



**SECTION 56G REVIEW OF AUCKLAND AIRPORT
CROSS-SUBMISSION ON COMMERCE COMMISSION DRAFT
REPORT**

14 JUNE 2013

CONTENTS

EXECUTIVE SUMMARY	1
SECTION 1: THE IRR MODEL AND AUCKLAND AIRPORT'S EXPECTED RETURNS	3
Overview	3
Opening asset base.....	4
Sensitivities undertaken by the Commission	5
MVEU valuation in 2017	8
Timing of cashflows	9
Land in asset base	10
SECTION 2: THE WACC IM.....	13
Overview	13
The percentile estimate of the WACC IM.....	14
The timing of the WACC IM.....	16
SECTION 3: PERCEIVED "GENEROSITY" IN THE DRAFT REPORT	18
Overview	18
There is no generosity bias in the Draft Report	18
"Regulatory responsibility" in the context of ID regulation	19
SECTION 4: ADDITIONAL ISSUES.....	22
Overview	22
Pricing efficiency.....	23
Runway projections: will runway demand exceed capacity in the near future?	24
Proportion of the regulatory asset base relating to non-pricing assets	25
Qantas' capital expenditure concerns	26
Noise mitigation costs.....	27

EXECUTIVE SUMMARY

1. Auckland Airport makes this cross-submission in response to the submissions on the Commerce Commission ("**Commission**") Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure ("**ID**") regulation is promoting the purpose of Part 4 of the Commerce Act for Auckland Airport ("**Draft Report**")
2. In our view, the Commission has made positive findings across the majority of the performance areas under assessment (including profitability) that are fully supported by the available evidence. As discussed in Auckland Airport's submission on the Draft Report, we consider that the available evidence supports the Commission going further in some areas to fully reflect Auckland Airport's positive performance and the impact and effectiveness of the ID regime.
3. In our view, the airline submissions on the Draft Report have not credibly challenged the Commission's draft conclusions.
4. Although all parties agree the Commission should take an evidence-based approach to assessing airport performance and the effectiveness of ID regulation, it is clear that the "evidence" on which the airlines seek to rely is not actually evidence about Auckland Airport's current behaviour and performance, or evidence about the current effectiveness of the ID regime. Instead, the assertions presented by the airlines are based on:
 - (a) repetition of a fixed and unhelpful view that ID regulation can never be effective;
 - (b) a refusal to accept that an ID regime which creates space for positive airport behaviour is effective, even if that positive behaviour is not directly caused by ID regulation;
 - (c) efforts to create a sense of panic about profitability due to potential future decisions, based entirely on unfounded speculation; and
 - (d) a misleading sense of urgency that decisions about the effectiveness of ID regulation for all time can only be made now.
5. Essentially, faced with actual evidence that demonstrates the clear impact of ID regulation on Auckland Airport's behaviour and decisions, the airlines have claimed that ID regulation is ineffective because it does not prevent speculation about what airports might do in the future.
6. We are disappointed the airlines continue to take this approach to ID regulation and to the section 56G review. This approach is not constructive or justified. In any event, the Commission has taken the airlines' concerns into account by appropriately recognising that it will continue to monitor and assess Auckland Airport's performance over time.
7. In support of their general theme, the airlines' submissions are predominantly focused on challenging aspects of the Commission's analysis of Auckland Airport's expected profitability. In particular, the airlines claim that:
 - (a) aspects of the Commission's internal rate of return ("**IRR**") analysis understate Auckland Airport's expected returns;
 - (b) the output of the Commission's IRR analysis has been compared to a weighted average cost of capital ("**WACC**") estimate that is too high and is out-of-date; and

- (c) the Commission's approach is inappropriately "generous" to Auckland Airport.
8. The airlines' submissions on these points reinforce the critical importance of assessing the current effectiveness of ID regulation:
- (a) based on actual evidence; and
- (b) in a way that is consistent with the impact of ID regulation and the guidance provided by the ID regime at the time Auckland Airport made the decisions that are now being assessed.
9. In addition, Air New Zealand places heavy reliance on a submission from the New Zealand Institute of Economic Research ("**NZIER**"). Air New Zealand describes this submission as "compelling",¹ and suggests that NZIER raises "significant concerns with the Commission's approach and the current regulatory framework".²
10. We do not agree with the claims made by Air New Zealand and NZIER. In our view, the discussion by NZIER is based on statistical theory without sufficient consideration of the light-handed, fit-for-purpose ID framework that is in place for New Zealand's regulated airports, and does not demonstrate an undertaking of how ID regulation works under Part 4 of the Commerce Act. We discuss these issues in greater detail in this submission, and **attach** a critique of the NZIER submission prepared by NERA Economic Consulting.
11. As will be discussed, Auckland Airport emphasises that incentive-based regulation such as ID regulation is designed to promote positive behaviour that works towards the Part 4 outcomes over time. As such, it is important for the Commission to recognise positive behavioural change and for the regulatory regime to ensure that the right incentives exist for airports to continue to make such changes. The Commission's Draft Report has done so, by recognising where Auckland Airport has positively responded to the ID regime, identifying areas for potential improvement, and highlighting aspects of performance that will be monitored over time.
12. We respond to the airlines' claims in more detail below, as well as addressing the remaining technical matters raised by airlines in their submissions on the Draft Report.
13. Auckland Airport's contact for matters regarding this submission is:

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¹ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 7.

² Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 13.

SECTION 1: THE IRR MODEL AND AUCKLAND AIRPORT'S EXPECTED RETURNS

Key points:

- The Commission's IRR model is one aspect of the information set used by the Commission to conclude that Auckland Airport is targeting a fair and reasonable return and that ID regulation is effectively limiting the ability of Auckland Airport to extract excess profits.
- The airlines' claims are based on speculation about future conduct and assertions that the impact of ID regulation should be assessed in a way that is not consistent with the guidance (and therefore incentives) provided by the ID regime at the time Auckland Airport made its pricing decision.
- In any event, the Commission has recognised that it is aware of the airlines' views in relation to potential future conduct.
- The key is for the Commission to recognise, as it already has, that Auckland Airport has acted appropriately now, and to identify areas that it will continue to monitor over time. Auckland Airport's future conduct and performance falls into that category.

Overview

14. BARNZ considers that the Commission has adopted a number of conservative assumptions in its IRR model which are favourable to Auckland Airport. In particular, BARNZ suggests that the Commission should:
- (a) use the moratorium pricing asset base as the opening asset base in its IRR analysis;
 - (b) give full weight and effect to all possible scenarios when considering the likely expected returns of Auckland Airport, instead of relying on the non-binding and qualified indications of Auckland Airport's future intentions;
 - (c) incorporate a "more realistic" 2017 market value existing use ("**MVEU**") assumption in its analysis;
 - (d) use mid-year cashflows as its main scenario; and
 - (e) remove \$18 million of land from Auckland Airport's asset base, as this land is unnecessary for Auckland Airport to own in order to provide airfield services.
15. We respond to each argument in turn below. However, as a general point, we note that the airlines appear not to understand the relevance of the IRR model. In our view, it is a tool that the Commission uses as one part of its assessment of expected future profitability, to assist it in drawing conclusions about the pricing decisions that have been made (and, in particular, whether ID regulation was effective at limiting excess profits at the time of price setting for PSE2). Clearly, it is not an accurate indicator of future profitability for all time. As appropriately noted by the Commission, future decisions will need to be monitored at the time they are made.

Opening asset base

16. BARNZ considers that Auckland Airport's returns need to be assessed against the moratorium asset base as both the opening and closing asset base in the Commission's analysis. In BARNZ' view, using the 2009 disclosed base overstates the value of assets used by Auckland Airport to set prices, produces a misleadingly lower estimate of the returns expected to be earned by Auckland Airport, and leads to incorrect conclusions about excess returns.
17. This is clearly not the case. BARNZ' argument confuses the distinction between pricing inputs, pricing outcomes, and the role of input methodologies in the Commission's assessment of performance. In response, Auckland Airport notes that:
- (a) The Commission's analysis is based on comparing the *outcomes* produced by Auckland Airport's pricing decision against the estimate of the value of Auckland Airport's regulatory assets in a workably competitive market. According to the Commission, the regulatory asset base is the value of Auckland Airport's assets that it is "allowed" to earn a return on before prices appear excessive.
 - (b) Auckland Airport is currently using an asset base at a lower value than its regulatory asset base to set charges. This does not mean that an analysis of forecast revenue against our current regulatory asset base produces a misleading estimate of Auckland Airport's expected returns. It simply means that the pressures and disciplines on Auckland Airport (from its pricing consultation and the ID regime) have resulted in the adoption of a lower asset valuation for pricing purposes than the current regulatory value of our assets. Indeed, it would be a strange outcome if Auckland Airport was effectively penalised for adopting an asset base for pricing purposes that is lower than the Commission's view of the value of Auckland airport's assets in a workably competitive market (as at the beginning of 2012).
 - (c) The Commission's approach correctly recognises that:
 - (i) the assessment of forecast profitability should examine forecast revenues against the regulatory value of Auckland Airport's assets (although Auckland Airport disagrees with the approach that the Commission has taken to base that regulatory asset value on the 2009, rather than 2012, asset base); and
 - (ii) the pricing revenues that it is assessing do not include revenues attributable to increases in the value of Auckland Airport's asset base in the future (as these are not forecast in the pricing asset base).
 - (d) BARNZ' suggested approach is inconsistent with the airlines' position in relation to Wellington Airport, where the airlines supported the Commission's approach of assessing forecast revenue against the 2012 disclosed asset base (which, in that case, was lower than the asset base used to set prices). There is no justification for adopting a different position where the disclosed asset base is higher than the asset based used to set prices - the appropriate reference point remains the same.
 - (e) We also note that, as recognised by the Commission, BARNZ has previously suggested that an option would be for the Commission to compare the outcome of Auckland Airport's pricing decision against an asset base excluding revaluations post-2009.³ This is the approach taken by the Commission in the

³ BARNZ *Post Auckland Airport Section 56G conference submission*, 15 March 2013 at page 7.

Draft Report, and BARNZ now appears to be resiling from its previous position that this approach would be a valid option.⁴

18. As we have set out previously, the correct approach is to assess the forecast revenues over PSE2 against the regulatory value of Auckland Airport's assets at the start of the Commission's period of analysis (ie the 2012 ID asset base).⁵ The Commission has been very clear, and we agree, that airports are free to adopt their own pricing inputs. What counts is the comparison of outputs (eg forecast revenue) against the ID benchmarks (eg the asset valuation input methodology ("**IM**")), applied consistently for the three airports.
19. The Commission's analysis focuses on assessing airport profitability from the start of PSE2, in recognition of the fact that 2012 represents the first opportunity that the airports have had to respond to the guidance provided by ID regulation on profitability. As such, the appropriate reference point for the Commission to use for its opening asset base is the Commission's view of the regulatory value of Auckland Airport's assets in a workably competitive market, as at the beginning of 2012. This is the IM compliant value.

Sensitivities undertaken by the Commission

20. As discussed in our post-conference submission, Auckland Airport does not agree with an approach to assessing returns that incorporates assumptions about potential future pricing behaviour, unless there is a clear and express caveat regarding the limitations of such an approach. However, given the discussion of PSE3 issues during the section 56G review, we provided information about our future intentions to assure the Commission and airlines that our future pricing conduct will be reasonable and appropriate, and to assist with the modelling that the Commission has chosen to undertake.
21. In summary, Auckland Airport stated that:⁶
- (a) In the absence of a successful merits appeal, it is highly unlikely that MVEU valuations would be adopted for PSE3. While MVEU was a reference in early consultation discussions for PSE1 and PSE2, Auckland Airport set prices in PSE1 and PSE2 based on market value alternative use ("**MVAU**") values. Auckland Airport suggests the Commission should disregard MVEU as an option in its profitability analysis.
 - (b) Auckland Airport will continue to take guidance from the IM benchmarks for price setting purposes. As such, IM compliant asset values will likely form a useful reference point in PSE3.
 - (c) Auckland Airport currently has no intention to revalue its asset base for pricing in PSE3. Continuing the moratorium or an approach involving indexing of the moratorium from 2017/2018 onwards are both distinctly possible outcomes.
 - (d) If the moratorium is unwound in the future, and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).
22. We repeat these assurances.

⁴ Draft Report at paragraph F42.

⁵ Auckland Airport *Section 56G Review of Auckland Airport: Post-conference Submission*, 15 March 2013 at paragraphs 99-101; Auckland Airport *Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report*, 31 May 2013 at paragraphs 144-150.

⁶ Auckland Airport *Section 56G Review of Auckland Airport: Post-conference Submission*, 15 March 2013 at page 9 (Section 3: Key points).

23. In its Draft Report, the Commission appropriately considered that Auckland Airport's assurances provided the best evidence of future performance at this time.⁷ As such, the Commission correctly gave no weight to potential PSE3 pricing scenarios that involved revaluation gains not treated as income.⁸ To be clear, we understand that our assurances about future conduct assist the Commission to determine that, at the time we set prices for PSE2, we were not aiming to earn excess profits in the future. There is additional value for airlines in that Auckland Airport will risk adverse attention if it departs from the guidance it has given in the future.
24. BARNZ, Air New Zealand and NZIER have all expressed concern that the Commission has adopted the "non-binding and qualified" indications of Auckland Airport's future intentions with respect to the moratorium and the treatment of any resulting revaluation impact should the moratorium be lifted in the future.⁹ As such, the submissions on the Draft Report have attempted to:
- (a) dilute the quality of the clarification provided by Auckland Airport in relation to its future intentions;
 - (b) discount the weight that the Commission can apply to Auckland Airport's statements about its future intentions;
 - (c) encourage the Commission to give weight to the fact that the Airport Authorities Act leaves open a potential "method of extracting excessive returns" in the future;¹⁰
 - (d) persuade the Commission to consider all potential options for 2017 "or beyond", no matter how unlikely, as part of the Commission's analysis on the basis that no future options have been "completely ruled out";¹¹ and
 - (e) encourage the Commission to take a statistical probability-based approach when considering likely future conduct.¹²
25. In response, we note that:
- (a) The track record of evidence demonstrates that Auckland Airport runs a thorough and reasonable consultation process with fair outcomes that seek to balance the needs of all airport stakeholders. This will continue in the future.
 - (b) Air New Zealand states in its submission that it would like to be able to accept Auckland Airport's non-binding assurances as a genuine commercial commitment.¹³ It can. Our comments were fully considered, carefully

⁷ Commerce Commission *Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport: Section 56G of the Commerce Act 1986*, 30 April 2013 ("**Draft Report**") at paragraph F33.

⁸ Draft Report at paragraphs E46-E47.

⁹ See, for example: Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraphs 36-42; BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at pages 7-9; NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 9.

¹⁰ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 3.

¹¹ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 8.

¹² NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 7-8.

¹³ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 41.

explained, and recorded in submissions that are available to the Commission, the public, all of Auckland Airport's substantial customers, and to Ministers and officials. Accordingly, these audiences will be fully aware of the assurances that Auckland Airport has given. In the context of this scrutiny, Auckland Airport would be harshly judged in the future if it moved away from the commitments that have already been given.

- (c) The Commission's task under the section 56G review is to review the information that has been disclosed and make an assessment about the current effectiveness of ID regulation. BARNZ appears to be encouraging the Commission to conclude that Auckland Airport is making excessive profits now, because there is nothing to prevent it from doing so in the future. It then encourages the Commission to use this as "evidence" that ID regulation is not currently effective. This is not a logical conclusion, and ignores the track record of the actual evidence that Auckland Airport should be judged on.
- (d) NZIER appears to consider that unlikely future possibilities should be given a probability weighting and factored into the Commission's estimate of expected returns in the future.¹⁴ In our view, this is inconsistent with the requirements of section 56G and the Commission's task under the review. As discussed above, the Commission's task is to assess how effectively information disclosure regulation is currently working based on disclosed information - using a theoretical probability analysis (of highly unlikely future possibilities) instead of current evidence to draw conclusions does not correctly fulfil the requirements of the section 56G review.
- (e) In any event, the Commission has already acknowledged that Auckland Airport has the ability to take different approaches in the future, and has been clear that it will be "closely monitoring whether Auckland Airport acts consistently with the guidance it has given during this review at the next price setting event".¹⁵

Auckland Airport considers this is exactly the right outcome to expect from a light-handed ID regime. In other words, the regime is intended to promote self-initiated behaviour change through transparency and monitoring over time. The key is for the Commission to recognise, as it already has, that Auckland Airport has acted appropriately now, and to identify areas that it will continue to monitor over time. Our future conduct and performance falls into that category.

- 26. Both BARNZ and Air New Zealand refer to the one-off nature of the section 56G review as an apparent driving influence for Auckland Airport's behaviour. The implication of the airlines' argument appears to be that the scrutiny on Auckland Airport will somehow be less after the section 56G review has concluded, and therefore that Auckland Airport will be free to do as it chooses in the future, without regard for the information disclosure regime or the commitments that it has expressed through the section 56G review process.
- 27. This is simply not the case. ID regulation will clearly continue to have an impact on Auckland Airport's behaviour and decisions in the future (and the airlines' comments in fact acknowledge that the ID regime is currently having a demonstrable influence on Auckland Airport's behaviour). As recognised by NZIER, ID regulation involves a lengthy chain of information, interpretation and deliberation over time.¹⁶ As part of that process, Part 4 provides the Commission with the ability to assess airport performance

¹⁴ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at pages 7-8.

¹⁵ Draft Report at paragraph E47.

¹⁶ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 15.

on an ongoing basis, such as through annual monitoring and reporting, and the power to request information. Auckland Airport is conscious that it must regularly report on how it is responding to the incentives set out in the Part 4 of the Purpose Statement.

28. As such, the Commission has the necessary resources and tools to identify and monitor future trends (including highlighting where it believes ID regulation can be improved, where airport performance may be of concern, or where regulation may no longer be required).

MVEU valuation in 2017

29. In the Draft Report, the Commission has appropriately recognised that a scenario based on MVEU valuations in 2017 should not form part of its analysis, given that:

- (a) the available evidence demonstrates that a change to asset valuations on a MVEU basis in future pricing decisions is highly unlikely in the absence of a successful merits appeal outcome; and
- (b) if the moratorium is unwound in the future, and a revalued asset base is used in pricing, Auckland Airport has stated that the cumulative revaluation impact would be treated as an offset to the future revenue requirement (in an NPV neutral manner).

30. Auckland Airport is surprised by the continued emphasis on MVEU valuations in BARNZ' submission on the Draft Report. In its submission, BARNZ:

- (a) attempts to discredit the assurances that Auckland Airport has provided about its likely future behaviour;
- (b) continues to emphasise that MVEU was an early option in pricing consultations in 2007 and 2012;
- (c) relies on the fact that the Airport Authorities Act and the ID regime do not prevent Auckland Airport from adopting MVEU valuations in the future;
- (d) attempts to draw an inference from the potential outcome of the input methodologies merits review proceedings as a sign that Auckland Airport may "inappropriately" adopt a MVEU valuation in the future; and
- (e) puts forward an alternative MVEU valuation in 2017 which, in its view, supports a conclusion that ID regulation is currently ineffective.

31. In response, we note that the assurances that we have provided to the Commission about MVEU are, as discussed above, genuine and credible. Accordingly, BARNZ' speculation about what might happen in the future cannot change the fact that now, and at the time we set prices for PSE2, Auckland Airport has no intention to earn excessive profits (and the ID regime is therefore effective). Auckland Airport's assurances combine with the strong track record of evidence about our current decisions and behaviour. In particular, we note that:

- (a) Auckland Airport has not used MVEU to value its pricing asset base since 2002. Although MVEU was a potential option discussed in consultation in the 2007 and 2012 price-setting events, submissions from substantial customers through consultation under the Airport Authorities Act and the presence of the ID regulatory regime *has already resulted* in Auckland Airport moving from MVEU to MVAU valuations for pricing purposes in 2007, and retaining this valuation approach in 2012.

- (b) It is not clear why BARNZ considers Auckland Airport's position in the merits review to support its position. Auckland Airport has already demonstrated that it is prepared to respond appropriately to the regulatory guidance that is in place at the relevant time, including where we may disagree with the reference points provided by the Commission's input methodologies (such as by excluding land held for future use from its pricing asset base).
 - (c) If the merits review outcome confirms that MVEU is the appropriate valuation approach for ID purposes, any decision to move to that valuation basis for pricing could not be viewed as inappropriate (as charges would then be assessed against a disclosure asset base valued on a MVEU basis). In any event, there is no certainty that Auckland Airport would move to a MVEU valuation in these circumstances.
 - (d) As the Commission has appropriately recognised, the more important question is how any possible change in the asset base for pricing purposes would be treated (if such a change were to occur). In this respect, Auckland Airport's assurances in its post-conference submission are unequivocal. *If* the moratorium is unwound in the future, and a revalued asset base is used in pricing (regardless of whether that asset base is valued using MVAU or MVEU), the cumulative revaluation impact *will be* treated as an offset to the future revenue requirement (in an NPV neutral manner).
32. As such, the specific issues raised by BARNZ in relation to the likely size of a MVEU asset base in 2017 do not change the Commission's analysis, and do not justify a conclusion that ID regulation is currently ineffective at limiting Auckland Airport's ability to extract excessive profits.
33. The calculations put forward by BARNZ highlight the risks with an assessment approach that:
- (a) relies heavily on assumptions about future conduct; and/or
 - (b) does not provide appropriate clarity regarding the (limited) role of modelling future profitability.

As exemplified by the airlines' submissions, such an approach simply encourages airline speculation based on unsupported contentions.

Timing of cashflows

34. The Draft Report correctly recognises that adopting an assumption of year-end cashflows for the Commission's IRR analysis is consistent with the current ID requirements, and consistent with the guidance provided by ID regulation at the time Auckland Airport set its prices.¹⁷ As such, the Commission has correctly considered that an assumption of year-end cashflows is appropriate when assessing the impact of ID regulation on Auckland Airport's ability to extract excess profits.
35. In their submissions on the Draft Report, the airlines encourage the Commission to reconsider its decision. In particular:
- (a) BARNZ encourages the Commission to make mid-year cashflows its main scenario in its IRR analysis because it is "axiomatic" that Auckland Airport incurs cost and earns revenue throughout the year.¹⁸

¹⁷ Draft Report at paragraphs E38, F13.

¹⁸ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 12.

- (b) Air New Zealand goes further, considering that it is "extraordinary" for the Commission to acknowledge that there is \$5 million per annum difference between returns calculated using year-end cashflows and those using mid-year cashflows, yet still find that Auckland Airport is limited in its ability to extract excessive profits.¹⁹

36. In response, Auckland Airport notes that:

- (a) As part of the discussion of the Initial Pricing Proposal during consultation, BARNZ queried the timing of assets commissioned in Auckland Airport's pricing model. The modelling methodology used by Auckland Airport was broadly based on the building blocks approach used by the Commission in the annual ID templates.
- (b) In relation to assets, Auckland Airport adapted its approach between PSE1 and PSE2, incorporating the use of the RIV estimate (as used for ID purposes), which took a proportionate commissioning approach. In terms of other building block elements, our pricing model used basic year-end cashflows (which is consistent with ID), and the timing of cashflows was not highlighted by airlines as an area that needed to be changed during consultation.
- (c) We agree with the Commission that Auckland Airport's pricing decision should not be judged based on an assumption of mid-year cashflows when an IRR-based assessment approach (as opposed to annual ROI calculations) was not anticipated or signalled by the ID regime at the time of Auckland Airport's pricing decision.
- (d) The airlines' approach attempts to encourage the Commission to draw an adverse finding about the effectiveness of ID regulation in a way that is inconsistent with the regulatory guidance provided by the ID framework at the time Auckland Airport set its charges.
- (e) In our view, a decision by the Commerce Commission now to use a mid-year cashflow assumption would not provide interested parties with information about the impact or effectiveness of ID regulation for Auckland Airport at the time prices were set. The Commission has assumed cashflows occur at the end of each year, with the exception of capital expenditure. It assumes that half of the capital expenditure forecast for each year of the regulatory period occurs at the beginning of that year, with the remaining half occurring at the end of that year. As the Commission notes, this is consistent with the treatment of cashflow timing in the annual performance measure under ID regulation. This is also entirely consistent with Auckland Airport's modelling for pricing. Therefore we consider the Commission has correctly focused on year-end timing assumptions in its modelling.

Land in asset base

37. BARNZ has encouraged the Commission to exclude 26.4ha of Southern Airfield restricted land (previously known as the Eastern Approaches) from the asset base used for assessment purposes. In BARNZ' view:

- (a) the Commission has previously determined that ownership of this land is unnecessary for the provision of airport services;

¹⁹ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 26.

- (b) planning provisions are able to adequately protect Auckland Airport from incompatible land uses on the land;
- (c) the land in question is "surplus land" and an "inefficiently held unnecessary asset"; and
- (d) the land should be excluded from Auckland Airport's regulatory asset base.

38. Auckland Airport considers that this land is used to secure the current supply of airport services, is appropriately and efficiently held, and correctly forms part of the regulatory asset base. In our view, there is no reason for the Commission to adjust its analysis of Auckland Airport's profitability in the way suggested by BARNZ. This appears to be an issue about the IM requirements, which Auckland Airport considers it is fully compliant with. The section 56G review is not the appropriate forum to deal with such issues. In any event, in response to BARNZ' claims, we note that:

- (a) Auckland Airport considers that the ownership of the land adjacent to airfield approach land is currently necessary, prudent, and provides significant advantages over reliance on planning restrictions alone. For example:
 - (i) Planning restrictions may provide an opportunity for Auckland Airport to object to incompatible activities, but would provide no guarantee of a successful outcome. If consent was granted for an incompatible activity it would be time consuming for the Airport to manage the effects of the activity on its operations, and would reduce the effectiveness of Auckland Airport's wildlife management control programme.
 - (ii) We continue to consider that selling the adjacent areas would create additional safety concerns for the airfield. For example, the British Civil Aviation Authority recommends consultation about developments that have the potential to attract birds within a 13-kilometre radius of the aerodrome reference point.²⁰ The 13-kilometre birdstrike circle is based on the fact that 99% of bird strikes occur below 2000 feet.²¹
 - (iii) In Auckland, the Council has been reluctant to prohibit activities in its District Plans. This means that an application can be made for resource consent for any activity. Resource consent may be applied for and granted even for activities which are deemed non-complying. There is often much effort required to oppose such applications (whether the opposition is brought by corporations or community interest groups). The task is even more difficult in areas of specialist knowledge such as aviation.
 - (iv) In addition, there are very limited planning restrictions on agricultural activities that could attract wildlife that may be hazardous to aviation. It is difficult to manage wildlife through the framework of the Resource Management Act 1991. As acknowledged by the Civil Aviation Authority, the most effective form of control is ownership.²²
- (b) In our view, it is not prudent to rely on planning restrictions and requiring the Airport to submit against and potentially appeal inappropriate land use activities

²⁰ CAP 738 Safeguarding of Aerodromes, Appendix A, page 1.

²¹ Bird strike is one of the greatest risks to an aircraft engines. Perhaps the most widely known example of this occurred in January 2009 when a US Airways flight struck a flock of Canada Geese during its initial climb out, lost engine power, and ditched in the Hudson River off midtown Manhattan.

²² Civil Aviation Authority Advisory Circular AC139-16: Wildlife Hazard Management at Aerodromes, 7 October 2011, page 12.

for such crucial land. There are numerous examples where planning restrictions have been insufficient to address reverse sensitivity issues or lengthy litigation has been required to prevent incompatible land uses on surrounding land.²³

- (c) From time-to-time, Auckland Airport has sought to identify alternative activities for this land. Auckland Airport does not currently consider that alternative uses (such as intensive agriculture) are appropriate given the potential risks to the current operation. We remain open to identifying appropriate alternative activities to offset the cost associated with holding this land.
39. BARNZ also suggests there is a disconnect between the value of the land in Auckland Airport's pricing asset base and its value in the disclosed regulatory asset base. We do not consider that it is possible or appropriate to ascribe values to portions of Auckland Airport's land in the way suggested by BARNZ, when the IM MVAU valuation task involves determining a valuation for a hypothetical development project across the entirety of Auckland Airport's regulated land assets.
40. In particular, the per hectare rates underlying the "pricing value" of the land are based on a zonal approach which valued this piece of land in isolation. However, the rates used by BARNZ to calculate the "disclosure value" of the land are based on a blended average across all of Auckland Airport's regulatory land. This is not an apples-for-apples comparison, and the figures presented by BARNZ do not represent a true picture of the change in value of this land.
41. This is essentially an attempt by BARNZ to cherry-pick a piece of land in isolation as an alternative way of presenting its main theme (ie that the regulatory asset base used in the Commission's IRR analysis is higher than the asset base used by Auckland Airport to set prices). As we have submitted (and as the Commission has recognised), Auckland Airport's disclosed asset valuation is the appropriate reference point for the Commission's analysis.

²³ See, for example *Wellington International Airport Limited v Wellington City Council* W55/05, where consent was upheld for a proposed four-level household unit building to be located within the Air Noise Boundary of the Airport. See also *Ports of Auckland Ltd v Auckland City Council* [1999] 1 NZLR 601 (HC), where Ports of Auckland was required to take action against the Council's decision to grant a resource consent on a non-notified basis for multi-storey residential apartments immediately opposite the Port.

SECTION 2: THE WACC IM

Key points:

- Auckland Airport considers that the 75th percentile estimate of the WACC IM is the minimum percentile estimate that is relevant for assessment purposes, in order to recognise both the inherent uncertainty involved in the WACC IM, and the asymmetric consequences involved in assessing whether excess returns exist.
- At the time of pricing, it was not precisely clear how the WACC IM would be used in the Commission's monitoring and analysis. While Auckland Airport understood the WACC IM would be part of the information the Commission would consider, we understood the Commission intended to put the WACC IM in context in its monitoring and analysis, and analyse the decisions Auckland Airport made in pricing as part of that context.
- When assessing the impact of ID regulation, the question to be answered is whether there is evidence that ID influenced price-setting decisions and, if so, how. The clear evidence is that the Commission's most recently published WACC estimate was influential for both Auckland Airport and its airline customers at the time of pricing, and had a constraining impact on the prices that were set.
- As such, the published April WACC estimate (appropriately contextualised) forms the correct reference point for the Commission's analysis of the effectiveness of ID regulation.

Overview

42. Auckland Airport has provided extensive submissions throughout the section 56G review process about how the WACC IM should be applied when monitoring and assessing airport performance.²⁴ We do not revisit these points in this submission.
43. However, BARNZ and Air New Zealand's submissions on the Draft Report devote considerable attention to the level and timing of the WACC IM that should be used when assessing Auckland Airport's returns. In particular, the airlines encourage the Commission to assess Auckland Airport's forecast returns against the 50th percentile estimate of an "updated" WACC IM.
44. In our view, these arguments are driven by the airlines' continued contention that the only appropriate outcome of an ID regime is for airports to set prices at the level of the Commission's WACC IM. This is clearly not the intent of ID regulation. For example, during the development of the amendments to Part 4 of the Commerce Act, the Ministry of Economic Development specifically rejected a suggestion that the WACC IM be binding for ID regulation, noting that:²⁵

Such a requirement could be interpreted to mean that the business has to price in a certain way including earning no more than its WACC. This amounts to price control, but the business is not under price control.

²⁴ See, for example, Auckland Airport *Section 56G Review of Auckland Airport: Post-conference Submission*, 15 March 2013 at paragraphs 51-85.

²⁵ Ministry of Economic Development *Commerce Amendment Bill: Report of the Ministry of Economic Development*, 4 July 2008 at page 25.

45. In addition, the Commission has specifically acknowledged that the WACC IM is not intended to be treated as a target rate of return, and does not prevent airports from making pricing decisions as they see fit.²⁶

46. We respond to the airlines' specific arguments below.

The percentile estimate of the WACC IM

47. The airline submissions put forward three different bases for the use of the 50th percentile estimate of the Commission's WACC IM to assess the appropriateness of Auckland Airport's charges. In summary:

(a) BARNZ considers it is appropriate to apply a mid-point estimate WACC as the target return, based on what an efficient debt structure and costs would be for the industry. In BARNZ' view, measuring the expected returns of an airport against a 75th percentile WACC estimate is effectively "endorsing an outcome which is 75% likely to be in excess of a reasonable return".²⁷ BARNZ considers the existence of non-aeronautical activities means that it is not necessary for airports to set charges at the 75th percentile WACC estimate in order to be incentivised to innovate and invest.

(b) Air New Zealand considers that the Commission is resiling from its previously expressed approach.²⁸ Air New Zealand suggests that the Commission's decision to justify the selection of any point about the 50th percentile is likely to be "insurmountably high in the circumstances".²⁹ Air New Zealand considers that the Commission has identified \$78 million of returns that are "by definition excessive" because they "represent an amount over and above the best available estimate of a competitive standard".³⁰

(c) NZIER rely on the basis of a statistical analysis to conclude that the Commission's decision to adopt the 75th percentile estimate is not reasonable.³¹

48. In response, Auckland Airport considers that the 75th percentile estimate of the WACC IM is the minimum percentile estimate that is relevant for regulatory assessment purposes, in order to recognise both the inherent uncertainty involved in the WACC IM, and the asymmetric consequences involved in assessing whether excess returns exist. The positions advanced by the airlines do not change this position. In particular:

(a) BARNZ' arguments are inconsistent with its position at the time of Auckland Airport's pricing consultation, where it applied the 75th percentile estimate of the Commission's WACC IM (at 8.04%) in order to provide an "absolutely

²⁶ Commerce Commission *Respondent's Submissions, Volume 2: Cost of Capital*, 6 August 2012 (CIV-2011-404-820) at paragraphs 88-89.

²⁷ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 14.

²⁸ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 20.

²⁹ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 24.

³⁰ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013, 31 May 2013 at paragraph 18.

³¹ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at pages 3-6.

reasonable yardstick" against which to assess Auckland Airport's proposed charges.³²

- (b) In addition, BARNZ' arguments in relation to Auckland Airport's non-aeronautical activities are misguided and without evidential foundation. In a dual till environment, the appropriate approach is to incorporate a percentile estimate that recognises the risk of underestimating WACC for aeronautical services and has regard to the social consequences of getting that estimate wrong. Auckland Airport accounts for the multi-faceted nature of its business by appropriate cost sharing and allocation approaches.
- (c) There is no regulatory uncertainty as suggested by Air New Zealand. The use of the 75th percentile is a recognised regulatory approach that is often used, and based on a principled preference for dynamic over allocative efficiency in order to promote the long-term benefit of consumers.³³
- (d) It has been recognised that the use of the 75th percentile estimate of WACC in price-setting is a rational economic approach to ensure that the appropriate incentives are provided to regulated suppliers. Accordingly, it is inconsistent to use a different (and lower) percentile estimate when assessing profitability. As recognised by an expert advisor to the Commission:³⁴

In the context of assessing excess profits, it would be appropriate to choose a WACC value from above the 50th percentile (this margin is denoted type 1), because the consequences of judging excess profits to exist when they do not are more severe than the contrary error.

[...] Accordingly the type 1 WACC margin should implicitly incorporate a significant allowance for the risk of deterring investment.

- (e) Air New Zealand claims that the use of the 50th percentile "balances the statistical risk between over-and under-estimation".³⁵ This misses the point. It is the *consequences* of over- and under-estimation that must be balanced in a regulatory context. In these circumstances, the risk of under-estimation, and the negative consequences that would have for the long-term benefit of consumers, is greater than any risk associated with over-estimation. The use of the 75th percentile estimate of WACC is an appropriate method to balance this risk. Further, the Commission has been clear that returns above its estimate of WACC are not automatically excess returns (as argued by Air New Zealand).³⁶ Air New Zealand's claims misrepresent the Commission in this respect.
- (f) NZIER's conclusion is similarly based on statistical theory without consideration of the real-world implications of the WACC IM in a regulatory context. We **attach** a paper prepared by NERA Economic Consulting which responds to the NZIER paper in more detail.
- (g) BARNZ, Air New Zealand and NZIER all appear to assume the Commission's industry WACC for disclosure purposes is Auckland Airport's true WACC.

³² BARNZ *Submission by BARNZ on Auckland Airport Revised Pricing Proposal on Behalf of the Airlines it has Authority to Fully Represent*, 7 May 2012, at page 2.

³³ Commerce Commission *Gas Control Inquiry Final Report*, 29 November 2004, paragraph 9.92; Lally *The Weighted Average Cost of Capital for Electricity Lines Businesses*, 8 September 2005, pages 62-63.

³⁴ Lally *The Weighted Average Cost of Capital for Gas Pipeline Businesses*, 28 October 2008 at page 94-95.

³⁵ Air New Zealand *Submission to the Commerce Commission on Draft Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Auckland Airport*, 31 May 2013 at paragraph 22.

³⁶ Draft Report at paragraph 2.32.

Auckland Airport has provided evidence that the industry WACC does not represent its true WACC, which has not been addressed by the airlines. The Commission has recognised that the use of the 75th percentile is intended to, in part, reflect differences between a suppliers' WACC and the industry-wide estimate.³⁷ The submissions of these parties do not engage with the evidence demonstrating the lack of precision in the WACC IM, and fail to give adequate examination (and, in some cases, any examination) of the fact set provided by Auckland Airport and UniServices.

49. Overall, the airlines' views have a short-term focus and do not appropriately recognise the practical consequences of getting regulatory decisions about WACC wrong. As recognised by the Australian Productivity Commission, decisions made by a regulator on WACC issues can have significant impacts for investment at airports:³⁸

[...] setting parameters that result in a lower-than-required WACC (and thus lower prices as the cost of capital feeds into the building blocks model) can result in inadequate or delayed investment, as investors seek higher returns elsewhere [...]

For airports, many of their lumpy investments will be an 'all or nothing' venture. If a regulator only allows the airport operator to earn 80 per cent of the return it needs to attract investment funds, it is generally not possible to build only 80 per cent of the runway those funds were intended for.

The timing of the WACC IM

50. BARNZ and Air New Zealand consider that the Commission has adopted an "out of date" WACC estimate to assess Auckland Airport's charges. BARNZ considers that:³⁹
- (a) it is the usual practice of airports to refresh the WACC estimate for price setting as close as practicable to the time that charges are set;
 - (b) this is what occurred when Auckland Airport reset charges in both 2007 and 2012; and, therefore
 - (c) the Commission should assess airport profitability using a cost of debt calculated at the date the airports refreshed their cost of capital estimates for pricing purposes.
51. In our view, this approach illustrates the dangers associated with a prescriptive application of the Commission's WACC estimate when assessing airport charges. The approach proposed by BARNZ, if followed for assessment purposes, strongly implies that the airport should simply set charges at the level of the Commission's WACC IM calculated at the date that prices are set. This is clearly not the intent of ID regulation and is clearly not the intent of the Commission's WACC IM.
52. The correct focus when assessing the impact of ID regulation is to consider how Auckland Airport responded to the incentives and understanding that existed at the time of pricing. These incentives were shaped by the way in which Auckland Airport understood its behaviour and decisions were to be assessed. As we have described previously, we understood that the Commission would use its published cost of capital estimates as a reference point when assessing our decisions (although, as we have

³⁷ Commerce Commission *Christchurch Airport Conference Transcript*, 24 May 2012 at page 60 (lines 9-15), per Commissioner Dignan.

³⁸ Australian Productivity Commission *Economic Regulation of Airport Services (Inquiry Report no. 57, Canberra)* 14 December 2011, pages 126-127.

³⁹ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at pages 15-16.

already submitted extensively, we considered that the Commission's WACC estimate would be put in context when assessing the appropriateness of our forecast return).

53. Auckland Airport updated its WACC estimate at the time of pricing, but this estimate in fact was not used to achieve NPV=0. Rather, Auckland Airport was influenced to accept an overall level of return lower than this target as a result of submissions by BARNZ. In particular, we were cognisant of BARNZ' view that 8.04% was an appropriate level to assess the reasonableness of Auckland Airport's proposed prices.
54. As such, the published WACC estimates were a useful reference point for both Auckland Airport and its substantial customers during the pricing consultation. This is evidenced by the fact that BARNZ referenced the Commission's April 2012 WACC estimate of 8.04% (at the 75th percentile) when assessing the overall level of Auckland Airport's charges and when presenting to the Board in relation to the proposed charges in May 2012.
55. Accordingly, we continue to consider that the April published WACC estimate is the appropriate reference point when considering how Auckland Airport responded to the ID framework at the time of price-setting.

SECTION 3: PERCEIVED "GENEROSITY" IN THE DRAFT REPORT

Key points:

- The airlines' assertions that the Draft Report contains a generosity bias are incorrect and do not correctly reflect the position that has been reached in the Draft Report.
- Auckland Airport encourages the Commission to reflect the sensitivities proposed by Auckland Airport in its analysis in order to ensure the Final Report presents a full, balanced and accurate picture for interested parties.
- The Commission is not erring on the side of a positive finding, as suggested by NZIER.
- In any event, promoting positive behaviour is the key to success of the ID regime, and it is critical for the Commission to recognise and value positive behaviour where that has been demonstrated (as is the case for Auckland Airport).

Overview

56. BARNZ, Air New Zealand and NZIER claim the draft report is overly generous to Auckland Airport in the assumptions that underpin the Commission's analysis and the assessment tools used to carry out that analysis.
57. NZIER goes further, suggesting that the Draft Report has erred on the side of a positive finding without good reason. NZIER suggest that a negative finding will better contribute to the ongoing success of the ID regime.
58. Auckland Airport disagrees with these claims, as discussed below.

There is no generosity bias in the Draft Report

59. The assertions that the Draft Report is weighted in favour of Auckland Airport are unfounded. These assertions do not reflect the evidence the Commission has used to draw its draft conclusions, and ignore the evidence provided by Auckland Airport that shows its return expectations are limited in a number of ways not recognised by the Commission. The Commission has correctly referenced the positions of airlines throughout the consultation process as an important part of that evidence.
60. In our view, the airlines' incorrect perception may be based on the way the Commission's sensitivity process has been presented in the Draft Report.
61. We have previously questioned the need for the Commission to include sensitivities based on assumptions that are not robust (such as the MVEU/ODRC valuation, a demand forecast that BARNZ has subsequently resiled from, or a reduction in Auckland Airport's land valuation).⁴⁰
62. As noted previously, we accept the Commission has taken a sensible approach in attempting to understand these sensitivities but concluding they are of no weight in its analysis.⁴¹ However, if the Commission continues to reference these sensitivities, we

⁴⁰ Auckland Airport *Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report*, 31 May 2013 at paragraphs 155-156.

⁴¹ Auckland Airport *Section 56G Review of Auckland Airport: Submission on Commerce Commission Draft Report*, 31 May 2013 at paragraph 155.

encourage the Commission to present a full picture of the potential scenarios, rather than presenting only the scenarios which would increase the estimate of Auckland Airport's expected returns.

63. For example, the Draft Report makes no reference to the valid sensitivity assumptions which would lower the expectations of Auckland Airport's forecast returns, such as:
- (a) an allowance for asymmetric risks;
 - (b) a 10% upwards adjustment to Auckland Airport's land values; and
 - (c) an adjustment to the asset beta to reflect Auckland Airport's systematic risk.⁴²
64. We encourage the Commission to reflect these sensitivities in its analysis to ensure that it is presenting a full, balanced and accurate picture for interested parties about Auckland Airport's forecast returns. Doing so would also dissuade the airlines of their incorrect view that the Commission's conclusions are weighted in favour of airports.
65. Of course, there can be no question about the Commission's decision to accept Auckland Airport's assurances about its future intentions. This is not a question of generosity or balance. As discussed above, this is simply the best evidence of Auckland Airport's future conduct, which the Commission has acknowledged will then be monitored over time.

"Regulatory responsibility" in the context of ID regulation

66. Air New Zealand has submitted that the opinion of NZIER on "regulatory responsibility" under an ID regime raises significant concerns with the Commission's approach and the current regulatory framework.
67. NZIER discusses these points at section 4 of its submission under the heading "Is generosity appropriate under information disclosure". NZIER considers that:⁴³
- (a) it is inappropriate to "err on the side of positive pronouncements" under ID regulation;
 - (b) indecisive or poorly evidenced judgements will diminish the efficacy of the ID regime;
 - (c) by being too generous in its assessments, the Commission "sends a signal to the Airport that it has room to manoeuvre", and incentives for improved performance are likely to be undermined;
 - (d) Auckland Airport already appears to have "afforded itself flexibility in how it interprets and applies the Commission's existing determinations"; and
 - (e) the Commission needs to take steps to ensure the regime works over time, and there is accordingly "no need to sugar coat the performance of the regime".
68. NZIER suggests the Commission should err on the side of a negative finding in order to send the correct signals to airports and to enhance the effectiveness of the ID regime in

⁴² As discussed above, we also consider that the Commission's reasoning for its IRR model suggests the 2012 disclosed asset base is the appropriate opening asset base, with the moratorium asset base as the closing value. If the Commission declines to reflect this in its analysis, this would also be a valid scenario to present as a sensitivity.

⁴³ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at pages 15-17.

the future.⁴⁴ It suggests this will send a signal that, based on the evidence, the performance of Auckland Airport has not been as positive to date as it might have been given the Commission's expectations and application of its IMs.⁴⁵

69. In response, Auckland Airport submits that:

- (a) The Commission is not erring on the side of a positive finding in the Draft Report. Across the majority of the performance areas under assessment (including profitability), it is deliberately making a positive finding that is supported by the available evidence.
- (b) In any event, Auckland Airport emphasises that incentive-based regulation such as ID regulation is designed to promote positive behaviour that works towards the Part 4 outcomes over time. As such, it is important for the Commission to recognise positive behaviour change and for the regulatory regime to ensure the right incentives exist for airports to continue to make such changes.
- (c) This will not be achieved by dismissing the actual evidence of current positive conduct and outcomes at Auckland Airport in favour of a negative finding that is based on purely theoretical speculation about future conduct. Indeed, that would risk disincentivising positive behaviour change and continuous improvement. From our reading of the Draft Report, Auckland Airport understands the Commission sees room for Auckland Airport to improve in some areas, which we will continue to be aware of going forward.
- (d) In addition, all other things are not equal in a regulatory context that is designed to promote positive performance and behaviour across a range of regulatory outcomes, not just returns. Erring on the side of a negative finding on returns, where that finding is not justified based on current evidence and behaviour, would carry a strong risk of negatively impacting the other elements of the Part 4 purpose statement.

70. In addition to these issues, Auckland Airport considers the comments made by NZIER demonstrate that it is not fully aware of the way in which the ID regime has been established or the way that the regime operates. For example:

- (a) As noted above, NZIER considers that Auckland Airport has "afforded itself flexibility in how it interprets and applies the Commission's existing determinations".⁴⁶ NZIER appears to base this finding on the fact that Auckland Airport has used and reported WACC methodologies and values which are different to those set out in the Commission's IMs.

This demonstrates a fundamental misunderstanding of the ID regime, which is a light-handed, fit-for-purpose regime that specifically allows airports to adopt tailored and flexible pricing approaches while ensuring that airports disclose a wide range of information about performance.

Auckland Airport has complied with all ID requirements and the Commission's existing determinations. What NZIER is in effect saying is that Auckland Airport has not adopted the WACC IM in pricing. However, as the Commission has noted, this is perfectly consistent with the ID regime, where the WACC IM

⁴⁴ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at pages 15-17.

⁴⁵ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 17.

⁴⁶ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 15.

was designed to encourage airports to be transparent about the approaches they have taken and the justification and reasoning for those approaches.⁴⁷

- (b) NZIER notes that Auckland Airport may well have forecast revenues that could fall within the range of appropriate returns, but that this has been achieved through ad hoc adjustments to pricing. In NZIER's view, this is "not very transparent".⁴⁸

This statement does not recognise that Auckland Airport is required to disclose a comprehensive and extensive summary of its pricing decisions and forecast pricing information in accordance with the Commission's ID requirements. As such, Auckland Airport's regulatory pricing disclosures are fully transparent and provide a great deal of information to allow interested parties to assess the decisions that have been made.

- (c) NZIER claims that Auckland Airport's statements about the rates of return it needs have been "undermined by its ad hoc pricing adjustment".⁴⁹ NZIER considers that Auckland Airport's reasonable rate of return is lower than Auckland Airport would have people believe. As part of this argument, NZIER asks how Auckland Airport has accepted a forecast rate of return which is below its view of the appropriate WACC for aeronautical activities.

NZIER appears to misunderstand the impact and influence of the ID regime and the pricing consultation process under the Airport Authorities Act on Auckland Airport's decisions, including on the overall level of return sought.

⁴⁷ Commerce Commission *Respondent's Submissions, Volume 2: Cost of Capital*, 6 August 2012 (CIV-2011-404-820) at paragraphs 68-69, 80-83. It is also not clear whether NZIER is aware of the presence of section 53F of the Commerce Act which, as the Commission is fully aware, provides that the WACC IM does not have to be applied by regulated airports for either disclosure or pricing purposes.

⁴⁸ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 17.

⁴⁹ NZIER *Assessing the effectiveness of information disclosure: A review of the Commerce Commission's draft report on the effectiveness of information disclosure regulation of Auckland Airport*, May 2013 at page 16.

SECTION 4: ADDITIONAL ISSUES

Key points:

- Auckland Airport disagrees with BARNZ' assertion that international passengers are meeting a disproportionate amount of common costs. Auckland Airport's charges were set having regard to efficient pricing principles, ensure that all charges cover the directly attributable costs of the relevant services, and recover common costs appropriately with regard to Ramsey pricing principles.
- BARNZ' comments on runway capacity are not immediately relevant to the Commission's task in the section 56G review. However, we note that for planning purposes, a horizon of 2025 (+2 years) is Auckland Airport's best estimate of the point in time at which congestion will prompt the requirement for additional runway capacity.
- The query raised by BARNZ in relation to the proportion of non-pricing assets in the regulatory asset base does not change the Commission's analysis (which is based on an assessment of regulated income across all regulated services).
- Auckland Airport has acted responsibly in our delivery of capital expenditure over PSE2 to date. We do not consider the comments raised by Qantas in relation to the timing of capex to be of concern. We note that Auckland Airport continues to engage with its substantial customers, including through the BARNZ Cost and Regulatory Committee (of which Qantas is a member).
- Auckland Airport agrees with BARNZ that the capital expenditure relating to noise mitigation activities undertaken prior to PSE2 should be included in the asset base for the Commission's analysis of Auckland Airport's profitability.

Overview

71. In addition to the concerns expressed by the airlines with the profitability analysis in the Draft Report, additional specific issues have been raised. In particular:
- (a) BARNZ has questioned aspects of Auckland Airport's pricing efficiency, focussing on the allocation of common costs and the percentage of these costs contributed to by international passenger charges;
 - (b) BARNZ has queried the congestion projections for Auckland Airport's existing runway and the timing implications for the development of the second runway;
 - (c) BARNZ also query the over-statement of the proportion of RAB relating to non-pricing assets; and
 - (d) Qantas has raised some concerns about changes to the capital expenditure programme and encourages the Commission to take this "new" information into account in its Final Report.
72. We respond to these concerns below. We also reiterate Auckland Airport's position in relation to noise mitigation costs in order to assist with the understanding of this issue.

Pricing efficiency

73. BARNZ acknowledges that information disclosure regulation has had a positive impact on pricing efficiency at Auckland Airport, in that Auckland Airport has made positive changes between PSE1 and PSE2.⁵⁰
74. However, BARNZ considers that international users are currently paying a disproportionate share of common overheads under the Ramsey pricing approach adopted by Auckland Airport. In BARNZ' view, 90% of common costs are currently covered by international users, which it considers to be inappropriate.⁵¹
75. In response, Auckland Airport notes:
- (a) As set out in Auckland Airport's price setting disclosure, we engaged Estina Consulting to provide advice on the appropriate efficiency principles to guide pricing.⁵² The allocation methodologies adopted were intended to reflect the principles that all charges should, at a minimum, cover the directly attributable costs of the relevant service and all other costs should be recovered having regard to Ramsey pricing principles.⁵³
 - (b) Auckland Airport has provided information through the course of this review which demonstrates that these principles have been met in relation to the setting of the prices for terminal and airfield services.⁵⁴
 - (c) In particular, demand-side factors were considered by:
 - (i) allocating common costs to reflect differences in demand elasticity;
 - (ii) considering the transition of price paths from previous prices in PSE1 to the new PSE2 prices for different services, in order to avoid price "shocks" to a service; and
 - (iii) treating costs such as roads, forecourts, utilities and landside circulation areas as common costs, with the aeronautical portion of these costs included in passenger charges and allocated between passenger types in a way that is likely to enhance price efficiency.
 - (d) BARNZ appears to be taking a selective approach to the area of perceived over-recovery. The better approach is to look at the overall approach taken by Auckland Airport to allocating common costs. For example:
 - (i) In its Final Pricing Paper, Auckland Airport proposed to acknowledge that a portion of passenger charges related to common costs for airfield services, rather than to create a step change in airfield charges.

⁵⁰ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 17.

⁵¹ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 17.

⁵² Auckland Airport *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010*, 2 August 2012 at Section 2.7 (pages 63-66).

⁵³ Ramsey Pricing concepts are used to vary the amount of common and fixed costs allocated to user types based on the likely impact of such a cost change on user behaviour. Users whose demand for service is more (less) sensitive to cost changes are allocated a proportionally smaller (larger) amount of common and fixed costs. Ramsey-Pricing techniques are commonly used to assign fixed and common costs in large networks.

⁵⁴ See, for example: Auckland Airport *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010*, 2 August 2012 at Section 2.7 (pages 63-78), which demonstrates that the direct costs of airfield services are covered by airfield landing and parking charges and the sharing of common costs is consistent with Ramsey pricing principles.

- (ii) In doing so, Auckland Airport balanced the various interests of parties at the time of price setting, rather than looking at international terminal services in isolation. Auckland Airport is satisfied that pricing of each service covers its direct costs of operation, and that there is no over-recovery in relation to certain activities.
- (iii) There is no over-recovery for terminal activities because the MCTOW charge (which Auckland Airport has undertaken to review ahead of PSE3) is under-recovering airfield allocated costs. The portion of the passenger charges that BARNZ claims are related to terminal activities are in respect of the airfield allocated common costs.
- (iv) The net effect of Auckland Airport's pricing decision is that there is no over-recovery across both terminal and airfield charges. Auckland Airport was clear in its proposals that a portion of passenger-based charges related to the supply of airfield services, and did not propose a rebalancing between airfield and terminal charges, on the basis that there was a preference by some carriers for passenger based charging over MCTOW-based charging.

76. We also note that BARNZ has stated that Auckland Airport's charges are high by international standards and attract negative comment from overseas airlines operating to New Zealand.⁵⁵ BARNZ does not provide any evidence of these assertions.

77. We are unsure of the sources of BARNZ' information. Auckland Airport incorporates international benchmarking data on pricing as an important element of price setting decisions, and we are confident that our prices benchmark very well compared to overseas airports in the region.⁵⁶

Runway projections: will runway demand exceed capacity in the near future?

78. In its Draft Report, the Commerce Commission has noted that the runway *may* become congested in 2016, based on a runway capacity of 40 movements per hour, and a busy period movement forecast of 41 in 2016.⁵⁷ BARNZ considers that Auckland Airport's runway congestion projections are overstated, and that it is highly unlikely that the forecast level of movements by 2016 is expected.⁵⁸

79. In response, we note that:

- (a) The claim by BARNZ that there is no evidence of any runway-caused delay at Auckland Airport is untrue. However, such delay generally only occurs in the peak runway busy hour (0730). Auckland Airport therefore currently chooses to manage any congestion issues through operational solutions, rather than by investing further material capital at this stage.
- (b) The busy period movements in Section 4.1 of Auckland Airport's price setting disclosure were developed as part of the New Terminal Facility planning process, with a particular focus on the 2030 planning horizon. As part of this process, there was considerable discussion about the appropriate benchmarks

⁵⁵ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at page 17.

⁵⁶ See, for example, the benchmarking data used by Auckland in setting charge in 2012; Auckland Airport *Price Setting Disclosure in accordance with clause 2.5 of the Commerce Act (Specified Airport Services Information Disclosure) Determination 2010*, 2 August 2012 at pages 71-72.

⁵⁷ Draft Report at footnote 114 (page 63).

⁵⁸ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at pages 19-20.

for an airport such as Auckland Airport which has limited opportunities to influence long-haul scheduling times.

- (c) BARNZ suggests that annual runway movements at Auckland Airport have remained constant at approximately 154,000 per annum for some time, and the United States Federal Aviation Administration guidelines suggest a single runway can manage approximately 225,000 annual movements. While it is possible to debate the relevance of the FAA guidelines on annual movements (which can be hard to interpret unless there is a high degree of similarity between distribution at peak times), the more important facts in the context of this submission are that:
- (i) The declared runway capacity of 40 movements per hour is out of Auckland Airport's direct control, and is set by Airways and the Civil Aviation Authority.
 - (ii) Auckland Airport is supportive of initiatives to increase the throughput of the runway, as is evidenced by our participation in the ACE programme (also involving Airways and Air New Zealand). This programme is targeted at improving runway capacity and introducing initiatives to achieve this.
- (d) Auckland Airport will continue to work with stakeholders to seek to influence the declared runway capacity to beyond 40 movements (while ensuring that safety is not compromised). If these initiatives are successful, and forecasts are broadly consistent with those estimated as part of the New Terminal Facility process (and agreed with Air New Zealand), Auckland Airport estimates that a second operational runway is most likely to be required between 2020 and 2030. For planning purposes a horizon of 2025 (+2 years) is our best estimate of the point in time at which congestion will prompt the requirement for additional runway capacity.

Proportion of the regulatory asset base relating to non-pricing assets

80. BARNZ have submitted that the Commission appears to have over-stated the proportion of the regulatory asset base that relates to non-pricing assets.⁵⁹ BARNZ' argument appears to be another way of expressing its view that the opening asset base used in the Commission's IRR analysis is higher than that used as an input for Auckland Airport's pricing decision in PSE2.
81. As we have discussed above, this view does not change the fact that, under the Commission's analytical model, an opening asset base that is drawn from Auckland Airport's disclosed regulatory asset base is the appropriate reference point.
82. BARNZ' discussion about the distinction between pricing and non-pricing assets does not appear to be relevant to the Commission's analysis, which assess forecast regulatory revenue across all regulated activities, and compares this to the full regulatory asset base. That is, any "correction" of the issue raised by BARNZ would result in the same assessed 8.0% return on aeronautical activities for PSE2 under the Commission's IRR model.

⁵⁹ BARNZ *Submission by BARNZ on Commerce Commission Draft Section 56G Report on Auckland Airport*, 31 May 2013 at pages 19.

Qantas' capital expenditure concerns

83. Qantas has submitted that there is "new information" regarding the timeliness of capital expenditure at Auckland Airport which should be factored into the Commission's conclusions.
84. Qantas has submitted that it has become aware that Auckland Airport proposes to delay some capital expenditure projects and is also reviewing the potential earlier timing of other projects. Qantas also considers that it has had limited updates from Auckland Airport in regards to the status of key projects since the new pricing decision was implemented.
85. At an overall level, Auckland Airport's approach to capital expenditure, including our approach since the pricing decision, remains fair, reasonable, and characterised by constructive engagement with our substantial customers. By way of general overview:
- (a) The capital expenditure forecasts in Auckland Airport's pricing decision were based on the assumptions that existed at that time, including assumptions about the potential location of future terminal development. In response to airline advocacy for a Southern-based expansion, the terminal development was excluded from Auckland Airport's pricing decision so that further analysis could be undertaken.
 - (b) A masterplan review has been undertaken in relation to the location of new terminal development. This review has included an evaluation of several options, including North and South location options. In the meantime, the Aeronautical Planning Manager has reviewed the capital expenditure plan in Auckland Airport's pricing decision to determine whether any projects could be affected by the outcome of the masterplanning process and the potential location of the new domestic facility.
 - (c) While the review of the future new domestic facility is still on-going, our aim has been to highlight those capital expenditure projects that are independent of any decision about the location of the new terminal development.
 - (d) Consistent with our positive approach to capital expenditure consultation, Auckland Airport provides regular updates to our customers through a BARNZ capex committee and via the BARNZ Cost and Regulatory Committee (of which Qantas is a member). The most recent update was provided on 22 May 2013 as part of a FY14 Capex Preview, in which Auckland Airport sought feedback on physical, operational or regulatory changes that were being experienced or were anticipated, and which should be responded to in the capex plan.
86. In response to Qantas' specific concerns (ie that capital spend may not be timely and that Auckland Airport proposes to delay projects which were negotiated with airlines as the most appropriate solution at the time of pricing), Auckland Airport notes that:
- (a) In respect of the domestic terminal, Qantas' concerns are unfounded. The forecourt works are now substantially complete, and contractors are commencing terminal and airfield capacity works in June 2013. There has been a few months delay to the project due to the time required to execute a necessary agreement with a key airline customer, but the relevant works are still scheduled to be completed by May 2014. Contrary to the implications in the Qantas letter, there is no material delay to this project, or opportunism on Auckland Airport's behalf.

- (b) In respect of the broader capital plan, Auckland Airport considers it has taken a responsible approach by recognising that it would not be appropriate to simply proceed with the agreed plan if there is a risk that the investment might be in the wrong place or prove to be a less efficient or desirable option in the context of new masterplanning information or changed circumstances.
- (c) For example, the capital expenditure plan refers to a stand development project which Auckland Airport proposes to delay (as communicated in our May 2013 meeting). Auckland Airport believes that we have the broader support of BARNZ Cost and Regulatory Committee that this delay is appropriate, as it would be a sub-optimal outcome if the \$25 million allocated to this project turned out to be wasted expenditure.
- (d) Auckland Airport received the following response from BARNZ in relation to the capital update recently provided:⁶⁰

Thank you for the update you and your team provided BARNZ with on 22 May. This has now been considered by the BARNZ Executive Committee and I can advise that the Airport's plan to defer construction of the remote stand and associated taxiway until after the Masterplan has been determined and the location of the new terminal resolved is seen as sensible.

We understand that at that point consideration will be given as to whether that proposed remote stand is required, or whether there are other works which may have a greater priority or benefit to airlines and the airport. We also see that process of revisiting priorities as sensible.

We would however note that in the event that additional capex is required, which triggers any new charges, then BARNZ would expect that the benefit to the Airport from deferring the forecast new stand and taxiway (in the form of the Airport earning charges which incorporate a return on and of the unspent capital sums) would be taken into account and would be offset against any additional requirement for revenue to provide a return of and on capex which was not included in the pricing forecasts. In other words, we would expect the Airport to take into account unders as well as overs if the situation arises where new charges are being set for additional un-forecast investment.

- (e) Auckland Airport welcomes the constructive response from BARNZ and will update the airlines and the Commission as soon as the masterplanning outcome is known. Auckland Airport has contacted Qantas to ensure Qantas understands the broader context of the information on which they have submitted. Auckland Airport will continue to engage with its substantial customers, including through the BARNZ Cost and Regulatory Committee (of which Qantas is a member).

Noise mitigation costs

87. In BARNZ' submission, it summarises its understanding of Auckland Airport's position in relation to noise mitigation costs. BARNZ correctly notes that:

- (a) \$10.9 million of capital expenditure on noise insulation undertaken prior to PSE2 has been included in Auckland Airport's pricing asset base;

⁶⁰ Email from John Beckett, 5 June 2013.

- (b) \$1 million of capital expenditure on noise insulation forecast to be undertaken during PSE2 has been excluded from Auckland Airport's pricing asset base; and
 - (c) The operational expenses relating to noise issues have been included in the operating expenditure forecasts for pricing in both PSE1 and PSE2.
88. Auckland Airport agrees with BARNZ that the capital expenditure relating to noise mitigation activities undertaken prior to PSE2 should be included in the asset base for the Commission's analysis of Auckland Airport's profitability. Similarly, we agree with BARNZ that the forecast noise mitigation costs over PSE2 should be included in the Commission's analysis.
89. Auckland Airport notes BARNZ' comment that there appears to be an inconsistency between how Auckland Airport has treated noise costs in pricing as compared with its annual information disclosure. We appreciate the understanding of BARNZ' position that has developed through the section 56G review, and note that Auckland Airport will move the relevant noise mitigation expenditure from works under construction to its regulatory asset base for the disclosure year ending 30 June 2013. This will improve the alignment of the pricing and disclosure approaches.