



Submission
Commerce Commission Draft Report (July 2001)
& Preliminary Recommendations
- Airfield Price Control Inquiry

14 August 2001

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ATTACHMENTS

- ATTACHMENT 1:** CRITIQUE OF APPENDIX 8 – COMMERCE COMMISSION DRAFT REPORT – PRICE CONTROL STUDY OF AIRFIELD ACTIVITIES – 3 JULY 2001
- ATTACHMENT 2:** NATIONAL ECONOMIC RESEARCH ASSOCIATES – COMMENT ON THE COMMERCE COMMISSION'S DRAFT REPORT "PRICE CONTROL STUDY OF AIRFIELD ACTIVITIES" – A REPORT FOR AUCKLAND INTERNATIONAL AIRPORT LIMITED – AUGUST 2001
- ATTACHMENT 3:** EVIDENCE OF ALFRED E KAHN ON BEHALF OF AUCKLAND INTERNATIONAL AIRPORT LIMITED – 10 AUGUST 2001
- ATTACHMENT 4:** SUBMISSION TO COMMERCE COMMISSION ON THEIR DRAFT REPORT DATED 3 JULY 2001: PRICE CONTROL STUDY OF AIRFIELD ACTIVITIES AT AUCKLAND, WELLINGTON AND CHRISTCHURCH INTERNATIONAL AIRPORTS – DR ALASTAIR MARSDEN
- ATTACHMENT 5:** STATEMENT OF DEREK A NOLAN ON BEHALF OF AUCKLAND INTERNATIONAL AIRPORT LIMITED IN RELATION TO COMMENTS ON THE SECOND RUNWAY AT AUCKLAND INTERNATIONAL AIRPORT BY THE COMMERCE COMMISSION
- ATTACHMENT 6:** STATEMENT BY THOMAS CHARLES BASS – REGULATION – AUGUST 2001
- ATTACHMENT 7** COPY "PROPERTIES" – COMMERCE COMMISSION'S MODELS – CIAL AND AIAL

GLOSSARY OF TERMS

ABC	Activity Based Costing
ACAM	Avoidable Cost Allocation Methodology
ACCC	Australian Competition and Consumer Commission
ACI	Airport Council International
ADC	Airport Development Charge
AIAL	Auckland International Airport Limited
AIAL Consultation	The AIAL consultation with its substantial customers over the recently introduced increases in airport charges
AIAL Disclosure Statements	The Disclosure Financial Statements as at 30 June 2000 prepared for the first time by AIAL under the Disclosure Regulations
Air NZ	Air New Zealand Limited
Airport Authorities Act	Airport Authorities Act 1966
Amendment Act	Airport Authorities Amendment Act 1997
ARA	Auckland Regional Authority
ATM	Air Traffic (Aircraft) Movement
Auckland Airport	Auckland International Airport as operated by AIAL
BA	British Airways
BAA	British Airports Authority plc
BARA	Board of Airlines Representatives of Australia

BARNZ	Board of Airline Representatives of New Zealand
CAA (UK)	Civil Aviation Authority (UK)
CC	Competition Commission (UK) (formally the Mergers & Monopolies Commission)
CIAL	Christchurch International Airport Limited
CIP	The Critical Issues Paper prepared by the Commission for the purposes of the Inquiry and dated 16 March 2001
Commerce Act	Commerce Act 1986
Commission	New Zealand Commerce Commission
CPI	Consumer Price Index
CRNEC	University of Auckland's Centre of Research in Network Economics and Communications
Draft Report	The Commission's draft report – Price Control Study of Airfield Activities at Auckland, Wellington, and Christchurch International Airports – 3 July 2001
Disclosure Regulations	Airport Authorities (Airport Companies Information Disclosure) Regulations 1999
Electricity Inquiry	Ministerial Inquiry into electricity industry
EU	European Union
FDC	Fully Distributed Cost Approach
FRS	Financial Reporting Standards as contained in the Financial Reporting Act
IATA	International Air Transport Association

ICAO	International Civil Aviation Organisation
Identified airport activities	<p>Identified airport activities is as defined in the Airport Authorities Act and refers to airside services, including:</p> <ul style="list-style-type: none">• “Airfield activities” (the operation of runways, parking aprons, lighting, emergency services, and holdings of lands and assets to use to those services in the future);• “Aircraft and freight activities” (the activities undertaken, within a security area, to service and maintain aircraft, and handle the transport of freight, including hangars; refuelling, catering and waste disposal facilities, storage; and freight security, quarantine and customs services); and• “Specified passenger terminal activities” (the activities undertaken and facilities and services provided to handle passengers while they are airside, including seating, thoroughfares, airbridges, information and public address systems, customs, immigration and quarantine facilities; duty-free collection facilities; security and Police facilities).
Inquiry	The present inquiry by the Commission into airport price control on airfield activities at AIAL, CIAL and WIAL
ITB	International Terminal Building
LFA	Leigh Fisher Associates
LRMC	Long Run Marginal Cost
Minister	Minister of Commerce
MMC	Monopolies and Mergers Commission (UK)
MCTOW	Maximum Certified Take Off Weight

NECG	Network Economics Consulting Group
NERA	National Economics Research Associates
NPV	Net Present Value
NZIER	NZ Institute of Economic Research
ODRC (or DORC)	Optimised Depreciated Replacement Cost
ODV	Optimised Deprival Value
Original CIP	The first critical issues paper prepared by the Commission for the purposes of the Inquiry and dated July 1999
Qantas NZ	As operated by Tasman Pacific Airlines of NZ Limited
SACL	Sydney Airports Corporation Limited
SRMC	Short Run Marginal Cost
substantial customer	Substantial customer (as defined in the Airport Authorities Act) is a customer who contributes more than five percent of an airport company's revenue in respect of identified airport activities, or someone who represents a collection of customers who, in total, contribute more than five percent of an airport company's revenues, for example, BARNZ.
Telecoms Inquiry	Ministerial Inquiry into telecommunications industry
TRL	Transport Research Laboratory (UK)
TSC	Terminal Services Charge
TSLRIC	Total Service Long Run Incremental Costs
WACC	Weighted Average Cost of Capital
WIAL	Wellington International Airport Limited

1 EXECUTIVE SUMMARY

Commission's Draft Recommendation

1.1 In its Draft Report, the Commission concludes that:

“based on an assessment of the net efficiency benefits, the Commission’s preliminary view is that market conditions are such that only the airfield activities supplied by AIAL should be controlled”.

AIAL's Response

1.2 The Board and Management of AIAL are both disappointed and surprised at the preliminary view the Commission has reached.

1.3 Disappointed because the draft recommendation has been based on a qualitative analysis of net efficiency benefits which has been sourced from **incorrect** financial data and includes a series of basic calculation **errors**.

1.4 Surprised because the Commission has subjectively elected to adopt a number of economic principles that have very limited academic **support and no precedent when attempting to approximate a competitive market situation**.

1.5 AIAL considers that the preliminary assessment of the Commission, as detailed in the Draft Report, is unsustainable for a number of key reasons. First, and very importantly, the financial calculations contained in the Draft Report are incorrect.

A: Revised Financial Data Should Result in Revised Recommendations

1.6 AIAL has checked each and every financial calculation applying to AIAL as included in the Draft Report.

- 1.7 AIAL **has discovered a series of fundamental errors** in the source data used in the Commission's calculations.
- 1.8 These errors have a dramatic effect on the individual calculations and **effectively negate** the draft overall conclusions and recommendations drawn by the Commission in its Draft Report.
- 1.9 The impact of correcting these errors results in the annual net efficiency gains of price control of AIAL airfield activities being reduced from a net benefit to acquirers of \$2,440,135 **to a net cost of \$47,788 per annum.**
- 1.10 It must be noted however, that the revised calculations merely correct fundamental errors that have been made in the actual calculations, **no adjustment has (at this stage) been made to the underlying economic principles adopted by the Commission.**
- 1.11 AIAL also has received from its independent auditors, Deloitte Touche Tohmatsu, confirmation that:
- a) Any changes made by AIAL to the financial information contained in the Commission's models reflects the correct position; and
 - b) Any modifications made by AIAL to the Commission's assumptions are soundly and appropriately based.
- 1.12 Deloitte Touche Tohmatsu state (report attached as part of Attachment 1) that the adjustments:
- "highlight material errors in the financial data and logic used in the Commerce Commission's model and accordingly is not a reliable basis upon which to determine the benefits of price control".*

- 1.13 **AIAL must stress that, given the correction of fundamental financial errors, the Commission cannot (using the same quantitative framework and even accepting the economic methodology as well – which AIAL does not) reach a view that price control is recommended in respect of the AIAL airfield activities.**
- 1.14 It was with considerable concern that, as a consequence of the release of the Draft Report, the AIAL Board observed the AIAL share price fall from (approximately) \$3.80 to \$3.50. This reduction represents a loss in value for AIAL's shareholders of approximately \$125 million.
- 1.15 This concern is further exacerbated by the fact that the recommendations contained within the Draft Report are, in fact, based on incorrect financial data.
- 1.16 Importantly the Commission should note the effect of the correction of the fundamental financial data on the projected **returns going forward.**
- 1.17 Even using the economic principles adopted by the Commission (their AIAL Scenario 8) the projected returns for the 2001, 2002 and 2003 financial years are well below the Commission's target return of 8.40%.
- 1.18 In fact, merely applying the rationale set out in the Draft Report would result in AIAL having firm justification to increase its current airfield landing charges by a further **11%** - ie an additional 6% increase over and above the 5% increases previously signalled as applicable from 1 September 2001 and 1 September 2002.
- 1.19 Accordingly, AIAL has no reason not to proceed with the 5% increase which will be effective 1 September 2001 – and given the apparent justification for a further increase, it may well be that AIAL would be better served to further consult with the airlines over a larger increase.

- 1.20 **In respect of the financial data, AIAL must also record the seriousness with which it views the fact that a number of the financial models used by the Commission appear to have been sourced from Air NZ or its advisers.**
- 1.21 When one views the “properties” of the relevant files, the original author is clearly shown as Air NZ – refer Attachment 7.
- 1.22 Whilst the Commission may well have adapted the models to fit its various scenarios, the models appear to carry fundamental errors and invalid assumptions that were inevitably inherited by the Commission when it then undertook its own calculations and outcomes.

Invitation to Visit

- 1.23 In its original submission, and subsequently by letter dated 3 August 2001, AIAL repeated its invitation to the Commissioners to visit Auckland Airport and view, discuss and better appreciate the key issues currently being considered and debated as part of this Inquiry.
- 1.24 This invitation remains, and AIAL continues to be of the view that such a visit would assist the Commission in its appreciation of AIAL’s airfield operations.

B: Further Reasons why Commission’s Draft Recommendation is Unsustainable

- 1.25 AIAL considers the preliminary assessment detailed in the Draft Report is also unsustainable for the following additional key reasons:
- (a) The **economic rationale** espoused in the Draft Report which results in significant downward adjustments to the **asset base** of AIAL’s airfield assets, is incorrect (as illustrated in this submission);

- (b) **The existing regulatory regime** has not been afforded sufficient time to operate, and as such, AIAL considers the adequacy of this regime has not yet been fully appreciated. Once it is, AIAL considers price control, as an additional regulatory intervention, will not be deemed necessary nor, indeed, desirable¹. AIAL has not to date, and does not going forward, expect to earn excess returns on its airfield activities;
- (c) While AIAL does not refute its market power, insufficient weight has been attributed to the other **constraining factors** on AIAL's ability to earn excess profits, including the not insignificant weight of the countervailing power of airline customers; and
- (d) Also, the extensive benchmarking data supplied by AIAL in its first submission appears not to have been taken into account in the Draft Report. AIAL considers this is an omission on the part of the Commission. This data clearly provides an empirical (as opposed to a theoretical economic) reference point which illustrates AIAL's pricing behaviour, has been, and continues to be, internationally competitive.²

Taking each of these additional reasons in turn:

¹ AIAL reserves its position regarding the validity of a price control inquiry under Part IV of the Commerce Act at all, given the provisions of section 4A of the Airport Authorities Act 1966, regulation 17 of the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 and the other provisions of the legislative framework which together create a stand alone light handed regulatory regime applicable to airports.

² This approach mirrors the approach taken by the UK Government in considering price control. As stated by Mr Tom Bass in his statement set out in Attachment 6:

"The UK Government has said that in deciding whether to designate other airports for price control it would take into account:

- *The market position, including the extent of competition from other airports and other modes;*
- *Prima facie evidence of excessive profitability or abuse of a monopoly position;*
- *The scaling and timing of investment, and their implications for profitability; and*
- *Efficiency and quality of service."*

Incorrect Economic Rationale – Pricing Principles and Asset Base

1.26 The Commission has included three significant downward adjustments to the estimated value of AIAL's airfield asset base. AIAL does not agree with any of these adjustments for the reasons summarised below.

Second Runway Land

1.27 AIAL presently owns the necessary land required to construct and operate the second runway. This has been excluded by the Commission in the Draft Report from AIAL's chargeable asset base.

1.28 Exclusion of this asset appears to be based on two critical contentions, being:

- a) The asset is not "used and useful"; and
- b) "Today's consumers should only bear today's costs".

1.29 AIAL considers the economic rationale to support these contentions is flawed, and that the further and significant economic commentary set out in this submission will justify its inclusion.

1.30 AIAL contends that all **efficient** investments, consistent with the delivery of services today and into the future, should be included in the asset base.

1.31 AIAL sought an opinion from the highly respected international aviation economist Professor Alfred E Kahn from New York on the inclusion of land held for the second runway – refer to his statement in full – Attachment 3.

1.32 Professor Kahn rejected the Commission's exclusion of the land and states (page 13):

"According to the Commission's pricing principles, "Prices should send appropriate signals for determining whether new investment ...would be

efficient.” This is precisely the reason why inclusion of either short-term marginal congestion costs or their surrogate, the capital costs of the additional investment required to hold those costs within efficient limits, should be reflected in price currently. This principle clearly justifies AIAL’s assertion that “land held for future use that is associated with current operations can be included in the asset base where there is an intention (and reasonable certainty) to use the land at a future date for operational purposes”, and there is agreement from substantial customers on the prudence of that intention.”

1.33 Professor Kahn concluded in his statement (page 13) that:

“AIAL should be permitted to recover the net cost incurred in holding and developing this land during the development phase as that would involve a time profile of charges more closely approximating marginal costs and therefore economic efficiency than would the Commission’s proposed treatment of those costs; and it would do so without increasing the total burden on its customers.”

1.34 Ownership of the second runway land has been endorsed by AIAL’s substantial airline customers and the timing of its purchase from the point of view of being necessary for planning consent and preparatory development purposes is optimal and economically efficient. AIAL will illustrate in this submission that the timing of the purchase of this land was in fact optimal in terms of the minimisation of overall cost, which cost is ultimately borne by the users – AIAL’s airline customers.

1.35 In defining airfield activities, the Airport Authorities Amendment Act 1997 also specifically **includes**:

“the holding of any facilities and assets (including land) acquired or held to provide airfield activities in the future (whether or not used for any other purpose in the meantime)”.

Land held by AIAL for the second runway clearly falls within this category. Despite all of this, this asset is then excluded from AIAL’s asset base by the Commission on the grounds that it is not “used **or** useful”.

1.36 The implication appears to be that AIAL should consider selling the land - only, presumably, to have to then re-purchase it closer to the time for the opening of the second runway (around 2007). This option, in AIAL’s opinion, is:

- Both nonsensical and impractical;
- Likely to be ultimately inefficient (and to the serious detriment of the acquirers of AIAL’s airfield services); and
- Pays no heed to the factual realities of efficient airport management.

1.37 The “theory” in the Draft Report is that *“today’s consumers should only bear today’s costs”*. This theory is highly questionable from any reasonable standpoint on economic principle; and AIAL’s considerable expert economic advisers have found no grounds to support why it should be so applied in the way that it has been applied. In particular, the theory seems to directly contradict (economic) marginal cost pricing principles and poses inherent difficulties in a market characterised by investments in assets which are very large, lumpy and have long lives.

1.38 The theory also ignores the myriad of planning and practical issues involved in planning and commissioning such a large and significantly important infrastructure asset, such as a runway. A detailed discussion is set out in this submission on issues relative to sustainable management for future generations,

noise control implications, no other viable location options for a second runway, how AIAL's planning sits within the proposed District Plan for Manukau City and the inadequacies of compulsory acquisition under the Public Works Act 1981.

1.39 Lastly, there are a number of international precedents illustrating the validity of including such assets in an airport's charging base for pricing purposes. Specifically:

- a) Terminal 5 at Heathrow Airport was included several years ago prior to receiving planning approval (CAA); and
- b) Land held for future development at the following international airports:
 - Manchester Airport (endorsed by CAA (UK));
 - Stansted Airport (endorsed by CAA (UK));
 - Melbourne Airport (endorsed by ACCC); and
 - Brisbane Airport (endorsed by ACCC).

Historic Cost v ODRC

1.40 The value of specialised airfield assets has been included on a depreciated historical cost basis rather than on the basis of optimised depreciated replacement cost (ODRC).

1.41 Up until now it has been generally accepted within New Zealand that ODRC has clear advantages over historical cost valuation and is appropriate for valuing specialised assets. It has been widely endorsed, including by way of example, by the Ministry of Economic Development in other contexts such as the electricity industry.

- 1.42 It is not clear in the Draft Report exactly why a somewhat different approach (ie that historic cost valuation is more appropriate) is arrived at, and adopted as part of the recommendations of the Draft Report.
- 1.43 AIAL has included within this submission substantial economic rationale which continues to support the use of ODRC valuation for its specialised assets.
- 1.44 AIAL notes in the Draft Report that there is reference to the fact that:
- “ODRC does not have any clear advantages over historic cost.”*
- 1.45 ODRC replicates the competitive market situation by attempting to measure:
- a) The valuation that would be consistent with the price charged by an efficient new entrant into an industry. It is therefore consistent with the price that would prevail in the industry in the long run; and
 - b) The price a firm with a certain service requirement would pay for existing assets in preference to replicating them.
- 1.46 **The test adopted in the Draft Report is one of abuse of market power, whereas, in AIAL’s view, historic cost ignores the comparative cost of entering the market and is therefore not an appropriate test to measure abuse or excess returns.**
- 1.47 Additionally, in respect of this issue, there does not appear to be an analysis of the **consequences** of a decision to value such specialised assets on a historic cost basis.
- 1.48 **Following the logic set out in the Draft Report, the decision to adopt Historic Cost could well lead to AIAL selling the runway assets and for the acquirer, having established a new revised historic cost (purchase price),**

to levy charges on airline users based on their more recent, and higher, historic cost.

- 1.49 Alternatively, AIAL could enter into a lease-back arrangement with international financiers which would also create the same result with AIAL continuing to operate the asset, albeit on, once again, a higher historic cost basis.
- 1.50 It therefore follows, in AIAL's view, that the logic set out in the Draft Report is flawed. The assertion that assets only have an economic (opportunity cost) value when they have an alternative use is simply incorrect. Such long life assets have an obvious economic value to the existing operator and to any potential purchaser.
- 1.51 The Commission's current preference towards historic cost also directly refutes the instruction received by AIAL from the Government in May 1998 when the then shareholders of AIAL (Government 51.6%) directed this company to undertake a revaluation of assets on an ODV basis.
- 1.52 It is also illogical to contravene accepted accounting standards. AIAL simply should not value its assets in its statutory accounts on one basis and then go about setting charges on an entirely different basis (ie concessions on pricing negotiations do not amount to a change in valuation methodologies and principles). To do so would result in values in the accounts failing to meet the net realisable value test. Such assets would then have to be written back to whatever value was incorporated in charges – yet another strong incentive to arrange the sale of the asset.
- 1.53 Likewise, it would seem to be equally illogical that airport charges might need to be changed dramatically, and potentially increase significantly, following the sale of these operational assets to reflect the purchase price paid by a new owner.

Seawall and Seabed

- 1.54 In a similar vein (but with a less dramatic result) the exclusion of the seabed and seawall leads to a misleading result. Whilst AIAL is prepared to concede that arguments exist for suggesting that a value should not be ascribed to the seabed in the asset base for charging purposes, it is difficult to conceive why the seawall should be excluded, given the fact that it is both a necessary civil work and its existence is an integral part of the runway construction.

Land Values

- 1.55 The Telfer Young Peer Review Report contained in the Draft Report generally confirmed the land valuation principles and practices followed and adopted by AIAL's land valuers.
- 1.56 AIAL, however, does have some difficulty in accepting that Telfer Young as Registered Valuers are professionally qualified to issue recommendations in respect of economic pricing principles. Reference in their report (page 298 of the Draft Report) that *"economically, it would be difficult to justify the inclusion of the second runway land in landing charges"* appears to go well beyond issues Telfer Young are qualified to comment upon.

Existing Regulation is Sufficient

- 1.57 AIAL has never argued that competition is not limited in the market for its airfield activities. However, due weight (and AIAL considers this has not been the case) should be given to the existence of two particular and significant constraining factors, being the existing regulatory regime and the countervailing powers of the airlines.

1.58 AIAL has illustrated that with correction of the fundamental errors in the financial data used by the Commission there is **no evidence of excess returns being earned** – with, in fact, the opposite being the case.

1.59 It is stated in the Draft Report:

“notes that the current inefficiencies may be able to be removed by a form of regulation other than price control, for example, one that involves a requirement on the airports to negotiate on price and service (rather than merely to consult) subject to set pricing guidelines, a requirement to disclose information, and the existence of an external body to act as an arbitrator in disputes over the outcome of negotiations”.

1.60 This seems to imply that, at its Draft Report stage, the Commission was not necessarily persuaded that price control was the most economically efficient way to proceed, and instead may be inclined to an alternative view that extensions to the current regulatory framework might provide a preferable solution.

1.61 The existing regulatory regime is designed to ensure that excessive charges are not set by the airports, by requiring both disclosure and consultation. This regime has not yet had time to be fully tested, and negative conclusions cannot, therefore, be meaningfully drawn about the regime at this stage. Moreover, the adequacy of the regime cannot simply be dismissed on the grounds that Air NZ (no doubt with tactical reasons in mind) has brought litigation regarding AIAL’s conduct of the required statutory consultation process.

1.62 Importantly, and something which is not adequately addressed in the Draft Report, the existing regime already includes provisions which allow for modification of the existing regime and for further direction and control (by way of the powers given to the Secretary for Transport to set guidelines under regulation 17 of the Disclosure Regulations). These guidelines could remove a number of

the key issues in dispute (being those issues which figured prominently in the recent AIAL Consultation), such as valuation methodology, the assets which should be valued and the appropriate return on investment in those assets (WACC).

- 1.63 Under the present “light-handed” regulation, a process of price control already exists – airport companies are effectively only allowed to achieve a return equivalent to the WACC on the assets employed plus a recovery for costs.
- 1.64 The only outstanding issue with the current regulation would appear to be the basis for the valuation of runway assets and the inclusion of land held for future development. Again the Disclosure Regulations foresaw these potential difficulties and contain provisions for the issuance of guidelines to assist in the resolution of potential dispute on these issues.
- 1.65 AIAL’s pricing methodology follows the principles of the Disclosure Regulations and the AIAL Disclosure Statements – the Commission would be aware that each year following issuance of AIAL’s Disclosure Statements, AIAL has undertaken to re-examine the financial performance of each of the Identified Airport Activities relative to the forecasts included in the AIAL Consultation for the setting of charges. Any evidence of excess returns (eg via higher than anticipated airline activity or lower costs) will be taken into account in the pricing formula thereby resulting in lower charges. **On the other hand, AIAL does not expect to be able to increase charges (above the levels consulted upon) in the event airline activity is lower than forecast or costs turn out to be higher.**
- 1.66 In other words, **all the upside is to the advantage of AIAL’s airline customers (as opposed to an airline’s passengers), while all the downside is at the risk of AIAL.** This risk has, in fact, not been fully appreciated in the calculation of AIAL’s WACC.

- 1.67 Another important factor that appears to have been totally overlooked in the Draft Report is the **successful** conclusion of the AIAL Consultation process in respect of AIAL's second largest customer, Qantas Australia.
- 1.68 **The Company and Qantas have reached a commercial agreement on the level of price increases to apply for five years and the terms and conditions of this agreement were, and still are, available to all other airlines.**
- 1.69 The prospect of price decreases in years four and five are well signalled within this particular agreement.
- 1.70 The agreement with Qantas illustrates that, with a reasonable commercial approach, satisfactory outcomes under the current regulatory regime are indeed achievable.

Countervailing Powers – Another Constraining Factor

- 1.71 A level of competition exists between airports (particularly in some market segments), which can be leveraged by an airline across the spectrum of its entire use of a competing airport. In this respect, the Draft Report does not appear to have taken into account the scale of the potential competition posed to AIAL. For example:
- a) By Hamilton and by other airports for trans-Tasman flights;
 - b) By the possibility of a second domestic airport in the Auckland region (eg. Ardmore or Whenuapai); and
 - c) By the steps taken by other regional airports to establish alternative airfreight gateways (eg the mooted plans for Ohakea).

1.72 AIAL's "substantial customer" airlines do, in fact, have significant countervailing powers. AIAL does not consider sufficient weight is given to this fact. AIAL notes again for the Commission's benefit:

- a) Since the corporatisation of AIAL, its airline customers have had significant input into the development of Auckland Airport and its associated investment decisions (often resulting in significant alterations to AIAL's original proposals);
- b) AIAL's airline customers have extensive representation in numerous airport operational management matters;
- c) AIAL is not able to withdraw supply like most commercial enterprises by refusing landing access to its runway, even if the carrier concerned withholds payment of landing charges;
- d) AIAL's airline customers have acted aggressively and in concert, and continue to (understandably in their own interests), via BARNZ and two significant global alliances (One World and Star) – which, taken together, have had the effect of increasing the size and strength of the airlines' countervailing monopsony powers. These powers have been reinforced by the evident willingness of certain airlines to resort to costly and time-consuming litigation; and
- e) The economic power of the airlines – particularly in aggregate via their global alliances - far exceeds that of AIAL. The airlines have an ability to impact significantly on AIAL's returns and profitability via relatively small changes in flight schedules (for example, by changes in aircraft type and codesharing arrangements, without detrimentally affecting the service level to their passengers).

Support for Major Customers

- 1.73 While it may appear that, by virtue of the various views espoused at this Inquiry and in the media, the relationship between AIAL and Air NZ, is somewhat strained, this is not a true reflection of the status of the relationship. On a day-to-day basis operational co-operation is essential for the smooth running of any airport operation and such co-operation is provided.
- 1.74 AIAL has, over time, always involved and consulted with Air NZ and its other major airline customers in all planning and operational issues. In fact, the assistance provided by AIAL to, specifically its largest airline customer, Air NZ, has been, by any objective standard, both considerable and generous.
- 1.75 In the lead-up to the publication of the Draft Report and in the lead-up to similar “inquiries” by the ACCC and Productivity Commission within Australia and in various other forums both local and overseas – much has been made of the supposed attitudes of airports in this part of the world towards their particular airline customers – in short, the perception that airports collectively do little for their key airline customers and any benefit or service enjoyed by the local carrier has been achieved against total opposition from the airport concerned.
- 1.76 At Auckland International Airport, this assertion cannot be made.
- 1.77 The list detailed below provides a number of examples of assistance given by AIAL to its major customer, Air NZ, over a period of many years:
- a) On becoming a corporate entity in 1988, AIAL immediately provided to Air NZ the long sought after new international check-in facilities;
 - b) Providing new and improved roading access to airside, including subdividing the inflight catering land and facilities;

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- c) Restructuring the Quarantine Incineration operations in the mid 1990's to accommodate over optimistic airline forecasting – (substantial write-off for AIAL involved as a consequence);
- d) Providing staff carparking at a discount to rentals paid by other airlines;
- e) Effecting major changes in the International Terminal Expansion Project (1995-1997) to provide for Premier Check-in facilities;
- f) Re-designing the second floor of the ITB to accommodate a significant VIP lounge;
- g) Allowing Koru Club carparking to use public car space at peak times (DTB);
- h) Allowing certain airline alliance signage within common user areas of the ITB;
- i) Extending a staff carpark to assist crew parking, thus helping in negotiations on crew allowances;
- j) Funding of numerous domestic and regional terminal studies at significant cost;
- k) Forecourt changes at DTB to accommodate valet parking;
- l) Pre-funding by AIAL of the Common User Terminal Equipment (CUTE) system;
- m) Waiving of all landing fees for Koru Care flights;
- n) Providing (on request) escorts for night access to staff carparks;
- o) Accepting sub-optimal returns on the DTB;

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- p) As a by-product of the runway rehabilitation programme, providing new gate lounge 30;
- q) Assisting with the funding of new water mains to new stores premise;
- r) Continuing to reserve strategic land for aviation development;
- s) Accommodating all requirements of Air NZ's current hubbing strategy;
- t) Continuing to accept the fact that the departure fee will not be collected by airlines (within ticket price) as is done by many airlines i.e. for instance, in Australia and generally throughout the world;
- u) Allowing major service suppliers (in respect of catering and ground handling) to continue to supply direct without any fee basis as is paid by direct competitors;
- v) Recognition of the favourable tenant position Air NZ continues to have on its jetbase operations since 1965;
- w) Providing access controls and associated equipment for provincial operations (DTB);
- x) Provision of new flight information displays at DTB;
- y) Assisting video and film crews for advertising and promotional work; and
- z) Significantly reducing electricity tariffs during the period AIAL acted as the electricity supplier.

Whilst providing a number of examples this list, as noted, is not exhaustive.

Benchmarking

- 1.78 No reference of any substance is made in the Draft Report to the price and performance benchmarking data supplied by AIAL in its earlier submission. This data provides an empirical (as opposed to a theoretical economic) evidence that AIAL's pricing behaviour (both historically and at present) is internationally competitive (ie appropriate and reasonable). This data has not been given due consideration by the Commission. Efficiency and quality of service are obviously important but as the Draft Report currently stands, no heed appears to be taken of this important factor.

Summary

- 1.79 It is AIAL's view that, it is the Commission that carries the burden of demonstrating a case for changing the status quo and recommending price control regulation.
- 1.80 **Even using the economic principles detailed in the Draft Report, following correction of the fundamental errors in financial data, no case has been proven for the introduction of price control in respect of AIAL.**
- 1.81 It could well be argued that, **even if** the Commission's calculations were soundly based, a net benefit of \$2.4 million is not, given the subjective issues involved, significant enough to conclude that price control should be imposed. This sum is well within any reasonable margin of error.
- 1.82 In short, it is not obvious, even without correcting the errors that the Commission has made in its calculation of "excess returns", that the not-inconsequential measure of recommending price control is warranted. It is certainly not able to be substantiated by the Draft Report when the calculation errors contained within the models are corrected.

- 1.83 Whilst AIAL commends the Commission for its overall approach and decision to use a quantification framework in trying to estimate market inefficiencies and the potential costs and benefits of price control, it considers that, unfortunately and totally unfairly to AIAL, undue weight has been placed on a number of overly simplistic calculations, which are capable of producing very misleading results. (This fact is demonstrated by AIAL's detailed reworking and correction of the models detailed in the Draft Report – the results of which present an entirely different conclusion.)
- 1.84 AIAL's overall conclusion is that the Commission's estimates of the allocative, productive, and dynamic efficiency gains that will likely result from price control have been calculated incorrectly and are inaccurate. Nor does AIAL consider such inefficiencies exist as:
- a) The **allocative** inefficiency estimates are predicted on wrongly calculated excess returns;
 - b) The **productive** inefficiency estimate, the Commission itself admits, has no empirical basis; and
 - c) The **dynamic** inefficiency estimate for AIAL has been set without proper regard to practical issues, such as the legacy of the investments in the seabed and seawall, or the need for current ownership of the land required for future development.
- 1.85 As a result of this, the draft recommendation for "price control in the case of AIAL" as detailed in the Draft Report is unsustainable. This is particularly the case when it is borne in mind that there are the well-documented risks inherent in price control and:
- a) It is generally acknowledged in New Zealand to be undesirable (and has been described as a "last resort" by the present Government); and

- b) Overseas experience with airport price controls indicate major shortcomings (“gaming” behaviour and higher prices, capacity shortages and delays in investment, and other operational distortions), which are causing many regulators to favour a move away from explicit price control regimes to more flexible frameworks, similar to the one that is already in existence in New Zealand.

Going Forward

- 1.86 It is a simple task to identify the time period when the tourism industry within New Zealand started to gather real momentum. It was in the early 1970’s and coincided with the introduction of the Boeing 747 – the first wide-bodied aircraft.
- 1.87 No other aircraft to date has had such an impact on how people travel.
- 1.88 The advent of the Airbus A380, expected to be in commercial use around the year 2007 and over time probably carrying 1,000 passengers, will without doubt, impact on aviation in much the same way as the 747 did some 30 years ago.
- 1.89 Development planning at Auckland International Airport must allow for the citizens of New Zealand to be, not only served, but to also benefit from such advances in technology.
- 1.90 Large aircraft do not serve many cities and regions of New Zealand. Connecting at Auckland is the reality.
- 1.91 It is in no one’s interests to have such connection further diluted over time if the facilities required in the future, are not provided for now.
- 1.92 In this regard it should be noted that both Qantas Airways and Singapore Airlines have already placed firm orders for the A380 – and both of these airlines continue to express ongoing commitment to Auckland Airport and to this region.

Structure of AIAL Submission

1.93 Each of the points discussed in this Executive Summary is elaborated on in further detail, together with answers to the individual questions posed by the Commission in its Draft Report, under the following main headings (which reflect the structure of the Draft Report);

- Section 2 - Draft Report Calculations, Tables and Conclusions
- Section 3 - Limited Competition
- Section 4 - Pricing Principles
- Section 5 - Asset Base
- Section 6 - Target Return (WACC)
- Section 7 - Allocative Efficiency and Cross-Subsidisation in Pricing
- Section 8 - Excess Returns
- Section 9 - Inefficiencies
- Section 10 - Control Necessary or Desirable in the Interests of Acquirers
- Section 11 - Are Market Conditions such that Control should be Imposed?
- Section 12 - Conclusion

2 DRAFT REPORT CALCULATIONS, TABLES AND CONCLUSIONS

2.1 The Commission has opted for a quantitative approach to the determination of whether Section 52 of the Commerce Act has been met (that control is necessary or desirable). The intended objectivity of this approach – in attempting to provide numerical estimates of the prevailing economic inefficiencies (of a market in which there is limited competition), and to quantify the potential net benefits of control – is to be commended.

2.2 The component calculations cover a variety of areas and include the following key tables:

- Average Assessed Annual Returns (Table 40);
- Potential Dynamic Inefficiency (Table 47);
- Estimated Future Excess Returns (Table 49);
- Potential Benefit to Acquirers (Tables 54, 56 and 57);
- Estimates of the Potential Benefit and Costs to Acquirers by Price Control (Table 58); and
- Estimates of the Annual Net Efficiency Gains of the Price Control of Airfield Activities (Table 59).

2.3 In checking the various calculations associated with each table, AIAL has discovered a series of fundamental errors in the source data used in the calculations. These errors have a dramatic effect on the individual calculations and, in turn, the draft overall conclusions detailed in the Draft Report.

2.4 The impact of correcting the identified errors is illustrated in the following revisions to the tables included in the Draft Report. Within this context, AIAL's

independent auditors (Deloitte Touche Tohmatsu) state (refer to full report – Attachment 1) that AIAL’s adjustments:

“highlight material errors in the financial data and logic used in the Commerce Commission model and accordingly is not a reliable basis upon which to determine the benefits of price control”.

**Average Assessed Annual Returns on Airfield Activities (AIAL) 1989 – 2000
(Table 40)**

2.5 The Draft Report’s assessment of AIAL’s historical returns (between 1989-2000) on its airfield activities contains a number of broad, pro-rata methods of estimation which have little or no foundation and produce results that are likely to be biased.

2.6 Examples of the more significant errors include:

- a) The adoption of the proportion of total revenue accounted for by airfield revenues in the year 2000 as the basis for calculating airfield operating expenses (as a fixed proportion of total expenses) in previous years. AIAL’s airfield revenues have declined progressively, from 40% in 1989 to 26% in 2000 (as shown in the Draft Report’s own calculations); and the Draft Report’s basis of calculating airfield operating expenses on a fixed (26%) basis therefore results in a significant understatement of expenses and a corresponding overstatement of returns in previous years;
- b) The Draft Report’s assumption of a nominal 33% tax expense ignores the actual tax expenses borne by AIAL (which ranged from 42-36% between 1989 and 1996) largely because of the lower rate of depreciation on the runway for tax purposes. Again, the Draft Report’s method of calculation results in higher estimated levels of return for AIAL’s airfield activities in past years; and

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- c) The manner in which the Draft Report has calculated the estimated revaluation gains in individual years, and adjusted for the exclusion of the value of the seabed, seawall and land purchased for the second runway is inaccurate; and results in unjustifiably large reductions in the value of the underlying airfield asset base, and hence incorrect calculations regarding the levels of “excess returns” in individual years. The type of errors that the Commission has made in the Draft Report include the simple transposition of figures between 1999 and 2000, without any apparent attempt to check or reconcile the numbers in the Draft Report’s estimation model with AIAL’s audited disclosure information.

	Actual Returns	Target Returns	Excess Returns
AIAL 1989-2000			
Commission’s calculation	13.47%	9.76%	3.71%
Corrected AIAL calculation	8.12%	9.69%	(1.57%)

Potential Dynamic Inefficiency (AIAL), Per Annum (Table 47)

2.7 The calculation of dynamic inefficiency in the Draft Report is based on its estimate of the value of optimised-out assets³ (the seabed, seawall and land held for the second runway).

2.8 In deriving its estimates of the relevant asset values, the Draft Report has:

³ Costed at the risk-free rate of 6.92%.

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- a) Overstated the value of the second runway land by wrongly including the value of all future (non-airfield) expansion assets, resulting in an overstatement of around \$26.0 m; and
- b) Included the seabed at the value shown for it in AIAL’s statutory accounts (\$30.1 m), rather than on the basis of the adjusted value included in AIAL’s pricing models (\$10.1 m).

2.9 These straightforward calculation errors are compounded by the implied double-counting in excluding the same assets from the allowable asset base for assessing excess returns (allocative inefficiencies) and using the same asset values as a proxy measure of dynamic inefficiencies.

Potential Benefits (\$)	
Commission’s estimate	6,711,684
Corrected AIAL estimate	2,143,584

Estimated Future Excess Returns (for AIAL) (Table 49)

2.10 The estimates of future excess returns detailed in the Draft Report incorporate a number of significant flaws:

- a) They incorrectly assume that future price rises apply for the full year in which they are introduced;
- b) They allow for no increases in future expenses (due to future MCTOW and passenger growth, and additional operating areas and equipment); and

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- c) They fail to include projected levels of capital expenditure in the estimated future values of the allowable asset base used for return calculation purposes.

	Excess Returns (\$) Commission's Estimates	Excess Returns (\$) Corrected AIAL Estimates
Year 1	3,797,395	Negative
Year 2	5,402,391	Negative
Year 3	7,087,637	Negative

Potential Benefit to Acquirers from the Elimination of Allocative Inefficiencies and Excess Returns (AIAL) (Table 54)

2.11 The same comments apply as in the context of the calculation errors discussed above under Table 49.

Potential Benefits (\$)		
	Commission's Estimates	Corrected AIAL Estimates
2000	1,284,609	Negative
Year 1	3,813,196	Negative
Year 2	5,432,850	Negative
Year 3	7,137,567	Negative
Average	4,417,055	Negative

**Potential Benefit to Acquirers from the Elimination of Dynamic Inefficiency
(Per Annum) (Table 56)**

2.12 The comments about the calculation errors contained in the Draft Report in estimating potential dynamic inefficiency (Table 47 above).

Potential Benefits (\$)	
Commission's estimate	6,711,684
Corrected AIAL estimate	2,143,584

**Summary of Potential Benefits to Acquirers from Price Control, Per Annum
(Table 57)**

2.13 The Draft Report has produced overstated estimates of the "potential benefits to acquirers" on the basis of its:

- a) Errors in calculating allocative efficiency (excess returns) and dynamic efficiency benefits – as outlined above (Tables 54/49 and Tables 56/43); and
- b) Inclusion of an arbitrary estimate of potential productive efficiency benefits (based on an unfounded nominal estimate of 1.0% of total airfield operating expenses, excluding depreciation).

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	Allocative Efficiency & Transfers	Productive Efficiency Benefits	Dynamic Efficiency Benefits	Total Potential Benefits
	(\$)	(\$)	(\$)	(\$)
Commission's estimate	4,417,055	131,910	6,711,684	11,260,649
Corrected AIAL estimate	-	131,910	2,143,584	2,275,494

Estimates of the Potential Benefits and Costs to Acquirers of Price Control on Airfield Activities (AIAL) (Table 58)

2.14 Correcting the basic calculation errors made in the Draft Report (as outlined above) results in a significantly revised estimate of the potential net benefits to acquirers of price control – changing the result from a potential net benefit of \$4.4 m to a potential net cost of \$0.1 m (this does not include changes to the Commission's underlying assumptions – only obvious errors and seemingly biased data calculations).

Benefits	Commission's Estimates	Corrected AIAL Estimates
Reduced excess returns and allocative efficiency (consumer surplus to acquirers)	\$4,417,055	Negative
Reduced productive inefficiency	\$131,910	\$131,910
Reduced dynamic inefficiency	<u>\$6,711,684</u>	<u>\$2,143,584</u>
Total Benefits	\$11,260,649	\$2,275,494
Costs		
Direct costs	\$1,200,000	\$1,200,000
Indirect costs (50% of the benefits above)	<u>\$5,630,324</u>	<u>\$1,137,747</u>
Total Costs	\$6,830,324	\$2,337,747
Net Benefits to Acquirers	\$4,430,325	(\$62,253)

2.15 The table above uses the estimates of the cost of price control contained in the Draft Report and shows, even using those costs, that there is no net benefit to acquirers. It should, however, be noted that the Draft Report's estimates of the costs of price control are questioned by AIAL's experts, refer to the report from NERA (Attachment 2).

Estimates of the Annual Net Efficiency Gains of the Price Control of Airfield Activities (AIAL), Per Annum (Table 59)

2.16 The net overall impact of these corrections, on the corresponding calculation of the net efficiency gains of price control set out in the Draft Report, is similar: changing the overall finding from one of price control producing a net benefit of \$2.4 m to it resulting in a net cost (efficiency loss).

Benefits	Commission's Estimates	Corrected AIAL Estimates
Reduced allocative inefficiency	\$436,678	\$28,929
Reduced productive inefficiency	\$131,910	\$131,910
Reduced dynamic inefficiency	<u>\$6,711,684</u>	<u>\$2,143,584</u>
Total Benefits	\$7,280,272	\$2,304,423
Costs		
Direct costs	\$1,200,000	\$1,200,000
Indirect costs (up to 50% of the benefits above)	<u>\$3,640,136</u>	<u>\$1,152,211</u>
Total Costs	\$4,840,136	\$2,352,211
Net Benefits	\$2,440,135	(\$47,788)

2.17 It must be understood that AIAL's revised calculations (as shown above) merely correct the fundamental errors that have been made in the Draft Report in its actual calculations. In the reworking of the Draft Report's calculations, **no adjustments have been made to the underlying economic principles or**

estimated costs detailed in the Draft Report. The correctness of the application of a number of these principles is discussed later in this submission.

Amended Overall Conclusion

- 2.18 In overall terms, AIAL believes that an undue and overstated level of confidence is placed in the Draft Report on calculations which contain a number of material errors and which thus result in figures (findings) to which no weight should be applied.
- 2.19 Simple re-calculation of the various tables (to correct for basic errors) results in the opposite result to the original finding in the Draft Report. This changes the estimated overall effect of introducing controls over AIAL's airfield activities from a **net benefit of \$2,440,135 to a net cost of \$47,788 per annum.** This suggests that there is no basis (under the approach adopted in the Draft Report and using the same quantitative framework) for recommending pricing control over AIAL's airfield activities.

3 LIMITED COMPETITION

Commission's Preliminary Conclusions

- 3.1 Under the Airport Authorities Amendment Act 1997, airfield activities are defined as the activities undertaken to enable the take-off and landing of aircraft. The Draft Report attempts to clarify the boundaries of the market by delineating it in such a way that it not only includes the take-off and landing of aircraft but also other inseparable operational activities such as aerodrome control, aircraft maintenance (excluding long-term aircraft repair and maintenance work) and ancillary aircraft servicing activities.
- 3.2 The Draft Report goes on to identify the limited supply-side substitutability between airports, and the economies of scale and scope in operating major international airports. The Draft Report then suggests that these factors point towards the:
- a) Need for a wide market definition (ie bundling together airfield activities as defined into a single market); and
 - b) Associated existence of limited competition (because of the barriers to new entrants and the destination-specific nature of the demand for airfield activities at each airport).
- 3.3 The Draft Report also inclines to the view that airports have significant potential pricing power based on the low price elasticity of demand for airport services.

AIAL's view - Understatement of Constraining Competitive Market Pressures

- 3.4 AIAL believes that the Draft Report has seriously understated the constraining competitive market pressures which AIAL faces in the form of:

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- a) Competition at the margin from other airports (which will potentially impact significantly on its profitability because of the high fixed cost structure of airports); and
- b) The strength of the countervailing power of airlines who use Auckland Airport, as evidenced by their:
- Active involvement in, and detailed knowledge of, Auckland Airport through their representation on numerous airport planning and operational committees;
 - Collective monopsony strength (through BARNZ and the Star and One World Alliances); and
 - Ability to penalise any potential market abuse on the part of any airport in New Zealand through their demonstrated willingness to resort to costly legal processes and payment withholding tactics.
- 3.5 **Accordingly, although competition may be limited, it is AIAL's view that the limitation is not absolute and that there are significant constraining factors to curtail AIAL's ability to exercise market power.**
- 3.6 Furthermore, the existence and scale of these constraints is evidenced by the Commission's own findings which show that WIAL has not been able to earn even "normal" profits and AIAL's correction of the basic errors and biased data calculations in the modelling contained in the Draft Report show that AIAL has also earned less than normal returns. AIAL has not examined CIAL's figures.

Commission's Questions – Specific Responses

3.7 *Is the Commission's approach to determining whether section 52(a) is met correct?*

a) The Commission has adopted an overall approach that AIAL concurs with, which involves considering both structural and behavioural issues. In particular, in paragraphs 2.24 to 2.29 of its Draft Report, the Commission suggests that competition analysis should take into account the:

- Number and size distribution of independent sellers, especially the degree of market concentration;
- Height of barriers to entry, that is the ease with which new firms may enter and secure a viable market;
- Extent to which the products of the industry are characterised by extreme product differentiation and sales promotion;
- Character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration;
- Nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities; and
- Behaviour in the market.

b) However, the Draft Report does not follow this analysis. As a result, its conclusion is open to question.

c) In particular, the Commission has not fully considered the nature or implications of the formal alliances between airlines. Nor has the

Commission taken into account the airports' returns analysis as part of its assessment of market power. An analysis of airports' returns is the only way to assess whether market factors have actually constrained their ability to earn excess profits. It is thus a better indicator of behaviour, rather than relying on judgments and assumptions.

- d) In addition, the Draft Report also fails to assess and take into account the impacts and ability of the existing light-handed regulation to contain the market power that airports may have.

3.8 *Are the markets appropriately defined?*

- a) Broadly yes. However, the Draft Report rightly identifies that the market constitutes a number of different segments, namely the:
- Market for airfield services for international flights;
 - Market for airfield services for large, commercial domestic flights; and
 - Market for small general aviation aircraft flights.
- b) The Draft Report includes a useful high-level discussion of the different competitive characteristics of these separate segments but stops short of any in-depth analysis. Further analysis might have qualified the conclusion then reached, such that only a subset of the airfield services market was found to have limited competition.

3.9 *Do any additional markets require consideration?*

No. AIAL considers the Commission has covered the key markets which would require consideration for the purposes of this Inquiry, although, as stated above, further work on the subsets within each market could have been undertaken.

3.10 *Is the Commission's assessment of the nature and scale of current competition in the supply of airfield activities correct?*

- a) Broadly yes. However, in its submission to the Commission, AIAL provided a number of examples of the regional competition for the supply of airfield activities which are not alluded to in the Draft Report.

- b) In addition, the main example referred to in the Draft Report (Hamilton Airport) poses a greater competitive threat and possible role in AIAL's market than is appreciated in the Draft Report. To illustrate, Hamilton Airport is presently trialing an arrangement with the Gold Coast Airport to land B737 aircraft on a reciprocal basis. This will be detrimental to AIAL as much of the potential passenger pool living in South Auckland and the Waikato, Bay of Plenty and Central Plateau regions of New Zealand would be more inclined to stop at Hamilton (if choosing to go to one of the many coastal destinations of Australia) than drive the additional 80 minutes to Auckland Airport. If flights out of Hamilton are also undertaken by "cut price" carriers, then another additional dimensions emerges. Auckland residents may also be prepared to drive to Hamilton to fly. 80 minutes travel to an international airport is not considered prohibitive by many airline passengers, and certainly not by international standards.

3.11 *Is the Commission's assessment of the likelihood, timing, nature and scale of potential new entry in the supply of airfield activities correct?*

- a) No. Taking the illustration above, the Draft Report has, in AIAL's view, failed to fully realise the extent to which airports, such as Hamilton Airport, are increasingly able to enter the market and compete for international (particularly trans-Tasman) flights.

- b) As also further illustrated above, airports such as Hamilton Airport become increasingly attractive as the number of lower-cost, more price-sensitive, airline carriers increases (eg Freedom Air and Virgin Blue).
- c) There has also been discussion around other prospective airline entrant, establishing a competing regional freight hubs at, for instance, the Palmerston North or Ohakea airports.
- d) Lastly, certain promoters (including Waitakere City Council and North Shore City Council – who are no longer shareholders in AIAL) are currently advocating an additional airport in Auckland – situated at the soon to be de-commissioned Whenuapai Air Base.

3.12 *Is the Commission's assessment of the degree of constraint imposed on AIAL, WIAL and CIAL by the acquirers of airfield activities—in terms of the ability of acquirers to substitute for the airfield activities provided at another airport—correct?*

The Draft Report's preliminary conclusion (that each airport faces a demand from acquirers who do not see the other airports as offering viable substitute services) is overly simplistic. While the conclusion reached recognises a range of examples at the margin (such as the establishment of airline hubs, engineering maintenance facilities, etc) the Draft Report does not accord sufficient weight to these examples in terms of:

- The potential financial impact on an airport operator who loses services to another airport operator, given the high proportion of fixed costs faced by airports; and
- The inevitable constraining power on an airport operator given such potential financial impact.

3.13 *Is the Commission's assessment of the price elasticity of demand for airfield activities at Auckland, Wellington and Christchurch International Airports correct?*

- a) No. The approach the Commission has taken to assessing the price elasticity (using passenger elasticities as a basis for determining the elasticity of airfield services) is fundamentally flawed because it:
- Assumes airlines pass on any increases in airfield prices on a one-to-one basis, which is empirically unlikely;
 - There are ups and downs in airline fares regardless of changes in a carrier's costs in the shorter term;
 - Assumes a one-to-one relationship between passenger demand variability and airline activity, whereas increases or reductions in passenger numbers tend not to result in corresponding changes in the number of flights or aircraft movements;
 - Fails to take into account other measures airlines may be able to take to reduce airport charges, such as changing the size and mix of their aircraft or entering into alliance codesharing arrangements;
 - Fails to account for substitutability between airports and the cross-elasticity effects when one airport increases (or reduces) its charges relative to others; and
 - AIAL can confidently illustrate the fact that changes in landing charges bear no relationship with the movements in airline ticket pricing.

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This is illustrated by the Statistics NZ survey of airfares. This survey asks airlines and travel agents what it would cost to fly to a variety of destinations with a variety of time periods between booking and travelling.

An index is constructed by weighing the cost of fares to all destinations by the number of people travelling to those destinations.

The graphs below illustrate the extreme seasonal pattern that has existed in international airfares at least since 1993.

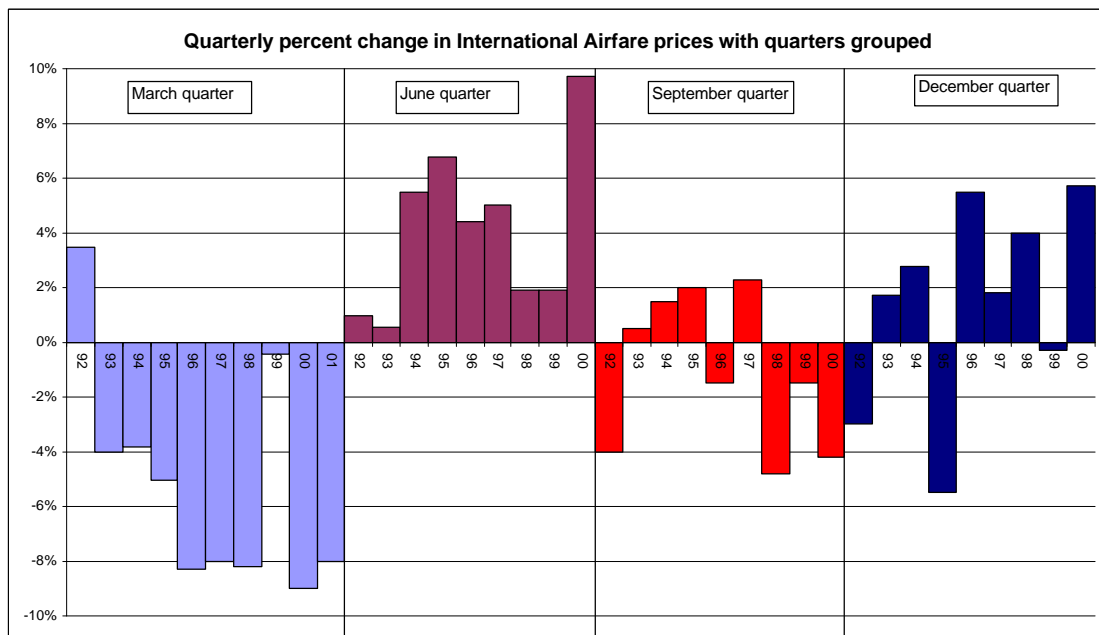
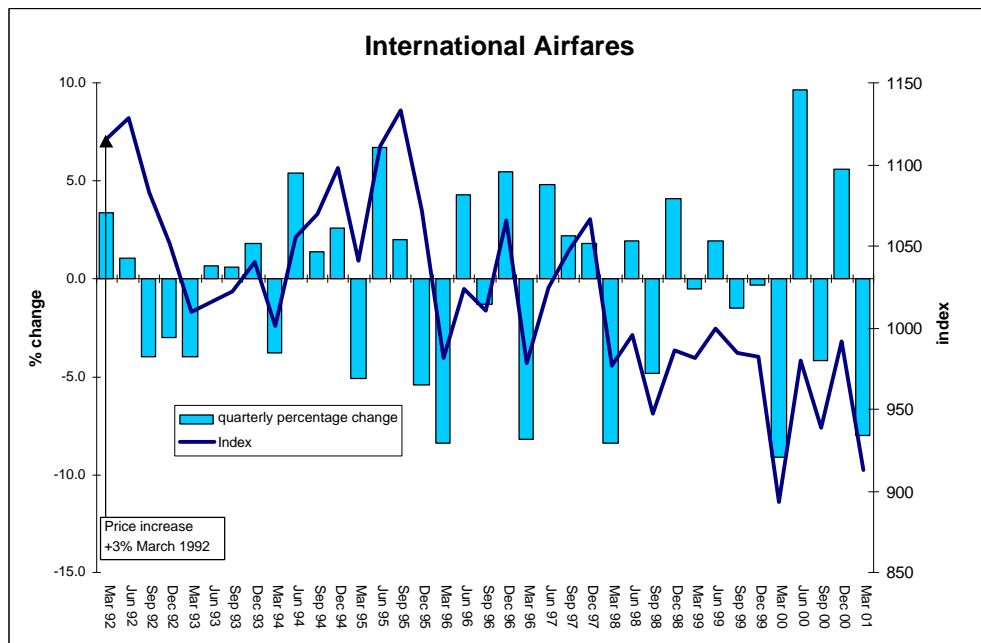
It is interesting to note that AIAL's increases in landing charges, during the periods reviewed by Statistics NZ, were as follows:

- March 1992 + 3.0%
- July 1996 - 3.0%
- September 2000 + 8.5%

Monitoring the index illustrates that:

- International airfares effectively reduced for three years following the 3% increase in landing fees in March 1992;
- Airfares increased for two years following the 3% decrease in landing charges in July 1996; and
- Airfares decreased following the 8.5% increase in September 2000.

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- b) AIAL considers that the price elasticities of demand for the range of likely changes in airfield charges are small and the potential impact of price reductions resulting from price control on future levels of demand (aircraft landings, passenger numbers and freight volumes) will also be small.

- c) Accordingly, the resulting quantification of allocative efficiency losses are likely to be insignificant (refer to later comments in Section 9 of this submission).

3.14 *Is the Commission's assessment of the extent to which any countervailing power of the acquirers of airfield activities constrains AIAL, WIAL and CIAL—the ability of acquirers to exercise countervailing power correct?*

No. The Draft Report has come to the incorrect conclusion that AIAL is unlikely to be significantly constrained by the countervailing power of airlines. This preliminary view:

- Assumes that, because airfield charges are small in relation to airlines' total costs, airlines are relatively unconcerned about them. However, these charges are much more significant when considered directly against an airline's profitability – hence the effort exerted by AIAL's airline customers into both the recent AIAL Consultation and this Inquiry, as well as the lengths some airline carriers are prepared to go in seeking legal redress on the issue of airport charges;
- Fails to fully consider the additional countervailing power created by the airlines' increasing concentration (through cross-shareholdings and alliances) and negotiation practices – the latter from a number of competing angles, including jointly (through BARNZ) but often through direct consultation approaches;
- Gives weight to the fact that airlines can credibly threaten not to go to an airport, but fails to recognise that airports (unlike most commercial businesses) are unable to withdraw supply and must allow all airlines to land (even when they refuse to pay charges). Nor is AIAL able (in practical terms) to disrupt the supply of services supplied to a defaulting

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airline carrier on the ground (eg withdrawing airbridges) as this impacts passengers to the detriment of AIAL in public relations terms. AIAL simply has to wear the risk that airlines from time to time will fail to pay and there is little that can be done by AIAL. AIAL, when reviewing its WACC calculation in due course, will need to assess whether this risk is adequately reflected in its asset beta. To illustrate further, six airline carriers have ceased business in recent times leaving over \$1.5 million owing and unpaid to AIAL. Further, AIAL is currently owed \$1.63 million by Air NZ and its various subsidiaries for unpaid charges pending resolution of the current court proceedings;

- Suggests that, because airlines are larger than any individual airport, they stand to lose more as a result of boycotting an airport and therefore are in a weaker bargaining position. However, airport charges represent a much greater proportion of the total revenue, profits and therefore financial well being of any one particular airport operator, so quite the converse is the case in both overall risk and percentage terms;
- Ignores the economic theory regarding negotiations and competitive neutrality, notably the balance of power between a monopolist and a (quasi-) monopsonist; and
- Ignores the evidence of market behaviour under the current regulatory regime, where airline carriers are willing to resort to litigation and to withhold landing charge payments. This has created significant additional costs for airports, materially impacting on the pricing behaviour and the potential monopoly powers (of all three international airports in New Zealand).

3.15 *Is the Commission's assessment of the ability of current or potential competition to constrain AIAL, WIAL and CIAL correct?*

No. As indicated previously, an analysis of the rates of return achieved by airports is a useful proxy measure of whether there is evidence that competition was (or was not) constraining airports' behaviour. A proper analysis of AIAL's returns indicates that there is no evidence of AIAL having achieved excessive returns. Furthermore, the Draft Report's own calculations indicate that the historical returns for WIAL (between 1991-2000) and CIAL (in the year 2000) have been below a competitively normal level. One can only conclude these airports must have been (like AIAL) constrained by the existence of either competitive and countervailing market constraints. **There is no other rational explanation for these sub-returns.**

3.16 *Is the Commission's view that the airfield activities supplied by AIAL, WIAL and CIAL are supplied in markets in which competition is limited correct?*

The Commission's market definition and assessment of competition between airports is broadly correct, but has failed to recognise the extent of the countervailing market power held by the airlines and the practical impact that this has had on airport pricing behaviour and profitability. The process which the Commission has undertaken to arrive at its conclusion lacks detailed rigour and sound analysis of empirical market data. Moreover, the Commission's conclusion that WIAL has been unable to earn even normal returns, and revised analysis showing a similar situation for AIAL, indicates the impact of the constraining competitive pressures. There can be no other rationale explanation for this sub-normal return situation.

4 PRICING PRINCIPLES

4.1 The Commission has adopted a framework which uses the standard measures of economic efficiency to assess AIAL's pricing behaviour, namely:

- **Allocative efficiency** (the prices paid by acquirers should equal the marginal costs of supply; and all things being equal, also produce competitively normal returns);
- **Productive efficiency** (AIAL should supply its airfield facilities and services in a manner that minimises the required operational costs); and
- **Dynamic efficiency** (AIAL should continue to innovate in new and improved products and production processes – as evidenced by “appropriate new investment management” and decision-making).

4.2 The Commission has attempted to reflect these measures of economic efficiency are, in turn, directly reflected in the pricing principles, namely (and quoting directly from the Draft Report):

- *“Prices should be as close as possible to their allocatively efficient level over the medium term. Prices should be commensurate with the desired level of service quality and based on appropriate costs (productively, and dynamically, efficient costs). Prices should encourage efficient use of a supplier’s facilities and avoid cross-subsidisation. Today’s consumers should only bear today’s costs.”*
- *“Prices should allow for a “normal” rate of return to be earned by suppliers over the medium term. Normal returns should be based on an appropriately determined asset base and rate of return. Returns which are greater, or lesser, than this normal rate should reflect superior, or inferior, performance respectively.”*

- *“Prices should on average, over the medium term, cover efficient operating costs (including any temporary deviations resulting from unexpected changes in external factors), and no more.”*
- *“Prices should send appropriate signals for determining whether new investment (or divestment) would be efficient.”*

4.3 The Commission has also stated that the outcomes achieved by competitive markets are a benchmark against which to compare the outcomes in other types of markets.

Commission’s Questions – Specific Responses

4.4 Are the Pricing Principles Considered by the Commission Appropriate?

Whilst in general terms AIAL is supportive of the use by the Commission of efficiency-based pricing principles, AIAL believes that it would be a very complicated empirical and analytical undertaking for any regulatory body to try to assess whether the structure of prices were as close as they could be to being allocatively efficient.

4.5 AIAL believes it would be more practical for the Commission to focus on whether airports have been abusing their market power by setting prices that result in the generation of revenues in excess of those an efficient firm would require to enter the market.

4.6 The Commission has attempted to focus on allocative efficiency, marginal cost pricing and Ramsey pricing principles – this, in practice, is not realistic in respect of airports and determining the optimal pricing strategy can only be a theoretical exercise in this industry.

- 4.7 The test for abuse of market power must therefore focus on whether a company has earned excess returns – as illustrated, this has not been the case in respect of AIAL.
- 4.8 Pricing principles will have implications in the assessment of normal or excess returns. A number of the principles applied in the Draft Report are **not** considered appropriate by AIAL. These are:
- Today's consumers should only bear today's costs;
 - Prices should be based on efficient costs; and
 - The issue of dynamic efficiency.
- 4.9 The statement that *"today's consumers should only bear today's costs"* has little or no relevance in a market that is characterised by investments in assets which are very large, lumpy and have long lives (and will therefore be used to provide services well into the future). This principle is also contrary to the concept of marginal cost pricing, which is **forward** looking in nature.
- 4.10 This concept is a contradiction to the notion of allocative efficiency whereby prices should reflect forward-looking (marginal) costs.
- 4.11 The principle that prices should include efficient operating costs, while correct in principle, may be less appropriate in practice. It is important to bear in mind that the average (normal) firm will only be averagely efficient. It is inappropriate for a test of abuse of market power to be based on an idealistic (high) rather than realisable principle.
- 4.12 The ownership structure of any monopolist will influence the incentives to reduce costs or maximise profit. AIAL's ownership – a private owned/publicly listed company – with transparent reporting requirements and dividend demands, is the most demanding in respect of efficiency.

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- 4.13 It could well be argued that “normal” returns are in fact the absolute minimum shareholders should reasonably expect – in order to increase shareholder wealth and achieve real value added a return in excess of WACC is required and should be achieved by companies if they are to be regarded as better than just “normal”.
- 4.14 The approach to dynamic inefficiency adopted in the Draft Report appears to be designed to allow adjustments for untimely investments.
- 4.15 However, as shown later in this submission, in respect of the land held for the future runway, the investment in this asset has been correctly timed and optimally priced in respect of the ultimate development cost of the service.
- 4.16 In respect of the issues of the Commission’s approach to the exclusion of the second runway land and the matter of “today’s consumers should only bear today’s costs” and the “used and useful” approach, we refer the Commission to the statement from Professor Kahn who completely rejects the Commission’s approach (Attachment 3).
- 4.17 From a public policy perspective, the inefficiencies associated with under-investment are likely to be far greater than those associated with over-investment.
- 4.18 It is important and essential that prices (revenues) adequately encourage and reward companies for efficient investment decisions.

5 ASSET BASE

Commission's Approach

- 5.1 The Draft Report recommends three significant downward adjustments to the value of AIAL's airfield asset base. The suggested reductions in value result from an approach that:
- a) Values specialised airfield assets on a depreciated historic cost basis, rather than on the basis of their optimised depreciated replacement cost (ODRC). The argument appears to be that specialised assets are sunk investments which have no alternative use and therefore no (economic) opportunity cost;
 - b) Optimises out the value of airfield land held for future use, on the grounds that it is not "used or useful" until it is commissioned and brought into use; and
 - c) Makes adjustments to exclude the value of other assets (seabed and seawall) which are assumed to have been allowed for in the value of the airfield land.

AIAL concerned with Commission's Logic

- 5.2 The Commission has calculated the effect of the above adjustments for AIAL at \$98.4 million (Table 25 page 1060 and later has adjusted this calculation to \$106.1 million (by email of 30 July 2001).
- 5.3 AIAL is concerned with the underlying logic of the Draft Report in the application of fundamental economic principles and also with the calculations detailed in the Draft Report. The Commission has provided an extensive financial model listing a number of scenarios that, in turn, model each possible permutation of inclusion or exclusion of various assets. AIAL has corrected the model (refer Attachment

1) which will provide analytical support to the Commission once the selected asset base is identified.

5.4 The issues in respect of determining an appropriate asset base can be summarised as follows:

- a) **WHICH** assets should be included in the asset base?
- b) **WHEN** should such assets be included in the asset base?
- c) At what **VALUE** should the assets be included, and should that value be adjusted over time?

5.5 To encourage the efficient use of resources, any guidelines used for determining these issues need to:

- a) Encourage efficient investment by the airport operator and discourage inefficient investment;
- b) Allocate risk to the party best able to mitigate the effects of any investment in order to minimise the cost of these risks; and
- c) Provide for stable price paths over time, as stable price paths are more likely to be allocatively efficient than volatile price paths.

WHICH ASSETS?

5.6 AIAL contends that all economically **efficient** investments, consistent with the delivery of services today and into the future, should be included in the asset base.

Efficient Investment Practice:

- 5.7 Airport investment patterns are characterised by a small number of large expenditures occurring at irregular times (eg a runway or terminal building etc), and a large number of regular small expenditures (eg upgrades to airfield vehicles and refurbishment of lounges etc). The latter investments are generally **not** contentious, but the former often are. In AIAL's view, the way to resolve any debate is to take an economic efficiency approach.
- 5.8 The most efficient investment approach to most of the capacity expansion issues faced by an airport operator is to invest in relatively large blocks of capacity at any one point in time.
- 5.9 To illustrate - at start-up, an airport invests in a runway (for some years before it is operational), which for the first few years will typically be under-utilised. Similarly, at the point when it decides to invest in a terminal building, it will typically build it with sufficient capacity to provide for expected demand over an extended period. This inevitably means it will invest in excess capacity in the short term. These investment patterns continue as demand rises and additional increments of capacity are required.
- 5.10 Clearly not all investment in excess capacity will be efficient, and the optimisation rules provide a means of identifying and adjusting for those that are clearly not required, given a forecast demand for services.
- 5.11 The issue then becomes one of identifying if the investment in certain assets is deemed to be economically efficient or optimal over time.
- 5.12 The Draft Report's approach is to include only those assets that are ***“used and useful”***.

5.13 AIAL sought an opinion from the highly respected international aviation economist, Professor Alfred E Kahn from New York, on the key issues of the inclusion of land held for future airport development in the asset base and whether the pricing principles - that only *“used and useful assets”* should be included in the asset base and that *“today’s users should only bear today’s costs”*, were economically sound.

5.14 AIAL commends Professor Kahn’s statement (Attachment 3) to the Commission. The views expounded in the statement are fully supportive of the approach consistently adopted by AIAL.

5.15 Professor Kahn’s answers to both questions – based on the Commission’s own stated first pricing principle (which he supports) that *“prices should be as close as possible to their allocative efficient level over the medium term”*, and in the context of AIAL’s present situation – are emphatically in the **negative**.

5.16 Professor Kahn submits (page 4) that:

“Whether or not one accepts the rule that today’s users should bear only today’s costs and that only used and useful assets should be included in the asset base, the cost of the land AIAL is holding for a future runway is unquestionably part of “today’s costs” in economic terms (or is at least a surrogate for today’s economic costs), and that exclusion of those costs from AIAL’s asset base and prices flatly contradicts both economic efficiency and the welfare of its present users”.

5.17 On page 6, Professor Kahn states that he has:

“Consistently rejected the proposition that costs associated with increases in capacity either (i) actively in construction or (ii) by general agreement necessitated by existing or clearly contemplated levels of demand, do not belong in regulated rates”.

5.18 AIAL's second runway is clearly associated with increased capacity, it has the agreement and support of the airlines, and is also necessitated by contemplated levels of demand.

5.19 AIAL shows that the purchase and holding of the second runway land is economically efficient and optimally timed.

5.20 Professor Kahn goes on to state (page 6):

"I have therefore explicitly rejected the opposing propositions, such as that "today's users should bear only today's costs" or that plant not yet in service is not "used [or] useful" when these propositions are interpreted to exclude the causal responsibility of today's demand for the need to build additional capacity".

5.21 In respect of the Commission's view that only "used and useful" assets should be included in the asset base, Professor Kahn states (page 9) that:

"Its application in the present situation to justify exclusion of the present – not future – costs of investment in assets that will by general agreement indeed be "used and useful", however, is not only incongruous; it has no justification in terms of either fairness or what the Commission itself has identified as the overriding criterion, namely, the dictates of economic efficiency".

5.22 The users of AIAL are causally responsible for the congestion that they impose on one another and these congestion costs form part of today's costs.

5.23 Professor Kahn (page 12) goes on to state that:

"The stated objective of regulatory control is to achieve an outcome as close as possible to that of an effectively competitive market".

AIAL illustrates the clear need for additional capacity to meet rising demand. Professor Kahn then states:

“This seems completely consistent with what would be expected of an efficient competitive business anticipating near term growth in its market beyond its current capacity – in which case, the Commission’s decision to remove this land from the asset base for the purpose of deciding whether it is or is likely to earn excessive revenues seems to me to violate the test of what a prudent competitive business would do”.

5.24 On page 13, Professor Kahn states:

According to the Commission’s pricing principles, “Prices should send appropriate signals for determining whether new investment...would be efficient”. This is precisely the reason why inclusion of either short-term marginal congestion costs or their surrogate, the capital costs of the additional investment required to hold those costs within efficient limits, should be reflected in price currently. This principle clearly justifies AIAL’s assertion that “land held for future use that is associated with current operations can be included in the asset base where there is an intention (and reasonable certainty) to use the land at a future date for operational purposes”, and there is agreement from substantial customers on the prudence of that intention.

5.25 He concludes on page 13:

“AIAL should be permitted to recover the net cost incurred in holding and developing this land during the development phase as that would involve a time profile of charges more closely approximating marginal costs and therefore economic efficiency than would the Commission’s proposed

treatment of those costs; and it would do so without increasing the total burden on its customers”.

Second Runway Land:

- 5.26 The only questions the Commission needs to address is whether the AIAL holding of land for a second runway is optimally timed and is the investment decision economically efficient?
- 5.27 It appears the Commission assumes, in reaching its view about AIAL holding land for a second-runway, that it is never optimal for an airport to own airfield land before it actually uses it for the runway.
- 5.28 This assumption will be incorrect where:
- a) The acquisition of land is subject to the risk of “holdout”, so that it is optimal for an airport to purchase land before it becomes widely appreciated that the airport needs a large quantity of land;
 - b) The acquisition of land now creates the option to build a runway later **at a lower** and more certain cost, and the value of this option (net of its cost) exceeds the expected value of the alternative option of buying the land only when it is needed;
 - c) The acquisition of land now allows AIAL to exercise the option to invest in the second runway at the **optimal time** as determined by airline traffic. Failure to acquire the land now may force AIAL to delay construction of the new runway beyond the optimal date due to the need for the airline traffic to rise sufficiently to meet the higher costs. It must be noted that increased congestion during this period will create additional operating costs for the airlines; and

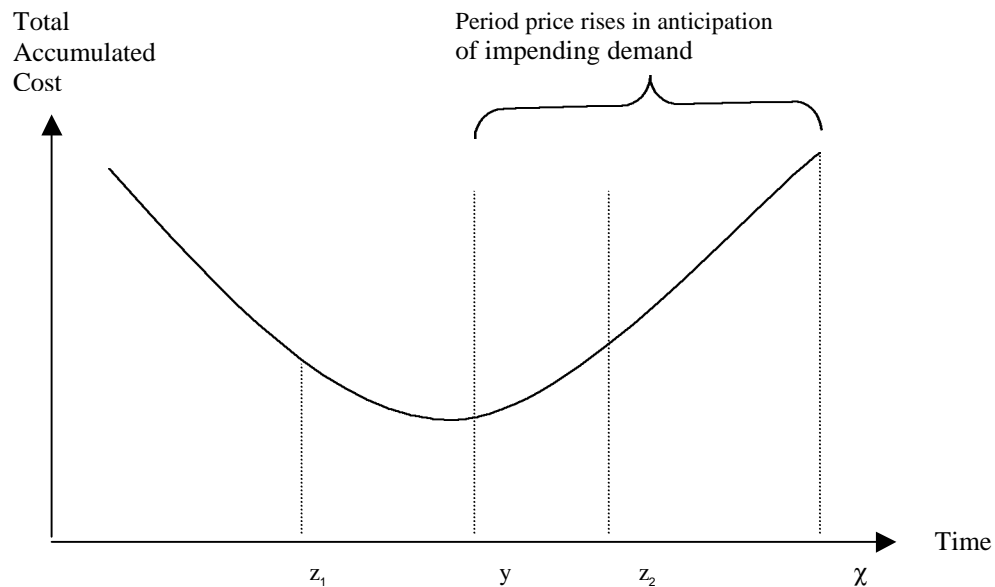
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d) If AIAL can only bring the land into the asset base when and only when the runway is constructed, it is incentivised to build the runway too early.

5.29 If it can be shown that it is optimal for AIAL to hold land for the second runway in advance of using it, pricing practice (including those related to what assets are to be included) should enable it to recover the costs of doing so.

5.30 AIAL contends that, given that construction of a second runway facility (based on current demand projects) will need to commence, say around 2005, for operation some two years later, AIAL's managed programme to purchase land, as and when available, has been the correct and the most efficient strategy.

5.31 The issue of establishing optimum timing is a complex matter and can be illustrated as follows:



- χ = Where asset is needed
- y = Optimal time to purchase asset
- z_1, z_2 = Practical optimal period to acquire asset

5.32 Practically speaking, the optimal time to purchase the land will be at a point where the imminent future need for the land has not been fully appreciated by the

market and an acquirer of the land will try to buy land as near as possible to that optimum point. However, large parcels of land are not always available and there is therefore a need for a longer and managed acquisition process. AIAL contends that to buy the land at a point in time, say in the 1960's, when the airport was first contemplated would have been too early, but conversely, buying the land too close to the projected commissioning of the second runway, would be too late.

5.33 AIAL believes the land was indeed purchased at a time when it could be acquired without paying the sellers a premium and therefore reflected an overall efficient cost. It should therefore rightly be included in the airfield asset base. The decisions to acquire the land cannot, and should not, be construed as a sign of dynamic inefficiency.

5.34 Whether or not the actual timings of individual purchases of land were optimal in the past, it is seemingly irrefutable that the land which is designated for the development of a second runway should be under AIAL ownership currently (for consenting purposes and engineering investigations plus preparatory earthworks). It is therefore not sensible to introduce forms of price control that potentially incentivise AIAL to sell the land now and try to re-purchase it later, or for the Commission in its Draft Report to offer explicit and supporting advice that:

“the land would be improved by it being used for its alternative use (and the associated value of that use realised)”.

5.35 AIAL requested Mr Derek Nolan of Russell McVeagh (Solicitors) to respond to the Commission's approach and suggestions in respect of the second runway land. A copy of his statement is attached as Attachment 5.

5.36 This statement highlights a number of important planning related and practical issues including:

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- a) Implications of the Resource Management Act – the need for AIAL under the RMA to be:

“forward-looking in terms of... management” [of its resources] so that “the reasonably foreseeable needs of future generations are met, and that the adverse effects of activities on the environment are avoided, remedied or mitigated” (page 3);

- b) Noise management and land use planning issues – the New Zealand noise standards ensure that:

“communities in close proximity to airports are properly protected from the effects of excessive aircraft noise”... (page 4).

To achieve this, but also to provide for the need for Auckland Airport to operate efficiently – not only in regard to the existing runway but also the *“projected number and type of aircraft operations that are predicted to be needed to occur on the second runway”* (page 4) – significant **limits** need to be placed on the location of new development sensitive to aircraft noise;

- c) Establishment of activities sensitive to aircraft noise – selling the second runway land would inevitably lead to pressure from those landowners to rezone to “business” use (rather than the current underlying zoning of “rural”) with the consequent development of certain buildings and activities on the land. This in turn, totally undermines any future ability to then:

“build a second runway in the currently planned location ... as it would result in unacceptable adverse environmental effects on the ASANs [activities sensitive to aircraft noise] built in the intervening period” (page 4);

- d) No other realistic option for location of the second runway – as stated:
- *“The aircraft movements intended to be accommodated on the second runway cannot simply be replaced on the existing runway”* (page 4);
 - *“A second runway cannot realistically be expected to be constructed by reclamation in the Manukau Harbour”* (page 5) – as this is contrary to the intent of sections 6 (a) and (e) of the RMA, unlikely to be supported by Maori who wish to protect the Manukau Harbour and inefficient as aircraft landing on this second runway would have to taxi across the original runway to get to the terminals to the north;
- e) Manukau District Plan issues – the current expectation is that the second runway will be needed within the next ten years. The **proposed** District Plan for Manukau City (the review of which commenced in 1994 which once operative will last for ten years and is now in the final stages of negotiation) needs to have incorporated within it all the necessary approvals and land use controls for a second runway. As stated (page 6):
- “AIAL could not realistically obtain District Plan provisions providing for the construction and use of the second runway without actually owning the land or having it under its control. This would always need to be achieved first and in plenty of time before such a planning process commenced. If runway construction were to commence in around say seven to eight years time, then if AIAL had to sell the land now, or lease it to third parties for other uses in the interim, it would have to repurchase the freehold or leasehold interests again within a few years (if it could) and then go through an identical planning approval process as it is going through right now, almost immediately, to have everything in place in time for*

*construction. Not only is that nonsensical, but there will not be another review of the District Plan for AIAL to use prior to possible construction, so there is no real opportunity to seek all of those approvals within the time required in any sensible manner. **AIAL has done the only responsible thing it could in acquiring the land**, going through this seven year period to get suitable District Plan provisions for the second runway and appropriate land use controls, then having those in place ready for actual construction to commence some time in the life of this new District Plan.”*

- f) Re-acquisition difficulties – the Commission is incorrect in assuming AIAL, if it sold the land, could re-acquire it with ease and little expense. The Commission needs to have regard to the fact that (page 7):
- *“AIAL does not enjoy any direct powers to compulsorily acquire land (freehold or leasehold) under the Public Works Act”;*
 - Application to the Minister of Lands is extremely slow and fraught with potential delays and difficulties such as referral of the proposed purchase to the Environment Court which, even if resolved, leaves outstanding the key issue of price. *“There must be voluntary negotiations and if they are unsuccessful, the land owner is entitled to have the price, or compensation for the taking of the land, considered by the Land Valuation Tribunal”* (page 7); and
 - In all, based on Russell McVeagh’s current experience – *“there just isn’t time to sell, re-acquire, voluntarily or compulsorily and go back through the planning process all over again. Intervening ASANs in the HANA [high aircraft noise area] and MANA [moderate aircraft noise area] could also rule the runway out”* (page 8). This too does not account for any possible **premium** that AIAL may need to pay in order to so acquire the land at such pace; and

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- g) Lastly, support of the airlines through BARNZ – *“through the auspices of BARNZ, the airlines have been working jointly with AIAL since the early 1990’s to make express provision for the construction of the second runway ...”* (page 8).
- 5.37 AIAL also considers Mr Nolan’s statement confirms AIAL’s strategy of acquiring the land was entirely sensible, efficient and optimal.
- 5.38 Additional considerations in respect of the stance taken in the Draft Report on the issue of inclusion are:
- a) By excluding it, a methodology is suggested under which the future price of airfield services would (in approximate terms) need to more than double immediately upon opening a second runway. This is unlikely to be consistent with marginal costs, which rise sharply in anticipation of investment in capacity and then fall significantly once the new capacity comes “on-line”; and
 - b) The airlines have always been in agreement with AIAL, that this land should be acquired and be held for future development.
- 5.39 As verified by Professor Kahn, and as illustrated herein, AIAL should be permitted to recover the net costs incurred in holding land reserved for the second runway development.

WHEN SHOULD ASSETS BE INCLUDED IN THE ASSET BASE?

- 5.40 This issue has been stated very clearly by Professor Kahn – the capital cost of the investment required to hold the costs within efficient limits (as illustrated by AIAL) should be reflected in the price currently.

AT WHAT VALUE?

- 5.41 The Commission has agreed that opportunity cost is the most appropriate method for valuing assets given that, in any test for abuse of market power, comparison with a competitive market situation is appropriate. In practice, this means valuing assets on a market value existing use basis – not market value alternative use.
- 5.42 However, in respect of specialised assets, the Draft Report adopts an historic cost approach.
- 5.43 In restating the value of specialised assets (runways, taxiways and aprons) on a depreciated historic cost basis, the Commission seems in its Draft Report to have been inclined initially to value such assets at zero (on the grounds that they have no alternative use and hence a zero opportunity cost). However, the Commission points out that *“valuing the assets at zero may affect the long-term viability of the owner of the assets”*, and it has therefore moved to an historic cost basis – apparently in preference to ODRC because otherwise *“today’s consumers will pay for some of tomorrow’s costs”* (in the form of pre-financing of the replacement of currently used assets). AIAL believes that ODRC does not involve pre-funding, but rather that it ensures that current providers are rewarded the same as any new or hypothetical alternative providers.

Valuing Specialised Assets to Historical Cost rather than ODRC

- 5.44 The Draft Report uses the term “historical cost” but, in its commentary adopts “depreciated historical cost”. It is also evident from this commentary that there is an assumption that “historical cost” has, within it, optimisation, so it can be concluded the Commission is analysing:

Optimised Depreciated **Historical** Cost vs Optimised Depreciated **Replacement** Cost

ODHC vs ODRC

5.45 AIAL provides a detailed commentary on these two economic valuation bases in the following manner:

Implementation practicalities and necessities of ODRC

5.46 AIAL's financial statements are required to be presented in accordance with the Companies Act 1993. Accordingly, all fixed assets were therefore originally stated in historic costs terms and depreciated on a straight-line basis based on the AIAL's official vesting value when originally corporatised in 1988.

5.47 In 1998, the Government decided to sell its 51.6% shareholding in AIAL by way of a public float. At a shareholders' meeting (22 May 1998) held before privatisation, the shareholders directed the AIAL Board to revalue AIAL's assets within one year of the public listing as follows:

*"... revalue in the books of the Company within one year after listing using the optimised deprival valuation concepts, credit the increased value so recognised to reserves and reconsider the capital structure of the Company at that point with the aim of maximising the use of debt in the Company's balance sheet consistent with sustainable development of the airport."*⁴

5.48 This revaluation directive was again confirmed in the official Prospectus (May 1988) for the initial public offering of shares, which were subsequently issued in July 1998 (refer page 45).

5.49 The Draft Report has ignored the implication of this directive from the shareholders, which included the **Government** as majority shareholder. AIAL

⁴ Refer 1998 Government prospectus, page 31.

cannot, as it would appear to be prompted by the Commission, value its assets using one basis and charge on a lower basis.

- 5.50 The ensuing upward valuation, had it not been able to be incorporated into prices, would immediately fail the net realisable value test and would have had to have been written back to whatever value adopted in the charging base.
- 5.51 AIAL suggests that, contrary to the Commission's views, the Government of the day that floated AIAL did want the assets valued both in the accounts, and for the purposes of charges levied to customers, on the basis of the current values of the assets.
- 5.52 AIAL does not have the option, as implied in the Draft Report, to charge on any lower basis than what the values are set in the accounts. To do so, would be in direct contravention of both recognised valuation and accounting standards.
- 5.53 AIAL perceives that ODRC has been widely endorsed by Government advisers as being the appropriate basis for valuing assets in a natural monopoly, infrastructural context (as the best way to avoid valuation circularities and to mirror competitive market outcomes). Furthermore, the Commission's suggested valuation approach directly refutes the directive received by AIAL from Government (in May 1998) to use ODRC as the basis for (re)valuing its assets.

Incentive and Effects if not Adopting ODRC

- 5.54 The underlying problem with DCF valuations is the circularity and the fact that prices could therefore be set to a theoretical infinity. Historical cost is almost the same.
- 5.55 Historical cost allows owners of monopoly assets to be guaranteed a return on their investment so it therefore encourages new owners and sellers of the present investment to transact a sale of the asset at a very high level, say 5 x

ODV. Using ODRC (over historical cost) puts an incentive to ensure that providers seek efficient costs to provide assets rather than pay an inflated value because they would not achieve a return on their investment if that investment was too high.

- 5.56 In the case of historical cost, an issue also arises as to which historical cost? In the case of AIAL, is it the value that the asset was originally purchased by the Airport Authority, or is it the value that was placed on the assets through the largely DCF valuation at vesting, or is it the privatisation value? There are obvious incentives for AIAL to sell all or part of its assets to any other party (or associate) at inflated prices who will receive income streams based on this higher valuation. The effect of this would be much higher prices and also much higher tax depreciation allowances claimed on the vastly inflated costs. The losers under this model would be the so-called captive customers.
- 5.57 This is clearly inappropriate and it would be understandable then for the Commission to further consider how to control the transfer values between sales.
- 5.58 In an environment where providers of infrastructure are able to enter and exit the market (through selling their business) only using **current values** to base charges ensures that:
- a) The rights of customers are protected;
 - b) The values of the sellers are appropriately (but not totally) protected; and
 - c) New entrants at the margin are not disadvantaged.
- 5.59 It is wrong to assert (as in the Draft Report) that assets only have an economic (opportunity cost) value when they have an alternative use. Long-life assets, like runways, taxiways and aprons have an obvious economic value at an existing designated airport location to any airport operator (being the potential price

charged to a new entrant or the cost to any operator of replicating or replacing existing assets and their service level (utility and capacity)).

- 5.60 The use of ODRC for specialised assets is rejected by the Commission on the basis that its analysis merely suggests that ODRC does not have **any clear advantages over historic cost**.
- 5.61 This analysis appears to be based on the perceived benefits and advantages comparison set out in Tables 22 and 23 on pages 97 to 99 of the Draft Report.
- 5.62 AIAL considers this is incorrect because there are a number of errors in the tables and makes the following comments:

Table 22

Arguments for and against the use of Historic Cost

F1 **Commission statement (for historic cost):** Book values are robust and easily ascertained.

AIAL comment: This statement is generally true but does not take account of the fact that companies that have evolved from cash accounting systems would have used accounting practices that do not always correctly measure and capture costs of new assets. Many companies in New Zealand that were created by Government and local body entities took some time to adequately account for new investments using standard accounting practices.

F3 **Commission statement (for historic cost):** Book values could be adjusted to “to optimise out” uneconomic or redundant assets (optimisation raised an issue as to what extent business should be “penalised” for past investment decisions, particularly where the decision to optimise is made with the benefit of hindsight, rather than based on the information that existed at the time that the decision to invest was made).

AIAL comment: Responsibilities, incentives and risks faced by companies in both monopoly and competitive sectors should be the same as much as practicable. Optimisation is a process whereby companies in monopoly sectors are treated [with the] same risks as those in competitive sectors. Without facing the implications of past decisions, even with the benefit of hindsight, there are insufficient controls and pressures on management to ensure the optimal long-term outcomes are achieved. The issues of optimisation relate to both ODHC and ODRC.

F5 **Commission statement (for historic cost):** In an inflationary environment, nominal interest rates, by incorporating an “inflation premium”, provides some compensation to investors for what would otherwise lead to a loss in the real values of their investments.

AIAL comment: Inflation components in nominal interest rates only provide investors with an inflated adjusted return **on** the historical cost of the original investment; it does not provide them with an inflation adjusted return **of** their investment (ie as depreciation is not adjusted to reflect current values).

F6 **Commission statement (for historic cost):** For a regulated business, the compliance costs of providing information on asset values would be very low.

AIAL comment: True, but only where no adjustments are contemplated. If the distorting effects of using historical cost are adjusted through application to regulators, the total costs of using adjusted historical costs are much higher.

Table 23

Arguments for and against the use of ODRC

A1 **Commission statement (against ODRC):** ODRC methodology leaves considerable discretion in the hands of companies on valuations, particularly with regard to “optimisation”, valuation of assets and asset lives.

AIAL comment: Valuations are performed not by companies but by independent valuers. Any subjective judgement can be largely overcome by guidelines as now widely used in the electricity transmission industry.

In relation to optimisation, any judgements by valuers to remove assets from the charging base must be better than using non-optimised historical costs that incorporate redundant assets. Again, guidelines would be the most logical remedy to overcome perceived subjectivity.

A2 **Commission statement (against ODRC):** The correct comparison for a past investment is not the modern equivalent asset now, but rather the modern equivalent asset at the time when the investment was made (investors cannot be held responsible for errors only evident with the benefit of hindsight). That would be difficult to assess.

AIAL comment: In AIAL's opinion, this seems a rather unusual statement.

It is fundamental that any investors should reap the rewards and penalties of past investments whether or not, with the benefit of hindsight, these investment decisions were optimal.

Competitive and monopoly providers should be treated in a similar way as much as possible, and monopolists should not be protected from future implications of decisions made in the past.

Directors are still in the best position to manage these risks and therefore they need to, and indeed do, carry responsibility for any implications of errors or changing circumstances.

A3 **Commission statement (against ODRC):** It is not clear why prices should be based on bypass valuations of assets. Where ODRC includes sunk costs that have been already written off, the resulting "high" prices could encourage inefficient bypass. In any case, competitive markets with lumpy assets would cycle between low prices when there is excess capacity, and high prices when additional capacity is needed.

AIAL comment: ODRC cannot include written-off assets in economic terms. If they have additional useful lives and have a replacement value, then they will have a value. There is no encouragement to produce an inefficient bypass. The second point is not a relative advantage of either ODRC or ODHC. Under either scenario, lumpy investments could cause fluctuating prices. The difference is that ODRC results in lower fluctuations.

A4 **Commission statement (against ODRC):** Normal returns can be earned on any assessed valuation of asset base. Moreover, prices could rise above the bypass prices if, as likely, there are entry barriers.

AIAL comment: This ignores the focus of ODRC. Valuations are based only on assets that are optimised and prices should never rise above the bypass value because either the **current** value will be the same for new entrants **or** if the new entrant has a more optimal solution then the optimisation will force the valuation down to the same value of a new entrant.

A5 **Commission statement (against ODRC):** For a regulated business, the compliance costs of providing information on ODRC-based asset values are assessed as “moderate”, ie higher than for historic costs. This may be optimistic, given ongoing revaluations. In addition, economic values have to be assigned to uneconomic parts of the business.

AIAL comment: Using modern fixed asset systems and standardised replacement costs, the cost to produce DRC valuations will be higher but not significantly so than DHC. The additional costs involve the ongoing evaluation of the level of optimisation and this applies to both ODRC and ODHC.

A6 **Commission statement (against ODRC):** Sustainability is assured when the firms are able to recover (with profit) the costs of prudent investments – there is no need for firms to amass cash reserves now to finance all future replacements and refurbishments. Moreover, ODRC is *not* sustainable where technological improvements are lowering the cost of modern equivalent assets (the ODRC will decline faster than the book value).

AIAL comment: This is in error.

Using ODRC incorporates anticipated declines in book values, and penalises shareholders for non-anticipated falls.

Rewarding firms based on ODRC means that they are receiving a current value return **on** their investment and **of** their investment. It has nothing to do with ensuring firms have sufficient funds amassed to replace assets. This would imply it incorporates pre-finance and it does not.

A7 **Commission statement (against ODRC):** There is no economic rationale for including the costs of sunk assets where those have already been written off (eg pre-corporatisation sunk costs). Moreover, any return on a sunk asset is an economic “rent”, and consequently is a “transfer” and not a “cost” – the size of the return has to be determined on non-efficiency grounds.

AIAL comment: Based on the Commission’s definition of sunk assets there is most certainly a rationale to include sunk assets in the asset base. It ensures that providers of monopoly and competitive sectors are treated equally. Reward for investment in sunk assets, whether pre-corporatisation or otherwise, is required to ensure a return on funds invested and a return of funds invested.

A8 This appears to be a general summary of the Commission’s views on ODRC.

Commission statement (against ODRC): ODRC can lead to a big price rise at the outset.

AIAL comment: ODRC most certainly does not lead to big price rises at the outset. Rather at the start ODRC = ODHC. Over time ODHC becomes remote from ODRC in an inflationary environment.

Commission statement (against ODRC): This results in a windfall gain to producers at the expense of acquirers.

AIAL comment: There is no windfall gain to producers – rather they are being rewarded in current terms for the investment measured in current dollars. Adoption of ODHC means they can only be rewarded in current dollars for investments made in historical dollars.

Commission statement (against ODRC): Faced with the options, acquirers would prefer a later price rise to an earlier one.

AIAL comment: Acquirers would obviously like to minimise their costs, but only rewarding investors based on historical dollars is likely to unfairly advantage acquirers at the expense of providers.

- 5.63 One of the main reasons the Commission has preferred historic cost over ODRC appears to be the view that ODRC involves an element of pre-financing of assets.
- 5.64 AIAL can only assume the Commission's interpretation of pre-financing in this instance is that, by using an ODRC basis, then this could mean that airports obtain a return on and of capital that is higher than the original (historic) investment.

- 5.65 ODRC ensures a company achieves a return on and of capital commensurate with the **current value** of that capital investment. This is not pre-financing – it is compensating investors for past investments.
- 5.66 ODRC replicates the competitive market situation by attempting to measure:
- a) The valuation that would be consistent with the price charged by an efficient new entrant into an industry, it is therefore consistent with the price that would prevail in the industry in the long run; or
 - b) The price a firm with a certain service requirement would pay for existing assets in preference to replicating them.
- 5.67 **The Commission's test is one of the abuse of market power – historic cost ignores the comparative cost of entering the market and therefore is not an appropriate test to measure abuse or excess returns.**

Commission's Questions – Specific Answers

- 5.68 ***Is it correct to value airfield land at opportunity cost?***
- a) Yes. However, there are various ways to measure opportunity cost depending on the question being considered. The opportunity cost measure adopted by the Commission (namely market value in next best alternative use) is only appropriate when considering the *minimum* return required to maintain assets in their existing use. However, **this is not the appropriate opportunity cost to consider in a test for abuse of market power.** The ODRC of specialised airport assets is a measure of the *opportunity* cost a new entrant would be prepared to pay to enter the (airport) market – being the envisaged cost to replicate equivalent assets. This value equates to the highest and best use of the land in question and this is determined by the **Market Value Existing Use (MVEU)**

methodology adopted by AIAL. The value must incorporate the cost of bringing the land into its present market use. AIAL, or indeed, any competitor needs to be compensated for the cost of bringing the asset from (market value) alternative use to (market value) existing use. It is therefore the appropriate opportunity cost to consider when comparing AIAL's prices with those likely to occur in a competitive market.

- b) The opportunity cost of the assets (to AIAL) clearly represents their potential value to a new entrant (MVEU).

5.69 *How should the opportunity cost of airfield land be determined?*

Given the Commission's framework, which has as its reference point the *competitive market*, the opportunity cost of airfield land should be determined through the use of *optimised depreciated replacement cost*. This values assets by estimating the cost of replacing them with the most efficient alternatives for producing the same level of services (MVEU – or their opportunity cost). It is therefore the cost a new entrant would face for similar assets.

5.70 *Should the costs of land include the costs associated with getting the land into airport use?*

- a) In AIAL's view, the Commission has inappropriately chosen to value the opportunity cost of land according to its *market value alternative use* rather than its *market value existing use*, the difference being the inclusion of the costs associated with getting the land to a stage where it could be used as an airfield.
- b) To maintain investment incentives, it is vital that firms be able to recover all of the reasonable costs associated with developing and holding airport assets. The Draft Report states that "*such costs should be included within the costs of any land improvements, such as runways, taxiways and*

aprons”, although it appears this adjustment is not then made owing to information constraints.

- c) AIAL considers that it would be more appropriate to include all land (development and improvement) costs within the estimate of the overall value of the land. Nevertheless, the Commission’s approach properly allows for these costs to be accounted for somewhere within the asset base.
- d) Considering the present runway:
- The original value of the land was very low since the majority was originally seabed;
 - Having an optimally sized thin strip of land that extends into the harbour comes at a considerable cost. This cost includes buying the seabed, waiting the holding period while obtaining the necessary resource consents, building a seawall, doing the reclamation and then building the appropriate infrastructure and improvements. This costs approximately \$580,000 per hectare;
 - It would seem that, if this is the most optimal means to construct a runway into the harbour, then this should be the basis upon which the assets should be valued;
 - AIAL chose a lower basis for pricing and valuation purposes, to account for the land at best alternative use and add to that the value of the seawall (since it provided additional utility to the land and it came at a cost); and
 - AIAL’s view is that there are strong arguments and this is the only fair and equitable means to reimburse the asset providers is to

allow providers to recover all costs incurred in transferring the land to current use. In AIAL's case this must also suggest that reclamation costs could well have been used rather than best alternative use.

5.71 *Is it correct to value specialised airfield assets at depreciated historic cost?*

No. ODRC would be a more appropriate basis, given the Commission's framework of comparing airport prices with those that would occur theoretically in a competitive market. This issue has been covered extensively in previous commentary.

5.72 *Is the extent of (and reasons for the) optimisation undertaken by the Commission in determining the asset base appropriate?*

- a) AIAL accepts that it may be appropriate to optimise out the **seabed** (given that AIAL can theoretically provide the same level of airfield services without ownership of this asset). However, AIAL nevertheless disagrees with the Commission's decision to optimise out both the seawall and assets that are held for the (imminent) development of a second runway.
- b) The **seawall** represents an optimum investment decision. Construction of the seawall at AIAL was necessary to ensure the operational integrity of the reclaimed portion of the runway.
- c) Alternative reclaim options would have involved significantly more land be reclaimed resulting in a higher capital cost and higher ongoing maintenance costs.
- d) To optimise out the seawall penalises AIAL for what is an optimal investment.

- e) The seawall has a separate and distinct value because it is a required development to land that would not be required if it was used for residential and commercial developments. The seawall would not be required for the land to be used in this next best alternate use, and would therefore not be reflected in the underlying, alternative use value (price) of such land. The seawall is validly included as a depreciating civil works that is specifically required for the conduct of airfield activities.
- f) The optimisation out of the second runway is covered earlier in this section.

5.73 *Are the Commission's views on when new investment should be included in the asset base appropriate?*

- a) See earlier commentary and statement from Professor Kahn (Attachment 3).
- b) The Commission's view is one approach, but it is more valid to include the cost of those investments that are supported by the test of efficient (optimal) investment analysis.

5.74 *Are the asset values determined for the airfield activities of AIAL, WIAL and CIAL appropriate?*

- a) No. There are two parts to this question. First, has the Commission undertaken the appropriate calculations in line with the methodology stated in its Draft Report? And, second, is the approach taken in the Draft Report correct?
- b) In relation to the first point, the Draft Report contains a number of calculation errors (as explained in Section 2 and Appendix 1).

- c) In relation to the second question, the Commission's approach to the valuation of airfield assets is not, in AIAL's view, consistent (between the various asset categories) and is also not appropriate.

6 TARGET RETURNS (WACC)

- 6.1 The Commission’s approach to determining the appropriate target return (WACC) for AIAL’s airfield activities mirrors the generally accepted use in New Zealand of the simplified Brennan-Lally Capital Asset Pricing Model. AIAL and its advisers regard this as the appropriate version of the capital asset pricing model under New Zealand’s dividend imputation system.
- 6.2 The Commission argues for the use of parameter values that are slightly different from those which were originally adopted by AIAL for price-setting purposes (based on the best information available at the time).

Key Parameter Values

	Commission	AIAL
	Pricing Assumption	Pricing Assumption
Risk-free rate	6.92%	6.97%
Post-tax market risk premium	8.0%	9.0%
Asset beta	0.4 to 0.5	0.45 to 0.55
Debt : Equity ratio	25 : 75	40 :60
Nominal tax-adjusted WACC	8.0 to 8.8%	8.5 to 9.4%

- 6.3 By using an asset beta of 0.45 to 0.55 a debt to equity ratio of 40:60 and with a PTMRP of 8%, AIAL estimates that its post-tax nominal WACC should lie within the range 8.5% to 9.3%. Accordingly, if the Commission wishes to adopt a single

mid-point estimate, AIAL believes that it ought to adopt a cost of capital of c.8.9% (mid-point of the range 8.5% to 9.3%) in determining a fair rate of return for AIAL's airfield activities.

6.4 In summary:

- a) AIAL argues that the WACC for its airfield activities will be higher than than supported in the Draft Report. AIAL considers that there is strong evidence to support an asset beta of 0.45 to 0.55 and also the target debt to equity used in the Draft Report is too conservative and a more realistic level is 40:60;
- b) The Draft Report initially concludes that the WACC for CIAL and AIAL are similar. AIAL considers that it has conservatively estimated its cost of capital but that for the reasons set out in Attachment 4 (Report by Dr Alastair Marsden), it will be higher than CIAL;
- c) That evidence of actual ex-post returns (including unrealised profits) exceeding WACC is not evidence of excess profits. There are a number of other issues that have meant that actual returns have exceeded expectation;
- d) That WACC needs to be set relative to the period prices are set. Since corporatisation, this has only happened on five occasions (1989, 1990, 1992, 1996 and 2000). Re-setting the WACC on an annual basis is inconsistent with the Draft Report's measurement of a WACC relative to the period of pricing consultation;
- e) In determining past pricing behaviour, a PTMRP of 9% should be used for all periods prior to June 2000 when that was the generally accepted position from practitioners and academics (including the Commission's adviser); and

- f) The WACC supported by AIAL relates to that for the existing airfield operations. It is not possible to transpose that risk weighting to the holding cost for assets that are subject to a substantially different risk profile, eg the suggested second runway treatment. A developer's risk is more appropriate under that scenario.

Commission's Questions – Specific Responses

6.5 *Is the appropriate debt premium adopted by Commission?*

Yes. The Draft Report's assumption of 1% concurs with AIAL's own estimate.

6.6 *Is the appropriate risk-free rate adopted by the Commission?*

- a) Yes. The Draft Report's estimate of 6.92% broadly concurs with AIAL's own assumption of 6.97% used in the pricing models.
- b) However, AIAL disagrees with the methodology used in the Draft Report to arrive at this figure on the following grounds:
- The Draft Report's suggested approach of calculating an average rate for Government stock over the period in which an airport consults (with a maturity matching the point at which prices will again be reviewed) is somewhat arbitrary and could lead to "gaming" behaviour were it to be adopted under a price regulation system; and
 - The approach might lead to different risk-free rates for the various airports depending on the timing of negotiations rather than underlying business risk, which is, in AIAL's view, inappropriate.

6.7 *Is the appropriate asset beta adopted by the Commission?*

- a) Broadly, yes. Although the Commission's view is somewhat lower than we consider appropriate. The Draft Report's assumption of an asset beta of between 0.4 and 0.5 is consistent with AIAL's own assessment (0.45 to 0.55).
- b) AIAL contends that the assumed asset beta would need to be recalibrated to allow for the effects (and, in particular, the added risks and uncertainties) of the suggested move to price control. For example, a recommendation for price control will have the effect of introducing additional substantial business risks, in terms of:
- The timing of inclusion of second runway into the charging asset base on assets held for future use;
 - Regulatory risk; and
 - The outcome of price arbitrations (rather than consultation).

This issue is discussed more fully in the report from Dr Alastair Marsden (refer Attachment 4).

6.8 *Are the comparators for the airfield activities supplied by AIAL, WIAL and CIAL used by the Commission in order to estimate asset beta appropriate?*

Broadly, yes - subject to the qualification that the benchmark betas which have been used in the Draft Report do not necessarily reflect the specific additional risks (uncertainties) referred to above as emanating from the type of price controls suggested by the Commission.

6.9 Should CIAL's asset beta be greater than AIAL's given the different exposure to domestic demand?

- a) To better illustrate the points AIAL wishes to make in this paragraph, total passenger movements (for an annual period in each case from the latest data published or available) and the breakdown between Domestic and International movements is set out in the table below:

PASSENGER MOVEMENTS							
	<i>New Zealand Airports</i>			<i>Australian Airports</i>			
	Auckland	Christchurch	Wellington	Sydney	Melbourne	Brisbane	Perth
International	4,942,947	1,125,332	445,877	8,048,190	3,000,000	2,600,000	1,599,485
Domestic	3,353,113	3,176,079	3,168,000	15,209,404	11,899,000	9,000,000	3,385,825
Total	8,296,060	4,301,411	3,613,877	23,257,594	14,899,000	11,600,000	4,985,310
Year ended	Feb-01	Feb-01	Dec-00	Jun-00	Dec-99	Dec-00	Jun-00
% change	5.0%	9.3%				8.3%	3.8%

Source: Statistics NZ, AIAL, CIAL, CPA, SACL

- b) It is noted in the Draft Report (in paragraph 5.66) and AIAL agrees with the Commission's statement:

"It is likely that the elasticity of demand for international air travel will be higher than for domestic air travel. This is because much more international travel is leisure-related, which is more discretionary and income sensitive. In addition, international travel is typically more costly than domestic travel, implying that a given percentage rise in price would have a relatively larger "income effect". There may be other factors, such as exchange rate risks related to "spending money", which may make international travellers more sensitive to changes in the price of air travel."

Thus, while AIAL may have a higher proportion of “international travellers” (comprising both overseas residents and NZ-resident passengers), both:

- The percentage of NZ-resident international passengers to total international passengers; and
- The percentage of NZ-resident international passengers to total (domestic and international) passengers

are higher for AIAL than for CIAL.

c) Moreover, the number of New Zealand resident passengers travelling overseas (mainly for holiday purposes) is likely to be strongly influenced by the national economy. As noted in the Draft Report, a large proportion of international travel is leisure related, which is both discretionary and income sensitive.

d) AIAL therefore submits it is wrong to necessarily conclude that:

“CIAL’s beta may be higher as its higher proportion of domestic traffic (relative to Auckland) means it is likely to experience greater shocks to changes in the domestic economy”.

e) Lastly, there are a number of additional reasons why AIAL’s asset beta and cost of capital might be higher than CIAL’s:

- Activity at AIAL, being the major hub airport in New Zealand, may have greater sensitivity to the national economy than CIAL, where activity might be more correlated to the regional South Island economy; and
- As is noted in the Draft Report (paragraph 8.61), CIAL has signalled that, should the fleet mix or the relative number of each

type of aircraft change, then it will look to change the allocation of total revenue and landing charges. This minimises CIAL's risk compared to the risks faced by AIAL (with its different pricing policy). If this is correct, then there is another reason for the asset beta for AIAL to be higher than CIAL's asset beta.

6.10 *Is the market risk premium adopted by the Commission appropriate?*

- a) Yes. The Commission's preliminary view is to adopt a post-tax market risk premium (PTMRP) of 8%, which is consistent with the latest research of a number of market analysts and commentators – despite the earlier wide body of evidence suggesting a PTMRP of around 9% (which was the basis previously adopted by AIAL for pricing purposes).

- b) The Commission, in calculating the cost of capital for AIAL over the period 1989 to 2000, has used a constant PTMRP of 8.0%. This appears unreasonable. It was only with the release of the March 2000 position paper published by PriceWaterhouseCoopers, which advocated a fall from 9.0% to 8.0%, that the market has tended to adopt the lower figure. Prior to that date, most market practitioners and academics used 9% as an estimate of the PTMRP (e.g., Lally⁵, The Treasury⁶, Transpower⁷ and Airways Corporation⁸). The Commission ought therefore to use a PTMRP equal to 9% prior to the 2001 year in its analysis for measurement of past excess returns.

⁵ Lally, M., 2000, The cost of equity capital and its estimation, Vol 3, MCGraw-Hill Series in Advanced Finance, The McGraw- Hill Companies, Inc. See page 13.

⁶ Handbook of October, 1997

⁷ For the year ending 30 June 1999 Transpower assumed a PTMRP of 9% (page 68 of Notes to Economic Value Added Statements, 1998/99 Annual Report). Transpower also assumed a PTMRP of 9% in its cost of capital assumptions for 2000 to 2002 (see its Statement of Corporate Intent, page 3).

⁸ For the year ending 30 June 1999, Airways Corporation used a PTMRP of 9% (page 29 of Notes to Financial Statements, 1999 Annual Report)

6.11 *Is the leverage ratio adopted by the Commission appropriate?*

- a) No. In AIAL's opinion, the Commission has adopted an unusually low debt to equity ratio (of 0.25:0.75) in its calculation of WACC. By comparison AIAL, in its submission, used a debt to equity ratio of 0.40 to 0.60.
- b) The Commission's assessment of a 25:75 debt to equity ratio is derived from taking the book value of debt in mid-2000 as a proxy for the market value of debt and, relating it to the share price, multiplied by the number of shares outstanding (as a proxy for the market value of equity).
- c) Going forward, AIAL considers a debt to equity ratio of 0.25:0.75 to be conservative for the financing of its airfield assets. It does not reflect what would be a more normal long run target debt to equity ratio.

6.12 *Are the WACC estimates developed by the Commission appropriate?*

- a) No. For the reasons outlined above (and the potential different values for individual parameters in the CAPM model), the WACC estimate should be stated as a range. Accordingly, the single-point adopted in the Draft Report is, in AIAL's view, inappropriately low. The appropriate range is 8.5 to 9.4% rather than the Commission's estimate of 8.0 to 8.8% adopted in the Draft Report.
- b) In assessing past returns, the WACC should not be re-set annually (as postulated in the Draft Report). The WACC should be set at time of review and fixed for the period to the next review date. Accordingly, the gap between allowable return and actual return is larger in AIAL's favour.

7 ALLOCATIVE EFFICIENCY AND CROSS-SUBSIDISATION IN PRICING

Commission's View

7.1 In considering the structure of charges for airfield activities, the Commission has identified that:

- a) Efficiency requires that separate products are priced separately according to the marginal costs of supply, but that the administrative costs of levying a wide range of separate charges must be taken into account;
- b) The need to recover fixed costs means that pure marginal cost pricing would not be financially viable; and
- c) Airports, because they offer a variety of services to a variety of users, have the potential to engage in cross-subsidisation.

7.2 The Commission highlights the economic efficiency arguments in favour of Ramsey pricing, which involves recovery of fixed costs in inverse proportion to price elasticities of demand. The Commission is also critical of the airports' "cost causation" approach to apportioning costs between different user groups.

7.3 The Commission, however, states that it has not identified any issues with cross-subsidisation and in this regard is supportive of the use by airports of the multi-till approach to determining landing charges.

AIAL's View

7.4 AIAL concurs with the Commission's findings with respect to the absence of cross-subsidisation and the advantages of the multi-till approach over the single-till approach. However, in relation to Ramsey pricing principles, AIAL believes the approach adopted in the Draft Report is once again simplistic. There are economic efficiency reasons for including the fixed costs (which can be attributed

to a particular user group) in prices for that group. If this is not done, the resulting prices are more likely to imply elements of cross-subsidisation.

- 7.5 Furthermore, Ramsey pricing is only applicable in a world in which information is perfect and there are no transaction costs. Ramsey pricing has substantial information requirements, including sound estimates of marginal costs (which the Commission has incorrectly assumed to be zero in its analysis) and the elasticities of demand.
- 7.6 The “optimal” pricing structure will depend on a wide range of variables including information and transaction costs, customer acceptability, international pricing constraints etc. In light of this, the Commission’s analysis appears overly simplistic.
- 7.5 Within this context, AIAL (and the users of its services) are likely to be in the best position to understand the true drivers of its costs and hence to be able to ensure that AIAL’s pricing approach is allocatively efficient. It is not obvious that prices which are prescribed by a regulator and set forms of control will necessarily lead to better allocative efficiency.

Commission’s Questions – Specific Responsea

- 7.6 ***Is the Commission’s assessment of the allocative efficiency of the structure of the landing charges of AIAL, WIAL and CIAL correct?***

The Commission has discussed the concept of allocative efficiency in the context of how closely prices reflect the principle of Ramsey pricing. This issue is covered in further detail under 7.8.

7.7 Is the Commission's assessment of the airports' approaches to cost allocation correct?

AIAL concurs with the Commission's view that its ACAM cost allocation methodology does not "result in any cross-subsidisation of non-airfield activities by airfield activities"; and that "the costs apportioned to airfield activities are less than the stand-alone costs".

7.8 Is the Commission's assessment of the extent of compliance with Ramsey pricing correct?

- a) The Commission has correctly arrived at the conclusion that it is questionable whether pricing schedules set on the basis of cost allocations would come as close to Ramsey pricing as the Commission considers desirable. However, this is an empirical issue and would require substantial analysis, none of which has been attempted in the Draft Report.
- b) In particular, the estimation of Ramsey prices requires an estimate of the relevant forward-looking marginal costs. The Draft Report assumes marginal costs are zero in its quantitative analysis, which is clearly inappropriate given AIAL's upcoming investment in the second runway.
- c) However, it is questionable whether the narrow focus on Ramsey pricing as the ideal solution is appropriate. Such a focus fails to fully consider the complexities of the pricing problems (and practicalities) that AIAL faces, as well as the international agreements it is subject to.

7.9 Is the Commission's assessment of whether there is any evidence of cross-subsidisation associated with the supply of airfield activities at Auckland, Wellington and Christchurch International Airports correct?

- a) The Commission has drawn the conclusion that *"the scope for cross-subsidisation between aircraft classes was limited"*. However, given the runway (take-off and landing) congestion at Auckland Airport at peak times, AIAL believes that there will continue to be cross-subsidisation of smaller aircraft (by larger aircraft) until the introduction of a differential landing charges at peak times, which is based on the congestion costs of each individual aircraft movement rather than the current universal MCTOW basis.

- b) The Commission has correctly drawn the conclusion that the dual (or multiple) till approach is the best way to prevent cross-subsidisation occurring between airfield and non-airfield activities. In this regard, the dual or multi-till approach is being increasingly accepted overseas as the most appropriate method of accounting for airfield against non-airfield activities.

8 EXCESS RETURNS

Commission's View

- 8.1 A crucial part of the Commission's views on the necessity and desirability (or otherwise) of imposing controls is its assessment of AIAL's returns in the past – which the Commission assesses to have been in excess of an appropriate WACC (and therefore to imply the existence of excessive or monopoly returns).
- 8.2 In carrying out its analysis, the Commission has calculated the accounting rate for profit (ARP) for AIAL's airfield activities in past years by extrapolating estimates from data in their possession, and comparing the results against the computed 'normal' WACC.

AIAL's View

- 8.3 There are a number of problems and errors in the analysis contained in the Draft Report. The following comments relate to AIAL's airfield activities only, and a more detailed discussion on each issue is set out in Attachment 1 of this submission:
- a) The formula used in the Draft Report is inconsistent with that specified covering the electricity industry;
 - b) There are obvious inaccuracies in the Commission's methodology in deriving operating profit and asset value figures for AIAL's airfield activities in past years by simplistically extrapolating the proportional figures in the AIAL Disclosure Statements backwards to produce corresponding figures for the preceding years. This ignores the fact that airfield revenues (with corresponding affects on costs) have declined significantly (from 40% to 26%) over the period in question. This type of elementary approach produces misleading results;

PART A

- c) The way in which each period's estimated asset revaluation gains (which are treated as income in the year in which they occur, and taken into account to the extent of 50% in the underlying average value of the opening and closing asset bases) will distort the assessment of percentage returns in individual years;
- d) The inappropriate optimisation out of certain airfield assets from the underlying asset base (refer Section 5 above);
- e) The simplistic assumptions made in the Draft Report in calculating a target WACC for each year in the past (which is an inconsistent basis for assessing AIAL's returns, which are based on prices set for an interval of three to five years at any one time; and, in doing so, includes annual adjustments in the risk-free rate but particularly overlooks the need to make corresponding adjustments for the fluctuating debt leverage ratios, etc); and
- f) Finally, the failure to appropriately recognise the number of assumptions that have to be made in determining an appropriate WACC, using the simplified Brennan-Lally CAPM model. In this regard, the Commission's own expert adviser (Martin Lally) recommends a range of between 8.0 – 8.8%. This not only overlaps AIAL's own assessment of between 8.5 – 9.4%, but the Commission has assumed a single point estimate of 8.4%, which – although it is equivalent to the midpoint of the assessed range - is arbitrarily 0.4% below the upper band recommended as being appropriate. The "WACC band" provides a "best guess" at the range within which the "right" WACC lies, and it is therefore only possible to categorically conclude a company is earning excess returns if its ARP consistently lies outside this range – not if it lies above the midpoint.

Commission's Questions – Specific Responses

8.4 *Is the Commission's assessment of the existence of, or potential for, excess returns correct?*

- a) No. The Draft Report contains a number of errors in its assessment of so-called "excess returns", including:
- The assumptions around the asset base, both in terms of the unjustified optimisation out of certain assets and the failure to include future capital expenditure;
 - The assumptions that have been built into its calculations in terms of the proportion of the airport's total activity that constituted airfield activities in previous years;
 - Other assumptions regarding the component parameters used in its calculation of ARP, such as the tax rate;
 - Inaccuracies in the calculation of the appropriate target competitive levels of return (WACC) in individual years;
 - The presumption that returns higher than the target WACC imply monopoly behaviour rather than, for example, greater than anticipated traffic levels or better than projected productive efficiency; and
 - Simple calculation errors (such as the transposition of data between years).
- b) AIAL has reworked the calculations detailed in the Draft Report, using the Commission's own spreadsheet model and corrected for errors. The

results were reviewed in Section 2 of this submission, and are presented in greater detail in Attachment 1.

- c) In drawing its conclusions about “excess returns” in the future, the Draft Report contains has made similar compounding errors, for example:
- Assuming an inappropriately low asset base as a starting point (due to the transposition of data);
 - Not taking account of future anticipated capital expenditure over the period being considered;
 - Not allowing for future growth in costs (with the anticipated growth in traffic);
 - Inappropriately optimising out land held for the second runway; and
 - Assuming an inappropriately low WACC.
- d) The analysis within the Draft Report also suffers from various other shortcomings by:
- Not testing the robustness of calculations (by providing a range of scenarios to illustrate the effects of applying different, equally valid assumptions, which would indicate the sensitivity of the results to the assumptions); and
 - Not including confidence bands to allow an assessment to be made of whether the results (and the basis for the Commission’s conclusions) are statistically significant.

8.5 AIAL considers the analysis in Appendix 8 of the Draft Report (as critiqued by AIAL in Attachment 1 to this submission) and particularly in scenario 8, where the average historical return to AIAL to be 13.47% compared to the average target return of 9.76%⁹ is calculated) is incorrect and flawed for the reasons outlined below.

a) **Price Reset Dates and Period Between Price Reviews:**

Prices were historically reviewed by AIAL in 1989, 1990, 1992, 1996 and September 2000. In undertaking any analysis to compare actual returns to target returns or expectations, the relevant benchmark should be the expectation of returns set at the start of each price review period. This same “expected” or target rate of return should apply each year until the next price review date. That is, in determining whether ex-post or historical actual returns exceeded ex-ante target returns, the analysis should not be undertaken on an “annual basis” but over the period between each price review date. Based on the analysis over the period 1989-2000 and the historical price reset dates of 1989, 1990, 1992, 1996 and 2000, only four “valid” observations¹⁰ can be made to compare ex-post or the actual outcomes to the target returns. With four observations only, AIAL contends that it is not statistically valid to conclude historical prices charged by AIAL have systematically been too high and indeed, even if they were, AIAL’s returns have not been above the benchmark.

⁹ Paragraph 10.16 of the Commission's report.

¹⁰ There were two price reviews in 1990 (March and August). Given the short time period between these reviews, they are considered as one price review only.

b) **Actual Outcome Versus Expectations:**

- Paragraph 10.6 of the Draft Report notes:

“An actual return in excess of an appropriate target WACC would suggest that the entity was earning an excessive or monopoly return, unless those returns reflected superior performance.”

However, the actual outcome will almost invariably not equal the ex-ante expectations.¹¹ This may result from both unanticipated deviations from forecast expectations and/or abnormal performance.

- Over the period 1989-2000 actual returns to AIAL may have historically exceeded expected returns due to:
 - Growth in air travel exceeding expectations; and/or
 - Greater than anticipated operating and cost efficiencies introduced by AIAL’s management subsequent to corporatisation in 1988.
- The fact that actual or historical returns to AIAL may (under the Commission’s analysis) then have been higher than expected cannot be construed as evidence that AIAL is “monopoly pricing” or setting prices too high. In this regard, it is noted:
 - First, the tourism industry has experienced substantial growth in the last decade, and there has been a correspondingly large increase in the demand for air travel. Over the period 1989 to 2000, forecast expectations for

¹¹ AIAL’s price review as at September 2000 was based on expected revenues and efficient costs over the three year period until the next price review date. Again, it is unlikely that the actual outcome will equal expectations.

growth in travel may have consistently *underestimated* the actual demand for air travel and aircraft landings in future years. AIAL considers that it would have been, and still is, quite inappropriate to assume this level of underestimation into forecasts;

- Secondly, AIAL was incorporated on 1 April 1998. Since corporatisation, AIAL's management have implemented substantial operating and cost efficiencies, based on the findings of numerous benchmarking studies and process re-engineering reviews undertaken by external consultants; and
- Lastly, the operating and cost efficiencies introduced by AIAL's management may have been much greater than anticipated at any price review. These efficiencies are evidence of good management and accordingly would be to the benefit of AIAL until the next price reset.

9 INEFFICIENCIES

Commission's View

- 9.1 The Commission has sought to provide estimates of the allocative, productive and dynamic inefficiencies resulting from the limited competition faced by each of the airports.
- 9.2 The **allocative** inefficiency measures are based on an assumed price elasticity of -0.105 and a comparison of AIAL's current and planned future prices versus those which the Commission projects might be imposed under a price control regime. For AIAL, the allocative inefficiency estimates range between \$132,723 (for 2000) and \$694,273 (for 2003).
- 9.3 The estimates of **productive** inefficiency are based on a hypothetical (nominal) 1% of airfield expenses (excluding depreciation) and are estimated at \$131,910 per annum for AIAL.
- 9.4 **Dynamic** inefficiency for AIAL is estimated at \$6,711,684 per annum and is based on the estimated value of the "inappropriate" airfield investments made by AIAL (eg AIAL purchasing land for a second runway before it is required and using it for low intensity farming purposes).
- 9.5 **AIAL does not accept that such inefficiencies exist:**
- The **allocative** inefficiency estimates are predicated on wrongly calculated excess returns;
 - The **productive** inefficiency estimate the Commission itself admits has no empirical basis; and
 - The **dynamic** inefficiency estimate for AIAL has been set without proper regard to practical issues, such as the legacy of the investments in the

seabed and seawall, or the need for current ownership of the land required for future development.

- 9.6 Productive inefficiencies can exist in any organisation and it is the residual claimant (in AIAL's case its shareholders) who will always have the most to gain from minimising this inefficiency. It is well known that following coporatisation of a number of Government departments, stepped improvements occurred in overall productive inefficiency. Directors, (especially those of publicly listed companies such as AIAL) for the benefit of shareholders, have an obligation to secure added value by reducing as much as possible any inefficiencies they observe.
- 9.7 Any organisation balances the operational needs, including the need to respond to issues in a timely manner, with the need to absolutely minimise operational costs and this is a judgement for directors and management to strike to optimal point. What is important is that companies in both competitive and monopoly sectors equally try to strike this balance to be normally efficient. Good governance structures must be the only way to crystalise this objective.
- 9.8 It is incorrect to ascertain that any company has 1% of productive inefficiency that price control will be able to eliminate. AIAL airfield activities have largely fixed costs. Even costs associated with manning levels are defined by safety standards. It has generally been observed that AIAL costs are 70-80% fixed in nature. Therefore, consider the following table sourced from the Draft Report:

	June 00	Fixed Costs % (assume 75%)	Variable
Employee and associated costs	8,016	6,012	2,004
Repairs & maintenance	2,410	1,808	602
General	2,265	1,699	566
Rates & insurance	<u>500</u>	<u>375</u>	<u>125</u>
Operational Expenditure	<u>\$13,191 m</u>	<u>\$9,894</u>	<u>\$3,297 m</u>

- 9.9 The Commission is therefore suggesting that it would be possible to save \$131,910 from \$3,297,000 or reduce variable costs by 4%. Further, given the relatively low variable costs of repairs & maintenance, insurance and general, it is likely that most of the savings would need to come from employee remuneration. The proportion is even greater at 6.5%.
- 9.10 The Commission cannot assume any productive efficiency gain can be realised through price control. On the contrary, the additional costs and support needed to satisfy the regulator will increase any inefficiency.
- 9.11 **Dynamic Inefficiency (page 150).** The Commission is using the concept of dynamic inefficiency as one of the measures to estimate the efficiency gains of price control. Dynamic efficiency relates to optimal timing of investments in capacity to match demand. It relates to whether the airport has purchased or acquired assets too early or too late and therefore incorporates a component of inefficiency within its assets or operations that relates to timing of meeting demand with provision of services.

- 9.12 **Paragraph 10.55 of the Draft Report makes a significant and material mistake.** It states that AIAL has “over invested” in some assets. The Draft Report suggests that there are dynamic implications associated with these poor investment decisions by AIAL.
- 9.13 **AIAL refutes this on a number of accounts.** There is no evidence that the acquisition of assets by AIAL was either a poor investment relative to cost or timing. Refer to the discussion on timing of second runway and the forecast operational need for that asset by 2007 detailed in Section 5 of this submission. Nevertheless, if as the Commission states, in its limited knowledge of running airports, that the assets could have been purchased at a later date and most importantly that, as a consequence, the total accumulated cost to acquirers would be less, then the dynamic inefficiency calculation would be correct. However, this is most certainly not the case.
- 9.14 There are a number of incorrect calculations within this analysis.
- 9.15 The value of the dynamic inefficiency is calculated at \$6,711,684. The Draft Report suggests that the optimisation of second runway land has caused this total writedown. However, the model does not follow this calculation.
- 9.16 The calculation removes more assets than have been optimised in the Draft Report in relation to the second runway and is therefore in error. In addition, the concept of all ‘optimised’ assets being included in the dynamic inefficiency calculation is also in error. The Draft Report states that for valuation and charging purposes, certain assets should be excluded. The Commission has not suggested, however, the assets are unnecessary and therefore they should not be included in the dynamic inefficiency calculation.
- 9.17 The value of the seabed being included as a dynamic inefficiency is also incorrect. The Draft Report states that it has no value and therefore, it cannot be

counted in any dynamic inefficiency analysis. Quite separate from this, if it did have a value it should be only \$10,100,000, (which was included in the pricing models) and not \$30,113,000. To quantify dynamic inefficiency, the Commission must be of the view that this land would flow to an alternative more efficient use if it were not held by AIAL. The Commission has not suggested this, nor is there any suggestion from either the airlines or other interested parties. In fact, the Commission has suggested it has absolutely no opportunity cost – and therefore it must be removed from the calculation.

- 9.18 The issue of seawall has never been raised as a matter of inappropriate investment, but rather the Commission's initial view is that value was implicit in the land value. Again, to suggest the seawall is either over engineered or inappropriate investment is not correct and therefore no dynamic inefficiency can be attributed to this asset.

Commission's Questions – Specific Answers

- 9.19 ***Is the Commission's assessment of the extent of, or potential for, allocative efficiency or inefficiency correct?***
- a) No. The Commission's assessment of the extent of, or potential for, allocative inefficiency is incorrect, as it is based on the Commission's assessment of excess returns.
 - b) Additionally, the analysis contained in the Draft Report suffers, in AIAL's view, from modelling errors.
 - c) Importantly, the Commission's estimate of allocative inefficiency is also not based on any estimate of marginal costs – prices will only be allocatively inefficient if they deviate from marginal costs. The Commission's assumption that marginal costs are zero significantly

underestimates actual (forward-looking) marginal costs given the airports upcoming investment in additional capacity.

9.20 *Is the Commission's assessment of the extent of, or potential for, productive efficiency or inefficiency correct?*

- a) No. The Commission has not made any serious attempt to assess productive efficiency, instead choosing to make an ad-hoc nominal assumption of 1% of total operating costs (excluding depreciation). Whilst, prima facie, this might seem to be insignificant, and therefore, an acceptable level, it in fact equates to a more material percentage of AIAL's variable (ie non-fixed) and therefore controllable airfield operating costs. To illustrate further, as approximately 70-80% of AIAL's airfield activity related costs are fixed, a supposed 1% assumption for productive efficiency actually translates to 4-5% reduction in variable costs. Further, at no time has AIAL been advised of any area where it can improve its efficiency of its airfield operation. Airlines have significant representation on numerous committees at Auckland Airport. Both their input and influence are significant.

- b) AIAL has commissioned a wide range of operational benchmarking and process reviews in recent years, with the aim of identifying (for management) potential areas of operational improvement (ie productive efficiency gains). These were referred to in AIAL's original submission to the Commission along with the results of an industry review of AIAL's (productive) efficiency against other airports (the TRL Report) and an independent review undertaken by Leigh Fisher Associates. These reports (and their findings), provide no grounds for an assumption of productive inefficiency, yet the Commission not only fails to refer to them but goes on to include them in its Draft Report (albeit "*for the purposes of*

illustration only”, although the figure has actually been included in the quantitative analysis as well).

9.21 *Is the Commission’s assessment of the extent of, or potential for, dynamic efficiency or inefficiency correct?*

- a) No. The Commission has made no attempt to assess the merits of AIAL’s investment programme, choosing instead to make an ad-hoc, unfounded assumption that all land held for the second runway development is a poor investment choice. In so doing, the Commission has ignored:
- The costs AIAL would incur were it to try to invest at a later date, especially given the timing of the commissioning of the second runway (by the year 2007);
 - The fact that AIAL’s substantial customers actively supported AIAL’s investment decision; and
 - The fact that theory suggests that implementing price control will lessen the incentives for dynamic efficiency.
- b) Although the Draft Report suggests that the asset write-down (ie dynamic inefficiency) is totally accounted for by the optimisation out of the second runway land, its underlying model and calculations do not support this assertion. Instead, the calculation includes both:
- All future airport land, including non-airfield land; and
 - The value of the seabed and seawall (both of which were assets transferred to AIAL on its incorporation and vesting and can

therefore hardly be deemed to be representative of a poor investment management decision, ie dynamic inefficiency)¹².

- c) Moreover, this erroneous calculation of dynamic inefficiency cannot be projected on a constant basis forward into future years. The runway will need to be used as an operating runway by 2007, and prior to that date (as indicated previously). Comprehensive planning requirements must be satisfied to allow AIAL to commence the required land improvements and runway development.
- d) There also appears to be an element of double-counting in the approach taken in the Draft Report, including the same adjustment to the asset base in the calculation of excess returns (ie allocative inefficiencies) and in the subsequent calculation of dynamic inefficiencies as well.
- e) In the Commission's calculation of dynamic inefficiency in respect of the second runway land, the Commission makes reference to the estimated annual returns on this land of \$400,000 per annum (page 151).

AIAL can advise that it has endeavoured in the past to find more productive uses for it in revenue terms, but in each case, they were not viable nor practical at the time. For example:

- AIAL worked with Fletcher Forests to assess the possibility of planting the land in pine trees. The plan was ruled out as the forest would need to stand for some 25-30 years before being felled to be commercially viable. The second runway was going to be needed well within this timeframe;

¹² AIAL is unlikely to have been able to "sell" either asset if they had been previously deemed to be held inefficiently.

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- Large scale dairying was considered but the configuration and access points of the various land holdings did not permit the scale of operation that would be required. Short-term leases were subsequently entered into, principally involving grazing;
- Low cost housing – this was considered undesirable from a social perspective by AIAL’s Board and possibly fraught with problems in the longer term when tenants needed to be moved on to make way for the second runway; and
- Lastly, planning issues were also a consideration. As noted in Mr Derek Nolan’s statement (Attachment 5 – page 6):

“If runway construction were to commence in say 7 to 8 years time, then if AIAL had to sell the land now, or lease it to third parties for other uses in the interim, it would have to repurchase the freehold or leasehold interests again within a few years (if it could) ...”.

9.22 To what extent are there other sources of detriment (e.g. spillover, effects, service quality)?

There are no other identified sources of detriment.

10 CONTROL NECESSARY OR DESIRABLE IN THE INTERESTS OF ACQUIRERS?

The Commission's View

- 10.1 The Commission argues that *“the presence of excess returns reveals an ability and willingness to set prices above the competitive level”*. The assessment of excess returns detailed in the Draft Report (and hence AIAL's asserted ability to earn excess returns) largely hinges on whether or not AIAL's asset base should be adjusted to exclude the value of land held for future airfield development and to replace the ODRC value of certain specialised assets with their depreciated historic cost.
- 10.2 To extend this argument to imply an overt “willingness” by AIAL to earn excess returns presumes that AIAL's pricing policies have been, by design, mischievous (uncompetitive). On the contrary, AIAL considers that AIAL's pricing policies had been entirely consistent with generally accepted (and endorsed) accounting valuation and pricing standards.
- 10.3 Even if one accepted all of the Draft Report's figures and economic policy, it is interesting to note going forward that the assessed difference between AIAL's promulgated charges in the year 2000 and the Commission's benchmark competitive price represents an “excess” of only 2.9%. AIAL is strongly of the view that any numerical and theoretical analysis as that undertaken by the Commission in this Inquiry must have attached to it a margin of error. A reasonable margin could easily be plus or minus 5%. Accordingly, AIAL contends it is well within the margin of error of the analysis contained within the Draft Report. This fact alone must throw the interim conclusion of inclining towards price control in some doubt. This is even before one argument is mounted against the Draft Report's numerical errors or economic analysis.

10.4 Another illustration of the questionable status (robustness) of the Draft Report's quantitative approach and analyses is the apparent illogicality in terms of the wide fluctuations in the reported average "excess returns" for the three airports over the 1989-2000 period in what the Draft Report argues is a largely uncompetitive and unconstrained market.

Commission's Questions - AIAL's view – Control is not necessary or desirable

10.5 ***Is the Commission's approach to determining whether section 52(b) is met correct?***

The Commission's approach to estimating the likely benefits of price control (that would accrue to acquirers) and balancing those against the likely costs of control is broadly appropriate within the confines of Section 52(b).

10.6 ***Is the Commission's assessment of the extent to which excess returns, allocative, productive, and/or dynamic efficiency could be improved as a result of airfield activities being controlled correct?***

No. The Commission has assumed that price control would improve allocative, productive and dynamic efficiency, whereas an equally convincing case could be made (on the basis of various overseas empirical studies and academic research papers) that price control would be likely to reduce efficiency in each of these areas. For example:

- **Allocative efficiency** – the Draft Report has assumed that price control would improve allocative efficiency by 50%. Aside from the fact that AIAL disputes the assessment of "excess returns" as detailed in the Draft Report, the Draft Report has also failed to recognise the relationship between prices and efficiency gains – a 50% reduction in excess profits would only reduce allocative efficiency by 25%.

- **Productive efficiency** – the Draft Report has assumed that price control would put pressure on airports to operate efficiently and therefore improve productive efficiency. Aside from the fact that the “estimate” of productive inefficiency is without foundation, there is a significant body of economic writing on price regulation which suggests that productive efficiency is likely to be worsened as a result of price control (particularly for an organisation that is otherwise subject to the incentives and competitive pressures of shareholders and the capital market); and
- **Dynamic efficiency** – aside from the Draft Report’s flawed reasoning in estimating dynamic inefficiency, it is difficult to see how price control would change the mix of assets held by AIAL, especially given the support the airport has from its substantial customers. Economic theory (and evidence such as delayed investments by BAA at Heathrow) suggests that price regulation is likely to reduce dynamic efficiency.

10.7 ***Is the Commission’s formulation of the likely counterfactual should airfield activities not be controlled, and the various features of that counterfactual, appropriate?***

- a) No. The Draft Report has not assessed the likely counterfactual in any depth, making bland assumptions about AIAL’s likely costs and asset bases in the future and failing to estimate future “excess returns” correctly or to consider the impacts of the existing light-handed regulation and airlines’ countervailing market power on AIAL’s ability to realise excess returns.
- b) In terms of the Draft Report’s “with price controls” future scenario, AIAL’s ownership of future airfield land (plus the seabed and seawall) are unlikely to change – unless the introduction of price control compels AIAL (for commercial reasons) to dispose of the land held for the imminent

development of a second runway (in which case the allocative and dynamic inefficiencies under the imposition of price control are likely to be much greater than have been allowed for).

10.8 *Is the Commission's assessment of the benefits to acquirers from airfield activities being controlled, relative to the likely counterfactual correct?*

No. There are three flaws in the assessment of the benefits to acquirers relative to the likely counterfactual set out in the Draft Report:

- a) First, it fails to correctly evaluate the counterfactual (see response to 11.6), which has led to a **significantly inflated estimate** of AIAL's projected future excess returns;
- b) Second, it fails to produce credible estimates of the potential allocative, productive and dynamic efficiency gains; and
- c) Third, it overstates the potential benefits of price regulation, failing to consider the risks associated with such regulation and assuming that any excess returns or inefficiencies can be realised and transferred to the benefit of acquirers.

10.9 *Is the Commission's assessment of the additional costs of control under the Commerce Act, compared to the status quo correct?*

It is difficult to determine whether appropriate allowance has been made in the Draft Report for:

- a) The initial establishment and start-up costs of regulation (including the regulator);
- b) The (one-off) costs of the present Inquiry;

- c) The potential full ongoing costs (incurred by all parties) as a result of the possible introduction of (an undefined form of) price control; and
- d) Normalising out the (extraordinary) costs associated with the uncertainties resulting from:
 - The relative newness of the existing regime (and, in particular, the lack of familiarity with the disclosure information and consultation process); and
 - The inclination of specific airlines to resort to costly and time consuming litigation.

10.10 *Is the Commission's assessment of the costs of control that acquirers are likely to bear correct?*

- a) No. This question is integrally linked to the preceding questions in relation to the degree of excess returns and the inefficiencies associated with AIAL's existing price structure and how much of the indicated benefits can be realised through price control.
- b) The Draft Report over-estimates the potential benefits to acquirers and then simplistically used these estimates as a basis for estimating the associated indirect costs. The calculations are rudimentary, and lack robustness and rigour. In AIAL's view, considerable further analysis is required in order to make the necessary corrections to the following points:
 - The Draft Report fails to properly consider the inefficiencies that could be created through price regulation and which acquirers would need to bear; and

- The Commission's assertion that its methodology arrives at a conservatively high figure for costs is inaccurate. It is stated in the Draft Report that "*the direct costs of control [are] ... conservatively low estimates*". Therefore, it is more reasonable to argue that methodology leads to an upper estimate of net potential gains.

10.11 *Is the Commission's preliminary view that the airfield activities supplied by AIAL and CIAL satisfy section 52(b)—that it is necessary or desirable in the interests of acquirers to control the airfield activities supplied by AIAL and CIAL—correct?*

- a) No. The preliminary view detailed in the Draft Report is based on a series of inaccurate estimates and flawed methodology. Appropriate changes to the analysis could equally well lead to the opposite conclusion (as evidenced by the reworkings set out by AIAL in Section 2 of this submission) - thus, for example correcting for the:
- Level of excess returns and inefficiencies, which have been considerably overestimated;
 - Extent to which price regulation might be expected to realise benefits for the acquirers, which have been overestimated; and
 - Potential direct and indirect costs associated with price regulation, which have been inappropriately estimated.
- b) Furthermore, the preliminary view contained in the Draft Report is based on point-estimates, which fail to provide a sense of the confidence (or margin of error) around its calculations and therefore the extent to which the resulting deductions or conclusions are significant enough to be able to be relied upon.

11 ARE MARKET CONDITIONS SUCH THAT CONTROL SHOULD BE IMPOSED

Commission's Questions – Specific Answers

11.1 *Is the Commission's analysis of net efficiency benefits appropriate?*

Yes. The analysis of net efficiency benefits is more important than the analysis of the benefits accruing to acquirers. Net efficiency benefits incorporate the long-term impact on the wider set of consumers rather than taking an inappropriately narrow (acquirers') perspective.

11.2 *Is the Commission's assessment of the public benefits to be gained from airfield activities being controlled, relative to the likely counterfactual correct?*

No. The assessment of the public benefits set out in the Draft Report suffers from the same fundamental errors as in its assessment of the benefits to acquirers, most notably:

- The excess returns and inefficiencies represented in AIAL's prices, which have been grossly overstated;
- The degree to which any potential benefits could be realised through price control, which have been overstated; and
- The methodology used to estimate the costs of price control, which is lacking in rigour and fails to account properly for the risks (and hence costs) associated with regulation.

11.3 Is the Commission's assessment of the lessons that can be learned from the experiences of airport regulation internationally correct?

- a) Having undertaken a review of airport regulations internationally, it is stated in the Draft Report (paragraph 11.74) that:

“it is very hard to know what the impacts (positive or negative) are of any regulation. There is no real benchmark against which to measure the effects”.

Despite this, the Draft Report then goes on to reach its conclusion about the relative advantages (over other forms of control) of price-cap regulation. This is not surprising, given that (apart from the US where it is historically embedded) the alternative of rate of return regulation is not regarded as an efficient form of regulation¹³. The Draft Report's subsequent quantification of the costs and benefits of (an unspecified form of) price control to apply in New Zealand seems without foundation.

- b) The Draft Report's assessment that price cap regulation can provide incentives for productive efficiency needs clarification. It is important to bear in mind that price cap regulation's advantage in this area is in relation to *other forms of regulation*, such as cost-based or rate-of-return regulation. It is not the case that a price cap provides better incentives for productive efficiency than a market situation where an unregulated firm has a strong profit-maximising incentive (such as AIAL has).
- c) Having undertaken this review, it is surprising that the Draft Report does not include any observations regarding the overseas precedents (in the context of overseas regulation of airports) for some of its draft recommendations – notably, for example:

- The “operational perversities of detailed regulation”;
- The overseas trend to move away from detailed regulation; and
- The use of current cost asset valuation methodologies, plus the inclusion of future runway land assets, notably in the UK.

These, and other empirical observations about the practical lessons that might be drawn from airport regulation overseas, are outlined in the statement from Mr Tom Bass of Macquarie Airports Group (whose aviation (and specific regulatory) industry experience includes 25 years with the CAA (UK)) (refer Attachment 6).

11.4 *Is the Commission’s preliminary view that the airfield activities supplied by AIAL should be controlled correct?*

No. Even if AIAL was to accept the Draft Report’s *point estimate* of the public net benefits of price regulation (which it does not), it is highly questionable whether the quantum of identified benefits (\$2.4 million) is sufficiently significant to recommend price control. The confidence bands around this figure are likely to be very wide, implying that it is probably statistically insignificantly different from zero (as evidenced by the corrected estimates derived by AIAL and set out in Section 2 and Attachment 1 of this submission).

11.5 *Is the Commission’s preliminary view that the airfield activities supplied by WIAL and CIAL should not be controlled correct?*

AIAL has not undertaken a detailed analysis of the calculations and estimates of the Commission’s preliminary view regarding WIAL and CIAL.

¹³ Other than where the objective is to legitimise higher charges to finance the development or expansion of a new airport that is regarded as nationally important.

12 CONCLUDING COMMENTS

12.1 AIAL submits that, when the necessary adjustments are made to correct the errors in the analyses and calculations contained in the Draft Report, it should be concluded that:

- There appear to be no net benefits (and instead quantified real net costs) in respect of the preliminary recommendation for control of AIAL's airfield activities;
- The potential net benefits to acquirers do not exist and are, in any event, unlikely to be passed on in the form of benefits to end consumers; and
- There is no evidence of monopolistic pricing behaviour (or resulting uncompetitive, excess returns) on the part of AIAL, either in the past or projected into the future.

12.2 **Accordingly, AIAL maintains that no conclusive evidence has been shown that control is necessary or desirable (Section 52).**

12.3 In addition, the Draft Report states that *"the impact of the outcome of this Inquiry has not been included"* - in the context of which AIAL believes that, given the apparent lack of robustness about the draft findings, the Commission needs to give obvious consideration to the potential ramifications of its findings to other infrastructural utilities (and the consistency of recommended asset valuation and pricing standards between sectors).

12.4 It is also stated in the Draft Report:

"notes that the current inefficiencies may be able to be removed by a form of regulation other than price control, for example, one that involves a requirement on the airports to negotiate on price and service (rather than merely to consult) subject to set pricing guidelines, a requirement to

disclose information, and the existence of an external body to act as an arbitrator in disputes over the outcome of negotiations”.

12.5 This seems to imply that, at its Draft Report stage, **the Commission was not necessarily persuaded that price control was the most economically efficient way to proceed**, and instead may be inclined to an alternative view that extensions to the current regulatory framework might provide a preferable solution.

12.6 AIAL alluded to this option in its own initial submission to the Commission and further pointed out that:

- a) The existing Airport Authorities Act and Disclosure Regulations have not yet had time to be properly tested; and
- b) The existing regulatory framework can, if necessary, be strengthened (through the issue of guidelines) to provide sufficient safeguards, and without the need to move at this point in time to a formalised arbitration process.

12.7 ***The Commission invites comments on any of the matters raised in the draft report, and any other relevant points.***

- a) The Draft Report has commented on numerous aspects of aviation, and obviously in particular, those pertaining to airports;
- b) AIAL has endeavoured to focus on the major issues relating to its activities, as interpreted by the Commission, and the Commission’s comments and findings thereof;
- c) There are, however, a number of items touched on within the Draft Report which AIAL believes convey potentially misleading conclusions relative to the activities of AIAL. For instance, it is not correct for the Commission to

suggest that “*compared to the situations at some airports overseas there are limited congestion problems at the three international airports in New Zealand*”. Which airports are we comparing? AIAL is currently spending \$20 million to expand the ITB to cope with congestion within the terminals which is a by-product of the airlines’ current hubbing strategy.

- d) AIAL looks forward to the opportunity at the forthcoming Conference to further comment on other such issues within the Draft Report, including:
- Noise controls and charges;
 - Economic impact concerns;
 - Airports’ charges as a percentage of airline costs;
 - The process of reducing pricing proposals within the recent AIAL Consultation;
 - Retail prices as set by airport retailers;
 - Airports within New Zealand and competition;
 - Airports anticipating further demand;
 - Airlines’ forecasting; and
 - The requirements of new entrants.

12.8 *The Commission invites comments on any omissions, or material or factual inaccuracies in the draft report.*

AIAL reserves its right to make further comments at a later stage, particularly in the context of cross-submissions in respect of the arguments put forward by other parties in their responses to the Draft Report.