



Cross Submission

In response to
**Submissions on Commerce Commission's
Draft Report on Airfield Pricing**

31 August 2001

TABLE OF CONTENTS

Introduction.....	3
Local and Regional Councils	3
Orion New Zealand Limited and UnitedNetworks Limited	4
Ministry of Transport.....	5
Negotiation and Arbitration.....	6
Remaining Submissions	7
BARNZ	7
Simon Terry Associates Ltd.....	25
Productivity Commission – Draft Report 24 August 2001	27
Better Regulation Task Force (UK) – Review of Airport Regulation (July 2001)	28
Concluding Comments.....	29
Attachment 1 – AIAL critique of Attachments 1 & 2 of the BARNZ Submission (10 August 2001) 31 August 2001	

Introduction

- 1 This is the cross submission of Auckland International Airport Limited (AIAL).
- 2 Capitalised terms not otherwise defined in this cross submission shall have the same meaning given to such terms in AIAL's earlier submissions of 27 April 2001 (April Submission) and 14 August 2001 (August Submission) respectively. Refer to the Glossary at the beginning of these two submissions.
- 3 AIAL's representatives and experts have read and noted all of the submissions lodged with the Commerce Commission (Commission) in response to the Commission's Draft Report on Airfield Pricing (3 July 2001) (Draft Report).
- 4 AIAL notes that cross submissions are due Friday 31 August 2001 and the Conference commences (with AIAL presenting) only two business days later on 4 September 2001. Accordingly, AIAL is not in a position to comment on the numerous submissions in detail but does however make the following key points.

Local and Regional Councils

- 5 The submissions made by local and regional councils (Christchurch City Holdings Limited, Auckland City and Auckland Regional Council) highlight the economic and social importance of long term infrastructure planning. They also concur with the view taken by AIAL and its advisors (as detailed in AIAL's August Submission on the Draft Report) that, in relation to the land held by AIAL for the proposed second runway, the application of the concepts "*used and useful*" and "*today's users should bear only today's costs*" is wholly inappropriate for a market characterised by investments in assets which are very large, lumpy and have long lives. The timing of the purchase of this land has been proven to be optimal and AIAL should be entitled to receive a return on this investment now.

6 AIAL considers the concluding comments (pages 2 and 3) from the submission made by the Auckland Regional Council summarises the position well:

“In summary, the ARC does not support the suggestion of the Commerce Commission that it may be more appropriate for AIAL to sell the land it is holding for the second runway. This would have major consequences for the long term use and development of the Airport and for Auckland and New Zealand. These consequences would be of strategic significance in that what the Commerce Commission proposes:

- ? *Is short sighted and does not take the longer view which is necessary for the planning and development of major infrastructure such as the Airport.*
- ? *Will result in uncertainty when certainty is required to plan and develop the second runway for the Airport.*
- ? *Unnecessarily forecloses on the plans for a second runway by requiring the land to be put back into private ownership.*
- ? *Fails to recognise the importance of the Airport as an infrastructure of major regional significance and national importance.*
- ? *Does not secure the future second runway and provide for the optimal, long term use of the Airport for the benefit of the Auckland Region and New Zealand.*
- ? *Constrains the long term potential of the Airport which will ultimately have consequences on the economy of the Auckland Region.”*

Orion New Zealand Limited and UnitedNetworks Limited

7 AIAL concurs with the concern expressed by both Orion New Zealand Limited and UnitedNetworks Limited in their respective submissions.

8 As stated at page 8 of Orion’s submission:

“rather than developing a new hybrid ODRC method, the Commission should confirm ODRC as a rational, accepted method of valuing infrastructure assets, regardless of their degree of ‘specialisation’ ”; and

Page 9 of the submission made by UnitedNetworks:

“The Commission proposes to value ‘specialised airfield assets’ at historic cost instead of replacement cost. The proposed change, in our view, would be efficiency reducing. The replacement cost approach allocates risks more efficiently. The historical cost approach can have some unintended consequences, in that inter-company transactions for the relevant assets could be used to inflate historic costs dramatically. Further, the act of changing the valuation methodology for what appear to be inadequate reasons undermines its stability over time. Stability of valuation methodology is critical to minimise the cost of capital for entities subject to, or potentially subject to, price control.”

Ministry of Transport

9 AIAL has noted the letter from the Ministry of Transport. Formal notification has now also been provided by the Ministry to AIAL that (page 1):

“Over the next six months, the Ministry intends to:

- ? Build up a picture of how the requirement to consult under section 4 of the Airport Authorities Act has worked in practice – through informal discussions with the industry; and*

- ? Assess the extent to which the requirements for information disclosure, as set out in Airport Authorities (Airport companies Information Disclosure) Regulations 1999, have been met.”*

- 10 AIAL considers this Inquiry is pre-emptive and should have occurred after the review proposed to be undertaken by the Ministry of Transport. Wellington International Airport Limited (WIAL) has only just commenced its consultation and only one set of disclosure statements from each of the relevant airports has been furnished under the Disclosure Regulations. It is accumulated data and experience over time which will indicate that the existing regulatory regime, along with the countervailing powers of the airlines (enhanced further by the provision of information both during consultation and under the Disclosure Regulations), is a major (and sufficient) constraining factor on AIAL's ability to exploit any possible market power it may possess.
- 11 Notwithstanding this, AIAL believes that, subject to minor amendment, and more importantly, the issuance of guidelines in some key areas, the Ministry of Transport's review ought to illustrate that the current regulatory regime (rather than price control) is the best way forward for the regulation of airports within New Zealand.

Negotiation and Arbitration

- 12 Aside from the issues (both legal and practical) which would arise from a "negotiation – arbitration" model, AIAL considers such a model would inevitably result in every significant issue between an airport and its substantial customers ultimately being adjudicated upon via an arbitration process. In fact, in the event of a failed negotiation (ie an airport does not agree with a customer's view) what would the customer airline have to lose in proceeding to arbitration? In AIAL's view, nothing. This is accepted by the Commission – refer to paragraph 13.48 of the Draft Report where it is stated, in relation to the negotiation and arbitration process in place in the telecommunications industry in Australia:

"Since its introduction in 1997, and until March 2000, there were 37 arbitration cases brought before the ACCC, of which only 7 were decided. This may reflect problems in the Australian approach, but may also be indicative of the

difficulties inherent in arbitration where difficult commercial questions are involved.¹

13 In addition, we concur with WIAL's position on this that:

“However, it does not agree that the “approach” of “pricing negotiations with principles set by the Commission” is a form of control that the Commission could either use either under section 70 or in terms of the provisions of section 72 referred to by the Commission at paragraph 12.5 as an undertaking under section 72 having the effect of an authorisation”.

14 AIAL remains firmly of the view that the current regulatory system is both appropriate and adequate.

Remaining Submissions

15 Other than the submission from the Board of Airline Representatives New Zealand (Inc) – August 2001 (BARNZ) which canvasses a number of matters, the remaining submissions largely address the issue of what is the appropriate valuation methodology for the valuation of specialised assets. This issue is addressed by AIAL in its review of the submissions made by both BARNZ and Simon Terry Associates Limited – refer below.

BARNZ

16 Whilst AIAL disagrees with much contained within the BARNZ submission, AIAL has, in this cross submission, focussed only on the key issues of principle. These and other additional matters will also be addressed at the Conference.

17 As a general observation of the BARNZ submission, AIAL notes:

 ? There appears to be an inconsistency in the approach taken by BARNZ on some of the key issues detailed in BARNZ' first submission (made

¹ Network Economics Consulting Group, *Assessment of the Telecommunications Regulatory Regime in Australia*, March 2000.

- in April this year) with that made by BARNZ in response to the Draft Report (August 2001);
- ? BARNZ appears to be “cherry picking” – agreeing with any issues in the Draft Report which would result in the justification of either a lower asset base or lower aeronautical charges in the case of AIAL;
 - ? BARNZ has largely relied on assertions and bald statements without providing supporting rationale or arguments. For the most part, the quality of the analysis is, in AIAL’s opinion, rudimentary and insufficient to provide compelling arguments;
 - ? An example of an inconsistency is where BARNZ’, in its April submission, proposed that current cost was the accepted methodology for valuing assets and argued strongly that revaluation gains should be treated as income. BARNZ however now concurs with the Commission that historic costs should be used to value such assets?;
 - ? BARNZ does not correct the Commission’s financial analysis when it has the information available to effect such corrections. For instance, the Commission advised both AIAL and BARNZ (post release of the Draft Report) of a significant correction in AIAL’s favour in the Commission’s initial calculation of dynamic inefficiency. Notwithstanding both the correction and BARNZ’ similar advice to the Commission that the Commission’s original analysis was highly questionable, BARNZ fails to correct the Commission’s error in its subsequent submission of August 2001; and
 - ? BARNZ has also provided data which, in AIAL’s view, is incomplete and therefore confusing. For instance, BARNZ provides a schedule in its submission (correctly marked confidential) that details the forecast AIAL capex each year. However, BARNZ does not go on to explain that the numbers provided by AIAL were expressed in **real 1998** terms

and needed to be factored upward by CPI, nor have they included a proportion of shared capex that supports airfield activities. The exclusion of such critical information can only result in a misunderstanding on the part of a reader of BARNZ' submission, possibly including, the Commission.

18 The Commission must take care not to fall into the trap of endeavouring to balance the views of different parties. Instead, the Commission must provide a compelling argument that price control is necessary in the case of AIAL. The Commission must take account of the **merits** of arguments raised rather than continuing to take such arguments at face value.

19 Turning now to the key points of principle:

a) **Airlines countervailing power:**

BARNZ' Position: The airlines have insufficient market power to constrain AIAL, WIAL and CIAL.

AIAL's Position: The airlines' countervailing power has been too easily dismissed in the Draft Report as insufficient to constrain an airport's behaviour. This, and the fact that the consumers are not individuals, is clearly stated in the Better Regulation Task Force (UK) Report (July 2001) (page 8):

*"The CAA is clearly different from Ofgem (energy) and Oftel (telecommunications) in that airports are not thought of as utilities. The other **key difference** is that the consumers in this case are not individuals as they are for Ofgem and Oftel **but powerful players in their own right, the commercial airlines**".*

The conclusion that airlines' have insufficient countervailing power is also inconsistent with the evidence of a lack of abuse of market power, most especially at WIAL, where neither the Commission nor BARNZ

found prices to be excessive, but also at AIAL where corrected and revised data indicate a rate of return below the target WACC.

b) **Use of historic cost rather than ODRC:**

BARNZ' Position: BARNZ now seems to agree with the Commission's use of historic cost.

AIAL's Position: Historic cost is inappropriate in a test for abuse of market power. The Commission should have used ODRC. ODRC mimics the outcomes in a competitive market and is the appropriate valuation methodology in a test for abuse of market power. In particular, ODRC measures the valuation that would be consistent with the price charged by an efficient new entrant and is consistent with the price that would prevail in a competitive industry in the long run.

c) **Market value of land:**

BARNZ' Position: The use of opportunity cost (ie the market value of land) is appropriate. The market value should provide the cap on asset valuations.

AIAL's Position: This form of opportunity cost proposed by the Commission is not appropriate. As stated above, the appropriate basis for valuation is **the cost to an efficient new entrant**, which results in prices mimicking those likely to prevail in a competitive market.

It would appear that BARNZ' comfort with the use of opportunity cost to value airfield land is subject to its determination being as defined by the Commission at paragraph 7.34 in the Draft Report:

“opportunity cost should be determined based on the highest alternative use value of resources used up or pre-empted”.

Such an approach of course differs from BARNZ' April submission (refer paragraph 12.1) that:

“assets should be valued with the objective of simulating a valuation as if the market for airport services were competitive”.

A new entrant (competitor) would be required, over time, to accumulate land at its market buying price (equivalent to AIAL's land in its next best alternative use) and to then seek to obtain consent approvals to use the land for airport purposes. Following receipt of consents, development work will be required to bring the airport to operational status in order to act as a market competitor. The question is “would a competitor pay more than the alternative use value for AIAL's existing airport use status when acquiring the land for airport usage?” – the answer is clearly, yes.

This value logic is confirmed by:

? BARNZ' valuation advisor (at page 4):

“it is most improbable that a developer would pay the same price for 10ha of land that would be developed over the next 3 or 5 year period, for a like 10ha parcel of land that would not be developed for at least 15 or perhaps 20 years”;

i.e. the market buying price of land with existing use options is greater than the same land in alternative use; and

? The Commission's valuers, Telfer Young (at page 333) state:

“current market value...must include the issues of time to accumulate land, obtain consents, planning and anticipation of civil works required to create an airport”;

i.e. to the current market buying price of land in alternative use should be added a premium for the airport existing use.

While AIAL may accept the definition of opportunity cost as being the most valuable alternative foregone by using the land for airport purposes, this has to be seen against the benefits in continuing to use Auckland Airport as an airport outweighing the opportunity cost in alternative use. The value in continuing to use Auckland Airport as an airport can be measured in terms of the utility that is derived from use of the airport. The explanation provided by AIAL in paragraph 5.59 of its August Submission is also relevant.

Any application of opportunity cost needs to be seen in the context of a specialised asset that is, in effect, irreplaceable. Opportunity cost does not require the existence of an alternative application for the same asset (a specialised asset would not have any other usage), but would reflect the cost of creating an equivalent asset with the same capability matching value in existing use.

d) **Treatment of costs associated with getting land into airport use:**

BARNZ' Position: The costs associated with getting land to airport use are more appropriately included within the costs of land improvements.

AIAL's Position: These costs should be included as part of the cost of land at their ODRC value.

e) **Exclusion of second runway land:**

BARNZ' Position: Land held for future use should be optimised out and no return sought until the land is brought into use.

AIAL's Position: Land held for future use is useful and should be included in the asset base. In a test for abuse of market power, the relevant comparator should be the behaviour of a competitive firm. There is no reason to believe that a competitive firm would not seek a return on assets held for future development. More importantly,

including this land in the asset base yields prices which are more consistent with allocatively efficient prices based on (forward looking) marginal costs as supported by Professor A E Kahn (refer to AIAL's August Submission).

f) **Calculation of dynamic inefficiencies:**

BARNZ' Position: BARNZ has not altered the Commission's calculations of dynamic efficiency.

AIAL's Position: AIAL does not consider the Commission's calculation of dynamic efficiency is correct. In fact, AIAL does not believe there is sufficient basis for assuming any dynamic inefficiencies. It is inappropriate to calculate dynamic inefficiency using the Commission's methodology in addition to estimating productive and allocative inefficiency and adjusting the asset base for optimisation. This double-counts the effect of holding assets for future use and mistakenly assumes the airport should (and could) divest assets such as the seawall and seabed at their book values.

g) **Cost of price control:**

BARNZ' Position: The Commission has overstated the costs of price control. BARNZ considers the additional direct costs of price control would be nil or potentially a saving to the airlines.

AIAL's Position: The Commission has understated the costs associated with regulation and BARNZ' position appears to only consider the cost to the airlines, without considering the wider costs that would be incurred by airports and any regulatory body.

The Commission has already provided quantitative analysis indicating that the on-going costs associated with price control would be higher than those incurred under the existing system. As indicated in AIAL's

August Submission, there is reason to believe this differential may be underestimated, given the costs incurred by other regulators.

Additionally, as also noted in AIAL's Submission, the Commission has omitted to take account of the costs associated with establishing a regulatory framework and bringing the regulatory body "up to speed".

h) **Ability of price control to yield 50% of the estimated inefficiencies:**

BARNZ' Position: BARNZ considers the Commission's estimate that the indirect costs of price control would be 50% of potential efficiency gains is far too high and that 25% would be more realistic.

AIAL's Position: The Commission's assumption that 50% of estimated inefficiencies could be realised through price control is well overstated. A more realistic estimate could well be that up to 50% of any "excess profit" could be transferred, implying 25% of allocative inefficiencies (to the consumer), and no improvement in productive or dynamic inefficiencies.

The assumption that "excess profitability" could be reduced by 50% is consistent with the short-comings of price regulation and the requirement to incentivise companies to seek efficiency gains over time. A reduction in excess profitability of this extent is consistent with a 25% gain in "lost consumer surplus", as discussed in AIAL's August Submission).

It is also highly unlikely price control would improve **productive efficiency** because price control blunts the incentives on firms to seek efficiency improvements.

It is also highly unlikely price control would improve **dynamic efficiency**, as defined by the Commission, as the assets that were optimised out could not, or should not, be sold by AIAL to realise any

“gains”. Furthermore, price control is generally recognised in the literature as worsening incentives for dynamically efficient investments.

l) Extent of productive inefficiencies:

BARNZ’ Position: The 1% productive inefficiency estimate assumed by the Commission is too low; 3% would be more appropriate.

AIAL’s Position: There is no reason to assume there are productive inefficiencies in AIAL’s operations; even a 1% inefficiency assumption is significant when taken as a percentage of variable costs.

Such assumptions are inappropriate in the context of considering abuse of monopoly power and would be even more inappropriate in a regulated environment, as they increase regulatory risks. Any assumption of this nature should be supported by sufficiently rigorous analysis, the burden of proof must lie with the Commission.

AIAL has strong incentives to operate efficiently, given its profit maximising incentives and market scrutiny. There is no reason to presume there are any material inefficiencies.

j) Modified multi-till approach:

BARNZ’ Position: BARNZ suggests a modified multi-till approach should be used under which a proportion of any excess profits earned on related activities (the demand for which is driven by the airport’s core business) are used to offset the costs of the airport’s core business.

AIAL’s Position: A modified multi-till approach, of the type proposed by BARNZ, would be inappropriate. A “pure” multi-till approach is preferable.

A modified multi-till approach would provide inappropriate pricing, investment and efficiency incentives to AIAL, leading to longer-run inefficiencies. It is worth noting that this was recently accepted by the ACCC in Australia in its final decision on SACL's (Sydney Airport) pricing proposal on aeronautical charges.

k) **Acquirer's incurrence of costs:**

BARNZ' Position: It is not appropriate to assume that airlines will bear the costs of additional regulatory action. The airports should bear these costs.

AIAL's Position: Either directly or indirectly, airlines should ultimately bear these costs.

Even if such costs are levied on airports, they will necessarily form part of the company's legitimate cost base, and would be allocated directly to the airfield cost centre. To disallow airports to recover these costs would be equivalent to forcing airport owners to accept a lower than appropriate rate of return.

l) **Valuation methodology:**

BARNZ' Position: BARNZ has a focus on a single valuation approach, the highest alternative use value using a comparable sales approach. This is despite the clarity in the Commission's own valuation experts (Telfer Young's (TY)) Peer Review recommending four distinct approaches to determining market value – existing use, being:

1. Comparable sales or market comparison;
2. A zonal approach (TY's preferred approach);
3. A DCF approach; and
4. A civil works approach.

AIAL's Position: Valuation is not an exact science. The use of different approaches is a generally accepted and reasonable practice amongst valuers and economists. AIAL, in its valuation, conservatively adopted the lowest outcome of the four distinct approaches listed above.

BARNZ, at paragraphs 14.11 and 18.4 of its August submission, continues to use arithmetical adjustments to the AIAL valuation which make a mockery of any current, existing or market value concept. TY at page 332 in its Peer Review criticise the "Mr Roger Taylor deflator method" of calculating land value saying that:

"this arithmetic approach to the assessment of a base value of land bears no relationship to MVEU of land and carries out the identical exercise in reverse that SP (AIAL's valuer) are accused of assessing as a value for the future".

TY concludes by saying:

"arithmetic exercises without an understanding of valuation principles and the market don't work and are not helpful".

AIAL has undertaken a comprehensive critique of the "Mr Roger Taylor deflator model" as set out in Attachment 1 to this cross submission. AIAL's view is that, Attachments 1 and 2 of the BARNZ submission clearly indicate the caution that needs to be placed in any numerical analysis that is provided by BARNZ in respect of AIAL. AIAL's objective has always been to establish an appropriate and defensible

valuation and charging base which also appropriately and fairly rewards AIAL for the risks it is exposed to. In AIAL's view, BARNZ' objective is to simply minimise airline costs at the expense of AIAL.

In respect of the comparable sales approach, the problem of valuing land where the only available market evidence on value relates to sub-optimal use of the land is a problem, which is confronted in the valuation of AIAL and a very limited number of other specialised assets. Lay observers of the valuation process expect the value of land to be determined from market evidence. For assets in general, market evidence comes from prices in an active market for the same or similar assets, or, where that information is not available, then from market based estimates of the discounted estimated cash inflows. It is appropriate to use such market evidence to estimate the value of land if the evidence relates to optimal use of the land; and that holds, irrespective of whether the actual use of the land is optimal or sub-optimal. However, use of market evidence produces an anomalous result **if the only available market evidence relates to uses that are sub-optimal** relative to the actual use of the land.

This is a problem faced by valuers at AIAL. The problem is not specific only to reclaimed land or land reformed through from extensive civil works at airports. Other examples would be reclaimed land for use by (sea) port companies and land resulting from extensive works by local or central government in constructing new roading. The common feature of **all** these cases is that works have been carried out to obtain land for a particular purpose or use, the land is then applied to that use, but the only available market evidence on the value of land of the same size and in the same vicinity relates to uses that are **sub-optimal relative** to the use for which the works were carried out.

Consider the following example. AIAL decides, on rational economic grounds, to undertake an expansion project involving the reclamation

of land immediately adjacent to the land it already uses. If the reclamation costs \$10m in total, but the available market evidence (from alternative uses) indicates a value of only \$1m then application of an approach which does not recognise the optimal nature of the existing use would result in AIAL writing down the cost of the land from \$10m to \$1m and recognising a revaluation loss of \$9m. Given the implication that estimated value in use is at least \$10m, to adopt a valuation based upon a lesser figure would be unsatisfactory.

Furthermore, if AIAL were subject to some form of regulation requiring that its pricing should, on average, result in the company earning just a normal rate of return on the market valuation of assets employed, then it could suffer real economic harm. The outcome would be reluctance on the part of the company to undertake such investments, even though they may be welfare enhancing.

These problems arise not because of the use of market evidence as such, but because of the resort to irrelevant market evidence where there is no relevant market evidence. The adoption of unadjusted alternative use values and the failure to recognise the current cost of civil works are examples of an approach, which seeks to use and adopt irrelevant market evidence.

m) **WACC (7.2%):**

Typically BARNZ agrees with the Commission's WACC estimates that lower the WACC (PRMRP) and disagrees with those that might be higher than their estimates (debt premium, asset beta).

n) **Optimisation of the lagoon land:**

BARNZ' Position: BARNZ queries whether all land held for future development has been optimised out by the Commission.

AIAL's Position: AIAL contends, with economic justification, that in fact the land held by AIAL for the future runway has been optimally purchased and should be included in the charging asset base. Therefore, any optimisation of such land is unnecessary. Refer to previous discussion in this cross submission.

The land referred to in paragraph 16.10 of the BARNZ submission (August 2001) - some 28.9883 hectares, relates to what is termed the "lagoon infill". More than half of this land is currently fully operational (being utilised for the construction of additional taxiways and international aircraft parking stands). There would have been substantially higher costs if this land had been reclaimed in two tranches rather than as a single work.

o) **The seawall and the seabed:**

BARNZ's Position: BARNZ's contends in its August 2001 submission that "*statutory planning documents are in place which provide adequate protection without the need for AIAL to own the land*".

AIAL Position: The seabed and the seawall should remain in the asset base. Ownership of the seabed has allowed Auckland Airport to reclaim and develop airport operational areas without the need to acquire those rights from a third party. It was always planned that the optimal expansion of Auckland Airport would be into the Manukau harbour. This is why the seabed was acquired and it is why the seabed adds value to the airport.

While an asset might not have a separate value in that, for example, it is land locked, it does not mean that in following the building block approach of the ODRC methodology the asset has **no value**. In the totality of AIAL's valuation, the seabed and the seawall are identifiable components to which values can be, and are, assessed.

- p) **Counterfactual = difference between +18.14% (yr 1) rather than announced +8.5% (yr 1):**

BARNZ' Position: Paragraph 38.1 of the BARNZ submission (August 2001) suggests that the appropriate counterfactual is not the status quo.

AIAL's Position: AIAL acknowledges it operates in a limited market and that it is statutorily required to consult with its substantial customers on charges that affect them. AIAL entered the AIAL Consultation with an open mind, cognisant of the views raised by its substantial airline customers.

BARNZ has quantified the counterfactual with reference to the difference between the eventual promulgated increases (+8.5% (yr 1) in August 2000) and those set out in the last proposal published by AIAL (May 2000). This difference has been attributed by BARNZ to be the countervailing pressure of the Inquiry. This is not the case. Instead, the difference should be more correctly attributed to the countervailing power of AIAL's substantial customers - the airlines. The difference indicates the allowances made by the AIAL Board of Directors (AIAL's Board) on a number of issues raised by AIAL's substantial customers, which the AIAL Board considered worthy of accommodation. In the final analysis, the AIAL Board chose what it believed to be a fair increase, albeit towards the conservative end of the spectrum.

- q) **Terms of Reference:**

BARNZ' Position: In paragraph 48.18 of the BARNZ submission (August 2001), BARNZ considers that, based on the Draft Report, there is ample justification for the Commission to initiate a separate inquiry into the pricing of terminal activities.

AIAL's Position: In the counterfactual, as AIAL has clearly demonstrated, there is no justification for price control. Accordingly, the stand taken by BARNZ in respect of terminals is also unfounded.

- r) **Land value \$90,000 per hectare cf. \$140,000 per hectare:** Seagar & Partner's (SP) Valuation of the AIAL Airfield Land which was carried out in accordance with the land value concept for non-contestable assets on the basis of market value for the existing use (MVEU).

Under this methodology, the value of the land component reflects the fair value/market value of the actual land held and where the land use is changing the value of the land under alternative use or highest and best use should be determined. This value is best determined by reference to market comparables using the land sales as a benchmark to apply to Auckland Airport with appropriate adjustments as required.

In order to assess the value of the land in aeronautical use at Auckland Airport, SP's assessment took into account the added cost which would be incurred by AIAL to enable the land to be used for airport purposes. Such costs would include planning approval, preliminary development and holding costs. There are considerable lead-in development periods applicable to airports and the associated cost should be reflected in any "existing use" land valuation.

In SP's original valuation of June 1999, a zonal approach to the airport land assets identified some 923 hectares contained within the International Airport runways, taxiways, aprons and approaches including seabed and other land used for specialised aeronautical activities. Of this area, some 351 hectares relates to the airfield alone

including runways, taxiways and aprons. In assessing the market value of this airfield land for its highest and best alternative use, SP considered that the most probable alternative uses would be urban in nature including a residential precinct with supporting commercial and business activities. Such uses would be consistent with the existing urban uses surrounding the airport and recognises the close proximity of this land to the central urban area of Auckland.

In the context of SP's original valuation of the 920 hectares contained in Zone 1, SP prepared a discounted cashflow approach based on a notional urban development of this land on the current market. The outcomes of this approach were referenced to an extensive database of comparable sales evidence relating to land in a range of uses including rural, residential, commercial and industrial land uses as well as land at Mangere designated for Airport use.

AIAL accepts that any DCF Approach applied to such a large land holding can give rise to a range of opinion depending upon the quantum and timing of the inputs in particular, and for this reason, the supporting sales data becomes more critical.

Further analysis of comparable sales has been undertaken subsequent to the June 1999 valuation date. These sales drawn from the East Tamaki Flat Bush area in Manukau City are of larger development land holdings situated within what is proposed to be a major future residential precinct in this part of Auckland. Between April 2000 and January 2001, AIAL is aware of 6 transactions where land developers and housing companies have acquired a total of 180 hectares of zoned future residential land at an average price of \$344,000 per hectare plus GST. Some of this land is not anticipated to be brought into actual development for several years, and has been acquired by these companies for their future use. This reflects the continued growth of Auckland and the constraints which are being increasingly applied by

planners to the expansion of urban land on the fringes of Auckland City.

These trends which are supported by statistics showing the continuing increase in residential land subdivision in Manukau City in recent years confirm the contestability of our original valuation of the underlying land in alternative use at \$140,000/hectare.

Further, if a similar approach were to have been applied to the 351 hectares alone contained within the airfield zone (which includes much of the coastal frontage), our valuation of this land on a per hectare rate basis would have been higher in the order of \$180,000/hectare plus GST.

These value levels would apply to the land in its natural state prior to earthworks or internal servicing. The values are not dependent upon the existence or construction of a seawall around the perimeter of the land which is assumed to be in its natural state and therefore does not take into account the reclamation works which were carried out to create a substantial portion of this land (141.5 hectares of the 351.72 hectares).

AIAL therefore believes the BARNZ Valuers' position is unsupportable and appears to ignore the market evidence made available to them from the AIAL Valuation reports. There is nothing to suggest that the base land value of \$140,000 per hectare adopted by SP in its advice to AIAL was other than robust and supportable and for the airfield land alone comprising 351 hectares our assessment on a similar basis would equate to \$180,000 per hectare as at June 1999.

s) **Need control to ensure credibility of existing regime:**

BARNZ Position: BARNZ does not agree that the appropriate counterfactual is a continuation of the status quo and submits this

would reduce even further the threat of price control. BARNZ in effect believes the threat of price control is not enough and for the threat to be credible there must be a recommendation of some form of price constraint.

AIAL's Position: This appears to fly in the face of natural justice – does it follow that parties found not guilty of a particular offence serve some form of sentence so as to illustrate the strength of the threat of punishment? AIAL submits this is an arbitrary and somewhat surprising position to espouse.

Simon Terry Associates Ltd

20 As with the BARNZ submission, AIAL has commented on some key issues arising out of the submission made by Simon Terry Associates Ltd (STA) below.

21 AIAL also notes that this submission, like the BARNZ submission, makes bold assumptions and assertions that are not supported by sufficient economic theory. AIAL also considers the economic rationale contained within this submission is misguided and the assertions made are unfounded.

22 Turning now to the key points:

a) **Use of historic cost rather than ODRC:**

STA Position: STA endorse the use of historic cost.

AIAL's Position: Historic cost is inappropriate in a test for abuse of market power. The Commission should have used ODRC. Refer to the previous discussion on this point in response to the BARNZ submission.

Most of the arguments raised by STA are irrelevant in a test for abuse of market power where the competitive market is used as the

comparator. STA seems to be more focused on developing a regulatory framework than addressing whether regulation is justified.

Also, some of STA's points are misleading – such as: the future costs loaded on today's users; the precipitation of price shocks; and returns of sunk costs being rents not costs.

Contrary to STA's statement, all of these points are **not** well grounded in the relevant economics literature.

UK regulators have tended to use the historic cost at privatisation as the asset base in the context of a regulated industry. This does not mean it is the appropriate comparator in a question of whether prices should be regulated. The UK approach is appropriate as it is applied in those particular circumstances, that is, consistently from the date of privatisation and to the value of the entire company rather than a specific component. In these situations, the use of historic cost (of the company, not particular assets) is consistent with what investors would have anticipated at privatisation because it ensures they receive a return on invested financial capital. This approach is not, however, appropriate for undertaking a test of abuse of market power for a component of AIAL's business at a particular point in time.

STA's discussion on future investment incentives and financial viability is irrelevant in an assessment of whether price control is justified and contradicts statements made earlier that ODRC cannot guarantee sustainability. This may be because STA, at this point, ignores the use of optimisation, which would offset (potentially completely) the "windfall rent" estimation.

b) **Ability of price control to yield 50% of the estimated inefficiencies:**

STA Position: STA considers the Commission's estimate that the indirect costs of price control would be 50% of potential efficiency gains is too high.

AIAL's Position: The Commission's assumption that 50% of estimated inefficiencies could be realised through price control is well overstated. Refer to the earlier discussion in response to the BARNZ submission.

c) **The use of historic cost and opportunity cost:**

STA Position: It is not appropriate to mix valuation methodologies. The airport asset base should be valued at the higher of opportunity or historic cost.

AIAL's Position: It is not appropriate to mix valuations; ODRC should be used consistently throughout. Also refer to the earlier discussion in response to the BARNZ submission (benefits of ODRC).

STA has been distracted by the question of what a regulator should do rather than whether price control is justified. The correct comparator is a competitive market scenario, not the least possible valuation that results in the ongoing provision of services.

Additionally, under the STA's proposed approach, the airport would have no incentive to invest in airfield specific assets (at least while the opportunity cost of land remains above the historic cost of the asset base), as, at the margin, these assets would be valued at zero and investing in them would directly reduce AIAL's return on total capital employed.

Productivity Commission – Draft Report 24 August 2001

- 23 The Commission is obviously aware of the release of the Productivity Commission's Draft Report "*Price Regulation of Airport Services*" (24 August 2001) recommending that the CPI-X price caps applying to Melbourne,

Brisbane, Perth, Adelaide, Canberra and Darwin airports be removed. The Productivity Commission considers the anticipated efficiency gains (post privatisation) have been met. This point is directly relevant to AIAL which was corporatised in 1989 and then privatised in 1998. AIAL has already been disciplined to become and remain efficient. A CPI-X style regime is therefore unnecessary in the case of AIAL.

Better Regulation Task Force (UK) – Review of Airport Regulation (July 2001)

- 24 This report has been referred to earlier in relation to the acceptance of the key fact that **airlines are powerful commercial players in their own right and therefore possess significant countervailing power**. The following observations are also of note and support AIAL's position as taken with the Commission in the Inquiry, including:

“RPI-X has worked well in the first phase of privatisation. It encouraged culture change in the formally nationalised industries and the savings made have generally been passed through to consumers in significant price cuts” (page 19);

“Since privatisation emphasis has tended to be on cutting prices to customers and not on investment. With indications of an increasing need for investment in some areas must change” (page 19); and

“There is a view that the financial incentives engendered by our RPI-X may inhibit investment for the future (page 19).”

25 The report then questions (page 20) as follows:

“But is it necessary for the four airports above to be regulated to this extent?”

[ie Heathrow, Gatwick, Stansted and Manchester – price cap regulation]

“Airlines have demonstrated that they can negotiate effectively with airports. The fact that price rises at airports operated by the British Airports Authority have regularly been below the price cap set under the RPI-X formula casts some doubt on the value of the price control”; and

“Regulations requiring airports to negotiate charges with airlines have worked well for the Scottish and English regional airports since 1987”.

“This raises the question of why price caps are needed. With the trend to greater use of competition law it might be worth considering a move away from prescriptive price control”.

Concluding Comments

26 Whilst AIAL makes, by way of cross submission, the key points above, AIAL refers the Commission again to its earlier submissions of 27 April and 14 August 2001. The arguments and expert views espoused in these two submissions are those AIAL will be re-emphasising to the Commission at the Conference.

27 AIAL looks now to the Conference, and is confident the Commission will conclude in its final recommendation to the Minister **that price control is not required in the case of AIAL.**