of airport debt that is maturing within a pricing review period, it is unknown at the start of the price review period:

(i) The market that the Airport will be sourcing debt from;

(ii) The form of the type of swap to be entered into in place (for example, the interest rate on bank debt is often floating but a typical bond is a fixed interest exposure); and

(iii) The exact date that the Airport will refinance any debt during the price review period (because to follow the Commission's implied debt management policy the Airport would need to put in place a forward starting swap for the remaining time of the price review period).

(i) In summary, adopting the Commission's debt management approach in its IM Reasons Paper would require fundamental changes to Auckland Airport's existing treasury policies. However, no rational business would seek to have all its debt maturing on the same date, as such an approach would expose it to funding liquidity and interest rate risk at the price reset date. The interest rate swap programme suggested by the Commission would also be highly complex

[30] Under the Commission's debt management approach, where a firm borrows fixed rate debt, then to align "interest rate risk" to the five-year price review cycle, the firm may need to enter into two interest rate swaps. However, the Commission's TCSD allowance seems only to provide for the execution costs of one interest rate swap.

and costly. Auckland Airport requests that the Commission consider the views put forward in this area by Uniservices and Bancorp (see above at paragraph 188 and Bancorp's letter to Auckland Airport, **attached** as **Attachment 1**).

(j) On the other hand, Auckland Airport is entitled to include an allowance for TCSD in its disclosures (pursuant to the ID Determination) given that its average debt tenor is over five years, and the Commission wishes to ensure that suppliers are not under-compensated in that case. Accordingly, Auckland Airport believes that using a seven year term of the risk free rate is an entirely appropriate and pragmatic real world position to adopt to ensure that Auckland Airport is not under-compensated. Such an approach is also consistent with the underlying rationale for the Commission's position. In this context, Auckland Airport notes that it has not included a TCSD type allowance in its price model.

Asset Beta

(k) In the Final Pricing Reasons Paper, Auckland Airport pointed out that the Commission had found that its asset beta was higher than the industry benchmark estimated by the Commission:[31]

> Auckland Airport reiterates that it has not departed from the Commission's methodology without good reason. In establishing the WACC methodology, the Commission found that Auckland Airport's asset beta was slightly higher (between 0.75 and 0.79) than the industry average (between 0.62 and 0.72).

(l) During the pricing consultation, Uniservices considered a number of approaches when estimating the appropriate asset beta for Auckland Airport, including first principles and direct measures of Auckland Airport's asset beta. It also updated the analysis of the comparative asset betas for the sample of airlines (including Auckland Airport) used by the Commerce Commission in its Input Methodologies Reasons Paper (2010), as follows:[32]

***Table B**: Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland Airport*

		Equity Beta		Net Debt Leverage Ratio		Net Debt / M Cap		Asset beta	
No.	Company	2 year	5 year	2 year	5 year	2 year	5 year	2 year	5 year
1	Aerodrom Ljubljana	0.44	1.20	(4.2%)	(1.3%)	(4.0%)	(1.3%)	0.46	1.21
2	Aeroporto di Firenze	0.06	0.20	6.2%	4.4%	6.6%	4.6%	0.06	0.19
3	Aeroports de Paris	0.74	0.89	28.8%	26.3%	40.4%	35.7%	0.53	0.65
4	Airport Facilities	0.88	0.74	36.6%	33.7%	57.6%	50.9%	0.56	0.49
5	Airports of Thailand	1.14	1.27	43.5%	40.8%	76.9%	68.8%	0.65	0.75
6	AIAL	1.11	0.86	28.8%	27.5%	40.5%	37.9%	0.79	0.62
7	Australian Infrastructure	0.86	1.08	(5.5%)	(0.2%)	(5.2%)	(0.2%)	0.91	1.08
8	Beijing Capital International Airport	0.96	1.31	49.5%	24.5%	97.9%	32.4%	0.49	0.99
9	Flughafen Wien	0.71	0.83	43.4%	29.6%	76.6%	42.1%	0.40	0.58
10	Flughafen Zuerich	0.82	1.27	35.3%	35.0%	54.7%	53.8%	0.53	0.83
11	Fraport	0.96	0.88	39.1%	27.0%	64.2%	37.0%	0.58	0.64
12	Gemina	0.65	1.27	61.1%	59.7%	157.1%	148.1%	0.25	0.51
13	Grupo Aeroportuario del Centro Norte	0.90	1.03	6.7%	(4.9%)	7.2%	(4.7%)	0.84	1.08
14	Grupo Aeroportuario del Pacifico	0.75	0.79	(4.9%)	(4.9%)	(4.7%)	(4.6%)	0.79	0.83
15	Grupo Aeroportuario del Sureste	0.90	0.92	(65.0%)	(531.5%)	(39.4%)	(84.2%)	0.90	0.92
16	Kobenhavns Lufthavne	0.18	0.60	21.6%	18.0%	27.6%	22.0%	0.14	0.50
17	Guangzhou Baiyun International Airport	0.90	0.72	4.1%	5.9%	4.3%	6.3%	0.87	0.67
18	Hainan Meilan International Airport	0.77	1.35	(28.1%)	(25.1%)	(21.9%)	(20.1%)	0.98	1.68
19	Japan Airport Terminal	0.62	0.37	29.3%	17.6%	41.3%	21.3%	0.44	0.30
20	MAP Group	0.78	1.22	47.0%	52.5%	88.6%	110.6%	0.42	0.58
21	Malta International Airport	1.05	1.08	19.1%	20.3%	23.6%	25.5%	0.85	0.86
22	SAVE	0.47	0.83	16.0%	12.9%	19.0%	14.8%	0.40	0.72
23	Shanghai International Airport	1.06	0.90	6.8%	5.7%	7.3%	6.0%	0.99	0.85
24	Shenzhen Airport	0.71	0.82	(12.0%)	(10.0%)	(10.7%)	(9.1%)	0.80	0.90
25	Xiamen International Airport	0.96	0.51	(6.1%)	(5.9%)	(5.7%)	(5.6%)	1.02	0.54
	Mean	0.78	0.92	0.16	-0.06	0.32	0.24	0.62	0.76
	Median	0.82	0.89	0.19	0.18	0.24	0.21	0.58	0.72
	Standard deviation	0.27	0.30	0.28	1.11	0.45	0.44	0.27	0.31

Note: in the case of Grupo Aeroportuario del Sureste the net debt / mcap ratio has been constrained to zero (as this otherwise becomes a significant outlier)
Data Source: Bloomberg as provided by First NZ Capital dated 25 August 2011. Bloomberg stock equity betas are calculated against local indicies e.g. NZX50 for NZ, ASX200 for Australia

[31] Auckland Airport, Aeronautical Pricing, Final Reasons Paper, 7 June 2012, at page 49.
[32] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at Appendix 3.

(m) The direct estimate of Auckland Airport's asset beta as at the end of August 2011 was between 0.79 and 0.62, using two years weekly data and five years monthly data respectively, with an overall average of 0.71.

From this data, Uniservices advised that first principles analysis suggests that Auckland Airport is exposed to:

(i) Systematic volume risk from the nature of services provided; and

(ii) Systematic risk from high operating leverage.

Accordingly, Uniservices concluded that:[33]

> ... an appropriate point-estimate asset beta for AIAL's aeronautical assets is 0.65.

(n) This point estimate asset beta is below Auckland Airport's average asset beta of 0.71 derived from the Commission's sample (as updated by Uniservices). It is below the value the Commission directly estimated for Auckland Airport (0.75 based on monthly observations and 0.79 based on weekly observations).[34] It is also below the updated Uniservice's average estimate (0.69) of the comparative company sample using two and five years data (see table above).

(o) A downwards adjustment for the regulated business asset beta has been made consistent with the Commission's approach to the IM in this respect:[35]

> This downward adjustment to AIAL's asset beta for its aeronautical assets reflects some allowance for lower systematic risk compared to the systematic risks of parts of AIAL's other business units.

(p) Auckland Airport considers that the 0.65 estimate of asset beta is also conservative because the historically observed asset beta includes decades of a TSC passenger, MCTOW and lease price structure, with approximately 80 percent of charges varying with underlying demand. Under the Final Pricing Decision, 97 percent of forecast revenue is demand dependent. This represents a fundamental change in Auckland Airport's risk profile, which has implications for the asset beta. A key factor in this respect is that the TSC was removed in favour of variable charging. This new structure is based on requests from substantial customers for greater risk sharing. As a result, our view is that we will be faced with increased systematic risk going forward, beyond that indicated in any historic regression analysis and/or based on historic fundamental risk factors. This is consistent with Uniservices observation in its October 2011 report that:[36]

> Any shift in pricing towards the PSC and away from the TSC will increase the overall systematic risk of AIAL's aeronautical assets.

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[33] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 31.
[34] Commerce Commission, Input Methodologies Reasons Paper, December 2010, table E19.
[35] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 31.
[36] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 30.

Leverage

(q) Uniservices provided advice on the appropriate leverage assumption as follows:[37]

> The first part of this analysis involved analysis of the actual leverage, which indicated that for AIAL over the last 2 and 5 years has been between 27.5% and 28.8% respectively:

***Table C**: Leverage*

Table 13. Leverage				
Airport	Basis	Average last 2 yrs	Average last 5 yrs	Current S&P ratings
Auckland International Airport Ltd	Market value of equity, book value of debt	28.8%	27.5%	A-

Uniservices then provided the following explanation of how leverage relates to asset beta, and advised that, given a downwards adjustment had been made to asset beta, a corresponding upward adjustment to leverage was required:[38]

> To ensure the post-tax WACC is invariant to leverage under NZ's dividend imputation regime, a necessary assumption is to assume a non-zero debt beta.
>
> The Commission considers that the relationship between cost of capital and leverage when applying the simplified Brennan-Lally CAPM is a significant matter, as the effect of leverage on the cost of capital estimate can be substantial.
>
> However, as already noted, our point estimate asset beta of 0.65 for AIAL's aeronautical assets is below both:
>
> - The "average" beta estimate across the combined two years weekly and five years monthly beta estimate of 0.69 for the sample of companies in Appendix 3; and
> - Below the direct estimate of AIAL's asset beta of 0.71 (also being the average of two years weekly and five years monthly beta estimate).
>
> **If the asset beta for AIAL's identified airport activities is considered less than the beta (systematic risk) of the non-aeronautical assets, an upward adjustment to the target leverage position for AIAL's aeronautical assets is appropriate. This recognises that most infrastructure firms are observed in practice to adopt debt in their capital structure.**
>
> [Emphasis added]

(r) Uniservices therefore concluded that it was appropriate to adopt a target leverage ratio of 30.0 percent in the determination of WACC for Auckland Airport's aeronautical assets:[39]

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[37] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 32.
[38] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 33.
[39] Uniservices, The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 6 October 2011, at page 33.

This is marginally above the historical average leverage ratio for AIAL. It reflects a greater leverage ratio that we apply to AIAL's aeronautical assets compared to AIAL's non-aeronautical assets.

*Tax-Adjusted Market Risk Premium ("**TAMRP**")*

(s) As already noted, Auckland Airport has used a point estimate of 7.5 percent for the TAMRP.

Auckland Airport appreciates that the Commission does not accept a 7.5 percent estimate for the TAMRP based on the historical estimates of the MRP reported by Dimson et al. (2010).[40] In the Commission's view the estimate of the TAMRP should be based on both historical and forward looking estimates.

In Table E12 of the IM Reasons Paper the Commission:

(i) Reports the historical TAMRP for the 2010 period for New Zealand (7.27 percent), US (7.67 percent) and Other (7.5 percent); and

(ii) Also provides estimates of the TAMRP for New Zealand, US and Other under the Siegel, Cornell and Survey approaches.

The reported mean estimates of the TAMRP in Table E12 are the average of the Historical, Siegel, Cornell and Survey approaches. That is, the analysis in the Commission's IM Reasons Paper (Table E12) appears to place 'equal weight' to all four methods or approaches to estimate the TAMRP, ie. the Ibbotson, Siegel, Cornell and Survey evidence.

In Auckland Airport's view, however, the Commission offers no evidence or support that an equal weight should apply to each method in Table E12. First, the Cornell and the Survey methods are both 'forward' looking methods. The Commission notes in its IM Reasons Paper that "...surveys can be unreliable as respondents can, for example, interpret questions in different ways."[41] Second, it is not clear that the Siegel method is used by many regulators or practitioners.[42]

In its IM Reasons Paper, the Commission also noted that New Zealand investment banks have current TAMRP estimates ranging between 6.5 percent and 7.25 percent.[43]

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[40] Dimson, E., Marsh, P., and Staunton, M. *Global Investment Returns Yearbook 2010.*

[41] Commerce Commission, IM reasons Paper December 2010, at paragraph 6.5.8.

[42] In estimating the market risk premium it is also important that the term of the risk free rate in the first term of the capital asset pricing model matches the term of the risk free rate in the measurement of the market risk premium. This assumption of consistency between the maturity of the first term of rf in the CAPM and the term of rf in the MRP/TAMRP (second term of the CAPM) is important, given historical estimates of the MRP/TAMRP generally show the estimate is higher measured relative to bills than long-term bonds. Table E12 of the Commission's IM Reasons Paper acknowledges that the Ibbotson estimate for "Other" and the "Siegel" estimate in this table are for a 10-year risk free rate and not a 5-year term. A comparison between Tables E7 and E9 of the IM Reasons Paper shows that based on TAMRP estimates for 2008 the difference in the TAMRP for the Ibbotson measure between a 5 year and 10 year term was 0.44% (US market) and -0.08% (NZ model). However, the NZ market may be "atypical" in that for most markets the market risk premium measured relative to shorter-term bonds is higher than that measured relative to long-term bonds (see Dimson et al. 2009 evidence). Thus, the Ibbotson estimate for "Other" in Table E12 is likely to be a biased downwards estimate of the TAMRP measured relative to a five-year risk free rate. In Table E12 the Siegel estimates for a 5-year term may also have downward bias.

[43] Commerce Commission, IM Reasons Paper, December 2010 paragraph E7.75 and Table E11.

However, Auckland Airport notes that:

(i) (Deutsche Bank has a different methodology to estimate the market risk premium in Table E11 of the Commission's IM Reasons Paper.

(ii) The Commission has ignored other available evidence (eg. the TAMRP used by independent parties in the valuation of SOEs for the Crown Ownership Monitoring Unit as shown in the table below).[44]

***Table D**: Summary of TAMRP used in SOE Valuations*

Summary of TAMRP used in SOE Valuations			
Party	**Point estimate of TAMRP**	**Date**	**Entity Valued**
PricewaterhouseCoopers (PWC)	7.50%	Nov 2011	Valuation of Animal Control Products Limited; Research Report Landcorp Farming Limited; and Research Report Learning Media Limited.
Ernst and Young	7.50%	Nov 2011	Valuation of Assure Quality Limited for The Treasury; SOE Economic Profit Analysis for 19 SOEs; and Valuation of Quotable Value Limited.
Macquarie Equities	7.0%	Nov 2011	Valuation of Genesis Energy; Valuation of Meridian Energy; Valuation of NZ Post; and Valuation of NZ Rail Corporation
First NZ Capital	7.25% (≡ MRP of 5.75%)	Oct 2011	Valuation of Mighty River Power; Valuation of Transpower; Valuation of NZ Post; and Valuation of Kordia.
Forsyth Barr	7.0%	Nov 2011	Valuation of Transpower; and Valuation of Solid Energy New Zealand Ltd.
Woodward Research	7.5%	Nov 2011	Valuation of Airways Corporation of New Zealand Limited for NZ Treasury; and Valuation of Meteorological Services of NZ Limited.

[44] Evidence from the website of The Treasury and the Crown Monitoring Ownership Unit. See http://www.comu.govt.nz/publications/information-releases/valuation-reports/2011/. To increase transparency of the value of the Crown's investment in various State Owned Enterprises, the Crown Ownership Monitoring Unit (COMU) has commissioned independent commercial valuation reports.

Other factors

(t) An appropriate return on investment is required to enable Auckland Airport to source suitable equity funding from global capital markets. The GFC has not completely ended and access to new capital is still constrained.

(u) Auckland Airport targets returns within a range, rather than an explicit point estimate, on the basis that it would rather be broadly right than precisely wrong.

Auckland Airport's forecast returns are reasonable

(v) Even if the only changes Auckland Airport made to the WACC IM (for its last published estimates, just over a month before Auckland's pricing decision) was to adopt an asset beta of 0.65 or an asset beta of 0.65 and leverage of 30 percent, it would result in the following estimates of WACC at the 75th percentile.

Table E: *April 2012 Determination with Auckland Airport specific beta*

	April 2012 Determination with AIAL Specific Beta	April 2012 Determination with AIAL Specific Beta and Leverage
Risk-free rate	3.61%	3.61%
Post-tax market risk premium	7.0%	7.0%
Company tax rate	28%	28%
Debt premium	1.94%	1.94%
Debt to debt plus equity ratio	17%	30%
Asset beta	0.65	0.65
Equity beta	0.78	0.93
75th percentile WACC	8.43%	8.67%

(w) In this context, Auckland Airport's forecast return and effective WACC of 8.475 percent to provide a NPV = zero outcome in its second PSE is entirely reasonable (also see section 3.4) when measures against its 75th - 85th percentile range with no allowance for asymmetric risk.

3.2 What is an appropriate level to reflect normal performance, and why?

205. Auckland Airport considers that returns in the range of the 75th to the 85th percentile of its estimate of WACC are an appropriate level to reflect normal performance.

206. During consultation, the strongest feedback that Auckland Airport received was that target returns should be either:

(a) Based on the 50th percentile, consistent with the Commission's indicated starting point for assessing returns under ID; or

(b) Based on the 75th percentile, consistent with the Commission's approach for default price paths.

207. Within the Commission's framework, the 75th percentile is a sensible starting point for assessing *ex ante* pricing disclosure.

208. The Commission has correctly accepted the general proposition that the social costs of setting allowed rates of return too low outweigh the costs of setting allowed rates too high.[45] That is, the adverse effects of under-estimation of WACC are likely to be greater than the adverse effects of the over-estimation of WACC. Reflecting this view the Commission often selects a WACC estimate above the midpoint of the estimated range when selecting allowed rates of return, and the 75th percentile is commonly selected.

211. However, a number of experts have stated that there is evidence that even the 75th percentile is conservative.[46]

212. In this regard, Professor Myers argues that the 50th percentile specifically, and the percentile approach more generally, create a misleading sense of precision in measuring WACC. He notes that there are so many uncertainties surrounding the parameters underlying WACC, many of which cannot be quantified, that describing the confidence bands around WACC in terms of standard deviations and percentiles provides a misleading sense of precision.[47]

213. An appropriate approach would be to determine the 95 percent or 99 percent confidence interval around the 75th percentile. However, this results in a very large range and an acceptable pragmatic alternative, which Auckland Airport adopted, was to target the 75th to 85th range.

214. As also noted above, Auckland Airport has not separately accounted for asymmetric risk which, on expert evidence, it could have appropriately done so.

3.3 What is an appropriate level to reflect superior performance, and why?

215. Auckland Airport sets prices to achieve a forecast return that reflects normal performance.

216. As acknowledged by BARNZ in its submission on the WIAL consultation, returns over an estimate of WACC can indicate superior performance. However, equally the

[45] Commerce Commission, *Revised Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital*, 19 June 2009 at paragraph 239.
[46] For example: Uniservices, Comments on the Commission's approach to estimate the cost of capital in its input methodologies draft reasons paper, report for NZAA 12 July 2011, page 44.; Synergies Economic Consulting, Initial WACC Review for vector, 13 August 2009, page 45; KPMG Cross Submission to Commerce Commission in Input Methodologies Gas Pipeline Services" draft reasons paper for Maui Development limited, 13 August 2009, page 14.
[47] Franks, Lally, Myers, *Recommendation to the Commerce Commission on an Appropriate Cost of Capital Methodology*, 18 December 2008, 5:11:001788.

Commission has set the WACC IM on the basis that returns over the estimate could indicate excess returns.[48]

217. Accordingly, Auckland Airport believes it is not possible to specify a target rate of return that indicates superior performance or excessive returns. Ultimately, assessing whether returns are excessive, or the result of efficiency gains, or due to unanticipated increases in demand, will require sophisticated analysis of the full range of information disclosed by airports.

3.4 Have there been any wash-ups, discounts or other discretionary adjustments to the forecast revenue requirements. If so, how should these be dealt with for assessing profitability?

218. In the first PSE, Auckland Airport made a $99 million adjustment to the forecast NPV requirement. This was a specific and pragmatic acknowledgement of the magnitude of un-forecast revaluation gains based on 2006 MVEU valuations of the land. Auckland Airport notes that this concession represented more than a 50 percent share of the unexpected gain, despite no wash-up mechanism in place from the prior PSE.

219. This wash-up at the start of the first PSE should not complicate the Commission's analysis as it related to the period prior to the introduction of ID regulation.

220. In the second PSE, Auckland Airport forecast the revenue using the WACC range of 8.88 percent to 9.45 percent, with the point estimate of the WACC being 9.16 percent, which resulted in a negative NPV of $25.4 million. This negative NPV was described in the Price Setting Disclosure in the section on 'Other Factors'. The negative NPV is best characterised as discretionary adjustment which was made in recognition of some remaining differences of view, the current market conditions, challenges facing its customers and the travel industry, which had the effect of reducing the forecast return to 8.475 percent.

221. In Auckland Airport's view, evidence of the first period wash-up and second period discretionary adjustments that has the effect of reducing forecasted profits, are strong evidence that Auckland Airport is limited in its ability to extract excessive profits. All things being equal, economic principle does not require such adjustments. However, in an environment where airports' performance is closely scrutinised, airports are seeking to avoid implementing approaches that customers would argue lead to excessive profits.

222. There were no wash-ups per se contained within the second PSE, therefore the profitability assessment in the second PSE is not complicated by such factors.

223. Forecast profitability in the second PSE should be based on the fact that Auckland Airport has set prices with the forecast of earning an effective return of 8.475 percent. Therefore, this forecast ought to be used by the Commission to assess the expected profitability of Auckland Airport.

3.5 How reasonable is Auckland Airport's revenue forecast for the second PSE compared to the first PSE forecasts, and why?

224. In Auckland Airport's view, our forecasts for both periods are reasonable. Forecasts in both the first and the second PSEs were derived following extensive consultation between Auckland Airport and its substantial customers. A primary input to those forecasts (in terms of the forecast revenue) was forecast demand for each element of the price structure. Ultimately, however, actual demand has and will deviate from forecast.

[48] Commerce Commission, Input Methodologies Reasons Paper, December 2010, at paragraph E1.22.

225. A notable new feature of the second PSE consultation process was that Auckland Airport invited and received direct airline input into its forecast demand. Reflecting on the consultation process on our forecasts, we believe that we received constructive feedback on the demand forecasts throughout the consultation process.

226. Auckland Airport's throughput demand forecasts were developed by Tourism Futures International[49] and Airbiz[50] and were reviewed following feedback from substantial customers.

227. While feedback from airlines on forecasts was mixed, when asked explicitly by the Board, we noted that

228. On the basis of expert advice, direct airline input, and with the benefit of hindsight, Auckland Airport is confident that the second PSE forecasts are more reasonable and less optimistic than the forecasts in the first PSE were proven to be. That said, it is of course very difficult to predict ash clouds from volcanoes, GFCs and international terrorist activity.

3.6 To what extent did actual results for the first PSE differ from forecasts, and why?

230. During consultation for both the first and second PSEs, Auckland Airport and airlines have generally agreed that Auckland Airport's forecasts will inevitably differ from actual results. The consultation task is to determine the most robust estimate possible.

231. Auckland Airport's objective is to:

(a) Ensure there is no systematic bias in the forecast at the time of price setting; and

(b) To manage its forecasts through the forecast period, and make appropriate trade-offs with as little impact on quality as possible (examples are discussed below).

232. As at October 2012, Auckland Airport has four years of actual results and five years of traffic statistics for the first PSE. Audited results for FY12 will be published by 30 November 2012.

233. The following table compares actual revenues to those that were forecast, for the subset of activity included in the PSE (that is, this excludes leased regulated areas).

[49] Tourism Futures International, Auckland Airport Final Pricing Decision, Appendix D - Final Aero Pricing Passenger Demand Forecasts for Auckland International Airport Limited, May 2012.
[50] Airbiz, Auckland Airport Final Pricing Decision Appendix E - Final Airbiz Report, 15 May 2012.

Table F: *Comparison of actual to forecast revenue first PSE*

	Year 1	Year 2	Year 3	Year 4	Source
	30 June 2008	30 June 2009	30 June 2010	30 June 2011	
Forecast					
Airfield activities	70,403	74,917	79,675	85,072	First pricing model
Specified passenger terminal activities	88,301	97,647	104,175	111,008	PSC and TSC only
Total	157,601	171,429	182,692	194,900	
Actual					
Airfield activities	71,159	72,633	69,015	72,529	
Specified passenger terminal activities	89,849	94,012	101,066	107,102	
Total	161,008	166,645	170,081	179,631	
Variance					
Airfield activities	756	-2,284	-10,660	-12,543	
Specified passenger terminal activities	1,548	-3,635	-3,109	-3,906	
Total	2,304	-5,919	-13,769	-16,449	

234. As can be seen from the above table, by the second year of the first PSE, (year ended 30 June 2009), actual revenue performance on a cumulative basis was behind forecast. This compounded throughout the period, so that in the fourth year of the pricing period, actual revenues were cumulatively $34 million behind the forecast.

235. The primary reason for the difference between forecasted and actual revenue was the failure of international demand to materialise as we had forecast, primarily due to:

(a) The GFC; and

(b) Materially adverse natural disasters, including the Christchurch earthquake and Chilean ash cloud.

236. The following table sets out a time series view of TFI's International Passenger Forecast excluding T&T,[53] demonstrating how the forecasts compare to actual revenue for the

[53] Auckland Airport notes that during the second PSE an error was identified between Auckland Airport and Immigration NZ regarding historical transit and transfer time series. Immigration NZ reconstructed a time series which was made available in late December 2011. This error did not affect forecast revenues in the first PSE, as the price structure did not incorporate an explicit price per transit and transfer passenger.

first PSE. This is consistent with the information provided in consultation, with a further year added and FY12 estimates.

***Table G**: Comparison of actual to forecast demand first PSE*

	Year 1	Year 2	Year 3	Year 4	Year 5	
	30 June 08	30 June 09	30 June 10	30 June 11	30 June 12	Cumulative
MCTOW						
Forecast	5,878	6,080	6,315	6,584	6,954	31,812
Actual	5,937	5,850	5,671	5,691	5,902	29,051
Variance	59	-230	-644	-893	-1,053	-2,761
	2008	2009	2010	2011	2012	
International pax excl transits						
Forecast	6,559	6,814	7,082	7,401	7,783	35,640
Actual	6,533	6,394	6,548	6,822	7,194	33,491
Variance	-26	-420	-534	-579	-589	-2,149
Domestic pax	2008	2009	2010	2011	2012	
Forecast	5,180	5,362	5,638	5,916	6,208	28,304
Actual	5,740	5,598	6,032	6,042	6,237	29,650
Variance	560	237	394	126	29	1,346

237. The above table demonstrates the downside risk that Auckland Airport has carried over the last five years, with an outturn of 2.1 million fewer international passengers than forecast.

238. While greater than 1.3 million domestic passengers were processed than forecast, during this period there was no domestic passenger charge, and therefore no direct aeronautical revenue upside resulted.

239. This analysis also demonstrates that despite a strong passenger performance through the RWC for the year ended 30 June 2012, international passengers were still some

590,000 less than forecast. Therefore, once finalised, we anticipate a material gap between the actual and forecast revenue for the final year of the first pricing period.

240. Like most businesses, Auckland Airport reviewed its strategy and business plans during the GFC, in light of the soft demand conditions. Key actions Auckland Airport took were to:

(a) Tightly manage capital expenditure and re-evaluate priorities;

(b) Implement a fighting fit strategy focussed on cost efficiencies; and

(c) Compete more heavily for incremental demand through the establishment of a business development and/or route development function.

241. Regarding steps taken to manage the difference between forecast and actual capital expenditure, we note the following:

(a) The decision to put the Northern Runway project on hold; and

(b) In terms of managing expenditure, the full scope of actual to forecast capital expenditure is shown in Schedule 6 of the FY11 Annual Disclosure. This information shows that by the fourth year of the first pricing period, Auckland Airport expended $50 million less than forecast. An explanation of each variance has been provided in the annual disclosure.

***Table H**: 2011 Annual Disclosure: Schedule 6 Capex Variance*

Actual to Forecast Expenditure ($000)

	Actual for Current Disclosure Year	Forecast for Current Disclosure Year*	% Variance	Actual for Period to Date	Forecast for Period to Date*	% Variance
Key Capital Expenditure Projects						
Expanded Arrivals excl Pier B elements	–	–	Not defined	41,176	41,711	(1.3%)
Airfield Pavements Rehabilitation	2,702	11,825	(77.1%)	9,767	26,778	(63.5%)
Stage 1A (Stands 15 and 16 + Connector)	(496)	–	Not defined	47,031	36,524	28.8%
Northern Rwy Stage 1 (1200m)	–	8,311	(100.0%)	–	35,381	(100.0%)
DTB Building Works	246	–	Not defined	5,864	6,754	(13.2%)
Meeters and greeters, forecourt mgmt & emigration	(1,968)	464	(523.9%)	20,204	17,063	18.4%
Terminal Precinct Roading & Services	377	3,727	(89.9%)	4,743	11,235	(57.8%)
Pier B Hardstand Stage 2 (Stand 19)	(224)	–	Not defined	6,986	8,383	(16.7%)
Engine run-up incl part cross taxiway	–	–	Not defined	–	8,042	(100.0%)
Noise prevention	–	373	(100.0%)	–	4,888	(100.0%)
Other capital expenditure	11,734	5,934	97.7%	47,256	34,370	37.5%
Total capital expenditure	12,370	30,635	(59.6%)	183,026	231,127	(20.8%)

242. Regarding operating costs and route development, we note the following:

(a) The annual information disclosures provide information on the extent to which operating cost actual performance varies to forecast. The forecast for the 30 June 2011 disclosure year has been sourced from the FY08-FY12 price setting disclosure. At the time of the first PSE, the Input Methodologies and Information Disclosure requirements had not been determined, therefore the new disclosure requirements were not contemplated, and relevant information was not collated in the manner now required to be disclosed.[54]

[54] The annual disclosure requirements relate to all Specified Airport Activities. The forecast disclosure requirement relates to the subset of airport activities covered in price consultation. The FY07 PSE excluded aircraft and freight activities and activities recovered by way of lease. Therefore the basis for the actual regulated expenses and capital expenditure has a different scope to the basis of the forecasts. Auckland Airport factored

(b) Nevertheless, Schedule 6a does provide interested parties with information on key drivers of the operating cost variance, and highlights the key difference between the forecasts and actuals (for activities excluding aircraft, freight and leases) to be $14 million of business development costs incurred over the period. This function did not exist at the time of the first PSE. The investment has resulted in greater incremental growth than would have otherwise been achieved and has been part of Auckland Airport's strategy to grow travel, trade and tourism. Auckland Airport considers the below forecast volumes from the first PSE would be considerably lower if Auckland Airport had not sought to stimulate demand through its business development activities.

Operational expenditure

243. The following table provides an analysis of the variance between forecasted and actual operational expenditure.

Table I: *2011 Annual Disclosure: Schedule 6 Operating Cost Variance*

Area	Annual variance	Explanation	Period to date variance	Explanation
Total variance	$17.2m	The scope of disclosed activities is broader than that which was included in the scope of the price setting event.	$42.1m	The scope of disclosed activities is broader than that which was included in the scope of the price setting event.
Aircraft and freight costs	$2.6m	14.7 percent of the annual variance relates to aircraft and freight operating costs which were not part of the price setting forecast.	$9.8m	22.8 percent of the year to date variance relates to aircraft and freight operating costs which were not part of the price setting forecast.
Business development costs	$10.4m	60.3 percent of the annual variance relates to aeronautical business development activities associated with competing to attract new air services for Auckland and New Zealand, through proactively targeting routes and markets.	$14.0m	33.0 percent of the period to date variance is for aeronautical business development activities. These strategic activities were not performed at the time of the price setting forecast and therefore not included in pricing. The airlines therefore have received the benefit of the services without the costs having been recovered from them.
Remaining variance $	$5.1m	The remaining variance is less than 10 percent of annual costs. This is attributable to leased areas which were excluded from the price setting event and other variances.	$18.3m	The remaining variance is less than 10% of period to date costs. This is attributable to leased areas which were excluded from the price setting event and other variances.

the new requirements into the second price setting disclosure and as discussed with the Commerce Commission this will be addressed from the FY13 disclosure onwards.

244. In summary, reflecting upon the extent to which actual results for the first PSE differed from forecasts and why, Auckland Airport's conclusion is that actual demand has been significantly softer than forecast, primarily as a result of the GFC and natural disasters, both of which were unknown at the time of forecasting and beyond Auckland Airport's control.

245. However, Auckland Airport is confident that it has taken positive action to stimulate demand in these difficult conditions, and to manage capital and operating expenditure through the period. Auckland Airport will follow a similar approach throughout the current pricing period.

246. In the past three years, Auckland Airport's route development campaigns have created incremental volume in:

(a) North Asia (China, Japan, Korea, Taiwan);

(b) South East Asia (Singapore, Kuala Lumpur, Bangkok, Indonesia);

(c) Tasman (Brisbane, Sydney, Cairns, Melbourne, Coolangatta, Mackay);

(d) United States; and

(e) Domestically, in New Zealand.

3.7 To what extent is the difference between forecast revenue and actual revenue disclosed under ID for 2011 and 2012 different due to changes in demand and what is the dollar value difference in each year due to the changes in demand?

247. The difference between forecast revenue and actual revenue is heavily dependent on changes in demand. FY12 actual results are yet to be audited, and therefore, Auckland Airport has focused its analysis on ID for 2011, with a forecast only provided for 2012 (which will be confirmed when FY12 ID is publically released in November 2012).

248. The table below shows that on a forecast basis:

(a) 99 percent of airfield revenues were volume dependent;

(b) 70 percent of terminal revenues were volume dependant; and

(c) Just over 80 percent of overall revenues were volume dependant.

Table J: *Analysis of revenue drivers FY11 and FY12 forecast revenue*

		30 June 2011	30 June 2012
Airfield volume based charge	Unit - driver - MCTOW	83,891,482	90,836,736
Airfield other	Semi indep of demand	1,180,521	1,204,131
Total airfield		85,072,003	92,040,867
		99%	99%
Passenger Terminal PSC Income	Unit - driver - International pax	83,627,964	87,943,596

		30 June 2011	30 June 2012
Passenger Terminal - TSC Income	Semi indep of demand	27,380,518	27,456,905
Other Income	Semi indep of demand	8,668,155	8,796,668
Total passenger terminal		119,676,637	124,197,169
		70%	71%
	Total forecast revenue	204,748,641	216,238,037
	Based on unit drivers	167,519,447	178,780,331
		82%	83%

Table K: *Actual versus forecast revenue by revenue type FY11*

		Forecast	Actual	Variance
		FY11	FY11	
Airfield volume based charge	Based on unit drivers	83,891	72,529	- 11,363
Airfield other		1,181	522	- 659
Total airfield		85,072	73,050	- 12,022
Passenger Terminal PSC Income	Unit - driver - International pax	83,628	78,760	- 4,868
Passenger Terminal - TSC Income	Semi indep of demand	27,381	28,342	961
Other Income	Semi indep of demand	8,668	NC*	scope of forecast and actual differs
Total passenger terminal		119,677		-15,929

249. Under the first PSE, the basis for the forecast and actual revenues are incomparable for other terminal income. Accordingly, we highlight the results for areas in which the scope of the information disclosed was consistent with the scope of the forecast. This demonstrates that for the airfield, $11.4 million of the $12 million difference from forecast to actual was based on revenues which were driven by MCTOW or movements. For the passenger terminal, there was a $3.9 million difference in FY10 between forecast and actuals, and on a volume basis PSC income was $4.8 million less than forecast. However, the Terminal Services Charge offset by being $960,000 or 3.4 percent greater than forecast.

3.8 How do the asset values used for the second PSE for pricing purposes reconcile to the asset values disclosed under ID?

250. Reconciling the second PSE and assets disclosed under information disclosure would be complex, with the asset values and treatment in the different registers diverting at 30 June 2009.

251. As interested parties are aware, in response to strong feedback from substantial customers, it was decided to base the asset values for pricing purposes on the 2006 valuations, rather than on the asset values disclosed under ID.[55]

252. A comparison was provided between the estimated asset values that would be disclosed under ID for FY11 to the proposal for price consultation by asset class and by land revaluation zonal area in the Initial Pricing Proposal, with the final comparison in the Final Reasons Paper as follows:[56]

***Table L**: Asset allocation: $ value allocation by asset class*

Y11 (Baseline Year)	Disclosure Statements View				Price Consultation View			
($ million)	Specified Terminal Activities	Airfield Activities	Aircraft & Freight Activities	Total Regulated Activities	Specified Terminal Activities	Airfield Activities	Future Use Activities	Business Subject to Price Consultation
Land								
Directly attributable assets	0.2	326.5	24.9	**351.6**	0.2	223.6	102.9	**326.7**
Assets not directly attributable	17.9	6	0.6	**24.5**	11.7	4.6	-	**16.7**
Sealed Surface								
Directly attributable assets	-	216.8	-	**216.8**	-	216.8	-	**216.8**
Infrastructure & Buildings								
Directly attributable assets	43	17.7	27	**87.7**	43	17.7	0.1	**60.8**
Assets not directly attributable	352.6	46.3	7.9	**406.8**	295.1	46.3	-	**341.5**
Vehicles, Plant & Equipment								

[55] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 26 at paragraph 3.2.
[56] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, pages 31 and 32.

Y11 (Baseline Year)	Disclosure Statements View				Price Consultation View			
Directly attributable assets	1.6	1.8	-	3.4	1.8	1.7	-	3.5
Assets not directly attributable	8	2.9	0.3	11.2	6.7	2.9	-	9.6
Total directly attributable Assets	44.8	562.8	51.9	659.5	45	459.8	103	607.8
Total Assets not directly attributable	378.5	55.2	8.8	442.5	314	53.8	-	367.8
Total assets	423.3	618	60.7	1102	358.1	513.9	103	975.6

Table M: *Land valuation per the Moratorium: 2007 and 2012*

Zones	Zone	Seagar valuation	2007 Price Consultation	2012 Standard Charges	Nature of difference
Seabed	1a	8.8	0	0	
Southern airfield	1b	276.1	185.5	194.4	2011 proposal to include Wiroa Island, which was excluded in 2007 and reallocation of airfield roads to this zone
Southern airfield REPA	1c	3.8	3.8	3.8	
Southern airfield RESA	1d	2.7	1.3	2.7	No commercial concession proposed
ITB	3a	45.5	4	4.1	Change in asset allocation
DTB	3b	11.2	2.1	1.7	Change in asset allocation
Infrastructure	6	3.3	1.8	5.8	Change in asset allocation
Other Property Plant and Equipment ("PPE") land	7			0.1	Change in asset allocation
Roads	8	10.7	6.3	5.0	Change in asset allocation
Total Land excluding future use & aircraft & freight		362.1	204.7	217.5	
Seawall		23.0	23.0	23.0	
Total land excluding future use and aircraft & freight but including seawall		385.1	227.7	240.0	

253. The asset values were based on values prior to the completion of the final regulatory asset register (the revaluations under the IM had not been made to non-land assets)

and prior to the finalisation of the allocation rules. As such, the Disclosure Statements view in the pricing proposals does not tie to the asset values disclosed under ID for FY11, which were based on final asset values and allocations derived under the IM and Schedule A.

254. The following table summarises the differences in the treatment in each register between the second PSE for pricing purposes and the asset values disclosed under ID:

Table N: *Treatment of assets in fixed asset registers*

	Pricing purposes	**FY11 disclosure purposes**
Land	2006 asset values	2011 MVAU asset values under Schedule A
	Pricing allocation rules	Disclosure allocation rules
Non-land	2006 asset values rolled forward to 2011 for additions, disposals and depreciation	2006 asset values rolled forward to 2009 for additions, disposals and depreciation 2009 asset values rolled forward to 2011 per the IM
	Additions per financial reporting including capitalised borrowing costs	Additions from 1 July 2009 include capitalised WACC
	Depreciation per financial reporting from month asset commissioned	Depreciation from 1 July 2009 excludes depreciation in the year of commission
	No revaluations	CPI revaluations from 1 July 2009 per the IM
	Pricing allocation rules	Disclosure allocation rules

255. Auckland Airport now maintains five asset registers (Financial Reporting (2), Disclosure reporting, Pricing and Tax), as the ability to use the financial reporting asset register to extract pricing or disclosure reporting values is no longer possible. To create the regulatory asset register, the accounting values at 2009 were rolled forward under the IM including adjusting all transactions between 1 July 2009 and 30 June 2011, where necessary. The pricing register was created by taking the financial reporting register prior to the 30 June 2011 property, plant and equipment revaluation, so as to reflect the 2006 asset revaluation outcomes used in the Moratorium.

256. In some respects, it is unfortunate that the asset values used for pricing were not the same as those disclosed under ID, as it makes it more difficult to reconcile asset values used for pricing in the second PSE, with asset values disclosed under ID. However, as discussed above, Auckland Airport chose to do so in response to requests from airlines.

3.9 What differences (including dollar value effects) are there between cost allocation methodologies and cost categories used for ID disclosure and the second PSE?

257. ID disclosure for FY11 was substantially completed in April 2012, prior to the May 2012 disclosure. By this time, Auckland Airport had consulted on asset and cost allocation through the Initial and Revised Pricing Proposals, prior to the Final Pricing Decision on 7 June 2012.

258. As noted in the Price Setting Disclosure at page 31, cost allocation rules were aligned with the materials consulted on in the Revised Pricing Proposal in March 2012.

259. However following the publication of the annual disclosures, in response to feedback, in the Final Pricing Decision it was decided to share the costs associated with non-airline specific route development activities (approximately $3.5 million per annum in the forecast) between Aeronautical Pricing and Non-aeronautical Pricing Activities. This reduced the allocation of these costs to aeronautical from the 100 percent used in the May 2012 Disclosure to the 73.2 percent used for this price setting disclosure for all regulated activities and of which 62.7 percent has been allocated to the Aeronautical Pricing activities.

260. There are no differences in the grouping of operating costs by operating cost category (that is, into corporate overheads, asset management and airport operations and asset maintenance) between ID disclosure and the second PSE.

261. In the final decision, there was a reduction in the allocation of the forecourt asset from 95 percent to 75 percent. The dollar value effect of this reduction was $2.2 million. The space allocation aeronautical pricing percentage also reduced from 62.9 percent at the time of the Revised Pricing Proposal consistent with Information Disclosure, to 60.4 percent in the final pricing decision. This had some minor knock on effects to other rules which rely on the space allocation rule.

3.10 How reasonable are Auckland Airport's asset valuations, and why?

262. Prior to entering the aeronautical pricing consultation, Auckland Airport recognized that asset valuation was a matter that would need to be fully tested with substantial customers, given that:

(a) It has strongly advocated to the Commission that updated MVEU and ODRC valuations was the most appropriate approach;

(b) It has entered into a 10 year Moratorium on asset valuations in 2007, subject to regulatory change;

(c) Substantial customers have strongly advocated to the Commission that historic cost approaches were most appropriate; and

(d) The Commission had established asset valuation IMs for information disclosure purposes that differed from all of the above.

263. Accordingly, at the outset of the aeronautical pricing consultation, Auckland Airport was undecided regarding the asset valuation that ought to be applied, although it had a firm view of what asset valuations were most consistent with the Part 4 purpose statement. Asset valuation had been a contentious issue in the first PSE, during which a significant volume of information and views were exchanged, which ultimately resulted in the decision to implement a Moratorium on asset valuations for at least 10 years.

264. On this basis, the Moratorium valuation was an important reference point for the second PSE, which we prioritised as one of the first areas to consult on with the airlines, in order to ensure sufficient time was available to consider all feedback.

265. Given that the Moratorium was ultimately retained in response to strong feedback from substantial customers, Auckland Airport would be very surprised if there were any allegations that our asset valuations for pricing purposes were unreasonable. We fully appreciate that our substantial customers would like to obtain greater certainty on what decisions Auckland Airport will make regarding asset valuation and the Moratorium for future pricing periods. Auckland Airport's current position is that it is appropriate for us to consider all relevant options and factors, including retaining the Moratorium, with an open mind at the time we next consult on prices. The only commitment that we consider

appropriate to give now is that we will fully and carefully consider all views provided to us by all customers at that time.

266. In order to assess and consider the application of the asset valuation IM for ID purposes, Auckland Airport commissioned Common Ground and Colliers to complete an urban design appraisal and market value alternative use ("**MVAU**") valuation for 30 June 2011. Neither of these experts had any involvement in the first PSE, but were commissioned to undertake the first regulatory valuations. Additionally, Opus Consulting ("**Opus**") was retained as a specialised asset specialist.

Reasonableness of Auckland Airport's ID asset valuation process

267. Auckland Airport's process in formulating ID asset valuations was reasonable and fully complies with the IM requirements. Key preparatory stages in developing reasonable and compliant asset valuations were:

(a) Engaging Wareham Cameron (a participant in the Part 4 IM development) to update Auckland Airport's Asset Valuation Handbook to ensure compliance with the Asset Valuation IM requirements;

(b) Requesting tenders for updated regulatory valuations in compliance with the Asset Valuation Handbook and IM;

(c) Selecting Common Ground, Colliers and Opus to undertake regulatory valuations; and

(d) Appointing Wareham Cameron to undertake a peer review of the regulatory valuations of Common Ground, Colliers and Opus.

268. Given that adoption of the ID asset valuations for pricing purposes remained under consideration, Auckland Airport's ID asset valuations were consulted on as part of the pricing consultation. Key consultation stages in developing reasonable asset valuations for pricing were:

(a) Providing substantial customers with current valuations developed consistent with IM requirements under Schedule A and seeking their feedback;

(b) Providing for the opportunity of expert cross-examination of the MVAU plan and valuations; and

(c) Consideration of feedback during consultation.

269. Information was first exchanged in September 2011, when the airlines were provided with the following independent expert information:

(a) NERA Report on Pricing Valuation Principles;

(b) Common Ground Alternative Use Report;

(c) Colliers – MVAU Valuation June 2011. (We note that the MVAU land asset valuation undertaken by Colliers, which was provided to airlines, applied the IM for land valuation); and

(d) Opus Specialised Buildings Valuation Report and Appendices dated 30 June 2011.

Reasonableness of the asset valuations

270. In addition to the reasonableness of our process in adopting our asset valuation methodology, Auckland Airport believes its actual asset valuations were and are reasonable.

271. During our consultation process,

272. The full consultation record demonstrates that:

(a) During a meeting on 29 September 2011, Mr Charles Spillane of Auckland Airport invited feedback from BARNZ regarding any issues with the valuations or double counting;

273. Common Ground provided expert advice that it worked closely with Colliers to come up with a realistic, market acceptable alternative use plan. Common Ground took Auckland Council's likely views into consideration and developed a residential based option that, though more conservative than the developers' approach, was a realistic option. Common Ground also clarified that while it had described a requirement for 500,000 sqm of 'commercial' area, that a more appropriate term for this 'commercial space' was 'non-residential', as the allocation of this space included education, healthcare and temporary stay accommodation.

274. As acknowledged in a

As at the time of this submission, Auckland Airport is yet to receive a formal response to the MVAU regulatory valuation.

Reasonableness of the Moratorium for pricing purposes

278.

This demonstrates the difficulty Auckland Airport faced in considering whether its historic decisions should remain appropriate or whether there were good reasons to depart from its previously adopted approach. It also demonstrates the difficulties Auckland Airport will face when it consults on appropriate valuations for pricing purposes.

280. The following extract from section 3.4.4 of the Initial Pricing Proposal summarises the key reasons behind Auckland Airport's decision to continue the Moratorium, despite the Commission's determination of an IM for ID purposes. In short, Auckland Airport was concerned that it was unlikely to reach a commercially acceptable outcome following consultation, if it did not accept substantial customers' submissions on this point:[62]

> Auckland Airport acknowledges that the Moratorium is a special case in light of Auckland Airport's specific decision (albeit qualified) not to revalue assets for a ten year period. It has nevertheless been incumbent on Auckland Airport to consider lifting the Moratorium given its consultation obligations, regulatory change and views expressed by its Substantial Customers.

281. Factors which Auckland Airport considered supported lifting the Moratorium included:

(a) The Moratorium was proposed subject to future regulatory change, which did occur;

(b) Since the Moratorium decision, the Commission released its IM Determination, which included asset valuation methodologies for information disclosure purposes;

(c) Influenced by substantial customer views, Auckland Airport decided to treat the input methodologies as relevant considerations that should be taken into

[62] Auckland Airport, Initial Pricing Proposal, Aeronautical Pricing Consultation, 19 January 2012, 3.4.4.

account as part of its decision-making process under the AAA (as distinct from being legally binding);

(d) Economic advice was received that supported the view that the Moratorium is inconsistent with workably competitive market outcomes;

282. Factors which supported retaining the Moratorium included:

(a) Strong views from customers that the Moratorium should be retained;

(b) Complexity in lifting the Moratorium; and

(c) Latent uncertainty regarding the regulatory environment, including the merits appeals of IMs from Air New Zealand and the three regulated airports.

283. In the end, Auckland Airport acknowledged that the Moratorium was a critically significant issue for its customers, and therefore agreed to maintain the Moratorium as part of an overall pricing package that ensured an appropriate incentive for Auckland Airport to invest. This necessarily means that the Commission's asset valuation IMs for the ID asset base were not followed for the Initial Pricing Proposal.

284.

. Indeed, whether or not the airlines agree, such an assertion would be baseless. Auckland Airport carefully considered the Commission's IMs and reasons for them, but in the end elected to retain the Moratorium because of other important considerations. In particular, Auckland Airport sought to develop proposals that, although based on robust economic principle, also form a commercially appropriate package for all parties. Retaining the Moratorium was part of that package.

285. Auckland Airport is confident that its asset valuations for pricing are reasonable because these were developed following a robust process and settled on by taking in to account views and expert advice received during both the first and second consultation processes. The pricing valuations were in fact below competitive market outcomes and the ID valuations.

3.11 What is the appropriate treatment for pricing purposes of assets held for future use?

286. Auckland Airport strongly believes that assets held for future use should be included in the asset base. The question then becomes to what extent a return should be sought on those assets. This is not an easy question, and is an example of a matter that should be fully explored and tested in pricing consultations.

287. In its 2007 price setting decision, Auckland Airport decided to 'optimise' the Northern Runway land, removing 44 percent of the airfield land to reflect the expected partial use of the Northern Runway at 1200 metres of an intended 2150 metre staged runway development. Or put another way, Auckland Airport did not seek a full return on assets held for future use (consistent with its view that including assets held for future use in

the ID asset base does not necessarily mean it will seek a full return on those assets now).

288. In response to strong customer feedback, and after considering the benchmark established by the IM for information disclosure purposes, Auckland Airport decided to exclude the Northern Runway from the asset base for pricing purposes in 2012.

289. Regarding its 2012 treatment of the Northern Runway for pricing purposes, Auckland Airport made the following public statement in the Price Setting Disclosure:[63]

> Auckland Airport consulted on price signalling options for the Northern Runway with Substantial Customers. Unlike terminal development, staging options are limited and pricing issues must be front-footed if investment is to be delivered in a dynamically efficient manner without price shocks.
>
> Throughout consultation with the Commission on the new information disclosure regime, Auckland Airport maintained that excluding strategically held assets (such as land) from the regulatory asset base could cause a fundamental problem and inhibit investment in projects strategically important to tourism and trade in New Zealand – such as the Northern Runway. Nevertheless, the Commission determined that land is to be excluded from the regulatory asset base unless it is currently used in the supply of specified airport services. Under the Commission's methodology these assets are simply tracked as "future use assets". Theoretically, absent any regulatory change, Airports can nevertheless expect to be able earn a full return on and of the costs incurred in holding and developing this land without profits appearing excessive, provided it is eventually commissioned for use to supply airport services – albeit a significant increase in charges at the time the new supply is created. Using the *Commission's approach this land will therefore theoretically enter the regulatory asset base once* demand is sufficient to justify expansion of the Airport – not before.
>
> During the Aeronautical Pricing Consultation Auckland Airport explored options to use the Commission's future use asset monitoring and an interim charge to smooth charges for the Northern Runway. Following consultation, Auckland Airport considers that the Commission's exclusion of the Northern Runway land from the regulatory asset base to be inappropriate and that even if the regulatory environment remained stable, the future use construct which has been developed in the input methodologies is a theoretical approach which will not deliver a commercially effective outcome. Incentivising investment for this strategic development is crucial in the context of the development of New Zealand's strategically important infrastructure. At present, alternative land use options exist, but Auckland Airport continues to prudently hold significant areas of land for future aeronautical purposes rather than selling or developing the land for other commercial use. **Yet this strategic landholding provides no cash return and future aeronautical returns remain highly uncertain. Auckland Airport will continue its dialogue with airlines and the Commission on this strategically important issue, with a view to developing the sort of certainty required for such significant investment to be made.**
>
> [Emphasis added]

Auckland Airport's consideration of the Northern Runway for the second PSE

290. As part of Auckland Airport's consultation on the second PSE, Estina Consulting set out its view of a range of options for Auckland Airport to consider in setting aggregate price levels, specifically contemplating the large lumpy capital expenditure assets associated with the building of the new Northern Runway.

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[63] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, pages 8 and 9.

291. Estina Consulting report suggested the following range of options for setting aggregate price levels:[64]

(a) Continuing the method used previously, and pricing at an aggregate level so that the NPV of five year forecast returns would be at or below zero. With respect to efficient pricing, Estina Consulting advised that this under-prices prior to the commissioning of new capacity (driving excess demand and accelerating the need for the second runway) and then over-prices when the runway has been commissioned (with the perverse consequence that demand is relatively discouraged when there is excess capacity).

(b) Price at LRAC based on comprehensive economic cost modelling. Estina Consulting advised that while this would be ideal to set efficient prices, it is complex, costly and difficult to audit. Additionally, it would be difficult to reconcile the basis for pricing with disclosure reporting.

(c) Treating the upcoming investment in the second runway separately, setting prices to the aggregate of:

(i) Applying the past method (pricing so that NPV=0 for five year forecast returns) for all costs excluding any costs of the second runway; and

(ii) Using forward-looking economic costing to recognise how increments in today's demand bring forward the need to commission the second runway. Estina Consulting advised that this additional charge, leading up to the commissioning of the second runway, was necessary for prices to accurately reflect the long run costs driver by incremental demand.

292. During the consultation, it was recognised that the timing of the second runway was sufficiently uncertain that it decided to delay the introduction of any additional charge to bring prices up to long run average cost.

293. Auckland Airport expects that the appropriate treatment of assets held for future use will depend upon:

(a) The lead time for intended commissioning;

(b) Methods for signalling prices efficiently; and

(c) Consideration of providing the right incentives (such as for Auckland Airport to invest in a second runway).

294. A contestable market would allow Auckland Airport to price at long run average cost. During the pricing consultation, Auckland Airport explored whether pricing in a manner that mimicked the IM requirements and disclosure monitoring regime would promote efficient pricing, given that there is a strong countervailing power to adopt methodologies proposed by the Commission. A key implication identified by Auckland Airport is that if it were to adopt the IM for pricing purposes, then the Northern Runway would not be part of the asset base until the time of commissioning. At that time the inclusion of the land value, together with holding costs and capital costs, would result in a significant step change in prices, which is inconsistent with efficient pricing. The challenge is that the IM provides legitimacy for airlines to advocate the use of the IM for price signaling.

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[64] Estina Consulting Limited, Aeronautical Pricing Methodology, Aeronautical Pricing Consultation, 13 September 2011, pages 3 and 4.

295. In the Initial Pricing Proposal, Auckland Airport sought the views of its substantial customers on choices available for:

(a) Incorporating a charge for the Northern Runway;

(b) The timing of the introduction of a charge; and

(c) The implications for the nominal value of the charge based on those timing considerations.

296. Responses received during consultation with substantial customers included the following views:

297. Auckland Airport understood and fully considered the feedback it received on pre-financing and concerns of inequity. However, ultimately, Auckland Airport agreed with the observations of Estina Consulting's in its Aeronautical Pricing Methodology paper that:

(a) It would be inefficient not to signal how demand growth is driving the need for a major capacity-step investment in a second runway;

(b) A charge for the Northern Runway prior to commissioning is more consistent with efficient pricing; and

(c) There are inequities in the pricing of services by not signalling the cost of growing demand, and instead pricing the services upwards just after a significant capacity step is commissioned.

298. The following quote from Estina Consulting's Paper is illustrative:[65]

[65] Estina Consulting Limited, Aeronautical Pricing Methodology - Review of Feedback, November 2011, page 5.

The pre-financing criticism has little to do with efficient pricing concepts and seems to spring from a view that airport charges are for the purposes of cost-recovery in the short term. It is worth noting that efficient pricing will also achieve cost recovery but sometimes over a longer term than a single year or even a five year period – as set out in Estina's recommendations.

In some cases the feedback goes further and takes a view that prices should adhere strictly to the Commission's determination of what to include in the RAB, as if the RAB should be treated as defining a form of 'shadow' price control. Estina set out in its recommendations how pricing to recover disclosed costs will deviate markedly from efficient prices when efficient investment involves large lumpy capacity-step investments with a long useful life.

Futures Consultants goes even further and dismisses the importance of efficient price signalling, because it considers the impact to be immaterial. Estina acknowledges that passengers have relatively low demand elasticity to small changes in airport prices. But the persuasiveness of Futures Consultants' argument is defeated by its own logic. If the end-users' reactions to the charge can be dismissed as immaterial then it also follows that an airline's basis for objecting to the charge (provided the NPV=0 principle is still adhered to) is also immaterial in the long-term interests of passengers (end-users).

In support of the BARNZ contention that airlines should only pay for assets that are 'used and useful', Futures Consultants poses an example where a retailer, that acquires an adjoining shop for future expansion, would not expect to be able to increase prices to cover the new additional costs when the asset is not yet in use.

This example revisits the arguments concerning 'assets held for future use' which relate to its inclusion (or not) in the RAB, but this argument is irrelevant to efficient pricing.

- If it is wise to acquire an asset earlier than it is needed, then the cost of acquisition plus holding costs will be equal to or lower than the expected (and risk-adjusted) cost of acquiring the asset later when it is needed. This is entirely consistent with the approach taken by the Commerce Commission – specifically, that land held for future use should not be included in the RAB, and that the value of the land should accumulate holding costs until it is commissioned, and then included in the RAB.

- The 'cost recovery' perspective is in contrast to the economic concept of efficient pricing which means prices should reflect the impacts of demand on future cash flows. If pricing cannot reflect the impacts of demand on future cash flows, because to do so would be to pre-fund those future cash flows, then efficient pricing is prevented.

- For the purposes of efficient pricing it is irrelevant whether assets have been acquired for future use or whether they will be acquired later, when needed. The relevant issue is how demand drives the timing of when the asset is needed, and therefore triggers an opportunity cost.

299.

300. Ultimately, Auckland Airport requested feedback from airlines on a potential mechanism to introduce an early change which provided for smoothed prices, while at the same time adopting the IM's requirements for assets held for future use.

301 which is in a sense consistent with the Commission's concept of bringing in the asset with all its holding costs and investment on day one of commissioning the future use asset. However, Auckland Airport considered:

(a) This to be a view some parties were likely to hold only at a point in time - that is, closer to the introduction of the asset, it is economically rational that the preference will move to price smoothing;

(b) That Futures Consultants would be likely to advocate discounts on day two of the commissioning of the new assets; and

(c) There is no pre-financing proposed - that is, the land is already paid for and financed, and is prudently and currently held for future expansion.

302. Auckland Airport therefore considers that the IM treatment of land held for future use does not support efficient pricing signaling, and by distorting incentives it compounds the challenges Auckland Airport will face to develop a commercially acceptable business case for the Northern Runway. Accordingly, we remain of the view that it is not the best methodology for promoting outcomes consistent with the Part 4 Purpose Statement. In our view, a better balance was struck by the approaches under the AAA, which explicitly included land held for future use in the asset base, so long as the investment was prudently made (i.e. a lower cost than the expected cost, including the risk, of buying the land later).

303. Auckland Airport is concerned that the existing IM distorts incentives by allowing existing customers not to pay for the congestion they are causing. While it is true that airlines are impacted by congestion costs, they receive gains through higher prices due to the constrained supply. Skewing incentives in this way will be to the detriment of all (including future) consumers. In Auckland Airport's view, it would be more appropriate if prices could be appropriately signaled and price shocks avoided, whenever possible.

304. Auckland Airport has provided the option for all customers to agree to a charging mechanism which, at a general level, reflects how their demand is driving the timing of the costs of the Northern Runway now, on the understanding that the charges they pay will be smoothed to commissioning and interim revenues collected would be offset against the future asset commissioning value. No customers have elected to pay that charge at this point in time, but Auckland Airport remains hopeful that their views will change.

305. Given our concerns, under this Review we seek the views of interested parties, including the Commission, on what sort of assurances can be provided that price shocks will be acceptable and not challenged when they inevitably occur in the future, and that there will be support for an efficient timing for the Northern Runway when perverse incentives to delay have been created. Alternatively, if price smoothing to better reflect efficient prices is preferred, we are interested in the view of interested parties on how this should be accommodated in relation to the ID.

4. Is Auckland Airport operating and investing in their assets efficiently?

Overview

306. Auckland Airport manages in excess of 50,000 assets, and is committed to developing and maintaining these assets in a planned manner that meets customer and stakeholder expectations.

307. Philosophically, Auckland Airport's preference is to maximise the utility of existing assets. In this regard, we pursue innovations (discussed in further detail in a later section) and strive for best practice maintenance, management technology and operational efficiency. We also place value on sustainable maintenance and construction practices. A key objective in this regard, is to provide reliable assets that ensure safe and efficient operations with an optimised lifetime value for the asset.

308. With this vision in mind, Auckland Airport continues to build its asset management practices, right across its portfolio of asset classes.

309. These are complemented by Auckland Airport's well established practices for exploring process efficiency options prior to capital expenditure on investment.

310. For instance, Auckland Airport led a LEAN forum (involving airline stakeholders and border agencies) to identify opportunities to gain incremental efficiencies from existing assets. **Attachment 3** contains background to the following LEAN initiatives implemented since June 2010, with the objective of improving operating efficiency:

(a) Advanced Passenger Display ("**APD**");

(b) Way-finding improvements in bag hall;

(c) Exit facilitation;

(d) Local control stations for bag claim arrivals;

(e) FIDS screens upgrade;

(f) Check-in zoning;

(g) FIDS messaging review;

(h) Carousel extension and related works;

(i) Improved Baggage Tracing Unit;

(j) International transit & transfer screening point upgrade;

(k) Immigration Hall – column mounted screens and local PA system;

(l) MAF configuration and process changes; and

(m) Automated carousel allocation tool.

311. In May 2012, Auckland Airport replaced the LEAN working groups and governance group with the Collaborative Operations Group ("**COG**"). This group meets fortnightly and daily and is made up of operations managers of Auckland Airport and its stakeholders from across the end to end process. The objectives of the group are to enhance active collaboration and real time communication and decision making.

312. In this regard, stakeholders at Auckland Airport have had, and continue to have, excellent opportunities to influence the operational efficiency of assets, and highlight investment priorities.

Significant capex under consideration

313. Throughout the second PSE, management has been deliberating at length on the most efficient form of investment in the next stage of domestic terminal capacity. In 2005, investment was made in the existing terminal, with an expected life of 10 years.

314. In early calendar year 2011 Air New Zealand introduced the first of its A320 aircraft for domestic routes. By April 2011 it was evident that the introduction of the A320 would have a more significant impact on terminal congestion than Auckland Airport, or any stakeholder, had previously anticipated. Since this time, Auckland Airport has been working closely with the domestic carriers on expansion options.

315. Initially, Auckland Airport sought to develop a capacity solution for its domestic operation and include this in the second PSE. However, in response to customer feedback, Auckland Airport came to the conclusion that it was important not to rush an investment decision which may have consequences for all airport customers for some 40 odd years. We therefore decided to remove the ITF (which has more recently been referred to as the NTF) from the aeronautical pricing proposal for the five year period from 1 July 2012, and conduct a separate ongoing consultation.

316. The other critical investment decision currently before Auckland Airport is the ultimate requirement for the Northern Runway. In Auckland Airport's experience, this is something which will only be known in the fullness of time. Therefore our focus is on:

(a) Continuing to participate in industry forums which have the potential to increase the capacity of the existing runway;

(b) Monitoring movements and peak hour performance against triggers, including when the four busiest hours of the 95th percentile peak busy day pass through 90 percent capacity;

(c) Developing options in respect of runway mode of operation and runway length;

(d) Managing airline expectations with respect to efficient pricing outcomes; and

(e) Highlighting to the Commission the commercial impracticality of holding this landbank, compounding the holding costs and hoping that customers will be prepared to pay these upon commissioning (as discussed above).

317. Auckland Airport has transparently disclosed these investment requirements in the FY11 annual disclosure as follows:[67]

> In particular, capacity in the domestic terminal is becoming increasingly constrained. Accordingly, in consultation with our stakeholders, we need to carefully and appropriately invest to ensure that Auckland Airport is able to meet expected demand and underpin growth within the region.
>
> With strong passenger and freight growth projected, and with the more than 40 year old existing domestic terminal infrastructure nearing the end of its useful life and degrading service, Auckland Airport needs to begin investing carefully now to ensure long-term tourism infrastructure capacity is in place at the right time and that out-dated assets do not negatively impact on New Zealand's reputation.

[67] Auckland Airport, Annual Disclosure 2011, Disclosure Date 17 May 2011, at page 6.

> Because of the dynamic operating environment, Auckland Airport must continually adapt for the long-term horizon. A long-term planning vision of a centralised domestic and international terminal served by two runways, surrounded by a vibrant airport business district, and well connected with the city remains central to the airport's thinking. With growth in passenger and freight transport, changing aircraft types, and associated aircraft movements Auckland is now confronting capacity constraints, particularly in the domestic terminal. These constraints will only become more acute as more of the larger A320 aircraft are deployed on domestic routes. The highest priority for the short to medium-term horizon is to address the capacity constraints in the existing domestic terminal and to find a pathway for enabling the future benefits for passengers and New Zealand resulting from the integration of terminals.

318. A second runway (to the north and parallel to the existing runway) has long been part of the Auckland Airport master-plan and will, in time, be essential to cope with forecasted long-term tourism and trade growth. Construction work on the Northern Runway commenced in 2007 and was temporarily paused in 2009 to maximise the capacity utilisation of the existing runway and better match timing of delivery with demand slowed by economic conditions. This suspension of construction was extended for several more years in July 2010, following extensive consultation with the airline industry and a review of capacity management. That review identified more innovative means of managing peak-time capacity on the existing runway, meaning it can handle expected growth for longer than earlier envisaged. Additionally, although passenger volumes are growing again, the growth trend is behind where it was anticipated to be when construction of the Northern Runway began. The eventual recommencement of the Northern Runway construction will be demand-driven relative to the capacity of the existing runway and terminals.

319.

320. Before responding to each specific question under section 4, the following responds to the overarching questions in section one as they relate to operating and investing in assets efficiently.

Has information disclosure had any impact on Auckland Airport's performance in respect of operating and investment?

321. As noted in the Annual Disclosure 2011, the objectives of the purpose statement strongly align with Auckland Airport's culture, values and strategy. In respect of operational expenditure and investment in assets, Auckland Airport introduced a Fighting Fit strategy in August 2009 with four key elements:

(a) A strategy sourcing review;

(b) Implementation of a LEAN programme;

(c) A focus on capital productivity; and

(d) A cost efficiency work-stream.

322. Auckland Airport is well aware of its responsibility to Auckland and New Zealand to ensure long-term tourism infrastructure capacity for predicted growth is in place. Auckland Airport must also carefully balance supply with demand to optimise the

efficiency of existing infrastructure and to ensure excess capacity is not delivered too far ahead of need and only once an appropriate return can be expected.

323. ID has not had a direct impact on Auckland Airport's level of operating cost. However, as explained above, we do not consider that this in any way means that ID is ineffective, as Auckland Airport had efficient operating costs by world standards prior to the introduction of ID.

324. Auckland Airport has however comprehensively reviewed all cost allocations prior to the annual disclosure and price setting. In this respect, although ID has not directly affected total expenditure, it has increased the consistency of allocated expenditure in order to ensure compliance with the new IMs.

Has information disclosure had any impact in understanding Auckland Airport's performance relative to the first PSE, in respect of operational expenditure and investment and why?

325. Auckland Airport has provided interested parties with a comprehensive disclosure for its 2011 expenditure on operating and capital expenditure. This is the first disclosure, and in this respect only provides an initial view. The disclosure does provide new information over and above that disclosed under the previous regime. For example, the variance analysis provided includes a level of analysis not previously provided to interested parties.

326. ID requires capital and operational expenditure to be disclosed in a comprehensive and consistent manner, with explanations for its investment regarding objectives and the basis for the needs assessment. This has encouraged Auckland Airport to ensure that the information provided during consultation was just as comprehensive, and was consistent with the information that would need to be subsequently disclosed pursuant to the ID Determination.

327. We believe that in comparison to the first PSE (where there was no structured or prescribed format for disclosing information), ID should have promoted a more informed understanding of Auckland Airport's forecast performance for operational and capital expenditure. This will become more powerful with the benefit of a longer time series of data.

Has information disclosure had any impact on the effectiveness and scope of consultation, in respect of operational expenditure investment in assets, as part of Auckland Airport's second PSE relative to the first PSE, and why?

Operating Expenditure

328. Under ID, there is now a Cost Allocation Input Methodology for expenditure. In our view, consultation was considerably more effective in respect of cost allocation due to the existence of this methodology.

329. In the first PSE, a significant amount of time was spent traversing economic principles and methodologies for allocating common cost efficiencies.

330. For the second PSE, the consultation record demonstrates how ID influenced Auckland Airport's approach to pricing. For example, in the Initial Pricing Proposal, Auckland Airport is clear that for efficiency reasons it adopted a cost allocation approach that is consistent with the IM Determination. In that context, Auckland Airport used its draft disclosure accounts as a key reference for the allocation of costs for pricing. Substantial customers supported the use of the principles contained in the cost allocation IM.

332. The background to Auckland Airport's route development function can be found in the Revised Pricing Proposal pages 50-53 and the Final Reasons Paper at pages 38-40.

333. The following extract from the Final Reasons Paper summarises the treatment of route development costs in the Final Decision, following the presentation by the airlines to the Board:[69]

> Auckland Airport recognises that there is sensitivity to the route development function generally, yet notes that there is a high degree of participation in route development initiatives. Auckland Airport considers that the competitive global environment requires New Zealand to compete on a global scale and that leading New Zealand's tourism promotion is in New Zealand's best interests. Auckland Airport's business development function is effective and is recognised amongst the best in class, receiving at the Routes Airport Marketing Awards 2012 a highly commended award in the Asian category. This is the fourth time Auckland Airport has received an award of this kind in three years and it was the only airport in Australasia to be acknowledged this year. While we understand that some carriers question how much difference the route development function makes over what would be generated organically, Auckland Airport is confident that the route development strategy is working and delivering incremental growth, which has resulted in higher volumes and therefore lower unit costs in FY13 than would have otherwise been the case.
>
> For the purposes of pricing, Auckland Airport has aimed to manage this sensitive issue by:
>
> - excluding speculative, non-committed route development and associated speculative volumes in forecasts;
> - including non-speculative, committed route development and associated volumes in forecasts;
> - continuing route development campaigns; and
> - sharing the general business development business unit costs according to the common-cost rule. The effect of this is that 38% of $16 million in costs over the five years has been removed from Standard Charges. This results in an NPV increase of $3.5 million.
>
> Auckland Airport values the contribution made by all carriers, large and small. We also acknowledge that economic conditions have been challenging. Many carriers will be well aware that they have been challenged to deliver the volume growth that may have been planned over the past five years. If airlines wish to see reducing unit prices over time, it is important to remember that a key element to unlocking this is to share infrastructure over a greater volume of passengers and traffic.

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[68] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 36.
[69] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 40.

Investment

334. Under ID, the Commission set out its expectation for disclosure of forecast capital expenditure under the price setting disclosure.

335. Auckland Airport used the Commission's structure of information requirements to provide and capture feedback through consultation. This assisted the consultation process. In particular, the focus shifted to significant and/or major projects, as defined by the Commission, and set out Auckland Airport's approach more clearly for interested parties. A comprehensive disclosure of Auckland Airport's approach to investment is contained in section 2.4.2 of Auckland Airport's Price Setting Disclosure 2012.

336. However, Auckland Airport notes that the requirement to provide 10 year capital forecasts was challenging, due in part to the fact that there are a discrete number of areas where Auckland Airport has yet to form a definitive view on investment.

337. It has also created a continuous disclosure obligation for Auckland Airport to notify the market when the 10 year forecast materially changes. In Auckland Airport's view, such a notification will be inevitable at some point, as forecasts will need to be revised.

338. Importantly, Auckland Airport agreed with views from substantial customers that it should continue to consult on capital expenditure following the price setting decision. In this regard, even though it was required to publish 10 year demand and capital forecasts for ID, they are subject to continuing consultation on:

(a) Long-term demand forecasts for the NTF; and

(b) The location and cost of the NTF.

340. None of these issues affected the current pricing. Auckland Airport continues to have an open mind on these matters, and has received feedback in support of its proposal to consult separately on the NTF outside the process for setting standard charges.[72]

What aspects of performance and conduct should we focus our efforts on for this review for Auckland Airport?

341. We invite the Commission to comprehensively review the record of performance and conduct for operational and capital expenditure.

342. We believe the Commission will find that Auckland Airport:

(a) Transparently disclosed its performance and expectations in these areas;

(b) Considered all feedback from airlines in the consultation process;

(c) Disagreed with airlines on discrete points of interest on pricing; and

[70] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 36.

(d) Moved from its starting position where it considered the key points made in consultation to be justifiable and reasonable.

4.1 Where and when do any capacity constraints occur at Auckland Airport, and is additional investment necessary to address these constraints?

343. The following table shows the key areas in which existing capacity constraints are evident and where actions are necessary to address these constraints – investment or otherwise:

Table O: *Summary of capacity constraints*

Where does constraint occur?	When does it occur?	Action
Taxiway on Western end of international apron.	This occurs during the international peak on Pier B – 05:30 AM – 08:00 AM and 12:30 PM – 15:30 PM.	This capacity constraint is one of the drivers for the investment case for Taxiway Lima, estimated to cost $21.5m, which was approved in FY11 for construction in FY12. This is described on pages 50 and 51 of the 2012 Price Setting Disclosure.
Domestic terminal - a number of domestic terminal facilities are operating at, or near, capacity. Pressure points include: • apron space for larger aircraft • Terminal congestion increasing and service levels declining • Departure/boarding lounge space • Regional concourse • Baggage reclaim • Forecourt • Access road	Peak hours of: 0600 – 0800 and; 1500 - 1700.	Auckland Airport has prioritised capital expenditure to alleviate some of the main congestion points in the short term. This project is described on page 44 of the 2012 Price Setting Disclosure. It has an estimated investment cost of $32m. Initiatives have already been completed to date to improve FY11 ground boarding and security screening operational constraints. In the longer term, additional steps are likely to be needed, including a larger terminal facility. This project described as the New Terminal Facility remains subject to consultation.
Secondary line reclaim hall circulation area.	During December and other peak months.	A proposed investment project called International Baggage Reclaim Expansion or RECLAIM 1 is described in the 2012 Price Setting Disclosure on page 44.

344. During the aeronautical pricing consultation, Auckland Airport provided further information on projected facility constraints by area, in the form of a power point presentation.[73]

345. Auckland Airport notes that its current facilities are sufficient for A380 aircraft. Emirates has now publicly confirmed its intention for further A380 operations into Auckland Airport. The extent of available capacity will depend on the intended scheduling of

[73] Auckland Airport, Capital Expenditure Forecast Overview, Information Pack Two, 17 October 2011, pages 36 to 41.

incremental operations. Auckland Airport will monitor this, and re-prioritise capital investment to reflect additional capacity requirements, if necessary.

4.2 What factors outside Auckland Airport's control have contributed to the capex and opex forecast for the second PSE and to changes in expenditure since the first PSE?

346. The forecast for the second PSE is based on the best available information at the time of the PSE. This takes into account expectations of:

(a) Consumer trends;

(b) Airline decisions for scheduling the peak; and

(c) Pricing from suppliers.

347. New regulatory requirements are often uncertain as to their timing or scope (e.g. security changes). Auckland Airport's approach has been to exclude these from forecasts for base prices.

Capex forecast

348. In developing the capital expenditure forecast, Auckland Airport considered:

(a) Emerging trends in consumer behaviour (which are outside of our control); and

(b) An estimation of peak requirements and priorities.

349. In practice, Auckland Airport has limited control on how demand eventuates. As airlines continue to announce changing schedules, aircraft mix and alliances, it is quite possible that priorities will need to be re-evaluated over the pricing period. By way of example, the base scenario contemplates a reasonable amount of up-gauging of domestic aircraft, and for international, only a modest increase in A380s was assumed. If Air New Zealand were to change its expectations on A320 roll-out or regional servicing options, this could impact on Auckland Airport's capital expenditure requirements. Similarly, if more A380s were announced over and above Emirates' planned increase, then this too may have capital expenditure implications. Accordingly, Auckland Airport expects there will be a need, in consultation with its customers, to review and re-prioritise capital expenditure on an annual basis to respond to changing market conditions.

350. The capital expenditure forecast for noise costs is partially outside of Auckland Airport's control in the sense that Auckland Airport has no influence on the number of landowners who would wish to take the benefits of the offers made to them under the District Plan. While these costs were included in the forecast in the first PSE, they have been excluded from forecast capital expenditure in the second PSE on the basis that they are linked to the Northern Runway consent requirements.

351. Significant regulatory changes also have the ability to affect operating expenditure and capital expenditure. Auckland Airport's preference is not to build in capital expenditure that is significant, sufficiently uncertain and out of its control, in the pricing forecast. Accordingly, these costs have been excluded from forecasts. It is our experience that the industry can generally come to agreement closer to the time, if and when such regulatory decisions are signaled.

352. In the first PSE, the TSC provided a charging mechanism to account for such events. In the second PSE, this mechanism was removed. In order to provide for material un-forecast investment requirements, a Regulated or Required Investment Policy ("**RRI**")

has been established, which provides for an adjustment to pricing in certain circumstances, as provided in the standard charges schedule as follows:

> Regulatory or Requested Investment is capital expenditure of at least $5,000,000 in relation to identified airport activities (as defined in the Airport Authorities Act 1966) provided by Auckland Airport primarily for purposes associated with the servicing of scheduled and non-scheduled passenger and freight services, that was not factored into the DPC, IPC, TPC or MCTOW charges at the time of the last price-setting event, and that is either:
>
> (a) required as a consequence of changes mandated by government agencies or local body authorities; or
>
> (b) requested by airlines.

Opex forecast

353. In the first PSE, the most significant costs outside Auckland's control that have contributed to baseline costs and actual costs have been:

(a) The MED levy for the costs of regulation under Part 4; and

(b) Internal costs associated with the ID regime and litigation relating to its application.

354. These costs were not included in the first PSE, but have been forecast in the second PSE. Auckland Airport understands that the levy was introduced on the basis that the consumers who benefit from regulation under Part 4 should pay the associated regulatory costs, and therefore it is entirely appropriate for Auckland Airport to recover such costs from its customers (i.e. the intent under the Act is for regulatory costs to be treated as pass through costs). Auckland Airport believes that its internal costs for implementing the regulation, including engagement on Commission consultation processes and litigation, should be subject to the same principal.

355. At the time of the first PSE, Auckland Airport did not have a route development function. Market forces drove Auckland Airport to actively participate to compete for incremental demand. Auckland Airport has developed an award winning route development function, which aims to attract additional connectivity, and allows Auckland Airport to have control over how much it invests in this activity. Although route development costs (which compete for demand) are under Auckland Airport's control, the level of investment is significantly influenced by market expectations and industry participation.

4.3 How reasonable are Auckland Airport's opex and capex forecasts for the second PSE, and how do these compare to forecast and actual expenditure from the first PSE?

Operating cost forecasts at the time of the PSEs were conservative and will be a stretch

356. In both the first and second PSEs, Auckland Airport's operating costs were developed following a robust and fulsome consultation process with substantial customers as follows:

(a) Information was provided to airlines together with an opportunity to consider the information and raise queries where they required clarification or additional information;

(b) Auckland Airport responded to specific queries raised by airlines and requests for additional information;

(c) Auckland Airport considered feedback received from airlines; and

(d) Where appropriate, Auckland Airport adapted its forecast prior to the Final Pricing Decision.

357. The consultation record contains sections dedicated to operating cost forecasts, which describe the process Auckland Airport adopted in its consultation, together with key assumptions.

358. Throughout the consultation process, Auckland Airport reviewed and refined its operating cost forecast to ensure that its aeronautical costs were reasonable, and that they targeted operating cost efficiencies over time. Care has been taken to ensure the base year excludes any one-off costs and incentivises Auckland Airport to seek efficiencies and deliver operating cost reductions per passenger in real terms.

359. As noted in the Final Pricing Decision,

360. As prices are reset only every five years Auckland Airport has a natural incentive to manage its costs efficiently because it has limited opportunity to recover unforeseen costs within the pricing period. In this sense, any efficiency gains represent a positive outcome for the business within the period, and then the actual out-turn for year five forms the efficient cost base for the forecasting period.

361. Auckland Airport acknowledges that forecast operating cost containment has not always been practically achievable. This is because of the difficultly in crystal ball gazing the events which will lead to both one-off cost and changes in business as usual costs, over and above how business as usual is defined at the time. Examples of one-off and unusual costs that were not predicted by Auckland Airport when we were forecasting operating costs include:

(a) The announcement of the changes to Part 4 (which led to one-off costs and new ongoing costs);

(b) Restructuring costs; and

(c) The progressive establishment of a route development function over the course of the first pricing period.

362. In the Revised Pricing Proposal, there were two main residual concerns from airlines. In the following paragraphs we outline the areas of concern and the rationale behind Auckland Airport's decision. We note that route development costs were prioritised as a concern to the Board by BARNZ Represented Airlines, and Auckland Airport adjusted its position in the Final Pricing Decision in response to this concern.

Merits review costs

363. However, Auckland Airport considers it appropriate to recover cost associated with

aeronautical regulation, particularly as the costs of the Commission's regulatory functions were intended to be paid for by consumers (on the basis that it is consumers who benefit from the regulation). We note that shareholders have already borne the unexpected costs of the regulation between FY09-FY12.

364. Auckland Airport also acknowledges that there was little support for risk sharing via the AVC for the merits review costs. On this basis, the merits review costs are no longer intended to be passed through on an outturn basis. The corollary of this is that no further risk has been transferred to the airlines, as the cost to consumers is effectively capped to what was included in the pricing model.

Route development

366. For the purposes of pricing, Auckland Airport has aimed to manage this sensitive issue by:

(a) Including non-speculative, committed route development and associated volumes in forecasts of the forecast, and the volumes of those new routes also included);

(b)

The effect of this is the removal from standard charges of (which is 38 percent of [75] underlying business unit costs over five years); and

(c) Continuing its route development campaigns; but excluding speculative, non-committed route development and associated speculative volumes in forecasts; ie. we expect to spend more than

367. Auckland Airport considers that the revised cost forecast is an appropriate target to shoot for in its management of the business. However, Auckland Airport is concerned that the forecast is overly ambitious, and one-off and unforeseen costs may mean that even with efficient cost management, that actuals will exceed forecasts.

We also note that in the Price Settling Disclosure Auckland Airport incorrectly indicated approximately $3.5 million per annum for non-airline specific route development activities. In fact, the average was $3.72 million per annum, a total of $18.7 million.

Capital expenditure forecasts were reasonable at the time of price setting

368. Auckland Airport acknowledges that there were significant differences in opinion throughout consultation on both the first and second PSEs on capital expenditure. However, in the final decisions prior to each event, methods were developed to narrow differences and find broad common ground.

369. In the first PSE, significant capital priorities were:

(a) Pier B;

(b) International Terminal Building arrivals expansion stage 3A;

(c) Incremental stand capacity; and

(d) Northern Runway.

370. In the final decision for the first PSE, a compromise was made with respect to stands, leaving the Northern Runway as the remaining point of difference. At that time, there was also ongoing and separate discussion on whether a further stage of arrivals expansion was required (Stage 3B), but this was excluded from pricing.

371. Auckland Airport received constructive feedback throughout the second PSE on capital expenditure.

372. By the time of the pricing decision, the major capital projects in the pricing period had been refined to the following:

(a) A terminal works programme, which included:

(i) Rehabilitation and refurbishment of the existing DTB facility;

(ii) A number of projects within the ITB, including:

(aa) Stage one of the expansion of the baggage reclaim hall;

(bb) Increasing baggage handling systems feed capacity;

(cc) Check-in efficiency technology project;

(dd) Construction of vertical circulation to the ground floor of Pier B to facilitate ground boarding; and

(ee) Reconfiguration of forecourt functions, facilities and utilities to accommodate further development of the ITB.

(b) An airfield works programme, which included:

(i) Replacement and renewal of runway and aprons, as necessary;

(ii) Construction of Taxiway Lima from Bravo to Pier B (east leg); and

(iii) A stand and taxilane development, which is related to the ITB expansion.

373. As noted on page 6 of the Price Setting Disclosure, following feedback from airlines, Auckland Airport extended the consultation on longer term plans for a new domestic terminal and associated facilities. The new domestic terminal will be a key part of Auckland Airport, the domestic travel experience and New Zealand's tourism and trade infrastructure for many years to come. Accordingly, Auckland Airport believes that there is merit in taking more time now to engage in meaningful discussion with stakeholders, to ensure that we get the plans right.

374. The Price Setting Disclosure provides a fulsome explanation of the process we adopted in supporting the capital expenditure forecasts, our key assumptions and background to each of the major projects during both recent pricing periods.

4.4 To what extent does the demand forecast presented by Auckland Airport as part of the second PSE accurately reflect expectations of future demand, and why?

Auckland Airport's second PSE demand forecasts reflect reasonable expectations of organic growth

375. The throughput demand forecast used in the second PSE represented the best expectations of Auckland Airport and its advisors regarding likely organic growth over the second PSE. Consistent with its approach to exclude speculative non-committed route development acquisition costs (i.e. costs to attract new routes), demand forecasts did not speculate on this potential upside.

376. The demand forecasts were developed iteratively following a robust consultation process. Key elements of that process were described in the Final Pricing Setting Disclosure:[76]

> Auckland Airport commissioned Tourism Futures International ("**TFI**") to prepare passenger forecasts for Auckland Airport for the period FY11 to FY22 in mid-2012 ("**passenger forecasts**"). The initial five year period was the focus for the Aeronautical Pricing Consultation.
>
> Acknowledging the sensitivity of the airlines to specific route development initiatives, Auckland Airport requested that the TFI forecast:
>
> - include all base volumes, including those stimulated by Auckland Airport's active route development over the past five years;
> - include any route development initiatives that had been announced (ie. were not speculative and had a very high probability of occurring); and
> - exclude more speculative demand (consistent with the approach of excluding the costs, which may be required to convert demand).
>
> Auckland Airport also asked the airlines to provide their own forecasts, which would be treated confidentially and provided to the expert advisors. Many airlines took this opportunity.
>
> TFI produced an original set of passenger forecasts for consultation in October 2011. This was updated in December 2011, March 2012 and May 2012 based on responses from the airlines, updated economic forecasts, revised capacity estimates and updated traffic data for 2011/2012.
>
> TFI has prepared the passenger forecasts based on unconstrained demand. TFI has not included constraints on capacity or the impact of any stimulation from new joint marketing activities as these are uncertain in terms of size and timing. The basis for the TFI forecasts involved a detailed consideration of

[76] Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 83.

> factors affecting forecast demand such as: the economic outlook, exchange rates, and resident population.
>
> Economic growth is the strongest driver of aviation demand. TFI reviewed the latest economic forecasts from the IMF, OECD, Central Banks and private forecasters. The following GDP assumptions formed the basis of the economic input assumptions.

377. The consultation record demonstrates that there was a

378. As explained in the Final Pricing Decision, in the interest of ensuring forecasts reflect the most recent information available at the time, Auckland Airport asked Tourism Futures International Limited ("**TFI**") and Airbiz Limited ("**Airbiz**") to update their forecasts in May 2012 in light of feedback and to reflect the effect of the recently announced cancellation

of services on transit and transfer passenger numbers and landing and MCTOW forecasts. This included the cancelled routes announced by Aerolineas Argentinas, which had not been accounted for in the Revised Pricing Proposal forecasts.

379. Key conclusions from TFI's Final Aeronautical Pricing Passenger Demand Forecasts, (May 2012) were:

(a) TFI based its forecasts on an analysis of the business environment and airline capacity developments. TFI considered that airline submissions did not contain additional hard information that would suggest the need for revision to the arriving and departing passenger forecasts, which TFI considered its best forecast based on information available at that date. The TFI forecasts excluded the impacts of new joint marketing activities which would add to growth; and

(b) TFI's view was that the adjustment to transit and transfer volumes was the only material update required since the March 2012 forecasts were produced.

380. Auckland Airport concurred with TFI's observation that the feedback did not provide any additional hard information warranting a revision of the forecasts.

381. Following completion of the March 2012 passenger forecasts, Aerolineas Argentinas announced that it would operate direct services from Sydney to Buenos Aires from July 2012, cancelling the Auckland leg. Airbiz updated its forecast to account for the cancellation of the Aerolineas Argentina's service.[78]

382. Auckland Airport considers that the record clearly demonstrates that a robust process was undertaken to develop the demand forecasts for pricing.

383. In the August 2012 Final Price Setting Disclosure, Auckland Airport set out the following risk statement regarding the demand forecasts:[79]

> Auckland Airport adopted the Aeronautical Pricing demand forecasts developed by its independent advisors, TFI and Airbiz. Auckland Airport considered that these organic forecasts contained significant downside risk associated with:
>
> - Macro-economic factors, with the global outlook highly tense as at June 2012;
> - The risk of increasing fuel prices and consequential impacts on passenger demand and route viability;
> - The impact of government taxes internationally such as Air Passenger Duty and Emission Trading Schemes on demand; and
> - One-off risks associated with natural disasters in the region.
>
> Nevertheless, Auckland Airport has strong ambitions for growth. Active marketing by third parties, such as governments, tourism bodies and tourism operators has created a competitive environment for air capacity and Auckland Airport must incur costs to remain internationally competitive for the limited number of available aircraft in airlines' fleet, and continue to grow overall volume for the benefit of all stakeholders and indeed New Zealand.

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78 Since the demand forecasts were revised, there have been further market announcements, such as United Airlines' cancellation of the Auckland to Houston route. These announcements have not been captured in the forecasts used for pricing on the basis that Auckland Airport has had to draw a line in the sand for the purpose of setting prices in a timely manner.

79 Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 86.

> Auckland Airport intends to further grow traffic to New Zealand via its route development function and considers there are a number of markets that could be opened up that will create incremental, non-cannibalistic growth over and above this demand forecast. This will come at cost, which has also been excluded from the 2012 Pricing Decision.

Facility planning forecasts

385. Auckland Airport was required to publish 10 year peak hour forecasts with its August 2012 Pricing Decision. As noted in the August 2012 Price Setting Disclosure, long term planning demand forecasts continue to be the subject of consultation as part of the NTF process.[80] In this respect, these are likely to be subject to refinement.

4.5 How reasonable is Auckland Airport's demand forecast for the second PSE compared to the forecast from the first PSE?

386. Auckland Airport considers that demand forecasts used in the second PSE are as reasonable as demand forecasts used in the first PSE - that is, both represented reasonably held views of independent experts at the time of pricing, and both sets of forecast were subject to robust scrutiny during the consultation process.

387. In terms of the consultation record, the airline views were:

(a) That the demand forecasts were too low for the first PSE; and

(b) Mixed in relation to the demand forecasts for the second PSE, as outlined above.

388. However, in practice for the first PSE, actual international demand (the primary driver of revenue) proved to be much lower than the TFI forecast and required incremental operating expenditure to attract carriers to achieve the actual demand levels. In this sense, with hindsight, the airline views were overly optimistic, as were the views of our independent advisors.

389. This is not surprising given that demand forecasts are heavily influenced by economic conditions and airline strategic choices. Airlines are also well known to be optimistic with respect to demand forecasts. Aviation is a fundamentally different environment for demand forecasting than other industries, such as the electricity industry. In this sense, variability from the forecast is to be expected and can be material.

390. For example, since the forecasts were concluded in May, five months ago, a number of significant announcements have been made which were not within the knowledge of industry (or Auckland Airport) at the time:

(a) The desire for a strategic alliance between Emirates and Qantas;

(b) Cathay Pacific limiting seasonal capacity increase;

(c) Continental announcing that the Houston Auckland service would be shelved for the time being;

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80 Auckland Airport, Final Price Setting Disclosure, Aeronautical Pricing Consultation, 2 August 2012, page 83.

(d) Jetstar Singapore reducing services;

(e) Hawaiian announcing a new service; and

(f) A domestic expansion for Jetstar.

391. Auckland Airport notes that airline planning is becoming increasingly dynamic as schedules or aircraft size are changed to better manage profitability and temporarily reduce capacity. These changes will all impact on actual demand over time, but do not detract from whether forecasts were reasonably held at the time of pricing.

4.6 What role did information disclosure regulation play in negotiations concerning Auckland Airport's expenditure forecasts?

392. The price consultation record shows that Auckland Airport used ID regulation as a key reference point for consultation on expenditure forecasts. Auckland Airport utilised the structure provided under ID regulation to present expenditure forecasts for all regulated activities and the aeronautical pricing subset of activities.

393. Evidence of this can be found in the Cost Forecasting section of the proposals and the Final Pricing Decision. Auckland Airport adopted the same structure for analysing costs under pricing consultation as used for ID, and used the ID information as a reference point.

394. While the scope of ID differs slightly from that of the pricing consultation, the cost allocation ID has provided a common language for discussions on expenditure forecasts.

395. A key reasons to ensure alignment of this structure is that Auckland Airport will be required to report actual to forecast variance against this structure in ID.

4.7 What impact has information disclosure regulation had on the efficiency of Auckland Airport's investment and operational expenditure?

396. Capital and cost planning are long term issues for airports and as such Auckland Airport has had robust programmes established for some time. Accordingly, it is difficult to quantitatively assess the impact that ID regulation has had on the efficiency of investment and operational expenditure.

397. That said, in Auckland Airport's view, ID regulation has increased focus on efficiency, innovation, quality standards, appropriateness of returns and needs of consumers, by requiring greater transparency of behaviour to determine consistency or inconsistency with the purpose statement. In this respect, it has provided a platform to further embed the objectives of Part 4 of the Commerce Act into Auckland Airport's company culture, values and strategies, which also include an efficiency focus.

5. Is Auckland Airport innovating where appropriate?

Overview

398. Auckland Airport takes the approach that innovation is not limited to technological innovation. Innovation takes many forms, and can lead to improvements in operational performance, reliability performance, efficiency of expenditure, efficiency of investment and success of route development initiatives.

399. On page 4 of the Annual Disclosure 2011, Auckland Airport sets out the basis upon which it identifies and implements innovations and examples of innovation:

(a) Examples of key innovations include:

(i) Auckland Airport's 'Blue Coat' ambassador programme that we initiated has been copied by many airports around the world, and is frequently cited in ASQ surveys and customer research as a source of satisfaction (Schedule 14).

(ii) Auckland Airport recently introduced a world-first 'Jackal' grass, especially developed by PGG Wrightson, containing a fungus that deters insects, and in turn, reduces bird activity near runways.

(iii) Auckland Airport was the first airport in Australasia to introduce Cat III technology to assist with airport operations in low-visibility conditions and significantly reduce the number of fog-related delays or cancellations for airlines.

(iv) A recent initiative implemented by Auckland Airport, dubbed 'Every Minute Matters', produced a number of ideas, including a winning idea from MAF Biosecurity, which identified a smarter way for 'disinsection' of a plane upon landing.

(v) Smart border initiatives - which include smart gate technology, LEAN six sigma efficiency work streams and the extension of smart gate to international departures. Auckland Airport is currently the only airport in Australasia to use smart gate technology on departures.

(b) Examples of product innovations for non-regulated activities that have an impact on our regulated services include the following:

(i) The introduction of free car-parking for the first 10 minutes, which has reduced the need for increased forecourt space required for passenger pick-up and drop-off and has reduced pressure on terminal capacity.

(ii) The Auckland Airport Emperor Lounge opened in late 2011, complementing a number of existing airline operated lounges that are located at Auckland Airport, providing greater choice for partner airlines and for passengers.

(c) An important service innovation from the first PSE was the removal of the international departure fee, which was replaced with a passenger service charge that is levied on the airlines. Consumer feedback for many years was unequivocal that having to pay a separate departure fee at the airport resulted in a poor experience. This Auckland Airport initiative has since been followed by CIAL and WIAL.

(d) Examples of airfield innovations include the following:

(i) Apron lighting, for low visibility conditions.

(ii) Ground power units, to improve energy efficiency of aircraft.

(iii) To be A380 capable, gate 15 and 16 in the Pier B building have been specially fitted with two Multi Aircraft Ramp System (MARS) air-bridges, which are able to disembark or load both levels of the

aircraft. These also provide the unique ability to service two A380s or four smaller aircraft at the same time.

(iv) To ensure New Zealand was A380 ready, Auckland Airport upgraded the main runway, adding a 7.5m asphalt strip down each side. While this runway rehabilitation was underway, the taxiway was converted to a runway to allow operations to continue. Innovative engineering techniques were employed for the first time in New Zealand to allow for sections of widened runway to be poured in a way that minimised impact on airline operations.

(e) Operationally, recent Auckland Airport innovations include:

(i) The introduction of Advanced Passenger Display, which has assisted with resource allocation and capacity utilisation for border agencies and airport staff.

(ii) Auckland Airport worked with Air New Zealand to introduce self-check facilities at international check-in.

(iii) Auckland Airport has also innovated in assisting passengers to get to the gate in time for flights, with new Flight Information Displays, supplemented by targeted gate announcements, helping to reduce missed flights.

(f) Examples where innovation has been used to generate sustainability efficiencies and energy savings:

(i) The LEED accredited Pier B international terminal has the largest solar voltaic panel array in New Zealand on the roof, 300m^2 of solar panels, providing much of the energy for the building.

(ii) Improvements in water capture technologies have reduced the water use per passenger down to 0.049 cubic metres in 2011, down from 0.055 cubic metres the year before.

(iii) Public recycling stations have been installed at Auckland Airport since 2008.

(iv) A terminal energy efficiency programme initiated in 2010.

400. Innovation plays a key role in the process we undertake in considering capital expenditure. This approach can be seen in our key capital expenditure disclosures.[81] As discussed in greater detail earlier, Auckland Airport has a robust and holistic process for considering key capital expenditure investment projects. We recognise the needs of our customers, and attempt to balance these against the necessary requirements of operating a functional, efficient and successful international airport. Accordingly, as part of considering key capital expenditure, we consider whether we may be able to innovate to achieve the required objectives in an alternative way. If innovation cannot achieve the required objectives, then Auckland Airport looks to capital expenditure to meet its objectives.

401. Auckland Airport's approach to considering innovation as part of considering investment decisions can also be demonstrated in:

[81] "Key Capital Expenditure Projects" are those where a current or future project or programme of capital expenditure involved total expenditure of more than $5 million over the life of the project or programme.

(a) Legal requirements arising from the operational District Plan required Auckland Airport to mitigate against the noise impact of airport operations on affected housing and schools. Auckland Airport found that the most effective way to reduce aircraft noise in homes was to keep doors and windows closed. Accordingly, Auckland Airport carried out an innovative pilot study where additions to homes were trialled to replicate the noise effects of having doors and windows closed, but achieve the same ventilation and other effects in the house as if the doors and windows were open. This approach was employed to meet the objective of mitigating noise from the airport.[82]

(b) In carrying out its forecast ITB Baggage Reclaim Extension, Auckland Airport considered the innovative technique of adding one belt in FY14 and a further belt in FY19, with the breezeway inside the building. In the end, the option of bringing the breezeway within the building line was considered impractical and would fail to address circulation deficiencies. Although Auckland Airport took an innovative approach, ultimately countervailing factors made it an inappropriate choice for us.[83]

5.1 How does the level of innovation at Auckland Airport compare to innovation at other airports both domestic and international?

402. Auckland Airport considers its level of innovation is appropriate for its size and position as the gateway to Auckland and New Zealand. This is demonstrated by Auckland's strong performance, which is due in part to the calibre of its people and the development of innovative and leading practices.

403. Auckland Airport has gained recognition for its innovative approach to sustainability by being awarded in the Strategy and Governance category at the S60 Sustainable Business Awards, and being the first New Zealand company to make the Dow Jones global sustainable investment index (September 2012).

404. Our culture of innovation is also demonstrated through the success and recognition of individual achievements of Auckland Airport staff. In 2012 Auckland Airport Airfield Manager Dennis Millington won the 2012 CAA Directors individual award for his outstanding contribution to safety in aviation. The Director of Civil Aviation Awards is presented each year to an individual with an overwhelming safety ethos. Dennis was recognized for his 12 years contribution to aviation safety and in particular his contribution to the successful implementation and operation of the CAT II/III instrument landing system, and innovative thinking when providing a solution for aircraft difficulty taxiing onto gates with the introduction of stand guidance lights.

5.2 What research and development (R&D) or innovation activities have been undertaken or are forecast to be undertaken by Auckland Airport and what was the outcome of these activities (if they have been undertaken), or the expected outcome?

405. As part of its Making Journey's Better campaign in 2009, Auckland Airport initiated an Every Minute Matters programme. This initiative stimulated innovative ideas from both Auckland Airport staff and its broader stakeholders which resulted in improvements to processing and experience. In terms of operating costs as part of its cost efficiency drive, under its Fighting Fit strategy, Auckland Airport identified opportunities for cost savings. One which required more of an innovation than others, was an initiative to join with a group of Australasian airports to achieve cost efficiencies in procurement in

[82] Auckland Airport, Final Price Setting Disclosure FY08 - FY12, Aeronautical Pricing Consultation, 27 October 2011, page 27.
[83] Auckland Airport, Final Price Setting Disclosure, 2 August 2012, page 46.

relation to airport owner's and operator's insurance and to create a long-term relationship with an insurer new to the New Zealand market in relation to material damage and business interruption cover. As a result, insurance costs are lower now than they were in 2006 even though most insurers would be experiencing significant increases in insurance costs.

406. Following a significant programme of research, Auckland Airport is taking a leading role in a continuing drive to stimulate travel, trade and tourism, particularly in relation to China, as part of its Ambition 2020. Auckland Airport has recognised the improved economic benefits of better visa processing for Chinese visitor and joined with the Tourism Industry Association of New Zealand ("**TIA**") in building a case for step changes to visa processing. Presently TIA and Auckland Airport are working on visa waiver status for China. We have also taken a lead role with being first to roll-out training events to help the New Zealand tourism industry focus and prepare for Asia. This was achieved by running cultural workshops around New Zealand for the Chinese and Indonesian tourism markets earlier this year.

407. Auckland Airport has proactively begun to develop trade marketing programs that target high net worth individuals. The outputs of these initiatives are to ensure we attract the very passenger segment that can help build yield on an aircraft, grow profitability and thereby strengthen the business case for increased flight frequency to Auckland. This helps New Zealand Inc economically overall, not only through high yielding visitor traffic, but more air freight opportunities, business travel, education and foreign investment.

5.3 How receptive is Auckland Airport to innovation activity led by airlines?

408. Auckland Airport believes that delivering on a smarter airport experience requires multi-party contributions. Accordingly, Auckland Airport welcomes innovation led by airlines or BARNZ.

409. Auckland Airport's LEAN initiative has stimulated initiatives generated by airlines and ground handlers, which Auckland Airport has implemented.

410. Auckland Airport has implemented airline-led innovation in assisting passengers to get to the gate in time for flights, with new Flight Information Displays, supplemented by targeted gate announcements, helping to reduce missed flights.

411. A significant project which saw Auckland Airport work with Air New Zealand to introduce self-check facilities at international check-in.

412. In 2012, Auckland Airport established a COG - a forum for regular interaction between Auckland Airport and airlines, which provides an opportunity for identifying and actioning day to day service innovations. These sessions are held fortnightly and daily.

5.4 How does the level of R&D and innovation activities compare now to activities prior to the introduction of information disclosure regulation?

413. Auckland Airport prides itself on its ongoing commitment to seeking efficiencies and enhancements in maximising the utility of its facilities to accommodate passenger growth and consumer satisfaction at the airport experience. This was our approach under the AAA consultation process with airlines (regarding pricing, capital expenditure and operations).

414. Auckland Airport believes that the ID regulatory regime has supplemented our existing practices, primarily by increasing the transparency of our service quality considerations. We also believe that the publication of further information disclosures over time will

provide a welcome opportunity for airlines and consumers to appreciate and assess Auckland Airport's culture of innovation.

415. As Auckland Airport had not previously reported on the variance analysis or specifically on the suite of innovations in such a structured manner, we anticipate that ID Regulation has improved the understanding of interested parties regarding the nature of innovations undertaken by Auckland Airport, relative to previous disclosures.

416. During the building blocks price consultation process, innovation tended to be in the background rather than the foreground of activity. While innovation was not a topic in its own right, it featured in discussions around investment options, operational practices and price structure. In this respect, ID has had more of an impact in providing transparency of operational innovations in performance, rather than being a focal point during the consultation process.

5.5 What innovation has occurred in other airports in New Zealand or overseas in recent years?

417. Auckland Airport's aeronautical team continually monitors industry developments, evaluates the suitability and cost/benefit of developments and forms a view on the right time to adopt.

418. WIAL has identified its common user terminal, swing gates, kiosks, international Smart Gates and baggage tags as good examples of innovation at its airport.

419. Overseas industry trends and innovations that Auckland Airport is aware of include the following:

(a) Increasing self-service solutions - while self-service is currently focused on the areas of check-in process and bag drop, in some airports it also occurs for gate boarding.

(b) Swing gate structures that enable a gate to be capable of servicing domestic or international operations.

(c) A range of initiatives globally enhance processing efficiencies and security requirements. Airports are utilising a range of profiling measures, including finger print, facial, iris, hand and vein identification. While these initiatives are still in the early stages, smart gate currently utilises facial recognition technology. 'Body scanning' technology is still controversial due to privacy concerns, but technology advancement in this area is continuing.

(d) Baggage screening with X-Ray image transfer technology.

420. In our view, there are limitations to comparing innovative practices at airports, because different airports face different challenges, requiring different innovative responses. However, there is a commitment at Auckland Airport to staying abreast of international and national developments that enhance the passenger experience and provide greater processing efficiency, while maintaining the necessary border compliance. This allows us to stay at the edge of technological developments, as appropriate for an airport of our scale.

6. Is Auckland Airport providing services at a quality that reflects consumer demands?

Overview

421. Auckland Airport considers that the quality of the service it provides is critical to its performance as New Zealand's international gateway. If our quality of service is below par, then this will have flow on effects for all businesses that rely on Auckland Airport retaining a reputation as providing an enjoyable and efficient travel experience for passengers.

422. Schedule 14 of the disclosure statements report on passenger service indicators, which are one measure of Auckland Airport's ability to provide services of the quality and range wanted and expected by consumers. The operational improvement indicators outlined in Schedule 15 also serve to highlight work required in order to maintain and improve customer satisfaction.

423. Auckland Airport uses a number of methods to understand and improve the quality of services required by customers and to assess customer satisfaction. These include:

(a) Membership of the global ASQ service rating system. Outlined in more detail in Schedule 14,[84] ASQ is a customer satisfaction analysis and benchmarking programme. Average survey scores for the year showed slow but steady improvement from what was already a relatively high base of customer satisfaction across the board.[85]

(b) Auckland Airport has been voted the best airport in the Australia Pacific region in the World Airport Skytrax awards for the last four years in a row. These annual awards are based on a global survey that received over 12 million entries in 2012, evaluating traveller experiences across 39 different airport service and product factors - from check-in, arrivals, transfer through to departure at the gate. Skytrax also named Auckland Airport in the top 10 airports in the world in 2009, 2010 and 2011.

(c) Auckland Airport benchmarks its performance against other airports with comparable scale and passenger mix, to compare the level of service quality it is providing customers, and to identify areas where it is performing well and areas where its performance could improve.

424. Auckland Airport undertakes regular qualitative and quantitative market research that assists in understanding consumer needs and preferences. The quality and range of products and services across the business has been expanded, including terminal amenities and passenger processing. This offers choice and encourages supplier innovation and competition to help grow the size of the overall market.

425. Specific measures undertaken by Auckland Airport that focus on the quality of services, (described further in response to question 6.1) that we provide are as follows:

426. Initiatives described in the 2011 Annual Disclosure:

(a) A major refurbishment of international departures, including an expansion of airside and emigration processing space and a reduced space landside. A refresh of the international arrivals experience thereby improving the capacity

[84] Commerce Commission, Auckland Airport Specified Airport Services Information Disclosure Requirements Information Template for Schedules 1-17, 23, 17 May 2012.
[85] Note that Auckland Airport's passenger survey results undertaken in accordance with the ASQ standards are set out in Auckland Airport's annual disclosures for the year FY 2011.

utilisation data (outlined in Schedule 13) and the passenger satisfaction indicators (outlined in Schedule 14).

(b) Improved terminal access for the disabled and for the mobility reduced.

(c) Continuation of Auckland Airport's 'Blue Coat' ambassador programme that we initiated in 1995, which has been replicated by many airports around the world, and is frequently cited in ASQ surveys and customer research as a source of customer satisfaction (Schedule 14).

(d) Use of an innovative bathroom text-based Facebook campaign used to identify improvements. A five years bathroom refurbishment programme was developed using this customer feedback.

427. Further initiatives undertaken in FY12:

(a) Launch of international gate lounge comfort and interior refurbishment programme.

(b) Improved inter-terminal connection - new walkway way-finding system installed, new and larger buses leased with improved signage.

(c) Mobile digital screens deployed for dynamic and targeted passenger messaging, including multi-lingual messaging.

(d) New covered canopy across the international terminal forecourt for pedestrians.

(e) Provision of additional aviation security capacity in domestic.

428. Air-service development initiatives have continued with the aim of driving market growth and increasing consumer choice. Auckland Airport has invested significantly in international air-service development to stimulate and accommodate targeted tourism and trade growth, and to benefit consumers through an increase in air-service competition and an expansion of destination options.

429. Improved physical access to the airport is important to consumer satisfaction. Auckland Airport has worked with transport agencies and operators to increase choice in airport transport options and improve the road and forecourt layouts to improve ease of use and increase safety. This has, to date, resulted in an increased frequency of bus services, an award-winning car-pooling system, and strong participation in council initiatives to identify and protect transport routes for a future rapid transit network option.

430. Consumers increasingly expect that organisations meet their responsibilities and obligations in relation to the community and the environment. Auckland Airport has the largest noise mitigation programme in New Zealand, designed to reduce noise impacts and meet our obligations to the community. The Auckland Airport Community Trust has now distributed over $2 million in funding to community initiatives within the airport noise contours.

431. In 2011 Auckland Airport gained 'Silver' status in the international Earthcheck sustainability benchmarking programme, and was the only organisation in New Zealand nominated in every category of the Sustainable 60 awards. Using a range of energy harnessing or energy saving-related initiatives there are continued improvements across all key measures, including reductions in carbon dioxide emissions and water use per passenger.

432. In 2012, Auckland Airport was the first New Zealand Company to be included in the Dow Jones Sustainability Index. The investment index ranks businesses based on their environmental, social and governance practices and performance. This provides Auckland Airport with the opportunity to benchmark our sustainability performance, in our sector and on a global scale.

6.1 What changes in quality have occurred since ID regulation was introduced?

433. A number of changes in quality have occurred since the first PSE. In the last two years, we have undertaken specific measures to improve the quality of the following services:

(a) In anticipation of the final ID Determination, Auckland Airport reviewed its existing processes and developed a further module of its fault diagnosis and management system in order to align it with the new ID reliability requirements. This resulted in a resetting of our reliability monitoring processes and was accompanied by training and the recruitment of an additional employee in the Apron Tower team. A positive consequence of this has been that the metrics are being monitored more regularly and the internal understanding of reliability has increased. Specific monitoring tools (within management dashboards) have been established which has increased the focus by management on areas where most improvement is needed.

(b) As discussed above, in order to enhance the airport's quality and ambience, in 2011 Auckland Airport completed a major refurbishment of international departures, including an expansion of airside and emigration processing space and a reduced space landside. This has helped Customs and Aviation Security to increase processing speed, and has assisted airlines by reducing the number of passengers missing flights. The refurbishment also had a particular focus on using design to enhance the passenger experience. The quality of the refurbishment was recognised in August 2011, being awarded the Supreme Winner at the national Red Retail Design Awards, which promote excellence in design.

(c) Processes have been adapted such that for any on-time performance events related to airport factors, a root cause analysis is undertaken and learnings shared. The aeronautical team also has a monthly review of data to ensure all known events have been captured.

(d) As also discussed above, a pre-RWC refresh of the arrivals experience included a review and upgrade of way-finding for international arriving passengers, making it easier for passengers to find their way around, and thereby improving the capacity utilisation data outlined in Schedule 13 and the passenger satisfaction indicators outlined in Schedule 14.

(e) Auckland Airport has trialled providing quality information to the Operational Improvement results in both the Regional Facilitation Forum (quarterly) and Airline Operational Committee (a monthly committee). Feedback suggests it will be more appropriate to move these back to the Regional Facilitation Forum.

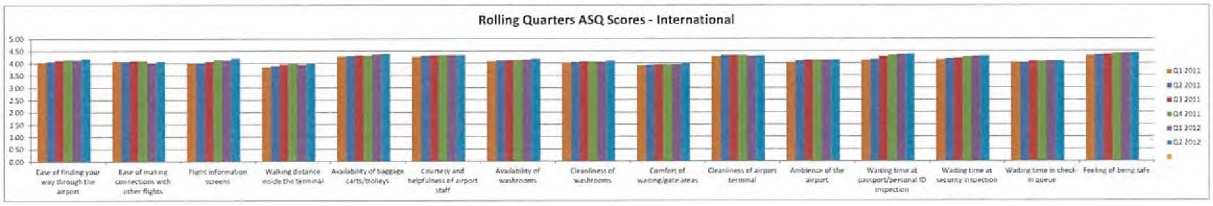
(f) Auckland Airport is also seeking to improve terminal access for the disabled and for the mobility reduced. In late 2010, an Access Audit was undertaken at both the international and domestic terminals by the Disability Resource Centre. A number of best-practice initiatives were developed following the recommendations of that audit, some of which have been completed and others of which are currently underway.

(g) As a further investment in continuous improvement, Auckland Airport established the COG in April 2012, as a forum for ongoing discussions with airlines. COG facilitates regular interaction between Auckland Airport and airlines in a forum for identifying and actioning day to day service quality innovations, rather than pricing consultation, which is based on broader quality trends and benchmarks (such as ICAO standards). Auckland Airport conducts fortnightly and daily COG sessions.

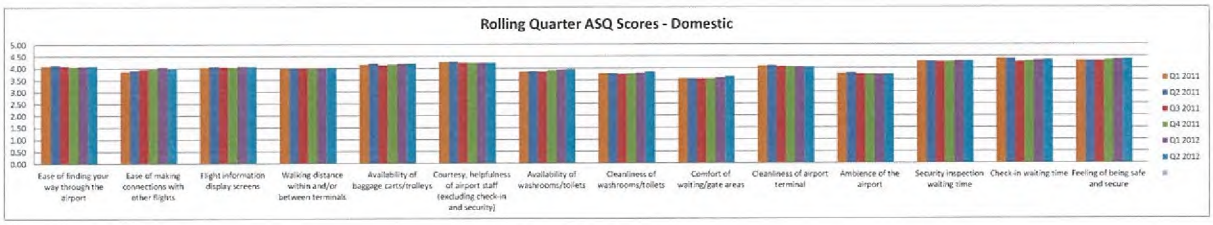
(h) Smart gates were introduced in 2010 and provide an alternative, secure, efficient way to clear passport control, which decreases the time taken for immigration processing of Australian and New Zealand passport holder with an e-chip. This initiative increases the service quality of the Trans-Tasman travel experience for Australians and New Zealanders currently holding e-chip passports, and will eventually include all Australian and New Zealand passport holders as older passports are completely phased out.

(i) Auckland Airport has a management philosophy of pro-actively responding to issues raise in stakeholder and passenger surveys.

434. The following chart illustrates passenger views of the quality of experience for the international and domestic terminal respectively. For the international terminal, scores rank consistently as very good since the introduction of ID, with baseline levels of service also very good.



435. For the domestic terminal, scores have been in the range of good to very good, lagging international terminal satisfaction. Initiatives are underway to manage capacity constraints in the domestic terminal which will also impact upon quality outcomes.



436. While there have been changes in quality since ID regulation was introduced (some of which are outlined above), Auckland Airport had consistently received excellent reviews under the global ASQ service rating system prior to the introduction of ID regulation (that is, following the first PSE and during the first pricing period).

437. It logically follows that the enhancement of service quality subsequent to the introduction of ID will be less significant if service quality was high to start with. Put another way, where an airport has been excelling at service quality, there is less scope to immediately improve it. For example, in 2008 Auckland Airport was ranked third in the world

In the following years of the first pricing period we were found to have consistently high levels of service across the board.

438. In short, Auckland Airport has for some time pursued a quality improvement programme that should result in continuous incremental improvement to the quality of services at

Auckland Airport. We would therefore be surprised if any recent improvements could be linked directly to the introduction of ID.

439. Auckland Airport is nevertheless confident that the requirements of ID will serve to help it retain (and where possible enhance) its high level of service quality going forward through the increased transparency and accountability that ID has brought, including:

(a) A broader set of quality and reliability metrics;

(b) Disclosure of the operational improvement process;

(c) Fieldwork documentation pursuant to completion of the Report on Passenger Satisfaction Indicators set out in Schedule 14 of its Annual Disclosures (ASQ); and

(d) A price setting disclosure following each PSE.

6.2 What, if any, aspects of quality do you think should or could be improved (or potentially lowered) at Auckland Airport?

440. Auckland Airport believes it maintains a good balance of service quality levels across the board, but constantly seeks improvement. As discussed above, Auckland Airport consistently scores highly in ASQ passenger surveys regarding service quality.

441. Auckland Airport has not received any feedback from airlines that areas of our service quality need to be improved or lowered.

442. In the absence of any compelling evidence to support a lowering in service quality, Auckland Airport would be unlikely to do so, on the basis that a reduction in service quality would carry the following risks:

(a) Failure of meeting consumer expectations; and

(b) Potential compromising of the efficiency and safety of existing services.

443. Auckland Airport has not received any feedback from passengers indicating that services may be above required levels. Indeed, we recognise that despite our commitment to quality, there is always room for improvement. For the year ended 2011, in all of the areas that Auckland Airport was assessed on in the ASQ survey there was room for us to improve our rating by at least 0.5 of a point (to score a maximum rating of 5).

444. Specifically, the ASQ surveys on passenger satisfaction for the most recent disclosure year (that is, the year ended 30 June 2011) illustrated that there are areas where our annual average was below a '4' rating (which means that area was rated 'good' rather than 'very good'). On the basis of the survey results, areas of focus for Auckland Airport in its domestic terminal were:

(a) Ease of making connections with other flights (where we scored 3.9);

(b) Availability of washrooms/toilets (where we scored 3.9);

(c) Cleanliness of washrooms/toilets (where we scored 3.8);

(d) Comfort of waiting areas (where we scored 3.6); and

(e) Ambience of airport (where we scored 3.8).

445. Auckland Airport considers the domestic travel experience (in contrast to its international travel experience which scored higher on the ASQ survey for FY11) is an area where the level of quality needs to be lifted. Auckland Airport is investing in a capacity enhancement project and continues to consult on the long term solution. We believe that all of our customers agree that it is no longer possible to maintain appropriate quality standards in the absence of such investment.

446. However we are doing what we can in the meantime. Specifically, Auckland Airport has been proactively working with its cleaning contractors to deliver improvements. Auckland Airport's focus has now moved to terminal presentation and the factors that influence ambience (as outlined above). We are also focusing on improving the comfort of waiting areas and gate lounges, flight information and the ease of way-finding.

6.3 What consultation was undertaken on aspects of service quality during Auckland Airport's second PSE? How does this differ from consultation on quality at the first PSE?

447. Quality of services is not separately consulted on in PSEs. It arises to the extent it is relevant to consultation on relevant building blocks - particularly operating and capital costs.

448. During the opex and capex forecasting stage of both pricing processes, Auckland Airport and its substantial customers shared views on areas where further investment was required in order to maintain service standards to meet passenger and airline expectations.

449. While a significant number of external factors influence capital expenditure priorities (such as volumes, carriers, types of aircraft and changes in safety and security requirements), a desire to maintain or improve quality was a key factor in our consultation on capital expenditure.

450. The rationale for the key capital expenditure projects is provided in the second PSE (outlined in more detail in paragraph 2.4 of Auckland Airport's, Final Price Setting Disclosure for both its first and the second PSE.

451. All of the major investments will tend to improve quality, including the DTB short term capacity enhancement. However, we understand the focus of this question to be on where quality considerations were the primary drivers in consultation.

452. In the first PSE quality driven projects included:

(a) The initial stage of the development to Pier B, which included an aim of ensuring that bussing levels could be maintained within an acceptable industry standard;

(b) Interim projects to provide for the maintenance of service standards in the existing meeters and greeters areas and in emigration prior to the opening of the next significant stage of terminal evolution; and

(c) DTB building works, which included a range of initiatives to improve service levels.

453. In the second PSE quality driven projects included:

(a) Taxiway Lima, which has been prioritised as a critical link in the infrastructure to eliminate or reduce delays due to taxiway availability and to provide an alternate access to gates;

(b) Maintenance driven programmes such as the airbridge refurbishment programme and pavement rehabilitation programme have been developed to ensure that quality is improved or maintained; and

(c) Pier B ground boarding is an initiative to provide an alternative means of access. To reduce forecast bus operations, at a lower cost than providing additional contact stands.

454. While a significant number of external factors influence capital expenditure priorities (such as volumes, carriers, types of aircraft and changes in safety and security requirements), a desire to maintain or improve quality was a key factor in our consultation on capital expenditure.

455. The rationale for the key capital expenditure projects is provided in the second PSE (outlined in more detail in paragraph 2.4 of Auckland Airport's, Final Price Setting Disclosure for the second PSE).

456. Consultation with airlines is ongoing in relation to service quality. There are formal and informal forums for airline customers to provide feedback on quality. This informs annual prioritisation of capex and opex rationing.

457. Whilst quality discussions in the second PSE focused on slightly different aspects of the airport experience, in both PSEs priorities were informed by expected initiatives required to maintain or improve quality.

6.4 What role did information disclosure play in negotiations concerning service quality during Auckland Airport's second PSE?

458. Auckland Airport's dialogue on service quality with its customers is an ongoing process that the ID regime has now provided a useful structure for. Service quality tools such as the ASQ have informed our understanding of trends and areas for focus.

459. Management regularly reviews the ASQ results and has therefore developed an understanding of which areas of the survey impact most on overall passenger satisfaction. Initiatives taken in this area tend to focus on incremental changes and do not trigger major investment. In this respect, these initiatives are not discussed in detail during the PSE.

460. The first audited information disclosed under ID was not complete until May 2012, whilst Auckland Airport's discussion on capital expenditure priorities commenced in October 2011. In this respect, the ID capacity metrics were not specifically referenced in the discussion on capital priorities, rather, changes in capacity requirements were forecast for the forthcoming PSE.

461. While the discussion on capital expenditure priorities during the second PSE was not directly influenced by the audited ID information, investment focused on improving quality or maintaining quality include:

(a) Investment in the existing domestic terminal;

(b) Terminal and bathroom cleanliness;

(c) Access; and

(d) Terminal ambience.

462. In our view, the publication of the surveys provides interested parties with increased information to assess and consider our performance. This transparency and accountability incentivises Auckland Airport to improve in those areas where service quality has room for improvement.

463. For the second PSE, Auckland Airport has established consultative forums with airlines where service quality issues can be addressed, as follows:

(a) Regional Facilitation Quarterly Forum; and

(b) COG - a joint working group to provide a forum for airlines including service quality issues.

464. Accordingly, ID may not have a significant or noticeable impact on service quality consultation. However, it is our view that the increased transparency and therefore accountability under ID provides a further motivation for airports in general, including Auckland Airport, to make service quality improvements where required.

6.5 Do the current ID requirements capture the right measures of quality?

465. Auckland Airport has made a significant investment to provide for on-going monitoring of the service quality measures required to be reported under ID. The reliability and passenger experience metrics were informed by airport and airline consensus during the IM consultation process and Auckland Airport considers the measures to be broadly appropriate.

466. Auckland Airport notes that the ID requirements were the outcome of a robust engagement between airports and airlines. Industry participants agreed they were appropriate and that they would enable useful comparisons between airports, as information is disclosed *over time*.

467. In our view, the ID requirements currently have value in enabling quality of service to be assessed and reviewed over time. However, given that this was the first year that annual disclosures were published, Auckland Airport is only now presented with its first opportunity to consider how the information that came out of those disclosures may be used going forward.

468. Leaving the ID requirements in place at present will provide Auckland Airport with the opportunity to fully implement the current regime and to assess the information itself, together with the guidance provided by the Commission in its annual summaries and analysis of information disclosed.

469. While we believe that the requirements should remain in place, we will be closely assessing whether the disclosures are useful to and valued by interested parties. Given that the provision of this information is not costless, we may in future suggest streamlining of information if it is clear that elements have not been useful to interested parties.

7. Is Auckland Airport sharing the benefits of efficiency gains with consumers, including through lower prices? Do the prices set by Auckland Airport promote efficiency?

470. Auckland Airport is sharing actual and expected efficiency gains with consumers, including through lower prices.

471. Sources of efficiency gains include operating efficiency focused initiatives such as 'Fighting Fit'. One work stream in this strategy was to focus on procurement efficiency. As a result of this, we successfully reduced the number of suppliers from over 5000 to fewer than 1500, generating operational efficiencies, greater economies of scale and reduced supplier management cost.

Capex efficiencies

472. As explained in Schedule 6 of the Annual Disclosure FY11, by the year ended FY09 these passenger volumes were 6 percent less than forecast. Auckland Airport undertook a review of its capital sourcing strategies and processes, with a view to improving capital productivity in a tough demand environment. This included:

(a) Initiatives to save cost and extend the lives of existing assets (such as pavement initiatives to increase greater competition into the tendering process without sacrificing quality, prioritising pavement areas at a more granular level of detail and extending the life of pavement through the use of epoxy injection repairs (increasing operating cost);

(b) Reviewing capital expenditure priorities to deliver projects at the optimal time based on new passenger forecasts;

(c) Not investing in discretionary projects (such as engine run-up facility given this existing solution was sufficient and met demand for the time being); and

(d) Reviewing passenger processes to seek efficiencies in capital utilisation and to increase overall capital efficiency as part of the LEAN project.

473. The 'Every Minute Matters' initiative also highlighted to staff how their individual productivity directly impacted efficiency and consumers.

474. Baseline efficiencies are being shared with consumers to the extent that initiatives such as LEAN and Every Minute Matters have led to on-going benefits in processes and the efficiency of operating and capital investment at the commencement of the second PSE.

Through driving international growth, increasing capital productivity and reducing unit international charges

475. Auckland Airport established a route development function in 2009. The costs of this function were not borne by consumers in the first PSE. The efficiencies presented by route development are various. For instance, existing carriers benefit from route development to the extent that relatively fixed costs can be spread over a greater volume of traffic. Additionally, it is in the long term interests of consumers for scale economies to be passed back to consumers over time, by way of lower charges per passenger, to the extent that there is available capacity. Indeed, Auckland Airport's commitment in this regard is demonstrated by the fact that our approach to pricing included a reduction in charges per international passenger.[86]

[86] Auckland Airport, Aeronautical Pricing, Final Pricing Decision, 7 June 2012, page 4.

476. Reducing international charges is due, in part, to the proactive stance Auckland Airport has taken to encourage carriers to consider new routes and to consider Auckland and New Zealand as a destination which should be at the top of their list. In the past three years, Auckland Airport's international route development campaigns have created incremental volume in North Asia (China, Japan, Korea, Taiwan); South East Asia (Singapore, Kuala Lumpur, Bangkok, Indonesia); Tasman (Brisbane, Sydney, Cairns, Melbourne, Coolangatta, Mackay); and the United States.

477. Incremental volumes as a consequence of route development initiatives have been included in the baseline forecast and have reduced the forecast unit cost applicable for pricing. Further, many of these routes occur at off-peak times, and therefore create limited incremental cost and increase asset utilisation.

478. We note that at the time of the first PSE, Tourism Futures International forecast anticipated significantly higher volumes than have transpired. Auckland Airport's proactive route development function during the GFC has meant that today's passenger volumes are much better than they might have been and charges are accordingly lower than they would have been without this function.

Pricing structure

479. In our view, our new pricing structure makes important steps towards addressing the historical perceived imbalances between domestic and international charges. It better incentivises efficient behavior by the airport and airlines, and establishes a price structure that appropriately apportions aeronautical costs across all airline customers. Although this increases complexity, Auckland Airport believes that its approach to pricing achieves a fair, reasonable and efficient outcome. In Auckland Airport's view, the price structure:

(a) Provides greater price certainty to airlines than the existing price structure by transferring risk to Auckland Airport. By removing the TSC – which was a pass through cost mechanism, this transfers risk to the party more able to manage that risk;

(b) Includes more charges within passenger charges, which a number of the airlines submitted they value as a more transparent method for cost recovery;

(c) Involves modest rebalancing, which results in both international and domestic charges being at or below average across a broad sample of other airports;

(d) Provides for a Regulatory or Requested Investment ("**RRI**") adjustment, which facilitates the recovery of expenditure as a result of airline-requested or regulation-required investment over $5 million. Auckland Airport believes this mechanism (which is much narrower than the AVC and former TSC) addresses the concerns of its substantial customers and shifts greater risk onto Auckland Airport to manage its capital costs; and

(e)

480. While not part of Auckland Airport's standard charges, an optional Northern Runway charge was proposed for those airlines wishing to make contributions to the Northern Runway land in advance of the runway becoming fully operational. The Northern

Runway opt-in charge may be favoured by those airlines that wish to manage price shock risk when the asset is commissioned.

481. The following table shows how the price structure evolved over the course of the consultation, taking into account feedback.

***Table P:** Consultation – Price Structure Evolution*[87]

		Initial Pricing Proposal	Revised Pricing Proposal	PRICING DECISION
Airfield charges	**Level of MCTOW charge**	FY12 charges increased by circa 5%, with domestic and international charges above 40 tonnes, increasing thereafter by 2.5%.	No further change based on general support for proposal.	No change based on general support for proposal, but a commitment to review MCTOW steps in good time before the next pricing decision.
	Airfield Parking	No increase proposed - flat charges proposed.	Approach amended further based on BARNZ Represented Airlines' recommendation. FY12 parking charges increased by 10% in FY13 and 2.5% per annum thereafter.	No further change based on general support for the proposal.
Terminal charges	**Domestic Passenger Charge**	$2.50 per passenger in FY13, increasing annually 2.5% thereafter.	Approach amended based on removal of ITF from pricing. $1.80 per passenger in FY13, increasing annually 2.5% thereafter.	Further change as a consequence of changes to other price structure elements based on feedback. $1.98 per passenger in FY13 increasing annually 2.5% thereafter.
	International Passenger Charge	$14.50 per passenger in FY13, increasing annually 2.5% thereafter.	Approach amended based on correction of errors as a consequence of changes based on feedback to other price structure elements. $14.25 per passenger in FY13 increasing annually 2.5% thereafter.	Further change as a consequence of changes to other price structure elements based on feedback. IPC of $15.16 for FY13, increasing 1.5% per annum thereafter.
	Transit Passenger Charge	No specific change proposed.	Approach amended based on BARNZ Represented Airlines' recommendation. $3.65 per combined arriving and departing passenger.	No further change based on general support for Revised Pricing Proposal.
	Exemptions	Children 0-12 exempt from passenger	Infants 0-2 to be exempt, with a 100% passenger charge for 2-	In response to feedback that full removal of the existing exemption for this

[87] Auckland Airport, Final Pricing Decision, Appendix G - Overview of Auckland Airport's proposals in the Initial Pricing Decision, Revised Pricing Proposal and Pricing Decision, 7 June 2012.

		Initial Pricing Proposal	Revised Pricing Proposal	PRICING DECISION
		charges.	11 year olds for all passenger charges based on feedback.	age group would impose too much of a price shock, Auckland Airport staggered the introduction of the application of the IPC so that 50 percent of the IPC would be payable in FY13, and 100 percent of the IPC payable from FY14 onwards. The IPC for 2-11 year olds to be 50% in FY13 and 100% from FY14.
	Check-in Facility Charge	Check-in facilities charges to be time-based.	No further change proposed based on absence of opposition to high-level approach. FY13 effective rate of $12.50 per hour, growing by 5.7% per annum.	No change to high-level approach based on general support for Revised Pricing Proposal. However, change in that time-based charging will be delayed one year to 1 July 2013, resulting in an FY14 effective rate of $13.50 per hour, increasing $1 per annum thereafter.
	Annual Variable Charge/ Terminal Services Charge	Annual Variable Charge proposed to replace the TSC. Circa $5 million forecast for FY13 compared to circa $30 million in FY12 for the TSC.	No change to high level approach despite opposition to proposal. Minor change to costs included in the AVC forecast. Circa $5 million FY13 forecast, bussing costs removed, merits review costs to be passed through, and only to the extent they are incurred.	Change based on feedback from substantial customers. AVC not introduced, but a narrower version of charge (the RRI Charge) introduced to cover regulatory or airline required capital expenditure of more than $5 million.

Do the prices set by Auckland Airport promote efficiency?

482. Auckland Airport believes that the prices it sets create appropriate incentives for Auckland Airport to:

(a) *Manage operating costs efficiently.* This is because the risk of exceeding forecast operating cost resides with Auckland Airport rather than airlines, just as any potential reward within the price period of managing costs accrues to Auckland Airport if it can drive cost out. Our forecasts are robustly tested during consultation.

(b) *Manage capital costs efficiently.* This is because there is risk and reward to Auckland Airport to deliver within the capital forecasts.

(c) *Invest in new route development initiatives* within the pricing period, with the reward of upside growth beyond organic growth. This reward is limited to upside that can be achieved within the pricing period.

483. We note that during the aeronautical pricing consultation, Auckland Airport's economic advisor, Estina Consulting, recommended removing the Terminal Services Charge and replacing it with an annual variable charge for costs outside of Auckland Airport's control.[88] Feedback on this approach during the aeronautical pricing consultation was mixed. Some disagreed on what costs should be considered to be outside of Auckland Airport's control, and preferred that costs that were beyond anyone's controls should be passed to Auckland Airport.

484. As a compromise, in very discrete circumstances a pass through cost is possible under RRI adjustment. In our view, this method is efficient, as it is limited to areas outside of Auckland Airport's control, which were not included in the forecast and have either been imposed by a regulator or requested by the airlines.

485. Auckland Airport's new pricing structure variabilises charges to airlines and provides them with more price certainty on a per passenger (and MCTOW) basis. It also increases risk to Auckland Airport on the basis that we now have no mechanism for unforeseen aeronautical costs.

486. Auckland Airport has provided extensive comment on its pricing principles and philosophy, its new pricing structure, and how and why this new structure promotes efficiency objectives in the material provided to substantial customers throughout the aeronautical pricing consultation process in the Price Setting Disclosure. In our view, this material demonstrates that we have priced in a manner that promotes efficient behaviour by the airport. This is crucial to ensure that the correct incentives exist for the airport to incrementally drive innovation and efficiency.

7.1 How do the prices set by Auckland Airport reflect previous efficiency gains? How did the prices set by Auckland Airport for the first PSE reflect previous efficiency gains?

487. In both the first and second PSEs the prices set reflect:

(a) Efficiency gains which have been realised in the base operating costs;

(b) Efficiency gains in investment in the opening pricing asset base as at FY13; and

(c) Efficiency gains which have been forecast over the period, in terms of target reducing operating cost per passenger.

488. Auckland Airport does not have a perfect measure of the efficiency gains it has generated in the lead up to either of the pricing periods as it has also faced unforeseen

[88] Estina Consulting Limited, Mark Jenkins, Aeronautical Pricing Methodology, 13 September 2011, pages 13 and 14.

one-off costs, such as restructuring costs and has raised its delivery to match ever changing consumer expectations (such as access to wifi).

489. That said, Auckland Airport has provided numerous examples of initiatives taken to increase efficiency within the airport over the past several years. For instance:

(a) In this pricing period, Auckland Airport has passed through the volume growth delivered by route development initiatives (which involved costs which were not in the prior period building blocks).

(b) Auckland Airport has completed a number of efficiency driven initiatives such as the LEAN programme to increase capacity within existing infrastructure. Other initiatives to manage capital expenditure have resulted in a reduced outlay to forecast, and provided a more efficient opening asset base than was inferred from the first PSE.

(c) The Fighting Fit strategy which directly sought out cost efficiencies during the first PSE, and more recent innovations such as grouping together with a group of Australasian airports to achieve cost efficiencies in procurement of insurance, have all helped to contain costs.

490. In practice, some areas of the business also face new costs, whether they are costs outside of our control (such as regulation) or costs of meeting rising expectations.

491. Even before the Fighting Fit strategy was introduced benchmarking indicated that Auckland Airport was highly cost efficient relative to airports against which it was benchmarked. In practice, Auckland Airport finds that it is increasingly difficult to achieve efficiencies off this base. However, as demonstrated in the forecast, Auckland Airport is committed to continually striving for cost efficiencies, and has passed expected efficiencies through in the setting of prices.

492. Auckland Airport provides the Commission with the following summaries to help inform Auckland Airports operating cost efficiency:

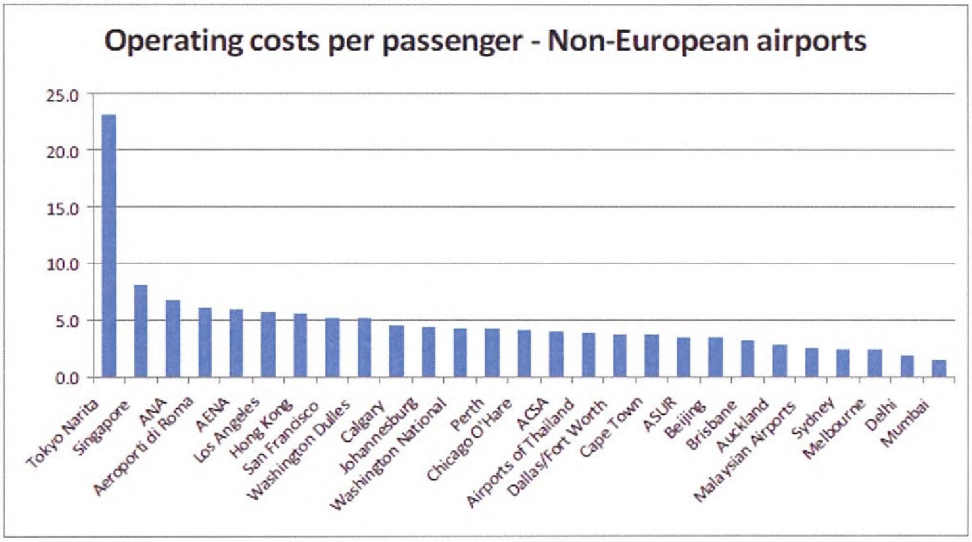
(a) Benchmark performance against other airports; and

(b) Timeseries operating costs per passenger.

493. A comprehensive summary of the benchmarking provided in Leigh Fisher's Airport Performance Indicators 2011 Report was provided to substantial customers in our Initial Pricing Proposal. This research demonstrated that by international standards, Auckland Airport's cost efficiency is very good.

494. By way of example, Auckland Airport ranked 45th lowest out of the total sample group of 50 airports and 22nd lowest out of the non-European airports for operating costs per passenger. The following extract shows a graph of operating costs per passenger in Non-European airports:

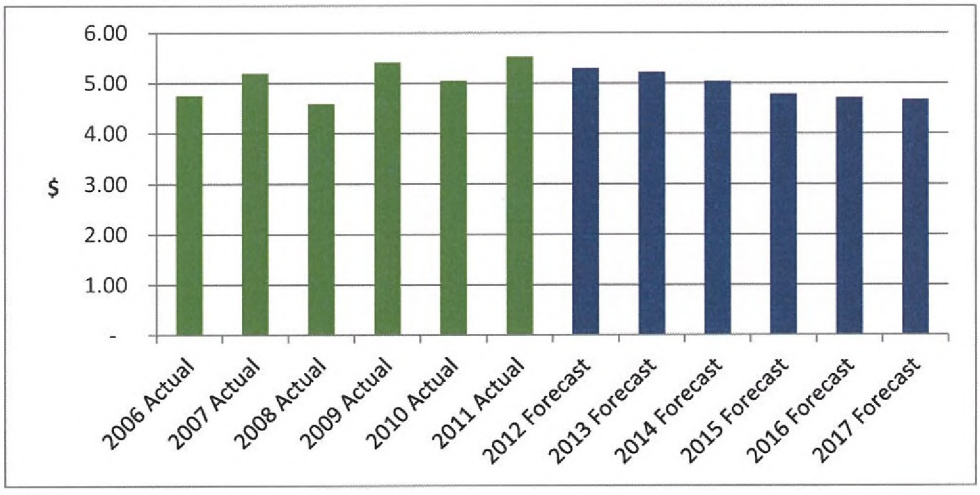
***Table Q**: Leigh Fisher – Operating costs per passenger 2011*



Source: Leigh Fisher, Airport Performance Indicators 2011 Report

495. In our Revised Pricing Proposal, Auckland Airport provided the following time series analysis of Auckland Airport's historic and forecast real aeronautical costs (in 2011 dollars):[89]

***Table R**: Time series – Total aeronautical cost per passenger (NZ$2011) (excluding depreciation)*



496. Operating costs per passenger have been, and are likely to continue to be, affected by material one-off costs such as:

(a) Severance payments following a restructure;

(b) Legal costs (such as the Merits Appeal); and

(c) Takeover costs.

[89] 2011 dollars were calculated for FY06 to FY10 by inflating actual reported dollar figures by the relative difference in the Statistics of New Zealand CPI index for those years versus as at 30 June 2011. FY12 to FY17 dollars were calculated by deflating forecast dollar figures assuming 2.5 percent per annum CPI inflation over the forecast period.

497. In the Revised Pricing Proposal, Auckland Airport noted that while it considered forecast costs were an appropriate target for the purposes of pricing, they contained some risk for Auckland Airport. Auckland Airport will seek to continue to innovate and drive efficiencies, but also notes that costs are not independent of quality of service expectations of passengers and airlines.

7.2 To what extent do changes in the pricing structure at Auckland Airport at the second PSE better reflect efficient pricing principles (for example, are prices subsidy-free, do they have regard to service capacity, do they take account of consumers' price sensitivity) relative to the first PSE?

Pricing principles and philosophy

498. When setting our charges, the pricing principles Auckland Airport adopted were to:

(a) *Allow airlines to consume and pay for only what they wish to consume by:*

(i) Setting standard charges only for a common set of needs for aircraft and passenger movements;

(ii) Treating specific asset requirements separately through leases and common-user licenses, for example: VIP Check-In, VIP Lounges, Office Space, Dedicated Plant, Common-User Check-In Desks/Technology; and

(iii) Entering into negotiations with individual airlines to reach agreement on variations from standard charges services (that is, allowing airlines to negotiate more for more or less for less) and risk-sharing (that is, changes to price structure or where specific needs require long-life investments) on terms that better accommodate the operating models of particular airlines (for example lower cost carriers prefer per passenger charges).[90]

(b) *Reflect supply side factors by:*

(i) Separating services where there are distinctly different cost drivers.

(ii) Recognising that, to a significant degree, airfield services are related to the aircraft type rather than passengers on board, and therefore that it is appropriate to continue to use MCTOW-based charges for aircraft movements, with the addition of a time dimension for parking charges.

(iii) Using per passenger charges for passenger movements.

(iv) Using per passenger charges instead of the existing TSC wash-up mechanism for airside terminal costs, with an annual adjustment to passenger charges only for airline-requested or regulation-required investment as required.

(v) Auckland Airport has considered whether peak pricing is appropriate, and concluded that it is mainly appropriate where there are no viable options to expand supply, and where peak pricing will drive more efficient use of available capacity. Given that Auckland Airport has a viable second runway option, and that in most situations airlines do

[90] Auckland Airport notes that some airlines have requested that individual negotiations commence, now that standard charges have been set.

not have the flexibility to be able to adjust their schedules materially in response to moderate peak charges, we concluded that the use of peak/off peak differentials should be deferred, unless there are delays to an efficient timing of the second runway commissioning.

(c) *Reflect demand-side factors by:*

(i) Separating services where there are distinctly different demand-side factors (price elasticity);

(ii) Setting prices such that the cost of a service is no more than its stand alone cost;

(iii) Allocating common costs to reflect differences in demand elasticity;

(iv) Considering the transition of price paths from current prices to the new prices for different services to avoid price 'shocks' to a service that may have the potential to impact demand; and

(v) Treating the cost of common goods, such as roads, forecourts, utilities and landside circulation areas as common costs, which are included in passenger charges and allocated between passenger types in a way that is likely to enhance price efficiency.

499. Auckland Airport's pricing philosophy also involves:

(a) Benchmarking charges to ensure they are competitive with charges offered by airports serviced from Auckland Airport.

(b) Smoothing prices, to the extent practical.

Auckland Airport will continue to explore mechanisms to smooth prices for airlines. However, if the industry does not support these, step changes in price following commissioning of projects such as the Northern Runway may be required. We continue to be concerned that the lack of smoothing fails to efficiently signal the impact of incremental demand on the timing of future capacity-step changes, and to some extent, efficient pricing has been distorted.

(c) Being mindful of the economic conditions faced by our airline customers.

500. These additional considerations have the potential to create tension with efficient pricing. That is, an economically efficient approach to pricing in the long term may not always best serve the market in the short-term or the need for transparency and other commercial concerns.

501. In balancing economic considerations with delivering a commercially acceptable outcome for our customers, Auckland Airport has taken into account the following practical considerations:

(a) Airlines' preference for a five year bounded NPV building block evaluation for transparency purposes, even though reflecting forward-looking economic cost data would be more efficient.

(b) Using the five year bounded NPV method means that lumpy investments create volatility in prices. It can therefore be necessary to isolate large lumpy investments and to charge for them in ways that signal to airlines how incremental demand drives the timing of investment. In practice, this results in

smooth price paths. Regarding the Northern Runway, this has been done by isolating the lumpy investment from the remaining assets, and proposing options for smoothing the cost via the voluntary uptake of a specific Northern Runway charge (which enables Auckland Airport to reflect how increments in demand impact the timing of the lumpy investment in the Northern Runway).

(c) Auckland Airport considered the building blocks for airfield charges, terminal charges, and then the overall building blocks, on the basis that a smoothing of prices overall may be preferable to a rebalancing between airfield and terminal charges. Auckland Airport priced in a way that a portion of passenger charges relate to airfield services rather than creating a step change in airfield charges. We did this because:

(i) Auckland Airport therefore did not propose a step change in landing charges, even though the building blocks model implied this would be less than a full recovery on airfield on a fully allocated building block basis. Instead, the evaluation was of the NPV across terminal and airfield overall. Accordingly, the passenger charge contributes to common costs and assets such as lighting, electricity networks, roading, rescue fire costs and storm water which for disclosure reporting and the pricing model (for consistency) have an allocation as a common cost to airfield.

(ii) Generally, international airlines (represented by BARNZ) considered that domestic charges should be increased so as to recover the costs of the domestic operations plus an appropriate contribution towards common costs. Domestic carriers on the other hand raised concerns that the increase in domestic charges was too high and common cost allocation ought to minimise the impact on demand.

(iii) Auckland Airport sought to moderate recovery from domestic operations (but still recover non-avoidable costs) to limit the price shocks, especially given that further domestic charges will be considered when the NTF consultation is concluded and an investment decision made.

(iv) Determining the most cost-efficient solution for the domestic terminal requires complex analysis, involving not just an assessment of the direct costs of alternatives, but the operational implications and consequences for airline network efficiency, together with permanent decisions affecting Auckland Airport's infrastructure for the next 40 years. Further analysis is required to determine the most efficient investment. On this basis, Auckland Airport determined not to base its prices on long-term forecasts that included costs of the Northern Runway when implementation and timing were very uncertain. Accordingly, the current prices understate the long-run cost of future supply

502. Auckland Airport does not consider that peak pricing is necessary yet at Auckland Airport, but might be needed if there is no support for a timely second runway investment and congestion begins driving material costs.

503. The aeronautical pricing consultation record shows that there was significantly more discussion of efficient pricing principles in the second PSE relative to the first PSE. Auckland Airport considers this is a function of:

(a) Parties involved in the process at the time – that is, there were some new carriers in the second PSE;

(b) Views on structural elements (such as the TSC) have evolved a little over time, with more preference generally for variabilisation of charges than in the past; and

(c) A different structure to the way parties have consulted, with a clearer representation of international carriers via the BARNZ Represented Airlines.

504. As stated in the 2012 Price Setting Disclosure, putting IM versus LRAC issues aside, Auckland Airport considers that its standard charges are allocatively efficient and revisions to the existing price structure will have the least possible impact on demand

505. Auckland Airport remains open to entering into negotiations with individual airlines to reach agreement on variations from charged services (e.g. more for more or less for less) and risk-sharing (e.g. changes to price structure or where specific needs require long-life investments). Some carriers have indicated a preference to see standard charges set before reaching any alternative agreement.

506. Auckland Airport has some remaining concerns regarding how it can efficiently price in the lead up to the requirement for a Northern Runway, in a regime where the Commission has excluded this runway land from the asset base for ID purposes. Auckland Airport has explored options using the Commission's methodology for assets held for future use to signal to carriers that if a step change in pricing is to be avoided a smoothed interim charge would be required. At present, Auckland Airport considers there is significant commercial uncertainty in this area and hopes to work constructively with regulatory bodies and substantial customers to address this at the appropriate time.

507. At the service level, individual prices reflect the key cost drivers for direct costs: MCTOW based charges for landing; terminal charges reflecting passenger numbers; and lease charges based on market or cost for specific space and plant.

508. Each service was priced at or above its forecast directly attributable cost, to recover different portions of common costs. No cross-subsidies were forecast in the charges.

509. In the interests of efficient pricing, Auckland Airport attempted to better balance its MCTOW charges and international and domestic charges during the second PSE.

510. In relation to MCTOW, we sought better balance by the following approach:

(a) Adopting the recommendations from Estina Consulting that airfield costs are most efficiently recovered by a MCTOW charge - an approach which received broad support throughout the aeronautical pricing consultation process.[92]

(b) Equalising the MCTOW charge for 40 tonne (and heavier) aircraft on the basis that there was no cost-based reason for maintaining differentiated charges.[93] We note however, that in the first PSE, some parties considered the higher MCTOW charge for domestic was reasonable given the lack of a passenger charge.

511. We acknowledge that some further analysis could be undertaken on the MCTOW curve and have committed to reviewing the MCTOW curve and other metrics used for airfield pricing (such as movements and passengers) before the next pricing consultation.[94]

512. Auckland Airport also sought better balance between its international and domestic passenger charges. For our domestic passenger charge ("**DPC**") we introduced a DPC of $1.98 in FY13 which will increase by 2.5 percent per annum going forward.

513. Our reasons for this were to:

(a) Bring Auckland Airport's terminal charging process in line with common practices at other airports, namely uniform billing on the basis of passengers; and

(b) Ensure that the increasing fleet capacity of the airlines using the domestic terminal building could be properly served in the medium-term, until such a time as future accommodation is decided upon and delivered.

514. A further structural change over the first PSE was to remove the exemption for two to 11 year olds from the IPC so that:

(a) Infants aged between zero and two years old (regardless of whether they occupy a seat or not) would be exempt from the IPC; and

(b) Passengers aged two to 11 years old would be subject to a 50 percent IPC in FY13, and 100 percent IPC from FY14 onwards.

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[92] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 63.
[93] Auckland Airport Initial Pricing Proposal for Aeronautical Charges, Aeronautical Pricing Consultation, 19 January 2012, page 136.
[94] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 63.

Further consultation continues with respect to the cost of providing additional service capacity

516. Auckland Airport has two service capacity issues which are pending – the next stage in its domestic terminal capacity and the next stage in its Runway. Auckland Airport explored price signals in relation to service capacity for the Northern Runway. However, regarding the domestic terminal, Auckland Airport considered that peak pricing in an environment where service quality standards are stretched, would be seen as an impost by Air New Zealand and Jetstar, and one that they did not have the flexibility to avoid. The tight scheduling of domestic flights means that even a doubling of terminal charges in peak would be very unlikely to alter demand for that period. Instead, Auckland Airport has focused its efforts on consulting on options that would enable the next level of capacity to be provided. Introducing a charge without consulting on the opportunities for capacity expansion would be an impost and so not helpful to the process. However, it is acknowledged that if capacity expansion is not supported that a peak charge may be necessary to provide the right economic signals.

517. Estina Consulting's original recommendations dismissed the need for congestion charging in the second PSE, based on the circumstances currently being faced by Auckland Airport. Specifically, Estina Consulting argued that congestion pricing is not appropriate for Auckland Airport at this time because:[96]

(a) The nature of the regulatory environment and the preference of airlines for price stability make it difficult to beneficially employ pricing based on short-run costs, and congestion pricing is most efficiently used when it is dynamic to actual demand in the short term.

(b) Setting congestion-based differentials for extended periods, such as for five years, may have detrimental, unintended consequences and require frequent price adjustments and therefore frequent costly consultation cycles.

(c) Auckland Airport is not currently facing high levels of runway congestion, but that at current growth rates (depending on aircraft up-gauging and pricing) congestion will become material in a matter of a few years. One of the problems with measuring and predicting congestion at airports is that airlines will naturally exploit the excess of demand over supply by raising their prices (or mix of prices) at congested periods. High airline prices may not be competed away when peak-time slots are scarce.

518. Estina Consulting relies on there being no delay to Auckland Airport's Northern Runway. Accordingly, we acknowledge that if there was a delay, then it is likely to provide good reason for Auckland Airport to reconsider its position on congestion charging (as stated below by Estina):

> At this time, Estina understands there has been no decision on the timing of commissioning of the second runway. However, it has been Estina's assumption that efficiency is best served by the commissioning of a second runway before congestion becomes significant. The reasons for this assumption are:
>
> Unlike many other airports that are operating at or near congested levels, Auckland Airport has a relatively simple option to add another runway. Adjacent flat land is available on the other side of the terminal buildings, suggesting that

[96] Estina Consulting Limited, Mark Jenkins, Aeronautical Pricing Methodology, Review of Feedback, 29 November 2011, page 14.

returns to scale are likely to remain relatively constant through the transition and for many years. Many relatively congested airports do not have such a ready option to expand.

Congestion pricing at airports is not common and tends to be employed by airports that are both congested and do not have a simple option to expand capacity. It seems that these airports introduce congestion charges to shift traffic to secondary airports permanently or at least during peak periods. The existence of secondary airports that can reach, or have reached, efficient scale also appears to be an important factor. To put it another way, the best option to provide new capacity is at secondary airports as opposed to growing the existing congested airport. In the case of the Auckland region the best option appears to clearly be a second runway at Auckland Airport.

Estina understands that the cost of the second runway will amount to a small number of dollars per passenger, though the size of the increment depends on how closely pricing can approximate long-run cost, as discussed at length above. It seems obvious that the elastic reaction of demand to this level of charge would quickly be overtaken by the damage caused through an inability to meet travel demand as Auckland Airport becomes congested, or by the increase in airline charges to exploit the excess of demand over supply. It therefore seems that the efficient point at which to add the second runway will be at a time when congestion is still below serious levels.

If these assumptions are correct then the benefits of adding congestion charges may be outweighed by the damage created by causing a period when airlines have to re-shuffle their network schedules to respond to congestion pricing or lack of slots, and when secondary airports have to invest to meet a demand that may only last a few years.

These assumptions could prove to be wrong, and the second runway may be delayed. If that proves to be so then Estina recommends that Auckland Airport introduces congestion pricing and scarce slot management (to compete away inflated airline prices) in the interests of efficiency at that time. While Estina has given some thought to how Auckland Airport could approach this, it is premature to fully address this issue when it is not clear that the second runway will be unduly delayed.

7.3 To what extent have airlines and other consumers of Auckland Airport's services been able to make price-quality trade-offs that best meet their needs for the second PSE? How does this compare with the first PSE?

519. Auckland Airport's pricing principles provide a benchmark starting point for our prices, through standard charges. However, the principles are only a starting point, and they can be departed from in order to achieve flexibility for airlines. Auckland Airport adopted its pricing principles for a range of reasons, a central reason being to:

(a) Allow airlines to consume and pay for only what they wish to consume by:

(i) Setting standard charges only for a common set of needs for aircraft and passenger movements; and

(ii) Entering into negotiations with individual airlines to reach agreement on variations from standard charges services (eg more for more or less for less) and risk-sharing (eg changes to price structure or where specific needs require long-life investments).[97]

[97] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 58.

520 For example, the decision whether incremental stands ought to be contact or remote stands, is a function of the relationship between current and forecast levels of bussing and policy, and airline views on appropriate bussing levels. The level of bussing at the international terminal is relatively low at present, having dropped from about 3.6 percent of average daily and annual aircraft operations (either on arrival or departure) prior to the opening of Pier B in October 2008, to just around 1 percent at present. However, the level of bussing is predicted to steadily rise as demand grows and as new active stands are added as remote stands rather than contact stands

Alternatives with differing price quality outcomes would have been increased bussing or further contact stands.

521. Auckland Airport receives and values feedback both during the pricing process, and over the course of the pricing period. In this respect, price quality trade-offs will continue to occur as feedback from various stakeholders is considered as part of the decision-making process.

7.4 To what extent do Auckland Airport's prices promote certainty and stability? How does this compare relative to the first PSE?

522. As far as practical, Auckland Airport's prices promote certainty and stability. Benchmarking of charges through Jacobs and Airbiz indicate that prices represent value for money and have a modest price path trajectory. The change in the price structure to remove the TSC promotes greater certainty for country managers for budgeting. That is, airlines will no longer face a separate unknown charge and wash-up for this item. Instead, airlines can base all budgets on a forecast cost per passenger. If passenger volumes rise or fall, so too will the airport charges.

523. One important part of Auckland Airport's pricing philosophy involves smoothing prices, to the extent practical. This allows us to promote certainty and stability for our customers.

Despite this, Auckland Airport continues to explore mechanisms to smooth prices for airlines. In this regard, we note that an opt-in/opt-out approach could be explored with interested parties via commercial agreement if those parties value a smoother approach than may be available via standard charges.[98]

524. However, Auckland Airport received strong feedback from substantial customers for Auckland Airport to continue consultation and exclude the NTF from its standard charges.

529. It is also uncertain whether the Moratorium on asset valuations will be retained for future pricing periods (as discussed above). Auckland Airport will fully and carefully consider all views provided to us by all customers at the time prices are next consulted on, including their views on price stability. However, we consider that there should not be undue focus on that issue now, given that it is one input among many that may or may not have an impact on our next pricing decision. As always, Auckland Airport will consider the desirability of maintaining a stable and certain price path.

7.5 How do airlines and other consumers of Auckland Airport's services expect their demand to change in response to the prices set by Auckland Airport in the second PSE?

530. Auckland Airport believes that airlines are better placed than Auckland Airport to provide information regarding how they expect their demand to change in response to the prices set by Auckland Airport in the second PSE. However, we note the following:

(a) Auckland Airport has set its prices in a manner that seeks to have minimum inefficient impact on existing demand.

(b) Auckland Airport has no reason to believe that its price changes will cause airlines or consumers to make significant changes to their existing demand:

(i) The price changes are small relative to Auckland Airport's prices, and much smaller relative to airlines' revenues derived through Auckland Airport. Therefore, Auckland Airport expects the elastic rea y76ction to its price changes to be small and relatively immaterial compare to other factors impacting demand in the air travel market.

(ii) International charges have reduced, and therefore no detrimental effect on demand is caused by the new prices.

(iii) It is conceivable that the change in domestic charges may be sufficient to cause some marginally profitable services to be reviewed by airlines. But if services are maintained we do not expect a material impact on demand. Auckland Airport was conscious of concerns from domestic carriers on the effect of the introduction of a domestic

passenger charge.

(c) In our view, our charges are appropriate for the quality of service provided.

7.6 What impact has information disclosure had on the pricing methodology set by Auckland Airport for the second PSE?

531. In our view, the requirement to transparently outline the pricing methodology for the second PSE promoted discussion with airlines, and through discussion with airlines, a number of changes were made to the price structure with the intention of improving the efficiency of pricing.

532. During the second PSE, Auckland Airport disclosed its pricing methodology at the beginning of its aeronautical pricing consultation process, in its first information pack. In terms of formulating our pricing methodology, we engaged Estina Consulting to provide expert advice on pricing methodology options, requesting Estina Consulting to consider and recommend options regarding efficient pricing given Auckland Airport's current capital and operating plans for the near future.

533. In summary, Estina Consulting recommended that Auckland Airport:[103]

> Set 'standard terms' for a common set of needs. Where the standard service offered is less than efficient for any individual airline, there will be natural incentives for the airline and Auckland Airport to negotiate agreements to share in the incremental value possible from more closely meeting the airline's needs. This is expected to be more efficient, due to greater flexibility, than attempting to define and price all possible needs in 'standard terms' offers. It is also consistent with how Auckland Airport currently provides services such as VIP lounges, VIP check-in etc.
>
> Continue to use MCTOW charging for aircraft handling. The shape of the MCTOW curve (price per MCTOW tonne varies for weight ranges) should reflect both supply-side (cost) factors and demand-side (demand elasticity) factors.
>
> Set passenger handling charges for different flight types (such as domestic/international or long-haul/short-haul/domestic-jet/regional), based on both supply-side and demand-side factors. This is recommended to replace the current TSC and PSC charges. There should also be a pass-through mechanism to avoid the need to re-price for minor changes in airline needs and/or for mandated changes.

534. Auckland's pricing methodology was then subjected to the pricing consultation process (through the Revised Pricing Proposal and Final Pricing Decision) and the views of substantial customers were taken on board and reflected where possible without materially damaging price efficiency. The openness under ID meant that Auckland Airport set its methodology and its prices in the knowledge that they would be subject to the scrutiny that comes with ID. In our view, this contributed to a more robust and fulsome price setting process.

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[103] Estina Consulting, Mark Jenkins, Aeronautical Pricing Methodology, Aeronautical Pricing Consultation, 13 September 2011, page 3.

8. Comparator airports

535. Given the regulatory, political and commercial debate that centres on aeronautical charges, Auckland Airport regularly seeks a regular professional assessment of how its charges compare with other airports that are relevant to its market. For the most recent PSE, Auckland Airport commissioned two reports.

536. The first report, by international aviation consultants Jacobs, was conducted in September 2010 and reviewed international charges. According to Jacobs, Auckland Airport's international aeronautical charges are 'middle of the pack', just below the average of the 20 airports serviced by Air New Zealand that handle more than 500,000 international passengers a year. These competitive charges have been achieved while providing excellent levels of service, as indicated by being named the best airport in Australia Pacific for four years running and receiving ASQ scores which indicate service to be very good relative to passenger expectations.

537. The second report, by Australasian aviation consultants, Airbiz, was conducted in August 2010 and reviewed our domestic charges. The Airbiz report found that Auckland Airport has amongst the lowest domestic charges in Australasia. ASQ scores with respect to domestic operations remain sound, in the range of good to very good, though further investment is required and has been prioritised for the period, given forecast capacity increases.

538. These reports are available on our website and extracts from these are provided later in this section.

8.1 What airports provide a useful benchmark for assessing the performance of Auckland Airport, and why?

539. Auckland Airport finds benchmarking useful for understanding which airports are best in class for various operational disciplines or for particular performance measures, and the lessons this may or may not provide for Auckland Airport. However, such an approach would not be appropriate if the Commission is seeking to promote yardstick competition through benchmarking.

540. For benchmarking of relative performance to be useful for Auckland Airport, it should seek to control for, or take account of:

(a) Scale of operations;

(b) Passenger mix;

(c) Ownership structure; and

(d) Regulatory environment.

541. In terms of national benchmarking, while Auckland, Wellington and Christchurch Airports share the same regulatory regime, economic environment and broad cost structures, there is a fundamental difference between the airports in terms of passenger mix. Auckland Airport has a much higher proportion of international passengers than either Christchurch or Wellington Airports. This difference significantly impacts on the complexity of our respective operations.

***Table S**: New Zealand airport passenger mix comparison*

	International Passengers	Domestic Passengers
Auckland Airport	56.3%	43.7%
Christchurch Airport	25.8%	74.2%
Wellington Airport	12.7%	87.3%

542. The international passenger processing costs are higher than domestic, which makes any cost or asset efficiency benchmarking challenging between the three national airports being monitored. Unless this is controlled for within the analysis, we would recommend that a broader set of benchmarks is used and controls for the factors set out above

543. In terms of benchmarking of charges, Auckland Airport has also considered the competitiveness of charges relative to other airports which its airlines connect to. The initial focus has been Air New Zealand's network. However, in principle, this could be expanded to any of Auckland Airport's carriers.

Operating cost efficiency benchmarking

544. In its Initial Pricing Proposal[104], Auckland Airport set out analysis on operating cost benchmarking. This information shows that:

(a) Auckland Airport has efficient operating costs. Based on total costs per air traffic movement, total costs per passenger and operating costs per passenger, Auckland Airport ranks as either the fourth or fifth lowest cost airport out of 50 global peers surveyed by Leigh Fisher. An extract of this report is provided in response to Question 7.1.

(b) Auckland Airport's operating costs compare favourably with the other major New Zealand airports, taking into account Auckland Airport's significantly higher number and proportion of international passengers for which the complexity of operations increases the cost base.

[104] Auckland Airport Initial Pricing Proposal for Aeronautical Charges, Aeronautical Pricing Consultation, 19 January 2012, pages 62 and 63.

International Charges benchmarking

545. During the aeronautical price setting consultation, global benchmarking analysis was extracted from Leigh Fisher's Airport Performance Indicators 2011 Report (as contained in Appendix H to Final Pricing Decision Auckland Airport's review of international airport charges).[105]

546. This shows that Auckland Airport's international charges are below average. Auckland Airport ranks 10th out of the 21 airports that Air New Zealand regularly flies to for charges for A320 and B777 aircraft types. On average, calculated charges sit between 8.5 percent and 9.4 percent below the average.

***Table T**: Current charges per passenger (each way) – B777-200ER (NZ$)*[106]

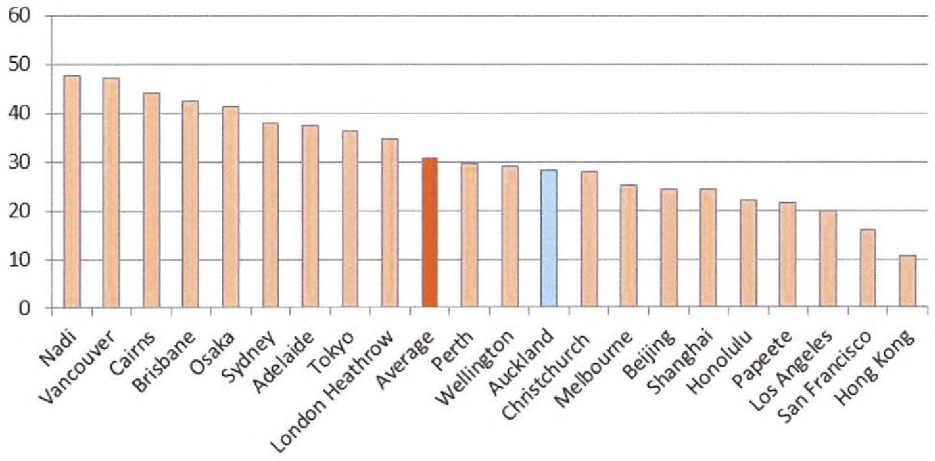
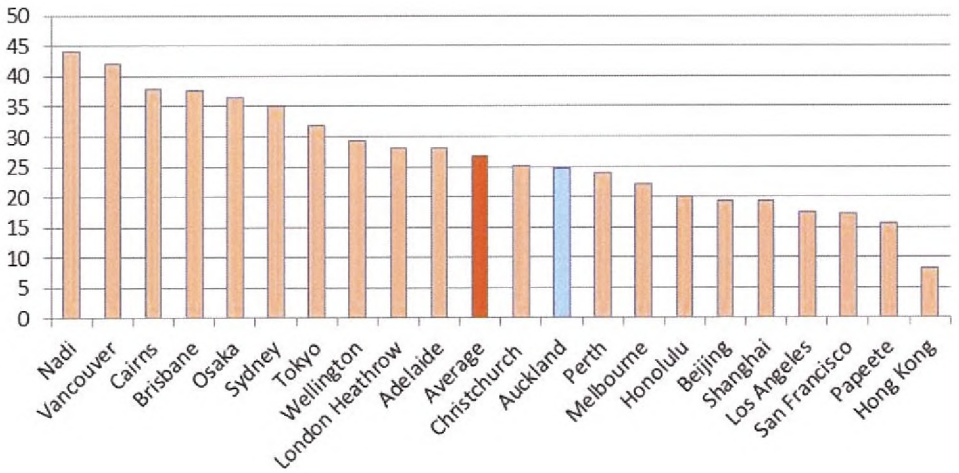


***Table U**: Current charges per passenger (each way) – A320-200 (NZ$)*[107]



[105] Leigh Fisher Management Consultants, Comparison of Airport Charges at Principal Airports Served by Air New Zealand, November 2011.
[106] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 95.
[107] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 95.

Domestic Charges

547. During the aeronautical price setting consultation, Auckland Airport commissioned Airbiz to benchmark domestic turnaround costs over the past few years. The analysis indicated that Auckland Airport's domestic charges were significantly below the market average because: [108]

(a) Turnaround costs for the A320 were the fifth lowest of the 23 airports surveyed; and

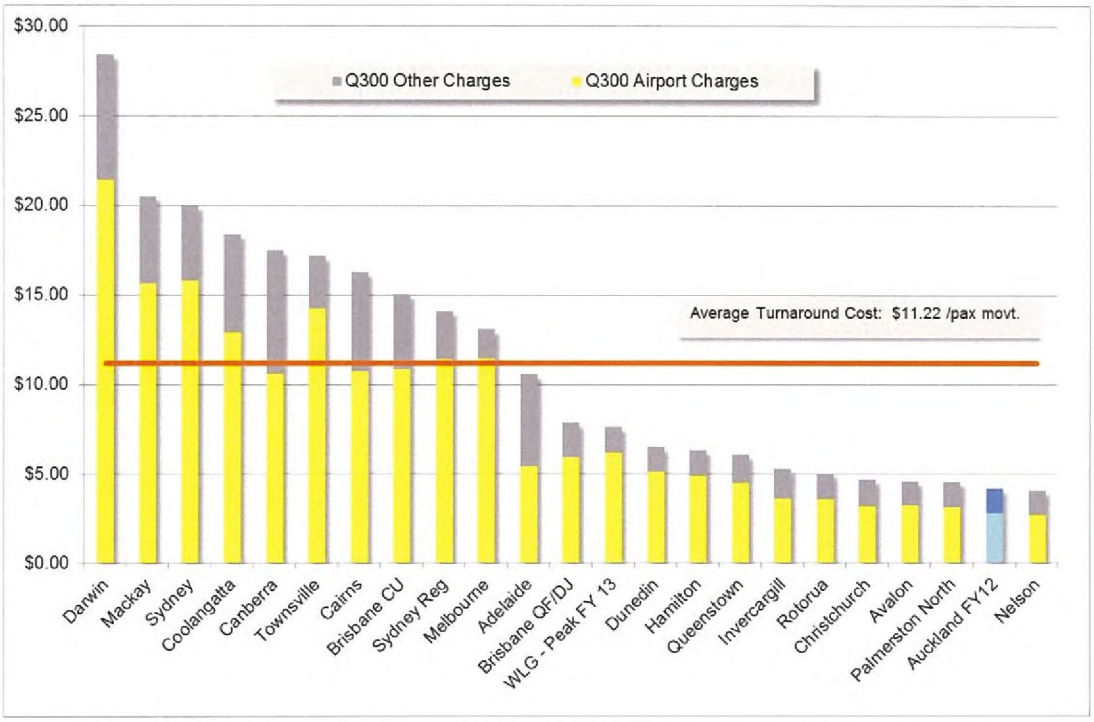
(b) Turnaround costs for the Q300 were the second lowest of the 23 airports surveyed.

548. The below graphs illustrate these points.

***Table V**: Current charges per passenger (each way) – A320 (NZ$)*

[108] Auckland Airport, Aeronautical Pricing Final Reasons Paper, Aeronautical Pricing Consultation, 7 June 2012, page 98.

***Table W**: Current charges per passenger (each way) – Q300 (NZ$)*



549. Although the evidence above shows that we are performing well comparatively, there are significant limitations in using benchmarking to form detailed conclusions on Auckland Airport. While we accept that domestic and international benchmarking can provide a useful means of obtaining indicators of market positioning or to identify performance outliers, it should be used in conjunction with other measures of assessing performance, given that no two airports are the same.

9. What are the strengths and weaknesses of the current ID requirements?

550. The greatest strength of the ID regime is that it provides a robust and tailored platform for monitoring airport performance over time. Auckland Airport expects that, over time, disclosures will provide greater consistency in reporting on a time series basis for Auckland, Wellington and Christchurch Airports than existed under ID under the AAA.

551. In BARNZ's submission on the Review of 28 June 2012 it noted the following:[109]

> As the first sets of information have only just been released, the full extent of the benefits [of information disclosure] have not yet been experienced. However, it is BARNZ's expectation that over time the information will prove beneficial, particularly as data series are built up, and as actual performance is able to be measured against forecast performance from price setting events.

552. Auckland Airport shares this view. Given that the regime is in its infancy, we are not yet in a position to form a conclusive view regarding the strengths and weaknesses of the existing regime.

553. We expect that there are likely to be opportunities for improvement as the regime beds-in over time, and welcome the opportunity to test and discuss any proposed changes in due course.

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[109] BARNZ, Submission Responses to Commerce Commission's Questions Relating to WIAL, 28 June 2012, page 29.

554. That said, from our perspective, there are already identifiable short-term benefits as a result of the implementation of ID - in particular, in two key respects:

(a) In its submission on the Review of 29 June 2012, Air New Zealand recognised the following strength of the ID Regime:[110]

The new framework provides an objective measure against which to assess an individual airport's performance and also provides for easier comparison across airports.

We agree with Air New Zealand. The objective reference points provided by the IMs have introduced a significant discipline to our pricing practices and have provided a framework for our discussions with our airline customers.

(b) Greater transparency of forecast outcomes to the public has meant closer scrutiny of our performance, measured against the purpose statement.

555. While we are hesitant to draw conclusive views about opportunities for improving the ID requirements while the regime is in its infancy, as the Commission is aware, there are nevertheless some matters on which Auckland Airport has firm views. In that respect, in the following discussion we have highlighted our concerns with the existing IMs, but have not sought to labour those points, bearing in mind that for the purposes of the ID Regime the IMs must be treated as established and binding.

Cost of capital

556. Auckland Airport would support the Commission giving further consideration to a cost of capital IM that is appropriate for monitoring purposes. In our view, the focus should be on establishing a methodology that is suitable for evaluative purposes, rather than simply using the same methodology that is used to determine a key input into pricing for entities subject to price control.

557. The key focus should be on requiring Auckland Airport to disclose the cost of capital it has used for pricing purposes, and the rationale for its approach to each parameter. The Commission could then comment on Auckland Airport's approach in its summary and analysis of the disclosure. We think this could provide a deeper and more contextualised analysis of performance. Our recent experience is that instead of engaging on whether airports are preparing robust, appropriate airport-specific approaches, airline customers have an entrenched position that applying the industry - wide WACC set for monitoring purposes is the only correct approach to pricing. Our customers are of course fully entitled to hold that view, but we also believe that it would be helpful if there was a clearer understanding among stakeholders regarding the appropriate treatment of the WACC IM in pricing decisions.

Further guidance

558. Accordingly, it would be helpful if the Commission could provide further clarification of its position in this respect, as that may assist future price consultations.

559. Further, if the Commission decides to retain the cost of capital IM in its current form and/or is not required to change it following the merits review proceedings, then Auckland Airport believes that it would greatly assist interested parties for the Commission to provide further guidance on how it proposes to use the estimate of WACC produced by the IM in its monitoring and analysis, as this is the source of the greatest amount of regulatory uncertainty under the new regime.

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[110] Air New Zealand, Submission on Process and Issues Paper Section 56G Review, 29 June 2012, page 65 at paragraphs 334 to 336.

560. In particular, we understand from submissions in the merits review proceedings that the Commission appreciates that it must exercise caution when comparing an annually adjusted estimate of WACC to returns that are the product of an estimate of WACC 'locked in' at the commencement of the pricing period. However this is not apparent in the IM itself or the accompanying reasons paper. Accordingly, we encourage the Commission to provide further guidance on the types of additional matters it will take into consideration when using the WACC IM to fully contextualise the reported returns, and how the WACC IM will be applied on a consistent basis. This would greatly assist to promote certainty consistent with the purpose of the IMs.

TCSD

561. As highlighted in section 3 above, it is not clear that the TCSD fully compensates suppliers for the costs of interest rate swaps. If the TCSD is to be retained, then the Commission could consider whether further adjustments are required to address this issue.

Future use

562. Under the Commission's asset valuation IM, the land which Auckland Airport proposes to use for the development of a second Northern Runway is classified as 'future development land' or 'works under construction' and, on this basis, is excluded from the regulatory asset base (together with holding costs) until it is 'commissioned'. As discussed more fully in response to question 3.11, our view is that this may encourage outcomes that are contrary to the Part 4 purpose statement.

563. According to NERA's Treatment of Future Development Land Report the general problem with excluding assets held for future use is that it may result in exactly the opposite profile of prices over time to that observed in competitive markets.[111] As our existing runway (or any other significant airport asset for that matter) approaches capacity, Auckland Airport may be constrained from implementing efficient price signaling for fear that the resulting returns would be regarded as 'excessive' compared with an asset base that excludes second runway assets. As we understand it, the Commission's approach may lead interested parties to mistake the very type of pricing that could be expected in competitive markets for 'excessive pricing'. This would:

(a) Constrain airports from pricing in a way that airports in competitive markets would; and

(b) Result in prices negatively affecting investment incentives compared to those in a competitive market through the skewed time profiles.

564. If, despite Auckland Airport's views on this important issue, the Commission believes that excluding assets held for future use is necessary to provide transparency for information disclosure purposes, then it would be helpful if it could provide further guidance or clarification that it was not its intention to prevent airports from implementing efficient pricing in relation to assets held for future use, consistent with the principles and expert advice discussed in response to question 3.11.

565. As the Commission is aware, we also believe that if the current approach to land held for future use is maintained under the IMs, then holding costs for suspended works under construction should continue to accrue in the same was as they do for works under construction and assets held for future use.

[111] NERA Consulting, Treatment of Future Development Land Report, 12 July 2010, page 3.

Future use treatment of tax

566. In December 2011, Auckland Airport asked the Commission to clarify its intent regarding the treatment of tax for future use assets, on which we await a formal response. The nature of the issue is that if Auckland Airport earns interim revenues on an asset, this should be netted from the carrying value of the assets. What is less clear is that net revenue is defined in 3.11 (6) (c) as revenue derived from the excluded asset (other than tracking revaluations) – operating costs incurred in relation to the excluded assets. Operating costs are defined to exclude amounts that are tax. Auckland Airport requests that the Commission clarify the definition since, in our view, it is not sensible to earn interim revenues, pay the tax on those revenues and then subtract the gross revenues from the future use asset.

Future use: schedule inconsistency with definition

567. Auckland Airport is aware of an inconsistency between the Input Methodology definitions and the excel schedules. The IM requires that the value of the excluded asset is:

> (2) Subject to subclauses (3) and (4), the cost of an excluded asset to which this clause applies for a disclosure year is determined in accordance with the formula-
>
> *base value + holding costs + net revenue + tracking revaluations.*

568. The definition of base value includes cumulative historical tracking revaluations. Accordingly, tracking revaluations are included in the base value and then ought to be subtracted in the formula, so that there is no significant net effect (except for the current year effect) on the excluded asset value.

569. However, in the excel schedules the formula for the total future use asset in 4b(viii) is:

> Base value + holding cost –net revenue + tracking revaluations

570. For the time being, Auckland Airport has put a negative sign on the tracking revaluations so as to report a sensible number. However, we are conscious that:

(a) This is misleading on its face, as the tracking revaluations are positive; and

(b) There is no comments box for this to be explained.

571. Auckland Airport advised the Commission of the situation in May 2012. Auckland Airport considers that when the templates are updated, it would be appropriate for the Commission to correct for this and to provide a comments box for the Future Use Schedule.

Assessment of expected revenue and profitability following price setting

572. Auckland Airport noted BARNZ and other airlines' concerns during the Wellington Airport Conference that the information disclosure requirements could better assist interested persons to focus on consultation materials (or the PSE) in which they are most interested (in particular Schedule 18). The price setting disclosure is extremely detailed, and Auckland Airport considers that feedback from BARNZ during the Wellington Airport Conference indicates it could be sensible to streamline the disclosure, such as by removing aircraft and freight and other areas negotiated by way of lease (where revenues are set in relation to market comparables, rather than a building block model). An alternative method to address this concern could be to add a simple table to formalise the record of the aeronautical pricing information in the form of Schedule 18. Auckland Airport has certainly not sought to 'camouflage' any matters. This is simply a possible improvement that could be made that we would be interested in flushing out parties' views on.

Reliability and capacity measures

573. Auckland Airport notes that it has found the definition of interruption complex for operational staff to interpret while also completing complex tasks (such as directing planes to stands) despite an additional FTE in this area. In this respect, Auckland Airport considers that it might be more appropriate to simplify the definition of interruption to unplanned outage time.

574. In our view, the capacity metrics are a strong first effort to capture metrics which summarise a complex environment. However, we note that notional and practical capacity can materially differ, and in this respect, the notionally capacity may in some instances provide an incomplete or misleading picture. Auckland Airport intends to manage this by continuing to report against these metrics and using the commentary section to provide further explanation. However, once a longer time series of information is available, the Commission may consider it is appropriate to refine these metrics.

9.1 What are the additional costs to Auckland Airport of complying with information disclosure?

575. Auckland Airport has devoted considerable resource and time to preparing its disclosures under the new ID regime. This process has come at a significant cost, including the cost of external advisors.

576. In comparison to disclosure under the AAA, additional costs arise from:

(a) Internal staff time to develop required processes and systems to reveal information in the manner required for disclosure, and time for completing disclosures;

(b) Costs of external advice and compliance with determinations and audit;

(c) Time for senior management to review disclosures and external advice, and report to the Board; and

(d) Time for the Board to review all information before certifying the disclosures.

577. Below is a table showing Auckland Airport's estimated regulatory costs point:

***Table X**: Auckland Airport's estimated regulatory costs point:*

	2009	2010	2011	2012	TOTAL
Operating cost	1,720	2,284	1,455	1,395	6,854
System cost			464		464
Total	1,720	2,284	1,919	1,395	7,318

9.2 How much of the information disclosed during the recent price setting round would have been publicly disclosed, or disclosed to airlines, in the absence of information disclosure regulation?

578. A small fraction of the information disclosed during the price setting disclosure document would have been publically disclosed in the absence of the ID Regime. This is because Auckland Airport's view is that the disclosed requirements are too technical for most interested parties. However, over time, the analysis and summaries provided by the Commission may address our concerns in this regard, by breaking down the information in a manner that makes it more easily digestible and understandable for interested parties.

579. Auckland Airport has provided the Commission with the full record of consultation for the most recent price setting consultation process. The consultation process, whilst not public, is conducted with the parties most interested in the issues and with the ability to properly analyse and consider it. This provides evidence of the extensive scope of information disclosed to the airlines and the ability under the AAA for the airlines to seek further information. Extensive information would have been disclosed to airlines in the absence of the ID Regime, but we have highlighted in this submission where we have modified how we present information to airlines to better align with the ID requirements.

9.3 What are the benefits to Auckland Airport, airlines and other consumers of Auckland Airport's services of using the information disclosed?

Benefits to airlines

580. Auckland Airport considers the following Schedules provide useful reference value for airlines:

(a) Annual disclosure of performance:

(i) In the annual disclosure, we expect that airlines will be most interested in Schedule One, the variance analysis in Schedule 6 and service quality outcomes in Schedules 13 and 14.

(b) Price setting disclosure:

(i) With respect to the Price Setting Disclosure, Auckland Airport expects that the information disclosed should provide a comprehensive record of Auckland Airport's forecast and actual performance. While a considerable amount of information is provided to the airlines in consultation, the Price Setting Disclosure formalises all key information underpinning the final aeronautical pricing decision in the PSE and as such, is likely to be a key reference document. However, Auckland Airport considers that the requirement to disclose on services is not addressed in the PSE, detracts from this disclosure and adds complexity which and may cause confusion, rather than promote understanding.

581. In order to assess the value of information disclosed going forward, Auckland Airport welcomes the views of airlines on which aspects of the information disclosed are particularly valuable to them.

Benefits to other consumers

582. As discussed previously, it is our view that the new information disclosure reporting regime is a significant improvement on previous reporting requirements. It

encompasses broader performance measures than simply financial outcomes, and provides for a more effective and comprehensive assessment of regulated services. The increased transparency of the new regime provides better means for explaining an airport's individual circumstances alongside its regulated services, including commercial pricing arrangements, capacity constraints and capital requirements.

583. We expect the forecast capital expenditure disclosure to be of most interest to those parties that did not directly participate in pricing consultation.

584. On an annual basis, we expect parties will be most interested in the overall returns, variance analysis and quality and capacity outcomes.

585. In Auckland Airport's view the ID Determination has provided more than sufficient information that will in the course of time, allow interested persons to assess whether the purpose of Part 4 is being met.

586. On the basis of the information provided, together with the Commission's section 53B(2) summary and analysis reports, consumers will soon have the opportunity to form a view on the performance of Auckland Airport in relation to its regulated services.

Benefits to Auckland Airport

587. Auckland Airport hopes that in the fullness of time, the airlines will see increasing value in the Information Disclosure regime changes that they advocated for. With greater transparency of actual performance and the basis for the pricing decision, Auckland Airport expects that information asymmetry between parties will be reduced and that we will at least be able to discuss performance in reference to clear benchmarks.

9.4 What additional information (not captured in responses to the questions above) could be added to the current ID requirements that would better help you assess whether the purpose of Part 4 is being met

588. The purpose of information disclosure is to ensure the provision of 'sufficient' information to enable interested persons to understand airport performance, and to ensure that the information is 'readily available' to those interested persons.

589. As discussed earlier, Auckland Airport considers that there are some limited areas of the new disclosure requirements where the Price Setting Disclosure may be difficult to understand as the manner in which the information is provided is complex. On this basis, the information may not be readily available to interested parties to understand, as was intended by the ID Regime. Where this is evident, we would support a simplification of the required disclosures, in order to better align with the purpose of the Act. However, we accept that when the Commission provides its summaries and analysis, this may provide greater clarity and go some way to addressing any concerns.

590. In our view, the Act implicitly requires that the resources and cost involved in providing information should be proportionate to the benefit or value it will bring, as acknowledged by the Commission in the Information Disclosure Reasons Paper, as follows:[112]

> *The Commission's view is that key elements of both materiality and weighing the costs and benefits of particular requirements are incorporated into consideration of its cost effectiveness.*

591. There will always be particular areas of our disclosures that attract a greater degree of interest from interested parties, which may translate in to requests for supplementary

[112] Commerce Commission, Information Disclosure (Airport Services), Reasons Paper, 22 December 2010, at paragraph 2.38.

information. Auckland Airport is genuinely open to considering additional information requests. However, we note that preparing and disclosing information does come at a significant cost, which needs to be balanced with its value to interested persons. We also note that further regulatory prescription is not necessarily the solution for managing any perceived information gaps. This is particularly the case where the cost/benefit is unclear.

592. Nevertheless, Auckland Airport supports the provision of additional explanation to existing Schedules to support interpretation and understanding. For example, the future use calculation is complex and Auckland Airport considers it would be helpful if there was a comments box to explain key changes in the future use calculation year on year (as discussed earlier).

593. Regardless of whether such changes to the format of the Schedules are adopted, Auckland Airport intends to continue with its practice of providing the fullest and closest information disclosures possible.