

CROSS SUBMISSION ON THE SECTION 56G REVIEW OF AUCKLAND AIRPORT

9 NOVEMBER 2012

1. The New Zealand Airports Association ("**NZ Airports**") makes this cross submission on submission on the paper entitled Airport Services - section 56G Reports: Process update and opportunity to submit on the Review of Auckland International Airport. It is made on behalf of Auckland International Airport Limited, Wellington International Airport Limited and Christchurch International Airport Limited (together, "**Airports**").
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OVERVIEW

3. Consistent with its previous submissions on the section 56G review process, in this cross submission NZ Airports focuses its views on relevant regulatory framework issues.
4. In our previous submission on the Auckland Airport review, we sought to address the Commission's concerns and questions regarding the relevance of input methodologies ("**IMs**") to the section 56G review process. Essentially:
 - (a) Although we accept that the IMs play an important role in the review process, NZ Airports believes that an effective ID regime does not replicate price control, and should not be judged by whether the IMs have been strictly applied in pricing; and
 - (b) Accordingly, an airport's decision to adopt a different approach to a pricing input than that set out in an IM can be perfectly consistent with the Part 4 purpose statement, especially when considered as part of the overall pricing package.
5. In that context, this cross-submission mainly responds to the comments made by Air New Zealand, the Board of Airlines Representatives New Zealand ("**BARNZ**") and Qantas (together the "**Airlines**") on the application of the WACC IM.
6. In addition, NZ Airports responds to specific issues raised by airlines which are of concern to NZ Airports. In particular, this cross submission comments briefly on the following areas where the approach taken by airlines reflects their approach to broader regulatory framework issues:
 - (a) Treatment of asset revaluations;
 - (b) The continuation of the moratorium at Auckland Airport;

- (c) Airline criticisms of Auckland Airport's MVAU valuations; and
- (d) Deviations from forecast capital expenditure.

EFFECTIVENESS OF ID

7. Airlines continue to argue that ID is ineffective and the wrong form of regulation.
8. NZ Airports makes the following observations in response:
 - (a) If the Airlines' concerns regarding WACC were put to one side, it appears that they have very few problems with the approach taken by Auckland Airport to pricing.
 - (b) In some places the Airlines acknowledge that information disclosure is having a positive effect.
 - (c) It therefore appears that the strong advocacy that information disclosure is ineffective is primarily based on a misconception that an effective information disclosure regime requires the WACC IM to be applied in pricing.
 - (d) On the other hand, Airlines seem willing to accept that departure from the asset valuation IM can still promote outcomes consistent with the purpose of Part 4. Indeed, they have raised concerns that Auckland Airport might consider departing from the asset valuation moratorium in the next price setting event.
 - (e) The views of Airlines regarding the WACC and asset valuation IMs appear to be a product of an undue focus on single inputs in isolation, instead of taking the more appropriate approach of considering whether, in aggregate and in combination, the inputs used by airports produce a package of outcomes that are consistent with the Part 4 purpose statement.

WACC

9. We acknowledge that, based on our preliminary review, some of the Airlines' incorrect views on the application of the WACC IM have been responded to by the Commission in the Draft Report on Wellington Airport. We nevertheless consider it appropriate to respond directly to the Airlines submissions as part of the Auckland Airport review process.

Airlines' views on the WACC IM

10. Air New Zealand claims that the Airports "continue to ignore or disregard expectations of pricing behaviour set by the ID regime", including by "disregarding" the WACC IM.¹ Air New Zealand has stated that:²

WACC is the major driver of Air New Zealand's conclusions regarding the appropriateness of AIAL's pricing and consequently the (lack of) effectiveness of information disclosure in promoting the section 52A(1) purpose statement.

11. Air New Zealand considers that "the work undertaken by the Commission in developing the WACC IM was comprehensive and sound and the resulting IM reflects the best advice of experts in the field".³ It considers that "returns consistent with the WACC mid-

¹ Air New Zealand Submission on Section 56G Review of Auckland Airport, 19 October 2012, at [13].

² Air NZ Submission on Section 56G Review of Auckland Airport, at [15].

³ Air NZ Submission on Section 56G Review of Auckland Airport, at [32].

point calculator pursuant to the WACC IM are an appropriate level of target return",⁴ and that.⁵

Through a comprehensive assessment, the Commission has calculated an appropriate WACC to be applied to returns from the supply of specified airport services.

12. Similarly, BARNZ argues that a failure to apply the 50th percentile of the WACC IM when setting prices will result in excess returns. This is at odds with BARNZ' recognition that the Commission uses the 75th percentile estimate when considering default and customised price paths for electricity and gas distribution businesses.⁶
13. NZ Airports is concerned that the Airlines rely on the mid-point estimate produced by the Commission's WACC IM as the *only* appropriate input for pricing purposes. NZ Airports believes that the airlines' single-minded focus on the figure produced by the Commission's WACC IM as the only acceptable WACC for price-setting purposes is:
 - (a) Illustrative of the problems that have been created by the establishment of a prescriptive WACC IM with no accompanying guidance of how it should be applied;
 - (b) Fundamentally inconsistent with the legislative recognition and intention that the WACC IM was not intended to be binding on Airports for disclosure or pricing purposes; and
 - (c) An unhelpful way to approach pricing consultations.

The WACC IM has created a problem

14. During the IM consultation process, NZ Airports expressed the belief that setting a WACC IM would create a misleading and inappropriate headline figure that would:
 - (a) Confuse, rather than inform; and
 - (b) Lead to shadow price control through inappropriate pressure to match pricing and returns to the WACC IM.
15. The Airlines' submissions under the section 56G Review process indicates that these concerns were well-founded.
16. Although NZ Airports maintains that a fundamentally different (ie less prescriptive) approach could have been taken when the IMs were set by the Commission, we accept that for the time being, the WACC IM applies to the Commission's monitoring and analysis functions, including under the section 56G Review.
17. Accordingly, NZ Airports sees the section 56G Review as an opportunity for the Commission to provide further guidance to reduce the regulatory uncertainty and confusion that has been created through the WACC IM. The draft WIAL report was a key milestone in that respect, which we will respond to separately in due course. In doing so, we will assess the extent to which the Commission's analysis and reasoning in the draft report has addressed our concerns regarding the uncertainty that will result if the airports fail to meet the "moving target" of the Commission's annually determined WACC. In particular, NZ Airports notes:

⁴ Air NZ Submission on Section 56G Review of Auckland Airport, at [33].

⁵ Air NZ Submission on Section 56G Review of Auckland Airport, Appendix A - Target Return at [153].

⁶ BARNZ Response to Section 56G Issues Paper Relating to Auckland Airport, 18 October 2012, page 7.

- (a) There is a clear mis-match between the WACC IM and assessments of Airport performance on an ex post basis. Prices are typically set for five year periods, such that the accuracy and usefulness of an annually updated WACC in monitoring airport returns is limited, and will likely lead to a high rate of "false positives" if not carefully contextualised against the full performance picture. In particular, any profitability assessment would need to consider all variances from *ex ante* forecasts, and variances due to unexpected market outcomes, in order to properly assess the level of returns over the period in question.
- (b) In other words, the application of the WACC IM as a yardstick for measuring profitability has created the very real risk that interested parties will ignore the big picture over time and judge excess returns to exist, when that is not in fact the case.
- (c) These concerns are compounded by the specificity of the WACC IM that has been set. Throughout the IM consultation process, NZ Airports submitted that any WACC IM (if one was developed at all), should simply assist the Commission and interested parties in *evaluating* the cost of capital determined by airports, and should not seek to *determine* an airport's cost of capital directly. Such an approach would be fully consistent with:
 - (i) The purpose of ID, ie to ensure "sufficient information" is readily available to interested persons;
 - (ii) The distinction contemplated by s 52T of the Act between IMs that *evaluate* and IMs that *determine*; and
 - (iii) The fact that suppliers that are subject to ID regulation only do not have to apply cost of capital IMs.

18. NZ Airports' concern with the WACC IM is that it looks and feels like a price control methodology, which has encouraged the Airlines to treat it as such, despite our understanding that the Commission did not intend that outcome, and despite the clear legislative scheme.

The WACC IM is not intended to be binding

19. The statutory provisions and the legislative context make it clear that the intention was to ensure that airports would not be pressured to apply the WACC IM (if such an IM was created) in ID or in pricing.
20. The explanatory note to the Commerce Amendment Bill notes that, in contrast to binding IMs, methodologies such as how to calculate the cost of capital would:⁷
- ... be in the form of guidelines against which the disclosed information would be assessed. This would allow airports and airlines and other customers to reach commercial agreements taking into account efficiency, productivity, investment, and other issues while providing clear guidance to assist commercial negotiations.
21. Similarly, in its advice on the draft Bill, the Ministry of Economic Development specifically considered and rejected the airlines' submission that a WACC IM should be binding for ID. In its view:⁸

Such a requirement could be interpreted to mean that the business has to price in a certain way including earning no more than its WACC. This amounts to

⁷ Commerce Amendment Bill 2008 (201-1) (explanatory note) at p 41.

⁸ Commerce Amendment Bill 2008, Report of the Ministry of Economic Development, 4 July 2008 at p 25.

price control, but the business is not under price control. Rather, these IMs should be used for analysis and comment by the Commission (including whether the business is earning more than WACC).

22. The Airlines' contention that the Airports should price to the WACC IM (and that any upwards deviation from the WACC value produced by that IM is evidence of excess profits) gives rise to the exact concern that Ministry of Development officials were clear should be avoided. This contention would require the WACC IM to be applied in an effectively binding manner for pricing, when it is clear that the IM is not binding and does not need to be applied by airports in an ID context, on the basis that this could amount to price control.
23. In its IM Reasons Paper, the Commission reiterated that airports do not have to apply the WACC IM, and that the cost of capital is only relevant in an ID context for comparative purposes.⁹ This is supported by the position taken by the Commission in its submissions in the merits review proceeding, where it acknowledged that:¹⁰

The WACC IM provides a basis for comparison with the actual methodologies used by the airports in determining cost of capital. This will encourage airports to be explicit about the assumptions and rationales used in their own modelling, and give interested parties (such as airlines in consultation with the airports over charges) some information for testing the airports' own assessments.

24. The Act itself is clear that airports do not have to apply the WACC IM for ID.¹¹ The scheme of section 53F envisages that airports are entitled to produce their own estimate of WACC, which they may then be required to disclose, and which the Commission may analyse (using the WACC IM if it chooses to do so). These provisions, and the statutory intention that underlies them, are inconsistent with the airlines' position that airports should strictly apply the WACC IM in pricing.

Effectiveness of consultation is not promoted

25. NZ Airports understands that the approach taken by the Airlines to the WACC IM is frustrating meaningful consultation on cost of capital under the Airport Authorities Act 1966 ("AAA") in price-setting, despite the Commission's intention that it would in fact promote more robust consultation.
26. Airlines are, of course, entitled to disagree with the method that an airport has used to calculate its WACC estimate for pricing, and to provide feedback through the consultation process on what they consider an appropriate estimate to be. Further, it is natural that customers will pressure airports to seek lower returns. Although it would be optimistic to think that complete agreement could be achieved on an appropriate cost of capital, airports and airlines can nevertheless engage in meaningful and valuable discussion designed to minimise areas of disagreement and move towards a package of pricing outcomes that recognises the unique circumstances in play for each airport (including the feedback of substantial customers in respect of their experiences at that particular airport).
27. In contrast to this approach, the Airlines appear to have maintained throughout the pricing consultations that the Airports have no justification for adopting pricing parameters that depart from the WACC IM set by the Commission as an industry benchmark. This effectively amounts to a refusal to:
- (a) acknowledge the company-specific nature of pricing; and

⁹ Commerce Commission IM Reasons Paper, 22 December 2010, at [2.8.12].

¹⁰ Commission's submissions, 6 August 2012 (volume 2) at [68].

¹¹ Commerce Act 1986, s 53F.

- (b) engage in any substantive way with the application of company-specific features to producing a WACC estimate.
28. In addition, the approach taken by the Airlines invites the conclusion that ID and the AAA are ineffective at promoting effective price-setting consultation. NZ Airports is concerned that any inferences of that nature would be a flawed and hasty conclusion to draw from a consultation process where the Airlines refused to engage or negotiate in any real manner on a key element of the building block model used to set prices.
29. Accordingly, it appears that in some respects the section 56G review process has become the forum for debate on matters that should have more properly (and usefully) been debated during pricing consultations. Regardless, NZ Airports is optimistic that the section 56 Review process will provide valuable guidance to inform consultation on future price setting events.
30. In conclusion, NZ Airports is deeply concerned about the Airlines' position and the implications if the Airlines' approach is adopted by the Commission. Our preliminary review of the draft WIAL report suggests that the Commission accepts that it is not appropriate to assess the effectiveness of information disclosure by reference to whether IMs have been rigidly applied in pricing.

RESPONSE TO ADDITIONAL AREAS OF AIRLINE CONCERN

Treatment of asset revaluations

31. Air New Zealand and BARNZ have raised concerns over the potential treatment of asset revaluations in pricing.
32. Auckland Airport, and the other airports, are required to revalue their assets periodically to comply with financial reporting standards and utilising methodologies that comply with these standards. Under information disclosure, the airports can revalue their disclosure asset base (using MVAU for land assets, with specialised assets rolling forward at CPI).
33. Asset bases utilised for the purpose of establishing prices need not be and, in Auckland Airport's case, are not the same as those used for financial reporting or information disclosure.
34. However, NZ Airports is concerned that the Airlines' comments about revaluation gains appear to be inappropriately blurring the distinctions between financial reporting obligations, information disclosure obligations, and pricing for specified airport services.
35. For example, BARNZ appears to imply that revaluations in corporate financial reporting (which includes non-aeronautical services not covered by Part 4 regulation or airline charges) should be treated as income in price setting:¹²

The treatment of asset revaluations and whether AIAL will treat all revaluations – both forecast and actual – as income for the purposes of setting charges as per the Commerce Commission input methodologies. The amounts are not immaterial. Revaluations included in Auckland Airport's annual financial accounts amounted to \$519m in FY11, made up of \$403m for land, \$56m for infrastructure and \$60m for runway, taxiway and apron revaluations.

36. Similarly, Air New Zealand refers to asset valuations disclosed by Auckland Airport in its annual information disclosures.¹³

¹² BARNZ Response to Commerce Commission Section 56G Issues Paper Relating to Auckland Airport, page 5.

¹³ Air New Zealand Limited Submission to the Commerce Commission on Section 56G Review of Auckland Airport, at [30].

Given that AIAL's 2011 disclosure identifies some \$75.4 million revaluation gains for Specified Airport Activity assets in the period since 30 June 2006 this is of major concern to Air NZ.

37. The treatment of revaluations in pricing determinations must necessarily relate to the asset base that forms the basis of the pricing calculations. For example, if the financial reporting valuations are used to establish the pricing asset base, then revaluations consistent with this asset base would need to be considered when setting charges. However, in Auckland Airport's case (where assets have not been revalued for pricing purposes) it would be incorrect to recognise asset revaluations in the pricing calculations.
38. Further, BARNZ refers to the recognition of both forecast and actual revaluation gains as income in price setting. In referring to actual revaluation gains, BARNZ continues to seek ex-post recognition of variations from revaluation forecasts. NZ Airports does not believe this behaviour to be consistent with workably competitive markets, as extensively submitted during the IM consultation process. For example, property owners do not reduce future rental cash flows because a valuation of their property exceeded their previous expectation.

Future price setting events

39. Air New Zealand and BARNZ have commented on the prospective impact on prices in the next pricing period ("**PSE3**") if the valuation moratorium is not maintained by Auckland Airport for that pricing period.
40. NZ Airports is unclear why the airlines have raised this issue as part of the section 56G review process. Clearly, future approaches to all pricing building blocks will be considered as part of the AAA consultation to establish prices for PSE3. Airline views at that time will obviously be an important contributor to that consultation process. We believe it would be inappropriate to seek to draw conclusions about an airport's current performance based on the unknown outcome of a pricing consultation in five years' time.
41. Additionally, and importantly, it is not necessary to do so as part of the section 56G review process. The Commission has properly acknowledged that its task is to assess the extent to which information disclosure regulation under Part 4 has had an impact on the Airports' performance and conduct.¹⁴ This does not require consideration of, or speculation about, future pricing periods.

Preparation of MVAU valuations

42. BARNZ has presented expert reports to the Commission which criticise the assumptions that underpin Auckland Airport's MVAU valuation analysis (contained in its MVAU land valuations as at 2009 and 2011).¹⁵ NZ Airports understands that Auckland Airport will be responding in more detail to these criticisms.
43. At a general level, NZ Airports notes that:
- (a) The airports have engaged qualified and experienced experts to carry out MVAU valuations that comply with the Commission's asset valuation IM, which requires the land to be valued at its highest and best alternative use.

¹⁴ Commerce Commission "Airport Services - s 56G Reports: Update on Process and Scope", 27 July 2012, page 8.

¹⁵ NZ Airports is aware that BARNZ' advisers made similar conclusions on WIAL's land valuations, and that WIAL did not agree with those conclusions, as discussed at the section 56G conference for WIAL on 7 September 2012.

- (b) The experts engaged by the airports to undertake that task will obviously give careful attention to all aspects of the IM Determination, including appropriate recognition to feasibility considerations, in the preparation of the MVAU valuation.
- (c) The MVAU valuation reports prepared for each airport have been transparently disclosed for ID purposes.

Capital expenditure

44. In its submission, Qantas has proposed that further measures should be introduced to ensure that Auckland Airport undertakes its capital expenditure in a timely manner. Qantas commented:¹⁶

The Qantas Group is also concerned by the lack of obligation for AIAL to invest the capital proposed in the PSE in a timely manner. Productivity measures and benchmarks need to be set with appropriate incentives and risk sharing mechanisms. For example, Qantas believes AIAL did not deliver the capex at the timing proposed in the first PSE and thus customers have paid for assets that never eventuated.

45. NZ Airports notes that Airports are required to report on deviations from forecast values as part of information disclosure, and to explain the reasons for those deviations. This is consistent with the role of information disclosure, which is to require airports to provide transparent information about their performance.
46. Qantas' concerns highlight that it is necessary for any assessment of that disclosed information to consider all variations from forecast. In particular:
- (a) Although capital expenditure may indeed be below forecast for a particular period, this may be balanced by other areas, such as operational expenditure, being higher than forecast. Further, revenue from landing and terminal charges may be below forecast in that period, which would need to be factored into any analysis.
 - (b) Qantas does not address other variations from forecast which would also have to be factored into any incentives or risk sharing mechanisms. The complexity of doing so at a benchmark level illustrates that any such mechanisms should be dealt with in pricing consultations between airlines and airports, not something that should be addressed by information disclosure regulation.

¹⁶ Qantas Group's response to the Commerce Commission Section 56G Issues Paper relating to Auckland International Airport, page 2.