BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND

SUBMISSION BY BARNZ ON COMMERCE COMMISSION DRAFT SECTION 56G REPORT ON AUCKLAND AIRPORT

31 May 2013

PART 1 – INTRODUCTION AND EXECUTIVE SUMMARY

In BARNZ's view the evidence before the Commission does not support a conclusion that information disclosure has been effective in limiting the extraction of excess returns in the case of Auckland Airport.

The Commission's conclusion that its IRR analysis results in a return of 8% to 8.5% is the result of a number of conservative assumptions favourable to the Airport, leading to the assessed return being understated. In particular, the Commission has:

- Used the 2009 RAB asset valuations as the opening asset base in its IRR analysis – even though the Airport has not reflected the 2009 revaluation in its asset base used for pricing purposes. This means that the revenue forecast to be generated by the charges set by the Airport is being compared against an asset base which is greater than that used to set prices.
- Adopted the non-binding and qualified indications of Auckland Airport's future intentions with respect to revaluations as the basis for its base analysis or core scenario and has not placed any weight on other potential outcomes when forming its draft conclusions on the effectiveness of information disclosure regulation.
- Under-estimated the likely uplift in MVEU valuation in 2017 by indexing the 2006 MVEU costs forward rather than estimating the MVEU uplift on the forecast 2017 MVAU base land value.
- Used year-end cash-flows as the main basis for reaching its conclusions rather than mid-point cash-flows when it is axiomatic that the Airport incurs costs and earns revenue throughout the year. BARNZ considers that the Commission needs to make mid-year cash-flows its main scenario.
- Not removed some $18m of land within Auckland Airport's asset base which the Commission has previously been determined is unnecessary for the Airport to own for the provision of airfield services.

The Commission has then compared this understated IRR result against its 8.04% 75th percentile estimate of the WACC range as at 1 April 2012 to incorrectly conclude that Auckland Airport's forecast returns fall within an appropriate range.

The 8.04% WACC used by the Commission is substantially too high. First, it is the 75th percentile estimate of the cost of capital, rather than the mid-point WACC estimate which the Commission continues to confirm is its starting point for undertaking profitability assessments for the purposes of information disclosure. Secondly, 8.04% is at the upper end of an out of date WACC range which does not represent the relevant cost of capital at the closest reasonably practical point prior to Auckland Airport setting its charges – this being the point which Auckland Airport has long adopted for determining its cost of capital when setting charges. An updated WACC as at 21 May 2012 when Auckland Airport last updated its financial model before setting charges gives a 5.70% to 7.67% WACC range, with a mid-point of 6.68%.

The combined result of the Commission adopting inputs favourable to the Airport in its IRR analysis, thereby understating the likely return, and then judging that understated return against an upper estimate of an out of date, too high, WACC, has led to an erroneous conclusion that no excess profits are present (when in fact they are) and that the ability of Auckland Airport to extract excessive returns is limited (when it is not).

In fact, the Commission's analysis demonstrates that at the (out of date) 1 April mid-point WACC Auckland Airport is forecast to earn $78m of revenue over what is required to achieve an appropriate return. In NPV terms, the post tax present value of these excess returns is $45m. This is clear evidence of excess returns being earned and manifestly demonstrates that information disclosure has not been effective in limiting the ability of Auckland Airport to extract excessive profits.

The Commission has also failed to give sufficient consideration to all relevant evidence. In focusing solely on its base scenario IRR outcomes, and not placing any weight on the results of the various sensitivity analysis it undertook, the Commission has not had due regard to the dual regulatory regime airports operate under in New Zealand and the consequent ability of Auckland Airport to change its approach in the future. The New Zealand High Court and Court of Appeal have specifically held that there is nothing in the AAA which prevents an airport from monopoly pricing, and that the effect of section 4A of that Act means that the presence of monopoly returns is not a ground on which airlines may seek judicial review of airport charges.[1] While Airports continue to have this invulnerability from challenge, information disclosure is not able to effectively prevent the extraction of excess returns.

Information disclosure regulation does not prevent the Airport from applying its long argued MVEU valuation approach. Information disclosure and consultation did not remove this approach from the Airport's preference list. It was only direct questioning from the Chair of the Commission in the one-off section 56G review which led to Auckland Airport indicating that it was 'highly unlikely' it would adopt this approach – but it has still not completely ruled it out. The ability of Airports to set charges as they think fit under the AAA leaves this method of extracting excessive returns open to Auckland Airport going forward.

[1] *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98.

Information disclosure regulation does not prevent Auckland Airport from only partially treating revaluations as income if it moves back to revaluing its assets for pricing purposes. Again, information disclosure and consultation did not result in this risk being ruled out. Again, it was only direct questioning from the Chair of the Commission in the one-off section 56G review which led to Auckland Airport indicating that if it moved to revalue assets at the conclusion of the Moratorium then it would treat such revaluations as income. However, it specifically excluded future revaluations from this assurance, leaving airlines in the same scenario as previously of Airports forecasting revaluations and not properly treating any actual revaluations in excess of the forecast. The ability of Airports to set charges as they think fit under the AAA leaves this method of extracting excessive returns also still open to Auckland Airport.

BARNZ continues to consider that, while airports have carte blanche to set prices as they see fit under section 4A of the AAA, information disclosure is not able to effectively limit the ability of an airport to extract excessive returns, and therefore it is not able to promote the purpose of Part 4.

BARNZ has summarised below the Commission's conclusions on the key elements of the purpose statement contained in section 52A, and its response to each of these conclusions:

Summary of Commerce Commission Finding	BARNZ Response
Innovation levels are appropriate at AA and information disclosure is effectively promoting incentives to innovate at AA.	Support finding, but note that information disclosure regulation does not itself provide any incentives as opposed to simply not detracting from other previously existing incentives.
The quality of service at AA generally reflects the demands of airlines and passengers. Information disclosure is effectively promoting incentives to provide services at a quality that reflects demand.	Support finding, but note that information disclosure regulation does not itself provide any incentives as opposed to simply not detracting from other previously existing incentives.
Information disclosure has had a positive impact on pricing efficiency with prices based on the pricing methodology in PSE2 more likely to promote efficiency than those previously in place.	Support the overall finding that in PSE2 AA improved the efficiency of a number of aspects of its pricing structure, but note that international users are meeting too great a share of common overheads under the Ramsey pricing approach adopted by the Airport to recover common costs.
Information disclosure regulation has been effective in limiting AA's ability to extract excessive profits over time.	While BARNZ acknowledges that information disclosure has had <u>an effect</u> on some of the decisions taken by AA on inputs to its financial model, BARNZ does not consider that information disclosure has been <u>effective</u> in limiting the ability of the Airport to extract excessive profits or in promoting outcomes consistent with workably competitive markets. Information disclosure regulation was not able to limit the Airport's ability to move to revaluing its assets going forward as it set charges – it was only the CC in the s56G review that was able to obtain any acknowledged (albeit non-binding) limitation by the Airport on its future behaviour. The mid- point WACC, which the CC has confirmed is its starting

	point, indicates the charges set by AA will result in it earning forecast excess returns of $45m, which translates to excess revenue paid by users of $78m. The CC has undertaken its analysis using inputs and decisions favourable to the airport at each step, which causes the return to the Airport to be under-stated. This error is compounded when the under-stated assessment of the return is compared against the high end of the Commission's WACC range (rather than the mid-point), resulting in an erroneous conclusion that no excess profits are present, thus legitimising the excess returns being earned by AA .
It is not yet possible to conclude whether information disclosure is effectively promoting improvements in operating efficiency	Support finding.
It is not yet possible to conclude whether information disclosure is effectively promoting efficient investment and innovation	While BARNZ considers that the capex forecast by the airport for PSE2 is at efficient levels, BARNZ accepts the CC's conclusion that it needs to see the actual outcome before it is able to reach a final conclusion.
It is too early to conclude whether information disclosure is effectively promoting the sharing of efficiency gains	Support finding.

Part 2 of this submission provides further detailed comment on the profitability conclusions reached by the Commerce Commission, which BARNZ considers are not supported by the evidence before the Commission. Part 3 addresses the appropriate WACC estimate. Part 4 makes some observations in relation to statements made or conclusions reached by the Commission in relation to other aspects of its draft report.

PART 2 – THE COMMISSION'S IRR ANALYSIS UNDERSTATES AUCKLAND AIRPORT'S RETURN

BARNZ considers that the Commission's IRR analysis of the return likely to be earned by Auckland Airport understates the level of return likely to be earned over PSE2. It does so by making a number of assumptions which are favourable to the Airport:

- The Commission has adopted an opening asset base which includes revaluations only undertaken for the purposes of information disclosure which have not been reflected in the asset base which formed the basis of Auckland Airport's pricing decision, without undertaking any alternative analysis of the outcome from applying the Moratorium asset base used by Auckland Airport to set charges;
- The Commission's determination of the closing asset base focuses solely on the 2009 RAB option thereby placing too much reliance on the non-binding guidance given by Auckland Airport that it currently has no intention of revaluing its assets. Other possibilities, which remain open to the Airport under the current regulatory regime, were not given any weight by the Commission as it drew its conclusions over the effectiveness of information disclosure regulation.
- The Commission's methodology of estimating the likely uplift in land value if an MVEU value was adopted in 2017 using CPI indexing from the 2006 MVEU valuation uplift materially understates the likely increase in value which is, in practice, primarily driven by movements in the underlying MVAU value of the land.
- The Commission's use of year-end cash-flows as the main basis for its analysis rather than mid-point cash-flows materially favours the Airport despite the fact it is axiomatic that the Airport incurs costs and earns revenue throughout the year.
- The Commission has not removed some $18m of approach land within Auckland Airport's asset base even though this land has previously been determined by the Commission in the 2002 Airport Price Inquiry to be unnecessary for the provision of airfield services by the Airport.

Cumulatively, these assumptions materially over-state the level of income required to be earned by the Airport in order to cover its efficient operating costs and earn a reasonable return on its assets. This leads to the estimate of the level of return forecast to be earned by the Airport being depressed. These matters need to be corrected within the Commission's analysis.

The Commission then needs to take into account the outcomes in all likely asset base scenarios (a moratorium asset base, the 2009 RAB, the 2017 RAB and a 2017 MVEU land revaluation) in determining whether information disclosure has been effective in limiting the ability of the Airport to extract excess returns. The approach adopted by the Commission in the draft report of focusing solely on the outcome produced by applying the 2009 RAB asset base, which results in the lowest return, and not placing any weight on the results of the other scenarios analysed, does not provide a complete picture of the possible outcomes open to Auckland Airport under the combined Commerce Act Information Disclosure and Airport Authorities Act pricing regulatory regimes or accurately reflect the limitations (or lack of limitations) on the Airport's ability to extract excessive profits.

The opening asset base

The Commerce Commission has modelled three main scenarios in its profitability analysis:

Opening asset base reflecting:	Closing Asset base reflecting:	Outcome
2009 RAB rolled forward for depreciation and capex	2009 RAB rolled forward for depreciation and capex	8.0% to 8.5% return
2009 RAB rolled forward for depreciation and capex	Forecast 2017 RAB	10.7% to 11.3% return
2009 RAB rolled forward for depreciation and capex	Forecast 2017 MVEU land valuation	11.5% to 12.1%

The 2009 RAB asset valuations feature as the opening asset base in all the Commission's IRR analysis – even though the Airport has not reflected the 2009 revaluation in its asset base used for pricing purposes. This means that the revenue forecast to be generated by the charges set by the Airport is being compared against an asset base which is greater than that used to set prices.

In BARNZ's view, in order for the Commission to be able to accurately assess whether information disclosure regulation effectively limits the ability of Auckland Airport to extract excess returns, the returns likely to be earned by the Airport in PSE 2 need to be measured against:

- The moratorium asset base as both the opening and closing asset base;
- An input methodology compliant asset base (with and without CPI indexation); and
- An MVEU closing asset base.

– with the results from all of these scenarios being considered by the Commission as it assesses how effectively information disclosure regulation has been able to promote the purpose of Part 4.

The Commission has undertaken the latter two scenarios – but not the former. In not doing so, there has been a failure to show a complete picture of all likely outcomes. This understates the likely return to the airport due to the Commission's use of an opening asset base which includes revaluations which have been undertaken for disclosure purposes only, but which have not been reflected in the asset base used to set charges.

At paragraph F30 the Commission states:

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

The same concerns apply equally to using the asset values disclosed under information disclosure as at 2009. The 2009 value similarly overstates the value of assets used by Auckland Airport to set prices and produces a misleadingly lower estimate of the returns expected to be earned by Auckland Airport and incorrect conclusions about excess returns. This danger has not been recognised in the draft report.

BARNZ believes that by not modelling the returns forecast to be earned by the Airport against the moratorium asset base (which was the asset base used by the Airport to set charges), the Commission's analysis has failed to show the complete picture of the returns likely to be earned by the Airport. In the present situation, where the pricing asset base is lower than the disclosure asset base, due to revaluations not being undertaken for pricing purposes, measuring the returns against the higher disclosure asset base rolled forward from 2009 shows a lower return to the Airport.

Discussing its approach at para E55 and E56, the Commission states that it '*excludes the effect of all revaluations reported in information disclosure as these revaluations were undertaken for disclosure purposes only and were not reflected in Auckland Airport's price setting'.*

However, this is not the case. As already noted, the Commission's approach does not exclude the effect of all revaluations undertaken for disclosure purposes only. The Commission has effectively treated revaluations undertaken for disclosure purposes differently depending upon whether they relate to the 2009 disclosure year or later disclosure years. Those relating to the 2009 disclosure year or earlier have been included in the Commission's IRR asset base. Those undertaken for subsequent disclosure years have been excluded. This is despite the fact that in the case of Auckland Airport both categories of revaluations were undertaken for disclosure purposes only and have not been reflected in Auckland Airport's price setting.[2]

<u>The closing asset base</u>

An integral component of the Commission's IRR analysis is the closing asset base. While the Commission modelled three scenarios for the closing asset base (an unindexed 2009 RAB, indexation of the opening 2009 RAB values to 2017 and a move to an MVEU revaluation in 2017), it only placed weight on the closing asset base calculated by rolling forward the 2009 RAB with no further revaluations or indexation of values post the 2009 MVAU revaluations. It has not placed any weight on the results produced by the other two scenarios in forming its draft conclusion on the effectiveness of information disclosure in limiting the ability of the Airport to earn excessive profits.

The Commission's base scenario has the lowest return of the scenarios modelled by the Commission – albeit still with excess returns at a mid-point WACC. All of the other scenarios modelled by the Commission disclosed the presence of greater excess returns. A closing asset base based on the input methodology asset valuation approach at the end of the moratorium indicated returns of 10.7% to 11.3% were likely. A closing asset base based on the Commission's estimate of an MVEU valuation approach indicated a return of 11.5% to 12.1% was likely.

Auckland Airport continues to have the right to set prices as it sees fit. As the Commission itself has acknowledged, the indication provided by Auckland Airport of its likely behaviour post the expiry of the current moratorium on asset revaluations is non-binding.[3]

Moreover, the wording of Auckland Airport's response to the Commission is not definitive:[4]

---

[2] This is acknowledged by the Commission at paragraph F28 of its Draft Report on Auckland Airport.
[3] For example see para D35 of the Draft Report on Auckland Airport.

- The Airport has not ruled out using an MVEU land valuation approach in the future – rather it has only said it would be 'highly unlikely'. The inference is that MVEU valuations are still possible. This is confirmed by the caveat added by the Airport with respect to the merits review process outcomes. This also accords with the fact that Auckland Airport continues to use MVEU as its valuation methodology for financial reporting purposes and to advocate in the merits review process that this is the appropriate methodology for input methodologies.

- The Airport has not ruled out revaluing its asset base – while the Airport has said in paragraph 35 of its post conference submission that it has 'no intention' of revaluing the asset base for pricing in PSE3, in the very next paragraph it leaves this possibility open by discussing what its approach will be 'if the pricing asset base is revalued in PSE3'. BARNZ notes that intentions can change as Boards and management change. For instance, when Christchurch Airport set its charges in 2008 it categorically undertook to not revalue its assets for two pricing periods, yet in 2012, just one pricing period later that Airport revalued its assets when resetting charges.

- The Airport has not said that it will continue the moratorium on asset revaluations (be it on an indexed or unindexed basis). Rather, it has said this is a 'distinctly possible outcome'. Other outcomes are therefore still on the table so far as the Airport is concerned.

Information disclosure regulation does not prevent the Airport from applying these other approaches. Information disclosure and consultation did not remove MVEU or ODRC revaluations from the Airport's preference list. It was only direct questioning from the Chair of the Commission in the one-off section 56G review which led to Auckland Airport providing partial assurances to the Commission over its current intentions – but even then the Airport still has not completely ruled out the possibility of moving to MVEU and it has not committed to treating all revaluations as income.

While the Airport has provided an assurance that, if the moratorium is departed from and assets are revalued, it will treat the revaluation impact as an offset to the future revenue requirement (in an NPV neutral manner), this assurance is limited to the potential termination of the moratorium on asset revaluations. It does not apply going forward with respect to future revaluations following a potential cessation of the moratorium on asset revaluations. In this situation the Airport continues to assert that it will only treat forecast revaluations as income in the charge setting process – not actual revaluations. Information disclosure regulation is not able to limit Auckland Airport's ability to extract excessive profits going forward through it under-forecasting future revaluation movements and retaining the benefit of the difference if actual revaluation movements exceed those forecasted.

The Commission, in BARNZ's view, has placed too much reliance on the indications given by the Airport of its future behaviour, and has not given sufficient weight to the caveats and to the less than definitive nature of the Airport's description of its future intentions. The Commission has failed to recognise the large degree of flexibility the Airport has retained for itself with respect to its future

---

[4] Auckland Airport S56G Post Conference Submission, 15 March 2013, refer wording of Key Points of Auckland Airport's Approach to Asset Valuation in 2017 at page 9.

intentions and the fact it can choose to adopt a different approach going forward if it so chooses. The Airport provided a clear written statement to its airline customers at the beginning of consultation that its preferred position was to revalue its land assets using MVEU and its specialised assets using ODRC and to not treat any of these revaluations as income in the charge setting process.[5] The subsequent indications by Auckland Airport in its post conference submissions do not provide a definitive or binding move away from the Airport's previously stated position.

The forecast 2017 MVEU is understated

The Commerce Commission has modelled an alternative scenario of the likely outcome if Auckland Airport reverted to an MVEU land valuation and did not treat the revaluation gains as income. The Commission has not placed any weight on the results of this analysis in forming its draft conclusions. Nevertheless, BARNZ notes that the Commission's estimate of the MVEU valuation uplift in 2017 is significantly understated and needs to be revised substantially upwards.

The Commission has forecast an MVEU valuation as at 2017 by indexing Auckland Airport's 2006 MVEU land conversion costs using CPI. The Commission describes its calculation of the forecast MVEU uplift as follows:

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

The Commission's method of estimating the MVEU uplift materially understates the likely MVEU valuation as at 2017 due to two key factors:

- The estimate of the 2006 land conversion costs used by the Commission only includes land conversion costs for 164 ha of airfield land, out of a total of around 441 ha[6] of RAB land, with MVEU costs relating to other land within the RAB being omitted from the Commission's analysis.

- The uplift in MVAU values (which is arguably the primary driver for movements in the uplift to an MVEU valuation) since 2006 materially exceeds actual CPI movements. CPI indexation of the 2006 MVEU uplift will therefore substantially understate the likely MVEU uplift as at 2017.

Commission's Estimate of 2006 MVEU Uplift Understated

The $43m which the Commission has taken as the MVEU uplift as at 2006 does not represent the MVEU uplift for all of Auckland Airport's RAB land. That $43m only relates to the land conversion

[5] Letter dated 14 September 2011 from Auckland Airport to its substantial customers.
[6] This excludes seabed, coastal margin, land held for future use and land in commercial areas. Refer Colliers June 2011 Auckland Airport MVAU Land Valuation Report, page 33.

costs for 164.5ha of airfield land.[7] It does not include any land conversion costs for the 138.1 ha of reclamation land used to provide airfield activities. These were separately reflected by Auckland Airport's valuers in the 2006 ODRC cost of $870,813 per ha of reclaiming that land. Nor does it include any land conversion costs for land associated with:[8]

- Wiroa Island (33.6ha)
- The Eastern Approaches restricted use land areas (37.7ha)
- The Runway End Protection Areas and Public Safety Zones (27.5 ha)
- Terminal buildings (12.8ha)
- Aircraft and freight activities (93.7ha)
- Land used to provide infrastructure such as stormwater (10.2ha)
- Land under roads (36.6ha)

The 2006 land valuation valued those areas at MVEU by comparison with land used for similar activities. This resulted in some areas of land being allocated an MVEU valuation vastly in excess of the MVAU equivalent (such as land under terminals which was valued at $4.45m per ha) but other areas being valued below the MVAU valuation (such as land under roads valued at $300 000 per ha or approach land valued at $100 000 per ha).

There was no separate identification of the change between an MVAU valuation and an MVEU valuation in the case of these other areas of land in the 2006 valuation report.

In its Report on the Initial Regulatory Asset Base Value[9] Auckland Airport disclosed that the adjustment to move from a 2006 MVEU land valuation to a 2009 MVAU land valuation for the year ended 30 June 2009 amounted to a $103.97m reduction. However, BARNZ is not aware of a disclosure which shows the complete uplift from a 2006 MVAU valuation to a 2006 MVEU valuation.

The Commission's uplift to MVEU from 2006 to 2017 is significantly under-stated

The primary driver of changes in MVEU valuations undertaken using the methodology routinely applied by Airport valuers is the movement in the underlying MVAU value. Increases in the MVAU valuation not only increase the base land valuation, if an MVEU valuation methodology is being applied they also broadly proportionally increase the holding costs which form the majority of the uplift to MVEU. Rates payable over the holding period and likely planning costs also form part of the MVEU uplift – although they represent only a minor component of the uplift when compared with the land holding costs. In short, the uplift to MVEU will increase largely in proportion to the increase in the MVAU valuation[10] – not in proportion to CPI which is what the Commission has assumed.

---

[7] See Seagar and Partners Land Valuation Report as at 30 June 2006, page 27.

[8] Land areas taken from the Seagars 2006 Airport Land Valuation at pages 27 to 35, particularly the summary tables at 10.2.7 and 11.0.

[9] Refer Schedule 23 of Auckland Airport Information Disclosure for the Year Ended 30 June 2011.

[10] All other matters remaining equal. This assumes that the Airport and its valuers continue to apply the same cost of capital in their calculations, and do not seek to significantly increase the cost of capital applied when

In Auckland Airport's case, there was a significant uplift in the underlying MVAU valuation in both the disclosure revaluations in 2009 and 2011 and the financial reporting revaluations of 2011. These increases were far greater than CPI.

In its 2011 information disclosure, Auckland Airport disclosed MVAU land revaluations of $50.5m, which represented a 16.5% increase in the MVAU disclosure valuations in that one year.

Auckland Airport's financial reporting in 2011 also discloses a significant uplift in the underlying MVAU valuation, with the Annual report stating that the adopted rate per ha prior to holding costs was $1,020,000 per ha for airfield land. This compares with the base value in 2006 of $600,000 per ha. This represents a 70% increase in the MVAU valuation of airfield land in a five year period.

Therefore the Commission's approach of increasing its (understated) estimate of Auckland Airport's 2006 MVEU uplift by 15.7% for CPI to June 2011 and then by 2.5% pa from FY13 onwards will further significantly understate the likely MVEU uplift as at 2017.[11]

Auckland Airport's Disclosed Methodology for Establishing MVEU should be Applied

Auckland Airport has set out the principal assumptions it uses to calculate the holding costs used for converting its MVAU land valuation of airfield land[12] to an MVEU basis at page 72 of its 2012 Annual Report. This indicates that the Airport:[13]

- Starts with the base value per ha (stated in the Annual Report to be $1,020,000 per ha as at 30 June 2011)
- Applies holding costs of 8.6% for five years, discounted at 10%
- Applies direct costs of $4.5m (for planning and rates), also discounted at 10%
- Applies site levelling costs of $35 000 per ha

BARNZ considers that the inputs outlined by Auckland Airport for calculating the uplift to MVEU represent the most appropriate approach for estimating the forecast MVEU uplift for 2017.

BARNZ calculates that for land with a base value of $1,020,000 per ha (as set out at page 72 of Auckland Airport's Annual Report) this approach would result in an uplift of $436,000 per ha as at 30

---

calculating the holding costs as has been the case with Wellington Airport over the past few revaluations. If the cost of capital used to calculate the land holding costs is increased, then the MVEU uplift will increase proportionately more than the MVAU land value (and vice versa).

[11] BARNZ also notes that there is a question as to whether the Commission's approach omits to index the MVEU uplift for FY12.

[12] Described on page 71 of Auckland Airport's 2012 Annual report as including land for runway, taxiways, aprons and approach land.

[13] See also Seagar and Partners, Auckland Airport Land Valuation report, 30 June 2006, page 27 for an explanation of how the MVEU uplift was calculated for the 2006 valuation. The same methodology was applied, albeit the base value was $600 000 per ha, holding costs were applied at 8.95% pa and the calculation was only applied to natural airfield land and not to reclaimed airfield land, REPAs, PSZ or approach land.

June 2011 to reach an MVEU valuation of $1,456,000 per ha. Indexing this uplift forward by forecast land valuation movements to 2017 results in an MVEU uplift of $485,000 per ha.

Applying this uplift to the 330 ha of airfield (both natural and reclaimed), runway end protection area and public safety zone land indicates an MVEU uplift of $144m as at 2011 or $160m in 2017. It should be noted that this calculation excludes any MVEU uplift for other land such as land associated with terminals or infrastructure. If terminal and infrastructure land is included in the MVEU calculation, then the MVEU uplift in 2017 would be in the vicinity of $170m.

An alternative means of estimating the likely MVEU uplift in 2017 is to apply Auckland Airport's MVEU assumptions[14] to the 2012 RAB land value of $357m. This produces an MVEU uplift of $152m as at 30 June 2012, which becomes $169m when indexed forward to 2017.

Both of these means of estimating what an MVEU uplift would amount to if undertaken in 2017, show that the Commission's estimate of $56m calculated by indexing forward the 2006 MVEU uplift, is materially understated due to that figure — first, only being a partial estimate of the land subject to the MVEU uplift and secondly, not reflecting the significant uplift to Auckland Airport's underlying MVAU land value since 2006.

The spread-sheet setting out BARNZ's estimate of the likely MVEU uplift as at 2017 if the assumptions set out in Auckland Airport's Annual Report are applied is attached to this submission. BARNZ also notes that Auckland Airport will highly likely hold a valuation report applying those MVEU assumptions.

<u>Use of year end cash flows</u>

The Commission has used year-end cash-flows as the main basis for its analysis rather than mid-year cash-flows even though it is axiomatic that the airport incurs costs and earns revenue throughout the year.

In its analysis the Commission has modelled the outcome if mid-year cash flows are applied. This would result in the IRR outcome being approximately 0.5 basis points higher in each given scenario. Under the Commission's base scenario, adopting mid-year cash-flows increases the estimate of the likely return from 8.0% to 8.5%.

The Commission acknowledges that this use of year-end cash-flows is a conservative assumption, and in the Airport's favour.

Nevertheless, the Commission uses the lower figure to erroneously conclude that no excess returns are being earned. This is despite the mid-year result exceeding the Commission's 75th percentile WACC estimate, and likely representing returns around the 85th percentile mark of the Commission's WACC range.

---

[14] Namely holding costs of 8.6% for five years, direct costs of $4.5m, both discounted at 10% and planning costs of $35 000 per ha.

BARNZ considers that the Commission needs to treat the results from the mid-year cash-flow analysis as its main scenario for assessing the returns to Auckland Airport.

Failure to exclude land previously considered unnecessary

The Commission has not removed land within Auckland Airport's asset base which has previously been determined by the Commission to be unnecessary for the provision of airfield services by the Airport. This relates to 26.4 ha of Southern Airfield restricted use land (previously known as the Eastern Approaches) which falls outside the Runway End Protection Areas and the Public Safety Restricted Use Zones. In the 2002 Airport Price Inquiry the Commission concluded that ownership of this land was not necessary, with planning provisions able to protect the Airport from incompatible land uses.[15]

The 2009 MVAU valuation indicates an average value for RAB land of $695 000 per ha (excluding coastal margin, seabed and commercial areas),[16] suggesting this land is valued at $18.4m in the 2009 RAB. By contrast, under the moratorium asset base this land was valued at $100 000 per ha, overall representing approximately $2.6m of value.

BARNZ considers that this land needs to be excluded from the RAB. It is not used in the provision of the regulated services. Failing to make this adjustment results in the asset base including land which it is not necessary for the Airport to own, with the result that the Airport is permitted to earn a return on an inefficiently held unnecessary asset, and the disclosed return on its efficiently held assets appears depressed by the inclusion of this surplus additional piece of land.

The ability of Auckland Airport to include this surplus land area within its asset base demonstrates that information disclosure has not been effective in creating incentives to improve efficiency in relation to the assets held by Auckland Airport.

[15] Airfield Price Inquiry, Final Report, 1 August 2002, para 8.130.
[16] Refer Colliers Auckland Airport MVAU Land Valuation Report, June 2011, page 33.

PART 3 – THE COMMISSION IS ASSESSING PROFITABILITY USING A WACC THAT IS TOO HIGH

The 8.04% WACC which the Commerce Commission uses as the basis for its conclusion that Auckland Airport has targeted returns within an appropriate range is too high for two key reasons:

- First 8.04% is at the 75th percentile estimate of the Commission's 6.08% to 8.04% assessment of the appropriate WACC range. This is despite the Commission confirming that the starting point for its profitability analysis under information disclosure is the mid-point WACC. The mid-point WACC should be used for the purpose of assessing whether returns have been targeted at an appropriate level.

- Second, the Commission has utilised a 1 April 2012 WACC, reflecting a point in time some seven weeks before Auckland Airport last updated its pricing model, and nine weeks before the Airport set charges. The cost of debt was falling during this time, therefore the resulting WACC is too high and is out of date compared with the timing of the pricing decision. The relevant WACC should be one determined as close as reasonably practical to when charges were set. This indicates a 6.68% mid-point WACC.

The appropriate point in the WACC range

The Commission appears to have solely focused on the comparison of the Airport's forecast IRR with the 75th percentile WACC estimate to conclude that information disclosure has effectively limited the ability of the Airport to extract excessive returns. In BARNZ's view, the sole focus on the top end of the Commission's range of WACC estimates, to the complete exclusion of the 25th percentile and the virtual exclusion of the mid-point is unreasonable, and results in the Commission reaching a false conclusion, namely that there are not any excess returns, when in fact the evidence outlined by the Commission — even before correction — clearly shows the presence of excess returns.

Measuring the Airport's expected returns against a 75th percentile WACC estimate is effectively endorsing an outcome which is 75% likely to be in excess of a reasonable return.

As BARNZ has previously noted, airports fundamentally differ from other regulated businesses such as gas pipelines and electricity lines businesses as they are able to leverage off aeronautical activities to create extremely lucrative retail and car-parking businesses whose customers are the passengers carried by airlines.[17] The fact that such a lucrative complementary revenue stream exists, 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 – the presence of the ability to earn additional revenue from provision of these complementary services already provides additional incentive on Airports to invest in maintaining or adding aeronautical capacity.

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. A higher level of WACC (such

[17] BARNZ Submission Responding to Commerce Commission Issues Paper on Auckland Airport, 30 October 2012, pages 7 – 8.

as the 75th or 80th percentile estimates) just increases the likelihood of the asset owner earning excessive returns.

When to Determine the WACC Estimate

The Commission has used 1 April 2012 WACC estimates of 6.08% to 8.04%, rather than the 5.70% to 7.67% WACC range applicable as at 21 May 2012 (when Auckland Airport last updated its financial model before setting charges) or the 5.51% to 7.48% range as at 1 July 2012 (the beginning of the pricing period).

The cost of debt had materially fallen since the first of those dates. BARNZ considers that the Commission needs to update its WACC estimate used for assessing the reasonableness of the revenue targeted by Auckland Airport to a point in time which represents the closest practical time for the Airport to update the WACC inputs prior to setting charges.

It has been BARNZ's experience that Airports refresh the WACC as close as practicable to the time that they set charges. This is was what occurred when Auckland Airport reset charges in both 2007 and 2012. BARNZ considers that the Commission should also use a cost of debt updated at that same point in time in relation to the price setting date.

Auckland Airport's Pricing Disclosures indicate that the Airport updated its WACC estimate as at 20 May 2012 when setting charges for PSE2.[18] This resulted in a cost of debt of 3.48% used by the Airport. The Airport's previous estimate with an effective date of 5 March 2012 in its Revised Pricing Proposal had been 4.09%. Uniservices in its April 2012 Report for Auckland Airport had observed that 'it is AIAL's intention to update both the risk free rate and debt risk premium parameter inputs into the WACC calculation as close as practical to the price re-set date of 1 July 2012. This will ensure these estimates are updated for market movements in bond yields'.[19]

Similarly, in 2007 both BARNZ's WACC adviser at the time (Professor J Bowman) and Auckland Airport's WACC advisor (Assoc. Professor A Marsden) agreed that the *'final determination of AIAL's WACC for its aeronautical activities [should] be subject to an adjustment in respect of an update to both the risk free rate and the debt risk premium as close as practical to the time final charges are set.'*[20] Auckland Airport's Revised Pricing Proposal in 2007 had noted that the Airport expected to update both the risk free rate and the debt premium prior to setting charges.[21]

This approach resulted in the risk free rate used by Auckland Airport increasing from 6.88% in Auckland Airport's Final Aeronautical Pricing Proposal of 7 June 2007 to 7.26% in Auckland Airport's Determination of its Final Charges made on 27 June 2007.

---

[18] Auckland Airport Price Setting Disclosures for the 2012 Pricing Decision, page 28.
[19] Uniservices, Update on the Specified Parameter Inputs into the Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd, 2 April 2012, page 6.
[20] Uniservices, Update on the Appropriate Weighted Average Cost of Capital for the Aeronautical Activities of Auckland International Airport Ltd, 18 June 2007, para 4.
[21] Auckland Airport Revised Aeronautical Pricing Proposal, March 2007, page 20.

The time frame between the updating of the WACC inputs and Auckland Airport's decision to set charges in 2007 was some ten days. The charging decision was announced five days later.[22]

The Commission's decision to utilise the 1 April 2012 estimate on the grounds that it 'was published in relatively close proximity to the time of Auckland Airport setting prices' creates uncertainty. It means that the Commission will be judging the Airport's pricing determination using a WACC set at a different point in time than that applied by the Airport. It also puts Airports in the position of being able to elect to update the WACC estimates if they are moving in an upwards direction, as occurred in 2007, but potentially choose to not update the WACC estimate if it is moving in a downwards direction.

This is not an acceptable regulatory outcome. The Commission has created uncertainty where it previously did not exist. It has also created a situation in which Airports would be able to influence the cost of debt input to the WACC calculation to their advantage by choosing either to update or not to update the cost of debt parameters.

In BARNZ's view the relevant WACC estimate to apply when setting charges and assessing their reasonableness, is the applicable WACC determined as close as practicable to when charges were set. BARNZ notes that this was also Auckland Airport's position when it set charges in both 2007 and 2012.

[22] The WACC was updated 18 June 2007, the Board determined the new charges on 27 June 2007, and these were publicly announced on 2 July 2007.

PART 4 – COMMENTS ON OTHER MATTERS

Is Auckland Airport's Ramsey Pricing Appropriate?

The Commerce Commission has made a number of statements supporting Ramsey pricing principles as leading to improved efficiency of prices, due to a greater proportion of fixed costs being allocated to users with the lowest demand response. The Commission considers that Auckland Airport's allocation of a greater share of common overhead costs to international users is consistent with Ramsey pricing principles and represents an improvement in pricing efficiency.

The international only airlines which BARNZ represented in pricing consider that the level of additional costs being met by international users at Auckland Airport is too great, and results in the International Passenger Charge at Auckland Airport being far higher than justified.

Auckland Airport has set its charges so that international users meet somewhere around 90% of common terminal costs[23] through the international passenger charge.

In addition, the international passenger charge has been set by Auckland Airport at a level which over-recovers on the terminal cost centre, so as to make good its perceived under-recovery on the airfield. The amount by which the international terminal passenger charge contributes to the common airfield costs varies according to the WACC applied, however:

- Auckland Airport's financial model shows that, at the 9.16% WACC it used, the international terminal charges were set so as to earn $51m more over the five years than required to cover terminal costs.
- Applying the WACC range used by the Commission, the over-recovery of international terminal costs over the pricing period is between $80m (at the 8.04% 75th WACC percentile) and $106m (at the mid-point WACC estimate 7.06%).

All $78m of additional revenue which the Commission has identified that users will pay beyond that necessary to provide the Airport with a reasonable return at the mid-point WACC is attributable to international terminal charges having been set too high. BARNZ has previously noted that Auckland Airport's own financial model shows that the charges set by the Airport for international terminal activities are likely to result in a return on terminal assets exceeding 11% over PSE2.

The international airlines consider that Auckland Airport has gone further than is justified in terms of loading costs onto international users. While international air-fares are usually greater than domestic air-fares, many international travellers are just as responsive to pricing signals as domestic travellers. Airport charges are already high at Auckland Airport by international comparisons and attract negative comment from overseas airlines operating to New Zealand, wanting to understand why Auckland Airport's charges are so much higher than those they pay at other airports.

The price responsiveness of international passengers should not be overlooked.

[23] Common terminal costs are estimated to comprise approximately $20m in annual operating costs and $35m of assets.

Noise Treatment Costs

Confusion still appears to reign on how noise costs have been, and should be, treated.

The Commerce Commission records at footnote 196 that it has excluded $10.9m of capitalised noise treatment costs from the asset base because these were excluded from the pricing event. Auckland Airport's Post Conference Submission is referenced.

During consultation BARNZ had understood (as a result of written material provided by Auckland Airport during consultation) that actual and forecast capital expenditure relating to noise was included in the pricing asset base and that operational expenditure relating to noise was similarly included in the forecast operating costs.

Auckland Airport's submissions on the Issues Paper appeared to put this in doubt, suggesting that forecast and actual capital expenditure relating to noise was excluded from the pricing asset base, and treated as an asset held for future use.

At the Conference, BARNZ objected to this treatment, on the basis that noise insulation costs were a necessary part of providing the regulated services today, and therefore should form part of the RAB.

Auckland Airport was requested to clarify its treatment of noise costs in its Post Conference Submission. BARNZ's reading of Auckland Airport's further statements on this issue in section 8 of Auckland Airport's Post Conference Submission is as follows:

- $10.9m of capital expenditure on noise insulation undertaken prior to PSE2 has been included in the pricing RAB. (BARNZ agrees with this treatment.)
- $1m of capital expenditure on noise insulation forecast to be undertaken during PSE2 has been excluded from the pricing RAB. (BARNZ disagrees with the exclusion of these costs, but acknowledges the amount involved is not material to the profitability analysis.)
- The operational expenses relating to noise issues have been included in the pricing opex in both PSE 1 and 2. (BARNZ agrees with this treatment.)

If BARNZ's reading of this explanation by the Airport is correct, then this suggests that the Commission should not be excluding capitalised acoustic noise costs from its analysis.

BARNZ understands that, contrary to the inclusion of the $10.9m of capital expenditure on noise insulation undertaken prior to PSE2 in the pricing RAB, this investment has not been included in the information disclosure RAB to date, instead being treated as WIP by Auckland Airport in information disclosure.

There is thus an inconsistency between how Auckland Airport has treated noise costs in pricing as compared with information disclosure, as well as between capital investment incurred to date on noise matters and that forecast to be incurred.

BARNZ's position is simple. All noise insulation costs incurred to date by Auckland Airport are acknowledged to be both reasonable and necessary to provide the regulated services and therefore should be included in both the pricing and information disclosure asset bases (and operating costs as the case requires).

Over-statement of proportion of RAB relating to non-pricing assets

The Commerce Commission appears to have over-stated the proportion of the RAB which relates to non-pricing assets. This is due to the Commission applying an MVEU valuation of non-pricing assets which Auckland Airport disclosed in its pricing disclosures, rather than an MVAU valuation of those assets.

The Commission appears to have used a 2012 value of non-pricing assets of $167.677m to then 'back solve' the pricing asset base component of the 2009 RAB.[24]

The 2012 value used by the Commission in its calculations is very similar to the FY13 RIV value for non-pricing regulated activities of $166.892m which Auckland Airport disclosed in its 2012 Price Setting Disclosures.[25] However, this $167m valuation for non-pricing regulated assets is not an MVAU valuation prepared in accordance with the input methodologies. Rather, it is an MVEU valuation based on 2011 rental rates.[26] The MVAU valuation disclosed by Auckland Airport for these assets is some $58.7m less.[27]

While this does not change the value of the RAB, it does affect the Commission's apportionment of the composition of the valuation. The use of the MVEU valuation of non-pricing aircraft and freight activity assets results in the proportion that the pricing asset base makes up of the 2009 RAB valuation being under-stated. In turn, this creates the misleading impression that the uplift in the asset valuation between the moratorium pricing asset base and the input methodology compliant asset base for pricing assets was not material.

Will Runway Demand Exceed Capacity in the Near Future?

The Commerce Commission has observed that, when Auckland Airport's disclosures of its forecast busy hour demand (forecast to reach 41 movements per busy hour in 2016) are compared against its declared runway capacity of 40 movements per hour, this suggests that the runway may become congested in 2016.[28]

BARNZ considers that the long term airfield planning demand forecasts included by Auckland Airport at section 4.1 of its Pricing Information Disclosure are considerably over-stated. They materially exceed the pricing related demand forecasts for airfield activity.

Annual runway movements at Auckland Airport have remained constant at around 154 000 per annum for some time. FAA guidance suggests that a single runway can efficiently manage approximately 225 000 annual movements. There is no evidence of any runway caused delay at Auckland Airport.

BARNZ is aware of recent work undertaken by an airline which suggests that Auckland Airport is capable of handling 48 movements per hour in visual conditions – significantly more than the

[24] Refer Asset Base Scenario Worksheet.
[25] Refer for example to Schedule 18 and explanations on page 22.
[26] Refer page 20 of Auckland Airport Pricing Disclosure.
[27] Refer Table C on page 22 of Auckland Airport Pricing Disclosure.
[28] Refer footnote 114.

declared runway capacity of 40 movements per hour declared by Auckland Airport. This work also indicates that based on latest forecasts and movement history, the existing runway capacity is unlikely to be constrained until late in the next decade and possibly beyond 2030.

In BARNZ's view the possibility of the Auckland Airport's runway becoming congested in 2016 is negligible.