

**BARNZ SUBMISSION ON COMMERCE COMMISSION DRAFT DECISION RELATING TO FAST TRACK
REVIEW OF INPUT METHODOLOGIES FOR THE APPLICATION OF AIRPORT LAND VALUATION
METHODOLOGY**

8 DECEMBER 2015

A EXECUTIVE SUMMARY

The key substantive change proposed by the Commerce Commission to the land valuation methodology rules is that Schedule A be amended to require that a valuation starting assumption be adopted of either the zoning prior to the land becoming an airport, the zoning consistent with the area surrounding the airport or the current zoning of the airport land. BARNZ considers that this proposal represents a fundamental change to both the underlying philosophy of the current valuation guidelines as well as the practical directions to the valuer of how to carry out the valuation.

BARNZ fundamentally disagrees with this proposal and considers it is inconsistent in all respects with both the overall objective of Part 4 and the specific purpose statements relevant to input methodologies and information disclosure. In particular, it is considered that:

- The proposed zoning assumption is inconsistent with the underlying economic concept of opportunity cost, as it does not reflect the costs necessary to convert the land to an alternative use, and will therefore produce a valuation exceeding the value necessary to retain the land in use as an airport;
- As such, the valuation will be inconsistent with the s52A objectives as it exceeds valuation outcomes produced in workably competitive markets and will enable regulated airport suppliers to target the extraction of excessive profits which is inconsistent with s52A(1)(d);
- The three zoning options included within the valuation starting assumption will result in increased subjectivity and uncertainty, which is inconsistent with the purpose of input methodologies as specified in s52R of promoting certainty for consumers and suppliers in relation to the rules and requirements of regulation under Part 4;
- The zoning options, and subjectivity of the resulting valuation, together with the fact that the outcome will exceed the opportunity cost value of the land, mean that the valuation guidelines also will not meet the statutory purpose for information disclosure of providing sufficient information to interested persons to assess whether the s52A purpose is being met.

BARNZ considers that the Commission should confirm, and if desired, clarify the directions already present in the current drafting of Schedule A, that the starting assumption for the zoning of the

airport land is 'the existing or underlying zoning of the land or its designations', as is stated in clause A9 and A10 of the present wording of Schedule A. This will result in:

- A valuation which takes into account the cost of obtaining zoning changes to move to the alternative use and therefore more accurately reflects the opportunity cost of continuing to use the land as an airport;
- A valuation which is a more accurate reflection of outcomes produced in workably competitive markets and therefore assists in limiting the ability of regulated suppliers to extract excessive profits;
- The input methodologies providing greater certainty for consumers and suppliers with regard to the valuation rules; and
- A valuation which provides better guidance to interested persons wanting to assess the degree to which regulated suppliers have been limited in their ability to extract excessive profits.

To the extent that it is considered this may create a potential disincentive to invest if additional land needs to be purchased at a value above the MVAU valuation produced by Schedule A, this can be addressed by providing that any amount paid in an arm's length commercial transaction for land needed to provide regulated airport services above the current land value produced through Schedule A, should be treated as a separate asset, able to form part of the RAB. This would address the potential concern over investment incentives for newly acquired land, whilst avoiding overstating the existing land holding for which the incentive to invest issue is not relevant.

If despite this submission, the Commission still wishes to adopt a fundamentally different approach of not having 'the existing or underlying zoning of the land or its designations' as the starting point (which we fundamentally oppose), then BARNZ urges the Commission to at least ensure that any change:

- Is sufficiently clear that it meets the S52R requirement of certainty (which the proposal does not); and
- Ensures that the resulting valuation is not one affected by the provision of regulated airport services (which the current proposal does not achieve due to the inclusion of surrounding land zones being able to form the starting zonal assumption).

If the Commission wishes to move away from opportunity cost and not take into account the costs of moving to the alternative land use, then BARNZ considers the Commission needs to accurately specify the appropriate starting zoning assumption for each of the three airports in Schedule A itself. Otherwise, Schedule A will simply be placing subjective decision making around the zoning changes needed, on top of subjective decision making around the alternative use being adopted, resulting in an input methodology containing significant uncertainty which fails to meet the purpose of s52R, in reduced information to consumers to assess whether the purpose of S52A has been met, and in an increased (as opposed to limited) ability of regulated suppliers to extract excessive profits.

In conclusion, BARNZ does not consider that the Commission's proposal in relation to the special zoning assumption meet any of the criteria the Commission have identified as necessary to justify a change to the current IM's. The proposal:

- Will not promote the purpose of Part 4 more effectively – rather the outcome is to move the land valuation, and measure of returns, further away from workably competitive outcomes;
- Will not promote the purpose of s52R more effectively – rather certainty will be reduced as a result of the multitude of potential starting assumptions for zoning; and
- Will not significantly reduce compliance or regulatory costs or complexity – rather such costs and complexity will just increase given the increased subjectivity and choices available.

B PROPOSAL INCONSISTENT WITH OPPORTUNITY COST PRINCIPLES

BARNZ commissioned Dr John Small of Covec to examine the Commission’s draft land valuation decision. Dr Small’s report is being provided to the Commission with this submission. In short, Dr Small considers that the Commission’s proposal is not consistent with opportunity cost.

As Dr Small notes, the essential component of the opportunity cost calculation is the choice the airports are notionally being rewarded for of choosing to retain the land in airport use as opposed to converting it to an alternative use.¹ He observes that this choice must be evaluated from the airport company’s perspective.² Applying these principles to the question of the treatment of the costs to obtain the necessary zoning changes to achieve any conversion of airport land to an alternative use, Dr Small states:³

From the airport company’s perspective, the starting point for land zoning is the actual current zoning of the land. If the land is not converted to an alternative use, this actual current zoning will remain in place. However if the land is converted to an alternative use then the current zoning will, in all likelihood, need to be changed. Any costs associated with changing the zoning status of the land will ultimately be borne by the airport company.

There is no ambiguity about this conclusion. If we are to value land at its opportunity cost then we need to deduct any costs of converting it so that it can achieve the best alternative use from the total value of the land in that alternative use. In the case of zoning, that means we must start with the current zoning, whatever that is.

Considering the Commission’s proposal to allow airport valuers to proceed from three different zoning scenarios, Dr Small considers that this approach is inconsistent with the way a commercially focused business would assess the business case for conversion of land to an alternative use. Dr Small notes that:⁴

... a commercially focused business in a competitive market [would] in fact start with the actual current zoning status of the land. From that point it will examine the costs of conversion and compare them with the expected revenues.

¹ Covec, Airport Land Valuation, 8 December 2015, para 28.

² Ibid at para 30.

³ Ibid at para 31 and 32.

⁴ Ibid at para 34.

Turning to specifically consider an airport, Dr Small observes that, if executives of an airport company were considering presenting a proposal for land conversion to their board, they would include any costs of changing the current zoning in their analysis. He therefore concludes that:⁵

... if we respect the opportunity cost concept by standing in the shoes of the decision maker it is clear that rezoning costs need to start from the actual current zoning.

Overall, Dr Small's conclusion in respect of the Commission's proposed changes to the treatment of zoning costs is that:⁶

... the proposed approach is most definitely not consistent with the concept of opportunity cost. As such, it stands in stark contrast to the Commission's previous endorsement of that concept in its 2010 IM reasons paper and in contrast to the broad support for opportunity cost as a land valuation concept which the Commission has also previously acknowledged.

The proposed change of allowing airport valuers to proceed from current uses of land surrounding an airport will likely result in a land valuation which is greater than the net benefit foregone by the airport from continuing to use the land as an airport rather than developing it for an alternative use. As such, that land valuation will not reflect the opportunity cost to the airport of continuing to use it for the purposes of providing airport services, nor the principles articulated in s52A of promoting outcomes consistent with those found in workably competitive markets. BARNZ considers that the Commission should instead confirm the current wording of Schedule A which directs a valuer to determine the existing or underlying zoning of the land or its designations.

C PROPOSAL REPRESENTS A FUNDAMENTAL CHANGE FROM CURRENT SCHEDULE A

Schedule A currently directs the valuer to ascertain what the airport's current zoning and designations are, and to then consider if any change is required in order to achieve the selected alternative land uses, and what the cost will be. BARNZ considers that the Commission's proposal therefore represents a significant change to the IMs which will result in material increases to airport valuations.

BARNZ disagrees with the comment in the Commission's draft decision that it is not specified in Schedule A how rezoning costs should be accounted for.⁷

BARNZ considers that Schedule A, as it currently exists, requires the valuer to take into account the costs of any changes necessary to hypothetically rezone the land from its existing underlying zoning and aeronautical designations to the zoning required to enable the hypothetical next best alternative use to be achieved. This was also the view of Darroch when it reviewed Wellington Airport's 2009 and 2011 valuations on behalf of the Commerce Commission in the course of the s 56G reviews undertaken by the Commission. Darroch expressly noted that one of the grounds on

⁵ Ibid at para 35.

⁶ Ibid at para 37.

⁷ Commerce Commission, Fast track review of input methodologies for the application of airport land valuation methodology, draft decision, para 2.12.

which it considered the Wellington Airport land valuation did not comply with Schedule A was the failure to appropriately allow for the likelihood or costs of obtaining the necessary zoning changes.⁸

Section A9 of the current Schedule A, which sets out the Practical Valuation Requirements, states that in undertaking an MVAU valuation the valuer must ...

(b) have regard to designation, zoning and other district plan and legal requirements applying to the land.

The explanatory notes to the current A9 expand this requirement as follows:

(4) The land is likely to be designated or zoned for the various aeronautical activities of the airport owner. In addition to considering the likely alternative uses for the land, the valuer should also consider the likelihood of the designation being uplifted or the land rezoned, and costs (if any) likely to be involved in this. (emphasis added)

Also relevant is current Section A10, which sets out the MVAU Valuation Steps, and states that in undertaking an MVAU valuation the valuer must:

(c) Determine the existing or underlying zoning of the land or designations and the likely zoning of the land for the highest and best alternative use, including the likelihood of zoning change or uplifting designations.

Schedule A specifically directs that the valuation must exclude any allowance for remediation expenditure or the costs required to convert the land into supply for specified airport services. There is a very detailed list of costs which must be excluded, or not be taken into account, when determining the valuation in paragraphs 13 and 15 of section A9.

Consistent with the fact that the valuer is expressly directed in A9 and A10 to take into account the costs and likelihood of the land being rezoned and designations uplifted, zoning and designation changes and costs are not included in the lists in A9 of specific matters to be excluded.

BARNZ therefore considers that there is a very clear direction in the current version of Schedule A for the costs of obtaining any zoning changes from the existing zoning and designations, which are necessary to undertake the selected next best alternative use, to be taken into account as part of the applicable development costs, and therefore be deducted from the expected gross realisation of the land.

Any change by the Commission away from the current policy and directions in Schedule A needs to be appropriately justified, which the Commission has outlined it will assess by only making changes which would:

- Promote the purpose of s52A more effectively;
- Promote the purpose in s52R more effectively, without detrimentally affecting the promotion of the s52A purpose; or

⁸ Darroch Ltd, Review of Land Valuation Methodology, Wellington International Airport Ltd, 1 February 2013, para 3.3 and 3.4

- Significantly reduce compliance costs, other regulatory costs or complexity, without detrimentally affecting the promotion of the s52A purpose.

BARNZ does not consider the change proposed in relation to the special zoning assumption satisfies any of these criteria.

D PROPOSAL INCONSISTENT WITH PART 4 PRINCIPLES

As part of the report Dr Small prepared, he specifically assessed the Commission’s proposal against the purpose of Part 4, as well as the purpose of input methodologies found in s52R and the purpose of information disclosure set out in s53A.

In relation to promotion of the s52A purpose statement, Dr Small has concluded that:⁹

- The fact the Commission’s proposal to amend Schedule A is inconsistent with the opportunity cost concept shows that the proposal is also in direct conflict with the overall objective of s52A of promoting outcomes consistent with outcomes produced in workably competitive markets.
- Since the proposed change will lead to higher asset values (and potentially higher targeted returns) it is also inconsistent with the objectives in s52A(1)(c) and (d).
- While the proposal addresses a potential concern around incentives to invest in additional land, it does so by effectively permitting higher values for all aeronautical land rather than seeking to align the incentives for marginal acquisitions. The proposal therefore results in a value, or targeted returns, which exceed those necessary to provide the appropriate incentives to invest.

With respect to the purpose of input methodologies as contained in s52R, Dr Small considers that:¹⁰

... the menu of three alternative initial zoning assumptions offered to valuers in the Commission’s proposal ... creates ambiguity (where none previously existed) because different choices will lead to different land valuations and different prices.

Similarly, Dr Small considers that the menu based options developed by the Commission do not compare well against the purpose of information disclosure, observing that the proposal *‘has strong potential to create conflict between valuers over methodological questions that lie at the heart of the proposal.’* Dr Small quite correctly observes that the challenge for interested persons in assessing whether s52A is being met is an order of magnitude greater than that which valuers will face under the Commission’s proposal.¹¹

Dr Small has identified an alternative proposal which he considers would materially better meet these various statutory purposes:¹²

⁹ Covec, Airport Land Valuation, 8 December 2015, para 60 to 64.

¹⁰ Ibid at para 70.

¹¹ Ibid at para 73 and 79.

¹² Ibid at para 54.

the obvious alternative approach is to find a way for new aeronautical land holdings to be incorporated into the airports' RAB valuations at their acquisition cost rather than their disposal cost. That outcome would give airports efficient investment incentives while preventing them from writing up the RAB value for all existing land holdings and setting correspondingly higher prices.

Thus, where land is acquired in an arm's length transaction, at a price exceeding the Schedule A MVAU value, then the premium paid above the MVAU value could be identified in the RAB as a separate asset.

The Commission has already provided a similar solution in relation to future land conversion costs incurred by the airports which are able to enter the asset base as they are incurred, despite the fact past land conversion costs (other than those relating to Auckland Airport's northern runway) were excluded from the opening RAB. This solution already exists in the short term for new land acquisitions as they are added to the asset base at their acquisition cost – it is only when the land is revalued that any potential reduction in value would arise. It is however worth noting that the airports will be able to flow this reduction in value through to their regulatory profit as a negative revaluation, as occurred in the case of Wellington Airport in relation to houses it purchased as part of its noise mitigation obligations.

This alternative proposal by Dr Small (of permitting arm's length transaction land acquisition costs above the Schedule A MVAU valuation to enter the RAB as a separate asset) is materially better than the Commission's suggested proposal as it both ensures investment incentives are maintained in respect of new acquisitions thus satisfying s52A(1)(a), while at the same time limiting the ability of the airports to extract excessive profits, meeting the s52A(1)(d) objective. It also maintains consistency with the opportunity cost concept, which underpins the workably competitive market standard which forms the stem of the s52A purpose statement.

BARNZ supports the conclusion by Dr Small that an amendment to the input methodologies, focused specifically on the concern around additional investment in land, is materially better at achieving the purpose in s52A, as well as the purposes in s52R and 53A, than a wide amendment which would result in an overstatement of the value of all an airport's land holdings in excess of the opportunity cost valuation of that land, and thus enable, rather than limit, the ability of regulated airports to extract excessive profits.

E IF THE ZONING ASSUMPTION IN SCHEDULE A IS TO BE AMENDED THEN GREATER SPECIFICITY IS REQUIRED

The Commission's proposal to provide the valuer with three options from which to select the preferred starting point for zoning changes to commence will inevitably lead to differences of opinion and divergent valuations. It seems to run counter to the purpose of input methodologies as set out in s52R of promoting certainty for suppliers and consumers with respect to the rules, processes and requirements applying to regulated goods and services.

Moreover, the second option proposed by the Commission (adopting zoning consistent with the area surrounding the airport) is inconsistent with a key principle enshrined in the original Schedule A of the valuation not being affected by the provision of the regulated airport services. For example,

market based evidence of land sales can only include land where the use is uninfluenced or unaffected by the supply of specified airport services.¹³ The Commission’s inclusion of zoning surrounding the airport is inappropriate as it will result in land uses, and therefore ultimately a land value, affected by the presence of the airport. Many land uses immediately around an airport provide commercial activities ancillary to the airport such as freight forwarding and consolidation activities, other aeronautical support services, offices, hotels, car-parking, and retail/entertainment activities for passengers and staff. If the Commission wishes to include a zoning option of the zoning of the area surrounding the airport, then an important caveat is necessary – namely where that zone is unaffected by the supply of specified airport services.

Dr Small has also identified other ambiguities contained within the Commission’s proposed suite of zoning options which will create further uncertainty. In particular, it is unclear what constitutes a ‘recent acquisition’. It is also not entirely clear whether the same zoning assumption must be adopted for the entire land holding, or whether different zoning assumptions can be adopted for different portions of the land holding.¹⁴

BARNZ does not support the Commission moving away from what we consider is currently specified in Schedule A – namely that the existing underlying zoning and designations are the starting point. To fail to take into account the time and costs involved in moving away from the existing zoning is to depart from the opportunity cost principle, and will result in a valuation which does not reflect the costs to the airport of moving to an alternative use, and therefore will result in a valuation above the opportunity cost value of the land.

However, if the Commission determines that it does wish to depart from the underlying opportunity cost principle, then BARNZ has been advised by both its valuer and planner that they consider the Commission should itself specify a clear special zoning assumption for each of the three airports within Schedule A. If that does not occur, then all the Commission has done will have been to increase subjectivity in the valuation process, by placing a subjective decision regarding the starting point for the zoning of the airport land on top of a subjective decision regarding the appropriate alternative land use plan. BARNZ’s valuer has advised that, as a valuer, he would not consider himself appropriately qualified to choose from the three options that the Commission has proposed, and would need to involve a planner in selecting the appropriate assumption. His view is that rather than place additional flexibility and subjectivity on the valuers and planners, it would be preferable for the Commission to itself clearly specify within Schedule A the appropriate starting point for zoning for the three airports – which will necessarily be different for each airport. This would better meet the s52R certainty purpose of input methodologies than the current proposal put forward by the Commission (although it is still subject to the same criticism as the Commission’s proposal of not promoting the s52A purpose statement as a result of it departing from the opportunity cost principle and thus not limiting the ability of regulated suppliers to extract excessive profits).

F SPECIFIC DRAFTING COMMENTS

¹³ Schedule A, Airport Land Valuation Methodology, A2(3) and (8)

¹⁴ Covec, Airport Land Valuation, 8 December 2015, para 76.

BARNZ has tracked a small number of drafting suggestions on the proposed new Schedule A released by the Commission.

The key drafting concern which BARNZ has with the new Schedule A (other than the proposal to move away from a true opportunity cost based on starting from current zoning and designations) is the loss of the guidance in the original Schedule A of what constituted MVAU. The expanded definition and set of principles for identifying the alternative use, and then its value, previously located in section A2 have simply not been carried forward into the new Schedule A. Paragraphs 1,2 and 3 of section A2, formed the core of any discussion or consideration of what constitutes an appropriate alternative land use over the past five years. The principles that the use must be one which is physically possible, appropriately justified, legally permissible and financially feasible, which results in the highest valuation of the land in questions was referred to again and again by all of the valuers and planners involved – on both airport and airline side. It was the lode stone against which the proposed alternative land uses put forward were judged in practice. To not carry it forward would be to rip out the heart of Schedule A as it previously functioned and leave it without one of its main guiding principles. It is hard to see any justification for these paragraphs being dropped. Their omission will only reduce certainty, not increase it.

Given the alternative use plan forms the foundation on which the valuation sits, any reduction in guidance over selection of the alternative land use plan runs counter to s52R and is a serious backward step.

BARNZ's valuer is also concerned over the proposal that land sales affected by the supply of airport services can be used as direct market evidence if they are adjusted to remove the impact of the supply of specified airport services on the sale. He observes that it is questionable how this can be done without it simply representing a subjective decision, which further reduces certainty over the appropriate valuation. Schedule A previously ruled out the use of land sales evidence that was affected by the supply of specified airport services.¹⁵ It is submitted that this is the more appropriate approach, which better achieves both the s52R certainty purpose, as well as the s52A objective of limiting the extraction of excessive profits.

These matters, as well as BARNZ's concern over the three options for the zonal assumption, and some other more minor drafting suggestions, have been tracked on the proposed new Schedule A for the Commission's consideration.

¹⁵ Schedule A, Airport Land Valuation Methodology, A2 (8).