COMMERCE COMMISSION NEW ZEALAND
AIRPORTS SERVICES CONFERENCE
HELD ON 26 FEBRUARY 2013

[9.55 a.m.]

CHAIR: Welcome to everybody. By my watch we're actually four minutes early but I think everybody appears to be here and so let's make a start.

I have the usual process and related announcements. Many of you would have heard it before so I apologise for what's going to sound very familiar to you all but we do need to do it to put it on the record.

So, I welcome you all to the Commission's conference on the review of Information Disclosure regulation applying to specified airport services provided by Auckland International Airport under part 4 of the Commerce Act.

I'm Mark Berry, Chair of the Commission, and with me are Deputy Chair Sue Begg and Commissioner Pat Duignan, who you all know from previous conferences. We are also joined today by our new Associate Commissioner, Elizabeth Welson, to my right, your left.

As background we determined the information disclosure requirements and input services for airport services at Wellington, Auckland and Christchurch airports in December 2010, as we were required to do under part 4, and under section 56G of the Commerce Act we are now going through the process of reporting to the Ministers of Transport and Commerce on how effectively disclosure regulation is promoting the purpose of part 4 of the Act.

As you'll know, we have already reported to the Ministers in relation to Wellington Airport and we are now in the process of going through the Auckland Airport exercise.

In September last year we issued a process and issues paper for our section 56G review in relation to Auckland. A number of issues were raised in submissions and cross-submissions on this paper. These we have found to be very informative and we thank you all for the time and effort you have put into submissions to date.

It is those submissions and cross-submissions, and our analysis to date, that have formed the agenda for today's conference. The objective of this conference is for us to understand the impact, if any, that part 4 Information Disclosure is having on Auckland Airport's performance and its conduct.

I'll turn now to procedural matters. We have set out in the memorandum dated 19 February the administrative arrangements for today. We have carefully read all submissions and cross-submissions. The conference is intended to focus on the areas where we want to test and deepen our understanding of the written submissions made by the parties further. We do not usually allow new material to be presented at our conferences given the parties would not have had an opportunity to consider such information. However, some flexibility may be warranted to this conference as parties have the opportunity to provide cross-submissions on any new material following the conference. So, if there is new material that becomes identifiable, let's see how we may need to manage that as we go.

The purpose of this conference is to discuss issues relating specifically to Auckland Airport. We will not be revisiting our approach to assessing the effectiveness of Information Disclosure in each area unless there is an issue that is specific to Auckland Airport.

I assume that you have all read our final report on the effectiveness of information disclosure at Wellington Airport and will therefore be familiar with our approach to the section 56G reviews.

If you have any new issues with our approach that you would like to raise, I ask that you include these in your cross submissions to this conference. We have allocated time for parties to introduce themselves to us. We have also allocated time later this afternoon for presentations to us. I understand that Air New Zealand, BARNZ and Auckland Airport wish to take up this opportunity. I should add that in providing this opportunity at the end of the day we ask that you avoid repeating material that has already been discussed throughout the day unless there are new points that you wish to make. The conference has generally been organised around the areas of performance relevant to part 4. We appreciate that each of these areas of performance interrelate, however for the purposes of this conference we simply have arranged them as separate topics and allocated time according to where we need further understanding and submissions and cross-submissions. The timing and order of the topics does not reflect their relative importance. Furthermore, each topic area may be relevant to any or all of the four objectives set out in section 52A(1) and you'll see from the agenda that we're going to move through each of these topics throughout the day.

Commission staff may also follow up on some of these issues. While the conference is focused on particular areas that we wish to explore further, the fact we may not refer to other issues in our questioning does not mean we have reached a view on any matter. The conference is simply focused on the issues where we believe we will be assisted by further explanation and discussion.

While this conference provides an opportunity for views to be discussed, we would like to reiterate that the various rounds of written submissions remain the principal avenue by which we seek and received interested parties' views. Please recognise the importance of the written materials you present throughout the consultation process and the need for your written submissions to set out your views in a comprehensive way.

As I've already mentioned, following the conference parties have the opportunity to make cross-submissions and they are due on 15 March 2013. Everybody is invited to make a cross submission on any matter discussed at this conference. There will also be an opportunity to make a detailed written submission on the draft report when we get to put that out.

As with previous conferences, we intend that there should be as little formality and technicality as possible. The conference, as you'll know from previous conferences, is not adversarial and no party has the right to ask questions directly of others in the course of these proceedings unless requested to do so by the Commissioners.

During each topic session we will expect the relative representative and expert of each participant to sit at this front table in front of us. It is our understanding that all independent experts appearing before us have signed the letter confirming that they agree to abide by the Code of Conduct for Expert Witnesses as set out in the High Court Rules.

Commissioners and Commission staff will ask questions and we may on some matters direct the question to a specific individual. In asking questions we will seek to canvass a full range of views on all issues. We appreciate that these representatives may not be able to answer all questions posed. If the timetable permits we may allow other advisors to respond to us. In the interests of time we may not be able to give all parties an opportunity to respond to every question raised today. However, as I have already mentioned, there is the opportunity for cross-submissions and written submissions so if you feel in the course of today that there is something that you would wish to elaborate on further, there is the cross-submission opportunity.

We will get a transcript of this conference on our website we expect by the end of this week. We will publish a list of all matters that parties undertake to come back to us on, on our website, together with the transcript hopefully by 1 March.

The conference proceedings are being recorded and you'll see that there are microphones available at the tables. The technical assistant has asked me to tell you that you have to speak reasonably directly into these microphones, so when you're speaking if you can just make a point of pointing the microphone towards you, that will certainly help in the process. Please speak clearly and slowly because we also have a stenographer here who will be doing the transcript so that's going really assist us on getting the transcript by 1 March if you can take that care.

The agenda provides for breaks at lunch and at afternoon tea. The agenda is flexible and we may need to make changes as we progress and so let's just see how we go on various of these topics, we may get through some of them faster than others, there may be an opportunity to spend some more time on others as the day progresses.

Commissioners aren't available for consultation during the breaks. Tea and coffee will be available at the rear of the conference room. The conference room will be open during breaks. The room is not secure, so in terms of valuables and secure documents, please take care of those for yourselves.

For administrative matters there are bathroom facilities located directly outside the room. If we have to evacuate the building, probably leave the way you came in is the instruction.

The Commission's contact person for the conference is Ruth Nichols. I'm sure most of you will know Ruth but she's standing here. Put your hand up Ruth so everybody knows. If you've got any questions about the administration or any other matters in the course of today, please have a chat to Ruth.

Okay. Well, I understand that the parties have been asked whether there is a need to discuss any confidential information in closed session and I am advised that we have no claim for a need for a confidential session today, but if during the day any issues of confidentiality arise and we do hit those kind of problems and there is a wish to go further with submissions or other matters to us, please let me know. We do typically handle confidential matters in confidential sessions. It is something we do routinely in our hearings both in regulatory and competition matters, so we do have protocols for hearing confidential matters.

I'm just about at the end of the introduction. In order to assist the parties in the planning of the participation at this conference you'll see that the agenda is arranged around various topic areas so we are, through these, exploring whether Information Disclosure is effective in limiting Auckland Airport's ability to extract excessive profits, whether it is effective in promoting services at the quality consumers demand, whether it's effective in promoting appropriate innovation, incentives to invest, the sharing of efficiency gains with investors and efficiency in pricing. Our agenda was issued on 19 February which provides further detail of what we propose to explore in relation to each of these topic areas.

Okay. Well, that's my introductory comments and before we go into the first session on quality I would like parties to identify themselves for the record and so we'll start by going around the table and if each participant can name themselves and which organisation they are from or which organisation they are appearing on behalf of, and so we'll do the round table first so that our stenographer will get to know who you are, and then if there are any other potential submitters in the audience we'll do those next in terms of appearances. So, if I could start with Mr Nicholls.

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ANDY NICHOLLS: Andy Nicholls from Chapman Tripp representing Christchurch International Airport.

NEIL COCHRANE: Neil Cochrane, Christchurch International Airport.

MIKE BASHER: Mike Basher for Wellington International Airport.

MARTIN HARRINGTON: Martin Harrington, Wellington Airport.

CRAIG SHRIVE: Craig Shrive, Russell McVeagh appearing on behalf of New Zealand Airports.

KEVIN WARD: Kevin Ward, New Zealand Airports Association.

EMMA RAE: Emma Rae from Russell McVeagh on behalf of Auckland Airport.

CHARLES SPILLANE: Charles Spillane, Auckland Airport.

SIMON ROBERTSON: Simon Robertson, Auckland Airport.

ADRIENNE DARLING: Adrienne Darling, Auckland Airport.

DR LAYTON: Brent Layton appearing at the request of BARNZ.

KRISTINA COOPER: Kristina Cooper for BARNZ.

JOHN BECKETT: John Beckett for BARNZ which for the purposes of this conference includes our members, Air Calin, Airwork, Cathay Pacific, EVA Airways, LAN Airlines, Thai Airways, Air Tahiti Nui, China Southern, Fieldair, Malaysia Airlines, Singapore Airlines, Air Pacific, Air Vanuatu, Emirates, Korean Air, Virgin Australia and Tasman Cargo Airlines.

NICK McDONNELL: Nick McDonnell, Air New Zealand.

PHIL de JOUX: Phil de Joux, Air New Zealand.

SEAN FORD: Sean Ford, Air New Zealand.

JOHN WHITTAKER: John Whittaker, Air New Zealand.

CHAIR: Thank you. I'm just mindful that there are some economic experts sitting in the audience and I just wonder if any of those experts are likely to be appearing in the course of the day. If so, they might just note their identity for the record, please.

ASSOCIATE PROF MARSDEN: Alastair Marsden, Auckland Uni Services representing at the request of Auckland Airport.

NIGEL DEAN: Nigel Dean from Colliers International on behalf of Auckland Airport.

RICHARD CHUNG: Richard Chung from Cameron Co, here on behalf of Auckland Airport, valuation experts.

JAMES MELLSOP: James Mellsop from NERA Economic Consulting at the request of Auckland Airport.

CHAIR: Okay, thank you. Well look, that's the - yes?

KRISTINA COOPER: Sorry, Commissioner, the Qantas group which includes Jetstar has asked BARNZ to convey its apologies for not being able to be present today and so too have the Air Cargo Council members, but both those organisations have noted they will be reviewing the transcript and are able to respond to any areas where the Commission identifies they would appreciate further information.

CHAIR: Thank you, and they too can have an ability to do a cross-submission if they so wish once they've had a chance to review the transcript.

Okay, that's the administrative and appearance matters out the way so let's turn to opening the first session which is on quality and I'll hand over to Elizabeth Welson to lead the questions on this.

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ASSOCIATE COMMISSIONER WELSON: Thanks Mark. Performance of regulated airports may be assessed by considering whether airports are delivering and maintaining the level of service quality demanded by consumers subject to cost and price. Submissions received indicate that quality at Auckland Airport generally reflects consumer demands with the exception of quality experienced by the cargo terminal operators. Submissions also noted some concerns about staff facilities and Auckland Airport's willingness to enter into a service level agreement. So service level agreement is the first issue that I wanted to raise a question about. The question was primarily directed at Qantas and I note the comment that they will be reviewing the transcript and willing to respond, so I will just read out the question so we have that on the transcript.

In Qantas' submission they expressed concern that Auckland Airport is not willing to incorporate service level agreements. We would like to hear from Qantas in their cross-submissions to the conference, comment on the following areas: What did they seek from a service level agreement with Auckland Airport; why did they want one; what process did they go through to try and agree a service level agreement; and, in Qantas' opinion why was that not successful.

Also like to ask Auckland Airport, in relation to service level agreements their submissions indicated that they are open to negotiating service level agreements. I'm wondering if you could help us, please, to explain why a service level agreement could not be reached with Qantas.

SIMON ROBERTSON: Simon Robertson from Auckland Airport just to respond. Just before I go, I guess, into the point around specific service level agreements, I do note that I started by addressing concerns in that you think Auckland Airport generally reflects consumers' demands. I would suggest that the recent Skytrax awards over the last four years that rate Auckland Airport as one of the best airports in the world, certainly in the top 10 for 2009, 10 and 11; the second best airport in the world for quality, for airport's between 10 and 20 million passengers; four years in a row as being the best airport in the Australia/Pacific region suggest perhaps a little bit stronger than your "generally reflects consumer demands". I would suggest, actually, is that what we have at Auckland Airport is an extremely good quality airport at the high end of customer satisfaction levels.

With regards to service level agreements, we absolutely as you pointed out, and in our submission, open to conducting specific agreements with suppliers on their needs. Through the pricing consultation process, we tried to provide a benchmark for pricing and then sought opportunities with airlines should they require different levels of service.

We see many examples of that today, actually. For instance, premium check-in facilities which are outside normal price-setting terms means that as an example, an airline can have a different level of service and have the price reflected in that should that be the level of service that they wish their passengers or certain groups of their passengers to experience.

We also noted Qantas' points in the submission but they haven't raised anything specifically with us following either our price consultation process or with regards to that submission. So, we're not clear on what service levels agreements they're after and how they might want that reflected but we remain open to receive any comments directly from them.

ASSOCIATE COMMISSIONER WELSON: Thank you.

KRISTINA COOPER: Can I add, after the first price-setting event, some time around 2008, all three airports and BARNZ, and Air New Zealand as well, put in a substantial effort to endeavour to reach a service level agreement and the sticking point was liability and indemnity, what happens if the service levels are not reached, and that I think is the barrier to entering into a service level agreement between airlines and airports at the moment, is that the airports are unwilling to have there be any sort of financial consequences if the service levels aren't met, and annually at Auckland Airport the airlines are currently paying about $200 million in charges and I think in a competitive market it would be extremely unlikely to have a provider refuse to enter into service level agreements when people were paying that amount of money, I think it would be expected.

ASSOCIATE COMMISSIONER WELSON: Certainly I think it would be very helpful if we can have Qantas' comments in the cross-submissions but thank you for that.

If there's no other comment I'll move on to my next -

SIMON ROBERTSON: There would be another comment --

ASSOCIATE COMMISSIONER WELSON: Very well.

SIMON ROBERTSON: -- sorry, if you open that up. The issue of indemnity and risk and reward actually goes to the heart I think of service level agreements. If, as Kristina has pointed out, there's a wish to be penalties then there also should equally be rewards associated with that. So, what's not clear in the process is what the risk reward trade-off for that, and also how you might deal with issues where it's not entirely clear who might be at issue on a particular service level, especially given the interconnected relationship of our different passengers' processing movements that might cause an incident, in fact it may actually be another airline's late arrival which might cause an on-time performance issue for another airline. The issues are relatively complex but we're absolutely open to exploring those with any airline that wishes to explore them with us.

ADRIENNE DARLING: If I might add, you know, I think that there's actually been progress as a result of information disclosure through PSE1, the industry collaborator, to suggest quality standards which should be monitored over time and we're very keen to see trends, work through the work horse analysis so we can actually understand where those issues are arising and then we'll be more confident when we're considering service level agreements.

ASSOCIATE COMMISSIONER WELSON: All right, thank you. So, my next question was addressed to New Zealand Air Cargo Council and I note the comment that they will be reviewing the transcript. New Zealand Air Cargo Council submitted that improvements in quality for cargo facilities are required at Auckland Airport, specifically what they would like to do is secure a route for transporting cargo from the cargo terminal operator premises to the air-side area. Auckland Airport submitted that they intend to review the existing security arrangement following I think it is relocation of the domestic terminal building, your master planning review process, although it's not clear to us when that will be undertaken.

So, my question first was addressed to the New Zealand Air Cargo Council, whether they consider that the proposed review by Auckland Airport will address their current concerns and why? Then the second aspect of that question is whether they have an idea of how much it would cost to secure access if access was to be secured at the current time and would air cargo operators be willing to pay the cost of doing so?

I've also got a question that I would like to direct at Auckland Airport and that question is, have you considered securing a route for the air cargo operators at the current time?

SIMON ROBERTSON: The issue around the transport of cargo is that part of it goes on public road which for the most part we have tried to address by minimising the amount of vehicle movements that might be in conflict with those cargo movements. We acknowledge actually that we probably dropped the ball on this one and we have changed our person of contact with the Council.

The issue is one that's live at the moment because of the various master planning issues at stake around the location and further expansion of domestic terminal capacity at Auckland Airport and we're not in a position to be able to resolve one without considering the other, so hence part of an overall master planning approach that needs to be considered.

CHARLES SPILLANE: And I think it might be useful for the Commissioners if you were to come and have a tour of Auckland Airport so that we can put this issue into context. What we're talking about is a relatively short piece of roading in order to link the two CTOs to the aerodrome proper through a point we call Checkpoint

Charlie, which is where the aviation security service does the screening of everything that goes into the air-side environment. When you do see that you'll see what's involved in the next step of the evolution of that facility to ensure that the entire operation can take place in a secure environment.

ASSOCIATE COMMISSIONER WELSON: Thank you. I get a flavour of the challenges but I'm still not clear and just wondering if you can confirm, is there an interim solution and have you considered it?

SIMON ROBERTSON: Not clearly an obvious solution today.

KRISTINA COOPER: I talked with the Air Cargo Council people yesterday, actually, and they explained the solution is an operational one, that they have to have a security guard with each set of ULDs or trolleys that are being moved from the cargo premises to air-side. So, I think you've just got your classic dilemma of an operational expense or a capital expenditure investment, and quite clearly the airport is facing a large strategic decision on where it locates its new domestic terminal and the future of freight and the freight, sort of, aprons is really dependent upon that. So, I think it's not unreasonable for the airport to say, we actually just need to sort out the overall plan of this area of the airport before we construct this secure facility. The Air Cargo Council are very clear that they want this but they do seem to acknowledge that yes, other items need to be decided first.

ASSOCIATE COMMISSIONER WELSON: Is there any further comment before I move on to the next question? Right, thank you for that.

I had one final question for Auckland Airport which is to get a better understanding of whether Information Disclosure has had an impact on quality at Auckland Airport. We have observed that the passenger satisfaction score has increased slightly at Auckland Airport since Information Disclosure was implemented and submissions also indicate that in recent years Auckland Airport has focused more attention on interruptions, including to the air bridges.

So, my specific question is, do you think that the increased transparency provided by Information Disclosure has had an impact on your processes around quality and the quality of service provided and, if so, can you provide some examples please.

SIMON ROBERTSON: One of the issues we have to consider is what drove what behaviour. If I stand back from Information Disclosure and the issues around quality and reliability I would probably see them slightly different. We've always strived actually for a good quality airport experience. What we are seeing through Information Disclosure is a significant increase in the transparency around quality through the ASQ surveys.

The ASQ surveys for Auckland Airport are not new. We've been doing them for many years. What is perhaps a little bit missing from the Information Disclosure regime is a little bit of context about what we do. So, you quite rightly noted that the trend was in the right direction. We would also say that actually the rating is also very very high. So, where that sits amongst a range of airports is, again, goes back to the same issue I raised earlier about, and is consistent with, the Skytrax surveys.

So, we currently have an overall rating of between 4 and 5. So, 4 is very good and 5 is excellent and I don't know if many of you are like me, I certainly with staff reviews, to give the top rating is always that hard thing to do, you're actually saying that there's no areas for improvement. So, getting a rating of between

4 and 5 I think actually is an exceptional outcome and something that all, from what we can see in the data, that all New Zealand airports actually can be very proud of on a global scale.

On reliability I would say that there has been actually some changes in behaviour. We've seen significant investment by Auckland Airport in processes and procedures around measuring, the reliability of various components. We've always worked quite strongly, certainly in the area of air bridges where we would recognise that a lot of our air bridges are nearing the end of their useful life and we do have a programme for replacement, and so we have had many instances of full engagement with the industry as we work through maintenance issues to get the most out of that particular asset.

JOHN WHITTAKER: If I can just reflect Air New Zealand's views on quality generally. We acknowledge that Auckland Airport does operate at a very high level of quality and the awards that they have won reflect that. We would just caution that quality at the level that consumers demand is not necessarily always at the highest quality and that we have a number of customers who are far more interested in price than they are in quality per se. So, that's just a trade-off that always, something that needs to be recognised when considering part 4 which is around the quality at the level that consumers demand, but generally we don't have any issues to raise in relation to quality.

ASSOCIATE COMMISSIONER WELSON: Thank you. If there's no other comment I'll just check if staff have any further questions before we move on to the next topic? No.

CHAIR: The next topic is profitability and Pat Duignan is taking the lead on this one.

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COMMISSIONER DUIGNAN: Good morning. In this session we want to explore some issues that will inform our assessment of Auckland Airport's expected profitability compared to normal returns with that assessment being based on our relevant IM determinations. That will assist us in assessing the effectiveness of part 4 ID in limiting the ability to earn excessive returns or profits. As you'll be aware if you've read our final report for Wellington Airport, our approach to assessing the airport's profitability for this review estimates the internal rate of return and compares this to our estimated IM compliant cost of capital and considers the effects of a range of sensitivities. So, that's what I wish to explore in this session. I should note that we are not here to re-open the IMs regarding the cost of capital. We're focusing on their application.

I would like to address the first question to Auckland Airport. We will obviously be preparing our own estimate of the return that we expect Auckland Airport to earn in PSE2 based on the forecast information that you have provided and consistent with the input methodologies where relevant. So, my question is, has Auckland Airport determined what level of return you are expecting to earn when that return is calculated in a manner consistent with the input methodologies?

SIMON ROBERTSON: The process that we undertook during pricing consultation was to forecast a return through the period of 8.475 on the matters that were covered by the pricing consultation process. The pricing consultation that we undertook was based on a different process for asset valuation than conducted under the IM. We recognise that there is a difference and we recognise that there is a challenge therefore to assess profitability in a way that is consistent with the approach taken for pricing.

COMMISSIONER DUIGNAN: So, my question then is to say that we would be interested to be provided with your assessment of the profitability, or really the rate of return, calculated in a manner consistent with the IMs recognising that your asset valuation processes differs, but we will be doing an assessment ourselves but this is, in effect, providing you with an opportunity to give us your view of the way to translate to that IM consistent analysis. So, that can be provided in cross-submissions but we rather wondered if you had any idea of it now since it's pretty clearly a matter that we have a need to consider.

SIMON ROBERTSON: I suppose the question that you're raising us asks us, it makes me think of a question back to the Commerce Commission because it's about consistency with approach, is how I would view it. So, we have in place at the strong request of the airlines during consultation a moratorium on asset values. Now, we recognised as part of that consultation process that that would be different to the process that the Commerce Commission undertakes in the IMs and different to what was included in Information Disclosure.

Auckland Airport is in a position now where the measures of profitability for Information Disclosure are actually inconsistent with the approach taken for pricing with both the asset base and also at the moratorium no revaluations through the period. I guess we're interested in how the Commerce Commission might take two equally economically principled ways, but different ways, and assess them for Information Disclosure?

COMMISSIONER DUIGNAN: Well, we're not so much here to predict the contents of our report, as you'll appreciate, so we will be considering that matter as part of preparing it. The purpose of the question, though, was that, my next question will be addressed to

BARNZ and is to ask BARNZ, that BARNZ has expressed the view that Auckland Airport will be earning excessive returns over the period and I'm about to ask BARNZ the basis for that view.

The first question was really to provide Auckland Airport with an opportunity to sort of indicate what your baseline using the IM compliant analysis is because we've had the Wellington Airport report out there and clearly we've indicated that we're going to take a consistent analytical approach, but if that's not something Auckland Airport has sort of seen as a matter to put in front of us at this stage, we would just hope that you will put it in front of us in our cross-submissions.

So, shall I move on to BARNZ. We've obviously got, as we have in the case of Wellington Airport, approaches which are not consistent with the IMs. That's fine, airports have insisted on exactly that point so we have no criticism of that but we in our analysis, as we're bound to, must go back to looking at how that translates to the IMs in order to undertake it, so this process necessarily involves that translation and we will do it but we always want to provide interested parties with the opportunity to give us their view on it. We'll see that, I hope, in cross-submissions but I'll just give Auckland Airport any last thought on this matter before we move on to some of the other elements.

ADRIENNE DARLING: Commissioner, if I may answer, we have done some analysis but we do not recall the numbers specifically so we can provide those in cross-submission. I think one of, the key issue relates to the methodology and, you know, we understand you have a preference to be able to plug some numbers into that methodology to get an outcome. The challenge is that it relates to what approach will Auckland Airport take in

2017, and we with all consultation come with an open mind so we are not in a position to say exactly what will happen with respect to asset valuation in 2017 but the Commission can rely on Auckland Airport's track record of listening to its customers with an open mind. We do not have any alternative asset valuation. If the Commission needed to put a number into its pricing model, the only asset valuation number that we have would be the rolled-forward moratorium value. We cannot guarantee that that will be the approach taken but it is a highly likely possible outcome, that the moratorium would be retained in 2017. I hope that gives you some guidance.

COMMISSIONER DUIGNAN: Well, thanks, but it was intended that question 8, I would move to address that, so we do have a few questions before we get to a discussion about that closing value, which is certainly one component but so, too, is the rolled-forward open value so we're interested in your views on that matter, not simply the closing number, but we'll get to it.

All right, BARNZ, you've expressed the view that Auckland Airport will be earning excessive returns so could you please explain the basis for that view and elaborate upon what you've had to say in your submissions

KRISTINA COOPER: Well, the BARNZ analysis was undertaken by applying the Commerce Commission WACC range from the 50th to 75th percentile estimates and it applied that to the moratorium asset base rolled forward. We did not do any analysis based on the input methodology RAB asset base because we did not have transparency to translate the input methodology asset base to the pricing subset of those assets. It then also raised questions, if one went down that route, one then has the questions about needing to treat the revaluations as income because, of course, prices were set for the 2007 to 2012 period on the basis or zero forecast revaluations. So, if one was to change from the moratorium approach to the input methodologies then for consistency your revaluations need to be treated as income.

So, the BARNZ analysis was based on Commerce Commission WACC input methodology and the Auckland Airport moratorium.

COMMISSIONER DUIGNAN: Thanks. Now that everyone has seen what we did for Wellington, I think that it would be reasonable, both from your perspective and from ours, to say that the cross-submissions we'll be receiving after this conference provide you with an opportunity to couch your argument directly in those terms and that would make from our perspective the numeric base for the points you are making more accessible to you and us. In other words, if you'd like to bring your analysis and line it up so we talk in the same language, given we have indicated our methodology, I think that would be helpful but obviously it's entirely at your discretion as to whether either, any of the parties respond that way.

KRISTINA COOPER: Yes, and also I'd say it's highly reliant upon whether BARNZ has the information to do that and I'm not confident that we do have the information to know the pricing asset base for the RAB valuations.

COMMISSIONER DUIGNAN: Right. Well, I'll move back to Auckland Airport. Your submission states that you use the IMs as a reference point, so there are two aspects to that. One is in respect of the question that was just raised, as to whether you are happy to provide an estimate of the asset base calculated in accordance with the IMs, or your view of it, just to facilitate all parties. If you were prepared to do that, incidentally, perhaps providing that at an early date would be helpful because we're going to have what we describe as a cross-submission round and so if you provided that information early it would probably help people like BARNZ.

So the key question that I want to ask you is, moving to focus upon the WACC aspect, as to whether you have estimated an IM compliant WACC during the price-setting process and, if so, when did you calculate this?

Now, you have shown to us a WACC calculation using your or parameters which differ in certain well-defined respects from the IMs, so again the question is to provide you with an opportunity to indicate to us what you would have calculated as being an IM compliant WACC during the price-setting process before we - I mean, we will look at that question but we're asking you if you're interested to give us your view of the translation, then we'll take that into account in our discussion of the matter.

SIMON ROBERTSON: We did so in our submission.

COMMISSIONER DUIGNAN: Okay. Staff, could I ask whether you feel that we have everything we need in that regard?

PAOLO RYAN: I think the question was whether the estimate of the WACC in terms of the Commission's IMs was as at the same date that the pricing decisions were made.

SIMON ROBERTSON: Yep, we propose - in our submission we put the parameters as at the date that we did pricing, comparing that to the Commission's position. So, the answer to that is yes, it's in the submission.

COMMISSIONER DUIGNAN: So what that does for us is to give us a basis on which we could say that that's your assertion, if I can put it that way, or your submission regarding the WACC, the compliant WACC, the IM compliant WACC that you would have had in your minds at the time of the price-setting.

SIMON ROBERTSON: Well, the only point I'd make is I think the words "compliant WACC" are the words that you've used. We've acknowledged that you have an input methodology on the weighted average cost of capital but you have also right through the process, through consultation on the Information Disclosure regime and the determinations, made it clear that this wasn't a form of de facto price control. We undertook a review of WACC from a first principle basis. With information that we had at the time we made the pricing decision. We were absolutely cognisant of the input methodology and the position of the Commerce Commission. We made it very clear where we did have departures from that and made it clear our reasons and rationale why, and our expectation is that the Commerce Commission has a look at that rationale and considers those on their merits.

COMMISSIONER DUIGNAN: Thanks. I think the relevance of the matter is simply that the way we would see it is we would start with our IM compliant analysis, then you have a different assets approach, a valuation approach, and you have a different WACC approach and that what one does then is to feed both those in and then see how the result compares. So, the importance of the question was really just to confirm that you did, you were in a position and had considered that you were able to consider that form of analysis, so that you could do the calculation using your parameters and see what that gave you, and then you could do it using, in effect, the ones the IMs indicate and consider the two so that we know that you in setting your prices were sort of informed about both sides, both approaches, and I think we've clarified that you were.

ADRIENNE DARLING: But perhaps if I might add, actually at the time at the forefront of our mind was submissions made by BARNZ to the Board and management, in that they made the assessment of the excess return and encouraged us to revise the pricing and the reference used in that was 8.04%.

COMMISSIONER DUIGNAN: Okay. Does BARNZ have any comment upon that discussion?

KRISTINA COOPER: I'm not sure if this is the right time or not to discuss the level of WACC and the range, or whether you've got a -

COMMISSIONER DUIGNAN: That's my next question, so I think we'll proceed. Great minds think alike. So, Auckland, your submission says your own estimate of WACC is based upon using an estimate that lies between the 75th and 85th percentile, so could you detail the reasons - I know you've indicated in a paragraph or two in your submission but this is an opportunity for you to give us a little bit more specifics and for us to ask about it - the reasons why it believes it's appropriate to go to a percentile which I think you suggest is around the 80% mark. So, could you please elaborate?

SIMON ROBERTSON: Yep. There was one main reason and another sub-reason for our position on the WACC range. The main reason was the fact that asymmetric risks were not included in the WACC parameters. The Commerce Commission's own work indicated also that that wasn't considered, and indicated that perhaps that could be taken into account in cash flows or by taking insurance to cover asymmetric risks. We did not include any asymmetric risks in the cash flows and getting insurance for unknown events is incredibly expensive. Therefore, how we suggested they be dealt with is with a modest change to the WACC parameters to account for those, and just also to clarify that while we worked on the range, at the end of the day we priced on a lower WACC ultimately than what was included in those ranges.

COMMISSIONER DUIGNAN: The term "asymmetrics" is probably being used here in two senses; there's the risk of error and then there's something, other types of risk, but the question for Auckland Airport, well maybe I'll in fact let BARNZ explain what your arguments are as to why the mid point WACC and not the 75th percentile provides the appropriate level of return, and then we can go back to hear Auckland's view on that.

DR LAYTON: First I would point out that in fact in the papers during consultation, Auckland Airport in their WACC did include another 1% for parameter estimates errors as well, so. The issue about whether you should do the 50% or 75%, or so forth, I think is really a question that one needs to consider two factors. I'm well aware the Commission uses a 75 when looking at some regulated situations in setting it, on the grounds that it is concerned that it may underestimate the WACC and that that may have a detrimental effect on the investment and key infrastructure and, as a consequence, may cause social costs which by having a higher WACC are avoided. I think that that needs, though, to be balanced from the fact that if the WACC is actually higher for infrastructural asset than is necessary to in fact bring forward the investments, there are social consequences also among the suppliers because they're having to pay it and at the margin, and we are talking here about the margin, they will be paying higher and there will be social costs as a result of them paying higher charges than are necessary to in fact bring forward the asset, and the real question that has to be weighed is are the social costs of charging customers higher amounts more costly to society than the social costs from the potential under-investment. I think it's hard to judge that question and for that reason I think the Commission's argument as to why it goes higher is not one that it should continue to pursue.

The second point, though, is when you come down specifically to the airports is that Auckland Airport has a very large part of its total revenue not related to the regulated activities, not related to the specified airport services that it provides but related to things like carparking, the provision of accommodation and so forth. So, I think there's - and they earn returns on those and indeed in some of those one would suggest that they're earning very substantial returns above what they would if they were in a workably competitive market, but that's another issue. And so they do have an incentive because what drives the demand for those other services, carparking and office space and hotel accommodation and that, around the airport is the passengers that are going through that airport. So, they have a strong incentive to, in fact, invest not only to get the return on the airport but also to get the return on those other ancillary services. So, the fear of under-investment I think is not a factor in this particular case. So, on those grounds I think the 50% is a better figure.

COMMISSIONER DUIGNAN: Well, I would like to give Auckland Airport the opportunity to respond to that. I mean my, just for what it's worth just to quickly paraphrase an aspect of the analysis presented is that in the case of airports and airlines, the consumer is interested in the overall product and that in fact the provision of that is split between two providers. So that the normal - I mean the argument but I'm not saying that we agree with it, but the argument would be that if you err or are concerned about an asymmetric consequence of erring on one side in regard to airports, then you run the risk that, taking the whole thing, the whole thing, that is airports and airlines, that you have reduced or not achieved the appropriate incentive for investment in the complementary service, namely flying. So, Auckland Airport, do you have any response because you have actually gone even higher than the 75%?

SIMON ROBERTSON: Just in response, I think for a start there's a level of precision assumed in that discussion around what the WACC is that I don't think is warranted. I think the debate around WACC would be a lot easier actually if you could actually say this is exactly what it is. We can't and so therefore it is always an estimate, is the 50th the best estimate of WACC. We don't know what the actual WACC is. So, you know, that's part of the reason as well for the 75th percentile.

I guess I'm a bit interested in Dr Layton's comments with regards to carparks and hotels, and suggesting that they don't operate in a competitive industry. We have 12 carpark competitors around the airport, in fact one of them is sitting here at the table themselves. We also, you know, it belies my logic to understand that we don't compete in the hotel market either for guests in the hotels. So, I am not quite sure what he's actually referring to.

I also don't quite understand when you've got an investment, say, in Taxiway Lima where you're dealing with the efficiency of the airport airline operations, how that has somehow relation to carparking income. I think they're tenuous at best. The DTB refurbishment currently underway is all about actually the aeronautical investment and the increase in aircraft size in the domestic terminal, and making sure that we can cope with the implications that that has had on our business. But I think maybe to also just add comment, it may be appropriate to ask our expert advisor whether they have any further comments on this particular matter with regards to Alastair Marsden from -

ALASTAIR MARSDEN: Yes, I think it's just important to clarify that the WACC range, as far as I understand it, reflects asymmetry of social consequences which you discussed. Just to clarify though, the question of asymmetric risks, which are the risks of such events like SARS or terror attacks, particularly type 1 asymmetric risks, and other sort of frictions or model error, in my view that's something that becomes an additional increment to the WACC in this case because, as Simon mentioned, my understanding is that those risks are not built into the expected cash flows under the building blocks model. So from then a practical alternative is to add this additional increment to the WACC. So, in my view in terms of where the Commission considers Auckland Airport's WACC within its final IM WACC range, it also needs to recognise that asymmetric risks should be part of that sort of overall consideration.

COMMISSIONER DUIGNAN: Is there any further, other comments on this specific 75th/85th percentile.

JOHN WHITTAKER: Sorry, Air New Zealand would like to make some comments. Firstly, in the reasons paper the Commission itself said in section 11.2 in the reasons paper that in the case of airports for Information Disclosure the Commission considers appropriate to take a range between the 25th and the 75th percentiles in assessing profitability for the airports an appropriate starting point for air assessment is the 50th percentile, the mid-point on the range. So, we think the Commission has actually made quite a strong statement about this itself.

Then later I think in 13.5 when having considered their mid-point at that time, the Commission concluded on balance the Commission considers the information supports the conclusion that the IM, being that mid-point, produces reasonable and commercially realistic estimates of the post tax WACCs for the regulated services of airports.

So, we think the reasons paper had some quite strong statements about the mid-point being appropriate.

COMMISSIONER DUIGNAN: Okay.

JOHN WHITTAKER: Secondly, in relation to the asymmetric risks two points we would like to make. Firstly, the risk, the first asymmetric risk mentioned can be mitigated by repricing during the five year period. So, the airports actually have the ability to reprice during the period. I think in the expert opinion on the appropriate WACC, the expert noted that Auckland Airport had that opportunity but had indicated to the expert that it had a preference not to do it, therefore it had built the asymmetric risk into the WACC but it does have that ability should the asymmetry risk actually occur.

COMMISSIONER DUIGNAN: Thanks.

JOHN WHITTAKER: Sorry, there was just one more, while on the asymmetry of the social consequences is that, I'm not an expert in this by any stretch but it seems to me that the approach of pricing extra into the WACC to possibly avoid the consequences of under-investment, which is mostly likely under-investment in capacity and therefore the outcome of that is most likely to be higher prices because there is a shortfall of supply, so it does seem somewhat illogical to me to ask customers to pay more to avoid the possible risk of paying more should there be a shortfall of capacity.

COMMISSIONER DUIGNAN: We could discuss this at greater length but I think we've aired is sufficiently so I would just like to move on now to the question of the intention to introduce new charges relating to a new domestic terminal, if and when it is completed, part way through the pricing period. So, this as I see it is a technical matter. The question is, what is the appropriate way to take this into account in assessing the profitability of Auckland Airport, including what WACC, kind of, would be applied given that situation of a new price potentially being introduced part way through the pricing period. There's a number of kind of technical complications which arise in this area and I don't want us to sort of spend too much time on it but I want to provide an opportunity to get a view now and thereby to allow you to address it in cross-submissions.

So, could I start with Auckland. How do you feel that provision should be addressed in an assessment of your profitability? Should it be left to one side on the basis that you will earn the return on it appropriate when it's built, is that the best way of doing it, or should it be brought into the analysis in some way? So, it's quite a simple question if you see it in those terms.

SIMON ROBERTSON: Yeah, I would agree. At this stage in the process of consultation over what the actual solution is, we do not have the detail of what that would cost other than general sort of statements, and at this stage we haven't consulted fully with all parties other than engaging with the most relevant parties on the two best alternatives. Without having the actual investment required or the timing of that investment required, I think it would be incredibly difficult to make assumptions also around the price. I might suggest that the best way is to exclude it actually at this stage in the process.

COMMISSIONER DUIGNAN: BARNZ, do you agree?

KRISTINA COOPER: Yes.

COMMISSIONER DUIGNAN: Okay. Does anyone else have any other view on that? Okay. I mean, the point just being that if one party felt that in fact, yeah, there was something special.

I'll move on now to what is in fact a major issue which has been mentioned earlier. So, I would like to discuss the value of the assets or the valuation to be used in analysis as regards the closing value for PSE2 and the opening value for PSE3, the basis of the assumption to be applied in analysing the internal rate of return.

So, our understanding is the following, that Auckland Airport declared a moratorium for ten years in 2007 and in the latest price-setting event and in submissions to us has declined to provide - and it's a question - any indication as to, or any guidance in which could be a basis for an analyst objectively deciding what valuation to use.

So, my first question to Auckland Airport is what valuation options will you consider when setting prices for PSE3?

SIMON ROBERTSON: The challenge is you're asking me to look into the future and predict what's going to happen, say, through the 56G review process, through 53B annual reviews, through the merits appeal decision, through other regulatory precedent that might occur between now and 2017. I don't know what might happen in all of those instances. We have a current position of a moratorium on our asset values. We're very interested to see what occurs over the next few years and we will keep an open mind about how we resolve what occurs in 2017. We would suggest that the best starting point position would be the moratorium asset value at the end of PSE2 because we would always recognise that if there is a move away from that, we would have to do so in a principled way, and do so through consultation.

COMMISSIONER DUIGNAN: I'll pose several questions to Auckland regard to elaborate on this and clarify the position or what is available, and then open it to other questions, or other parties.

I can't resist the observation that what you've just said to us carries the implication that the process that Parliament put in place to put a framework regarding issues relevant to airline, so airport charges, you have actually suggested that that process is a reason for your not being able to do what you did in 2007 where you gave the airlines a ten year certainty. So, I do want to press you on the point, that it is, to say it sounds paradoxical, that all of the work that the Commission has done at Parliament's behest to define input methodologies in your eyes has made it less possible for you to do what you were able to do in 2007 before part 4 existed where you were prepared to give a statement of the position for the next ten years.

SIMON ROBERTSON: I would agree, it is a paradox. In 2007 the moratorium was put in place subject to there being no change in regulation. During the 2011-2012 pricing period, notwithstanding that we believed that there had been quite some changes in the regulatory environment in New Zealand, the airlines very strongly submitted that they would like the moratorium to continue. We understood their issues, we understood where they were coming from and we elected to maintain the moratorium to 2017, but to suggest that the regulatory precedent for asset valuations and the assessment of profitability of airports that might take a different view, is absolutely critical to how we might think about what we do in 2017.

COMMISSIONER DUIGNAN: Well, I then come back to the question of, are you able to give any indication of the appropriate assumption that should be made by somebody who's undertaking this analysis?

SIMON ROBERTSON: I would reiterate what I said before, that the best assumption today is the moratorium closing value because what we would do, if there was, and not suggesting there is because we haven't made any decisions, I haven't even had to consider the issue in detail and, as I also said, there would be a lot of other points between now and 2017, but if there was a change we would do so in a principled way.

COMMISSIONER DUIGNAN: So if I can, in order just to get all the issues on the table as opposed to going to asking the response of other parties, I think it is best to tease this out. Two aspects, you referred to "in a principled way" so I would have to then say, I would interpret the concept of principles applied to this issue as being that you would take or you would assure consistency between your valuation approach and your decisions regarding the treatment of valuation gains for the purposes of profitability analysis. So, to me, when you speak of a principled approach, that would be the relevant principle. So, could you indicate to us, is that what you mean by a principled approach or do you have something far more vague in your calculation.

SIMON ROBERTSON: I think the question being economically principled is exactly what I'm referring to. The issue that you have referred to is revaluation gains. I don't think we could say that there would be revaluation gains when there was no assumptions of revaluations. I think what we'd be dealing with is a change in the asset base.

COMMISSIONER DUIGNAN: Sorry, we are talking about valuation, we're not talking about, you know, whether the northern runway is completed, we're talking about the issue is valuation so I'm afraid I just don't understand. I mean, if you've got a change in a valuation base, you have a change or revaluation gain or loss. I mean the two things logically are, they can't be separated. So, the issue of the treatment of that revaluation gain if you change the, away from a moratorium, a moratorium of course is constant but anything else produces a valuation gain or loss under any methodology, the issue is when you speak of a "principled approach" do you mean that your approach to the revaluation gain would be consistent with the IMs for example?

SIMON ROBERTSON: Could very well be an outcome that's consistent with the IMs or the IMs as they potentially might get changed between now and 2017.

COMMISSIONER DUIGNAN: Thanks. My final question to you at this stage before inviting other comments is that Auckland Airport has argued in the High Court in the IM appeals that market value existing use is materially better than indexed historic cost, and presumably by implication than the moratorium. So, what implications should we take out of that assertion to the High Court, that it is a view of Auckland Airport that MVEU is materially better? It does appear to have an implication, I'm asking you for your comment upon the matter.

SIMON ROBERTSON: I think our view would be described as the Commerce Commission at the start of the IM process had an opportunity to look at asset values from the start and we think that the most principled way on an economic basis is to think about the replacement cost value of those assets and MVEU as the entrant of a new party to establish the equivalent airport. That being said, we acknowledge that we've got AAA pricing consultation obligations. We do take those very seriously. We enter those consultations with a complete open mind and so far has resulted in an outcome that's a moratorium because we're based on MVAU, because we're prepared to hear and listen to the views expressed by our customers that approach to consultation won't change.

COMMISSIONER DUIGNAN: I'll invite other parties to give us any response addressed to the statements that have been made.

KRISTINA COOPER: Thank you. There seems to have been three topics that have been covered; what are the potential range of options for pricing for the asset base in 2017; how should revaluations, if any, be treated at that time; and, the merits or otherwise of using MVEU.

So, turning first to those options for pricing in FY17, seems to BARNZ to be very clear that there's three options that the Airport would have in front of it.

First, as they have noted is continuation of the 2006 moratorium. Now, that could either be on an indexed or unindexed basis. Obviously if indexed, the revaluations, BARNZ would expect them to be treated as income for the purposes of pricing.

The second option that I would see as being before the Airport is to apply the input methodology regulatory asset base. Of course then you've got the issue of needing to treat those revaluations as income because there's been no forecast revaluations for the previous ten year period and there needs to be consistency between pricing and the asset base as you make that change.

And the third option is for there to be a new MVEU valuation of the land and a new ODRC revaluation of specialised assets.

Now, that was Auckland Airport's opening position in this present consultation and there's a document, which I'm sure the Commission has access to, 14 September 2011 was where the Airport set that out to the airlines. It's also the position the airport argued for through several years of the input methodology development process; it is the position the Airport is putting forward in the merits review process; and, finally, that is also the basis on which the Airport has undertaken its financial reporting valuations. So, I don't think that can be taken off the table. It is very clearly an option before the Airport and is seen by the fact that Wellington Airport priced in that manner. It is an option that is open to the Airport under the current regulatory regime and there is nothing in the Airport Authorities Act to stop the Airport moving to price at that very high level. Obviously BARNZ would be strenuously arguing against it during consultation.

Now, the reason that BARNZ argued so strongly for the continuation of thee moratorium at this stage was because when the Airport came out in this 14 September letter with proposing its preliminary view to move to MVEU and a new ODRC valuation, was that the Airport stated that its position was it would only include forecast revaluations on an income perspective basis. So, in other words, all the uplift from the moratorium to the new MVEU valuation and the new ODRC valuation was on the Airport's initial approach to be retained by the Airport.

COMMISSIONER DUIGNAN: Right, could - have we -

KRISTINA COOPER: Virtually, do you want to comment on MVEU?

DR LAYTON: I have nothing more to add that hasn't already been said.

COMMISSIONER DUIGNAN: Thanks, I will come back to -

SIMON ROBERTSON: We have nothing else to add, thank you.

COMMISSIONER DUIGNAN: Auckland Airport, could I ask then whether you felt - I mean, you've referred to the question that if the decision's made it would be done on a principled basis. Are we to take it that the proposition that you put to the airlines, which was, as we read, it's been aired here, to revalue the assets but not take the revaluation gain into account, conforms to your view of what would be a principled basis, and therefore is it that a - I mean, that is the one indication we have from your actual written behaviour, that plus the submissions in the High Court, are sort of an indication, or could be taken as an indication, subject to your comments today, of your view and therefore the approach you might consider taking given that you're not able to give us any other indication?

SIMON ROBERTSON: I'm not sure of the question. Can you repeat that again Pat sorry?

COMMISSIONER DUIGNAN: The question is whether the approach that was tabled in the negotiations was, in your view, an approach that you would consider principled and therefore a possible approach that you would take in the PSE3 negotiations?

SIMON ROBERTSON: I would have to go back and look at that. I can't recall it so I'd have to go back and look at the context in which it was written.

COMMISSIONER DUIGNAN: Well, we'll look forward to your cross-submission on the point because it obviously is, in as much as we're trying to understand how to evaluate the different possible options, then those two matters that I've referred to are specifics where Auckland Airport has stated a view regarding a possible way of approaching this issue. And so they carry some weight in our considerations which we're providing you with an opportunity to modify.

SIMON ROBERTSON: I would just clarify that, I guess ultimately the test on us is what we decide during consultation. We put a lot of ideas during the consultation process actually, the evidence before us now is on what we actually decided was to continue the moratorium on values and to continue with MVAU.

COMMISSIONER DUIGNAN: Yes. Well, the context being that you had said that you would have a ten year moratorium unless you invoked the require - or the qualification regarding regulation.

I think we can move on from here except to provide an opportunity for Auckland Airport to just comment upon the following matter, which is that you have actually indicated that you consider part 4, the introduction of Part 4 regulation of airports has by some process required you to provide less certainty to your customers regarding the future pricing than was the case in 2007, and although it is sort of a specific matter, if the Commission in considering as it is the effectiveness of part 4 regulation, the implication of that is paradoxically that you have advised us that part 4 regulation has resulted in your not being able to provide as much certainty regarding valuations than you did in 2007. I just wanted to get a final comment upon that because it is certainly rather a paradoxical situation. It also is to say the last paradoxical that whereas the Commission often hears regulated entities calling for greater certainty, in this case you're saying that regulation forces you to not, or prevents you from offering certainty of the type you did previously. These are all matters for you to comment on rather than - I'm putting them as propositions, not as fixed conclusions.

SIMON ROBERTSON: I think we need to go back to 2007 to consider some of the reasons and rationale for the moratorium. Back in 2007 we'd just experienced quite an unprecedent period of asset revaluations, in particular with reference to land, changes in asset values that weren't expected at the beginning of that price-setting event. That became a pretty vexed issue between airlines and airports at that particular point in time.

Equally, there was at that time a view that maybe regulatory precedent, particularly out of Australia, was heading to a line-in-the-sand type approach. So, in 2007 we were mindful of the big issue that was in front of us on the table and mindful of perhaps some regulatory precedent. As it turned out, the Commerce Commission had some chances to talk about Information Disclosure and for airports maybe to disclose how they went through asset valuations, but the outcome is one that is a bit more prescriptive in terms of what it means for Information Disclosure, therefore we have to follow the IMs for Information Disclosure and that provides a difference between what was a fairly largely settled issue between airlines and Auckland Airport. So, in this case the change by giving a prescriptive way for how it has to be done under the Information Disclosure in this case has created greater uncertainty for Auckland Airport and how we would be judged over time with regards to the assessment of profits.

COMMISSIONER DUIGNAN: Thank you. I want now just to wrap up with a set of more technical questions. Essentially the issue is in regard to actually applying the IMs as regards valuation. So, the first question is to provide an opportunity either here or in cross-submissions for you to indicate what CPI rate, forecast CPI rate you would consider should be used in applying the IMs where necessarily you are involved in rolling forward an asset base. So, very quickly, is there any comment here that any of the experts wish to offer? Okay. If we could, though, note that as an item we're interested in, in the submissions.

Secondly, very quickly, given that you've not indexed the asset base an IRR analysis based upon the unindexed approach, which is of course the type of IRR analysis that has been undertaken. I just wanted both parties to have the opportunity of expressing their view as to the role that should play in the analysis. In other words, we will be doing the IM compliant analysis. There is this other analysis based upon the constant base. I just provide Auckland and the other parties an opportunity to give us any views on the role it plays. (Pause). Okay, that's fine -

ADRIENNE DARLING: Perhaps could you clarify what you intend when you say, does that involve an opening base, you know, what's the reference asset base for that constant analysis?

COMMISSIONER DUIGNAN: Well, that would be that we take as the opening base the valuation, the fixed constant moratorium valuation that you are using, and so it was really just a let's put it for cross-submissions because I can recognise it's not a question you were expecting, that we would be interested in any views as to what role you think that should play in our analysis. I mean, the obvious answer being that we will do a fully IM compliant analysis and we're just saying this is an alternative. If anyone wishes to advocate that we should put some weight upon it, we'd be interested to hear that argument.

DR LAYTON: Yes. I think some reflection on what the task of the Commission is may be useful in this context because the task of the Commission is really to decide whether the Information Disclosure is meeting the purpose of Information Disclosure, which is incentivising essentially parties to meet the obligations including excessive profits. So, you really do need to look at what are the possibilities under the current regime that are realistic for them in terms of their returns, and in this case one of the possibilities, that Kristina has outlined, is going from the moratorium which really was just a decision to adopt historic cost, unindexed historic cost, that's all it was, because new assets got added at their cost so it wasn't a locking of the asset base, it was just an adoption of historic cost. To go from that in 2007 to all the way to 2017 and then add the valuations, I think it is a relevant factor for you to consider because a forecast of what those revaluations may be and the revaluations that may come about by them changing the concept from MVAU to MVEU and by adopting an ODRC rather than an index base is actually very relevant for working out what is the potential returns they could have earned over the period from when they set the moratorium, and hence is this regulatory regime constraining their ability to earn excessive profits and remembering that the AAA allows them to set charges as they see fit.

COMMISSIONER DUIGNAN: Thank you. Right, any further on that? No. Then I just want to briefly cover with Air New Zealand the southern, BARNZ has submitted that the southern airport restricted land should not be included in the asset base used to set prices as it's considered that this land is not required to be held by the airport and it is not used for the purpose of providing specified services. Does Air New Zealand agree with that, and then I'll offer Auckland Airport the opportunity to comment upon that southern air field restricted land briefly.

SEAN FORD: Air New Zealand has got the same view as BARNZ in respect of that.

COMMISSIONER DUIGNAN: Thank you. Auckland, just on that issue of, that particular technical issue regarding that piece of land, if you have any view?

SIMON ROBERTSON: The approach land on the southern runway, we believe that the ownership of that provides significant benefit to the airlines by being able to control its use and therefore have less issues with regards to other owners and their potential use of that land. At the end of the day, a pretty minor cost.

COMMISSIONER DUIGNAN: Right. So, we've heard the views on that and in cross-submissions you can elaborate on them. I think that's all we need to cover on that.

Then we come to the final question which is that - sorry, there's one technical question later but just the second to final then, regarding the alternative land use plan used by Auckland Airport to determine its market value alternative use. BARNZ has raised concerns that there is, "An extraordinarily high level of retail and commercial use".

Now, we've read the papers and the additional support that Auckland Airport has provided but could I ask whether we have a qualification of the difference between the two assumptions which in fact I should really ask BARNZ, is there a concrete estimate of what your view would imply, or your experts -

KRISTINA COOPER: Yes, I should qualify I'm not a valuer, not an expert. In discussing it with them I think from memory it's something like 36 hectares of land that would need to move from commercial use into the mixed housing, and that would then have consequential flow-on effects with respect to the timing or absorption period for the sell-down of all the sites.

COMMISSIONER DUIGNAN: And well, I'll just invite you to give us some indication, but not in a highly technical sense, of what you think the difference would be. I recognise that Auckland Airport has brought with it the experts on this topic. Just because of the pressures of time I think we have those views already, so I don't think there's a need to canvass the matter in that respect but I'll allow Auckland to offer any thoughts.

SIMON ROBERTSON: Happy to do so in the cross-submission stage.

COMMISSIONER DUIGNAN: Yes, thank you. Final question to Auckland is that, to the extent that our analysis may, and I stress may, conclude that Auckland has earned a return above our assessment of WACC, does Auckland have any explanation as to why that is appropriate in terms of superior performance? So, I invite you to offer us any view you have as regards any justification if - and it is a conditional question by definition - if the conclusion of the analysis was that a return above a normal return was being earned.

SIMON ROBERTSON: In terms of the pricing consultation process it's not our intent to earn more than a fair return on the assets. I think the debate here is what is the fair return on the assets. That being said, if we step back from that, if there was such a conclusion I would also hope that the Commerce Commission looked at the broader aspects of the purpose statement to assess whether there were trade-offs within there in terms of quality, innovation et cetera.

COMMISSIONER DUIGNAN: Thank you. I think that concludes this session unless there is some matter that any party feels that we've missed and then I'll invite staff briefly to indicate any questions they have. Staff, do you -

JO PERRY: Yes, I believe we have a few follow-up questions. Paolo, would you like to -

PAOLO RYAN: Yes, Paolo Ryan for the Commission. We talked about the opening asset value that might be used in our IRR analysis. I just want to put the question to Auckland Airport, Air New Zealand and BARNZ, as to if that IRR analysis is being done over the five year PSE2 pricing period, what the appropriate opening value were we to apply an IM compliant asset base, would that be an indexed value or an unindexed roll-forward of the 2009 regulatory asset base?

CHARLES SPILLANE: Sorry, can you ask that again?

PAOLO RYAN: Sorry, just to be clear, in the analysis of Wellington Airport and the five year pricing period, we used an indexed opening regulatory asset base as the benchmark. In this case obviously we have the situation of no indexation, and the question is, therefore, what the appropriate reference regulatory asset base would be for analysis over the same period in respect of Auckland Airport?

CHARLES SPILLANE: Opening in which pricing period?

PAOLO RYAN: For the five year pricing period.

ADRIENNE DARLING: I think we'll need to come back in cross-submissions on that.

PAOLO RYAN: Yeah, that's fine. Just one other question in relation to the WACC margin. I note the cautionary comment by Auckland Airport in respect of the assumed precision around this but Dr Layton observed that there was a 1% parameter estimate for model error in the consultation on WACC which itself, I guess, would suggest a degree of precision in this respect. In the discussion on the 75th to the 85th percentile, Dr Marsden stated that it was appropriate to include an increment for model error and the question is, is in that 75th to 85th percentile range I would just like to clarify what, if any, part of that relates to the risk of model error and what part relates to other types of asymmetric risk?

SIMON ROBERTSON: Paolo, just to clarify, I'm not sure where Dr Layton was referring to his 1%, it certainly wasn't in our final decision, it was part of the discussion papers I believe prior to a final decision being made.

The difference between the 75th and the 85th percentile was to account for asymmetric risks and model error, so the two of those are together, but I'm not sure how relevant all of that is when we actually priced on a lower value, lower WACC number than that again.

PAOLO RYAN: Simply trying to get at what, in that final WACC that you actually used for pricing purposes, the margin that you applied; to what extent that actually includes a specific increment for model error?

ADRIENNE DARLING: It wasn't disaggregated and the effect of return targeted in the aeronautical pricing was 8.47% which was not returning a full return on WACC.

PAOLO RYAN: Thank you.

JO PERRY: We just have one final question, sorry, Jo Perry for the Commission. Auckland Airport stated its substantial customers have a full understanding of its performance given the comprehensive consultation process. I guess we were just looking at Air New Zealand, BARNZ, whether they feel that they agree this is the case, that there is a full understanding of Auckland Airport's performance and whether Information Disclosure has provided any assistance in understanding Auckland Airport's performance, or whether their understanding would have been the same under the existing consultation process; whether IDs had any additional impact, I guess.

KRISTINA COOPER: The understanding which BARNZ has relates to the pricing asset base and we have largely a full understanding there but, as I think has been drawn out in the discussions on trying to undertake an analysis on the input methodologies, we don't possess a full understanding of that break down, which was simply because consultation was focusing on the moratorium asset base.

COMMISSIONER DUIGNAN: Thank you. Chair, I'll hand back to you.

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ASSOCIATE COMMISSIONER WELSON: If we could move to innovation next, please. This should hopefully be a reasonably short session, I don't have too many questions. So, our review of the effectiveness of Information Disclosure regulation at Auckland Airport will assess whether the level of innovation at Auckland Airport is appropriate and whether the Information Disclosure regulation has had any impact on innovation. So based on the submissions that we've received so far, the airlines consider that innovation at Auckland Airport is appropriate. Furthermore, Auckland Airport is perceived as being receptive to airline innovation. Cargo terminal operators, however, have raised some concerns about Auckland Airport's innovation activity and my first question was very much around the issue raised by New Zealand Air Cargo Council. Again, they're not here but noting that they will be reviewing the transcript I will read out the question that I have and invite comment from them.

The New Zealand Air Cargo Council submission states that from a cargo perspective there is little or no innovation at Auckland Airport. We would ask that they provide us with some specific examples of where they consider that Auckland Airport has not innovated appropriately or has not been receptive to innovations by the cargo terminal operators.

My next question was for Auckland Airport - I was going to say, you're welcome to comment on that as well so if you would like to do that now.

CHARLES SPILLANE: I would like to comment just briefly and to reiterate our offer for the Commissioners to come up and see the facility to put this into context, because one issue is where the scope for innovation actually lies. We do work hard to seek to help our customers run their businesses efficiently. The layout of the cargo precinct, as we call it, is something that has been in place for a long time and is subject to historic decisions about where things would most sensibly be.

You might be interested to know that the existing domestic terminal was once the cargo shed and it then got turned into the international terminal and then got turned into a domestic terminal. So, change happens over a long period of time in this sort of area. The next sensible time for change is through our current master planning process during which we'll be making the decision about where the next most sensible place for establishment of domestic terminal facilities should be, be that in the south or in the north of the airport. That's a big decision and one which the tail should not be wagging the dog. The two CTO operators have their very significant operations in the southern area and just exactly how that will work with Checkpoint Charlie, as I mentioned, is crucial to this.

ASSOCIATE COMMISSIONER WELSON: Thank you, and I understand that's related to the quality issue but we are particularly interested to hear if there's particular innovation concerns around the whole location area as well.

CHARLES SPILLANE: Yep. I mean what we're talking about is the allocation of a very scarce resource for the dollies to be towed to the aircraft and things that drive off it are the location of the CTO facilities themselves. Now, they're built and established, quite hard to move, so innovation in this instance isn't something that can happen overnight.

JOHN WHITTAKER: We would support Auckland Airport that this is a complex issue and that they are consulting with us about it, so.

ASSOCIATE COMMISSIONER WELSON: Thank you. BARNZ?

KRISTINA COOPER: Yes, I think the word "disenfranchised" was used previously and I think, speaking with the cargo people yesterday, they are feeling a little bit left out of discussions about, you know, the future location of the terminal and how that is going to affect cargo. So, I mean, I think it's good that this is being aired. I think Auckland Airport is aware of the need to engage with this group of customers now and I just would again support Auckland Airport, they can't make a decision on a secure access for the cargo route until decisions have been made regarding the new terminal facility.

ASSOCIATE COMMISSIONER WELSON: Thank you. Andy?

ANDY NICHOLLS: I was just thinking of this dynamic of parties putting in a submission and then not being here to answer questions and what that means potentially is when we see their answers after we've made cross-submissions, I was wondering if you could ask them to get their submissions in say a week earlier than cross-submissions are due, or something, so we can see what they're saying.

CHAIR: I was actually thinking through that very issue. That we actually haven't faced this situation before of a party not being present to answer questions, and my sort of indicative thinking was to perhaps, depending on what answers come back to these questions from the Airport Cargo Council, my instincts would be to give Auckland Airport a chance to put a further response in just to that. So, let's just see how it plays out. We're very much in the hands of Air Cargo Council as to what they will do in response to these questions but on the assumption they put their answers in by the due date, I think we just have to rethink exactly whether we may give Auckland Airport or any other interested party a chance to respond to that as if it was a slight rehash of a, you know, cross-submission round. So, look, let's just park that but we are mindful of it.

ASSOCIATE COMMISSIONER WELSON: Then the last question is addressed to Auckland Airport around your approach to innovation and how that has been affected by Information Disclosure. If you could comment on that please and provide us with any examples of the impact of Information Disclosure on your approach to innovation.

SIMON ROBERTSON: What we would try and do at Auckland Airport is ensure that innovation actually is a key part of how we think about our business. Back in 2008-9 when we reassessed our strategy, innovation was a key part of how we would deliver many of the changes. It's again hard to see which comes first and how that ultimately gets influenced. What I would say is that our business drivers support innovation, our business drivers support the fact that if we can think of ways to improve passenger processing it does two things; it increases the passenger experience because they have a better quality experience through faster throughput; and, second of all, it can in some instances delay the requirement for otherwise delivering an infrastructure solution. So, clearly we've seen that with the introduction, say, of Smart Gate on arrivals and departures, increasing the throughput and therefore out in future years delaying a need to expand it with infrastructure build. So, what I would suggest is that there's a core business driver actually in the business which helps support innovation and we're always open to new ideas on how to deliver on that.

ASSOCIATE COMMISSIONER WELSON: Thank you. Is there any comment from the airlines?

JOHN WHITTAKER: So I think we would agree that Auckland Airport does innovate and has generally supported us implement the innovations that we wish to implement as well. As to whether that's a result of Information Disclosure, I think they were innovative prior to Information Disclosure regime and they've remained innovative since. So, I couldn't say Information Disclosure has had any effect on that but that they are innovators.

ASSOCIATE COMMISSIONER WELSON: Thank you.

NEIL COCHRANE: If I could add a comment on that. Neil Cochrane, Christchurch Airport. When you're looking at major capital investment, particularly for terminal redevelopment, that takes some years to go through the planning feasibility and so on. If we look at our new terminal now, that started in 2003 and has been progressively developed with the airlines and so on, and as part of the way through that we've seen a change in business model with the entry of low-cost carriers. So, Information Disclosure has influenced the near term but when you look at major infrastructure investment it takes a long period of time and particularly bringing in efficiency in innovation. So, a lot of this stuff taken in our situation happened long before information disclosure came along.

ASSOCIATE COMMISSIONER WELSON: Right, thank you. I'll just check with - oh, sorry, was there one other comment?

ADRIENNE DARLING: Perhaps if we were to try and celebrate some of the successes of Information Disclosure. I do believe that there's greater transparency around outcomes and in relation to innovation and the other limbs of the purpose statement, and, you know, I think that I've received feedback from some of the airlines, that they weren't aware of some of the sort of grass roots initiatives we might be doing that actually result in better outcomes at the airport. A very basic example of that might be the Jackal grass on the runway. So, there are small things that we do that we don't necessarily celebrate and information disclosure has provided a vehicle for that.

CHARLES SPILLANE: Another very material example is the Lean process methodology we ran on the arrivals processing which saw the average time for arrival processing of international passengers reduce from around about 45 minutes to around about 18 minutes. Now, what that does for a delay of what would otherwise have been necessary capital expansion, through everyone at the airport working together is very material, in my estimation, and that's another one of the projects that the people involved in it know about but it's only through the Information Disclosure regime that we really tell other people, because actually we're busy getting on with the next improvement process rather than telling people about the one we've just done. So, ID works in that example.

ASSOCIATE COMMISSIONER WELSON: All right, thank you. Any questions from staff? No. I think the next one is investment.

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COMMISSIONER DUIGNAN: We now turn to the question of whether Auckland Airport invests efficiently and whether part 4 information disclosure has been effective in promoting this.

The submissions we've received so far in regard to the first pricing period raised concerns or historically reported concerns with the timing and level of capex in that pricing period, particularly in relation to the second runway. In contrast, capital expenditure in the second pricing period, the one just settled, is considered reasonable and the prioritising process adopted by Auckland Airport has been praised by BARNZ and Air New Zealand. So, I'll start with Air New Zealand and BARNZ. What process took place that led to this positive outcome for capex, and your view on the role that part 4 Information Disclosure played in achieving that?

KRISTINA COOPER: When airports sat down at the beginning of consultation effectively with a wish list of all possible projects that could take place over the next five to ten years and asked for airline views on which projects were seen as most important and which should happen first, which could be deferred, were there any alternatives, and it was a very constructive process. We had several meetings where the airport, all operators were invited, including those not participating in the consultation process, to hear about the projects and give the airport their feedback. We also arranged for Menzies, which is the second ground-handling agent at Auckland Airport, to come to a consultation meeting to also provide their feedback. And examples of what occurred during that process, for example there was debate over the timing for constructing additional contact stands in Pier B and through an exchange process it was determined that actually the more efficient next step would be to construct ground boarding from Pier B to utilise the hard stands that are directly adjacent to the terminal thereby keeping bussing operations down. So, that was how the process worked which we thought was very good and very constructive. Was it as a result of Information Disclosure? I'm not entirely sure. I would possibly call it just a maturation and continuation of Auckland Airport's commitment to conduct consultation in a constructive process.

SEAN FORD: I'll just add that also following the formal consultation process I think the airport is to be commended for the way it is establishing a sort of ongoing review process to look at priorities as we're going through, forecast versus actuals, and is there a need to reprioritise. Again, in terms of is that a result of ID? Questionable. To some extent it's a return to past practice which has sort of fallen by the wayside there for a little while. It reflects best practice at other airports around the world, which we get involved in, so, yeah, is ID the basis for it? Uncertain.

COMMISSIONER DUIGNAN: Given the pressure of time I'll move on. First of all, on the basis of what we've heard it's appropriate to conclude that the airlines and BARNZ are confident that the capex projects Auckland forecasts will be applied in a timely and efficient way, will be implemented in a timely and efficient way, and that the forecasts reflect an efficient level of investment. So, just really I think you've pretty much indicated this but just to confirm.

KRISTINA COOPER: Yes to the second question, and the first question on will they be undertaken at the time committed to, we're confident that either they will be or that Auckland Airport will have engaged with users through the process that Sean mentioned and that there would be a constructive sort of collaborative decision to either bring something forward or to defer it.

COMMISSIONER DUIGNAN: Apart from basking in the praise you've just heard, does Auckland Airport have any other aspect to add to that? We'll move on to something else in a minute.

SIMON ROBERTSON: Just quickly, two points. First of all information disclosure around the price-setting event was quite explicit in terms of the detail around capital expenditure. That was a key part to how we thought we would be looking at disclose and then formed a key basis for how we described each of these potential capex opportunities and pass those through to the substantial customers as part of pricing. So, I would say, actually, that Information Disclosure was very helpful in providing a framework for us to go through that process.

The second point I would raise is actually, forecasts, I think we've got a consensus here that based on the information we had in May 2012 best, looking forward, we think we've got the capex about right. Future events, future demand changes, both positive and negative, future regulatory issues on, say, safety or security could change those capex orders and priorities and quantities. The one thing we know is that the actuals will not be the same as the forecast but I think we can say that we made a good attempt to try and get the best assumptions at the time pricing was made.

COMMISSIONER DUIGNAN: That leads to the next question which is that in PSE1 some of the forecast capex did not occur as projects were delayed or occurred later in the period of forecast. Now, leaving aside the domestic terminal, you've made special provision for that, if a project is delayed or cancelled in the second pricing period do you have any plans to reflect that delay or cancellation in prices?

SIMON ROBERTSON: We have not agreed a wash-up mechanism for the capital expenditure. There's all sorts of reasons why capital expenditure might be different. I think what you're suggesting in a case potentially of it being down, not up, you know, what are the implications, there might be reasons that the capital expenditure is down because of, say, demand. So, how do you wash-up something where you've got another side of the equation which is going in the opposite direction, I think, we open into the dialogue with our customers on what is the best way to manage in front of us and we make those forecasts and continue our dialogue with our customers to try and get the best outcomes as we keep moving forward.

COMMISSIONER DUIGNAN: Thanks, I'll move on. If you want to address that right at the end, that would be fine. But our next question was addressed to Qantas, or rather an issue that Qantas has raised, namely expressing concern that the domestic terminal upgrade has been given a five year depreciation profile when it occurs, recognising it's a contingent project.

Qantas have expressed concern about the five year depreciation profile. We'll just note in the record that we would appreciate from Qantas clarification as to whether the fact that you would, that Auckland Airport is going to have a discrete wash-up on the investment charge, the extent to which that would satisfy them.

But I for the moment wanted to ask Air New Zealand and BARNZ, do you have any concerns with the depreciation that would arise from the 29 million current estimate, domestic terminal upgrade, resulting from the five year term? I mean, I think the point that's being argued is that the depreciation period seemed short.

KRISTINA COOPER: During consultation I think from memory it was actually increased to a six year period, I was just checking.

COMMISSIONER DUIGNAN: Right.

KRISTINA COOPER: I seem to recall as well that the airport indicated that if the terminal, if those works ended up having a longer life, then it would wash that up as it reset charges for the terminal future, and provided that's done appropriately I think that's satisfactory.

SEAN FORD: That's our understanding as well and we're comfortable with that position.

COMMISSIONER DUIGNAN: Well, I think we'll ask through the transcript for, whether, taking into account those comments, Qantas does have a continuing issue or whether it was more a reflection of something that was on the table but may have been sorted.

CHARLES SPILLANE: If I could, I just wanted to clarify because I wasn't sure when you were putting the question, but you seem to be joining the bolt-on mechanism that we had talked about in the consultation process with this issue, which is actually a separate issue and I just wanted to make sure that you had that clear in your mind as well.

COMMISSIONER DUIGNAN: Well, if you could clarify that in the submission. I think if you look at what Qantas has said, we'll take into account what we've heard, it's really probably something that, by the sound of it, is resolved if everybody just states their understanding.

CHARLES SPILLANE: They're two separate projects but economically it will wash-out.

COMMISSIONER DUIGNAN: Yep. Right. I want to just very quickly deal with some sort of issues regarding how noise mitigation costs have been allowed for in the past and in the future. First, the cross-submission on the process and issues paper, which is some time ago, stated that - this is Auckland Airport's submission - that noise mitigation costs in PSE1 were associated with consent for the northern runway and were capitalised. Can you confirm there was no opex associated with noise mitigation activities in the opex numbers reported for PSE1, so, the PSE1 doesn't have noise mitigation in its opex?

ADRIENNE DARLING: There is a point of detail there. There is a noise trust in the order of $250,000 per annum and it was agreed in consultation that that would be included in opex in PSE1 and that practice should have continued in PSE2.

COMMISSIONER DUIGNAN: Right, so if we could just get that then just so we know the position regarding PSE1. And then in regard to the capex forecast for PSE2, our understanding is that there's no noise mitigation costs in that because there's no further work on the northern runway forecast for PSE2. So, we just want to clarify, does that mean that all noise mitigation costs in Auckland is directly associated and linked to the future of the northern runway and that there's no element of noise mitigation in other elements of the forecast, just for clarity. We're not saying whether there should or shouldn't be. So, you can regard it as a technical question that you answer in your cross-submissions but we would appreciate -

KRISTINA COOPER: If I could just state BARNZ' position, we don't accept that the noise mitigation costs are directly associated with the second runway.

COMMISSIONER DUIGNAN: Okay.

KRISTINA COOPER: They are specifically required in the District Plan. It states the development or use of any runway is subject to compliance with the noise mitigation programme, and when you have a look at the plans and see where the houses are that have had the insulation work done on them, it is because they are in what's called the high aircraft noise area, the HANA, or the medium aircraft noise area, the MANA, of current operations on the current runway. It's not in respect of the northern runway or future aircraft which aren't there.

So, to be very clear, BARNZ have no objection to the work being undertaken, have no objection to paying for it at an efficient, at a reasonable cost of capital, but we do not agree that it's associated with the northern runway, we don't believe it's an asset held for future use, and we consider it should be in the current asset base on which charges are currently being paid.

Now, unfortunately, during consultation there was a little bit of disconnect between the pricing model which excluded it but the written material the airport provided BARNZ with which indicated it was included, so we did not pick up this discrepancy during consultation.

COMMISSIONER DUIGNAN: So, could Auckland clarify for the Commission, then, the extent to which noise mitigation costs are occurring and the treatment of them, so we do know how they've ended up being treated.

ADRIENNE DARLING: We can and we can confirm the quantum of capex which was excluded with pricing associated with those noise costs in cross-submission.

COMMISSIONER DUIGNAN: Thank you. Now, final question on this, just in time. The submissions have praised the consultation - we've partly covered this right at the outset but the submissions have indeed praised the consultation process that Auckland Airport adopted to prioritise capital for PSE2, and that's been further acknowledged here.

So, our question for Auckland is, if I can put it this way, the extent to which that change, which as it's clearly being indicated it's felt to be a change from previous practice, Auckland might not necessarily see it that way but that is clearly how the airlines have felt it to turn out, and so we're interested as obviously our objective is the impact that Information Disclosure has had on the Auckland Airport's conduct of that process.

SIMON ROBERTSON: I made the point -

COMMISSIONER DUIGNAN: I realise you asked the question but just as a wrap up.

SIMON ROBERTSON: Yeah, I made the point earlier that, you know, I acknowledge points raised by BARNZ and Air New

Zealand there, but we do believe that the price-setting disclosure requirements around capital expenditure provided a really sound framework for engagement during the consultation process on capital expenditure.

COMMISSIONER DUIGNAN: Thank you. Staff, do you have any? No. Chair.

CHAIR: Okay, well look, that brings this morning's session to a close. We're back at 1 o'clock, thank you.

(Conference adjourned from 12.09 p.m. until 1.02 p.m.)

CHAIR: Okay, I assume we're ready to start now for the afternoon session so I'll hand over to Sue Begg to lead questions on efficiency and opex.

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DEPUTY CHAIR BEGG: Thanks, Mark. Just starting, then, on operating efficiency. We've had submissions on the question of whether Auckland Airport's improving its operating efficiency and there have been a few concerns that have been highlighted, particularly with the increase in opex per passenger during PSE1, and particularly in the last few years of that period. One concern that airlines have expressed is the inclusion of marketing and route development activities in the opex forecast in the merits review cost.

I just wanted to start with Air New Zealand and BARNZ, and ask whether aside from the marketing costs and the merits review costs do you consider that Auckland Airport's opex is efficient, and why; if that's correct, why you've come to that conclusion?

KRISTINA COOPER: On a per passenger basis the pricing opex has increased by around $1 over the last pricing period per passenger. Given the amount of, sort of, cost lines Auckland Airport has we don't tend to focus on those individual levels of granularity during consultation. We're more focusing on the per passenger unit. I think, no, there are concerns still just over the magnitude of that increase.

DEPUTY CHAIR BEGG: And so it's ended up in the base opex for the period going forward; so that's the concern, is it?

KRISTINA COOPER: Absolutely. It's that it's started off from a high base. I mean, over the five years of the pricing period, costs of forecasts have stayed relatively flat or the airport see it's declining in real terms but it's that major uplift that happened in FY9 and FY11. FY11 will be, I guess, attributable to the marketing costs but there was still significant uplift prior to that period.

DEPUTY CHAIR BEGG: Did Air New Zealand want to add anything to that?

SEAN FORD: No, I think that characterises it quite nicely. In terms of going forward in PSE2, yeah, with the exception of obviously the two items you mentioned, the opex appears to be reasonable, seems to be reasonable control. I guess the one issue is that starting point.

DEPUTY CHAIR BEGG: Just then asking Auckland, was there anything in particular in the base year other than those marketing costs that might have led to the base year being higher than what it had been earlier in the PSE1?

SIMON ROBERTSON: Two other aspects I think that warrant increases that weren't expected potentially, is rates increases, first of all much earlier in the process rectifying an error where no rates were allocated actually to aeronautical activities previously. So, we fixed that. And then the second aspect was clearly the costs of regulation, we didn't anticipate them but they have been substantial.

DEPUTY CHAIR BEGG: And so in your base year, I know the airlines expressed concerns about the merits reviews' costs being in the forecasts and they put that value at about 4 million. Are they in the base year or is that something you've forecast over time to be included?

SIMON ROBERTSON: They were forecast for the price-setting period coming up because the regulatory merits appeal costs were minor prior to 1 July.

DEPUTY CHAIR BEGG: I'd appreciate if people could just speak up a little bit. I'm just having a bit of trouble hearing, thanks. Okay, just then on the marketing costs I wonder if you would just mind describing exactly what that money's been spent on, it wasn't a hundred percent clear to me exactly what that provided for?

SIMON ROBERTSON: Marketing and promotions expenditure goes to trying to grow passenger volumes in markets and in routes, both new and existing.

DEPUTY CHAIR BEGG: But how, is that money you spend on, I think in fact it says somewhere you don't offer discounts but this is just marketing expenditure, advertising the airport, or what exactly is involved?

SIMON ROBERTSON: Yeah, correct. So, in the case specifically, say, of new routes where an airline might be expanding or entering into a new market, a not uncommon approach amongst airlines is to offer some form of discounts during the start-up period of that particular service to assist in them growing it up to be sustainable. Our approach is not to do that. We think it is much better to ensure even if the same value is on the table, that it is directed towards growing the market that specifically you wish to grow. So, in those instances we would work with the airline concerned to tie into their marketing programmes and assist those programmes directly with marketing support.

CHARLES SPILLANE: It has an added benefit of, in a country as small as New Zealand with limited resources to put into these sorts of activities it also enables us instead of us just discounting the charges but to leverage that investment with other tourist-focused bodies, such as Tourism New Zealand, and the regional tourism bodies. So, the investment has that much greater benefit than it would have if it was simply taken off the costs line.

DEPUTY CHAIR BEGG: I would be interested also in your views on how you assess the effectiveness of that expenditure in terms of demand because obviously you've got a with-and-without problem, what would demand be without the expenditure/what would it be with the expenditure. How confident are you that you're making that estimate accurately, I mean how do you go about it and what sort of - give us an idea of the numbers there, if you can?

SIMON ROBERTSON: Individual arrangements are specific to individual carriers so I can't go into any details, as I'm sure you can understand, but the overall principle in most cases is that it's actually tied towards, the marketing support is tied towards the growth in outcomes. So, if there's no growth, then we'll look at not supporting the marketing campaign, because in most instances the marketing campaign has led by the airline.

DEPUTY CHAIR BEGG: So, you're saying that the marketing is targeted to particular entities so you can measure reasonably readily whether they respond to your marketing, and so therefore you're getting the with and without, or?

SIMON ROBERTSON: In many cases it might be focused on a market and so you can measure the performance of that market to see whether it has achieved the growth that you would expect.

DEPUTY CHAIR BEGG: And when you're trying to persuade the airlines that they should be paying for the marketing, what sort of information do you provide to them in terms of, you know, how it's going to result in increased demand and how that's through economies of scale, I presume, is going to reduce their costs; do you provide anything specific on that?

SIMON ROBERTSON: We had some discussions through the price consultation on this issue. The challenge for us is how do you give evidence of that without providing insight into an individual airline. We're very confident, actually, that the marketing that we've undertaken in recent years has grown the market and that we've got higher passenger volumes than we would otherwise have had. Second of all, the first pricing event did not actually include that marketing expenditure, so the opening volumes that have been achieved to date has, in effect, had a free carry from airlines who have benefitted from the higher opening volume base than would otherwise be the case.

DEPUTY CHAIR BEGG: And are you confident that there are economies of scale that can be realised through increasing throughput, given that you're becoming constrained on your runway and you're having to build new terminals et cetera; how do you factor that in?

SIMON ROBERTSON: The short answer to that is, yes. I mean, we've talked publically now about the northern runway being more like a middle of next decade than any time soon and we will continue to work with all parties, airlines, airways, ourselves, to try and grow the capacity on the existing infrastructure as much as possible. The current issues that we have at domestic, that's an area of our business that doesn't receive a lot of marketing support. At an average fare of $4.50 per passenger it's very difficult actually to make the economics work in providing marketing expenditure when that's the level of the sort of average per passenger charge for all domestic services. So, it tends to be focused on international. International has greater scope to incrementalise capacity increases also through innovation, through using better passenger processing tools et cetera. So, that's not an immediate concern of ours.

Adrienne has just reminded me, too, that a lot of the growth, and then we look at markets today in the world what we'll see is a very sharply declining European-sourced markets and a significantly growing source of Asian and trans-Tasman travel. One of the benefits, I suppose, of a growing Asian market is they tend to arrive and depart off-peak filling in the gaps, which also assists with ensuring that it doesn't bring forward significant amounts of capital expenditure.

DEPUTY CHAIR BEGG: I'll just then ask BARNZ and then Air New Zealand whether you're generally happy with the airport's forecasts of demand and the amount that's attributable, the growth that's attributable to these marketing initiatives?

KRISTINA COOPER: With respect to demand, BARNZ is generally happy. I mean we had for completeness a small difference with the airport on forecast international passengers in the first year. A year down track it would seem the airport was more correct than BARNZ. On the other hand, the airports, the actual domestic results which the airport has just announced were double what the airport had forecast, so demand is about right.

In terms of the inclusion of route development costs, in a word no, we're not happy. This is something new that's come up since the last pricing period, so BARNZ had to give considerable thought to it and what we did is essentially consider route development costs in two parts. The first is a general development that grows the markets, generally the market's a destination overseas and is available for use or benefits any number of carriers, and for that expenditure BARNZ felt that it benefitted both the airlines and the commercial side of the business, therefore it needed to be shared proportionately between the aeronautical side and the non-aeronautical because it grew both businesses. So it took a little while but by the end of consultation Auckland Airport's Board accepted that. The other half of the route development costs are those that are destination specific that only benefit that particular airline flying to that destination and BARNZ does not think that those costs should be included in the pricing asset base because you've got airlines that are not benefitting from those costs that are being charged for them and as the key RK principle, the airline should only be charged for services and facilities that they use.

Now, in our submission we commented, I asked her about this and they weren't aware of any airport overseas that was charging for these costs. Now, subsequently to that we've actually come across a decision by the Brussels Regulatory Service and that airport is now, I think, being partly managed by Macquarie and they had tried to include these route development costs in their cost base, and the regulatory regime in Brussels is it goes to the regulator to review the decision and then tick it off or not, and that regulator said that those commercial incentives to support airlines in their start-up will further development, allocated 100% to regulated activities which implies that the commercial advantages of some airlines are being paid by all airlines, and they corrected it to allocate that cost to 100% non-regulated. So, those individual airline specific costs BARNZ does not think should be in the cost base.

DEPUTY CHAIR BEGG: And how much of the total is the amount that you don't think you should be paying for approximately?

KRISTINA COOPER: I'll need to come back in cross-submissions because that is one of the two confidential matters.

DEPUTY CHAIR BEGG: Okay, no problem.

KRISTINA COOPER: But we will.

SEAN FORD: And similarly from Air New Zealand's perspective, I think, as we said in our submission, we're generally comfortable with the demand forecasts that were used in respect to pricing. I guess the issue there is that Auckland is saying that the non-speculative marketing costs have been included and the demand associated with those are in the costs base but the speculative stuff is out. I guess similarly to BARNZ, our view is that any sort of marketing costs which are specific to an airline should not be paid for by other airlines.

SIMON ROBERTSON: Just like to clarify. First of all, route development is available to all airlines. So, it is available should someone wish to share their growth ambitions with us, and if we're supportive of that then we'll participate alongside them. So, it's not purely selective.

Second of all, in the price-setting event we excluded all of that marketing costs that was associated with potential new route development in the period and, therefore, were quite clear and explicit that the demand forecast also excluded any unknown potential new entrants of any new carriers during the period. So, we have excluded the volume and been consistent and excluded the costs.

ADRIENNE DARLING: Perhaps if I might clarify, the only routes-specific costs which are included in the PSE2 is the tail end of commitments made and all of the volumes associated with those commitments are included in baseline volumes.

DEPUTY CHAIR BEGG: So any other points?

JOHN WHITTAKER: So, I just think in terms of marketing, those route specific marketing costs, the reference for us is back to a workably competitive market and in a workably competitive market it seems highly unlikely to us that a new entrant would receive an incentive payment which was not for the incumbents, especially when that is shifting demand often, either directly or indirectly, off incumbents. So, in a workably competitive market the largest volume player would normally get the greatest series of incentives. This seems to be not an outcome which is consistent with workably competitive markets.

SIMON ROBERTSON: With all due respect, I'd disagree. I think I see it every day at the supermarket actually when I go in and the supermarket supplier have launched a campaign to grow a new product and it's not related - it might be selling different brands of the same product equally on the shelves, so it is actually relatively common for trade marketing to occur. I do find it slightly ironic to be sitting in front of the Commerce Commission defending us trying to grow markets and provide greater choice for the consumer and provide better connections globally for New Zealand.

DEPUTY CHAIR BEGG: I don't think anyone is objecting to Auckland doing that, I think they're objecting to who pays the costs of the marketing that achieves that. So, any other thoughts? If not, one thing I was interested in, which is quite a different matter, is in the submissions Auckland notes that its insurance costs are lower now than they were in 2006 which is quite an impressive achievement given what's been happening in the insurance market. I'd just be interested in hearing a little bit more about how you achieved this. As I understand it, it's through collaboration with some of the Australian airports but to the extent that you're able to share what you've done there I would be interested to hear about it.

CHARLES SPILLANE: On one hand I don't want people to know because they might get the idea to do it as well, but what we did is with a number of Australian airports, and this relates primarily to the aviation policies which is of course most relevant to aeronautical pricing, we banded together with a number of Australian airports, second and third tier airports, so not Sydney, Melbourne or Brisbane, to buy together insurance in London. When I say "buy together" actually we go up together and market it but we don't - because we each have a different sort of risk experience, we don't actually have the same premium but we do have the same policy and we market to the underwriters together. All of this insurance is sold out of London. On the property side of the insurance portfolio we managed to secure a long-term insurance agreement which we've managed to get the underwriter not to terminate following the Christchurch earthquakes through the nature of our relationship with them.

DEPUTY CHAIR BEGG: Okay. Just one question that goes to the asymmetric risk questions that were earlier in the period, about the cost of capital, not the investment concern but compensating for uninsured events et cetera et cetera. I just wondered if you're able, maybe can't do this in an open session but I just wondered to what extent are you not insured? What's insured and what's not? Where are you self-insuring that might, say, justify these arguments we've heard about asymmetric risk? So, how much risk is the airport itself taking in terms of these sort of catastrophic events or major events?

CHARLES SPILLANE: That is a very complicated question, actually, and I think it would be best for us to come back to you in cross-submissions, and it goes to limits and exactly what the policy covers which is actually very technical and may not be that helpful in the final analysis, but we'll come back to you on it.

DEPUTY CHAIR BEGG: Yeah, even if we can just get a sense of how much is insured and not - for example, in the lines businesses they can't get insurance for the cables so there's a whole, you know, big part of their asset base is not insured and I'm really just trying to get a feel for how exposed the airports are to those risks.

CHARLES SPILLANE: Right, I understand the question.

DEPUTY CHAIR BEGG: Okay, thank you. Just then a question for Air New Zealand and BARNZ, and really that is, in terms of operating expenditure how constructive have you found the consultation to be? Were you able to effectively engage? And, has there been any improvement in the consultation this period compared with the previous in terms of operating expenditure? And then, if there has, is it related at all to Information Disclosure?

KRISTINA COOPER: I think in the case of Auckland Airport operating expenditure is difficult to engage on unless the airlines - unless (a) the airport was prepared to open its books to this instance and the airlines were prepared to send somebody in to go through line-by-line. So I think engagement on opex is probably, is more limited than any of the other areas and I don't think there's been any material change between the first and second pricing event in that area.

SEAN FORD: I think that's probably correct in the sense that in terms of the consultation process it's not our job to micro-manage the business of the airport, they're very good at doing that themselves. Again, from a consultation perspective Auckland has always been very good at it and so to the extent that we have sort of transparency over what's there, that really hasn't changed. There's obviously some changes to the categories that were, that things were classified under as a result of ID. Whether that's provided better or similar levels of transparency, I guess, is sort of open to question.

KRISTINA COOPER: If I can add, Sean has just jogged my memory that of course with, that one of the consequences of the removal of the TSC agreement is now that there's going to be substantially less transparency over operating costs in the air side area of the international terminal because previously under that agreement every year there was a review for the previous year, a wash-up, there was a forecast for the next year and the airport would actually specifically engage with airlines on matters such as the level of busing operations, whether new buses were required or not, whether, how long engineers should be on-call for servicing the air bridges, et cetera, which really enabled airlines to make, you know, very clear price quality trade-offs in that area. So, I think one of the consequences of the removal of the TSC is less transparency and trade-off ability on that air side terminal opex.

DEPUTY CHAIR BEGG: Okay. Just had a final question on opex and this is for all parties, actually, but I'll start with Auckland and the question I have here is whether the ID requirements have reduced consultation costs? We hear, of course, that IDs involve significant extra costs and we see the merits reviews involving costs but through some of your submissions we get suggestions, for example, from Auckland that the consultation process regarding the second PSE was significantly shorter and more constructive than the previous consultation processes. So, I just wondered if you're able to provide some quantification of that. I note that Air New Zealand on the other hand said that information disclosure had no impact on the effectiveness and scope of consultation other than for the allocation of roading costs. But just in terms of what Auckland's view is, I just wondered if you had any, you know, you could put a number on what you'd saved through the process, if anything?

SIMON ROBERTSON: As a party to certainly the 11 and 12, I certainly have a perspective on that. While I was at Auckland Airport in 2007 I must admit to personally not being a direct party to that consultation process, but being at Auckland Airport I can say that the process in 2011 and 12 was much more streamlined, happened with a lot of consensus in a lot of areas relatively quickly. I think we've still got some areas of debate, I acknowledge that, most notably around WACC and most notably around potentially today the understanding of the moratorium issue as well, but actually a lot of others, there was a lot of commonality; capital expenditure, demand forecasts, notwithstanding that subsequently some further additional services which weren't known at the time of pricing have come in on domestic but at the time of pricing that was our best estimate. So, cost allocation, depreciation lives, I think there was not a lot of issues raised compared to what was there previously, but I could certainly defer to Adrienne on that.

ADRIENNE DARLING: I would concur that I believe that there's a better process because we have transitioned to the Information Disclosure language so we now speak a common language on, many things are centered around the IMs, so I think that's where we see the real outcome in terms of cost allocation, the matter at hand. There was an advisor that we used for PSE1 and we debated various cost allocation methodologies but at the close of that process we came to the agreement to have some more transparent rules and those have flown through into PSE2. So, there has been some cost saving there but it's not material. I think the material difference is in the process and where we've, between airlines and airports, had slightly less time dedicated to elements of the consultation.

CHARLES SPILLANE: Kristina, Sean and I are the only ones who have lived through both consultations. Brent flittered in and out when his expertise was required by BARNZ, and I can tell you that the second consultation was a much more efficient process than the first one and conducted in a much more positive spirit. I'm convinced that it's at least partly due to the existence of the new regulation along with the different approach taken by all parties to the consultation.

I've also noticed what I think is quite an interesting dynamic where in your roles you're seeking to identify where the regulation is making a difference and I'm hearing different perspectives about whether it has or not, and I wonder if some of that is because we didn't start from a position of being absolutely terrible in all of these things. So, if you're starting point is one which is actually relatively high in terms of the consultation process that we followed under the Airport Authorities Act, the room for improvement is not that sort of scale but rather fine-tuning, and as one of the few people who has been through both processes I'm convinced that it has served to improve the situation and provided for greater transparency in the processes that are adopted in conducting it.

DEPUTY CHAIR BEGG: Any other comments on that?

KRISTINA COOPER: Yeah, I think part of the reason for improvement in terms of timeframe and effort between the first and second pricing period as well is that the second price-setting event built on what was achieved during the first price-setting event, and that shouldn't be underestimated; things like the moratorium, we took forward the vast bulk of the cost allocations that were worked through in some detail in the first price-setting event, so, I mean there was efficiencies that were able to be enjoyed there.

SEAN FORD: Yeah, I concur with that, in terms that I think, yeah, the second PSE reflects the process that we went through in terms of the first PSE to a large extent in terms of resolving a lot of those matters that, well, resolving to the extent of getting to a better understanding of the way to take them forward. I guess the highlight just sort of looking when you reflect on the linkage between ID and the performance in the second PSE is just to look at, well, we're still some way apart it appears in respect of the asset valuation approach and the appropriate level of return. You can make your own conclusions there as to the extent to which it's informed the process.

DEPUTY CHAIR BEGG: Okay, I'll just check with staff? No further questions there. Okay, then we'll just quickly move on to sharing efficiency gains just as part of this question.

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Now, Auckland basically in their submissions have said that they have passed on efficiency gains whereas the airlines express some doubts. This first question I have, I think I've got the answer which is, can you confirm that the forecast opex for PSE2 used 2012 opex as the base year and just what adjustments did you make to that base year? So, we've discussed a bit of this already but just can I confirm that that's what you've done, you've used the 2012 base year and what adjustments happened?

SIMON ROBERTSON: Yes, the 2012 budget of the organisation was used at the start of the process and then updated with a forecast during consultation to try and get as accurate picture of where we thought that would close out for 2012. Adrienne is whispering in my ear telling me, and we removed the one-off costs incurred with the Rugby World Cup from that base year.

DEPUTY CHAIR BEGG: I just wonder if the staff had any particular issue here?

ISOBEL OXLEY: Isobel Oxley for the Commerce Commission. How much were the Rugby World Cup costs in 2012?

ADRIENNE DARLING: We'll come back in cross-submissions if we can.

ISOBEL OXLEY: Okay, thanks.

DEPUTY CHAIR BEGG: And just then a final question on that, has Information Disclosure had any impact on whether you share efficiency gains?

SIMON ROBERTSON: I think to the extent that there's a lot more transparency in all aspects of allocation methodologies et cetera and pricing outcomes, that there is more transparency in the result of the sharing of efficiency gains.

KRISTINA COOPER: The clear example of where economies of scope really have been achieved or a change from the input methodologies was the allocation of roads. I don't know - yes, you'll remember there was a significant debate during the development of input methodologies about roading allocation, it had been a vexed issue in PSE1 where the airport was allocating 90-95% of the main roads to aeronautical under A-Cam and they've moved to sharing that between aeronautical and commercial in a more appropriate manner. A change going the other way which hasn't yet been fully worked through is that with the removal of the terminal services charge agreement the airport is now retaining all of the benefit of advertising on walls and doors and ceilings and floors in the international terminal building. Now, previously under the TSC agreement that was taken into account by the valuers when they set the market rate. So, we now have a situation where the airlines are paying for the building structure cost but the airport is treating that advertising revenue on the walls of that building as retail revenue.

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DEPUTY CHAIR BEGG: Okay, any further questions? We'll turn then to pricing efficiency. So, in this session we're going look at whether Auckland Airport's pricing methodology results in prices that improve efficiency and we're specifically concerned about improvements in allocative and dynamic efficiency. Now, there's been some quite significant changes to the pricing methodologies for PSE2 and submissions consider that some of the changes better promote efficiency but some have concerns about some of the changes and I note, of course, that the airlines don't necessarily agree amongst themselves on some of the changes that have been made. But I've got a few questions here I would like to explore to understand whether the pricing methodology in the second period better promotes efficiency than in the first.

But first of all I would like to just ask Auckland why have you made changes to the pricing methodology? I think in your submission you suggest in part that was because of the requirement in Information Disclosure to transparently outline the pricing methodology. Was that part of what prompted the change and were there other reasons why you've moved to make some changes?

SIMON ROBERTSON: That was a very clear part of the process, was to disclose in the price-setting event the rationale and methodology between the pricing and pricing efficiency. That caused us to engage very early in the process and seeking expert assistance on pricing efficiency concerns and enabled us to incorporate that into the consultation process.

DEPUTY CHAIR BEGG: So any - BARNZ got any thoughts on whether ID had any effect or what prompted the changes in pricing efficiency and your engagement?

KRISTINA COOPER: No. I mean, the airport just, yes, put papers forward and considered changes and really we just responded to them.

DEPUTY CHAIR BEGG: So one of the pricing principles is that prices should be subsidy free and I just note that the airlines raise concerns about the cost drivers late in the price-setting process and raise concerns about cross-subsidisation of aircraft under 40 macto by larger aircraft. I just wonder if there's been any update, really, in the information that people have as to whether there is a cross-subsidy there between the larger and the smaller aircraft? I guess I'll ask Auckland and then BARNZ or Air New Zealand.

SIMON ROBERTSON: The issue of where the particular price breaks occur through weight of aircraft was raised late in the consultation process, which we acknowledged and said that we will address it for the next price-setting event. So, our intention is to incorporate that into the consideration set for 2017. I wouldn't jump to the conclusion that just because it wasn't reviewed, somehow the conclusion must be that larger aircraft are subsidising smaller aircraft. I would be very loathed actually to do that. In fact, my default position as an industry expert but without doing the analysis would be that smaller aircraft use a shorter part of the runway, they don't need the full length, they're incredibly lighter so the damage on the runway is mainly - you know, the 777 is a very hard aircraft on the runway compared to smaller aircraft. So, I wouldn't assume that the outcome is potentially the subsidy that, subsidy from larger to smaller. It could be the other way, if there is one at all.

DEPUTY CHAIR BEGG: And so Air New Zealand might take a different view to BARNZ on this one?

SEAN FORD: I think that's fair to say, yeah. To be fair, I think BARNZ was just saying it's an issue that perhaps needed to be looked at and I think from our perspective and we noted in our responses to Auckland Airport that it may well be the other way round. I think as Simon has noted, it's an incredibly complex issue and does take really a long long time to work through to get it right.

KRISTINA COOPER: I mean, for the airlines which BARNZ is representing who are predominantly the international carriers who don't have domestic operations in New Zealand, this is a key issue. Just anecdotally, when I was presenting to those airlines outlining the analysis that we had undertaken for, on the airport's pricing proposal and all that information which I find very interesting, and most people don't, so they were texting, they were noting, they were reading other things, and I came to, right, we'll look at the domestic terminal and they sat up and all of a sudden I had everybody looking at me. This is what their head offices wanted to know. Are the international charges subsidising the domestic ones? And so we put a great deal of work into looking at the domestic terminal charge and were able to satisfy those airlines that the proposed new charge by the airport meant that the domestic terminal charges would be meeting, or with the direct costs there. We weren't able to do the same thing for the air field and the airports noted it was raised late. Well, it wasn't actually raised late, I mean perhaps they didn't cotton on to the issue or didn't appreciate the issue until late, but when the initial, at the very beginning of consultation the airport had put out a paper by Estina Consulting and Estina had recommended that the Macto curve be reviewed, and so those BARNZ airlines were waiting for the outcome of that review and thought it would be looking at the Macto curve and the weight breaks. Well, it didn't so at that point, in the BARNZ response which was in March, that was when we first raised this specifically and said, well, if that hadn't happened it needs to happen next time because it has to be acknowledged. It is an extremely complex issue, by that point it was too late now for PSE2. Now whether which way it goes in terms of the cross-subsidy, I'm not an expert, but again would just note that the aircraft under 30 tonnes are representing 40% of the landings at Auckland Airport. Now, if you're looking at a new runway in the next 20 years it's got to be relevant that a particular category of aircraft is contributing that much of the use or representing that much of the use, and those aircraft represent 8% of the macto but only 5% of the revenue for the air field, yet it's 44% of the landing slots. So, it's a complex issue but I think everyone acknowledges, albeit probably not happily, but they acknowledge it needs to be addressed next time.

SIMON ROBERTSON: Just to clarify on the review of the curve, we did address the anomaly of different charging rates for different weight breaks in this period. So that is where we didn't focus immediately on amending that curve.

KRISTINA COOPER: Yes, but I mean the anomaly that was fixed is that international jets were paying a rate that was lower than domestic jets, and there was no justification for that. Perhaps the more strategic approach from the international airlines could have been to say that they would not accept the international rates going up unless the lower rates did too. So, I mean, that particular fix cost the international airlines, but to their credit they accepted that was appropriate and didn't object to it.

DEPUTY CHAIR BEGG: Okay, thank you. I note that Auckland Airport's consultant, Estina, represented that separate charges be introduced for long-haul and short-haul international flights, and for trunk and regional domestic flights and to reflect differences in costs or demand elasticity for these passengers, and we've perhaps touched on some of these elements before but Auckland submitted that this recommendation was opposed by the airlines. So, I just wondered if you'd mind just providing a bit of background as to why that was rejected.

SEAN FORD: From Air New Zealand's perspective I think "opposed" is possibly a little bit too strong. I think what we said was the approach that is normally taken is in respect of just understanding what sort of costs each of those different customer groups are actually driving into the operation of the airport in terms of asset requirements, et cetera et cetera. In terms of the domestic split, the airport itself did actually undertake an analysis, because we did raise the issue of whether it was appropriate to have a single, the same charge for all domestic passengers or whether there should be a variation between turbo prop versus jet customers. The airport did an analysis which suggested that the costs arising out of both of those groups of customers was effectively the same so therefore there was no real rationale for making a differentiation between it.

In terms of looking at the international side of things and differentiating on a long-haul/short-haul basis, I guess the response there was based on needing, the airport needed to have a much greater depth of understanding of what the actual make-up of the various customer groups in those different elements was because in terms of a long-haul passenger you're going to have some that are sort of premium and are paying a lot and therefore the demand impact of paying more at the airport is going to be less, whereas you've also got a lot of people that are travelling on much smaller fares, therefore the response is going to be different.

Another issue that arose in there is actually determining who is a short haul customer and who is a long-haul customer. That's quite simple to do in terms of looking at okay, an aircraft sector length, but when you're looking at a lot of the operations out of Auckland, if you're looking at Tasman customers a lot of those are actually connecting on to, either on the same aircraft on to a longer journey outwards or they're actually transferring from one aircraft to another without actually landing in an Australian airport. So, are they a short-haul customer or are they a long-haul customer? So, again, it's a complex issue that needs more analysis than simply saying, well okay, you're travelling to Australia, therefore you're short-haul, you're travelling to North America, therefore you're a long-haul.

KRISTINA COOPER: And the other thing is that the international security requirements and processing requirements are exactly the same. You go through Customs, you go through MAF, you go through Asec, whether you're going to Australia or whether you're flying on to Argentina or Chile.

DEPUTY CHAIR BEGG: Just then perhaps asking Auckland, I mean part of this debate is whether the prices should be based on cost or whether demand elasticity should be taken into account. I think the argument for long-haul is a demand elasticity rather than a cost factor. I just wonder to what extent you did take into account demand elasticity? Is that part of the explanation for why the terminal charges for international are higher than for domestic? Obviously costs differ between those as well but is that partly what's explaining that?

SIMON ROBERTSON: Just to clarify Kristina's point, I do think larger aircraft provide peak air movements which put more pressure on infrastructure. So generally, actually, a long-haul customer would drive higher costs but I absolutely acknowledge the point Sean made, which is quite, absolutely valid, and certainly when he made it in consultation, is that how do you distinguish between customers when their first sector flight might actually be shorter, and the complications of trying to do that were difficult considering from a costs basis.

With regards to pricing elasticity and was that taken into account in our pricing decision, the answer to that is, yes. First of all, we wanted to ensure that there was no cross-subsidisation between, say, the domestic and international, but also we are very conscious that in doing so there was a little bit of rebalancing of some charges from previous and we wanted to ensure that we had as least impact on consumer demand that we could. So, it was very much a consideration set. We're not sure to the extent airport charges do affect price elasticity, I think the jury is still out actually on that, but while there was debate about it we wanted to err on the side of caution in terms of impacting demand.

CHARLES SPILLANE: And that's particularly the case in a market where you see low-cost carriers playing a bigger - actually "low cost carrier" is not the right term because we have carriers who play in different parts of the market. So, in a market as complicated as this, which is changing before our eyes, we didn't want to take action which might unsettle the development in the market that was actually happening. So, as Simon has indicated, from a conservative point of view we wanted to make as little impact in the market dynamics as we could.

ADRIENNE DARLING: Perhaps just to clarify that, it was our expectation at the time of pricing that there was very real risk of reduction of domestic services as a result of the pricing, we were not expecting the price war which has eventuated.

DEPUTY CHAIR BEGG: Just turning then to congestion charging. We note that Auckland Airport hasn't proposed introducing congestion charges for runway use and it's not necessary yet they submit, and note that in the submissions you say that maybe that will be considered if there isn't support for the second runway but at the moment it seems that the proposal would be to invest in the second runway rather than manage peak demand using congestion charges, slot management or other mechanisms, and I just wondered whether your conclusion is that it's more efficient to invest before the airport gets congested, or is it better to manage congestion for some period and then proceed with the second runway, I just wonder what your current views are on that at the moment?

SIMON ROBERTSON: Our current views is to stay very close to the industry on solutions to maximise the use of the existing runway, that's through airlines and airways processes and procedures and hence why we thought it was too early at this stage, but we're open to try and resolve the best use of an asset and send the right price signals but doing so at the appropriate time.

DEPUTY CHAIR BEGG: So, just given some of the forecasts it looks like in some scenarios the runway would become congested before the second runway was built and what will you do when that happens, what's the current thinking?

SIMON ROBERTSON: I think, then, you must be assuming we have a set date for when the runway is occurring. We don't, we have a range. So, we've given, at this stage our best estimate is 2025 plus or minus three years. Now, that estimate can change as circumstances and market developments change, new demand, new entrants could change that dynamic as well as changes to efficiencies. So, it's an estimate of the future and will be changed depending on circumstances going forward.

DEPUTY CHAIR BEGG: Just then turning to the airlines, it sounds like it's up to you whether you would rather have congestion charging or the second runway built. I would just be interested in your views.

JOHN WHITTAKER: So, I think we're open to the most economically efficient way of dealing with the issues. So, we have already set about, for example, upgrading our 737 aircraft to A 320 aircraft which have 40 more seats on the aircraft. That pushes out the requirement for a second runway and is probably the most economically efficient way of dealing with that, neither via a congestion charge nor second runway. So, we do work closely with both the airport and airways to look at where there is possible congestion and what is the best way to deal with that. At some point it will undoubtedly be a second runway and we're committed to keeping to work with the airport as to what that time is and when the best time to make that investment is.

KRISTINA COOPER: From the perspective of the BARNZ airlines they wholeheartedly encourage the airport to continue to maximise utilisation of the current runway and just optimise capacity as long as possible before building the new runway, you know, when delays exist and when it is required. We see the use of congestion charging as being part of a toolbox which is available to the airport to do that, not necessarily as the first step. I mean, we would see voluntary discussions with airlines to see if there can be voluntary schedule changes, would be the first step. I mean, there's collaboration with airways on more efficient use of air space. Techniques such as there can be modifications to taxiways, to have high speed exits, et cetera, to really improve the throughput on the runway. You could perhaps have incentives to encourage airlines to move out of the peak, and then you might look at congestion pricing but we completely agree with Auckland Airport and Air New Zealand, now is not the time for that, but the preference would be certainly to use that prior to prematurely constructing a very lumpy piece of infrastructure.

DEPUTY CHAIR BEGG: In terms of terminals, the same sort of -

KRISTINA COOPER: Well, the terminal, apart from the new terminal facility for domestic, the terminal infrastructure is able to happen in a much more manageable step to fashion, yep, through the incremental addition of gates and through sort of ground boarding facilities, additional use of busing operations, so don't actually see the need for congestion pricing in the terminal.

DEPUTY CHAIR BEGG: Okay, thank you. Any further comments?

KRISTINA COOPER: I think Brent had something to say.

DR LAYTON: One of the other issues that the parties and BARNZ I know is aware of is, when and if congestion charging comes about, is making sure this doesn't add to the overall return of the airport rather than altering the use and the efficiency of the use of the airport. So, that will be a matter that will have to be sorted out at that time.

DEPUTY CHAIR BEGG: Just then looking at price quality trade-offs, I think we possibly addressed this in our earlier discussion of quality but in the review of Wellington there were concerns about Wellington not facilitating price quality trade-offs but we haven't heard any issues really raised here in Auckland, so I just really wanted to confirm that the airlines were happy with their ability to make price quality trade-offs and the way that Auckland's responded to any requests in that regard?

JOHN WHITTAKER: So, Auckland's pricing structure generally hasn't attempted to make price quality trade-offs. Our view is that overall those things are probably not very material and so we're comfortable with the structure that doesn't try to make them. Where we were uncomfortable was where Wellington had tried to make price quality trade-offs in some areas where we saw as actually we couldn't actually make those trade-offs, like parking of aircraft was one example, whereas they wouldn't implement price quality trade-offs in areas like air bridges and baggage where we felt it could be done. So, inherently we don't think they're that material, we're very comfortable with them not being included.

KRISTINA COOPER: From the perspective of the international airlines, the removal of the TSC agreement, as I noted, did remove the ability to make price quality trade-offs on a consistent basis throughout the year. I agree with John that they weren't of material sums but it was a way which changes to levels of service could be very easily made and that is lost now. Now, only time will tell whether or not the airport is receptive to making such changes without the ability to flow them through to costs immediately.

ADRIENNE DARLING: Just to respond to Kristina's point, I would note that since the establishment of the new pricing structure we have also developed new forums to ensure the ongoing consultation occurs on all capital expenditure with a focus on the major capital expenditure items.

DEPUTY CHAIR BEGG: Just another question, this one I think's been partly touched on during Pat's discussion of asset, what's in the asset base, but during our review of Wellington Airport there were concerns raised by the airlines about paying for assets they didn't use, such as the RESA, and I think earlier in this morning's session we talked about a parcel of land that the airlines were arguing shouldn't be in the asset base, but I just wanted to check whether there was any other concerns about airlines paying for assets that they think they don't use?

KRISTINA COOPER: No, it is just limited to that, the approach land. I just note, there's been quite a bit of history on this, that during the first air field price inquiry the Commission removed all the eastern approaches in its entirety. Now, subsequent to that time there's been regulatory changes which have now mandated the use of RESAs which are within that eastern approach area previously excluded by the Commission, and also overseas there's now a regulatory practice to have what's called public safety zones, I think, which are a further area. Now, even that's not required yet in

New Zealand, BARNZ has taken the approach of not objecting to the inclusion of those land areas. So, effectively half of the area the Commission excluded in 2002 is now accepted by BARNZ members, at least, as being appropriate to include. So, I think we're left with something like 27 hectares of land and I know the airports commented that it's not material because it's only a value of around $2.7 million. Now, that's correct for the moratorium value but if the airport was to move to an MVEU value, that would be $27 million of land so it is quite material for the future and, yes, the BARNZ position is simply that that land, the airport does not need to own it, it can be adequately protected through planning restrictions in the District Plan.

DEPUTY CHAIR BEGG: Thank you.

CHARLES SPILLANE: One concern we have about protecting things through the District Plan is, District Plans come and go and the one thing we're sure of is that the airport of Mangere can't come and go if the country wants to stay open. We consider it crucial that our licence to operate on an uncurfewed basis is maintained into the future and we're therefore holding that land to ensure that we have that capacity. We don't want the sort of situation that they're facing in Heathrow and Sydney to happen in Auckland, when you put into the context that we're at the end of the world and we have to take aircraft when they want to come here.

DEPUTY CHAIR BEGG: That concluded my questions. I'll just check with staff whether they had any further questions they would like to ask.

ISOBEL OXLEY: Just one question to Auckland Airport. So, the pricing methodology for the second pricing period has something called an investment charge to cover the costs of the new terminal facility and I was just wondering how Auckland proposes to structure that charge to recover the costs, or is it going to be on a per passenger basis, or per seat basis, or per plane?

ADRIENNE DARLING: We have outlined in our pricing reasons paper and the revised pricing proposals the detail behind the investment charge and I think you will have heard today that we take an open mind to consultation. So, we've outlined a process of how it might occur, however, at the time that pricing consultation occurs we will have discussion on those elements. So, what was outlined involved a building blocks approach and many of the principles applied in the pricing decision, but I think as we have discussed earlier today, we don't have the numbers to plug in to have any meaningful discussion on that at this time.

CHARLES SPILLANE: Just to put that into a bit more context, we don't know whether it's going to be to the south of the international terminal or to the north of it. Either location has a number of different consequences so we're simply nowhere near being able to make any calls on that.

ISOBEL OXLEY: And you've no indication at this stage how you would spread the cost of recovering that cost?

ADRIENNE DARLING: We will consult on that. We have indicated that to the extent that there are common assets in there, the charges may apply to domestic and international, even though there may be a bias towards domestic. We have also indicated it may be appropriate to invoice on the basis of passengers but at the end of the day we will consult on that, take feedback and consider it at the time.

DEPUTY CHAIR BEGG: Thank you. Just turning then to a couple of general questions. I would just be interested in Auckland's views on how much its behaviour has been affected by this 56G review, which is a one-off review, first is just the general Information Disclosure regime?

SIMON ROBERTSON: I think it's fair to say we're influenced by the regulatory precedents and regulatory decisions all the time. So whether that forms part of the ID/IM determinations, the process that led to those, the 56G review, at the appropriate time the 53B reports, merits appeal, they will all form part of how we think about how our pricing behaviour, quality et cetera will be considered as part of the process.

DEPUTY CHAIR BEGG: Just for BARNZ, then, I think it was in your submission that you suggested that Auckland Airport targeted a lower WACC and your view was that this was because of a section 56G review. I just wondered if you would like to comment on that and whether there was any other observed behaviour?

KRISTINA COOPER: I mean, it's very subjective to make a sort of call like that but that was I think our overall impression, was that the presence of the 56G had to some degree moderated the airport's behaviour in respect of, you know, pricing to that 8.5% WACC as opposed to the 9.16 that was their target.

ADRIENNE DARLING: May I just add that there has been material changes between PSE1 and PSE2 in terms of profitability outcomes. We are targeting less than an 8.475% return for PSE2 and that's compared to the 9.83% targeted in PSE1. For a number of the WACC parameters we have moved closer to the WACC IM. We consider that the systemic risk of Auckland Airport differentiated Auckland Airport and that was also observed in the Commerce Commission materials. We've excluded the northern runway for pricing and we consider that we have a reasonable and efficient price outcomes I think were set in PSE2. One thing that we haven't discussed today is actually the level of pricing that have been observed as an outcome of PSE2, and overall what we're seeing is price increases of less than inflation for the five year period. I think that's important context for this review.

DEPUTY CHAIR BEGG: Okay. I'll just check with staff, were there any other questions? So that finishes those sessions.

CHAIR: Just a related question. I think today we've heard a lot of quite positive remarks from the airport and airlines about how the Information Disclosure regimes created the relationship that you can have amongst yourselves. I think the one problem spot where I think Auckland Airport has suggested there might be a problem is a lack of regulatory certainty, and that relates to what you can say about PSE asset valuation price going forward to 2017. But can I just ask the question, if you had the certainty or the knowledge, let's assume that all of the input methodology litigation is behind us, what would your answer be, would you expect to be in a position to be able to represent what your position would be for PSE3 asset value starting point? Is that the one sticking point that was really behind your comments about lack of certainty this morning?

SIMON ROBERTSON: Without knowing where the Commerce Commission gets to in how it assesses profitability over a five year period, we're equally challenged this morning by a view that, you know, what assets do you put in, what asset values do you put in at the closing value. Our fear is that we priced on a moratorium basis but the regulator looks at it with revaluations and based on the IM without any consideration of actually what we did in pricing and the two aren't compatible. So, our issue is the approach and the consistency in the approach, and if we have a moratorium but get accused of earning more because of revaluations, we would scratch our heads to try and figure out, well, what more could we have actually done if you have a moratorium in place but the regulator concludes that maybe there's potential for excessive profits because of a regulatory issue that you put in year 5 of a five year model.

COMMISSIONER DUIGNAN: Sorry, there's piece of logic there that I'm struggling with. The issue that you were being asked this morning was to offer some indication as to the future of pricing at the end of the moratorium period, you've just confront - or generated a catch 22 in which you're saying you can't do that because we may come up with a view on the matter. That's what your words implied. I just don't understand that. If you were offering a view and an indication, and it could be that you said subject to the outcomes of the merits review as the Chairman invited you to, but if you offered a view then that would be relevant. What you've said is you can't offer a view because we may take a view. I just don't understand the logic.

SIMON ROBERTSON: I think that's what I referred to as the paradox this morning but I tried to be explicit as I could in that our view today is that if there is because of regulatory issues a change in the closing position at 2017, there needs to be a change there because regulatory and pricing are diverging in terms of the assumptions, then we'll do so in a principled way. So, as Kristina pointed out, that is likely to mean some form of wash-up if there is a change in asset values. But we're equally concerned about what the Commission views takes where asset values plays such a significant role in determining an IRR over a five year period.

DEPUTY CHAIR BEGG: Can I just confirm, because the decision on what the end asset valuation is less important if you are able to commit to treating any revaluation gains as income, the whole issue of the end valuation is if you don't treat revaluation gains as income. So I just wonder, you did touch on this, this morning and in the end I wasn't quite sure whether you were saying that your principled position would generally lead you to treat any changes in the valuation approach that led to revaluation gains, you would treat those as income, is that correct?

SIMON ROBERTSON: The approach I've outlined is that we would be economically principled in how we would deal with asset valuation changes which would imply some degree of, and I don't know what the right word is because I haven't really considered how that might be actually delivered but some form of wash-up to recognise the change in asset values at 2017.

DEPUTY CHAIR BEGG: So the wash-up is treating that as income, in effect, and off-setting it against the future, for example.

SIMON ROBERTSON: For example, yeah.

COMMISSIONER DUIGNAN: Well, when you say "for example" you've said you would be economically principled. I'm an economist, I'm afraid that that term has not really got a lot of content by itself so that's why we've just now asked the question. When you speak of "economically principled" I think that for it to be sort of meaningful you do have to define more precisely what you mean by that term as applied to this issue.

Now, you've just said that you do agree that treating the value, revaluation gain as income is, seems to be what you would bring within the category of being economically principled, but then you have said "for example" and in saying "for example" you've sort of rather turned that into just a comment rather than an indication of what we, which is what we were offering you the opportunity to give us. So, I wonder if we could just be clear, when you speak of economically principled, which is the term you've used, if you could give us a rather clearer definition of what that means to you?

SIMON ROBERTSON: I was responding directly to Commissioner Sue Begg's comment where she used that, as an example, it was her words first saying, as providing it as an example, then saying as an example, by agreed as an example that would be an outcome.

COMMISSIONER DUIGNAN: Perhaps, then, in your cross-submission if we could have as clear a statement as Auckland Airport is able to give us as to its approach to the issue of the valuation that will be used for PSE3, that's the question we would pose and we will regard your answer as being of some significance to our view of matters.

CHARLES SPILLANE: I would just request that you bear in mind that we have consultation obligations under the Airport Authorities Act which we won't give up. This is not a price controlled or price setting Tribunal and we do take very seriously our obligations to consult with our customers and we will do that before the next price-setting event, and we won't pre determine what the outcome of that will be unless that has been consulted on, which was the case in relation to the moratorium in the first instance.

DEPUTY CHAIR BEGG: One thing I suspect the airlines wouldn't object to would be Auckland stating that as a principle it would treat revaluation gains as income. I suspect they wouldn't mind a pre commitment to that.

KRISTINA COOPER: I could go further and say that the airlines would be prepared to consult on that aspect right now and then in relation to that particular item, would waive in writing their right to be consulted on it which is allowed for in the Airport Authorities Act, so we would be happy to sort that out now.

COMMISSIONER DUIGNAN: I mean, I'm sorry, the answer doesn't, is not logically convincing because in 2007 you saw fit under the AAA Act, the same Act that you've just referred to, to be able to give a commitment to a moratorium as being, and I suppose if one thinks about it, it is that that's the default case that the airlines can plan on, if you commonly agree to something different then well and good. So, your proposition that you can't do what we have indicated we would like to have you do, namely give an indication, because of the AAA is refuted by your own past experience. You were able to do that in 2007 -

CHARLES SPILLANE: That's simply not the case at all, we consulted on that.

COMMISSIONER DUIGNAN: Okay, you're then creating the following situation, that you were asked the same question during the consultations this time and you declined to consult on it. Now you say, therefore, you are viewing yourself as precluded from giving the Commission guidance, that's what we're asking for, as to your intention.

ADRIENNE DARLING: We should not forget that the merits appeal also is something in the background here as well which was not there in PSE1.

COMMISSIONER DUIGNAN: That was where the Chairman -

CHAIR: That was my question.

ADRIENNE DARLING: I thought it was a very good question.

CHAIR: Well, that seemed to me to be the one barrier, I couldn't understand what other barriers would be as to why you couldn't give indications for the benefit of airlines, for the benefit of investors, and so on, as to what your intentions might be in 2017. I mean I understand that - you know, it may have been better that we held this conference if the legislation had allowed us to do so after all if the IM litigation was finished but we didn't have that option, I was just posing that hypothetical because that seemed to me to be the one sticking point.

Okay. Well, if there are no further questions we are at the end of that part of the process today and we have actually moved very efficiently through this afternoon's proceedings.

We have two requests for presentations from Auckland Airport and BARNZ, so we would hear BARNZ first and then followed by Auckland Airport. Can I just get a feel for how you would like to timetable this. We had it initially scheduled for a 2.50 break for afternoon tea, then the lack of certainty presentations after that, but can I suggest if the parties are in a position to proceed with presentations now that we could perhaps make a start, but I'm in your hands. If you want to have a brief recess to consider a little bit further about what exactly you wish to say, we can by all means take, say, a 15/20 minute break if you wish.

KRISTINA COOPER: I think we would like a ten minute break if that's all right.

CHAIR: Okay, well, let's come back at say 20 to 3 and you'll be in a position to follow on straight afterwards, Auckland Airport. Thank you.

(Conference adjourned from 2.21 p.m. until 2.39 p.m.)

CHAIR: Okay, well, let's reconvene for what will be the last session of this conference and we'll invite BARNZ to lead off with its presentation which I understand will be about ten minutes or so in duration, and then following that Auckland Airport for about 30 odd minutes, I gather. So, that means that we'll be done certainly by 3.30, so if we can invite BARNZ to present, please.

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KRISTINA COOPER: Thank you. I think we've had an efficiency improvement over the day and we've shortened our presentation.

BARNZ is here today representing 15 international airlines and two domestic airlines. Those international airlines comprise approximately 37% of the international passengers that move through Auckland Airport and we have taken particular care to ensure that the views represented here today by BARNZ and the written submissions previously made by BARNZ reflect the views of those airlines.

In this closing statement there's two key issues that BARNZ wishes to emphasise.

The first is the need for guidance on WACC from the international represented airlines, those international represented airlines wish for greater guidance on WACC.

And the second issue is the choice of the valuation methodology and the treatment of any revaluations in 2017 and when the moratorium expires.

So, turning to the WACC issue. The BARNZ represented airlines are mostly overseas carriers that are very used to a different regulatory regime which involves a regulator setting charges or a revenue cap. When those station managers and airlines come to New Zealand they find it very difficult to understand New Zealand's light-handed regulatory regime whereby airports have the right to set pricing charges without there being any net required approval from a regulatory body or any review process that normally occurs by a regulatory body, and they can't understand that we don't have the Commerce Commission that's going to look at it and say whether or not the charges are right, they don't understand that the CAA doesn't have to approve it or that the MOT don't have to approve the charges. So those airlines are particularly seeking the Commission's views on whether or not it is necessary for an airport that can earn virtually as much from its complementary carparking and retail businesses as it's able to from its aeronautical business, to price at the 75th percentile WACC.

Airports are very different from gas pipelines businesses and electricity distribution businesses which do not have that extremely lucrative complementary revenue stream that the airports have. In the BARNZ represented airlines' view, those other revenue streams make it unnecessary to allow prices to be set at a targeted 75th WACC estimate in order to incentivise investment. It's considered that for airports with that large complementary revenue stream, the use of the mid-point WACC is more than sufficient to incentivise investment and provide a reasonable return.

So, turning to the second issue. That is a pivotal issue of appropriate valuation methodology and the treatment of revaluations in 2017. In the present price-setting event it was simply kicked for touch by Auckland Airport continuing to apply the 2007 moratorium on asset revaluations. There was no commitment by the airport to continue to apply this approach. The issue of valuation methodology and whether or not those revaluations should be treated as income is still a hot potato between the airport and the airlines, as we've heard today, and Auckland Airport is continuing to put forward or has been putting forward methodologies inconsistent with those specified by the Commission. They're referring to MVEU as opposed to the moratorium.

So, the airport's clearly stated preference as conveyed to airlines at the beginning of consultation was for it to revalue its land using MVEU with a new ODRC valuation of specialised assets, and to only treatment forecast revaluations as income for the purposes of setting charges with any unforecast revaluations being retained by the airport.

Now, that was also the position that Auckland Airport advocated to the Commerce Commission during the input methodology determination process, it is also the position we understand the airport is currently putting forward in the High Court merit review process, and we believe that it would leave the airport potentially retaining the benefit of all valuation uplift since 2006 if the airport went down this route. It would result in the MPV equals nought rule being materially breached and it would result in significant excess profits and windfall profits being pocketed by the airport. We believe that the fact that such an outcome is permissible under part 4 Information Disclosure regulation clearly demonstrates that by itself Information Disclosure regulation is not able to effectively limit the ability of airports to earn excessive returns. While the input methodologies remain non-binding on the airport in relation to their pricing decisions, while airports are simply required to consult over charges but have the ability to set prices as they think fit, and while there's not any independent binding dispute resolution process, then Information Disclosure in the view of BARNZ represented airlines is simply unable to effectively promote the purpose of part 4 and results in uncertainty going forward for all parties.

Thank you for giving us the opportunity to be heard today and thank you I think to the staff for all the work that they have done.

CHAIR: I now call on Auckland Airport, please.

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SIMON ROBERTSON: Commissioners and staff, thank you for the opportunity to address the conference today. We value this opportunity because we wish to ensure that some much the positives of the new Information Disclosure regime and our conduct as a major airport have an equal opportunity to be raised in this forum. We are concerned that the conference and submission approach to date is focused on identifying the issues and points of disagreement between parties.

Disagreement between parties in the aviation industry is not new or unique. We accept that we can have different timeframes for investment considerations and have different value drivers. However, debate of differences between airports and airlines, or debate even between the airlines themselves does not necessarily point to a problem. In many cases industry debate is healthy, normal and assists to ensure that good sound decision-making on aviation issues has the best opportunity of prevailing. Focusing on points of difference will fail to recognise that there is greater consistency of outcomes of pricing, quality and capital expenditure requirements between our airlines and Auckland Airport than ever before.

We believe the new Information Disclosure regime has had a positive effect and has been a move in the right direction. We are committed to full and absolute participation in the regulatory process, that relates to airports, airlines and our interdependent partners, the passengers. We believe at the heart of it we have a goal that in many cases is shared with airlines, that is to produce the best possible long-term outcome for New Zealand. A small and remote country such as ours has too many challenges in the global context for us not to share such a common goal even if there are sometimes different views on the means to achieve it. Our approach in business and to any discussions with key business partners such as customer airlines is very much informed by this goal.

New Zealand needs airports and airlines to work together. We're all part of the same passenger experience and industry supply chain. We are acutely mindful that what is revenue to us is a cost to airlines and we do take that into account. We appreciate that that is easy for us to say but we also strongly believe that our actions, so the actual outcomes, are like our deferral of the price increase during the worst of the GFC and the results we've delivered for New Zealand in growing tourism have been speaking much louder than just our words. Our disappointment in the approach to reviewing the effectiveness of the new disclosure regime is that it does not highlight the strengths and the positive impacts we've had in the dealings under the AAA and the depth of the information available to interested parties to assess the importance of airport regulated activities.

I hope to bring in this presentation and raise some of the positive aspects to Auckland Airport's conduct as a major airport and as a driver of economic growth for New Zealand.

In 2009 Auckland Airport announced a new strategy that we called our flight path for growth. We were determined to play our part in travel, trade and tourism for the markets we serve. This required a transformation of the company from just being a builder of infrastructure to a sales-led organisation driving economic growth for Auckland and New Zealand.

At the core of this goal is "Making Journeys Better". It is what we try and do as an organisation. It encompasses what we call our "spirit", what many of you might call our "company values", that our people themselves identified were necessary to deliver on our goals. These are to be outstanding, ambitious, authentically New Zealand and welcoming. These are not just words but are built into our employee development system and our reward and recognition systems that we call our "Shining Stars".

This strategic direction played an important role in our approach and conduct in the AAA pricing process and in our adoption of the new Information Disclosure regime. Information Disclosure is not new for Auckland Airport, however we do acknowledge that the new regime is a significant improvement on the previous one. The old regime was purely financial. The new regime provides an opportunity for interested parties to assess, incentives to invest and innovate, improvements in efficiency, quality, as well as checking that there is a fair return over time.

In fact, while I was not personally a direct party to price consultation in 2006/2007 we can say that the conduct during pricing in 2011/2012 was significantly less controversial and in many cases the airport and the majority of airlines were largely aligned. We believe the new disclosure played an important role together with the company's new strategic approach to leave a few major points of significant debate remaining unresolved. We believe at the time of the pricing decision there were no major disagreements on demand forecasts, allocations of assets and expenses, asset valuations, capital expenditure assumptions, depreciation lives or taxation. We do urge the Commerce Commission to take a look at forecast assumptions at the time these were made to avoid the one-sided nature of criticism about future outcomes with the benefit of hindsight.

In fact, at the Board meeting where the airlines were given the opportunity to address the Board directly before our pricing decision, BARNZ raised their six most important issues and Auckland Airport responded with changes to address these points. I remember at the subsequent meeting with BARNZ to discuss the outcomes of the Board meeting I can recall Kristina Cooper describing Auckland Airport as the "Poster boy of consultation".

Air New Zealand also took up the opportunity to address the Board directly. However, for the most part they utilised the time to raise too with our Board their preference for a location for domestic capital expansion. I can only presume they did this because they thought this was a more valuable use of their time with the Auckland Airport Board than discussing the outcomes of pricing.

However, the Information Disclosure regime is not just about pricing, it is also about quality.

We are proud of our achievements to produce a quality passenger experience. Auckland Airport has been recognised for this quality in the Skytrax Airport Awards voted as the best airport in Australia/Pacific for the last four years; a top 10 airport for 2009, 2010, and 2011, and 13th in 2012; best airport staff service award for Australia/Pacific in 2012; and, the second best airport in the world for airports in the 10 to 20 million passenger range in 2012.

The Information Disclosure regime uses ASQ surveys to measure quality. This is useful in highlighting trends over time. However, it does not show how this compares to global airports. We know we rate consistently as a top airport in Australia/Pacific from the ASQ surveys. In fact, it's easy to forget that a rating of 2 is fair and 3 is good and 4 is very good. So our rating between 4 and 5 we think is an exceptional outcome.

The Information Disclosure regime also fails to show what Auckland Airport does with the ASQ surveys. I wish to raise with you that the information is reported back to the leadership team to review and investigate trends. We specifically track the top ten drivers of satisfaction as determined by passengers in those ASQ surveys which in turn creates items to address, trends and understand how quality can be efficiently improved.

For example, our approach to lift our performance in the cleanliness of washrooms has helped us to identify that in many cases it's about being new rather than being clean. Clean but tired does not satisfy passengers. We used information gathered from ASQ to establish a text feed-back system from our toilets. We gathered over 10,000 texts from toilet users at Auckland Airport. We then used this information to prioritise our refurbishment programme, establishing priorities and amending cleaning schedules. Our focus on toilets saw Pulitzer Prize winning columnist, Thomas L Friedman of the New York Times, make a positive statement about Auckland Airport's toilet systems.

However, the Information Disclosure is not just about quality, it's also about innovation.

Auckland Airport believes innovation plays an important role in our organisation as a way to solve complex capacity and reliability issues, as well as to drive improvements in operations. Driving operational improvements through innovation has the benefit of improving throughput, delivering benefits to the consumer and a better quality experience going to that "Making Journeys Better", but also has the effect of delaying the need for further capital investment to deliver capacity which shares those benefits and lower prices than would otherwise be the case.

Innovation shows up in the way we have to deliver capital expenditure in a live environment. We have a history of staging incredibly complex projects to minimise the impact on current operations, capacity and customer experience. We cannot choose to shut down the airport for three months while we do some form of maintenance and upgrade.

Some examples of this include the challenge of being one of the few concrete single runway airports globally. Solving the continuation of flight operations while replacing concrete slabs in the middle of the runway required incredible innovation in delivering alternative operations as well as innovative ways to ensure the concrete is set quickly to minimise the time taken for the whole project. The Pier Segregation project was a regulatory impost on Auckland Airport to deliver segregated arriving and departing international passengers as a safety requirement post 9/11. This was another very complex project of building a new level on top of an existing operating pier. Today you can see this in the staging process of the domestic terminal refurbishment programme where careful consultation with all the stakeholders and complex staging plans enable the delivery of a project. This occurs in an environment of constant change. I bumped into Robin on the way up here who is the Air New Zealand Domestic Terminal Manager and he was in discussions trying to figure out whether the 34% increase in baggage in January was a more permanent change that we might have to reflect as how we go about the refurbishment.

Other innovations deliver significant cost savings to airlines with little direct benefit to Auckland Airport. Examples include our CATIII lighting, installation of ground power units, or how we can work collaboratively with airways and airlines on flight approaches.

Most recently we have developed many processing improvements that have been hugely successful in reducing passenger processing times. In 2010 we invested in Lean 6 Sigma and bought in the buy in from multiple other onsite stakeholders to the benefits of engaging with our team on Lean 6 Sigma initiatives. This has been hugely successful and has now been built into our operations as a core under the group known as COG. Our Lean 6 Sigma work has delivered or enabled the delivery of advanced passenger display, more flexible baggage allocation belt processes, Smartgate on arrivals and departures, and these have enabled a world class passenger processing of departing and arriving passengers as they move through the border process.

However, the Information Disclosure is not just about innovation, it is also about investing appropriately.

We have a history of consulting widely with stakeholders on future capital expenditure at levels of capital expenditure far below any statutory requirement. We do so to ensure that a capital project is delivered at a time and in a format that best suits the needs of the industry. This may mean revisiting projects like the second runway. It may mean not progressing on projects that we thought initially were valid, like project 3B. And, again, nowhere is this more relevant today than in the next stage of domestic terminal capacity expansion. This is a major decision for the airport that locks in the terminal development pathway for the next 50 years and must consider the long-term issues of other supply chain aspects like surface access, forecourt space, apron implications, as well as impacts on the future northern runway. Our consultation with key airline stakeholders to date has been very deep, thorough, and I must say in good spirit. We expect that that engagement will continue and result in the best long-term decision with the long-term implications and risks fully understood.

However, the Information Disclosure is not just about investing appropriately, it is also about efficiency of operations.

Much of the discussion to date on efficiency has involved looking at Auckland Airport's operating costs in some degree of detail. However, if you take a step back you will see we are one of the most efficient airports in the world. Our operating costs per passenger are low by international standards. Auckland Airport has had numerous discussions with other airports who seek us out to understand how we deliver a low-cost operating environment. Let's be very clear, we have no incentive to be lazy or to operate with an inefficient cost-base. Much of the discussion does centre on air service development expenditure. We will defend this position strongly. Air service development expenditure has developed capacity increases in New Zealand that would not have otherwise occurred. The truth is New Zealand is an end of line destination and is not the first thought for global airlines as they contemplate new routes or expanding on existing routes. We build business cases that introduce the possibility of New Zealand as a growth option for the airlines. Let's be very clear, no money on marketing will subsidise a poorly performing route. The business case needs to stack up but will often require different degrees of promotion in the early stage to build awareness through different sales channels including wholesalers and end consumers. This delivers real benefits to consumers in choice, improve connectivity to other destinations, and ultimately through price resets lower aeronautical charges than would otherwise be the case. It also has an indirect benefit of us understanding our airline customers significantly better. We need to understand their revenue drivers, their target markets and their strategic growth drivers.

Also our cost base in general cannot be looked at in isolation. There is often significant interdependence between different aspects of the purpose statement. For instance you cannot consider the cost base without considering quality, for example, the cleanliness of the terminal; you cannot consider the cost base without considering capital investment, for example, increasing innovative maintenance procedures on the runway can delay the need for more costly capital expenditure; and, you cannot consider the cost base without considering operational efficiency, for example, how we might deploy staff to manage bottlenecks in real time that can improve airline on-time performance and reduce the airline operating costs.

Overall, if we step back from the detail we believe that Auckland Airport delivers a world-class quality airport experience and does so at a price that benchmarks at about average globally for international charges and cheap for domestic charges with comparisons across Australasia. An outstanding achievement.

It appears to us there are three main issues outstanding for the industry as they relate to Auckland Airport. The moratorium on asset valuations; how is the timing for returns on land held for aeronautical use incorporated; and, what is an appropriate WACC for Auckland Airport.

With regards to the moratorium, the discussion today has been useful and we will consider in submissions post the conference how we might best explain our views on the moratorium and the future path for asset valuations. On land held for future use this land for a second runway is a critical piece of the airport's assets, that should not be underestimated. It provides the pathway for aviation expansion that would be the envy of many aviation parties in different airports globally. It also provides the resilience and flexibility to deal with changing aviation needs, both expected and unexpected, because the land remains within the control of Auckland Airport.

We believe that the Commerce Commission by excluding this asset from the Information Disclosure regulated asset base has been prescriptive in how returns on this asset can be managed over time. We understand the general airline view of not paying for future assets, however the land is not a future asset, it's not a future expenditure of Auckland Airport, it's a $200 million current value investment with no current cash returns. A key method of price signalling has been taken away from Auckland Airport with an inefficient methodology for assessing income associated with the land held for future use by not allowing for any taxation expense on that income. We believe that the current methodology will deliver a future price shock to the airlines at the exact time that new capacity is being added to the network. This remains a key unresolved issue for Auckland Airport under the Information Disclosure regime.

For WACC, the determining of an appropriate WACC to assess whether returns are fair on the investment made remains another issue outstanding. In the process of establishing the new disclosure regime there was much debate on WACC. Auckland Airport was concerned right through the process that a prescriptive approach to WACC would result in de facto price control. This was rejected by the Commerce Commission on numerous occasions. However, here we are with the 56G review process outlined to date and the Commerce Commission approach so far has been prescriptive in its views on

WACC. So far we've not seen any analysis on the WACC position taken by Auckland Airport. It appears the process under the 56G reports is to use the Commerce Commission WACC as a target return. This is despite the approach expected by Auckland Airport and defended by the Commerce Commission in its merits appeal where the Commerce Commission said, "A cost of capital IM provides a basis for comparison with the actual methodologies used by the airports in determining cost of capital. This will encourage airports to be explicit about the assumptions and rationales used in their own modelling, and give interested parties such as airlines in consultation with the airports over charges, some information for testing the airport's own assessments".

Or, "The advantage of a specific IM is to provide interested persons with an objective basis upon which to evaluate airport's own assessments of their cost of capital".

Or, "Airports are required to disclose the approaches they have taken under ID determination. The cost of capital IM simply provides a tool which can be used by interested parties to assess the appropriateness of the airport's approaches".

We believe that taking an open mind to Auckland Airport's decision in May 2012 on WACC is essential to an assessment of fair returns. Before I go into some of the WACC parameters and where we did change, there is a real risk that the theoretical position on WACC and business reality is diverging. This will have a significant impact on having the right incentives to invest.

We have a real example today of the market assessing WACC in a market transaction for highly relevant airports in Australia. The Future Fund is making an offer for stakes in Sydney Airport, Melbourne

Airport, Perth Airport, Gold Coast Airport and Darwin Airport.

Grant Samuel is the independent expert advisor to assess whether the offer is fair. Grant Samuel provides a WACC discount rate of between 8.5% and 9.5%. In fact, the offer is at the lower end of the Grant Samuel range indicating the offer represents a WACC closer to 9.5%. The Grant Samuel report as a practitioner makes a reference between the disconnect, between the theoretical models and what investors are actually seeking in returns.

For Auckland Airport we see the same disconnect. The most recent WACC by the Commerce Commission established a 6.49% at the 50th percentile and 7.48% at the 75th percentile. The sell side analysts that publish WACC currently have their assessment of WACC at the 50th percentile, higher than the Commission. This is the sell side analysts on Auckland Airport. Deutschebank/Craig, 8.51%; Forsyth Barr, 8.10%; Goldman Sachs, 7.70%; JP Morgan, 8.80%; Macquarie, 8.20%; Morningstar, 8.60%; Credit Suisse/First NZ Capital, 8.1%.

We also see a disconnect between the theoretical models and Auckland Airport's actual cost of debt. For the six months ended 31 December our actual cost of debt is 6.3% compared to the Commerce Commission's assessment at 5.3%. This clearly raises the question of, is Auckland Airport inefficient in its debt costs compared to our peers. We asked Bancorp to compare the debt cost of funds to their infrastructure clients and they concluded that Auckland Airport in the years to 30 June to 2011 and 2012 had the lowest or second lowest cost of debt.

Then if we look at the individual parameters used in our pricing decision you will see that we did make and undertook to update the theoretical approach, and to also consider the commercial reality in some of the parameters.

For instance, the Commerce Commission approach is to consider asymmetric risks in the cash flows or to consider insurance. These were not practical and the more practical approach is to recognise these in the WACC. Our asset beta, as determined by the Commerce Commission, is slightly higher than the industry. This was confirmed by our own analysis. We were also cognisant of the change in pricing structure which sees an increase in systemic risk compared to the historical position.

The leverage provides an anomaly for an A minus rated airport where our actual leverage is 27% compared to the position of the Commerce Commission at 17%. In our assessment, that the regulated part of the business would have slightly higher leverage than the non-regulated business, very similar to the approach we took on the asset beta to reduce the asset beta for the regulated side of the business.

Market risk premium analysis referenced more recent work and more recent changes from practitioners since the Commerce Commission determination.

The WACC range is consistent with the Commerce Commission approach for pricing at the 75th percentile. In fact, I think by the time we made a judgement call and priced at 8.475 it was at about the 60th percentile of the WACC range.

At the end of the day we recognise the airlines have a different view but we also recognise that at the time of pricing in May 2012 the position of BARNZ was a WACC of 8.04%, a difference of about 40 basis points and not an issue that made their top six points raised to the Board of Auckland Airport.

In summary, we believe airport charges are designed to achieve a reasonable return on significant investments in essential long-term infrastructure. We also have a responsibility to deliver appropriate investment in air travel infrastructure to ensure that airline growth aspirations can be accommodated and future consumer demand met.

Auckland Airport is proud of its airport performance and has embedded the objectives of part 4 of the Commerce Act into our company culture, values, policies and decision making. We genuinely believe we have been delivering on our end of the bargain to deliver the best possible outcome for New Zealand.

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CHAIR: Right. Well look, that brings the session to a close today. I would just like to make three comments at the conclusion largely by way of housekeeping matters.

First of all in this conference we have posed a number of questions the participants have agreed to address in cross-submissions and, as I mentioned at the start of the conference, we will publish a list of those questions on our website and we also will have the transcript available hopefully by Friday the 1st of March, so that's the target we're aiming to achieve in terms of that workload.

The second point I would like to make is that following the conference, again as I've already mentioned, there is the chance for cross-submissions and they are due on 15 March and everybody is welcome to make cross-submissions on matters raised today and in relation to earlier consultation rounds. I should add that, as we've indicated, we will go through a process of doing a draft report and so there is then yet another full written submission rounds after that. So, there's full opportunities for submissions then.

The third point I would like to raise is that in the course of the hearing today we've been in the slightly different situation where parties not in attendance have had questions put to them, namely Air Cargo Council and Qantas, and I think also we have put questions to Auckland Airport today on matters that haven't been I think much, or if at all, canvassed in earlier submissions. So, I think the best way forward is that given that it's only a fortnight essentially for cross-submissions on 15 March, we'll leave that as the date for this next wave of responses and so that's when Qantas and Air Cargo will have the deadline to submit their responses, together with all other parties. Once we are in receipt of that, then we'll do an audit of the material and work out what questions we may need to put to other parties to make sure that there is proper consultation on anything that is taking on the appearance of being something new. So, we'll be back in touch with you once we've had a chance just to reflect upon the record as it is after cross-submissions are in.

On behalf of my fellow Commissioners, I would like to thank everybody for their submissions today and also in particular for the careful written submissions. I think it's because of those written submissions we've had such an efficient process here today. So, once again, thank you all very much for your participation at this conference.

Thanks also to Commission staff for all of the background work and organisational matters that have been attended to, and also to the transcriber and technical assistant that we have.

So, with those brief comments I'll bring this conference to a close. Thank you.

(Conference concluded at 3.18 p.m.)

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