

CROSS SUBMISSION BY BARNZ ON RESPONSES BY INTERESTED PARTIES ON THE COMMERCE COMMISSION'S DRAFT REPORT ON PRICE CONTROL OF AIRFIELD ACTIVITIES

1.0 INTRODUCTION

1.1 Opening Remarks

1. At the outset, BARNZ wishes to take the opportunity to reiterate that it is only with regard to prices that the airlines are in dispute with AIAL and CIAL. Airlines generally have good working relations with all three airport companies and appreciate the quality of service provided. We do however, have strong differences over charges as identified in this cross-submission and in BARNZ's previous submissions and responses to the Commerce Commission.
2. In our response on the Commerce Commission Draft Report BARNZ emphasised our view that the essential outcome of the Inquiry was the development of a clear set of pricing principles to guide the parties in the future. Our view is that ideally, prices should be negotiated between the relevant parties. However, if the current consultation regime is to continue, then BARNZ considers that the existence of pricing principles will greatly assist that process. BARNZ notes with disappointment that the airport companies do not appear to have considered the Commission's Draft Report in this light. BARNZ continues to view the development of clear pricing principles as being vital to the proper functioning of the light-handed regulatory regime applying to airports.
3. BARNZ continues to remain firmly of the view that it is necessary or desirable for a short period of price control to be introduced at both AIAL and CIAL in relation to airfield activities and that the Minister should exercise his discretion to make such a recommendation to the Governor-General.
4. BARNZ also still considers that the issues in relation to terminal related charges at AIAL and CIAL are sufficiently serious that there is a clear need for the Commission to instigate a price control inquiry into these aspects of AIAL's and CIAL's businesses. Alternatively, the airport companies may be willing to review their terminal charges in light of the pricing principles identified by the Commission.

1.2 Key Outstanding Issues

5. BARNZ and our advisors have reviewed the 16 responses made by interested parties. In some situations, points have been made which have caused BARNZ to alter our analysis, for example the reforecasting and transposition of data at CIAL. Such matters are noted in this cross-submission. However, overall we continue to support the thrust of the Commerce Commission's Draft Report.

6. From BARNZ's analysis of the responses, the following appear to be the key areas of difference between the parties:

Airport Wide Issues

- (i) Whether the existing countervailing power significantly constrains AIAL, CIAL and WIAL;
- (ii) The level of productivity improvement available;
- (iii) Whether sealed surfaces should be valued at historic cost or ODRC;
- (iv) The cost of price control; and
- (v) The approach to be taken to the exercise of the Minister's discretion to recommend price control to the Governor-General.

CIAL specific issues

- (i) WACC;
- (ii) The 'used and useful' concept with implications on pre-financing and setting prices using a DCF model, particularly with respect to the terminals; and
- (iii) The level of over-recovery.

WIAL specific issues

- (i) WACC;
- (ii) The ascertainment of the opportunity cost of the land in its next best alternative use; and
- (iii) The calculation of costs of getting land into use as an airport.

AIAL specific issues

- (i) WACC;
- (ii) The level of historic over-recovery;
- (iii) The level of future over-recovery;
- (iv) The ascertainment of the opportunity cost of the land in its next best alternative use;
- (v) Calculation of the cost of getting land into use as an airport;
- (vi) Application of 'used and useful' concept to land held for future use;
- (vii) Whether the seawall is subsumed in the land value;
- (viii) Calculation of historical cost of sealed surfaces; and
- (ix) Whether dynamic efficiency has been properly calculated.

1.3 Structure of this paper

7. BARNZ has structured this cross-submission using the same structure adopted by the Commission in its Draft Report:
 1. Introduction
 2. Section 52(a) – is competition limited?
 3. Pricing
 - 3.1 Pricing principles
 - 3.2 Asset base
 - 3.3 WACC
 - 3.4 Airfield pricing
 - 3.5 Performance analysis
 4. Section 52(b) – is control necessary or desirable?
 5. Discretion to control
 6. Other matters
8. Attached to this cross-submission are three appendixes:
 - (i) A revised benefits analysis for CIAL reflecting the corrected forecasts; (BARNZ CS-01)
 - (ii) A report by Mr Roger Taylor on the adjustments made by AIAL in response to the Commission's analysis of historical and future over-recoveries; (BARNZ CS-02) and
 - (iii) A report by Dr Paul Carpenter of the Brattle Group on 'Asset Valuation and the Airfield Activities Price Controls'. (BARNZ CS-03)
9. In this cross-submission, BARNZ has not responded to every matter raised by interested parties in their responses. We have merely sought to highlight those matters which we believe are directly relevant to the points made by the Commission in its Draft Report. The failure to raise any particular point should not be taken as acceptance or acquiescence in that matter.

2.0 SECTION 52(A) – IS COMPETITION LIMITED?

2.1 Countervailing Power

10. The Commission reached a preliminary conclusion that competition is limited in the aircraft movement market. The three international airports do not appear to challenge this conclusion. However, all three submit that the Commission did not give enough weight to the countervailing power possessed by the airlines.
11. The Commission concluded in paragraph 5.108 that AIAL, WIAL and CIAL are unlikely to be “significantly constrained by the countervailing power of airlines” under the current regime, and that airlines stand to lose greater amounts if they withdrew custom than the airports would.
12. In our response on the Draft Report, BARNZ agreed with the conclusion that airlines do not have sufficient countervailing power to discipline pricing decisions by the airports.
13. In our response to question 23 of the Critical Issues Paper, BARNZ noted that countervailing power will only arise if:
 - (i) the buyers have access to sufficient information to determine whether the offer from the upstream firm is a good one; and
 - (ii) the buyers can create a legitimate credible threat of an undesirable consequence, for example, a credible threat to remove custom from the upstream firm.
14. In the case of the three international airports, these pre-conditions are not met.
15. With regard to the first point, at the time of consultation with AIAL and CIAL, BARNZ considered that the airlines did not have sufficient information to determine if airfield charges were efficient. BARNZ considers that the airlines still do not have enough information to determine if costs are properly allocated within the terminals or if terminal charges are efficient. Consultation has only recently commenced at WIAL, therefore we are not able to make any final comment with regard to the information which WIAL will provide.
16. With regard to the second point, the lack of alternative airports to meet customer driven origin and destination demand, means airlines cannot credibly threaten to remove sufficient custom to produce an undesirable consequence, and thereby discipline any airport’s pricing decisions. Any reduction in use by one airline will tend to be replaced by increased use by another airline, as that second airline moves to meet the customer driven origin and destination demand in the competitive market.
17. AIAL has referred to the agreement reached with QANTAS regarding the payment of landing charges. QANTAS is represented on the BARNZ steering group, which has developed this cross-submission and BARNZ’s previous responses. QANTAS advises BARNZ that the exact terms of the agreement reached are confidential, but that the agreement reached was without prejudice to the Airport Price Inquiry, and specifically included a provision to allow for lower prices if the outcome of the Commerce Commission Inquiry led to price control. QANTAS also considers that the comments made by AIAL at paragraphs 1.67 through to 1.70 of

its Response are misleading and inappropriate to make in the medium of a Response to the Commission.

2.2 Price Elasticity

18. The Commission has adopted a price elasticity of demand for airport services of -0.105.
19. AIAL has challenged the Commission's conclusions in respect of price elasticity of airfield charges by attempting to show the absence of any correlation between movements in airfield landing charges and ticket prices.
20. The analysis by AIAL is too simplistic as it fails to appreciate that many factors other than landing charges influence ticket prices at any point in time. Unlike airports, airlines operate in a competitive market. In a competitive market, changes in costs of inputs, all other things being equal, are inevitably reflected in price.

2.3 Potential Competition to AIAL

21. Statements by AIAL at paragraph 1.71 regarding competition from other possible airports in the Auckland area, particularly Ardmore or Whenuapai, appear to conflict with the advice from its own expert adviser, Mr D Nolan. Mr Nolan has stated that a second runway at a distant airport would "not provide for a convenient and efficient transport system" and that "reports commissioned by the Auckland Regional Council confirm that the military bases are unsuitable" (refer paragraph 21 of Mr Nolan's report).

3.0 PRICING

3.1 Pricing Principles

22. In its draft decision the Commission set out a number of pricing principles at paragraph 6.24. BARNZ notes these principles are supported by a number of other submitters, including Federated Farmers and the shipping interests, who see the value in principles to guide pricing decisions.
23. The report which Air NZ has obtained from Dr Paul Carpenter, and made available to BARNZ for this cross-submission, advises that the Commission's pricing principles "are consistent with sound economic theory and international practice" (refer paragraph 4, BARNZ CS-03).
24. With one exception, BARNZ also supported these principles in our 10 August 2001 Response on the Commission's Draft Report. This exception related to the implication in the second bullet of the Commission's principles that returns in excess of a normal return may be earned in reflection of superior performance. BARNZ noted there would almost certainly be practical difficulties with the application of this point, with airport companies being likely to say that all and any above normal returns were a reflection of superior performance. This reservation has been shown to be valid by the statement made by AIAL at paragraph 4.13 of its Response that:

"normal returns are in fact the absolute minimum shareholders could 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."
25. In addition to considering it inappropriate for a monopoly provider to seek to earn a return above WACC on assets in the monopoly component of its business, BARNZ is also firmly of the view that the level of service for which a return at WACC should be allowed, must be limited to the level of service reasonably required by customers. To allow a return on higher service than reasonably required, would encourage airports to 'gold-plate' their service.
26. At least two of the airport companies do not appear to be particularly supportive of either the concept of pricing principles or the content of the principles developed by the Commission. CIAL, in particular, has described them as "functionally useless" (refer para 36).
27. While AIAL states it supports efficiency based pricing principles in general terms, it encourages the Commission to focus on whether airports have been abusing their market powers. AIAL does not appear to favour the development of principles to assist in the future determination of efficient prices. AIAL also states that it does not consider a number of the principles appropriate (refer AIAL's Response to Draft Report at paragraph 4.8).
28. WIAL appears to concur with the Commission's pricing principles, other than the concept of only charging for used and useful assets.
29. BARNZ finds the concept of 'used and useful' to be straight-forward and easy to apply. It is very simple to determine whether an asset is being used or not. We have no problem with this aspect of the pricing principles or with the principle that "today's consumers should only bear today's costs".

30. BARNZ notes that the building block formula and issues such as WACC and asset valuations are only a component in setting prices for monopoly businesses. As BARNZ stated at paragraph 12.2 of our Response to the Draft Report, the important issue is whether the prices that result replicate those that would rule in a competitive market. It is the characteristics of the prices and whether or not they provide the right signals for efficiency which are the real issues, and not the means by which they are derived per se.

3.2 Asset Base

31. Under the building block approach used by the Commerce Commission, AIAL and WIAL, the asset base has a significant impact on the resulting charges, as both return of capital (depreciation) and return on capital are calculated from it.

3.2.1 Optimisation

Principle

32. One of the Commission's pricing principles is that "today's consumers should only bear today's costs". A consequence of this is (as concluded by the Commission at para 7.49) "only used and useful assets should be included in the asset base on which a rate of return is calculated".
33. The airport companies appear to have some difficulty with the concept that, in the absence of a commercial agreement to that effect, they may not charge the airlines a rate of return on assets held for future use or on assets which are planned to be built in the future.
34. BARNZ considers that the principles "today's consumers should only bear today's costs" and "only used and useful assets should be included in the asset base on which a rate of return is calculated", are fundamental to determining efficient prices. Without these principles, there is nothing to prevent an airport company from purchasing or developing additional assets and fixing prices so as to earn a return on these, or even, as in the case of CIAL, currently collecting a return on assets which are yet to be built or paid for.

Land Held For Future Use

35. The Commission reached a preliminary view that all land held for development by AIAL should be optimised out of its asset base for calculating charges.
36. BARNZ does not consider it is valid to suggest land held for future use should be charged against today's passengers who do not have use of that asset. The efficient costs associated with holding land for future use will be capitalised as land improvements and have a return earned on them when the land becomes used and useful. AIAL's approach would result in it recovering the cost of holding land for the second runway twice – once while it was being held, and again when it comes into use (since holding costs are included in improvements (as per the Commission) or through increases in the land value (as per AIAL)).
37. AIAL holds significant portions of land for future commercial use (ie retail sites, logistics premises, warehouses etc) as distinct from future airfield use. AIAL's Prospectus (1998) states that the airport has 345 ha available for future development other than airfield use.

38. The question arises as to who is currently providing AIAL with a return on this land, and if no party is, why AIAL's shareholders and board have not decided to sell it. The answer is simply that AIAL knows this land is highly likely to be sought after by commercial enterprises in the future and hence will be able to earn a profitable return when it comes into use. In a competitive market (such as for commercial land) buyers or users do not provide a return on assets being held for the future until such time as it is actually used. In a similar fashion, today's users of the current runway should not be asked to pay for the land held for the future (second) runway.
39. BARNZ considers the 'used and useful' test provides the appropriate incentives for efficient investment decisions. BARNZ does not consider this test implies land held for future use must be sold. We are mystified as to why organisations such as the ACC and ARC have developed the view that the Commerce Commission is requiring the land to be sold. That is not our understanding.
40. What the 'used and useful' test does mean is that a provider has the appropriate incentive to ensure that the land is purchased at the most appropriate time, such that the purchase price (and actual net holding costs), will not exceed the opportunity cost (and efficient net holding costs), as measured at the time the land comes into use. Thus a provider who purchases too early will be penalised through not being able to recoup the higher holding costs. A purchaser who judges their purchase at the optimal time will be able to recoup the benefits of that decision because the opportunity cost will exceed the purchase price paid.
41. BARNZ acknowledges that there are some overseas examples where users have, in situations where they were reasonably well-informed, accepted partial funding in advance of an asset coming into use. However, this is usually only the case where the presence of a regulator ensures that the advance payments are netted off so the overall pricing result is the same. There have been no such agreements between the airlines and AIAL, CIAL or WIAL. Moreover, neither AIAL nor CIAL has provided any assurance regarding the use of any monies collected in advance. Indeed, in correspondence with CIAL over its terminal charges which were set from an asset base which included estimated costs of future terminal development, CIAL declined to 'ring-fence' the funds relating to the future terminal development, and saw such funds as being available to be distributed to today's shareholders rather than being held to underwrite the foreshadowed future development.
42. BARNZ has not suggested that AIAL has purchased the land at the wrong time. What BARNZ is suggesting is that as the airlines have not commenced using this land, the time to pay for it has not yet commenced. When the airlines do start using the land, then the airport will be able to earn a return on the opportunity cost of the land measured by its next best alternative use and net efficient holding costs.
43. AIAL has put forward an affidavit by Professor Kahn supporting forward looking marginal cost pricing on the grounds that today's users are contributing to the initial congestion which will make it necessary to construct the second runway. This argument ignores the fact that using an airport today does not commit an airline to use it next year or in 2007 when the new runway is forecast to be needed. This is illustrated by the recent withdrawal of Korean Air from CIAL and by the demise of Tasman Pacific.

44. Moreover, it assumes congestion and the resultant costs of increasing capacity are such that the long run marginal costs are significantly above current prices and that the most efficient way to price for this congestion is to charge today's users the long run incremental cost. BARNZ does not consider that the minimal levels of congestion that occur on the airfield from time to time at AIAL (ie weekdays between 7.00am and 8.00am and 4.30pm and 5.30pm) mean that the economically appropriate response is to charge all of today's users for the cost of the land held for the second runway. BARNZ notes that other approaches to managing what little congestion there is in respect of the airfield are available when needed.

Seabed

45. The Commission concluded the entire seabed area at AIAL should be optimised out.
46. BARNZ continues to consider that owning the seabed is not necessary for AIAL to be able to protect its approaches, and also that the seabed does not have any opportunity cost value. BARNZ notes that AIAL's advisors have stated "it is difficult to imagine AIAL selling the seabed at a price close to \$10 million." (refer p 27 of Nera's report).
47. BARNZ submits that it is time for the seabed (which during consultation AIAL was claiming had a value of \$30 million) to be deleted from the 'used and useful' asset base.

Seawall

48. The Commission concluded that the seawall is subsumed in the land value and therefore does not have a separate value to include in the asset base, as AIAL has done. BARNZ continues to agree with the Commission's view.
49. BARNZ notes that as part of a review of AIAL, undertaken on behalf of the Crown, Auckland City Council and AIAL in August 1997, Merrill Lynch was requested to re-value the assets of AIAL. This was undertaken using an ODV methodology for the airfield. Merrill Lynch engaged Beca Valuations to undertake an ODRC valuation which produced a value of \$206.6 m for the airfield in May 1997. This compares with AIAL's value in June 1999 of \$302m for the airfield.
50. Page 12 of Merrill Lynch's synopsis of its detailed review states:

"Land value has been optimised for location factors, with an optimisation value of nil applied to reclamation earthworks on the existing runway. This reflects the fact that reclamation would not be necessary if an alternative optimal site for the runway was used."

Other Land

51. Questions still exist over the usefulness of Wiroa Island and the eastern approaches. In addition, not all of the recently reclaimed 'lagoon land' at the western end of the runway is 'used or useful'.
52. During consultation AIAL advised 73.2513 hectares of reclaimed land had not been included in the asset base and made an upwards adjustment of \$22.3m. BARNZ is not certain which portion of this land is in use and which is not. Clearly, that portion intended to act as a taxiway between the existing runway and the

proposed second runway is not 'used and useful'. AIAL's 1999 Annual Report refers to an area of 29 hectares being reclaimed at the western end of the international terminal "for additional apron expansion and, eventually, second runway access".

53. Once it has further information on this question, the Commission needs to make an appropriate adjustment for those portions of this land not yet in use.

3.2.2 New Investment and Pre-Financing

54. The Commission's preliminary view is that the pre-financing of new investment is generally inappropriate and that only used and useful assets should be included in the asset base (refer para 7.63). BARNZ agreed with this in our response and has not read anything in the responses from the other parties to alter this view.

3.2.3 Opportunity Cost of Land

55. The Commission has made a preliminary decision to value land at opportunity cost based on the highest alternative use of the assets for the purposes of calculating a return.
56. BARNZ supports the use of opportunity cost based on the highest alternative use of the assets. BARNZ notes there are efficiency benefits to be gained from pricing up to alternative use value, but no efficiency benefits to be gained by pricing at a higher value. BARNZ also notes there are circularity issues involved in valuing assets in their existing use in a monopoly market because the cash flows which would be used to support the existing use value, are in fact driven off that value.
57. BARNZ observes that in his evidence to the ACCC on behalf of Sydney Airports Corporation Ltd, Professor Kahn stated the following with respect to measuring opportunity cost by the value of the next best alternative use: (17 January 2001 refer page 4)

The Wellington Airport, consistently with its general position that I have already cited, claimed that the land it occupied should for rate making purposes be valued (and the return on it allowed) on the basis of its market value when used as an airport - \$45 million, it estimated. My airline clients and I maintained that the only possible basis of independent valuation – free of the circularity I have described – and in any event its true economic cost was its opportunity cost – its value in its next most valuable alternative use, which the Airport estimated at \$16 million. I know of no economist who would disagree with that proposition, and the Sydney Airports Corporation explicitly adopts it here. (Emphasis added)

58. The issue of opportunity cost is also addressed by Dr Carpenter in his report at paragraphs 19 and 20 where it is stated:

The use of opportunity cost for land valuation correctly recognises that while the investment is sunk, appropriate compensation is necessary to provide an incentive for the monopoly service provider to keep the asset in service. The level of compensation necessary to accomplish that objective is the opportunity cost in its next best use.

At least one submission suggested that the opportunity cost concept did not sufficiently recognize the value of the land in its existing or best use (i.e., as an airport). [See Prof. Boyd's submission on behalf of CIAL, paragraphs 4-5, and NERA's submission on behalf of AIAL at page 21.] But the Commission's approach which recognises the cost of getting the land to its best use as a component of the value of the specialised assets does, in fact, compensate for the difference.

59. Having reached a preliminary conclusion in its Draft Report that land value should be measured by opportunity cost based on highest alternative use, the Commission now needs to determine this value for each of the airports.
60. Our understanding is that this was not an issue Telfer Young was requested to provide evidence on. Nor is it an issue the airports directly addressed in their responses. However, it is a fundamental issue. BARNZ considers the Commission needs to give serious consideration to obtaining further independent advice specifically on the question of the opportunity cost value of the next best alternative use of land at AIAL and WIAL.
61. In our Response to the Draft Report, BARNZ noted at question 13 that we had obtained further advice from Barrett Boyes Jefferies on the opportunity cost value of AIAL airfield land in its next best alternative use. This showed that the alternative urban use value was a maximum of \$90,000 per hectare and the alternative small rural block value was \$32,000 per hectare, which indicate the \$140,000 per hectare adopted by AIAL, and currently used by BARNZ, is at or beyond the upper end of the range of reasonable values. A raw land value of \$90,000 per hectare would result in AIAL's land value needing to be adjusted downwards by \$17.6 million.

3.2.4 Cost of Getting Land into Use as an Airport

62. The Commission concluded that the costs associated with getting the land into airport use (the costs and benefits of moving and of building the new airport) are more appropriately included within the costs of land improvements. However, due to a lack of information, the Commission did not make any adjustment to the asset base of the airports in this respect.
63. The airport companies did not provide any further detail regarding this component of their valuation in their responses to the Commission's Draft Report. However, BARNZ notes the evidence of Mr Horsley (current adviser to WIAL and adviser to AIAL during its revaluation exercise and consultation) supports BARNZ's position that holding costs are calculated for the previous period of time during which the asset was held, rather than on a forward looking basis (refer paragraph 9.25 of WIAL's Response to the Commission's Draft Report and page 8 of Mr Horsley's report).
64. In our Response on the Draft Report, BARNZ calculated the historical costs associated with getting the land owned by AIAL into airport use, by adjusting AIAL's levelling costs in accordance with the Consumer Price Index, and calculating holding costs by reference to the Index published by Quotable Values, this being a proxy for market land values as at that time. These calculations produced levelling costs of \$17,536 per hectare and holding costs of \$6,317 per hectare, a combined total of approximately \$24,000 per hectare to get the land at Mangere to a state it could be used as an airport in 1988 (refer response to question 14 in BARNZ Response to Draft Report).

3.2.5 Total Costs Associated With Land

65. The adjustments by BARNZ in respect of AIAL's land, produce the following total costs associated with land:

AIAL Land Costs

	AIAL Cost	BARNZ Cost
Raw land market value	\$140 000	\$140 000
Holding costs	\$133 000	\$6 317
Levelling costs	\$32 000	\$17 536
Value per hectare for airfield land including costs associated with getting land to use as an airport	\$305 000	\$ 163 853

66. The removal of AIAL's levelling and holding costs of \$165,000 per hectare from the land value, and the addition of \$23,853 per hectare into the improvements land value (for the 351.7205 hectares within zone 1 airfield land) results in a downwards adjustment of \$49.6 million to AIAL's land valuation. The details of these calculations were set out in BARNZ's Response to the Draft Report and Attachment BARNZ-01: refer questions 13 and 14.
67. In addition, if a raw land value of \$90,000 per hectare was adopted, then AIAL's land value would need to be adjusted downwards by a further \$17.6 million.

3.2.6 Historic Cost of Sealed Surfaces

68. The Commission's preliminary view was that specialised airfield assets should be included in the asset base at historic cost (para 7.46) as this is consistent with the principles adopted by the Commission and provides investors with a return on the amount invested and preserves incentives to invest in the future.
69. In our Response to the Draft Report, BARNZ noted there are different methods to value assets and whichever methodology is adopted, it is important that it is applied consistently and in an internally logical manner.
70. In his report on 'Asset Valuation and Airfield Activities Price Controls', commissioned by Air NZ and provided to BARNZ for use in this cross-submission, Dr Paul Carpenter has discussed the question of historical cost vs replacement cost valuation for specialised assets at paragraphs 8 through to 17 BARNZ CS-03. Dr Carpenter makes the following points:
- (i) Either approach, when properly and consistently applied, can satisfy the Net Present Value test.
 - (ii) The choice between the two methods hinges on issues of complexity and consistency over time relative to investor expectations.
 - (iii) Historical costs tend to be easier to define than replacement costs and make sense if the Commission is hoping for administratively manageable and transparent prices, and perhaps in some cases agreement between the parties.
 - (iv) The consistency of the valuation of these assets through time, and the reasonable expectations of the investors in the airports and their customers is another reason to recommend historical cost valuation for specialised assets in this case.
 - (v) The fact that ODRC represents a proxy for the cost to a new efficient entrant of providing the same services as the incumbent does not mean that a competitive market valuation could never be less than ODRC. This is because the specialised assets being valued represent "sunk" investments, whose opportunity cost is close to zero.

- (vi) There is no economic theory or basis in international practice for insisting that the only valuation technique consistent with a competitive market paradigm is ODRC.
- (vii) If properly implemented, ODRC valuation does not include any pre-financing of replacement investment. However, if the implementation of ODRC involves upward revaluations (that are not offset in prices for the capital gains involved), then the valuation approach no longer satisfies the “NPV test” (*i.e.*, it will produce rates of return in excess of the cost of capital) and it could be fairly concluded that the methodology so implemented involved an unwarranted “advance” on future investment.

71. BARNZ has read the LECG Report produced for WIAL entitled *Historical Costs and Replacement Costs: Efficiency Implications of Their Use In Price Setting* and refers the Commission to the following statements:

“Properly implemented both the historic costs and ODRC approaches can equate the expected present value of an airport’s cost and revenue. Used consistently over time, both can preserve incentives to invest.” (page 3)

“The arguments for choosing between historic costs and ODRC approaches at the outset of an investment in a sunk asset are subtle, and different approaches might reasonably be chosen in different circumstances. But the arguments against *changing* approach midstream are strong.” (page 4)

72. In respect of this point, Dr Carpenter has commented as follows:

“A more accurate reading of the history would be that the airports have instead unilaterally imposed a change in methodology subsequent to vesting (without an offsetting credit for the revaluation capital gains). In this light, the use of historical cost valuation for specialised assets is simply a return to the original vesting basis of the airfield investments. There is no efficiency advantage in permitting the airports to exercise their market power by imposing a “midstream switch” in valuation methodology to ODRC with no offset to prices for the implied capital gain. The result of the continued use of ODRC in that case is simply continued permission to collect monopoly rents, which is the very matter that price control is designed to prevent. (See *Telecom Corporation of New Zealand v Clear Communications Ltd* [1995] 1 NZLR 385, at 408 (PC).)”

73. BARNZ agrees that significant difficulties exist when changing valuation approach midstream. In the case of an airport such as WIAL, which has re-valued its sealed surfaces every three years since corporatisation, and which appears to have properly accounted for re-valuation gains as part of its return, then there is a risk involved in changing valuation approaches.

74. Similarly, an airport such as AIAL, which has used historic corporatisation costs from 1988 through to 1999, should not be permitted to change valuation approaches to ODRC midstream, unless it is prepared to properly account for re-valuation gains as it changes valuation approaches. BARNZ submits that there are two options open to the Commission in relation to the value of AIAL’s sealed surfaces:

- (i) Move AIAL back to historic cost at the time of corporatisation and thus, in effect, refuse to allow AIAL to alter its valuation methodology for the purposes of setting prices, midstream in the life of those assets.
- (ii) Accept the use of ODRC by AIAL so long as the revalued amounts are properly accounted for. Thus, if AIAL wants to set prices off the new value, then it needs to take into account the revaluation gains. A good example

of an appropriate treatment of revaluation gains is the approach taken by Transpower whereby revaluations are treated as revenue and are offset against required revenue over the next three years.

75. BARNZ is comfortable with either option as, applied correctly, both should lead to similar results.
76. In its response to the Commerce Commission's Draft Report AIAL has suggested that if the Commission's view on adopting the historic cost approach for sunk airfield infrastructural assets remains unaltered, it could sell its assets at inflated prices so as to allow their purchaser to receive increased income streams based on the higher valuation. AIAL has identified a sale at a level of five times ODV. BARNZ suggests such an approach could only be contemplated by a monopolist, and illustrates why price control is necessary and desirable in the case of AIAL. AIAL's suggestion fails to take into account that any gains on such a sale would need to be treated as a component of its return.

3.3 WACC

77. The Commission came to a preliminary determination that appropriate WACCs for the three international airport companies were 8.4% for AIAL and CIAL and 7.77% for WIAL.
78. All three airport companies and BARNZ made submissions on the issue of WACC, raising the following parameters:
- (i) asset beta (all);
 - (ii) risk free rate (WIAL);
 - (iii) debt premium (WIAL and BARNZ);
 - (iv) PTMRP (CIAL and WIAL); and
 - (v) leverage (AIAL, WIAL and CIAL).
79. BARNZ acknowledges that the issue of WACC is one fraught with judgmental decisions, on which expert views will differ. BARNZ has reviewed the Responses by the airports on WACC and continues to consider that an appropriate nominal post tax WACC for AIAL is in the vicinity of 7.2% and for CIAL is in the vicinity of 7.1%, as discussed in our Response to the Commission's Draft Report.

3.4 Airfield Pricing

80. The only significant issue raised with regard to the Commission's assessment of airfield pricing appears to be CIAL's continued support for the use of prices based on a discounted cashflow methodology. BARNZ continues to oppose pre-financing. Moreover, we do not agree with the use of discounted cash-flows to set prices as there are an infinite number of sets of prices which will lead to a net present value of zero.

3.5 Performance Analysis

81. The Commission has undertaken a comprehensive analysis of the performance of the three airports to determine if it is necessary and desirable for there to be price control. Measures examined by the Commission include historical level of returns,

future level of returns, allocative efficiency, productive efficiency and dynamic efficiency. The three airport companies and BARNZ have all submitted that adjustments should be made to these calculations.

3.5.1 Historical Excess Returns

CIAL

82. The Commission concluded CIAL has over-recovered by \$6.6m over the past 12 years. CIAL has not raised any issues with regard to the Commission's analysis of its historical returns.

WIAL

83. The Commission concluded WIAL has under-recovered by \$6.5m over the past 10 years, \$3.8m of which was in 2000. WIAL has taken this analysis and extended it to include 2001 and 2002 and forecast this to result in total under-recoveries between 1990 and 2002 of between \$5m and \$36m for aeronautical activities.

84. BARNZ has not analysed this extension of the Commission's work, but does note the following matters:

- (i) WIAL has not used the Commission's WACC in its analysis;
- (ii) The analysis by WIAL is stated to relate to aeronautical activities, which have not been defined;
- (iii) The analysis is now a combination of historical returns and future returns; and
- (iv) The most significant of the under-recoveries relate to the period 2000 to 2002 during which WIAL is constrained under the Deed.

AIAL

85. The Commission concluded AIAL has over-recovered by \$66m since corporatisation, earning more than its cost of capital in every year. AIAL has raised a number of issues with respect to this analysis, the combined effect of which it submits shows that it has only earned an average return of 8.12% over the past 12 years, which represents an under-recovery of between \$35m and \$53m. The issues raised by AIAL are commented upon below, and in the report by Mr Roger Taylor attached as BARNZ CS-02.

- (i) **The WACC should be altered only when AIAL reset charges, not every year as the Commission did.**

BARNZ does not agree with this adjustment. Analysis of historical returns should focus upon actual historic performance. The Commission's calculation provides that approach. AIAL's ex post facto approach probably does not replicate what would have been set if prices were being fixed for a number of years. In that case, prices would have been set to take into account the expectations at the time – namely that long term interest rates were below short term interest rates.

BARNZ also notes that the appropriate initial WACC was not a commercial WACC. In the first years following corporatisation,

shareholders adopted clear target returns that represented their particular interests. Reflecting this, the Memorandum of Understanding entered into between AIAL and the airlines in 1989 provided for a 10% rate of return on **shareholder's funds** (5% for the rescue fire cost centre). This equates to an average WACC of 8.52%, which is lower than the Commerce Commission mid-point target of 9.76%.

(ii) The PTMRP should only reduce to 8% in 1999.

BARNZ agrees this adjustment is appropriate.

(iii) Expenses should not be calculated using a straight 26% adjuster, but should reflect the proportion airfield revenue represented of AIAL revenue as a whole.

BARNZ agrees that a straight 26% adjuster is not necessarily appropriate. However, the approach taken by AIAL of adjusting expenses on the basis of the revenue is not appropriate either. BARNZ considers that the better approach would either be to use actual verified and audited historical costs (it is noted AIAL should have these as the MOU provided for cost centre reporting) or to adjust costs item by item using historical projections. For instance, wages could be calculated by using staff numbers and a wage rate index, rates could be calculated using Council records.

(iv) Tax should reflect actual tax paid by AIAL rather than 33%.

BARNZ considers that use of the 33% tax rate is logical.

(v) Revaluation gains have not been correctly identified or spread.

AIAL has submitted that the revaluation gains attributable to the airfield amount to only \$45.7m out of the revaluation reserve of \$281.3m. BARNZ requested Mr Roger Taylor examine the adjustments made by AIAL. His report is attached as BARNZ CS-02.

Due to a lack of information and incomplete explanations by AIAL, he has not been able to develop a definitive view regarding both the adjustments made by AIAL and the original analysis by the Commission. However, his report does demonstrate that the adjustments made by AIAL result in significant anomalies in the movement of asset values. For example, as shown by the following table, AIAL's calculations result in airfield land having increased in value by 33.6% over the past 12 years as compared to land held for the second runway having increased in value by 223.3%.

Revaluation Rates of AIAL Assets

Asset class	Current value \$000	Historical cost \$000	Revaluation \$000	Revaluation % to HC
<i>Airfield</i>	115,106	86,169	28,937	33.6%
<i>Seabed</i>	30,113	0	30,113	Infinity
<i>2nd runway</i>	36,757	11,368	25,389	223.3%
<i>Contestable</i>	130,964	70,169	60,768	86.6%
<i>Land held for future development</i>	26,617	8,232	18,385	223.3

BARNZ has serious concerns regarding the adjustments made by AIAL to the revaluation gains. The effect of the adjustment is to minimise the extent of the revaluations to the airfield. BARNZ believes the Commission needs to obtain further information from AIAL in respect of these issues including those matters identified by Mr Taylor in his report.

(vi) The Commission's assessment of historic costs of sealed surfaces is incorrect.

The Commission reached a preliminary determination that sealed surfaces should be valued at historic cost. It made an adjustment of \$49.773m to AIAL's valuation to reflect this decision. AIAL has submitted that the adjustment to historic cost of sealed surfaces should be \$16.787m.

AIAL's figures suggest airfield infrastructural assets have increased in value by 55% whereas other infrastructural assets have increased by 83%. Differences such as these require explanation as AIAL's results appear derived rather than based on actual figures. In addition, the fact infrastructure was not previously identified as a separate item in AIAL's asset base needs consideration. Note 7 to AIAL's 1999 Annual Report shows infrastructural assets moving from a nil value in 1998 to \$105.624m in 1999. It is stated:

The Directors have, as part of the revaluation exercise, separately identified infrastructural assets (including roads, drainage and storm-water systems, reticulation networks and car parks) owned by the company and have classified these in a separate category; infrastructural assets. In 1998 these assets were incorporated in the lands and buildings categories and generally had not been depreciated.

(vii) Net Working Capital needs to be included in the asset base.

BARNZ agrees it may be appropriate to add net working capital to the asset base. However, while AIAL has added a proportion of current assets, it appears not to have made the corresponding adjustment for current liabilities. The effect of this is to overstate assets and therefore understate apparent actual returns.

3.5.2 Future Excess Returns

CIAL

86. The Commission calculated that CIAL will over-recover by \$3.8m annually for the next three years. In making this calculation the Commission has used different forecasts to those which CIAL used during consultation with the airlines during 1999-2001.
87. CIAL has pointed out that the combination of the Commerce Commission using different forecasts, and an error the Commission has made in entering data resulting in the movements of the Tupolov TU154 being transposed with the metroliner, have resulted in an overstatement of revenue of approximately \$3.4m.
88. During consultation BARNZ reviewed the CIAL forecasts and accepted these. BARNZ therefore considers it would be appropriate for the Commission to use the

forecasts developed by CIAL during consultation (as at January 2001) in its modelling.

89. In light of this alteration, BARNZ has revised the alterations previously made to the Commission's modelling in our Response to the Commission's Draft Report. This is discussed in section 5.3 of this cross-submission.

WIAL

90. WIAL has combined its analysis of future under-recoveries with the table reviewing historical over-recovery. BARNZ has commented on this above.

AIAL

91. The Commission calculated that AIAL will over-recover by \$5.4m per annum on average over the period 2001 to 2003, a total over-recovery of more than \$16m.
92. AIAL has made a number of adjustments to these calculations which would result in it under-recovering and which AIAL considers would entitle it to increase charges by a further 6%. The alterations made appear to be:

- (i) **AIAL has included annual airfield capital expenditure of between \$31m and \$44m in each of the next three years.**

BARNZ has acknowledged AIAL consulted with us regarding the need to rehabilitate the runway and that BARNZ agreed the work was necessary and that the best means for the work to be carried out was to widen the taxi-way to enable it to be used as a runway, while work was carried out on the runway. At that time (1998 to 1999) AIAL indicated that the cost of the project would likely be \$110m over five years (ie around \$20m per year) but that this would be unlikely to result in an increase to landing fees. There was therefore no formal consultation over costs or the impact on charges at that time.

During consultation over landing charges in 1999 to 2000, AIAL did include airfield capital expenditure in the asset base. The amount included was significantly in excess of the \$100m represented at the time consultation over the project took place. The amount included also altered significantly during consultation. At the end of the consultation process, AIAL implied (via media releases) that the airfield capital expenditure project was the reason landing charges were being increased.

Now, in its 14 August 2001 response to the Commerce Commission, AIAL has included airfield capital expenditure which is far in excess of the amounts included in the 1999 to 2000 landing charges consultation.

The quite significant differences in the forecast capital expenditure are set out below:

AIAL Comparision Forecast Airfield CAPEX

	<i>Initial Consultation CAPEX September 1999</i>	<i>Final Consultation CAPEX October 2000</i>	<i>CAPEX now claimed August 2001</i>	<i>Difference between consultation and API</i>
<i>2001*</i>				
<i>2002*</i>				
<i>2003</i>				
<i>Total 2001 – 2003</i>				

[REDACTED]

BARNZ does not consider it is acceptable for AIAL to unilaterally increase the forecast capital expenditure by approximately [REDACTED]\$. Moreover, we question whether all the amounts being spent represent capital expenditure or whether a significant portion is not restoration of an asset to the previous level of serviceability. Furthermore, given that AIAL appears to have priced landing charges on the service provided (i.e. a 747 capable runway) and not a depreciated runway near the end of its life, BARNZ is beginning to wonder whether in fact the airlines have not already pre-financed a large portion of this work through the excess returns earned by AIAL in respect of the airfield business unit since corporatisation.

BARNZ requests that the Commission investigates both the validity of the manner in which AIAL is treating this capital expenditure in its charging regime, and whether AIAL is now trying to earn a return on capital expenditure for which it has already been paid.

(ii) Increase of expenses by 12% in 2001, 5% in 2002 and 5% in 2003.

During consultation AIAL [REDACTED]. BARNZ does not consider it is acceptable for AIAL to now, in its 14 August Response to the Commerce Commission, unilaterally seek to increase costs by a cumulative 23.5%, especially when the airport company is arguing it is unreasonable to be asked to save 1% of costs. No reasons or explanations have been provided in support of these significant differences from the forecasts on which current prices are based.

(iii) AIAL has increased the depreciation charge to reflect the increased capital expenditure.

BARNZ agrees that the forecast depreciation needs to be adjusted to reflect the capital expenditure ultimately included. However, as BARNZ has unresolved issues with the capital expenditure included by AIAL in the model, BARNZ does not agree with the depreciation amounts included by AIAL.

(iv) Inclusion of 3.5% MCTOW growth.

BARNZ agrees an adjustment needs to be made to the model to reflect MCTOW growth. Forecast MCTOW growth of 3.5 % was used during consultation. On that basis, BARNZ is comfortable with the adjustment.

- (v) **AIAL has increased the WACC to 8.5% as this was the figure it used during consultation and it is within the Commission's range.**

BARNZ considers AIAL's WACC of 8.5% to be too high and has been advised an appropriate WACC is one in the vicinity of 7.2%.

- (vi) **AIAL has adjusted the revenue to reflect the fact the increases in charges apply from September and are therefore not for the entire financial year.**

While technically correct, as September increases only apply for 10 months of the financial year, BARNZ considers this adjustment over complicates the analysis. A full year comparison has advantages.

- (vii) **AIAL has adjusted the asset base from the Commission's \$179m to \$219m to reflect its view of the historical cost of sealed surfaces and to add current assets.**

As discussed above, AIAL's alteration in respect of working capital appears over-stated as a corresponding adjustment for current liabilities does not seem to have been made. As also discussed above, BARNZ does not have sufficient information to accurately assess the alteration of the sealed surfaces revaluation from \$49m to \$16m. As identified in Mr Taylor's report, there are significant issues in respect of this adjustment and AIAL needs to provide further information to the Commission to substantiate the adjustment.

3.5.3 Allocative Efficiency

93. The Commission has developed a formula to calculate allocative efficiency. This formula draws upon the level of excess returns. Since CIAL and AIAL (as well as BARNZ) have differing views from those of the Commission on the level of over-recovery, their respective views on allocative efficiency also differ.

3.5.4 Productive Efficiency

94. The Commerce Commission has concluded that there is likely to be some room for improvement in the productive efficiency of the airfield activities at each of the three airports." (para 10.53) and has adopted a figure of 1% of airfield costs as an illustration of an appropriate measure of productive inefficiency at the three airports.
95. This equates to productive inefficiencies of \$131,000 for AIAL, \$60,000 for CIAL and \$35,000 for WIAL. The cost savings involved are relatively small compared to the total cost base, ie at AIAL the cost savings of \$131,000 compare to a cost base of \$13.1m. Despite this, AIAL and CIAL are disputing the assumption that there are even relatively minor cost savings to be made.
96. AIAL goes further and indicates price control will not encourage efficiency cost savings since, under the current model (ie no price control) AIAL has the incentive to make cost savings as it "is able to retain 100% of any cost savings". (page 34 NERA Report). AIAL has also included cost increases in its revised modelling of 23.5% over the next three years.

97. BARNZ is surprised at the strength of the rejection by the airports of the 1% cost savings adopted by the Commission. BARNZ continues to consider this figure is actually too low and that cost savings of at least 3% should be able to be easily made.
98. BARNZ points to the fact that WIAL has reduced expenses by 7.2% over the period 1998 to 2000 following privatisation, during which time its revenue was capped under the Deed which specified prices. There is therefore a reasonable argument to support WIAL's contention that further savings are difficult. Notwithstanding this, the WIAL achievements indicate that the 1% target for AIAL and CIAL should be more than able to be achieved.
99. BARNZ also notes that in its Draft Decision on Sydney Airports Corporation Ltd Aeronautical Pricing Proposal, February 2001, the ACCC stated the following at pages 132 and 133 in relation to aeronautical operating expenses:
- "Based on the experience of private sector airport operators it is reasonable to expect some level of efficiency improvements. The Commission has calculated the average cost savings achieved by Melbourne, Perth and Brisbane Airports and examined SACL's operating costs in comparison. If SACL is committed to improving operating efficiency the Commission would expect to see SACL achieving cost savings at a rate similar to these privatised airports. As such, the Commission would expect to see SACL achieving future cost savings at a rate of approximately 5 per cent per year in real terms."
100. In its decision of May 2001 the ACCC imposed cost savings of 4% per year noting at page 167 that SACL had suggested that "a more reasonable figure would be a reduction of 3 per cent per year." (p. 167).
101. We note that AIAL has again sought to raise the issue of benchmarking. BARNZ believes that the only objective way of benchmarking the charges imposed by airports, is to ensure that the comparison is based on the same services and that the comparison only relates to revenue accruing to the airport (as opposed to the Government or State) for the provision of those services.

3.5.5 Dynamic Efficiency

102. The Commission has calculated dynamic inefficiency on the basis of applying the risk-free rate to assets which are not 'used or useful'.
103. The Commission states that it "has attempted roughly to quantify the extent of these dynamic inefficiencies" (para 10.56) and that its "approach has been to use evidence of faulty investment decisions in the past as a basis for predicting further such decisions in the future." (para 10.57) It has used as its measure "the difference between the percentage return currently earned by the land, and the higher return the land could earn based on its alternative use, as indicated by its valuation in the airport's accounts." (para 10.58)
104. AIAL has included in its balance sheet a value for the seabed, seawall (as distinct from the value of the land it encloses) and land held for future use. Given that AIAL itself has claimed these values, and included them in the asset base on which it sought a return from the airlines, it is difficult to see why such values should not be used to calculate dynamic inefficiency. BARNZ acknowledges it is difficult to measure dynamic efficiency. However, the starting point must be the values claimed by the airport in its valuation for assets which are not being used, a

valuation which was signed off by its board and which was included in its annual report.

105. In addition to the seabed, seawall and land held for future use, BARNZ questions whether the recently reclaimed land at the western end of the runway, a large portion of which does not appear to yet be 'used and useful', should not also be included in the dynamic efficiency calculations. AIAL's 1999 Annual Report noted that 29 hectares of the lagoon had been infilled to the west of the terminal, this land being "required for additional terminal apron expansion, and, eventually, second runway access".

4.0 SECTION 52 (b)

4.1 Necessary or Desirable

106. The Commerce Commission has used its performance analysis (discussed under section 3.5 above) as the basis for determining whether it is necessary or desirable in the interests of acquirers for there to be price control. It has then deducted the costs of price control to determine whether there is a net benefit or cost of price control to acquirers.
107. The airports have variously criticised the Commission for taking an approach which is too theoretical or pure. CIAL has described the Commission's approach as 'a pure economic perspective' rather than 'a competition standard of workable and effective, not perfect, competition' (paragraph 6).
108. BARNZ does not agree with this criticism. In its calculations of whether it is necessary or desirable for price control, the Commission has reduced by 50% the benefits which it has calculated, as a representation of benefits unlikely to be achieved. BARNZ has submitted that a reduction of 50% is far too high, and that 25% is a more appropriate discount. Regardless of the exact amount, clearly the Commission has recognised that workable competition, rather than perfect competition, is the standard.

4.2 Counter-factual

109. In its Draft Report, the Commission assumed the status quo would be the counter-factual.
110. In our response, BARNZ submitted that the appropriate counter-factual at AIAL would be a price increase of 9.6% [REDACTED] This produced an average counter-factual benefit of price control of \$2.985m per annum (refer question 38 in BARNZ's Response to Draft Report).
111. AIAL has confirmed in its response that the status quo is not the appropriate counter-factual, and that, based on its most recent analysis, a further increase in charges would be justified. AIAL stated it has:

"firm justification to increase its current airfield landing charges by a further 11% - ie an additional 6% increase over and above the 5% increase previously signalled as applicable from 1 September 2001 and 1 September 2002".
(paragraph 1.18)
112. An additional increase of 6% produces counter-factual benefits of \$1.865m annually. BARNZ therefore considers that counter-factual benefits of price control of between \$1.865m and \$2.985m should be included in the Commission's assessment of the benefits of price control for AIAL.

4.3 Costs of Price Control

113. In assessing whether it is necessary or desirable for price control to be introduced, the Commission conducted a net benefits to acquirers test. This necessarily involved assessing the costs of price control, and deducting such costs from the

benefits acquirers would otherwise receive. In order for the Commission to be able to assess the costs of price control, and for the parties to be able to develop their own views on the likely costs, it was necessary for the Commission to consider the possible forms of price control.

114. BARNZ also notes that section 56(2) gives the Commission power to have regard to “all matters it considers necessary or desirable”.
115. BARNZ is therefore surprised at objections by some parties to the Commission discussing various means of price control and indicating a preliminary preference.

5.0 DISCRETION TO RECOMMEND PRICE CONTROL

5.1 Relevant Factors

116. The Commission applied a public benefit efficiency test to determine whether the Minister should exercise his discretion to recommend price control to the Governor General.
117. In our Response to the Draft Report, BARNZ submitted that this approach elevated the concepts of efficiency and the public benefit test in section 3A above the directly relevant statutory criteria in section 52 and above the long title of the Act. BARNZ identified a number of factors which, in our view, the Minister should take into account in exercising his discretion, and therefore the Commission needed to take into account in making its report to the Minister. These were set out in paragraph 43.15 of BARNZ's Response. BARNZ considers the most important of these are the key statutory criteria of the degree to which competition is limited, and whether it is necessary or desirable in the interests of acquirers that price control be imposed.
118. BARNZ continues to be concerned that the application solely of the public benefit test in section 3A would result in the Minister's discretion being curtailed in a manner not intended by Parliament.

5.2 Should Price Control be Recommended at AIAL?

119. While BARNZ acknowledges there needs to be alterations to particular aspects of our analysis of the benefits of price control at AIAL as set out in Attachment BARNZ-03 and question 42 of our Response to the Draft Report (due to factors such as MCTOW or capital expenditure when the issues surrounding this have been resolved), we are still firmly of the view that airfield activities at AIAL should be the subject of price control for two to three years.
120. The cumulative increase in landing charges of 19.6% set by AIAL in September 2000 will result in AIAL substantially over-recovering over the next three years, thus continuing a pattern of sustained over-recoveries in the 12 years since it was corporatised. AIAL is vigorously defending the prices it has set, and is continuing to submit that these prices will actually result in it under-recovering. AIAL is now stating that it would be justified in imposing further increases. There are significant differences of economic principle between the airlines and AIAL, as well as between the Commission and AIAL.
121. Tactics employed by AIAL such as unilaterally increasing its forecast capital expenditure and operating expenses, thereby reducing the over-recovery, only serve to underline the clear need for price control to be imposed for two to three years.
122. The terms of reference for the current Inquiry only extend to airfield activities. There are significant unresolved issues at AIAL with regard to the allocation of costs and assets within its international terminal. BARNZ continues to consider it is necessary for the Commission to initiate a separate Inquiry into terminal related charges at AIAL.

5.3 Should Price Control be Recommended at CIAL?

123. BARNZ acknowledges CIAL has raised a valid issue with respect to the Commission's forecasting of MCTOW. BARNZ agrees it is appropriate for the forecasts developed by CIAL during consultation to be used. BARNZ has therefore adjusted the benefits analysis which was set out in question 43 of our Response to the Commission. The results are summarised below, and the full detail set out in BARNZ CS-01.
124. This shows benefits of between \$1.5m and \$1.9m if price control was imposed. Therefore, BARNZ is still of the view that it is also necessary and desirable in the interests of acquirers for there to be a period of price control of airfield activities at CIAL as well as AIAL.

Net Benefits to Acquirers at CIAL

	ComCom WACC \$	BARNZ WACC \$
<i>Benefits to Acquirers</i>		
Reduced excess returns	1,839,653	2,292,462
Reduced allocative inefficiency	12,853	19,959
Reduced productive inefficiency	157,800	157,800
Reduced dynamic inefficiency	49,218	49,218
Total benefits	2,059,524	2,519,439
<i>Costs to Acquirers</i>		
Direct costs	Benefit	Benefit
Indirect costs (25% of benefits)	514,881	629,860
Total Costs	514,881	629,860
Net benefits to Acquirers	1,544,643	1,889,579

125. BARNZ notes that this analysis only applies to airfield activities and does not extend to the terminal where significant issues exist with regard to the prefinancing of the terminal buildings and the discounted cash-flow model CIAL is using. BARNZ continues to consider there is sufficient justification for the Commission to now commence a separate inquiry into terminal activities at CIAL, unless CIAL now reviews its terminal prices in light of the pricing principles developed by the Commission.

6.0 OTHER MATTERS

6.1 Form of Price Control

126. BARNZ notes that the Commission is interested in exploring forms of control other than heavy-handed approaches involving the Commission setting prices, allowable rates of return or revenue caps. With this in mind, the Commission has suggested a form of price control involving the parties negotiating within parameters set by the Commission, with the prices which emerged from such negotiations being accepted by the Commission as an undertaking under section 72 of the Commerce Act (having the effect of an authorisation). As noted previously, BARNZ has made approaches to CIAL and AIAL in this vein.
127. Questions have been raised by some of the other parties regarding the ability of the Commission to set prices in this manner.
128. The power of the Commission to make authorisations under section 70 is very wide, and extends to 'using whatever approach it considers appropriate'. BARNZ is not presently able to identify any difficulty with the Commission's proposed approach, and in fact, considers the Commission's approach is a sensible one which would allow the parties to develop the mechanisms to solve such pricing issues in the future themselves, without the need for involvement by the Commission.
129. BARNZ also notes that Federated Farmers and Business NZ both support the manner in which the Commission has indicated it might move forward.

6.2 Monopoly Behaviour

130. There are instances in the responses made by the airports which appear to indicate the mindset of a supplier not constrained by competition or by the possibility that its customers might elect to purchase services elsewhere.
131. The airports are resisting the notion that even a one percent cost saving could be achieved. A one percent cost saving amounts to savings between \$45 000 and \$131 000, on cost bases ranging from \$4.5m to \$13.1m.
132. All three airports are campaigning for the ability to charge airlines today for assets before they are actually 'used or useful'. CIAL, in particular, has included significant terminal expansion (which has yet to be built or paid for) in its DCF model used to set terminal prices.
133. The comments and behaviour by AIAL, as identified below, serve to further emphasise the need for a short period of price control of airfield activities at AIAL:
 - (i) In its response to the Commerce Commission's Draft Report, AIAL has suggested the possibility of selling its assets for five times their ODV value, so as to create a new asset base from which to inflate prices.
 - (ii) AIAL has commented that the present system encourages efficiency as the airport is able to retain the benefit of all cost savings.
 - (iii) AIAL's adviser, NERA, has commented that AIAL would not be able to sell its sea-bed for \$10m, yet AIAL included \$30m in its financial accounts for seabed and attempted to charge the airlines for a return on this amount.

- (iv) AIAL has expressed the view that WACC is the minimum it should earn, and that it actually needs to earn a return above this level.
- (v) In response to the Commission's preliminary conclusion it will over-recover over the next three years, AIAL has unilaterally increased its runway capital expenditure by [] over the next three years, as compared to that used in the financial modelling on which current charges were based.
- (vi) AIAL has unilaterally increased its forecast costs by [] over the next three years, as compared with those forecasts which current prices are based.
- (vii) AIAL is continuing to maintain its sea-wall has a separate additional value to that of the under-lying land, despite continued representations by the airlines against this, despite this being inconsistent with the practice at other airports and despite the Commission having made a draft determination that this was incorrect.

6.3 Further Work by the Commission

134. During this cross-submission BARNZ has identified several areas where we believe it is necessary for further work to be undertaken, or advice obtained by, the Commission. These are:

(i) Ascertainment of the opportunity cost value of land at AIAL and WIAL in its next best alternative use.

In its Draft Report the Commission identified opportunity cost measured by next best alternative use as the appropriate land valuation approach. Our understanding is that the Commission had not specifically requested Telfer Young for advice using this methodology. In our Response on the Draft Report, BARNZ included further expert advice on this issue, however AIAL and WIAL did not. BARNZ considers the Commission needs to obtain independent advice specifically on this question.

(ii) Ascertainment of the costs associated with getting the land into use as an airport.

In its Draft Report the Commission concluded costs associated with getting the land into use as an airport should not be added to the land value but should be treated as an improvement to land. However, the Commission noted that due to lack of information, it had not made any adjustments to the airport companies' asset bases. In our Response to the Commission's Draft Report, BARNZ provided further information on this issue, and gave our view that the appropriate historic costs of getting land into use as an airport for AIAL amounted to approximately \$24,000 per hectare. None of the airports have provided any further information on this issue.

(iii) The treatment of AIAL's capital expenditure.

The forecasts of AIAL's capital expenditure have increased significantly over the past three years. In addition, it is not clear to what extent the project represents capital expenditure and to what extent it represents restoration of an asset to its previous level of serviceability. Furthermore, questions must arise as to whether the airlines have not already paid for a

large portion of this work through constant charges which have not decreased as the value of the asset decreased.

(iv) The allocation of AIAL's revaluation reserves to airfield activities.

At the time AIAL revalued its assets, it created a revaluation reserve of approximately \$281m. AIAL has submitted only \$45.7m relates to the airfield. In addition, AIAL has submitted that the sealed surfaces have only increased in value by \$16m rather than the \$49m which the Commission has adopted in its Draft Report. Further information is required in relation to these adjustments. This is identified in Mr Taylor's report, attached to this cross-submission.

6.4 Looking to the Future

135. Reading the responses made by the airport companies to the Commission's Draft Report, one is left with the unfortunate impression that the airports are more concerned with ensuring they are able to charge for future assets today, than they are about developing pricing principles to enable efficient prices to be determined in the future.
136. In our Response to the Draft Report, and again at the beginning of this cross-submission, BARNZ expressed the view that the essential outcome of the Inquiry is the development of pricing principles to assist in the future determination of efficient prices. Without principles such as those in paragraph 6.24 of the Commission's Draft Report, airlines can expect further protracted, pointless and expensive consultation rounds in the future as a precursor to airport companies setting prices as they think fit under section 4A of the Airport Authorities Act 1966, in disregard of airline views.
137. On the whole, BARNZ is very supportive of the pricing principles developed by the Commission and believes they are simple and easily able to be applied. A combination of these principles, and a two to three year period of price control for AIAL and CIAL, should go a long way towards allowing the light-handed regulatory regime to work effectively for New Zealand airports.