Auckland Airport

SECTION 56G REVIEW OF AUCKLAND AIRPORT

POST-CONFERENCE SUBMISSION

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OVERVIEW

1. This submission is divided into eight sections:

   (a) **Section 1:** This section describes the approach that Auckland Airport encourages the Commission to take to the section 56G review and to its draft report, including a summary of the positive conclusions that we consider can be drawn in relation to Auckland Airport.

   (b) **Sections 2-6:** These sections address the topics that formed the key discussions at the Commerce Commission's conference for Auckland Airport ("**Auckland Airport Conference**").

   (c) **Section 7:** This section discusses Auckland Airport's concerns with the technical operation of the input methodology ("**IM**") and information disclosure ("**ID**") requirements for land held for future use.

   (d) **Section 8:** This section addresses the technical queries raised at the Auckland Airport Conference and provides further information to assist the Commission's analysis of these issues.

2. In summary, we encourage the Commission to take an evidence-based approach to the draft report that fully recognises the range of ways in which ID is having an impact on Auckland Airport's conduct and performance. If this approach is adopted, we submit that the Commission can readily recommend to Ministers that Auckland Airport's behaviour and performance demonstrates that ID is effectively promoting the Part 4 purpose statement.

3. This cross submission should be read together with the New Zealand Airports Association's cross submission, which Auckland Airport supports.

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SECTION 1: APPROACH TO THE SECTION 56G REVIEW AND DRAFT REPORT

Key points:

- Auckland Airport encourages the Commission to take an approach to the review that is evidence based.
- For Auckland Airport, a balanced and full consideration of the evidence demonstrates that each limb of the purpose statement is being effectively promoted under ID regulation.

The Commission's approach should be evidence-based

5. Auckland Airport is committed to full and absolute participation in the regulatory process. We have provided extensive information to the Commission about our conduct, performance, business drivers, decision-making philosophies, pricing consultation process and relationships with our substantial customers. That information has been fully and transparently disclosed through regulatory disclosures under Part 4 of the Commerce Act, in submissions in response to the section 56G review, and in response to information requests from the Commission as part of the review process. In addition, Auckland Airport has provided the Commission with the full record of its pricing consultation materials.

6. Auckland Airport acknowledges the Commission has a considerable task ahead of it in processing this extensive information and preparing its section 56G report. The report forms an important part of the ID framework for all interested parties - airports, airlines, the Commission, Ministers and officials, investors and, ultimately, current and future passengers.

7. In this context, Auckland Airport encourages the Commission to take an approach to the Review which is:

   (a) **Evidence based**. The Commission's draft and final conclusions must be drawn from the extensive evidence before the Commission on Auckland Airport's current conduct and behaviour. While the Commission is entitled to draw conclusions about expected performance, those conclusions should be the product of current evidence and decisions that have actually been made, not speculative assumptions about potential future behaviour.

   (b) **Balanced and even-handed**. Auckland Airport submits that the Commission ought to properly identify and recognise positive performance from Auckland Airport and not focus on the few remaining points of difference between Auckland Airport and some of its airline customers.

   Quality, innovation, capital expenditure and operating costs cannot be considered in isolation of each other or in isolation of overall returns, and many of these elements cannot be captured by modelling or numerical analysis. Financial modelling is one factor to be weighed in a balanced analysis, but not the conclusive answer.

   We continue to encourage the Commission to explore the interdependencies between the different limbs of the Part 4 purpose statement, and to reflect on how these interdependencies can be fully acknowledged in its analysis and conclusions.

   Further, any minor issues that have been raised should be considered in proportion to the overall picture of airport performance, and should not outweigh the positive outcomes that can be observed.

An evidence-based approach leads to positive findings for Auckland Airport

8. Auckland Airport continues to consider that ID regulation is in its infancy, and we expect that it will have a stronger impact on continuing improvement, conduct and performance over time, as more information is disclosed, clearer benchmarks are established, and ongoing monitoring and analysis reveals performance and behavioural trends.

9. Even at this early stage, the evidence currently before the Commission demonstrates that each limb of the purpose statement is being effectively promoted at Auckland Airport under ID regulation. We believe the following findings are fully supported by the evidence:

- **Innovation:** ID regulation has positively affected incentives to innovate at Auckland Airport. Evidence of regular innovation at Auckland Airport has been provided, which demonstrates that Auckland Airport is committed to both airport and airline-driven innovation.

  ID has been an important influence on Auckland Airport's behaviour as the transparency and attention given to innovation has required Auckland Airport to consider more deeply how it can play its role across a wide range of possibilities for aviation business innovation.

- **Investment:** Auckland Airport and its airline customers have a high degree of engagement and alignment on forecast investment in capital expenditure. Auckland Airport is currently consulting on near-term investment in new domestic terminal capacity, and its investment horizon includes medium to long-term investment in a second runway. While investment is currently appropriate and efficient, care needs to be taken to ensure ID regulation provides the appropriate incentives, and does not provide disincentives, for Auckland Airport to invest efficiently and responsibly in these projects.

  Further, ID regulation provided a strong framework for the capital expenditure consultation during pricing for PSE2, and was a significant contributor to the considerable alignment between airlines and Auckland Airport on forecast capital expenditure.

- **Quality:** ID has had a positive impact in this area. Auckland Airport provided high quality services prior to and following the introduction of ID regulation, and is providing quality at a level that reflects consumers' demands. Auckland Airport's management practices incorporate measures from ID regulation, which has had a positive effect on ongoing monitoring of quality and performance. This has also improved the transparency for all users of the quality aspects of ID and the impact of business decisions relating to quality.

- **Pricing efficiency:** ID regulation has had a positive impact on this outcome. Prices based on the pricing methodology for PSE2 are more likely to promote efficiency than those previously in place. The evidence from Auckland Airport's submissions and its pricing consultation demonstrates that ID was one of the reasons for its change in pricing methodology.

- **Operational expenditure efficiency:** Auckland Airport's operating costs have risen over PSE1. However, these increases are consistent with the changes in Auckland Airport's operating environment since 2007, and Auckland Airport continues to have highly efficient operating costs by world standards. There is evidence that Auckland Airport is seeking to improve its operating efficiency for PSE2, and forecast efficiencies have been incorporated into prices for PSE2.

Although subsequent information on actual expenditure during PSE2 will assist in drawing conclusions on Auckland Airport's efficiency, we consider that ID is being effective in its early days. In particular, the transparency that is promoted enables all users of airport services to be informed on operational expenditure efficiency.

- **Sharing the benefits of efficiency gains:** Auckland Airport is targeting forecast efficiencies over PSE2, which have been passed through to airlines in lower prices today. Growth forecasts in PSE2 reflect shared efficiencies through increased passenger volumes (and consequential improvements in asset utilisation) which are associated with route development initiatives undertaken and paid for by Auckland Airport in PSE1. Overall, Auckland Airport's prices result in modest forecast revenue growth and a price path of less than inflationary growth per passenger over the next five years.

- **Limiting excessive profits:** The evidence demonstrates that Auckland Airport has been limited in its ability to extract excessive profits, and that the existence of ID regulation clearly moderated the return sought by Auckland Airport for PSE2. It set aeronautical charges which forecast a return on its pricing asset base of 8.475%. This return is less than its target return for PSE1, below the WACC estimate recommended by its independent advisor, and within a reasonable range having regard to the full range of contextual information presented to the Commission (including within a reasonable range of airline assessments made at the time of pricing).

  Auckland Airport's estimate of its forecast return (following the Commission's IRR approach set out in the WIAL Report) across all regulated assets is **5.74%**. In addition, that forecast return may be impacted downwards by asymmetric risks over PSE2 and beyond.[1]

[1] Further detail is included in section 5 of this submission.

SECTION 2: OVERVIEW OF THE AUCKLAND AIRPORT CONFERENCE

Key points:

- A number of areas of positive performance and behaviour have been identified in submissions and were reinforced during the Auckland Airport Conference. Auckland Airport welcomes these positive comments, and encourages the Commission to fully incorporate these matters in its draft and final reports.
- Auckland Airport has considered key areas of discussion at the conference, and expands on these areas in the following sections of this submission. In particular, Auckland Airport seeks to provide more certainty to airlines and the Commission about potential options for future pricing asset values, and the treatment of any asset revaluations.

Positive behavioural and performance discussions must be fully recognised

10. We submit that the Commission should give full recognition to the areas of positive behaviour and performance that have been highlighted in submissions to date and at the Auckland Airport Conference.

11. Auckland Airport has previously highlighted a number of the positive acknowledgments made by BARNZ and Air New Zealand in this section 56G review process.[2] In summary:

    (a) Airlines have recognised that information disclosed by Auckland Airport has led to greater transparency and greater understanding of Auckland Airport's performance (as intended by the ID regime).[3]

    (b) BARNZ, Qantas and Air New Zealand have all recognised Auckland Airport's open, engaging and receptive approach, and its willingness to engage comprehensively with stakeholders in relation to innovation, improving operational performance and efficiency, and improving service quality.[4] In particular, BARNZ has noted that Auckland Airport is considered to be "responsive and proactive" in relation to quality matters raised by airlines.[5]

    (c) Air New Zealand has recognised that (setting aside the level of charges), changes to Auckland Airport's pricing reflect efficient pricing principles, and have created a stronger link between the facilities that are used and the charges and revenues associated with those facilities.[6]

    (d) Similarly, BARNZ has acknowledged that the airfield MCTOW charges, airfield parking charges, international transit and transfer passenger charge and international check-in counter charges were all reasonable.[7]

    (e) BARNZ has acknowledged that the ID regime (through the presence of the section 56G review) did have an impact on Auckland Airport's approach to its cost of capital methodology and the target return sought by Auckland Airport.[8]

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[2] See Auckland Airport Cross-submission on the Section 56G Review Auckland Airport Process and Issues Paper 6 September 2012, 9 November 2012 at paragraphs 10-28.
[3] Air New Zealand Submission on Section 56G Review of Auckland Airport Airport Limited, 19 October 2012 at page 7; BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, 18 October 2012, page 2.
[4] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 34, 35, 39; Qantas Group Response to Section 56G Issues Paper Relating to Auckland Airport, 24 October 2012, section 5; Air New Zealand Submission on Section 56G Review of Auckland Airport, page 17.
[5] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 37.
[6] Air New Zealand Submission on Section 56G Review of Auckland Airport, page 19.
[7] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 12.
[8] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 3.

(f) Air New Zealand and BARNZ have made positive comments about Auckland Airport's consultation philosophy, including our approach to capital expenditure consultation, which was positively endorsed by BARNZ,[9] and described as "robust, transparent and inclusive" by Air New Zealand.[10]

(g) BARNZ has acknowledged that it considers the capital expenditure included by Auckland Airport in its aeronautical pricing model for PSE 2 is both reasonable and is more efficient than the expenditure which was forecast in the first price setting event.[11]

12. Auckland Airport was pleased that a number of these positive areas were further reinforced at the Auckland Airport Conference:

(a) There was considerable discussion of Auckland Airport's positive engagement with its airline customers on key issues, and of its positive consultation behaviour. Auckland Airport encourages the Commission to strongly reflect this in its draft report.

(b) A key reason behind the introduction of ID regulation, and the specification of IMs, was to provide better information to guide consultations between airlines and airports, and to facilitate more effective consultation on commercial pricing outcomes. Accordingly, Auckland Airport considers that its positive behaviour in this respect should feature prominently in the Commission's conclusions about the effectiveness of ID.

(c) Evidence has been provided by Auckland Airport and its airline customers of positive performance outcomes in a number of areas, including quality, innovation, investment, pricing efficiency, and the majority of areas concerning operational expenditure. We submit that these positive outcomes should be fully and appropriately recognised in the Commission's draft report.

13. As outlined in previous submissions to the Commission, Auckland Airport is committed to actively engaging with its stakeholders as a core element of its corporate philosophy. As such, we continue to appreciate and value this positive feedback from our substantial customers, and continue to engage with our customers to promote continual improvement. We encourage the Commission to reflect this feedback in its conclusions.

Superior performance

14. As Auckland Airport highlighted during the conference, we do not believe it is possible to consider any element of the purpose statement in isolation. Investment, innovation and quality standards are a key part of the regulatory framework, and we encourage the Commission to acknowledge our superior performance in these areas in its analysis.

15. Several key examples of Auckland Airport's superior performance include:

(a) **Superior quality.** We have won a number of quality awards in recent years. In the Skytrax World Airport Awards, which is a strong passenger satisfaction indicator, we have been ranked the best airport in Australia/Pacific from 2009 to 2012, and in the top 10 airports in the world in 2009, 2010 and 2011. Additionally, in 2012 we were ranked the best airport for staff service in Australia/Pacific, and the second best airport by size (10-20 million passengers).

We see these awards as a sign from passengers that their expectations are being met and recognition that we are performing exceptionally to deliver the

[9] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 30.
[10] Air New Zealand Submission on Section 56G Review of Auckland Airport, page 16.
[11] BARNZ Cross-Submission on Auckland Airport s56G Issues Paper, 9 November 2012, page 2.

quality of service demanded by consumers in a cost effective manner (when considered in conjunction with charges that benchmark favourably on an international and domestic basis[12] due to our efficient operating costs, capital expenditure and innovative practices).

(b) **Superior engagement.** We consider that we deliver a superior service level in our engagement model with customers:

(i) On an ongoing basis: Auckland Airport recognises the critical role it plays and the importance of engagement with its airline customers and other stakeholders in order to make journeys better. During PSE1, Auckland Airport invested in a Lean Six Sigma process to promote best practice and unlock efficiencies. This investment has delivered superior outcomes in a number of areas (such as the reduction of international processing times for arrivals from 45 minutes to 18 minutes). Auckland Airport continues to invest in ongoing forums to innovate, optimise efficiency and promote direct improvements in price and quality outcomes for passengers. These outcomes have natural positive consequences for airlines, broader stakeholders, and the New Zealand economy.

(ii) During consultation on prices and capital expenditure: Maintaining an open mind and genuinely engaging during consultation is a fundamental philosophy for Auckland Airport. We appreciate feedback from BARNZ that we have made changes to include airline priorities as a fundamental initial step in capital expenditure planning. The record also demonstrates that Auckland Airport was very responsive to airline feedback in setting its prices for PSE2. We were pleased to be described as the "poster-boy" of consultation by BARNZ, and consider this positive feedback to demonstrate our superior engagement model in this area.

(c) **Superior innovation, investment and promotion of growth.** We consider our innovative route development initiatives are a key area where we have demonstrated superior performance in PSE1 (and will continue to perform at a superior level over PSE2). We discuss these activities further in section 6 of this submission, but we note that:

(i) Our route development activities are efficient, effective and recognised amongst the best in their class internationally.[13] Our investments in this area have led to a number of new routes being developed, new growth and recognition of our route development practices through international awards.

(ii) These activities were not performed at the time of the PSE1 price-setting forecast and so were not included in pricing for PSE1. All volumes associated with committed routes delivered during PSE1 are included in demand forecasts for PSE2. This means airlines have received 100% of the benefit of the volume generated through route development at a fraction of the cost.

(iii) Auckland Airport has won and continues to win awards recognising its superior innovation and performance.[14]

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[12] Auckland Airport Submission on the Section 56G Review Process and Issues Paper, 19 October 2012, pages 123-125.

[13] Auckland Airport Submission on the Section 56G Review Process and Issues Paper, 19 October 2012, p 78.

[14] See Auckland Airport Submission on the Section 56G Review Process and Issues Paper, 19 October 2012.

(d) **Superior promotion of the Part 4 outcomes.** Our superior engagement models and route development activities are a key example of the interaction between the limbs of the purpose statement in practice. These activities are not simply operating costs in isolation. Instead, they represent:

(i) an efficient and innovative investment to provide services of the choice and quality demanded by passengers as consumers;

(ii) a practical example of sharing efficiency benefits from increased growth and asset utilisation with our airline customers;[15] and

(iii) a demonstration of our engagement with our substantial customers, and our desire to work with these customers to facilitate shared goals and promote lasting economic growth for New Zealand.

Identification of areas for further discussion

16. Against this positive backdrop, several key issues were raised during the course of the Auckland Airport Conference which require further discussion. We expand on each of the following issues in the sections below:

(a) Auckland Airport's approach to asset valuation in 2017 (PSE3).

(b) The Commission's framework for its profitability analysis, including the assumptions that analysis makes about future behaviour, and the use of the WACC IM in analysing profitability.

(c) The detail of the IRR model, including Auckland Airport's view of the appropriate opening and closing asset bases, and our calculations of returns consistent with the Commission's IRR approach.

(d) Auckland Airport's route development costs.

(e) The approach to assets held for future use.

[15] In relation to sharing of efficiency gains more generally, we note that BARNZ has suggested the increase in the average domestic passenger charge in FY13 indicates that Auckland Airport did not fully pass on the effect of the associated efficiency gains to consumers. Auckland Airport acknowledges that some of the benefits of efficiency gains have been offset by other factors through the course of PSE1. This does not, however, lead to a conclusion that the airport not is sharing the benefits of efficiency gains with consumers. Auckland Airport agrees with the Commission's comments in the WIAL Report (see, for example, paragraphs I12 and I18) that efficiency gains can be shared with consumers in methods other than reduced prices, and we consider this is the case at Auckland Airport.

SECTION 3: AUCKLAND AIRPORT'S APPROACH TO ASSET VALUATION IN 2017

Key points:

- Auckland Airport does not agree with an approach to assessing returns that incorporates assumptions about potential future pricing behaviour.
- However, given the discussion of PSE3 issues during the section 56G review, it wishes to assure the Commission and airlines that its future pricing conduct will be reasonable and appropriate.
- In the absence of a successful merits appeal, it is highly unlikely that MVEU valuations would be adopted for PSE3. While MVEU was a reference in early consultation discussions for PSE1 and PSE2, Auckland Airport set prices in PSE1 and PSE2 based on MVAU values. Auckland Airport suggests the Commission should disregard MVEU as an option in its profitability analysis.
- Auckland Airport will continue to take guidance from the IM benchmarks for price setting purposes. As such, IM compliant asset values will likely form a useful reference point in PSE3.
- Auckland Airport has no intention to revalue its asset base for pricing in PSE3. Continuing the moratorium or an approach involving indexing of the moratorium from 2017/2018 onwards are both distinctly possible outcomes.
- If the moratorium is unwound in the future, and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).

Overview

17. As discussed further below, Auckland Airport does not agree with an approach to assessing returns that is heavily sensitive to an assumption about future pricing behaviour. However, even though Auckland Airport does not agree with the Commission's analytical approach, we are concerned that the Commission may consider Auckland Airport is being elusive or trying to "game" the regulation in relation to asset valuation for PSE3.

18. We wish to assure the Commission, and interested parties, that this is absolutely not the case. However, in order to sensibly discuss Auckland Airport's position in this respect, it is necessary to consider:

    (a) the evidence of Auckland Airport's behaviour, including:

        (i) the circumstances and rationale behind Auckland Airport's decision to adopt a 10 year moratorium on asset valuations in 2007;

        (ii) the role that the moratorium played in consultation and price-setting for PSE2; and

        (iii) evidence that Auckland Airport seeks to respond appropriately to regulatory guidance, and that regulation has an influential and constraining impact on its behaviour; and

    (b) the approach that will be taken in PSE3.

Evidence of Auckland Airport's behaviour

19. In 2007, Auckland Airport's pricing decision was based on a desire to reach an appropriate commercial outcome with its airline customers, and to minimise the areas of disagreement. The treatment of asset revaluations was a key area of airline concern, and Auckland Airport was keen to address this concern and respond appropriately when setting charges.

20. In its initial pricing proposal for the 2007-2012 price setting period, Auckland Airport included forecast revaluation growth in land and non-land assets in its building blocks model, and deducted these forecast revaluations from the revenue requirement. During consultation, Auckland Airport sought feedback from airlines on this approach. Acknowledging the significance of airline concerns, Auckland Airport considered other potential options to address the issue and drew guidance from the international regulatory environment which existed at that time.

21. The most recent authoritative aeronautical regulatory determination at that time was that of the Australian Productivity Commission, which had released its 2006 review of price regulation of Australian airport services. In a pragmatic attempt to reach a compromise with its airline customers, Auckland Airport elected to follow the recommendations in that report in relation to asset valuation (which were consulted on and generally supported by airlines during consultation for PSE1).

22. As a result, Auckland Airport decided to adopt a 10 year moratorium on asset revaluations for pricing purposes. We adopted the then most recent asset valuation, being as at 30 June 2006,[16] and committed to roll this asset base forward with additions and depreciation, and no revaluations, until at least 2017 (subject to changes in the regulatory environment).

23. Consultation for this pricing period was extensive. It began in August 2004, and prices were set in July 2007. As already discussed, the focus was on achieving an appropriate commercial outcome, which we consider was achieved. The final pricing proposal was peer reviewed by Frontier Economics, which concluded that Auckland Airport's proposed prices were reasonable, and were "based on inputs that reflect a reasonable compromise between economic principles and the desire for objectivity, transparency and long-term solutions".[17] No decisions were made about what might happen in 2017.

24. Although the moratorium was entered into for 10 years, it was open for discussion in the consultation process for PSE2. In accordance with our obligations under the AAA, Auckland Airport consulted on whether the moratorium should be retained, and was open to the possibility of moving away from the moratorium if that approach was supported by airline customers. Auckland Airport was very conscious of the significant changes in the regulatory environment in New Zealand that occurred after PSE1, and was willing to move to an asset valuation approach that was IM compliant. Ultimately, in response to very strong feedback from airlines, Auckland Airport agreed to maintain the moratorium. As with the previous price setting period, no decisions were made about the approach that might be taken in 2017.

25. The regulatory framework had a strong influence on Auckland Airport's final decisions for PSE2. We excluded land held for the Northern Runway, worth $199.7 million, in response to the Commission's IM framework, and the presence of the Commission's WACC IM was a factor in Auckland Airport pricing below its WACC estimate when setting overall charges. Any departures from the Commission's IM were due to the strong insistence of the airlines (such as maintaining the moratorium) or were carefully considered, explained, and justified with reference to expert advice.

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[16] Land assets were valued at MVAU, and specialised assets were valued on an ODRC basis.
[17] Frontier Economics Executive Summary June 2007, page 2.

26. In short, the clear ***evidence*** is that:

    (a) Auckland Airport is strongly influenced by the regulatory signals that exist at the time of price setting. The evidence of its pricing behaviour in 2007 and 2012 demonstrates that Auckland Airport seeks to respond appropriately to regulatory guidance, and that regulation has an influential and constraining impact on its behaviour. Regulation will continue to have this impact in the future.

    (b) Auckland Airport has been strongly positively influenced by ID regulation and the views of its substantial customers. The evidence demonstrates that Auckland Airport will respond appropriately and adjust its preferred views to take account of ID regulation and feedback from its airline customers.

    (c) As a consequence, Auckland Airport has and will adopt approaches in pricing that are different to the approaches it considers best from a theoretical economic perspective. Auckland Airport understands that it operates in an environment that, while not amounting to price control, is one where regulation plays a significant and influential role.

27. In contrast, there is no evidence that an MVEU valuation would be the likely outcome in 2017 (although the impact of a successful merits review on the regulatory environment would be a material factor when setting prices in 2017). Similarly, there is no evidence that any revaluation gains would not be treated as an offset to the future revenue requirement in a NPV neutral manner, particularly given:

    (a) the clear signalling in this area from the Commission and airlines; and

    (b) the current evidence demonstrating Auckland Airport's appropriate responses to regulatory and customer influence.

The evidence demonstrates that MVEU is not a likely outcome

28. No inferences can reasonably be drawn from statements about MVEU during the merits review or at the start of pricing consultation in light of the clear evidence about Auckland Airport's actual conduct in its final pricing decisions (including its response to the regulatory framework and to pressure from substantial customers).

29. Statements in the merits review proceedings reflect the asset valuation approach that Auckland Airport considers appropriate for industry-wide ID, for the purpose of informing interested parties about the value of its airport assets. Using these statements to make inferences about potential pricing options:

    (a) does not recognise the distinction between pricing and information disclosure, and the different purposes of each;

    (b) ignores the fact that Auckland Airport has, and will continue to, respond to customer views and adopt decisions in pricing that might vary from its view of the correct industry-wide approach for information disclosure.

30. Further, although MVEU has been a reference point in the early stages of past pricing consultations:

    (a) Auckland Airport has not set aeronautical pricing charges on an MVEU basis since the 2000 price-setting consultation.[18]

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[18] For aircraft and freight activities, which are excluded from aeronautical pricing, rentals are driven by contracted rental rates, and renegotiated at the end of the term of the lease following benchmarking to comparative market rentals. Contracts include rental dispute escalation practices and include arbitration clauses. These activities

(b) The moratorium asset values adopted for aeronautical pricing in 2007 and continued in 2012 are based on 2006 **MVAU** values.

(c) An aeronautical pricing valuation based on MVEU would be highly unlikely unless there is a change in the regulatory environment.

31. In summary, in the absence of a successful merits appeal, it is highly unlikely that MVEU valuations would be adopted for aeronautical pricing. Even in that situation, it is entirely possible that MVEU valuations would not be adopted. Auckland Airport therefore suggests the Commission should disregard this option in its profitability analysis.

The approach that will be taken in PSE3

32. Consultation is a complex and comprehensive process. The consultation process and its pricing outcomes occur in the context of Auckland Airport's ongoing relationships with its substantial customers, and set the tone for those relationships for the next five years. Auckland Airport is required to make complicated and often pragmatic decisions on a wide variety of inter-connected issues, balancing economic principles, expert advice, competing views from different airlines, and commercial considerations.

33. Consultation for PSE2 began in August 2011, with the final pricing decision released on 7 June 2012. Over the course of consultation, Auckland Airport's focus was on running a robust and open process that resulted in reasonable pricing outcomes and a balance between the interests of the travelling public, airlines and investors. Although some issues were raised about the expiry of the moratorium in 2017, there was a significant number of more detailed and pressing issues that directly impacted on PSE2 and needed to be considered as part of price setting.

34. However, Auckland Airport acknowledges that the section 56G Review has drawn out how important PSE3 issues, particularly asset valuation, are from the perspective of airlines and the Commission. Accordingly, Auckland Airport is prepared to invest time now, as part of the Review process, to think about potential options and to consider what assurances it can provide to the Commission and to airlines in this respect.

35. Against that context, Auckland Airport submits that:

(a) Auckland Airport will continue to take guidance from the IM benchmarks for price setting purposes. As such, IM compliant asset values will likely form a useful reference point in PSE3.

(b) Customer feedback during consultation will also be highly influential, as it was in 2007 and 2012.

(c) However, Auckland Airport has no intention to revalue its asset base for pricing in PSE3. Continuing the moratorium is a distinctly possible outcome, especially if customers support that approach.

(d) During the Auckland Airport Conference, BARNZ indicated that an appropriate approach may be based on the moratorium, with the rolled forward moratorium asset base indexed from 2018 onwards. This approach may also be a possible outcome.

36. If the pricing asset base is revalued in PSE3, any revaluation gains will be treated appropriately in pricing.

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were valued using current market values on an MVEU basis as at 30 June 2011, updated to forecast 30 June 2012.

37. Where there has been a reasonable, unbiased ex ante forecast for asset appreciation, and all parties involved understand the risk balance on a forward-looking basis, Auckland Airport understands that it would be appropriate for it to carry the risk and reward of any changes in asset values over a pricing period.

38. However, Auckland Airport acknowledges that the moratorium is different to this scenario. This is not a situation where the forecast revaluations were zero, and have turned out to be greater than expected. There were, simply, no forecasts made. In these circumstances, if the moratorium is unwound in the future and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).

39. Despite these assurances, it is important to acknowledge that the final pricing decisions in PSE3 will be influenced by two key factors:

    (a) Auckland Airport's previous conduct demonstrates that we have sought to respond appropriately to the Commission's ID framework and its monitoring benchmarks. Any future guidance and feedback that we receive from the Commission, including through the s 56G review process and the s 53B reports, will be a similarly important influence on our conduct in PSE3.

    (b) Auckland Airport will be guided by its consultation process, including feedback from its substantial customers (and their expert advisors), in pricing for PSE3. As with previous pricing periods, an appropriate consultation process will be followed to ensure that the outcome is fair and balanced for all parties.

ID regulation is effective without information about future pricing decisions

40. For completeness, Auckland Airport notes that ID regulation is effective without knowing the outcome of future pricing decisions.

41. The Commission has suggested requiring airports to disclose, at the time of pricing, an IRR calculation that uses an estimate of the asset base expected to provide the basis for setting prices in the subsequent pricing period. The Commission considers this would better serve the aim of increasing transparency and allowing interested persons to assess whether excessive profits have been made.[19]

42. Auckland Airport does not agree this is necessary or appropriate to promote transparency or enable the ID regime to function effectively. ID is at an early stage, and it is natural that more limited information is currently available for analysis than will be the case in the future.

43. The fact that the ID regime does not provide information about future pricing assumptions does not demonstrate a weakness in the regime. ID is providing robust and ongoing information, which will be added to over time as subsequent disclosures are made and further monitoring and analysis has been undertaken. It is the increasing picture of actual evidence, built up over time, which will improve transparency and the ability to draw longer-term conclusions. This picture will, obviously, be added to when future pricing decisions are made.

44. Put another way, seeking to "lock in" future pricing decisions now is not an appropriate or effective way to overcome the fact that assessment of returns is properly made over time, and should not simply be a snapshot analysis.

[19] Commerce Commission, Final WIAL Report, at paragraph E50.

SECTION 4: THE APPROACH TO PROFITABILITY ANALYSIS IN THE REVIEW

Key points:

- Auckland Airport is concerned that the Commission's analytical model produces an estimate of returns that is heavily based on an assumption about future pricing behaviour. Auckland Airport strongly encourages the Commission to assess current performance and expected returns that are a product of decisions that have actually been made.
- Auckland Airport is concerned the Commission is treating the cost of capital IM as establishing a "target rate of return" or "specific returns benchmark" that airports must achieve in order to support a finding that ID is effective.
- Auckland Airport understood the Commission intended to put the WACC IM in context in its monitoring and analysis, with that context to include the airports' own methodologies and estimates. It encourages the Commission to follow this approach, to acknowledge and assess the reasons advanced by Auckland Airport for the decisions it took in relation to WACC, and to factor these aspects into its modelling and analysis (including as a sensitivity option when considering overall returns).
- When that context is properly analysed, Auckland Airport considers the evidence clearly demonstrates it is limited in its ability to earn excessive profits, and that ID is effective.

Assumptions about future behaviour should be avoided

45. The discussion of potential options for Auckland Airport's asset valuation in PSE3 highlights the sensitivity of the Commission's modelling and analysis to the assumptions that it is making about future pricing behaviour.

46. In measuring the effectiveness of ID, Auckland Airport considers the Commission's focus should be on analysing the decisions that Auckland Airport has actually taken, the effect of those decisions, and the impact of ID in the decision-making process.

47. When carrying out that analysis, Auckland Airport considers the Commission should assess current performance and expected returns that are a product of decisions that have actually been made. In addition, those decisions should be assessed based on the information that existed at the time they were made. Assumptions about future decisions can provide no evidence in relation to the critical question of how effectively ID is promoting Part 4 now. At the very least, assumptions should not be made about future conduct if those assumptions lead to negative findings regarding the effectiveness of ID now.

48. This is particularly important in relation to the treatment of revaluations in the Commission's analysis. Auckland Airport's current decision has been to exclude from its pricing model asset revaluations for Airfield and Terminal assets through until at least 2017. However, Auckland Airport is concerned that the Commission may seek to judge our performance now based on assumptions about:

    (a) potential changes in the asset valuation approach for future pricing periods; and

    (b) how any changes in asset values may be dealt with in pricing.

49. Auckland Airport's intention was that no asset revaluations would occur until at least 2017, except for Aircraft and Freight activities (which were excluded from standard aeronautical charges). Accordingly, its Terminal and Airfield asset base and prices over PSE2 do not include changes in asset values. There is no certainty that this approach will change. While this approach continues, the Commission's modelling should not include any assumptions about possible future revaluations for Terminal and Airfield activities.

50. If there is a change in asset valuation for pricing in PSE3, and the Commission has concerns about Auckland Airport's treatment of revaluation gains or losses as a result, the appropriate time for the Commission to analyse the impact of those concerns is when the relevant decisions have actually been made.

Measuring expected returns against the WACC IM

51. The way the Commission is measuring the estimate of returns from its analysis against the WACC IM (including the conclusions the Commission is drawing from that comparison), is of significant concern.

52. Auckland Airport has disclosed, extensively and transparently, detailed explanations for its reasons for departing from the WACC IM in setting its prices, both throughout consultation and in its submissions to the Commission to date. We do not seek to repeat that analysis in this submission.[20] Instead, we wish to emphasise the following key points:

(a) Auckland Airport is not attempting to persuade the Commission that the WACC IM should not be applied in its monitoring and analysis tasks. Rightly or wrongly, a WACC IM has been set, and must be applied by the Commission.

(b) Similarly, we are not asking the Commission to re-determine the WACC IM, and are not seeking to re-litigate the IM benchmark in this context.

(c) However, we are asking the Commission to carefully consider **how** it applies the WACC IM in the section 56G review in light of:

(i) the nature and purpose of ID regulation;

(ii) the nature and purpose of the WACC IM;

(iii) the Commission's statements about the role of ID regulation and the way the WACC IM would be used in that context;

(iv) Auckland Airport's understanding, at the time of price setting, about how the WACC IM would be used;

(v) airline views at the time of price setting; and

(vi) the prospect of regulatory error and disincentivising investment.

53. Put simply, Auckland Airport is asking the Commission to follow the approach we understood it would take in its monitoring and analysis: to put the WACC IM in context and analyse the decisions Auckland Airport actually made in pricing as part of that context.

[20] A table showing the location of Auckland Airport's reasons for departing from the WACC IM in setting its prices (as set out in its pricing consultation documents and in submissions to the Commission in the section 56G review) is included as an annexure at the end of this submission.

54. When evaluating the effectiveness of ID, the Commission should not simply ask whether forecast returns exceed its WACC estimate. That is a price control approach. Rather, the key question is whether there is evidence that the WACC IM has influenced price setting decisions and, if so, how. Clearly, if there is evidence that Auckland Airport may have sought a higher return in the absence of the WACC IM (and ID more generally), then it must be found that ID has been effective at limiting excess returns.

The importance of placing the WACC IM in context

55. When the WACC IM was being developed, we were concerned that it would be treated as a target rate of return by the Commission and interested parties, but we were assured that would not be the case.

56. At the end of the IM process, it was not precisely clear how the WACC IM would be used in the Commission's monitoring and analysis. While we expected that the WACC IM would be part of the information the Commission would consider, we did not think that the Commission's WACC estimate would be treated as a target rate of return or specific returns benchmark that airports must achieve.

57. This was particularly the case given:

   (a) The Commission had been clear that ID regulation was not de facto price control.[21]

   (b) While a WACC IM had been developed for the industry, the Commission had acknowledged through the IM process that the systematic risk of companies may differ, with an associated impact on the return requirement.[22]

   (c) In its IM Reasons Paper, the Commission acknowledged that suppliers of regulated service were exposed to asymmetric risks,[23] and that it may be appropriate to deal with asymmetric risks through some form of adjustment or mechanism (such as adjustments to cash flows).[24] This is discussed further below.

   (d) The Commission used market reference points (including longer-term market estimates) to assess the reasonableness of the estimate produced by its WACC IM.[25]

58. At the time prices were set, Auckland Airport understood that the ID framework, including the IMs, was intended to impose disciplines on our pricing behaviour. Accordingly, the IMs, including the cost of capital IM, were a key reference point for our pricing decision in 2012. At the same time, we understood that ID regulation was intended to promote transparency around the decisions that we were making.

59. Accordingly, we understood that we were not required to strictly apply the IMs in pricing, as ID regulation was seeking to understand our pricing and investment decisions, including our rationale and justifications for those decisions. We understood that the cost of capital IM, which is not required to be applied by airports for pricing or ID purposes,[26] certainly fell into that category.

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21 See, for example, IM Reasons Paper, 22 December 2010, at paragraph 2.9.2: "Some submissions on behalf of Airports have argued that the Commission is "strongly at risk of" and "dangerously close to" setting de facto price control of airport services. This is incorrect. The Commission is not attempting to implement de facto price control of airport services. Airports are able to charge as they see fit."
22 IM Reasons Paper at paragraph E8.9.
23 IM Reasons Paper at paragraph E12.2.
24 IM Reasons Paper at paragraph E12.1.
25 IM Reasons Paper at section E13.
26 Commerce Act 1986, s 53F(1)(b).

60. Our understanding was confirmed in the merits review proceedings, where the Commission noted concerns that the WACC estimate would be treated as a target rate of return, but said that these concerns "ignored the way in which the information would be used".[27]

61. The Commission was very clear that it would put the WACC estimate in context, including by reference to the airports' own methodologies and estimates:[28]

> The Commission is required to publish the WACC estimate, but it is also required to publish a "summary and analysis ... for the purpose of promoting greater understanding of the performance of individual regulated suppliers". **In other words, the Commission must put the WACC estimate in context. This context will include reference to the airports' own methodologies and estimates, which are required to be disclosed and which are therefore part of the information the Commission is required to summarise and to analyse.** [Emphasis added]

62. This confirmed Auckland Airport's previous understanding. In short, we understood the Commission's position to be that:

    (a) The WACC IM would provide a basis for comparison with the actual methodologies used by Auckland Airport, and was intended to encourage the airports to be explicit about the assumptions and rationales used in their own modelling.[29]

    (b) Airports were required to disclose the approaches they took in pricing under the ID Determination. The role of the WACC IM was to provide interested parties with information and a "tool" to allow them to evaluate Auckland Airport's own assessment of its cost of capital and assess the appropriateness of Auckland Airport's approach.[30]

    (c) If there were genuine reasons why the rate of return differed from the cost of capital estimate determined by the WACC IM, Auckland Airport (and the other airports) would be able to explain these to interested persons.[31]

    (d) The Commission would take into account a range of information when assessing airport performance, and would not take the WACC IM as establishing a "target rate of return" or a "specific returns benchmark" that airports ought to achieve.[32]

63. Auckland Airport is now concerned that the WACC IM is being considered by the Commission to be an "absolute standard"[33] to measure performance, and is being treated as the only acceptable return. We see this as contrary to the purpose of ID and to the understanding that we had at the time of price-setting. We are also concerned that the Commission expects that airports will have instantly met this "absolute standard".

64. In addition, given Auckland Airport's understanding at the time of price setting, we consider it would not be right to draw negative inferences regarding performance or the effectiveness of ID based on a simplistic view that airports set returns "knowing" those returns were higher than the Commission's WACC estimate.

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[27] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 89.
[28] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 89.
[29] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 68.
[30] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraphs 68-69, 81.
[31] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 83.
[32] Commerce Commission submissions, 6 August 2012, Volume 2 at paragraph 80.
[33] In the WIAL Report at paragraph 2.27, the Commission states that: "The cost of capital set out in the input methodologies provides an absolute standard (or benchmark) against which to measure profits." At paragraph E22, the Commission reiterates its comment, noting that "the cost of capital set out in the IMs provides an absolute standard (or benchmark) against which to measure performance".

Estimating WACC is not a precise science

65. Auckland Airport also encourages the Commission to take into account the nature of WACC estimates when applying its WACC IM in analysing airport profitability, including appropriately acknowledging the judgement involved in producing estimates of WACC.

66. We consider that there is significant doubt that WACC estimates (whether at the 50^{th} or 75^{th} percentile) are suitable for use as an absolute benchmark.

67. By way of example, a recent independent expert report prepared by Grant Samuels (in relation to the Future Fund's offer for stakes in highly relevant airport assets in Australia) notes the dangers of a "mechanistic application of formulae" derived from theory. The report goes on to note that theoretical models should not be relied on as producing a single truth:[34]

> The discount rate represents an estimate of the weighted average cost of capital ("WACC") appropriate for these assets. [...] In selecting the discount rate range, we utilised the capital asset pricing model ("CAPM") as the starting point in our analysis to determine a cost of equity. **However, it is easy to credit the output of models with a precision it does not warrant. The reality is that any cost of capital estimate or model output should be treated as a broad guide rather than an absolute truth. The cost of capital is fundamentally a matter of judgment, not merely a calculation.** [Emphasis added].

68. Further, the report notes:[35]

> However, while the theory underlying the CAPM model is rigorous the practical application is subject to shortcomings and limitations and the results of applying the CAPM model should only be regarded as providing a general guide. There is a tendency to regard the rates calculated using CAPM as inviolate. To do so is to misunderstand the limitations of the model.

69. When the above factors are taken into account, Auckland Airport considers that it is clear that superior performance is not the only reason that would justify an airport earning a return above the Commission's WACC estimate. To believe otherwise implies a level of absolute accuracy to the WACC IM as the only correct estimate of an appropriate return. Auckland Airport encourages the Commission to reconsider such a view on implied accuracy, and to reflect on how it can:

   (a) acknowledge the judgements and lack of precision inherent in producing estimates of WACC;

   (b) give effect to the surrounding contextual factors that are relevant to the Commission's application of its WACC IM; and

   (c) take into account that it would be better to be broadly right (by using a wider range of contextual information) than precisely wrong (by relying on an "absolute standard" which cannot ever represent the "true" value of WACC).

70. We believe this is a key way in which the Commission can give effect to its assurances that ID would not amount to de facto price control.

[34] Grant Samuel Australian Infrastructure Fund Proposal, Appendix 1: Selection of Discount Rate, 7 December 2012 at page 1. (The full Grant Samuel report is available as Annexure 1 in Hastings Funds Management, AIX Notice of EGM and Explanatory Booklet, 12 December 2012, available at http://www.hfm.com.au/asxlisted/funds/aif/reports/).

[35] Grant Samuel Australian Infrastructure Fund Proposal, Appendix 1: Selection of Discount Rate, 7 December 2012 at page 1.

Analysing the contextual information for Auckland Airport

Asset beta

71. The most significant contextual factor for Auckland Airport is its systematic (ie non-diversifiable) risk. In light of this, we strongly urge the Commission to consider the asset beta of Auckland Airport when undertaking its analysis in the draft and final report. We encourage the Commission to reflect on the following key justifications:

(a) As discussed above, the Commission acknowledged in its IM Reasons Paper that airport services may face different levels of systematic risk, and that different equity betas could apply, in principle, to different airports.[36]

(b) Auckland Airport's expert adviser, Dr Alastair Marsden of Uniservices, provided evidence to Auckland Airport about the appropriate asset beta for use in pricing, based on a combination of first principles, direct estimates, and replication of the analysis undertaken by the Commission when developing the asset beta for the cost of capital IM. We **attach** (as Attachment 1) a short report from Dr Marsden summarising his advice that 0.65 is an appropriate asset beta to reflect the systematic risk of Auckland Airport.

(c) Auckland Airport's use of an asset beta of 0.65 in the second PSE is consistent with Air New Zealand's recognition that the change in pricing structure in the Final Pricing Decision creates additional systematic risk for Auckland Airport:[37]

> Conversely, the complete reliance on per passenger charges for terminal facilities for the forthcoming pricing period does create some additional uncertainty for AIAL as its PSC revenue is totally dependent on passenger movements.

Market evidence

72. Auckland Airport reiterates its previous concerns about the lack of precision in the WACC IM, and the dangers associated with relying on theoretical models as the absolute truth. In light of these comments, there is a real risk that the theoretical position on WACC is diverging from business reality. This will have a significant impact on whether Auckland Airport has the right incentives to invest and is able to attract the necessary capital to do so (given its risk profile):

(a) In pricing, Auckland Airport drew considerable guidance from theoretical WACC modelling, including the Commission's IM. However, we also sought to consider the commercial reality of the parameters that make up the theoretical WACC model.

(b) A material disconnect between theory and reality is evident in sell-side analyst reports. The Commission's most recent WACC estimate of 6.49% at the 50th percentile and 7.48% at the 75th percentile (which post-date Auckland Airport's pricing event) can be contrasted with the estimates from sell side analysts for Auckland Airport (at the 50th percentile):[38]

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36 IM Reasons Paper at paragraph E8.9. Similar comments were made in the Commission's 2002 Inquiry into airfield services, where the Commission noted that: "Each airport may have its own unique characteristics which can result in a distinct risk profile and WACC" (at paragraphs 8.162, 9.114 and 10.98.

37 Air NZ Submission on Section 56G Review of Auckland Airport, at paragraph 86.

38 Although these are corporate WACC estimates, there is still a material disconnect between the estimates and the Commission's 50th percentile estimate of 6.49%.

Analyst	WACC estimate	Date
Deutschebank/Craigs	8.50%	21/02/2013
Forsyth Barr	8.10%	21/02/2013
Goldman Sachs	7.70%	12/11/2012
JP Morgan	8.80%	21/02/2013
Macquarie	8.20%	11/02/2013
Morningstar	8.60%	11/02/2013
Credit Suisse/FNZC	8.06%	21/02/2013
UBS	6.40% - 8.30%[39]	07/02/2013

(c) There is also a material disconnect between Auckland Airport's actual cost of debt of 6.3% for the 6 months ended 31 December 2012, compared to the Commission assessment of 5.3%. There is no evidence to suggest that Auckland Airport's debt funding is inefficient. In fact, evidence provided by Bancorp demonstrates that Auckland Airport is efficient in its debt costs compared to Bancorp's other infrastructure clients.[40]

(d) Further, we note that the WACC IM appears to produce estimates that are volatile over short periods of time. The WACC estimates published by the Commission have fallen over 1.5% in the space of two years, and the difference between estimates published in April 2012 and July 2012 is over 0.5%. We encourage the Commission to consider whether there is a disconnect between the WACC IM in theory and WACC in practice, which in our experience is more stable, as indicated by the Commission's own benchmarking analysis in the IM Reasons Paper.[41]

Evidence at the time of pricing

73. At the time it set prices, Auckland Airport considered its effective forecast return relative to:

(a) the Commission's most recent WACC determination for Auckland Airport (published July 2011);

(b) the Commission's most recent WACC determination for Wellington Airport (published April 2012); and

(c) Auckland Airport's own estimate of its WACC as at 21 May 2012.[42]

74. In our view, it is clear that our intentions and conduct in setting prices should be measured against information available to Auckland Airport at the time of pricing. This means that a WACC estimate published by the Commission after Auckland Airport set its prices should not be used to analyse those pricing decisions. The fact that there is a material difference between the published WACC estimate available to Auckland Airport at the time of pricing, and the estimate published three months later demonstrates both:

(a) the importance of assessing the information available to Auckland Airport when it set charges; and

[39] UBS uses two rates, the first for its near-term forecasts and the second for its longer-term forecasts and terminal value.

[40] Bancorp letter to Auckland Airport, 2 October 2012 (included as Attachment 1 to Auckland Airport's Submission on the Process and Issues Paper, 19 October 2012).

[41] IM Reasons Paper, 22 October 2012, section E13 (see, for example, Figure E2).

[42] Auckland Airport did not estimate an IM compliant WACC in May 2012. However, an IM compliant WACC estimate as at 21 May 2012 was produced in December 2012 as part of Auckland Airport's submissions to the Commission in the section 56G review. This estimate demonstrates that isolated changes to the Commission's WACC parameters result in an estimate of WACC that is very close to Auckland Airport's effective return.

(b) the imprecision of using a WACC estimate that can vary considerably over short time periods as an absolute standard for assessing five-year decisions and long-term profitability.

75. In consultation on aeronautical pricing, customers advocated a range of responses which referenced these two published estimates:

(a) In its presentation to Auckland Airport's Board on 15 May 2012, BARNZ evaluated Auckland Airport's Revised Pricing Proposal relative to the Commission's April WACC determination, and assessed Auckland Airport's charges against a WACC estimate of 8.04% at the 75th percentile.[43]

(b) Air New Zealand did not provide any response on the appropriate WACC range in its submissions to Auckland Airport, but recommended that Auckland Airport adopt a position consistent with the Commission.

(c) In its response to the Revised Pricing proposal on 7 May 2012, Qantas requested that Auckland Airport use a WACC range within the 50th to the 75th percentile. Qantas referenced a risk free rate estimate published by the Commission in January 2012 in its submissions.[44]

(d) Auckland Airport's Revised Pricing Proposal stated that it intended to determine its WACC estimate at a date ahead of its final pricing decision. No requests were received that the WACC estimate be updated closer to July 2012.

Asymmetric risks

76. Finally, Auckland Airport notes that it has not factored asymmetric risks into its cash flows. Auckland Airport understood the Commission's reluctance to make an adjustment to the industry-wide WACC IM was due to its desire to maintain flexibility in how these risks could be accounted for in monitoring,[45] and because it considered that adjusting the WACC IM would imply that all suppliers of a particular service were exposed to the same level of asymmetric risk.[46]

77. TFI developed traffic forecasts for Auckland Airport, underpinned by economic factors and airline information. In section 6.2 of its report, it summarises the risk factors and notes that "no allowance has been made for the one-off impacts of negative events such as natural disasters, terrorism and flue epidemics".[47]

78. Auckland Airport continues to face exposure to asymmetric risks that are not covered by its insurance.[48] An allowance for these risks should be made in the Commission's modelling, and Auckland Airport suggests that an appropriate method of doing so would be to consider a WACC estimate above the 75th percentile when assessing the outcome of the Commission's IRR analysis.

79. The treatment of asymmetric risks in pricing by Auckland Airport is discussed further in the UniServices report which is **attached** to this submission.

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43 Auckland Airport Board Minutes: AAA Consultation - BARNZ presentation on the Revised Pricing Proposal, 16 May 2012, page 2.
44 Qantas Response to Revised Pricing Proposal, 7 May 2012, page 3.
45 IM Reasons Paper at paragraph E12.7.
46 IM Reasons Paper at paragraph E12.2.
47 TFI, Air Traffic Forecasts for Auckland Airport, March 2012, page 34.
48 The extent to which any asymmetric risks may be covered by Auckland Airport's insurance is addressed in section 8 of this submission.

Drawing conclusions form Auckland Airport's evidence

80. Auckland Airport is not attempting to convince the Commission to **amend** its industry-wide estimate for ID purposes to reflect Auckland Airport's actual circumstances (including its actual cost of debt). Nor is Auckland Airport suggesting the Commission should not apply its WACC IM.

81. However, Auckland Airport considers the Commission should carefully evaluate the full range of contextual evidence that is available when **applying** its industry-wide WACC IM. Any disconnect between the theory and reality of WACC is an important part of that context. Further, Auckland Airport strongly encourages the Commission to appropriately acknowledge the judgment and lack of precision in theoretical models of WACC, including the WACC IM, when analysing that evidence and presenting its conclusions.

82. Overall, the evidence demonstrates that:

(a) Auckland Airport set prices responsibly with a return expectation influenced by the balance of a number of factors, including consultation with substantial customers, the Commission's ID framework, expert advice, and consideration of its unique circumstances.

(b) We understood that we were entitled to take these factors into account and that they would form part of the context and range of information the Commission would analyse. Our price setting disclosure is clear about the issues we confronted and the process and reasoning we adopted.

(c) We made departures from the Commission's WACC IM in key areas where there had been considerable debate through the IM process, and where we considered those departures were justified given expert advice on market conditions and our systematic risk.

83. When that context is analysed, it is clear that the WACC IM is not, and should not be, a "target return". Negative inferences that are drawn from conclusions that an airport "knew" its returns would be higher than "the Commission's estimate of an appropriate economic return" do not accurately represent the circumstances at the time of pricing, including the fact that Auckland Airport believed its approach was consistent with the nature and purpose of the ID framework.

84. Similarly, it is clear that returns above the WACC IM do not necessarily indicate excess profits. The WACC IM is a broad industry estimate, which does not account for differences in systematic risk or the presence of asymmetric risks. Nor is superior performance the only possible justification for returns above the WACC IM. Having said that, we consider there are a number of areas where we have been and are demonstrating superior performance, which have been highlighted through our submissions to date.

85. In summary, there is considerable amount of evidence to support a finding that ID is effective at limiting Auckland Airport's ability to earn excess returns:

(a) ID regulation imposed significant discipline on Auckland Airport's pricing behaviour.

(b) In relation to asset valuation, Auckland Airport's pricing asset base for aeronautical charges is based on MVAU, the same valuation approach as the Commerce Commission's IM. Further, Auckland Airport is not seeking a return on a significant portion of its asset base (the Northern Runway land), due in part to the ID regime.

(c) Written materials provide clear evidence that Auckland Airport actively considered the WACC IM throughout consultation.

(d) Auckland Airport adopted WACC parameters more conservative than it considers are appropriate for an industry benchmark, as advocated in the merits review proceedings.

(e) In PSE2, Auckland Airport's expert advisor determined a WACC range of 10.21% - 12.23% (at the 75th to 95th percentiles) for use in pricing.[49] Auckland Airport adopted a WACC range of 8.88% - 9.45% for consultation, with a midpoint estimate of 9.16%, using parameters more conservative than advised by its expert.

(f) BARNZ acknowledges that the ID regime did in fact have an impact on Auckland Airport's approach to price setting, and the presence of the section 56G review resulted in Auckland Airport's decision to price below its WACC estimate of 9.16% when setting charges.[50]

(g) The difference between Auckland Airport and its customers at the time of price setting was considerably less than is being portrayed through the section 56G process, demonstrating that the WACC IM allowed substantial customers to assess the appropriateness of Auckland Airport's approaches (as intended). BARNZ elected to apply the Commerce Commission’s updated 75th percentile WACC estimate of **8.04%** when considering the charges proposed in Auckland Airport's Revised Pricing Proposal:[51]

> Therefore, in order to provide an absolutely reasonable yardstick for comparison, the BARNZ Represented Airlines have elected to apply the updated Commerce Commission’s 75th percentile WACC estimate of 8.04 percent when considering the charges proposed by Auckland Airport.

(h) This demonstrates that BARNZ and Auckland Airport had a similar understanding of what would be an appropriate return at the time of price setting, with a difference of 0.4% between Auckland Airport's final aeronautical pricing decision (at 8.475%) and the reasonable yardstick used by BARNZ in its assessment of the appropriate charges.[52]

(i) Overall, Auckland Airport's WACC estimate reduced from 9.88% in PSE1 (range 8.76% - 11.00%) in PSE1 to 9.16% in PSE2. Similarly, its effective forecast return for aeronautical pricing reduced from 9.44% in PSE1 to 8.475% in PSE2. ID regulation was a key factor in Auckland Airport's reduced return expectations.

(j) Ultimately, in response to submissions from its airline customers and in response to the ID framework (including the presence of the WACC IM and the section 56G review), Auckland Airport set standard charges with a forecast return of 8.475% across its aeronautical pricing asset base. The overall forecast regulatory return across Auckland Airport's regulated services for 2012-2017 is estimated by Auckland Airport to be 5.74% (following the Commission's IRR approach in the WIAL Report).[53]

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[49] Uniservices "The Appropriate Weighted Average Cost of Capital for the Aeronautical Airport Activities of Auckland International Airport Ltd", 6 October 2011, page 42.

[50] BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, page 3.

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

[52] Note: The figure of 8.475% refers to a subset of Auckland Airport's regulated activities, and is a measure of the forecast returns from aeronautical pricing activities across the asset base for those activities (which is a subset of Auckland Airport's full regulatory asset base).

[53] Based on the Commission's IRR methodology, using the 2012 disclosed RAB as the opening asset base, and the closing asset value in Auckland Airport's price setting disclosure as the closing asset base.

SECTION 5: DETAILS OF THE IRR MODEL AND RETURNS CALCULATIONS

Key points:

- Auckland Airport considers that the Commission's IRR analysis should measure returns on all regulated services against the full regulatory asset base. Auckland Airport understood at the time of pricing that its returns would be assessed against its ID regulatory asset base.
- The Commission should take an approach which is consistent with that taken in the Wellington Airport report. If this approach is followed:
  - The opening asset base for Auckland Airport is the IM compliant asset valuations as at 30 June 2012.
  - The best estimate of the closing asset base for Auckland Airport is the forecast value of assets employed at 2017, contained in the Price Setting Disclosure.
- For the segment of assets for which there are no revaluations forecast in pricing (ie Terminal and Airfield activities), no revaluations should be factored into the closing asset base.
- For the segment of assets for which there are revaluations forecast in pricing (ie Aircraft and Freight activities), revaluations should be factored into the closing asset base in accordance with those forecasts.
- Any alternative asset valuation put forward by BARNZ should not form part of the Commission's analysis for Auckland Airport because they have not been subject to rigorous scrutiny.

86. We understand the Commission is using its IRR analysis to assess two things:

(a) Auckland Airport's conduct and intentions at the time of price setting; and

(b) the level of forecast returns over PSE2 and beyond.

Auckland Airport's conduct and intentions at price setting

87. Auckland Airport did not carry out an IRR analysis analogous to the Commission's model before it set prices. At the time, we understood that the Commission was intending to use the ROI information in each year's information disclosure to analyse profitability. As such, we believed that Auckland Airport's ROI values would vary each year, with the "unders" and "overs" fluctuating, but would ultimately result in a fair and reasonable return over time.

88. We considered the biggest challenge with the ROI assessment measure would be the balancing of these "unders" and "overs" in any analysis, the need to take a long term view, and the challenges that resulted from an annual ROI measure which included updated valuations for ID purposes which had not and were not intended to be realised in pricing over PSE2.

89. When we set prices, we estimated how our disclosed ROI figures were forecast to look over PSE2 under the Commission's ID framework. We estimated our annual disclosed ROI figures for PSE2 would be as follows:

Forecast ROI - Calculations & Outputs

Year Ending 30 June	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)	2017 (F)
Return on Investment (ROI)						
Regulatory profit / (loss)	102,096	108,328	120,280	122,457	130,383	139,771
less Notional interest tax shield	3,837	3,922	4,047	4,196	4,419	4,467
Adjusted regulatory profit	98,260	104,406	116,233	118,261	125,964	135,304
Regulatory investment value	1,147,928	1,194,398	1,231,345	1,307,001	1,328,239	1,353,849
ROI—comparable to a post tax WACC (%)	8.6%	8.7%	9.4%	9.0%	9.5%	10.0%
Post tax WACC (%) at 50th percentile*	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%
Post tax WACC (%) at 75th percentile*	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
ROI—comparable to a vanilla WACC (%)	8.9%	9.1%	9.8%	9.4%	9.8%	10.3%
Vanilla WACC (%) at 50th percentile*	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%
Vanilla WACC (%) at 75th percentile*	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%

* *Calculated by the Commerce Commission for FY12 on 8th July 2011*

90. Auckland Airport was conscious that these disclosed ROI measures would include revaluation gains calculated in accordance with the IMs, but which would not in fact be realised for pricing purposes. Accordingly, the disclosed ROIs would not accurately reflect our forecast returns (which were not based on revalued assets). We believed the Commission would appropriately acknowledge the extent to which revaluation gains we were required to disclose:

    (a) were not realised through prices;

    (b) did not represent increases in the asset base on which charges were set; and

    (c) were not part of the effective return for PSE2.

91. As such, a key reference point for Auckland Airport when setting charges was the forecast estimates of our ROI across PSE2, excluding revaluations. This analysis gave Auckland Airport the following estimated ROI figures across PSE2 (based on our forecast data):

Forecast ROI - Calculations & Outputs

Year Ending 30 June	2012 (F)	2013 (F)	2014 (F)	2015 (F)	2016 (F)	2017 (F)
Return on Investment (ROI)						
Regulatory profit / (loss)	73,409	79,408	90,433	91,528	98,058	107,292
less Notional interest tax shield	3,522	3,518	3,554	3,611	3,741	3,692
Adjusted regulatory profit	69,887	75,890	86,879	87,917	94,317	103,600
Regulatory investment value	1,054,715	1,074,733	1,085,146	1,133,720	1,127,364	1,124,319
ROI—comparable to a post tax WACC (%)	6.6%	7.1%	8.0%	7.8%	8.4%	9.2%
Post tax WACC (%) at 50th percentile*	7.6%	7.6%	7.6%	7.6%	7.6%	7.6%
Post tax WACC (%) at 75th percentile*	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
ROI—comparable to a vanilla WACC (%)	7.0%	7.4%	8.3%	8.1%	8.7%	9.5%
Vanilla WACC (%) at 50th percentile*	7.9%	7.9%	7.9%	7.9%	7.9%	7.9%
Vanilla WACC (%) at 75th percentile*	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%

* *Calculated by the Commerce Commission for FY12 on 8th July 2011*

92. We considered these figures compared favourably, over time, with the then current Commission estimate of WACC for Auckland Airport (published on 8 July 2011 for FY12) at the 75^{th} percentile.

93. Auckland Airport considered its returns were reasonable and fair over time for a number of reasons:

    (a) the moratorium approach was retained following submissions from airline customers, and resulted in a forecast ROI profile which was within an appropriate range;

(b) the final aeronautical pricing decision increased the variability of actual revenues based on passenger volumes;

(c) the forecast effective return on aeronautical pricing was relatively close to BARNZ' assessment point (based on the 75th percentile estimate of the Commission's April 2012 WACC determination); and

(d) as described earlier in this submission, we understood that the Commission would apply the WACC IM in context, including with reference to the contextual evidence that a strict application of the WACC IM may risk Auckland Airport's ability to access debt and equity funding.

94. It certainly was not the case that we believed our forecast returns would be higher than the Commission's benchmarks simply because that is what our forecast of "IM compliant" returns could indicate.

The IRR approach and forecast returns over PSE2 "and beyond"

95. The Commission's IRR approach (as set out in the WIAL Report) is to assess the return of an airport relative to the value of its assets over time. This approach requires the Commission to determine the value of an airport's assets for regulated activities at the beginning of the period of analysis (the opening asset base) and at the end of the analysis period (the closing asset base).[54]

96. For WIAL, the Commission's approach was to:

(a) Use the value of assets disclosed in the annual information disclosure at the beginning of PSE2 (the 2012 disclosed RAB) as the opening regulatory asset base and the opening asset value in its IRR analysis.[55] This is because, in the Commission's view, the opening asset base should best represent values in a workably competitive market, and therefore should be IM compliant.

(b) Use the forecast value of assets used by Wellington Airport to set prices for PSE2 as the estimate of the closing regulatory asset base. This is because, in the Commission's view, the closing asset base should best represent the expectation of future cash flows for an airport.

97. If a consistent approach is followed for Auckland Airport:

(a) the 2012 disclosed RAB, included in Auckland Airport's annual regulatory disclosure published on 30 November 2012, is the appropriate opening asset base; and

(b) the forecast value for the year ended 30 June 2017, set out in Auckland Airport's price setting disclosure published on 2 August 2012, is the appropriate closing asset base.

98. When this approach is followed, we estimate Auckland Airport's IRR to be **5.74%**. We **attach** a spreadsheet (as Attachment 2) setting out this analysis in more detail.

The impact of the moratorium

99. The moratorium can appropriately be considered in the Commission's analysis. This is because:

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[54] WIAL Report at paragraph E27.
[55] WIAL Report at paragraph E27.1.

(a) The Commission's analysis focuses on assessing airport profitability from the start of PSE2. The Commission's decision to move away from its proposed seven-year IRR model was in recognition of the fact that profitability before this period is the product of decisions made before the introduction of ID regulation. The Commission therefore accepts that its analysis of profitability properly starts at the beginning of PSE2 in order to assess and understand the impact of ID regulation.

(b) The moratorium should not have an impact on the opening asset base used by the Commission in its analytical model. The appropriate reference point for the Commission to use for its opening asset base is the Commission's view of the value of Auckland Airport's assets in a workably competitive market, as at the beginning of 2012. The Commission has been clear that the asset valuation IM represents its best estimate of the value of airport assets in a workably competitive market.

(c) Similarly, the moratorium does not impact the Commission's approach to selecting the closing asset base. Auckland Airport has advised the Commission in this submission of the potential options that it may consider when setting prices for PSE3. As discussed above, the Commission can take comfort that, if there is a change in the asset valuation approach used by Auckland Airport when setting charges, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).

(d) Auckland Airport considers that the forecast closing asset base, as disclosed in its price setting disclosure, is the only potential option that the Commission can use as its closing asset base in its analysis. In this context, the presence of the moratorium will mean that:

(i) For the segment of assets for which there are no revaluations forecast in pricing (ie Terminal and Airfield activities), no revaluations will be factored into the closing asset base, consistent with the fact that revaluations had not been included in the asset base on which prices have been set, and have not been included in that asset base going forward over PSE2. This extends to CPI revaluations.

(ii) For the segment of assets for which there are revaluations forecast in pricing (ie Aircraft and Freight activities), revaluations will be factored into the closing asset base consistent with the treatment of those revaluations and pricing as forecast. For this segment of assets, revaluations were forecast at 2.5%.

(e) Treating the moratorium in this way means that the Commission's analysis will be based on evidence that Auckland Airport will either:

(i) continue the moratorium in PSE3; or

(ii) if it moves away from the moratorium values in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).

100. Auckland Airport submits it would be inappropriate to use a closing asset base with revaluations included for all regulated activities (such as a rolled forward 2012 disclosed RAB) as:

(a) This would incorporate hypothetical returns which were not sought in Auckland Airport's pricing decision for PSE2 and are not actually being earned through prices; and

(b) This analysis assumes a future revaluation of assets for pricing and an "incorrect" treatment of revaluation gains at that time. Auckland Airport submits that these assumptions do not reflect the evidence before the Commission.

101. We understand that the moratorium is different to the Commission's asset valuation IM. However, the simple matter is that the overall value of the asset base used by Auckland Airport when setting charges is lower than the Commission's estimate of the current value of Auckland Airport's assets in a workably competitive market. There is no need to make adjustments to the Commission's analytical model to account for this.

BARNZ' asset valuations should not be included in the analysis

102. The Commission has invited BARNZ to indicate the impact of its criticisms of the alternative land use plan used by Auckland Airport to determine its market value alternative use.

103. Auckland Airport is aware the Commission used the alternative asset valuations prepared by BARNZ in its analysis of Wellington Airport. However, we consider that doing so is not appropriate for Auckland Airport:

(a) Auckland Airport carried out a robust process to produce its land valuation, including seeking the best experts in the field and tendering for valuations. We engaged an expert valuer to undertake the valuation in accordance with the IM determination and a peer reviewer to provide guidance throughout.

(b) The Commission should be hesitant to cast doubt on Auckland Airport's alternative use plans and valuations that have been prepared by independent experts simply because the airlines' advisers may have a different view of the hypothetical exercise in question. The significance of this should not be underestimated. It amounts to a conclusion, without due process, that Auckland Airport has failed to comply with the IM.

104. Even if the Commission was prepared to do so, making an adjustment in its profitability analysis of Auckland Airport is not appropriate. The criticisms that have been raised by BARNZ and its experts in relation to Auckland Airport's land valuation are that:

(a) the alternative land use plan was too aggressive in terms of the amount of commercial land that was included; and

(b) the length of the development period adopted was too short.

105. However, Auckland Airport submits that the alternative use plan prepared by Common Ground complies with the IM in the respects that have been criticised by BARNZ. In particular:

(a) The alternative use plan prepared by Common Ground complies with the IM requirement to determine the highest and best alternative use of the land.

(b) The land use plan developed by Common Ground provides sufficient evidence in terms of the rationale for the selection of the various land uses and the areas of land identified for those uses.

(c) General market and economic analysis was undertaken to establish the supply and demand, and potential market absorption, for the land uses in the master plan. The conclusions as to market demands are realistic estimates.

106. In light of this, Auckland Airport does not consider that there is a valid reason to adopt any alternative land valuation that may be put forward by BARNZ.

SECTION 6: ROUTE DEVELOPMENT COSTS

Key points:

- The key issue is whether Auckland Airport's operating costs, including its route development activities, are efficient. Auckland Airport is confident the route development strategy is working and delivering incremental growth above that which would be generated organically. This results in higher volumes and lower unit costs than would otherwise have been the case.
- All route development comes with material economic benefit to the country, as well as meaningful impacts for passengers through greater choice at more reasonable prices. Carriers representing 96% of international passengers to and from Auckland Airport have actively participated in route development activities - and domestic carriers benefit from the increased volumes.
- Some airlines have indicated that they consider Auckland Airport is spending "their money" on marketing. This is not the case - airlines pay aeronautical charges which cover the reasonable costs of operating an international airport. Business marketing and route development activities are part of those costs.
- Our engagement in route development activities has led to a complete change of approach in our relationship with our customers - we are now focussed on a customer-centric approach which has led to engagement with our customers' business objectives and how we can contribute to their growth activities.

Auckland Airport's operating costs (including route development) are efficient

107. Auckland Airport has approached its operating expenditure forecasts, including its forecast business development costs, in a careful manner which has internal consistency.[56] The route development costs that have been included in Auckland Airport's opex forecasts are the tail end of marketing associated with committed expenditure, where the associated growth has formed part of the demand forecasts on which prices have been set.

108. Following the discussion at the Auckland Airport Conference, we are concerned that the question appears to have become whether airlines should be "paying for the marketing". This question does not reflect the approach that should be taken to assessing Auckland Airport's route development costs:

(a) Aeronautical charges cover the reasonable costs of operating an international airport. Business marketing and route development activities are part of those costs, and are appropriately recovered through aeronautical charges.

(b) The key question is whether Auckland Airport's operating costs (including its business marketing costs) are efficient and reflect the costs of operating an international airport.

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[56] In relation to operating costs more generally, we note that BARNZ has suggested there may be an incentive for suppliers to increase operating costs in the final years of a pricing period (or defer or bring forward maintenance). We are not aware of any such behaviour at Auckland Airport, and there is no evidence that this behaviour may be occurring. Auckland Airport consults extensively with its substantial customers to ensure its operating cost base and forecast operating costs used for pricing are as accurate and reasonable as possible. In particular, we note that care was taken to remove any one-off costs, including those costs associated with repairs and maintenance and staff (including any costs associated with the Rugby World Cup) to ensure these were not included in the operating cost base used for pricing. As with any forecast, actual operating expenses will differ from the forecast values.

(c) There is an advantage for all parties in collaborating on strategy and driving asset productivity. Auckland Airport is confident its business marketing expenditure promotes efficiency and delivers incremental growth above organic levels, producing higher volumes and lower unit costs for airlines than would otherwise have been the case. Where volumes are increased, efficiencies can be increased and shared with airlines through lower unit prices.

(d) Transparency on operating costs is provided so that the efficiency of those costs can be tested by interested parties, not so that individual customers can debate whether what they perceive to be "their money" should be spent on particular line items.

Auckland Airport is innovative in how it markets for growth

109. Many other airports take the traditional discount approach to marketing new routes. Auckland airport has innovated in the way it markets for growth, directly targeting markets and routes in order to drive increased and sustainable growth above organic volumes. Auckland Airport sees both approaches as equally acceptable ways of driving the same outcome, and Auckland Airport believes its method of undertaking route development activities is more likely to translate into successful and enduring volume growth.

110. Route development costs, including route-specific and airline-specific activities, have the same economic effect as landing fee discounts (or, more generally, the types of discounts observed in workably competitive markets to drive volumes). Whether growth activities are factored into pricing as an incentive scheme or a marketing cost item should not influence the treatment of these activities by a regulator. However they are factored into prices, growth activities are an important part of supplying airport services, widely undertaken by airports, and appropriately form part of the Commission's analysis under the ID framework.

111. Auckland Airport would be concerned if we were criticised for our efforts to grow new routes in an innovative manner, and to constructively engage with our airline customers facilitate and encourage choice and reduced cost for passengers. Auckland Airport would be concerned if the ID framework reduced our incentives to invest in this area and cooperate with our customers in growing air services to New Zealand.

112. In fact, Auckland Airport considers that route development activities are a key area where we have demonstrated superior performance in PSE1:

(a) Auckland Airport's route development activities are efficient, effective and recognised amongst the best in their class. Auckland Airport received a highly commended award at the Routes Airport Marketing Awards in 2012, and was the only airport in Australasia to be acknowledged in 2012. We have won four awards of this type in three years.

(b) These activities were not performed at the time of the PSE1 price-setting forecast and so were not included in pricing for PSE1. All volumes associated with committed routes delivered during PSE1 are included in demand forecasts for PSE2. This means that airlines have received 100% of the benefit of the increased volumes associated with route development, at a fraction of the cost.

Route-specific costs are appropriately included in aeronautical charges

113. Some airlines have indicated that they object to "airline-specific" route development costs being included in Auckland Airport's operating expenses. Auckland Airport understands that these airlines consider this will result in them being charged for costs that they do not directly benefit from. In response, Auckland Airport notes:

(a) As discussed above, airlines are not "paying for" specific marketing campaigns that they do not benefit from. Airlines are paying aeronautical charges which cover the reasonable costs of operating an international airport.

(b) We do not consider our route development activities to be anti-competitive in any way. Auckland Airport will work with any airline that wishes to engage in these activities.

(c) "Airline-specific" or route-specific costs that have been included in aeronautical pricing for PSE2 represent committed activities. This means that the overall growth forecasts used to set charges for **all** airlines include the forecast growth associated with these committed activities (resulting in lower charges for **all** airlines than would otherwise have been the case). In order to ensure consistency, both the forecast growth and forecast expenditure are included in aeronautical charges for PSE2.

Route development activities characterise Auckland Airport's changed approach

114. Our engagement in route development activities has led to a complete change of approach in our relationship with our customers. When Auckland Airport started the route development function in 2009, we were beginning our transformation from an infrastructure company to a driver of economic growth for New Zealand. We are now focussed on a customer-centric approach which has:

(a) led to engagement with our customers' business objectives and how we can contribute to and participate in their growth activities; and

(b) encouraged growth to the benefit of passengers, airlines, and the New Zealand economy.

115. This change in behaviour flows through all aspects of our operation. Auckland Airport sees itself as building relationships and engaging in what is important to our customers, understanding their drivers and objectives, and working with them to facilitate those outcomes. This attitude flows through to our decisions on operations, quality, investment and innovation. This function has been a crucial element in the transformation of our business and the benefits that have been delivered to date to consumers and the economy would be at risk if it were discontinued.

SECTION 7: ASSETS HELD FOR FUTURE USE

116. The Commission has assured airports that they can expect to be able to earn a full return on, and of, the costs incurred in holding and developing land for future use without profits appearing excessive, provided that land is eventually commissioned for use to supply airport services.[57]

117. As Auckland Airport has submitted extensively through the Part 4 consultation process and in the merits review proceedings, we consider that there is real risk with this approach. For Auckland Airport, the issue is not simply the timing of returns. When a new asset is commissioned, the impact of the new asset value and the compounded holding costs over the time that asset was held may be substantial. For this reason, we consider it will be difficult to achieve an implementable and commercial approach when new capacity is commissioned into use.

118. Auckland Airport continues to be of the view that a long-term approach, involving a steady price path, is the most consistent with workably competitive markets and the most efficient for customers and suppliers in the long term.

119. We have attempted to balance this belief within the context of the ID framework, by excluding the relevant land from the pricing asset base, and exploring methods for price signalling and smoothing of price paths with our substantial customers (in a manner where this can be transparently tracked through the ID requirements).

120. However, putting Auckland Airport's concerns with the exclusion of future use assets from the RAB to one side, we consider that there is a mechanical flaw in the current IM which makes it difficult to sensibly introduce price signalling for the Northern Runway land. Auckland Airport has raised this issue previously with the Commission, and is keen to resolve this issue with the Commission.

121. Briefly, Auckland Airport's concerns are:

    (a) The potential price path options that have been explored for smoothing or signalling the development of the Northern Runway would involve tracing any returns prior to commissioning of the assets involved on a transparent basis, using the disclosure templates for future use assets in the ID framework.

    (b) However, as currently drafted, the treatment of tax in the future use IM reduces the incentives to do so. Auckland Airport's understanding of the IM is that:

        (i) If Auckland Airport earns interim revenues on an asset held for future use this should be subtracted from the carrying value of the assets. This seems logical and fair.

        (ii) However, Auckland Airport would be required to pay tax on any interim revenue that may be earned on a future use asset, but would be required to subtract the gross revenue from the carrying value of the assets. We consider this to be a mechanical error in the IM.

122. Auckland Airport would like to engage with individual carriers who may be prepared to negotiate and agree to a smoothing of the costs associated with developing the Northern Runway before it is commissioned. We consider this is a key discussion to start having with airlines now.

123. However, the treatment of tax in the IM may create difficulties in those discussions. Accordingly, we are keen to explore the likely process and timing for moving this issue forward with the Commission.

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[57] IM Reasons Paper at paragraph 4.7.34.

SECTION 8: RESPONSES TO CONFERENCE QUESTIONS

Party	Question	Transcript	Response
Auckland Airport	What is Auckland Airport's assessment of its rate of return calculated consistent with the input methodologies? What is Auckland Airport's estimate of the asset base calculated in accordance with the input methodologies?	18 – 22	See above at paragraphs 95 to 101. Auckland Airport's estimate of its rate of return, calculated consistently with the input methodologies and the Commission's approach in the WIAL report, is 5.74%. Auckland Airport considers the appropriate opening asset base to use in the IRR analysis is the full regulatory asset base. This is included in the 2012 annual disclosures, published 30 November 2012. The asset base is calculated in accordance with the input methodologies, with two adjustments. In total the value is $1.132 bn. A breakdown is provided in the excel document.
Auckland Airport	Was the approach that was tabled in the price-setting consultation an approach that Auckland Airport would consider principled and therefore a possible approach that it would take in the PSE3 negotiations?	37	The context of this question relates to the treatment of potential future revaluation gains in pricing. This is covered in the submission above at paragraphs 36 to 39. We also note that BARNZ suggested an option of indexing asset valuations from 2017, which we interpret to be indexing from 2018 from the carried forward 2017 moratorium value. Auckland Airport had not previously considered this option, but we agree that this would provide for internal consistency in the treatment of revaluations from 2018 (with no revaluation effect in 2018) and revaluations reflected in forecast assets and income from 2018. This approach also seems principled to us.
Auckland Airport	What forecast CPI rate would Auckland Airport consider should be used in applying the IMs where you are rolling forward an asset base?	39 – 40	Auckland Airport has rolled forward Aircraft and Freight asset values at CPI in the price setting disclosure. A rate of 2.5% per annum was used for this segment and forecast revaluations are explicitly shown in the price setting disclosure. The price setting disclosure shows the combined effect of the moratorium approach for the majority of assets, and CPI revaluations for the Aircraft and Freight segment.
Auckland Airport	What should the Commission take as the opening base valuation? What role should the fixed constant moratorium valuation that Auckland Airport is using have in our analysis?	39 – 40	See above at paragraphs 95 to 106. Auckland Airport considers the appropriate opening asset base to use in the IRR analysis is the full regulatory asset base. This is included in the 2012 annual disclosures, published 30 November 2012. The asset base is calculated in accordance with the input methodologies, with two adjustments. In total the value is $1.132bn. A breakdown is provided in the excel document. The fixed constant moratorium determines the appropriate closing asset base for the IRR analysis. The appropriate closing base is, accordingly, one that does not include revaluations for Airfield and Terminal (as no revaluations are currently forecast over PSE2 and beyond) and includes revaluations for Aircraft and Freight assets. Following this approach, Auckland Airport submits the forecast closing asset base in its price setting disclosure (for all regulated activities) is the appropriate closing asset base in the Commission's IRR analysis. The value of this asset base is $1.121 bn. A breakdown of this figure is given in the excel spreadsheet attached to this submission.

SECTION 8: RESPONSES TO CONFERENCE QUESTIONS

<table>
<tr><th>Party</th><th>Question</th><th>Transcript</th><th>Response</th></tr>
<tr><td>BARNZ and Auckland Airport</td><td>Some indication of what you think the difference would be between the two assumptions regard the alternative land use plan used by Auckland Airport to determine its market value alternative use. Auckland Airport also offered to provide thoughts on this matter in its cross submission.</td><td>42 – 43</td><td>See above at paragraphs 102 to 106. Auckland Airport will request that external experts peer review any alternative MVAU valuations that are put forward and will respond separately.</td></tr>
<tr><td>Auckland Airport, Air New Zealand and BARNZ</td><td>Given that Auckland Airport has not indexed its asset base for pricing purposes since the introduction of the moratorium in 2007, should the opening asset valuation used in the IRR analysis (as at 30 June 2012) be based on an un-indexed roll-forward of the 2009 RAB?</td><td>44</td><td>See above at paragraphs 95 to 106.

The Commission's stated approach is that it will use the value of airport assets at the beginning of its period of analysis (ie at the time of price setting) using its IM compliant asset valuation approach. This means that the question of indexing is not relevant to the starting asset value. Auckland Airport submits that, as the Commission's analysis begins at 1 July 2012, the opening asset base should be based on the IM asset base at that date (ie the disclosure values as at 30 June 2012).</td></tr>
<tr><td>Auckland Airport</td><td>What was the position regarding PSE1 in relation to the noise mitigation costs?

Could Auckland clarify for the Commission the extent to which noise mitigation costs are occurring and the treatment of them so we understand how they have ended up being treated?</td><td>56 – 58</td><td>There are two types of noise mitigation costs: an operating cost associated with a trust which oversees noise issues in the community, and the capital costs associated with acoustic treatment for housing and schools.

The Manukau District Plan requires Auckland Airport to offer acoustic treatment packages to owners of houses and educational facilities in noise affected areas (High Area & Medium Area). This applies to buildings completed before 10 December 2001. These acoustic treatment packages reduce the amount of aircraft noise heard inside the buildings, and can include the installation of ventilation systems, insulation and kitchen extractor fans.

PSE1

In PSE1, both operating and capital cost forecasts associated with noise were included in pricing.
At the end of PSE1 the actual capital costs associated with the noise programme in PSE1 were $10.9 m. This was included in the closing asset base that was rolled forward to PSE2.

<table>
<tr><th>(m)</th><th>Input</th><th>2008</th><th>2009</th><th>2010</th><th>2011</th><th>2012</th></tr>
<tr><td>Noise Trust costs</td><td>Forecast</td><td>0.3</td><td>0.3</td><td>0.3</td><td>0.1</td><td>0.1</td></tr>
<tr><td>Capital costs for Acoustic Treatment</td><td>Forecast</td><td>2.5</td><td>1.1</td><td>0.9</td><td>0.4</td><td>0.3</td></tr>
<tr><td>Acoustic treatment</td><td>Actual PSE1</td><td></td><td></td><td></td><td></td><td>6.2</td></tr>
<tr><td>Acoustic treatment</td><td>Prior to PSE1</td><td></td><td></td><td></td><td></td><td>4.6</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td><td>10.9</td></tr>
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SECTION 8: RESPONSES TO CONFERENCE QUESTIONS

Party	Question	Transcript	Response
			PSE2 Noise trust operating costs of $300,000 were included in the forecast operational expenditure for pricing in PSE2 (increasing at CPI over PSE2). Forecast capital costs associated with acoustic treatment of houses for PSE2 were excluded from pricing. These were not forecast to be very material in PSE2.

(m)	Input	2013	2014	2015	2016	2017	
Noise trust operating costs	Forecast included	0.3	0.3	0.3	0.3	0.4	
Capital costs for Acoustic Treatment	Forecast excluded	0.3	0.2	0.2	0.2	0.2	1.0

We understand that the airlines' strong preference is that the acoustic treatment costs are covered in standard charges and do not compound as per the future use treatment methodology.

Auckland Airport proposes that the Commission's analysis adds the acoustic costs incurred to date ($10.9m) to its analysis, given BARNZ' preference for these to be included.

Auckland Airport understands that the airlines support the acoustic treatment costs incurred over the course of PSE2 being included in the PSE3 asset base, based on outturn costs.

Correction

Auckland Airport confirms that the civil works associated with the Northern Runway were not included in the pricing asset base. The cumulative acoustic treatment costs to date were the only capital costs included.

Pending amendment to IM

In its submissions in the merits review proceedings, the Commission stated that Auckland Airport's noise mitigation costs related to the Northern Runway were treated incorrectly in the IM determination. The Commission proposed to take appropriate steps to amend the IM accordingly, so that the noise mitigation costs in question as at 30 June 2009 ($5m) would be eligible to enter the RAB once the Northern Runway is commissioned.[58] Auckland Airport notes this issue remains listed as "under consideration" in the Commission's register of requested amendments to the IM determination.

[58] Commerce Commission submissions, 6 August 2012, Volume 3 at paragraphs 734-735.

SECTION 8: RESPONSES TO CONFERENCE QUESTIONS

Party	Question	Transcript	Response
Auckland Airport	To what extent are you not insured? What's insured and what's not? Where are you self-insuring that might, say, justify these arguments we've heard about asymmetric risk? So, how much risk is the airport itself taking in terms of these sorts of catastrophic events or major events?	68 – 69	Auckland Airport faces asymmetric risks from events such as natural disasters, pandemics, and terrorist threats. These events can take place within or outside New Zealand, and a number of these types of risks are not covered, or are covered in a limited way only, by Auckland Airport's insurance policy. In the absence of a specific fact scenario, we can make the following general comments (which are all subject to the terms, conditions and exclusions contained in the policy): • Cover is provided for natural disaster damage occurring in New Zealand. This includes both physical loss and cover for business interruptions. • Damage or business interruptions resulting from pandemics and other similar events within New Zealand will generally be excluded by the policy. • Physical loss or damage resulting from terrorist threats in New Zealand may be covered. This type of damage is limited in both quantum and the length of time of any business interruption that will be covered. In relation to events outside New Zealand which may disrupt flights and impact demand: • Limited cover is available for natural disasters abroad which impact on Auckland Airport. Losses incurred and any reduction in turnover by Auckland Airport may be covered, provided these types of losses are as a result of a physical loss or damage experienced by a direct supplier or customer in another location. Auckland Airport's understanding is that events such as recent volcanic eruptions which disrupt flights but do not cause physical damage to its overseas suppliers or customers would not be covered. • Pandemics and terrorist threats outside New Zealand are currently excluded from Auckland Airport's policy. Therefore, only limited cover is available for natural disasters which cause loss to a direct supplier or customer due to physical loss or damage to that airport. Even if this was the case, cover would only be available for the period of closure. However, Auckland Airport may have no method to prove that the necessary physical damage has occurred. In practice, this limits Auckland Airport's cover to the limited event when it suffers flight cancellations due to a natural disaster closing an airport. The indirect effects on travel of such events can extend well beyond the date of the natural disaster. They also affect aircraft availability which can result in cancellations throughout the network. Further, the policy provides for the exclusion of certain events in high hazard zones both in New Zealand and abroad. Downside risks which have impacted travel at Auckland Airport, but fallen outside our insurance

SECTION 8: RESPONSES TO CONFERENCE QUESTIONS

Party	Question	Transcript	Response
			cover, have previously included: • Flight cancellations for ash cloud over South America (this impacted domestic and international flights); • Flight cancellations as a result of Icelandic volcanic activity, impacting on airline's aircraft distribution across the network; • Effects of demand for travel from Japan following the tsunami; • 9 / 11 flight cancellations and indirect effects on travel; and • Pandemics such as SARs / Bird Flu. Auckland Airport cannot predict the level or nature of asymmetric risks such as natural disasters, pandemics, and terrorist threats it will face over PSE3. However it is highly likely that there will continue to be events which are not covered by its insurance.
Auckland Airport	How much were the Rugby World Cup costs in 2012?	74	The Rugby World Cup costs were $0.8m ($0.5m for Asset Maintenance and $0.3m Casual & Agency staff).
Auckland Airport	What is your approach to the issue of the valuation that will be used for PSE3? Auckland Airport to explain its views on the moratorium and the future path for asset valuations.	93, 108	See above at Section 3, paragraphs 17 to 44. Auckland Airport will continue to take guidance from the IM benchmarks for price setting purposes. As such, IM compliant asset values will likely form a useful reference point in PSE3. Customer feedback during consultation will also be highly influential, as it was in 2007 and 2012. However, Auckland Airport has no intention to revalue its asset base for pricing in PSE3. Continuing the moratorium is a distinctly possible outcome, especially if customers support that approach. During the Auckland Airport Conference, BARNZ indicated that an appropriate approach may be based on the moratorium rolled forward, with assets indexed from 2018 onwards. This approach may also be a possible outcome. If the pricing asset base is revalued in PSE3, any revaluation gains will be treated appropriately in pricing. Where there has been a reasonable, unbiased ex ante forecast for asset appreciation, and all parties involved understand the risk balance on a forward-looking basis, Auckland Airport understands that it would be appropriate for it to carry the risk and reward of any changes in asset values over a pricing period. However, Auckland Airport acknowledges that the moratorium is different to this scenario. This is not a situation where the forecast revaluations were zero, and have turned out to be greater than expected. There were, simply, no forecasts made. In these circumstances, if the moratorium is unwound in the future and a revalued asset base is used in pricing, the cumulative revaluation impact will be treated as an offset to the future revenue requirement (in an NPV neutral manner).

ANNEXURE

Location of Auckland Airport's reasons for departing from the WACC IM in price setting (as set out in pricing consultation documents and in submissions on the s 56G review)

SUBMISSION	DATE	REFERENCE
Pricing consultation and disclosure materials		
Initial Pricing Proposal	19 January 2012	Section 3.10 (pages 112-121)
Revised Pricing Proposal	5 April 2012	Section 3.9 (pages 86-97)
Final Pricing Decision	7 June 2012	Section 3.7 (pages 46-52)
Price Setting Disclosure	2 August 2012	Section 2.2.3 (pages 23-28)
Section 56G Review of Wellington Airport		
Post-conference submission	17 August 2012	Pages 5-7, Table 3 (pages 17-21)
Submission on Draft Report	30 November 2012	Paragraphs 71-80 (pages 23-24)
Section 56G Review of Auckland Airport		
Submission on Process and Issues Paper	19 October 2012	Paragraphs 67-89 (pages 38-50)
Cross-submission on Process and Issues Paper	9 November 2012	Paragraphs 54-62 (pages 18-21) Paragraph 123 (pages 35-36)