SUBMISSION BY BARNZ ON COMMERCE COMMISSION DRAFT REPORT ON HOW EFFECTIVELY INFORMATION DISCLOSURE REGULATION IS PROMOTING THE PURPOSE OF PART 4 IN RELATION TO WELLINGTON AIRPORT

30 November 2012

1. INTRODUCTION AND EXECUTIVE SUMMARY

The Commerce Commission has released its draft conclusions with respect to whether information disclosure regulation has effectively promoted the purpose of Part 4 of the Commerce Act in relation to Wellington Airport. The Commission's key conclusions in its draft report are:

- Information disclosure is effectively promoting the purpose of Part 4 in relation to:
  - **Innovation** where innovation levels appear appropriate, although information disclosure itself has had limited impact on Wellington Airport's incentives to innovate;
  - **Quality** where Wellington Airport appears to be providing services at a level of quality that reflects consumers demands, with information disclosure having had a positive impact on Wellington Airport's performance and conduct; and
  - **Pricing efficiency** where information disclosure has had a positive impact on the efficiency of prices with prices set in PSE2 being more likely to promote efficiency than those previously in place
- Information disclosure has not been effective in limiting Wellington Airport's ability to **extract excessive profits** with the Airport earning an excessive return over time with this being primarily attributable to:
  - Wellington Airport using its own asset valuation methodologies to revalue assets without fully accounting for the resulting revaluation gains in determining its revenue requirements; and
  - Wellington Airport targeting the recovery of a cost of capital that exceeds the estimate provided by the input methodologies of the cost of capital that could be expected if the Airport was subject to workable competition.
- The Commission has been unable to reach conclusions on the effectiveness of information disclosure in relation to:
  - **Operational expenditure** because there is mixed evidence of whether the Airport is operating efficiently or improving its operating efficiency;
  - **Efficient investment** because information on actual investment over PSE2 is necessary before a conclusion can be reached on whether information disclosure is effectively promoting efficient investment; and
  - Whether **the benefits of efficiency gains are being shared with consumers** because it is too early to conclude whether there are any operational expenditure and capital expenditure efficiency gains that could be shared.

The Commission is seeking submissions from interested parties before it finalises its report to the Ministers of Transport and Commerce.

For the most part BARNZ considers that the Commission's conclusions are supported by the evidence before the Commission. Key areas where BARNZ disagrees with the Commission are:

- ***The Commission's conclusion that it is too early to draw any conclusions on whether the benefits of efficiency gains are being shared with consumers.***

  BARNZ considers that the Commission's analysis in its report has not fully considered whether the economies of scale and scope that should have been achieved as a result of increasing passenger volumes and the presence of related ancillary activities over the first PSE have been shared with consumers. BARNZ considers that conclusions should be able to be reached by the Commission now in relation to the lack of achievement of expected efficiency gains over the first two years of the new regime, and the failure to share the economies of scope which exist at Wellington Airport with consumers.

- ***The Commission's use of the 75th percentile WACC estimate when undertaking its assessment of the returns earned by the Airport.***

  BARNZ considers that, in the case of Airports, which are able to earn considerable additional revenues from the provision of complementary ancillary activities such as retail concessions and car-parking as a result of the provision of aeronautical facilities, there is no need to allow a return at the 75th percentile level in order to address the asymmetric consequences of errors in estimating the WACC.

BARNZ will address these points in more detail as it responds to each of the key conclusions reached by the Commission.

2. IS WELLINGTON AIRPORT OPERATING EFFICIENTLY?

The Commerce Commission's draft conclusion with respect to this aspect of the s52A outcomes is that it was unable to conclude whether information disclosure regulation is effectively promoting the purpose of Part 4 in relation to improvements in Wellington Airport's operating efficiency as:

- It is too early to assess meaningful trends in opex at the Airport; and
- The evidence of whether Wellington Airport is improving its operating efficiency is mixed.

The mixed evidence the Commission outlined in its draft report comprised the following matters raising questions regarding the efficiency of Wellington Airport's operating costs:

- Increases in unit opex of 18% per passenger and 50% per aircraft movement during PSE1;
- Opex in PSE1 being 16% higher than forecast, with some of these costs having been within the control of Wellington Airport;
- Unit opex increasing at a faster rate at Wellington Airport than at Auckland and Christchurch Airports;
- Airline concerns that recent and forecast opex is not efficient, compared to previous levels at the beginning of PSE1 which were acknowledged to be efficient; and
- Total opex is forecast to increase by 19% (excluding noise mitigation costs) over PSE2, relative to opex in PSE1.

And the following evidence, on the other hand, suggesting that operating expenses might be at efficient levels:

- Unit opex is forecast to decline during PSE2 although still remaining at a higher level than actual unit opex prior to PSE1 and forecast for PSE1, although the Commission has been unable to determine the extent the forecast reductions in unit opex are due to economies of scale or improving efficiencies;
- The forecast decline in unit opex at Wellington Airport of 11% per pax and 1% per movement is at a similar rate to Auckland Airport, which may indicate these are reasonable levels of opex efficiencies in the current operating environment; and
- Benchmarking data indicates that Wellington Airport has low unit opex relative to other airports in NZ and Australia, although it is unclear whether this is due to Wellington Airport being relatively more efficient or to differences in its operational circumstances such as a lower ratio of international passengers

BARNZ acknowledges that, while the Commission's conclusion that it is too early to assess meaningful trends in the efficiency of forecast operating expenses is understandable on a forward-looking basis, the evidence before the Commission is nonetheless more than sufficient to support a conclusion that there is no evidence in the first two years of information disclosure regulation of improvements occurring in Wellington Airport's operating efficiency. In fact, the evidence in relation to historical disclosures over the last two years very clearly shows that operating expenses have increased on a per unit basis immediately prior to and since the commencement of Part 4 information disclosure regulation and improvements in efficiency have not been achieved despite significant increases in passenger volumes having occurred.

BARNZ therefore considers that the Commission needs to reach separate conclusions on the question of whether information disclosure under Part 4 is promoting improvements in operating efficiency on an actual basis considering the results of the first two years of disclosure (where the evidence clearly shows diminishing efficiency) and on a forward looking basis (where the evidence is mixed and additional time would assist in enabling a more reliable conclusion).

BARNZ also notes that the Commission decided not to undertake a disaggregated review of the different components of opex as it considered that the specific concerns raised by the airlines would not have a significant enough impact to merit the costs of undertaking such a review. This is unfortunate as it is only with such an analysis that accurate conclusions regarding efficiency and the availability of economies of scale can be reached. BARNZ's approach of adopting the 2007 per pax unit opex as an efficient starting point, and indexing this forward for inflation and passenger growth (without allowing for economies of scale) would have resulted in a reduction of total opex of approximately 10% or $7.9m over PSE2. The Commission deciding that it is not worth incurring the costs of undertaking such a review should be expressly recorded as an assumption which is in Wellington Airport's favour.

Finally, BARNZ notes that comparisons with other Airports need to be treated with caution. Differences in operating environments, passenger mixes (ie international, domestic or turbo-prop) and the aircraft types operating at the Airport all contribute towards creating individual levels of costs for each Airport. In BARNZ's opinion, it is the measurement of trends over time at each Airport which will provide the strongest evidence about whether efficient levels of operating expenses are being achieved.

3. IS WELLINGTON AIRPORT INVESTING EFFICIENTLY?

The Commerce Commission's draft conclusion on this aspect of s52A is that it is too early to tell whether information disclosure regulation is effectively promoting efficient investment at Wellington Airport until time tells whether the concerns raised by the airlines regarding Wellington Airport's practice of forecasting key capex projects to occur at the beginning of a pricing period and then deferring the construction of the asset continue to be applicable.

BARNZ considers that the Commission's review of the matters raised by submitters in relation to this aspect of the s52A outcomes is balanced and its conclusion is appropriate, subject to the following two observations.

First, while the Commission has acknowledged the significant concerns held by the airlines over the quality and timing of some investments in the first price setting period, before information disclosure regulation under Part 4 took effect, the Commission notes at paragraph C5 that it has not undertaken a detailed review of these investments to form a view on whether these concerns are justified. This is explained as being because the concerns relate to investment prior to Part 4 information disclosure. BARNZ does not consider that it is appropriate for the Commission to avoid reaching conclusions on this issue. This investment forms part of the RAB on which Wellington Airport set its charges, and on which the Commission is assessing the profitability of the Airport. Any inefficient capital expenditure decisions taken immediately prior to the Part 4 information disclosure regime commencing will have an enduring impact on both the opening RAB disclosed and the assessment of profitability in the new regime.

The second observation by BARNZ relates to comments made by the Commission on the effectiveness of the Airport Authorities Act requirement for airports to consult over significant capital expenditure. The Commission appears to have assumed that this requirement acts as a constraining factor on airports, preventing them from undertaking investment which does not have the support of users.[1] It does not. The threshold for consultation over capital expenditure under section 4C of the AAA of the project cost being 20% or more of the cost of the regulated assets is now so high as a result of ongoing asset revaluations that it is only triggered extremely rarely. In fact, BARNZ is only aware of it being triggered once – which was the new terminal building at Christchurch Airport which is just being completed. The s4C capex consultation requirement was not triggered for The Rock or the RESAs at Wellington Airport or for Pier B or the new international arrivals area at Auckland Airport. Nor was it triggered for the now postponed first stage of the Northern Runway at Auckland Airport. The ongoing practice of asset revaluations has virtually rendered the requirement in s4C to consult over major capital expenditure projects nugatory and it certainly does not act as a constraining factor on airports in practice.

4. IS WELLINGTON AIRPORT INNOVATING APPROPRIATELY?

The Commerce Commission's draft conclusion on this aspect of s52A is that, while information disclosure is having a limited impact on incentives to innovate at Wellington Airport to date, this is not a concern because other incentives play a more important role in driving innovation, and information disclosure does not appear to have negatively impacted on those incentives. The Commission therefore concluded that information disclosure is effectively promoting the purpose of Part 4 in relation to innovation.

[1] See for example paragraph E5.

BARNZ agrees with the Commission's conclusions that other incentives play a more important role in driving innovation than information disclosure, and that information disclosure has not negatively impacted on those incentives.

However, BARNZ questions the validity of moving from a conclusion that information disclosure has not negatively impacted on incentives to innovate to assume that information disclosure is therefore effectively promoting the purpose of Part 4 in relation to innovation. The later conclusion is not an automatic or logical consequence of the former. The more supportable conclusion from the facts and evidence outlined in the Commission's draft report would appear to be that Part 4A information disclosure has had neither a positive nor a negative impact in relation to the promotion of innovation by airports.

5 IS WELLINGTON AIRPORT PROVIDING SERVICES AT THE QUALITY CONSUMERS DEMAND?

The Commerce Commission's draft conclusion on this aspect of s52A is that information disclosure under Part 4 is effectively promoting the purpose of Part 4, and has had a positive impact in relation to Wellington Airport providing services at a quality that reflects consumer demands. The Commission particularly noted that:

- Improvements in passenger satisfaction levels occurred as a result of improvements made following the introduction of customer surveys required by the disclosure requirements;
- Quality of service at Wellington Airport compares well against other airports; and
- Airlines are generally satisfied with the quality of service provided at Wellington Airport, albeit that concerns exist over investment being at too high a quality.

BARNZ considers that the Commission's comments and conclusions in relation to quality are all appropriate and balanced, although BARNZ does not consider that the Commission's observation in paragraph E5 that the requirement in the AAA to consult on material capital expenditure creates an incentive to understand the level of quality consumers demand is an observation that is supportable, as the threshold for consultation is one that is virtually unattainable in practice.

6 IS WELLINGTON AIRPORT SHARING EFFICIENCY GAINS WITH CONSUMERS?

The Commerce Commission's draft conclusion on this aspect of s52A is that it is unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers. This is because the Commission considers that it is too early to conclude whether there are any opex and capex efficiency gains at Wellington Airport that could be shared with consumers.

In reaching this conclusion, BARNZ considers that the Commission has given insufficient weight to the evidence of reductions in operating efficiency at Wellington Airport over the first PSE, which encompasses the first two years of Part 4 disclosure, and to the Airport's failure to share the benefits of economies of scope with consumers as it reset its charges in PSE2.

Efficiency gains should have been achieved over the previous pricing period:

- Economies of scale as a result of increasing activity should have been enjoyed and shared with consumers. Passenger volumes increased by 13% over the first pricing period from 4.6m in FY07 to 5.2m in FY12. However, there was an 18% increase in unit opex per passenger during this time. One of the ways in which monopolies can exhibit inefficient tendencies is through not holding costs at efficient levels. These figures indicate that Wellington Airport has been inefficiently increasing its operating costs. One of the known characteristics of monopolies is that they do not just set charges too high, they also have weak incentives to improve efficiency, and often accept costs being higher than necessary. This is what appears to have occurred at Wellington Airport over PSE1, and is leading the Commission to conclude that there are no efficiency gains which were able to be shared. This leaves unanswered the question of whether there were, or should have been, underlying efficiency gains, which have been disguised by Wellington Airport and retained for its own benefit through it increasing costs in other areas.

- Economies of scope as a result of multiple activities are achieved by the Airport and should be shared with consumers. Wellington Airport's Annual Report for the year ended 31 March 2012 indicates that the Airport earned $31.6m for 'retail and trading activities'. This equates to slightly over $6 per passenger. Retail activities in the passenger terminal depend wholly on the presence of aeronautical activities and the passengers which airlines move through the Airport. Yet, rather than sharing the benefits of economies of scope with airlines, Wellington Airport is retaining the benefits of these economies of scope for itself, while allocating a disproportionately high level of costs to aeronautical activities. There are two striking examples of how the Airport has failed to share the benefits of economies of scope with airlines and the travelling public:

    - First, Wellington Airport has altered its previous allocation of the seating area for food and beverage consumption as a commercial space, and has now made airline charges meet 75% of the costs of providing this seating area for food and beverage consumption. BARNZ considers that this was a deliberate move on the Airport's part to transfer costs from the retail business to the aeronautical cost centre and the charges levied on airlines.

    - Secondly, the Airport has treated the full cost of its new incentive programme (budgeted by the Airport to cost $11m) over the next pricing period as an aeronautical cost, met through airline charges. This is despite the fact the Airport earns considerable retail and concession revenue from each additional passenger that moves through the terminal.

BARNZ considers that there is clear evidence that Wellington Airport has avoided sharing the benefits of economies of scale with consumers over the first two years of disclosure under Part 4 through its inefficient increases in operating costs. Moreover, the methodology used by the Airport to allocate costs in PSE2 clearly shows that, as it reset charges for PSE2, the Airport has not shared with consumers the benefits of efficiency gains that should have been achieved but have been hidden through other costs increasing or the benefits of efficiency gains achieved (and that are forecast to be achieved) through economies of scope available as a result of the provision of ancillary complementary retail and car-parking services to passengers (but which are not visible in the disclosure accounts due to the Airport's practice of allocating additional costs to the aeronautical business).

BARNZ therefore does not consider that the Commission's draft conclusion that it is unable to conclude whether Wellington Airport is sharing the benefits of opex and capex efficiency gains with consumers is valid. The Commission has failed to give sufficient weight to the evidence of reductions in operating efficiency at Wellington Airport over the first PSE, and the Airport's failure to share the benefits of economies of scope with consumers in the charges set in PSE2.

7. DO THE PRICES SET BY WELLINGTON AIRPORT PROMOTE EFFICIENCY?

The Commerce Commission's draft conclusion on this aspect of s52A is that the prices set by Wellington Airport based on the pricing methodology it adopted for PSE2 are more likely to improve efficiency than those previously in place, and therefore information disclosure has effectively promoted efficiency of pricing, albeit that further improvements to promote efficiency could occur, particularly in relation to price-quality trade-offs.

While BARNZ agrees that some of the PSE2 prices set by Wellington Airport are more likely to improve efficiency than the PSE1 prices, there are several aspects of the conclusions made by the Commission in this part of its draft report with which BARNZ disagrees.

The Commission has concluded at paragraph G17 that *'given the low marginal costs of airport services … there is unlikely to be cross-subsidisation at Wellington Airport during PSE2, with the exception of cross-subsidisation of smaller aircraft in peak periods'*. The information prepared by Wellington Airport and provided to BARNZ by the Airport during consultation does not support this conclusion in relation to international terminal passenger charges.

The Airport has set a common terminal charge for domestic and international passengers of approximately $5.25 per passenger. This is despite the fact that many of the facilities are solely international or solely domestic. BARNZ notes that one of the pricing principles used by the Commission to assess the efficiency of prices is that *prices should signal the efficient incremental economic cost of providing the service to individual or groups of consumers.* The new $5.25 common terminal charge does not cover the incremental economic cost of providing international terminal facilities at Wellington Airport. Wellington Airport advised airlines during consultation that $32.7m of assets are directly allocated to international terminal activities.[2] Given the forecast number of international passengers, a charge of approximately $9 per passenger would be required to meet the incremental costs of the purely international space. This is without any account being taken of common processing space such as the baggage sortation system or thoroughfares in the main terminal building.

It therefore seems very clear to BARNZ that the international passenger terminal charge has not been set at a level that signals the incremental cost of providing international terminal facilities, and it is highly likely that terminal charges for domestic passengers are cross-subsidising the cost of Wellington Airport providing international passenger terminal facilities.

At paragraph G24 the Commission refers to BARNZ supporting the peak pricing and gate charges introduced by Wellington Airport, referencing the response by BARNZ to the Commission's initial issues paper where BARNZ acknowledged that:

- The introduction of peak pricing charges should provide improved signals to airlines over runway capacity and scarcity of airport resources at peak times.

[2] WIAL Initial Pricing Proposal, 18 August 2011, Appendix 8, page 113; see also discussion of this issue at page 30 of BARNZ's post conference cross submission dated 17 August 2012.

- The move to setting counter charges and aircraft parking (beyond an efficient allowance for the unavoidable time necessary to achieve the turn-around of an aircraft) on a time basis should also improve pricing signals to airlines over the time that they occupy these limited resources.

While BARNZ confirms its view that such charges should provide improved pricing signals over the use of a scarce resource, BARNZ did not support the introduction of these charges during consultation. Wellington Airport has set its parking charge so that it becomes applicable in too short a timeframe, which is creating considerable administrative costs to airlines. The counter charge has been set at a rate which is resulting in charges many times what they previously were, and far above the revenue levels forecast by the Airport in its pricing model. Moreover, the peak charge creates considerable risk of future excess charges being levied by the Airport, particularly in light of the decision of the Court of Appeal that airport charges set under s4A of the AAA cannot be challenged by judicial review on the grounds of unreasonableness.[3]

Nevertheless while BARNZ did not support the introduction of these charges, we nevertheless do recognise that the introduction of such charges can lead to improved efficiencies.

8. IS WELLINGTON AIRPORT EARNING AN APPROPRIATE ECONOMIC RETURN OVER TIME?

The Commerce Commission's draft conclusion on this aspect of s52A is that Wellington Airport is earning an excessive return over time within the meaning of s52A(1)(d) of the Commerce Act and information disclosure is not effectively promoting outcomes consistent with those produced in competitive markets such that Wellington Airport is limited in its ability to extract excessive profits. The Commission notes that this is primarily attributable to:

- Wellington Airport using its own asset valuation methodologies to revalue assets without fully accounting for the resulting revaluation gains in determining its revenue requirements; and
- Wellington Airport targeting the recovery of a cost of capital that exceeds the estimate provided by the input methodologies of the cost of capital that could be expected if the Airport was subject to workable competition.

The Commerce Commission has undertaken a profitability analysis and concluded that:

- An IRR assessment shows an expected return of 10.1%[4] for the seven years following the introduction of the new disclosure regime, which is significantly in excess of the Commerce Commission's estimates of the cost of capital range of 7.06% (midpoint) and 8.04% (75th percentile) and even in excess of Wellington Airport's targeted return of 9.51%.
- The present value of net cash flows expected to be generated by Wellington Airport over PSE2 is a positive outcome in excess of the IM cost of capital estimate of between $19.7m at the 75th percentile estimate and $38.5m at the mid-point.[5]

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[3] *Air NZ Ltd v Wellington International Airport Ltd* [2009] NZCA 259 29 June 2009, particularly para 36 and 98.
[4] Updated by the Commission on 21 November from the 10.18% indicated in the draft report.
[5] Updated by the Commission on 21 November from $20.1m at the 75th percentile estimate mid-point and $38.8m at the mid-point indicated in the draft report.

The Commission concluded that while information disclosure regulation provides a number of incentives which could be expected to have a significant impact on limiting Wellington Airport's ability to extract excessive profits, they have not been effective in the case of historical or projected profitability for Wellington Airport, and if Wellington Airport continues to apply its current approach to setting charges in future price setting periods, then it will continue to show excessive profits over the longer run.

BARNZ agrees with the Commission's overall conclusion that information disclosure has not limited the ability of Wellington Airport to extract excessive profits, and that the Airport is using its own asset valuation methodologies and cost of capital to set charges at levels that will result in significant excess returns being earned.

However, BARNZ considers that the Commission's analysis favours Wellington Airport by under-stating the level of excess returns and the detrimental effect on consumers in three key areas:

- The Commission is focusing on the 75th percentile WACC estimate in its *ex ante* analysis, rather than a mid-point WACC, because it considers that a 75th percentile WACC produces outcomes more likely to promote dynamic efficiency.
- The Commission has estimated the post-tax present value of the excess returns expected to be generated by Wellington Airport – without also assessing what the impact is on consumers in terms of excess charges paid to Wellington Airport.
- The Commission has made a number of assumptions in its calculations which favour Wellington Airport, many of which the Commission consider do not have a material enough effect to warrant adjustments being made. However, taken together, the cumulative impact of these factors for which adjustments have not been made will be material and likely to result in the Commission's analysis significantly underestimating the level of excess returns being earned by Wellington Airport.

Mid-point WACC vs 75th Percentile WACC

The Commission has placed greater emphasis on the results of its analysis using the 75th percentile WACC estimate, than it has on analysis outcomes using the mid-point WACC estimate. It has referred to the fact that it generally favours outcomes that promote dynamic efficiency and has referred to its decisions in the context of Natural Gas Distribution Services.

BARNZ has sought comment from Futures Consultants Ltd (FCL) on the validity of the Commission's focus on the 75th percentile estimate of WACC when estimating WIAL's forecast excessive profits. FCL's report is provided to the Commission with this submission. FCL have summarised the Commission's rationale for using the 75th percentile WACC estimate in the context of Gas Distribution Businesses as follows:[6]

> … the Commission uses the 75th percentile WACC as a benchmark for excessive profits in the circumstances of control of gas distribution businesses because it believes the social costs of controlled providers under-investing due to returns being too low outweigh the social costs of consumers paying prices that are too high. There is, according to the Commission, an asymmetric social welfare loss function from errors in the WACC applied to controlled entities; the costs are higher for under-estimates of WACC than for over-estimates.

[6] Futures Consultants Ltd, Report to BARNZ on the Commerce Commission's Draft 56G Report on WIAL, 27 November 2012, page 2.

FCL then examines how appropriate it is for the Commission to use the 75th percentile WACC estimate when assessing Wellington Airport's forecast returns, concluding that it is inappropriate for the Commission to use the 75th percentile WACC estimate as the benchmark for historical assessments of excessive profits of regulated airports.[7]

FCL give three key reasons for the 75th percentile being inappropriate in the case of regulated airports:

- First, significant revenue opportunities exist for airports from the provision of ancillary services to airline passengers (such as shops, food and beverage offerings and car-parking) and airlines themselves (leasing lounges and other areas).[8] Airports are different from gas distribution businesses in this respect. This ancillary revenue and profit increases as passenger flows increase through an airport. A decision by an airport not to invest in regulated assets which adversely impacted passenger volumes would also inhibit the airport's profit from these ancillary activities. Hence a return at the 75th percentile WACC estimate is not necessary to ensure dynamic efficiency at an airport, unlike gas distribution businesses.

- Secondly, three of the four non-parametric sources of uncertainty identified by the Commission in estimating WACC will tend to result in the WACC being over-stated[9], with illustrative calculations suggesting that the bias towards over-statement could be material. The true range of WACC, if it were known, would be centered on a point materially below the mid-point estimate produced by the Brennan-Lally model and monthly data. Using the 75th percentile estimate is therefore likely to compound this bias towards excessive prices and profits.

- Thirdly, pricing by low cost carriers and other airlines to attract marginal customers means that the proportion of airport charges within these ticket prices has become significant. A significant amount of airline innovation and market stimulation relates to these 'low value customers'. The impact of airport overcharging on these innovative fares and services by airlines is significant and should not be dismissed by the Commission when assessing the social costs of excessive profits and overcharging.

BARNZ notes that the complementary nature of the retail and car-parking activities occurring at airports has led many countries to treat airports as single till businesses, with aeronautical charges set after taking into account the non-aeronautical revenue earned by the Airport. Heathrow Airport is one of the most well-known examples. Regulation of New Zealand Airports is currently implicitly based on a dual till approach, whereby assets, costs and revenues are split between the different activities, with charges for aeronautical activities set in isolation from the tens (even hundreds) of millions of dollars able to be earned from the provision of car-parking and retail activities to airline passengers.

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 or ancillary services already provides additional incentive to Airports to invest in

[7] Ibid at pages 3 – 4.

[8] Wellington Airport's Annual Report for the year ended 31 March 2012 disclosed that the Airport earned $31.6m from 'retail and trading activities'. This equates to slightly over $6 per passenger.

[9] These are use of a domestic rather than an international CAPM, use of monthly data for estimating betas and the effect of the Brennan-Lally model as leverage increases.

maintaining or adding aeronautical capacity. Any internal consideration by airports of the business case for adding additional aeronautical capacity (such as additional contact gates, hard stands or passenger processing capacity), will not only take into account the forecast aeronautical revenue to be earned from such investment, it will also consider the likely increase in retail and car-parking revenue from the additional passenger volumes. Airports fundamentally differ from other regulated businesses such as gas pipelines and electricity lines businesses in this respect.

BARNZ therefore considers that the Commission's analysis of the returns earned, and forecast to be earned by Wellington Airport (and all regulated airports) should utilise the mid-point estimate of the WACC range.

Measuring the impact of excessive returns

The Commission has undertaken an estimate of the present value of the post-tax estimated net cash-flows over PSE2 at its WACC range in order to provide an indication of the magnitude of Wellington Airport's profits.

The resulting calculation indicates the present value of the excess returns retained by the Airport after tax, which is \$19.7m at the 75th percentile estimate and \$38.5m at the mid-point over PSE2.

However, this calculation does not provide an indication of <u>the excess charges paid by airlines and the travelling public</u>, which are necessarily greater due to the impact of tax, which because of its inclusion in the building blocks approach, uplifts the amount of revenue sought by the airport. Users not only have to meet the high cost of capital being targeted by Wellington Airport. They also have to meet the additional tax payable as a result of the increased profits. In addition, in the case of end use consumers, GST also has to be paid on the higher charges and is not able to be claimed back, which further increases the impact on consumers of the over-charging by Wellington Airport.

BARNZ considers that the Commission's report also needs to disclose the impact of the over-charging by Wellington Airport in terms of how much additional revenue users will have to pay the Airport in charges as compared with what would be paid to enable the Airport to earn its midpoint cost of capital. This is the additional cost consumers have to pay as a result of the Airport targeting a WACC in excess of the level applicable in workably competitive markets.

An Array of Assumptions Favouring the Airport

Throughout its draft report, the Commission has made a number of assumptions which are in the Airport's favour or has chosen not to make any adjustment for points raised by the airlines on the grounds that the matter is not material enough to significantly affect the outcome.

The concern which BARNZ has is that while some of these adjustments may be able to be individually dismissed as not materially affecting the outcome, the cumulative outcome of all of these matters is highly significant. All of these matters appear to be in the favour of the Airport. The end result is one which hides the level of excess returns being sanctioned by the Commission, and results in the Airport earning considerably more than a 75th percentile return.

The matters noted by BARNZ where the Commission has made assumptions which favour the Airport include the following:

- *The Commission has not made any adjustment to the inclusion of the costs of the incentive scheme* – notwithstanding that questions have been raised as to whether any one airline will meet the threshold and whether the 'rebates' will be paid out. These rebates amount to around $11m over PSE2. The Commission noted that, if the volumes increased to the level forecast by the Airport but the incentive scheme was not triggered, and these 'rebates' were not paid out, then the Airport's revenue would increase by $21.7m and it would earn a return of 9.46%, compared with 9.14%, over PSE2.[10] Yet the Commission's favoured analysis leaves the incentive scheme costs in the cost base.

- *The Commission has applied Wellington Airport's MVAU land valuation of $1.4m per ha* – notwithstanding the advice from Zomac Planning Solutions and Property Advisory Ltd that the alternative land use plan adopted by Wellington Airport's valuers was not feasible and significantly over-stated the amount of commercial land able to be justified or supported in the area were the airport to close, resulting in the value being materially over-stated. PAL completed a valuation of Wellington Airport land applying the Commission's input methodologies, which resulted in a MVAU value of $0.95m per ha. The Commission noted that, if the PAL valuation figure of $0.95m per ha was adopted, then this would result in a forecast post tax IRR of 9.78% compared with the 9.14% based on WIAL's MVAU valuation figure.[11] Yet the Commission's favoured analysis applies the higher Wellington Airport MVAU valuation figure as the opening asset base.

- *The Commission has not undertaken a disaggregated review of the different components of opex or made any alterations to Wellington Airport's forecast operating costs*, notwithstanding the clear evidence it noted about the increasing costs during PSE1, where opex was 16% higher than forecast, and unit opex increased by 18% per passenger and 50% per aircraft movement, which was a faster rate than occurred at Auckland and Christchurch Airports. BARNZ considered that FY07 represented a time when operating expenses were at an efficient level, and therefore unit costs should be indexed forward by CPI from that point. This suggested a 10% reduction in forecast opex was required, which equated to approximately $8m over PSE2. In not making any reduction to forecast operating costs, the Commission has also allowed the Airport to pass on the legal costs of its participation in the judicial and merits review proceedings the Airport is taking challenging the Part 4 input methodology determinations by the Commission, notwithstanding that most of the Airport's customers have elected not to challenge the Commission's determination. The Commission's analysis is therefore based on a level of forecast opex which is generous to the Airport, and likely to allow the Airport to make savings without any superior performance being required.

- *The Commission has included leased regulatory assets in its analysis*. The effect of this is to understate the returns earned by Wellington Airport on its pricing asset base due to the returns on leased assets being below both the target level of WACC sought by the Airport, and the WACC range estimated by the Commission. The Commission has noted that it does not consider that the inclusion of leased assets and revenue in its analysis materially affects the analysis as income from leased assets accounts for less than 7% of total regulatory income and the profitability targeted in relation to leased asset activities is comparable to that of other services provided.[12]

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[10] Commerce Commission draft s56G report on Wellington Airport, para G39 and H81.
[11] Commerce Commission draft s56G report on Wellington Airport, para H81.
[12] Commerce Commission draft s56G report on Wellington Airport, refer footnote 179.

This is a different approach to that taken by the Commission in the 2002 Airport Price Inquiry where the Commission excluded leased airfield land from its calculations of airfield profitability, noting that *the costs associated with leased land is presumably recovered from the parties that lease the land.*[13]

The return for leased assets is determined through leases negotiated between Airports as the landlord, and tenants (often airlines but also Government Agencies and other third party service providers). These leases usually incorporate arbitration provisions and reference market rates. They are much closer to outcomes produced by workably competitive markets than is the case with respect to the aeronautical pricing asset base. As such, BARNZ considers that the returns earned from leased assets, together with the associated costs and assets, should be excluded from the both the calculations by Airports to set standard charges and from the Commission's analysis of the profitability of the Airports under Part 4.

BARNZ notes that Auckland, Christchurch and Wellington Airport all exclude leased assets from the asset base on which charges are set.[14] Information provided by Airports during consultation has consistently indicated that the revenue derived from leased aeronautical assets is below the level of return targeted by Airports through the application of its WACC to the revalued asset.[15] For example, Wellington Airport's disclosures following PSE2 indicate that:

- Leased aeronautical assets are valued at circa $44m.
- The revenue from leased aeronautical assets comprises $4.8m on average over PSE2.
- If the average depreciation rate of 2.8% is applied, then this indicates that the post-tax return on these leased assets is 5.8%. However, this does not take into account depreciation, insurance, rates or other opex associated with these leased assets.
- An NPV deficit for each year for activities not included in the pricing asset base is disclosed in Wellington Airport's pricing disclosures of $0.74m pa or $3.7m over PSE2.

While the Commission has dismissed the impact of it including leased assets as not material in relation to the total level of revenue earned by the Airport, the short-fall is highly material when compared to the Commission's Assessment of excess returns. A shortfall of $3.7m from these other activities represents 19% of the $19.7m excess returns identified by the Commission at the 75th percentile, or 10% of the $38.5m excess returns identified by the Commission at the mid-point.

- *The Commission has undertaken end of period discounting in its analysis*, which it expressly acknowledged gives rise to a conservative estimate of the IRR in favour of the Airport, as opposed to attempting to approximate the actual timing of cash-flows.[16]

[13] Commerce Commission, Airports Inquiry, 1 August 2002, paragraph 9.79.
[14] With the exception of the rental revenue from the houses which Wellington Airport was compulsorily obliged to acquire due to an order of the Environment Court, which BARNZ considers is appropriate to include as an aeronautical cost.
[15] The exception would be the duty free Collection Point at Auckland Airport, albeit that that activity is a more accurately characterised as a concession rather than a lease.
[16] Commerce Commission draft s56G report on Wellington Airport, refer footnote 192 and para I16 – I17.

- *The Commission has not undertaken any optimisation of recent gold-plated investment which was undertaken at significantly greater levels of quality and specifications than that required by users.* The construction of the international terminal extension as a multi-faceted copper sheathed cylindrical shape is a striking example of the lack of efficient discipline on recent investment decisions by Wellington Airport. Runway End Safety Areas (RESAs) have also been constructed to specifications exceeding aircraft currently operating regular scheduled services to Wellington Airport. These additional costs will impact the asset base, and profitability calculations, for many years to come.

- *The Commission has not made any adjustment to Wellington Airport's allocation of 75% of the value of the food-court space to the aeronautical cost centre,* noting that the $2.25m impact on the pricing asset base is immaterial. The Airport's altered allocation approach reverses its previous practice, adopted since the terminal was constructed 15 years ago, of treating this space as commercial. The impact over the five years of PSE2 on the required return on capital, tax, depreciation and the resulting consequential impact on common asset and common cost allocations is likely to exceed $2m over the pricing period.

Taken in isolation, any one of these matters may be able to be dismissed as not of sufficient materiality to affect the outcome to any large degree. However, when taken together with the other matters the Commission has not adjusted for, these supposedly non-material issues soon add up to become highly material, and together result in the Commission's assessment of the excess returns being earned by Wellington Airport being a material understatement.

BARNZ therefore considers that the Commission needs to reassess its decisions not to incorporate these matters into its analysis of the level of excess returns which Wellington Airport is earning.