



AUCKLAND CITY

AUCKLAND CITY'S SUBMISSION

on

COMMERCE COMMISSION'S DRAFT REPORT

on

**Price Control Study of Airfield Activities
at
Auckland, Wellington and Christchurch
International Airports**

8 August 2001

1. EXECUTIVE SUMMARY

1.1 VALUATION OF RECLAIMED LAND AND SPECIALISED AIRFIELD ASSETS OTHER THAN LAND

Auckland City Council (“Auckland *City*”) does not agree with the Commission’s view that optimised, depreciated Historic Cost should be used to value Auckland International Airport Limited’s (“AIAL’s”) Specialised Airfield assets.

It is our view that Optimised Deprival Value (“ODV”) / Optimised Depreciated Replacement Cost (“ODRC”) should be used, because:

- It provides investment signals which most closely proxy those in a competitive market.
- Redundant or over-engineered assets are optimised out of the asset base, reducing incentives for “gold-plating”.
- ODV/ODRC effectively values the asset using the cost of a modern equivalent asset now (appropriately depreciated). This is consistent with what happens in competitive markets. If a new firm can enter the market with significantly cheaper and more efficient assets, existing firms with older assets will be penalised.
- Allowing a regulated firm to set prices based on ODV/ODRC assures the sustainability of the entity. In comparison, Historic Cost may vary significantly from Replacement Cost over time, due to inflation or technological developments making the assets cheaper. Therefore, under Historic Cost, the depreciation associated with the asset may not bear a strong relationship to the cost of maintaining and replacing the asset.
- As AIAL is currently using ODRC, the Commission’s arguments that a change to ODRC will result in price increases do not apply to AIAL.
- It minimises the likelihood of significant price shocks when assets are replaced.
- A change to pricing based on Historic Cost would result in a windfall gain to users of the Specialised Airfield Assets, at the expense of AIAL and its shareholders.

1.2 TREATMENT OF THE SEAWALL

Auckland *City* considers that should the reclaimed land behind the seawall and the seawall be deemed to be a single land asset, then it would be inappropriate to value that land asset using opportunity cost. Instead Auckland *City* advocates the “purest hybrid approach” outlined in the Commission’s report which recognises the “value in use” of the asset.

The optimisation out of the seawall penalises AIAL and its investors for undertaking the most efficient option open to AIAL in extending and constructing its runway. The adverse signals to AIAL and its shareholders from optimisation out of the seawall will lead to sub-optimal investment decisions in the future.

Should the Commission continue in its view that the reclaimed land should be valued at opportunity cost separately to the seawall, Auckland *City* considers that the seawall should be regarded as a land improvement as it falls within the definition of “Specialised Assets” as defined in the New Zealand Institute of Valuers, Valuation Standard 2.

1.3 TREATMENT OF THE SECOND RUNWAY

Auckland *City* disagrees with the Commission’s view that the land held for the second runway should be optimised out of AIAL’s asset base.

Auckland *City* believes that the Commission, in taking the view that there is no need to hold the land set aside for the future runway because the land could be sold then compulsorily re-acquired, has understated the costs of compulsory acquisition. If AIAL were to sell the land then it would have to either:

- Designate the land for compulsory re-acquisition, which would result in a low sale price; or
- Declare the land surplus, which would allow AIAL to sell the land at market value but would result in re-acquisition being very costly or impossible.

Auckland *City* considers Auckland Airport to be an important infrastructural asset for the Auckland region and that to place a requirement on AIAL to sell the land held for the future runway would subject the future infrastructure of the region to an unacceptable risk.

Auckland *City* considers that the Commission’s approach to returns on long-term investments stands to:

- increase the return required by both financiers and equity holders through increasing the level of regulatory uncertainty and changing the risk profile of the investment;
- provide an insufficient return to the company; and
- make certain types of investment unattractive to equity holders leading to an overall reduction in investment and/or sub-optimal investment.

2. INTRODUCTION

Auckland *City* is the largest shareholder in AIAL, owning 25.75% of shares. It therefore has an interest in the Commerce Commission's draft report both as a shareholder in AIAL and as a local authority. Auckland *City* has reviewed the draft report and wishes to make selective comments on the following issues:

- The valuation methodology used for valuing specialised Airfield Assets. (Section 3).
- The treatment proposed by the Commission in relation to AIAL's seawall. (Section 4).
- The treatment proposed by the Commission affecting AIAL's second runway and other assets held for future development. (Section 5).

3. VALUATION OF RECLAIMED LAND AND SPECIALISED AIRFIELD ASSETS OTHER THAN LAND¹

3.1 RATIONALE FOR USING ASSET VALUES AS A BASIS FOR PRICING

Auckland *City* agrees with the Commission's line of reasoning that:

- AIAL does not operate in a competitive market.
- In markets which are not competitive, it is not appropriate to value assets based on the revenue those assets can generate, because there are no competitive constraints on prices, and hence.
- When determining whether AIAL is charging appropriate prices, it is therefore appropriate to use a valuation methodology, which is not determined by revenue.

3.2 ASSESSMENT OF ALTERNATIVE VALUATION METHODOLOGIES

Auckland *City* agrees with the Commission's view that it is desirable for the valuation methodology used to provide investment signals which are as close as possible to those which would occur in a competitive market.

There are a number of alternative methodologies for determining asset value, including:

- Historic Cost: The original cost of constructing or acquiring the asset.
- Opportunity Cost: The highest alternative use value of the asset.

¹ "Land" is defined as land required for Airfield Land prior to any improvements being undertaken. The land is therefore in its raw, undeveloped form.

- ODV incorporating ODRC:

ODV = Lower of (EV, ODRC) and EV (“economic value”) is the higher of a DCF or earnings based value, or the net realisable value of the asset;

The Commission has suggested using Opportunity Cost to value AIAL’s Airfield Land and (optimised depreciated) Historic Cost for its Specialised Airfield Assets.

Auckland *City* **agrees** that Opportunity Cost is the appropriate methodology for valuing AIAL’s Airport Land (with the exception of reclaimed land – see discussion in section 4.1).

However, Auckland *City* **disagrees** with the use of optimised Historic Cost for valuing AIAL’s Specialised Airfield assets. It is our view that ODV/ODRC provides investment signals which most closely proxy those in a competitive market.

3.3 INVESTMENT SIGNALS FROM ODRC/ODV

The ODRC/ODV methodology is used to value assets for regulatory purposes in other New Zealand regulated network industries, such as the electricity and gas industries. A shift away from use of ODRC/ODV is likely lead to uncertainty in the New Zealand capital markets, reducing the availability of capital and retarding new investment activity.

Auckland *City* believes that it is important to establish broadly consistent pricing and incentive structures across regulated and unregulated markets. As ODRC/ODV results in investment signals which are more consistent with those in a competitive market, it is more likely to achieve this goal than Historic Cost.

Emulation of competitive markets is the most compelling advantage of ODRC/ODV over Historic Cost. ODRC/ODV provides proxies for competitive market factors as follows:

- **Appropriate entry barriers.** In a competitive market the asset valuation should not exceed the most efficient replacement cost. This reduces the likelihood of uneconomic new participants, such as a second major airport in Auckland, being encouraged by ambiguous price signals generated by Historic Cost.
- **Appropriate signals for exit.** In a competitive market, an asset which reduces in Customer-value over time (eg an asset which is used to produce something which is no longer in demand) will generate less and less revenue, and its value will reduce accordingly. ODRC/ODV mirrors this situation, by optimising out redundant assets.
- **No dominant suppliers.** Economic theory argues that when a market reaches a steady state, marginal prices will equal marginal values. ODV means value of an asset to the Customer is adopted where the value placed on an asset by a Customer is less than the asset’s replacement cost. In the case where ODV equals ODRC, this is affected through both depreciation and optimisation and is consistent with a competitive market.

As the Commission notes:

“ODRC is argued by its proponents to have efficiency advantages in terms of:

- Mirroring conditions in a competitive or contestable market inasmuch as the firm does not make a return on inefficient investments...
- Minimising the likelihood of a significant shock to the tariff when it comes time to replace the assets.” (page 99)

Auckland *City* agrees with these advantages of ODRC/ODV.

3.4 COMMISSION’S ASSESSMENT OF THE DISADVANTAGES OF ODRC/ODV

The Commission also states, however, that its tables of comparison of Historic Cost and ODRC/ODV suggests that ODRC/ODV does not have any clear advantages over Historic Cost. Auckland *City* **disagrees** with this view.

Auckland *City* has the following specific comments on the arguments for (F) and against (A) use of ODRC set out in Table 23 of the draft report:

Points made in Table 23	Auckland <i>City</i> ’s comments
<p><u>Point F1.</u> The ODRC of existing assets is the cost of modern equivalent assets, and therefore provides an “objective” measure of the valuation of assets, against which the performance of the company can be assessed (BUT: see A1).</p> <p><u>Point A1.</u> ODRC methodology leaves considerable discretion on the hands of companies on valuations, particularly with regard to “optimisation”, valuation of assets and asset lives. See also A7.</p>	<p>Any concerns in this respect can be resolved by introduction of a robust methodology including tightly defined assets valuation and life guidelines. Such a methodology has been introduced as part of the regulatory regime applying to the electricity industry, in order to deal with similar concerns.</p>
<p><u>Point F2.</u> ODRC prevents inappropriate upward valuations of assets and strips out any redundant or over-engineered assets. The entity cannot be over-valued in relation to the required level of services. Investors remain responsible for errors of judgement (BUT: see A1 and A2).</p> <p><u>Point A2.</u> 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).</p>	<p>Auckland <i>City</i> considers that using the cost of a modern equivalent asset now is an appropriate reflection of asset value for a monopoly asset.</p> <p>The modern equivalent asset now may well be cheaper and more efficient than what was available at the time the investment was made, and this will result in the value of the asset being “optimised” downwards. This is consistent with what happens in competitive markets. If a new firm can enter the market with significantly cheaper and more efficient assets, existing firms with older assets will be penalised. Therefore, the ODRC/ODV</p>

<p>That would be difficult to assess.</p>	<p>approach more closely proxies what happens in a competitive market.</p>
<p><u>Point F6.</u> By allowing a regulated firm to recover (with profit) the ODRC valuation of its prudently incurred investments in assets assures the sustainability of the entity—prices can be set at levels that guarantee the funds required for replacement (BUT: see A6).</p> <p><u>Point A6.</u> Sustainability is assured where the firm is 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 <i>not</i> sustainable where technological improvements are lowering the cost of modern equivalent assets (the ODRC will decline faster than the book value).</p>	<p>This is related to point F8 about price shocks. At the time an asset is purchased, its Historic Cost valuation will equal its Replacement Cost valuation. However, Historic Cost is likely to differ from Replacement Cost over time. Inflation will cause Historic Cost to be lower than Replacement Cost, whereas technological developments will cause it to be higher. Therefore, under Historic Cost, the depreciation associated with the asset may not bear a strong relationship to the cost of maintaining and replacing the asset.</p> <p>We therefore agree with the comment under point F6 that an ODRC/ODV valuation is more consistent with long-term sustainability.</p>
<p><u>Point A7.</u> There is no economic rationale for including the costs of sunk assets where those have already been written off (e.g., 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.</p>	<p>An asset which still has some life remaining may have been written off under the Historic Cost methodology, but would be revalued under ODRC/ODV. This would lead to an increase in asset value, and a resulting jump in prices. However, this is not an issue when a company is already using ODRC/ODV, as AIAL is. Provided the ODRC/ODV methodology is being applied correctly, the value of the assets will accurately reflect their future useful lives. In fact, as the Commission notes under point F8, price jumps are much more likely under Historic Cost.</p> <p>Auckland City disagrees that obtaining a reasonable return on “sunk” assets (i.e. assets which are currently being used in their best use, and for which the costs cannot be recovered if the service is discontinued) is an economic “rent”. Investors should be able to get a reasonable return on past investments – if they cannot, future investment decisions will be significantly distorted.</p> <p>Assets which are no longer used can be optimised out of the valuation base under either Historic Cost or ODRC/ODV.</p>
<p><u>Point F8.</u> ODRC valuations of assets at the outset would avoid rises in price for purchasers of the service in the future when assets are replaced (BUT: see A8). Such rises could be</p>	<p>As AIAL is currently basing prices on ODRC, continued use of ODRC will not lead to price rises.</p>

<p>“disruptive”.</p> <p><u>Point A8:</u> F8 can be countered as follows:</p> <ul style="list-style-type: none"> • ODRC can lead to a big price rise at the outset. • This results in a windfall gain to producers at the expense of acquirers. • Faced with the options, acquirers would prefer a later price rise to an earlier one. 	<p>Any change between Historic Cost and ODRC/ODV could result in transfers of wealth between AIAL and customers of its Specialised Airfield Assets. A change to pricing based on Historic Cost would result in a windfall gain to users of the Specialised Airfield Assets, at the expense of AIAL and its shareholders. Given the arguments above for using ODRC/ODV, Auckland City’s strong view is that the status quo should be maintained.</p>
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4. TREATMENT PROPOSED BY THE COMMISSION IN RELATION TO AIAL’S SEAWALL

We note the Commission has excluded the seawall from the airfield assets of AIAL. We believe the following matters must be taken into consideration when assessing the appropriate treatment for the seawall.

4.1 BASIS OF VALUATION OF RECLAIMED AIRFIELD LAND

We note the Commission’s preliminary view is that airfield land should be valued based on Opportunity Cost. Whilst Auckland City agrees in principle with the Commission’s argument that the mutual dependence of the reclaimed land and the seawall implies that they are a single land asset, it is considered that opportunity cost is not an appropriate way of valuing this land. Auckland City believes the “purest hybrid approach” (incorporating ODRC methodology) should be used in valuing the reclaimed land when it includes a seawall. That is, that the reclamation be treated as a civil work since that was what it was originally.

Auckland City believes there is little economic basis to value reclaimed land based on Opportunity Cost, using either rural land values or the value of land with urban potential. This is because the “value in use” of the land is not taken into account under Opportunity Cost.

The importance of accounting for “value in use” of the land flows from the fact that the decision to reclaim the land would never have been economic if it was for urban or rural purposes. Instead it was the strategic location of the potential land that added sufficient value to it to make reclamation viable. Without this additional value the decision to reclaim the land, which was the best option at the time, would not have been taken. Now that the land is in place, it is difficult to see how this value has disappeared.

The “value in use” of reclaimed land must therefore be taken into account. The value in use concept is consistent with the findings in the case of WIAL versus Air New Zealand that stated:

“Value must mean its value as it is enjoying its position of sole provider of airport services in the capital.”

Auckland *City* considers that the purest hybrid approach (incorporating ODRC), which is built on the principles of value in use, is the most relevant valuation methodology to value reclaiming land. Returns to AIAL should not be based on the Historic Cost or Opportunity Cost of reclaimed land when it may:

- Not be economically rational to reclaim land for the potential alternate uses available; and
- Result in a return on less than the ODRC derived cost of the reclamation.

4.2 EFFICIENCY CONSIDERATIONS

Auckland *City* considers that the decision to optimise out the seawall may lead to inefficient investment decisions being made.

A seawall is necessary to preserve the integrity of the reclaimed land. Alternative reclamation options such as reclaiming significantly more land without the need for a seawall would presumably have involved higher initial capital costs and higher ongoing maintenance costs to combat erosion of the land.

The optimisation out of the seawall penalises AIAL and its investors for undertaking the most efficient option open to AIAL in extending and constructing its runway. The adverse signals to AIAL and its shareholders from optimisation out of the seawall will lead to sub-optimal investment decisions in the future as capital will be drawn to investments which stand a lower chance of being optimised out, for example reclaiming more land rather than building a seawall. This is not in the best interests of its customers, or the community/consumers.

4.3 IS THE SEAWALL AN IMPROVEMENT?

Should the Commission continue with its view that the reclaimed land should be valued at opportunity cost, then Auckland *City* considers that there is a case that the seawall be treated as separate to the land.

We note that the Commission states in paragraph 7.33 of the draft report

“land values should not include the cost of getting the land to a stage where it could be used as an airport. Such costs should be included within the cost of any land improvements such as runways, taxi ways and aprons.”

Auckland *City* considers the seawall, which is an integral airport asset should also be regarded as a land improvement. The seawall falls within the definition of “specialised assets” as defined in the New Zealand Institute of Valuers, Valuation Standard 2:

“Specialised, special purpose or speciality designed property ... which ... has utility restricted to particular uses/users, and is rarely, if ever, sold on the open market, except as part of a sale of the business in occupation, ... restricted or not markets ...”

5. TREATMENT PROPOSED BY THE COMMISSION AFFECTING AIAL'S SECOND RUNWAY AND OTHER ASSETS HELD FOR FUTURE DEVELOPMENT

Auckland *City* disagrees with the approach adopted by the Commission with respect to determining asset bases. In particular, Auckland *City* disagrees with the Commission's preliminary view, in paragraph xxvii of the draft report, that:

"...only those assets that are currently "used and useful" should be included in the asset base on which a rate of return is calculated. All other assets should be optimised out."

This effectively means that assets purchased for the specific purpose of future development, such as AIAL's second runway, are unable to be incorporated into the asset base of the airport.

There are several reasons why Auckland *City* disagrees with this view and is concerned with the impact on the asset base of AIAL. Specifically, Auckland *City* considers this approach:

- Understates the downstream impact of this approach, namely the costs of compulsory acquisition of Airfield Land; and
- Will potentially stifle investment activity in airports, and may also set a precedent that will negatively impact other regulated industries that require long-term, large-scale investments.

These points are discussed in more detail in the following paragraphs.

5.1 AIRPORT AUTHORITIES ACT 1966 AND SECTION 224 OF THE PUBLIC WORKS ACT 1981

The Commission notes in paragraph 7.57 that Airfield Land may be compulsorily acquired for an Airport. Auckland *City* considers that view the Commission has taken with respect to the compulsory acquisitions understates the costs involved.

In divesting itself of the land the Airport could either:

- Designate the land for re-acquisition before sale.
- Declare the land surplus and then sell it.

In the first case the land would likely sell only at a significant discount on the market price. Both the act of designating the land for acquisition, which precludes development, and the uncertainty about when the re-acquisition will take place will act to suppress the sale price. However when the airport comes to reacquire the land the threat of legal action and lengthening of the negotiation process makes it likely that re-acquisition will be at a price not less than market value. Hence there is likely to be a significant cost to the airport of selling the land in this way.

In the case of declaring the land surplus, the airport would likely be able to sell the land for its market value, but then there would be no controls on what was done with the land. If improvements were made to it, then these would have to be purchased when the land was re-acquired, but unless the improvements were consistent with the land's use for a second

runway, they would have to be removed and would likely add no value to the airport. Additionally, if improvements were made and the current owner was not prepared to sell the land then the initial act of making the land surplus would make compulsory acquisition difficult. In such a case it is likely that the land would eventually have to be purchased outside of the Public Works Act. In the extreme case the land may simply never become available to the airport and an alternative site would have to be found.

Given the importance of Auckland Airport as an infrastructural asset in the Auckland region, Auckland *City* considers that a decision which requires the airport to sell the land would subject the future infrastructure of the region to an unacceptable risk.

If investment in airport infrastructure in the region does not keep pace with international levels then there will be a risk that airlines will choose not to fly to Auckland because the airport is unable to meet their requirements. This would result in the need for travellers to go to a different airport (Sydney, for example) to catch a flight to their desired destination.

Auckland *City* considers that a likely outcome of the decision by the Commission to optimise out the land held for the second runway will be to give the airport a perverse incentive to keep the land and begin immediately to make that asset “used and useful”. The current plan is not to build the second runway for some years, so accelerating the project is likely to be a sub-optimal investment decision. However, considering the large costs of holding the land with no return or of selling the land and re-acquiring it later, building the runway early may present itself as the best option.

5.2 INFRASTRUCTURE INVESTMENT AND ADEQUATE RETURNS FOR LONG TERM INVESTMENTS

In paragraph 7.66 of the draft report the Commission concluded:

“The cost of new investment in land that is eventually included in the asset base should include the capitalised cost of financing construction and any holding costs of land (less any revenue that may have been derived from former use of the land), up to a cap of opportunity cost.”

Auckland *City* considers that this view of the Commission will:

- Increase the return required by both financiers and equity holders through increasing the level of regulatory uncertainty and changing the risk profile of the investment;
- Provide insufficient return to the company; and
- Make certain types of investment unattractive to equity holders leading to an overall reduction in investment and/or sub-optimal investment.

5.2.1 Increase in the Required Return

Auckland *City* considers that the Commission's approach will cause financiers to necessarily add a premium to the cost of debt to reflect a greater level of regulatory uncertainty.

Shareholders will also seek a greater return on their equity to reflect both the regulatory uncertainty and the greater risk imposed upon them by the airport being required to act in the role of a land developer, that is, to hold land with no return until the development is completed.

Auckland *City* considers that the effect of increased risk for both financiers and shareholders will result in higher costs to end users through:

- Significantly higher capitalised costs relating to assets purchased for future expansion; and
- Higher allowable revenues to reflect an increase in the required return (WACC) as a result of the increased cost of debt and equity and risk associated with this approach.

5.2.2 Insufficient Return

The approach advocated by the Commission is likely to mean returns insufficient to adequately compensate for the risk involved in long-term investment behaviours. This is because:

- It is not clear what finance costs are capitalised. That is, whether only interest costs (return to debt holders) are included or whether the total asset cost and costs of construction capitalised at an appropriate WACC (return to equity holders) are also included.
- It appears that the Commission is seeking to cap AIAL's returns close to general inflation on the value of the land, under its next best use, using opportunity cost. Auckland *City* considers that this will not provide an adequate return when land is purchased or held (e.g. for a second runway) for a period of years during the construction phase of any new investment and where the growth in land value based on opportunity costs is less than an appropriate WACC. AIAL should expect to earn a return based on an appropriate WACC for the risks implicit in long-term investments undertaken.

5.2.3 Distortion of investment incentives

By removing the land held for the second runway from the asset base, the Commission is expressing the view that 'holding costs' should be determined based on required returns for debt holders alone, as opposed to both equity holders and debt holders. Should this be the case then there will be a disincentive for AIAL to purchase assets to hold for new investment as the compensation paid in the future will be inadequate. Rather, equity holders will place their investment funds into projects that meet their WACC, and most likely, into projects that provide an immediate cash flow. This approach may therefore result in a reduction of investment activity and lead to sub-optimal investment.

If the approach advocated by the Commission is adopted in other regulated industries that require long-term, large-scale infrastructure investments, then the flow-on impacts to the New Zealand economy could be significant. Clearly, the government's aim to:

*"rebuild New Zealand's tattered social and economic infrastructure"*²

will be dealt a severe blow if investors react negatively to the approach being advocated by the Commission.

² Hon Dr Cullen, Budget 2000 Speech