

GLOSSARY :

ACAM	-	Avoidable Cost Allocation Methodology
ACCC	-	Australian Competition and Consumer Commission
ADC	-	Airport Departure Charge
AIAL	-	Auckland International Airport Limited
BARNZ	-	Board of Airline Representatives NZ (Inc)
CAA	-	Civil Aviation Authority
CIAL	-	Christchurch International Airport Limited
CPI	-	Consumer Price Index
CC	-	Commerce Commission
MCTOW	-	Maximum Certificated Take-Off Weight
ODRC	-	Optimised Depreciated Replacement Cost
PTMRP	-	Post Tax Market Risk Premium
SACL	-	Sydney Airports Corporation Limited
TSC	-	Terminal Services Charge
WACC	-	Weighted Average Cost of Capital
WIAL	-	Wellington International Airport Limited

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

INTRODUCTION

General Remarks

It was BARNZ's hope going into this Inquiry that the outcome would be a clear set of pricing principles which would guide the parties in the future, and enable prices to be negotiated in a commercial manner without the need for regulatory intervention. BARNZ sees the principles as an essential outcome of the Inquiry, and is pleased that the Commission has identified this approach in its preliminary decision. The general pricing principles enunciated by the Commission (such as the purpose being to emulate a competitive market and that only 'used and useful' assets should be included in the asset base), as well as more specific principles (such as the seawall being incorporated in the land value), can only assist the airlines and the airports alike during future consultations or negotiations over charges.

BARNZ's preferred method for determining prices is a commercial model. However, where this has not worked, and monopoly pricing has been found to be present (as is the case with AIAL and CIAL), and prices are higher than an economically efficient level, then BARNZ believes it is necessary for the price control provisions of the Commerce Act to be invoked, since these are an essential component of the light-handed regulatory regime.

In Chapter 12 the Commission has identified the possibility that the prices which would apply during any period of price control imposed, would be ones negotiated in the first instance by the parties, within principles and parameters set by the Commerce Commission, with the Commission authorising an undertaking from the airport, based on this price. Only if the parties were not able to develop a price, would the Commission step in and set a price. *BARNZ is comfortable* with this approach towards price control.

BARNZ agrees with the Commission's draft determination that airfield activities at AIAL need to be the subject of a price control order. The level of historic and projected future over-recoveries are of such a nature that:

- A. Price control is in the interests of acquirers; and
- B. The Minister should exercise his discretion to impose a short period of control.

The Commission's work confirms the airlines' strongly held view that AIAL had no justification for increasing its landing charges by 8.5% last year and has no justification to further increase them by 5% in September 2001 and again in September 2002.

BARNZ agrees with the Commission's draft determination that it is in the interests of acquirers of airfield activities at CIAL, that CIAL should also be the subject of a price control order in respect of its airfield activities. The Commission has the airlines' confirmed view that CIAL's recent increases in landing charges are too high and will result in it over-recovering.

BARNZ does not agree with the Commission's draft determination that the costs of control are greater than the benefits at CIAL and therefore, despite the fact it is necessary and desirable in the interests of acquirers at CIAL, price control should not be imposed.

BARNZ does not agree with the quantum of costs of price control, which have been calculated by the Commission, and believes these to be significantly overstated. BARNZ members' experience with the current light-handed regulatory regime has been very costly. BARNZ believes that the costs of price control will, in fact, be less than the costs currently being incurred by the airlines and the airport companies. In any event, it is questionable whether it is appropriate for airline users to bear the cost of additional regulatory action required as a result of the inappropriate behaviour of airport companies. *In BARNZ's view*, this should be an airport shareholder cost, since it was the shareholders who have, over a sustained period, benefited from the monopoly prices and excess returns. In this way, the right incentives would be provided to ensure conduct of this kind does not continue or reoccur.

BARNZ does not agree with the approach the Commission has taken to the appropriate legal test and the Minister's exercise of discretion. While efficiency is one of a number of possibly relevant factors to be considered by the Minister, the public benefit test applied by the Commission is not the test contained in the statute for the imposition of price control. *BARNZ has real concerns* about the whole approach in Chapter 14 of the Commission's draft report. The Commission has incorrectly sought to elevate efficiency, and the public benefit test in section 3A, above the long title of the Commerce Act (which emphasises the long-term benefit of consumers) and above the factors identified in section 52 which are directly relevant to the exercise of the discretion of the Minister. The degree to which competition is limited, the structure of the markets, the behaviour in the markets, the history and extent of over-recovery, the manner in which prices were set during the last consultations in the face of objection from users, and the overall effect to the acquirers are also relevant factors, as is the credibility of the light-handed regulation.

Price control is an important component of, and not an alternative to, the current regulatory regime applying to airports. In light of the evidence of monopoly pricing which the Commission has now confirmed (albeit in its draft report), imposition of controls at AIAL and CIAL is essential to maintain the credibility of the light-handed regime.

BARNZ agrees with the Commission's draft determination not to recommend price control at WIAL. However, like the Commission, *BARNZ notes* that price movements resulting from WIAL's upcoming consultation could make it necessary for the Commission to further consider pricing issues in respect of WIAL. *BARNZ* has not made detailed comments in respect of the Commission's analysis of returns or efficiencies at WIAL as, not having been through a detailed consultation recently, it does not have a sufficient knowledge base.

BARNZ notes that the Commission has confined the recommendations in its report to airfield activities alone, a reflection of the terms of reference. As the Commission is aware, *BARNZ is of the view* that the Inquiry should be extended beyond airfield activities, to all areas where the airports have substantial market power. This need was particularly illustrated during the recent consultations with AIAL and CIAL which highlighted significant issues with regard to pricing and cost allocation in the terminals as well as with the airfield.

The fact the Commission has now found abuse of monopoly position in the case of AIAL and CIAL in respect of their airfield activities, means that, in *BARNZ's* view, unless AIAL and CIAL initiate a revision of their terminal charges within the relevant principles and parameters identified by the Commission, there is justification for the Commission to initiate a further Inquiry into pricing of terminal activities at those airports.

Structure of Response

The Commission has posed 49 questions in its draft determination and has requested comments in relation to these. Before responding to these questions, *BARNZ* sets out the pricing principles which it has drawn out of the Commission's draft determination.

In preparing this response *BARNZ* has received advice from: Dr Brent Layton, economist; Mr Roger Taylor, financial consultant; Professor RG Bowman, Auckland University; and Mr Bob Lawton, registered valuer with, Barratt Boyes, Jefferies Ltd. Mr Taylor has adjusted the Commission's financial modelling, with amended inputs which one explained in this response the results of which are appended at Attachment BARNZ-01 to BARNZ-04. Mr Lawton has provided further valuation advice to *BARNZ* regarding the valuation of AIAL's land on the next best alternative use. This is appended at Attachment BARNZ-06.

BARNZ has also relied upon the following reports previously provided to the Commission:

- A. Professor RG Bowman, Report on Average Weighted Cost of Capital, 26 April 2001.
- B. Professor RG Bowman, Review of Underlying Data and Reports Associated with AIAL's Proposals for Landing and ADC Charges, 31 July 2000.
- C. Mr Roger Taylor, AIAL Valuation Issues: Report Commissioned by *BARNZ*, September 2000.

- D. NECG, AIAL – Airport Efficiency, July 2000.
- E. The Brattle Group, Asset Valuation and the Pricing of Monopoly Infrastructure Services: a Discussion Paper, 28 July 2000.
- F. Simon Terry Associates, Rate of Return at Auckland International Airport: Effect of Revaluation on IRR, prepared for Air NZ, July 2000.
- G. Edward Rushton Australia Pty Ltd, Valuation Submissions: CIAL and AIAL, February 2000.

Pricing Principles in Draft Determination

BARNZ notes that the Commerce Commission, in recommending price control in its draft report, appears to be favouring commercially negotiated prices within the principles and parameters laid down by the Commission, with the Commission acting as a backstop to set prices if the parties are unable to agree.

The Commission’s overall aim seems to be to emulate the positive characteristics of a competitive market. With this in mind it has set out the following pricing principles at paragraph 6.24:

- “Prices should be as close as possible to their allocatively efficient level over the medium term. Prices should be commensurate with the desired level of service quality and based on appropriate costs (productively, and dynamically, efficient costs). Prices should encourage efficient use of a supplier’s facilities and avoid cross subsidisation. Today’s consumers should only bear today’s costs.
- Prices should allow for a “normal” rate of return to be earned by suppliers over the medium term. Normal returns should be based on an appropriately determined asset base and rate of return. Returns which are greater, or lesser, than this normal rate should reflect superior, or inferior, performance respectively.
- Prices should on average, over the medium term, cover efficient operating costs (including any temporary deviations resulting from unexpected changes in external factors), and no more.
- Prices should send appropriate signals for determining whether new investment (or divestment) would be efficient.”

The Commission has then applied these principles in practice to airfield activities to create the following principles and parameters relevant to pricing of airfield activities:

1. PRICING METHODOLOGY

- A. Discounted cash-flow (DCF) models are circular and should not be used to set prices.
- B. The Commission implicitly endorses the pricing formula based on $WACC \times \text{Asset base} + \text{efficient operating costs} + \text{depreciation} - \text{asset revaluations}$.

- C. The Commission discussed the relationship between Ramsey pricing principles and MCTOW pricing and concluded that while MCTOW pricing is not as close to Ramsey based pricing as it would have liked, the practical difficulties of implementing Ramsey based pricing in the airfield meant MCTOW based pricing should be currently continued.
- 2. “USED AND USEFUL”**
- A. Only assets which are used and useful may be included in the asset base on which charges are set.
 - B. This means seabed, land held for future use, any excess sealed areas or civil works need to be optimised out.
 - C. This means there is to be no-prefinancing - works which are contemplated or in progress are not entitled to earn a return until they come into use.
- 3. LAND VALUE**
- A. Land is to be valued at its opportunity cost, which is its value in the next best alternative use.
 - B. It is not appropriate to add holding costs to the opportunity cost of land.
 - C. It is not appropriate to measure the land value by including the cost of getting the land to the stage where it is fit for use as an airport – land value should not include costs of moving, building a new airport or getting the land to the stage it can be used as an airport.
 - D. The value of seawalls is incorporated in the value of the land.
- 4. IMPROVEMENTS**
- A. The Commission favours historical cost for determining the value of the sealed surfaces because the opportunity cost is zero given that the asset is sunk and has no alternative use.
 - B. The costs of levelling of land should be treated as a civil work and included in the value of improvements.
- 5. WACC**
- A. An airport company is entitled to earn a normal rate of return on used and useful assets.
 - B. The rate of return is calculated to reflect the levels of risk of the business – the asset beta for NZ airports falls between the US rate of return regulated utilities and the UK RPI – X regulated airports.
 - C. The risk free rate is calculated by taking the average rate for government stock for the term for which prices are being set based on the six months prior to prices being set.

- D. There must be consistency of application between real and nominal asset revaluations and the resulting treatment of revaluations.

6. COSTS

- A. The Commission does not favour cross-subsidisation.
- B. The Commission favours multi-till.
- C. ACAM did not result in cross-subsidisation for airfield activities.
- D. Future productive efficiency improvements should be factored into future prices.

For its part, BARNZ believes that once these principles and guidelines have been incorporated in a final report, they should enable the parties to determine efficient prices for airfield activities in the future. However, BARNZ does note that ultimately, issues such as WACC and asset valuation are only components in setting prices. 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 issue, and not the means by which they are derived *per se*.

BARNZ also observes that significant issues exist in relation to setting prices for terminal activities, and that, in setting out the above principles in relation to airfield activities, the Commission has not addressed questions such as how a multi-till pricing approach should work within the terminal or whether ACAM is appropriate for terminal activities.

SUMMARY OF RESPONSES TO COMMISSION'S QUESTIONS

Section 52(a) – Competition Limited

BARNZ agrees that the Commission's approach to determining whether section 52(a) of the Commerce Act 1986 is met is correct. *BARNZ has no concerns* with the markets identified by the Commission nor with the conclusion that airfield activities make up a part of the aircraft movement market.

BARNZ agrees with the Commission's preliminary conclusion that competition is limited in the aircraft movement market and that:

- A. There are no substantial near entrants which would compete effectively with the three large airports.
- B. The airports operate largely within their own geographically distinct regional market and are the only substantial supplier in that market.
- C. There are no supply side substitutes.
- D. The countervailing power which exists is not sufficient to constrain AIAL, WIAL and CIAL.

Pricing

Pricing Principles

For its part, *BARNZ considers* that the setting out of pricing principles and parameters as in paragraph 6.24 of the Commerce Commission draft report should be of considerable help to the industry in determining future economically efficient prices. *BARNZ agrees* these principles are appropriate, *with one caveat* regarding returns in excess of a normal return being earned in reflection of superior performance. This point is discussed in response to question 11.

Asset Base

BARNZ is satisfied that, in relation to the three international airports the subject of this Inquiry, the Commission's decision to use opportunity cost for land valuation, should result in prices which provide the right efficiency signals to users and suppliers.

BARNZ agrees with the Commission that it is not appropriate to value specialised airfield assets at opportunity cost, since the zero opportunity cost these assets have would not provide appropriate signals.

BARNZ agrees the costs associated with getting the land into airport use (the costs and benefits of moving and building the new airport) are more appropriately included within the costs of land improvements, and has therefore adjusted AIAL's asset base by \$49.6 million to reflect the historical costs of getting the land into airport use.

BARNZ agrees only 'used and useful' assets should be included in the asset base on which a rate of return is calculated and all other assets should be optimised out. *BARNZ agrees* with the optimisation undertaken by the Commission and the proposed

treatment of new investment. *BARNZ notes* that not all land AIAL has reclaimed from the lagoon and western end of the runway appears to be in use and useful at the current time, and therefore some of this reclaimed land ought to be optimised out of the asset base on which AIAL calculates its required return.

BARNZ has made the following adjustments to AIAL's and CIAL's asset base:

AIAL Airfield Asset Base

	Amount (\$000s)
AIAL Valuation 30 June 1999	\$ 312,751
Adjustments by AIAL for Pricing Purposes 2000	-27,504
CC Optimisation of Seabed	-9,800
CC Optimisation of Seawall	-9,787
CC Optimisation of Second Runway Land	-36,757
CC Adjustment to Sealed Surfaces Value (ODRC to HC)	-49,773
Commission Asset Base	179,130
BARNZ Adjustment of levelling and financing costs (ORDC to HC) (refer question 14 and BARNZ-01)	-49,644
BARNZ Adjustment for increases in land value (refer question 31 and BARNZ-03)	1,477
Adjustment required for optimisation of unused reclaimed land	?
BARNZ Asset Base	130,963

CIAL Airfield Asset Base

	Amount (\$000s)
CIAL Valuation 30 June 1999	\$ 41,930
Adjustments by CIAL for Pricing Purposes 2000	-381
Adjustment to Sealed Surfaces Value (ODRC to HC)	-13,491
Add back of Reseal Reserve	6,633
Commission Asset Base	34,691
BARNZ Adjustment for increases in land value (refer question 31 and BARNZ-04)	290
BARNZ Asset Base	34,981

WACC

BARNZ agrees with the Commission's assessment of the PTMRP and the manner in which it has measured the risk free rate. *BARNZ does not agree* with the debt premium or the asset beta adopted by the Commission. *BARNZ's* estimate of these factors leads to a WACC of 7.17% for AIAL, 7.12% for CIAL and 7.54% for WIAL.

Performance Analysis

BARNZ agrees with the Commission's preliminary conclusion that both AIAL and CIAL have exploited their market power in airfield activities by raising prices above

the competitive level in a sustained fashion. *BARNZ has adjusted* the Commission's model in respect of asset base, land revaluations, WACC and treatment of resale provision in expenses. These adjustments produce the following excess returns:

Excess Returns at AIAL and CIAL

	CC WACC	BARNZ WACC
AIAL average p/a 2000 – 2004	\$ 10,377,350	\$ 12,020,114
CIAL average p/a years 1 – 3	\$ 4,340,727	\$ 4,793,537

BARNZ notes not including adjustments for 'used and useful' capital expenditure and MCTOW growth in the model, does affect the outcome. If these factors are included then the overall effect for AIAL would be to reduce the level of over recovery. *BARNZ considers* that once these factors have been assessed as accurately as is possible, then they should be incorporated into the model.

The BARNZ adjustments to the asset base and to WACC alter the Commission's allocative efficiency calculations. *BARNZ has applied* the Commission's formula, using the BARNZ adjusted inputs, to produce the following levels of allocative inefficiency:

BARNZ Calculations of Allocative Inefficiency

	CC WACC			BARNZ WACC		
	Consumer	Producer	Total	Consumer	Producer	Total
AIAL average 2000 – 2004	117,787	854,048	971,835	157,125	947,862	1,104,987
CIAL average years 1 – 3	56,342	343,092	399,434	68,710	365,901	434,611

BARNZ has applied a 3% productive efficiency improvement at AIAL and CIAL, which it believes is a more appropriate reflection of available efficiency improvements, which produces efficiency improvements of \$395,730 at AIAL and \$157,800 at CIAL.

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

Section 52(b) – Control Necessary or Desirable in the Interests of Acquirers

BARNZ does not agree that the appropriate counterfactual is the continuation of the status quo. *BARNZ considers* that if price control is not imposed, this would reduce the threat of price control and undermine the light-handed regulatory regime, which could lead to the airports imposing further monopoly prices and greater inefficiencies.

During consultation AIAL proposed a number of different increases, the penultimate proposal in May being for an initial 18.14% increase as opposed to the 8.5% initial increase finally set. *BARNZ considers* the 9.6% difference between the increase proposed by AIAL in May 2000, and that actually imposed in August 2000, is the appropriate counterfactual for AIAL. This counter-factual produces a further benefit of price control of \$2.985 million annually (an average of 2001, 2002 and 2003).

BARNZ does not agree with the Commission's assessment of the costs of price control. *BARNZ considers* that the direct costs of price control for airfield activities would be nil or potentially even represent a saving to acquirers. *BARNZ considers* that the Commission's estimate that the indirect costs of price control would be 50% of potential efficiency gains is far too high. *BARNZ considers* that 25% is a more realistic estimate of the indirect costs of price control.

BARNZ agrees with the Commission's preliminary view that it is necessary or desirable in the interests of acquirers to control the airfield activities supplied by AIAL and CIAL. *BARNZ believes* the true net benefit to acquirers is much greater than the Commission's estimates in paragraph 13.54, and *submits* the following revised estimates using the Commission's WACC. If *BARNZ's* WACC is used, then the net benefit to acquirers is \$16.7 million for AIAL and \$3.8 million for CIAL.

Net Benefits to Acquirers Using Commission's WACC

	AIAL	CIAL
<i>Benefits to Acquirers</i>		
Reduced excess returns (different to Commission's due to alterations to the asset base)	10,377,350	4,340,727
Reduced counter-factual return (based on AIAL's May 2000 proposal)	2,985,000	-
Reduced allocative inefficiency (different to Commission's due to alterations to the asset base)	117,787	56,342
Reduced productive inefficiency (3% improvement assumed)	395,730	157,800
Reduced dynamic inefficiency (Commission's calculation unchanged)	6,711,684	49,218
Total benefits	20,587,551	4,604,087
<i>Costs to Acquirers</i>		
Direct costs	Benefit	Benefit
Indirect costs (25% of benefits)	5,146,887	1,151,021
Total Costs	5,146,887	1,151,021
Net benefits to Acquirers	15,440,664	3,453,066

Discretion to Control

BARNZ does not accept that the Commission's legal analysis of the issues relevant to the exercise of the Minister's discretion is correct. The Commission appears to have 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* has real concerns with this approach.

While BARNZ acknowledges that an analysis of net efficiency benefits is relevant, this is only one of a number of factors that the Minister might take into account, the most important of these being the key statutory criteria of the degree to which competition is limited and whether it is necessary and desirable in the interests of acquirers that price control be imposed. The issues surrounding airport pricing are more than just asset values or cost allocations – the behaviour of AIAL and CIAL over the past 12 years amounts to a systematic misuse of market power.

Other factors which BARNZ considers the Minister needs to take into account in the exercise of the discretion to introduce price control, include:

A. The degree to which competition is limited, including market structure and behavioural factors.

The Commission concluded competition is limited in the aircraft movement market, that market power is probably relatively high due to the lack of supply-side substitutes and that AIAL, CIAL and WIAL are unlikely to be significantly constrained by the countervailing power of airlines under the current regulatory regime.

B. The degree to which current regulation has constrained (or failed to constrain) the behaviour of the monopoly supplier, and prevented (or failed to prevent) abuse of market power.

The Commission concluded that AIAL and CIAL have exploited their market power in airfield activities by raising prices above the competitive level in a fairly sustained fashion, and also that under the current regulatory regime, AIAL, WIAL and CIAL are unlikely to be significantly constrained by the countervailing power of airlines.

C. The overall quantum of the monopoly pricing, i.e. not just the level at which the price is above the competitive benchmark, but what this translates to in dollar terms and as a percentage of the monopoly's turnover.

The Commission concluded that AIAL has over-recovered by 38.03% or \$66 million since corporatisation 12 years ago, with it recovering more than its cost of capital in every one of those 12 years. The Commission concluded CIAL has over-recovered by \$6 million since corporatisation, or 20.84%. BARNZ considers this amounts to systematic abuse of market power.

The Commission concluded that such over-recoveries will continue in the next three years. CIAL's recent increases mean its prices (by the Commission's calculations) are 28% above the competitive price. The Commission calculated CIAL will earn \$3.8 million annually more than it should for the next three years, an over-recovery of more than \$11 million. The Commission concluded AIAL will over-recover by \$16 million over the period 2001 to 2003, an average annual over-recovery of \$5.4 million.

BARNZ has been advised that the future over-recovery for the next three years is as high as \$14.5 million annually for AIAL (between 25.8% and 38.0%) and \$4.7 million annually for CIAL (between 32.8% and 37.6%).

D. How gross the abuse of market power has been? (i.e. the level of the over-recovery and the length of time over which such excess returns have been being earned).

The abuse of market power has amounted to \$66 million (38.03%) by AIAL and \$6 million (20.84%) by CIAL, and in the case of AIAL, has been for every one of the past 12 years.

E. The likely impact on other users and consumers in the economy.

Air travel is an important component of today's society and airports are key infrastructural assets. Over-pricing of the degree and sustained nature engaged in by AIAL and CIAL will have had a significant effect on the over-all efficiency of the New Zealand economy by constraining travel, trade and commerce.

F. The overall size of the benefits to the acquirers if price control was imposed.

BARNZ considers that the annual benefits which could be achieved by the imposition of price control on airfield activities at AIAL are between \$15.4 million and \$16.7 million and at CIAL are between \$3.4 million and \$3.8 million.

G. The costs of the new regime versus the costs of continuing the current regime.

BARNZ considers the direct cost of price control would be no higher than the costs of the current regime (which are not insignificant) and in fact, should even be less.

H. The effect on users and consumers if price control is not imposed. Would the current situation continue or would the level of excess pricing increase?

BARNZ believes that if price control is not imposed, prices are likely to be significantly higher in the short to medium term. Behaviour by AIAL during the recent consultation, suggests further price increases of at least 9.6%.

I. The disincentive to monopoly price in other markets which would result from a decision to impose price control as a consequence of the monopoly pricing which has occurred in this market.

Failure to impose price control in the face of past over-recovery of 38% by AIAL and 20% by CIAL, and forecast future over-recovery of up to 15.5% by AIAL and 28% by CIAL (by the Commission's calculations) will provide a benchmark, under which it will be understood that the price control provisions of the Commerce Act will be unlikely to be invoked.

J. The effect on the New Zealand light-handed regime if an organisation is found to be monopoly pricing but no action is taken against it.

Light-handed regulation depends on all examples of demonstrable monopoly pricing being addressed, not merely those which outweigh arithmetically

calculated benefits. A decision not to impose price control at AIAL and CIAL, despite evidence existing of sustained monopoly pricing, would severely reduce the credibility of price control and undermine the effectiveness of the light-handed regulatory regime.

BARNZ agrees with the recommendation that airfield activities at AIAL should be controlled. However, *BARNZ considers* that the Commission's assessment of the benefits of price control at AIAL are significantly understated. *BARNZ considers* the benefits which could be achieved by the imposition of price control on airfield activities at AIAL are between \$15.4 million and \$16.7 million per annum.

BARNZ disagrees with the recommendation that airfield activities at CIAL should not be controlled. There would clearly be net benefit for acquirers from imposing such controls, and that is the test under section 52. *BARNZ considers* the benefits which could be achieved by the imposition of price control on airfield activities at CIAL are between \$3.4 million and \$3.8 million per annum.

While BARNZ agrees with the recommendation that airfield activities at WIAL should not be controlled, it has not commented on the detail of the Commission's calculations with respect to WIAL due to a lack of comprehensive information. *BARNZ notes*, that any future decisions by WIAL with regard to prices of airfield activities, may influence the Commission's draft decision.

BARNZ is comfortable with the notion of light-handed price control developed by the Commission in paragraphs 12.63 to 12.65 of the draft report, under which, instead of the Commission moving immediately to set a price, it would direct the parties to develop a price within the principles and parameters set out by the Commission in its report, which price would then be accepted by the Commission as an undertaking from the airport company and be authorised. If, however, the parties were not able to develop an appropriate price, the Commission would move to set prices itself. *BARNZ* believes this approach would both provide the discipline to prevent monopoly pricing, but also still ensure industry self-regulation to the extent possible. It would also ensure the development of the principles and guidelines necessary to enable the parties to move forward upon the expiry of price control.

RESPONSES TO COMMISSION'S QUESTIONS

Section 52(a) – Competition Limited

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

- 1.1 *BARNZ agrees* that in making its recommendation to the Minister, the Commission should “consider the new Part 4 and new sections 70 to 74, as amended, on the basis that the Minister has to consider, and make a decision based on, the Commission's report under the amended provisions of the Act.” (paragraph 1.6) This was confirmed by the Minister in his recent renewed request for the Inquiry under the amended sections of the Commerce Act.
- 1.2 *BARNZ agrees* “that any assessment ... as to the state of competition in a market requires the Commission to take into account the structural elements of the market, as well as any relevant behavioural considerations” (paragraph 2.29) and that the structural and behavioural elements identified in paragraph 2.35 are all relevant.

2. Are the markets appropriately defined?

- 2.1 *BARNZ agrees* that “the purpose of defining a market under the Commerce Act is to provide a framework within which to analyse the extent of competition, or its antithesis – market power”. (paragraph 5.7)
- 2.2 *BARNZ agrees* that “one approach to identifying a significant degree of market power (in the context of market definition) is in terms of the ability of the hypothetical monopolist to increase profits by imposing a small but significant and non-transitory increase in price (a ‘ssnip’) above the competitive level.” (paragraph 5.11)
- 2.3 *BARNZ agrees* that “the process of identifying the relevant market(s) should keep in mind the object of so doing” and that for the current purpose “the objective is to determine whether any of the three major airports have the potential to exert market power, such that competition in the market(s) for ‘airfield activities’ is limited.” (paragraph 5.8)
- 2.4 *BARNZ agrees* that “markets are not always easy to define in practice” and that “it may not be practical – nor, indeed, always necessary – to identify the precise boundaries of the activities included in a market.” (paragraph 5.15)
- 2.5 *BARNZ agrees* that “the definition of the activities of airports set out in the Airport Authorities Amendment Act 1997 do not necessarily equate with the concept of markets used in the Commerce Act.” (paragraph 5.1)
- 2.6 *BARNZ agrees* that a “strict application of the statutory definitions in the Airport Authorities Act and the Civil Aviation Act would be unhelpful for

comparing the activities undertaken at each airport” and therefore a “practical and less strict application of the definitions” should be taken. (paragraphs 4.4 to 4.7)

- 2.7 *BARNZ considers* there is a need for the definitions in the Airport Authorities Act 1966 to be reviewed and amended to align them with the practical reality of airport operations, but acknowledges this is not within the terms of reference for the Commission’s Inquiry.
- 2.8 *BARNZ has no concerns* with the delineation of markets put forward in paragraphs 5.26 to 5.44, nor with the conclusion that within that delineation “Airfield activities make up part of the Aircraft Movement Market.” (paragraph 5.44)

3. Do any additional markets require consideration?

- 3.1 *BARNZ agrees* that no additional markets require consideration for this Inquiry, given that it is restricted to airfield activities and does not extend to terminals.
- 3.2 *BARNZ agrees* that “economies of scope making the unbundling or duplication uneconomic” (paragraph 5.12) and “the complementary nature of many activities suggests a broader market definition may be appropriate”. (paragraph 5.22)
- 3.3 *BARNZ considers* the first four of the five markets identified by the Commission are closely related and have a complementary nature.

4. Is the Commission’s assessment of the nature and scale of current competition in the supply of airfield activities correct?

- 4.1 *BARNZ agrees* that “there appears to be considerable scope for substitution between a number of adjacent airports for ...GA aircraft.” (paragraph 5.55)
- 4.2 *BARNZ agrees* that “it seems likely that there are no substantial near entrants to compete effectively with the three large airports for domestic commuter traffic and international traffic.” (paragraph 5.56)

5. Is the Commission’s assessment of the likelihood, timing, nature and scale of potential new entry in the supply of airfield activities correct?

- 5.1 *BARNZ agrees* that the factors listed in paragraph 5.46 “combine to suggest that barriers to entry of new airports are likely to be very high, and hence the potential competition faced by existing airports from this source is weak.” (paragraph 5.47)

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

- 6.1 *BARNZ agrees* that “each of the three major airports operates largely within its own geographically distinct regional market, which are the greater population areas around the three airports Each airport faces a demand from acquirers who do not see the other airports as offering viable substitute services.” (paragraph 5.90)
- 6.2 *BARNZ agrees* that “meeting demands for flights is the overriding factor determining which airports an airline flies to, rather than the costs of doing so. Airport charges, although not insignificant to airlines, are unlikely to make the difference between an airline flying or not flying to a particular city.” (paragraph 5.91)
- 6.3 *BARNZ agrees* that “each of the [major] airports is ... unlikely to find itself constrained by the behaviour of its users. Variations in charges between airports are unlikely to influence demand much, although they may have some impact at the margin.” (paragraph 5.91)
- 6.4 *BARNZ agrees* that substitution possibilities for GA traffic are greater.
- 6.5 *BARNZ also agrees* that “GA yields relatively insignificant revenues for the major airports and it would not be expected to induce competition between them”. (paragraph 5.55)

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

- 7.1 *BARNZ has no issue with* the method and data used to assess the elasticity of demand for airfield activities.
- 7.2 *BARNZ notes*, however, the inherent uncertainties involved in making an estimate such as this, and raises a query as to whether a range estimate might be more appropriate.
- 7.3 *BARNZ agrees* with the conclusion of the discussion of price elasticity that “the implication is that airports have significant pricing power, but the exercise of that power has little impact on final consumer demand.” (paragraph 5.72)

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

- 8.1 *BARNZ agrees* that “the current regulation of airports relies principally upon the countervailing power of airlines and the requirements on airport operators to consult major customers ... under section 4 of the Airport Authorities Amendment Act 1997.” (paragraph 5.92) *BARNZ notes* that the information disclosure requirements in the Airport Authorities (Airport Companies Information Disclosure) Regulations 1999 also form part of the current regulation of airports.
- 8.2 *BARNZ agrees* that AIAL, WIAL and CIAL are unlikely to be “significantly constrained by the countervailing power of airlines” under the current regime. (paragraph 5.108) *BARNZ also agrees* that “airlines stand to lose greater amounts than airports from withdrawing custom ...”. (paragraph 5.100)
- 8.3 *BARNZ notes* that the absence of countervailing power able to significantly constrain AIAL, CIAL or WIAL, means that the foundation upon which the current regulatory regime is presumed to be based, does not exist. *BARNZ therefore considers* that the Airport Authorities Act 1966 needs reviewing with a view to strengthening it in the case of specified airport companies.
- 8.4 *BARNZ comments* that the consulting or negotiating position of the airlines may be increased and inequalities reduced if the Commission were to demonstrate that the powers contained in Part IV of the Commerce Act to recommend the imposition of price control represent a realistic or credible threat to monopoly price setters.

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

- 9.1 *BARNZ agrees* with the competition assessment for the Aircraft Movement Market in paragraphs 5.118 to 5.123.
- 9.2 *BARNZ agrees* that “market power is probably relatively high in [the aircraft movement] market due to the lack of supply side substitutes” and the fact that “the bulk of assets ... are ... provided by a single supplier” in each of the specified markets. (paragraph 9.121)

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

- 10.1 *BARNZ agrees* with the Commission's preliminary conclusion that “competition is limited in the aircraft movement market” (paragraph 5.127) and “the first requirement of section 52 is satisfied”. (paragraph 5.129)

Pricing

Pricing Principles

11. Are the pricing principles considered by the Commission appropriate?

- 11.1 *BARNZ agrees* that “the positive characteristics of a competitive market is an appropriate consideration in determining whether the requirements of section 52 are satisfied, and in whether control should be recommended.” (paragraph 6.1)
- 11.2 For its part, *BARNZ considers* that the setting out of pricing principles and parameters as in paragraph 6.24 should be of considerable help to the industry in determining future economically efficient prices.
- 11.3 *BARNZ agrees* that the pricing principles set out in paragraph 6.24 are appropriate, *with one caveat* which relates to the implication in the second bullet that returns in excess of a normal return may be earned in reflection of superior performance.
- 11.4 *While BARNZ agrees* that it may be appropriate for superior performance to be able to be rewarded, it notes that there will almost certainly be practical difficulties with the application of this aspect of the pricing principles. Under the current approach to pricing and information disclosure in New Zealand, airport companies will be likely to say that any and all ‘above normal’ returns reflect superior performance. In an ideal regime with full and frank transparency and agreed service levels, it may be appropriate for superior performance to be rewarded with ‘above normal’ returns – if the higher level of service is in response to the acquirer’s wishes. However, the current situation with airports, where there is not full transparency, no agreement on pricing principles nor agreed service levels, means that this aspect of the Commission’s pricing principles is not presently workable.
- 11.5 *BARNZ agrees* that the “principles should not be seen as standing in isolation. They are interrelated considerations in evaluating the efficiency of a particular situation.” (paragraph 6.25)
- 11.6 *BARNZ agrees* that “there is a circular problem if discounted cash flows are used to set prices, since prices will influence the level of expected cash flow, which in turn determines asset value”. (paragraph 7.5)
- 11.7 *BARNZ notes* the comments in paragraphs 6.33 and 6.34 regarding a multi-till approach, and notes also that the Commission supports a multi-till approach to determining landing charges. *BARNZ also notes* the Commission has not explained how it envisages the multi-till approach operating within the terminal and other areas of the airport.

- 11.8 *BARNZ refers* the Commission to the approach it put forward in its submission on the Critical Issues Paper. BARNZ suggested a modified multi-till approach be used under which a proportion of any excess profits earned on related activities (the demand for which is driven by the airport's core business) are used to off-set the costs of the airport's core business: refer BARNZ response to question 44 of the Critical Issues Paper. This was the original approach of the ACCC in relation to SACL.
- 11.9 *BARNZ also refers* the Commission to the approach taken by the ACCC in its decision regarding the Adelaide Airport Multi-User International Terminal where a sharing of joint and common costs was mandated. Finally, BARNZ observes that an analogy may be drawn between anchor tenants at a shopping mall and airlines. In a commercial context, the anchor tenant invariably pays a lower rental per square metre in recognition of factors such as size of area leased, credit risk, the long-term nature of the tenancy and the role those tenants play in attracting customers to the mall.
- 11.10 The above clearly illustrates that a multi-till approach raises a number of complex issues regarding identification and allocation of costs. *BARNZ submits* it would be useful if the Commission were to set out what it considers to be the principles which should govern cost allocation and information disclosure in a multi-till environment.
- 11.11 *BARNZ notes* the Commission's comments in paragraph 6.32 that "price discrimination by time of day could be efficient where there is constrained capacity at peak times". *BARNZ understands* the general principle to be that airports should not be able to earn more than their required revenue, but that this is not incompatible with peak pricing provided that any excess charges to users at particular times are off-set by discounting charges at other times, i.e. required (or reference) revenue would be unaffected by the differential pricing regime. *BARNZ considers* that it would be useful if the Commission outlined how it would envisage peak pricing working efficiently.

Asset Base

12. Is it correct to value airfield land at opportunity cost?

- 12.1 In its submission on the Commission's Critical Issues Paper, BARNZ submitted that "assets should be valued with the objective of simulating a valuation as if the market for airport services were competitive". (BARNZ's response to question 46 of the Critical Issues Paper)
- 12.2 Asset valuations are components in setting prices for monopoly businesses. The important issue is whether the prices that result replicate those that would rule in a competitive market; that is, whether the resultant prices conform with the pricing principles in paragraph 6.24 of the Commerce Commission's draft report. 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*.

- 12.3 *BARNZ agrees* that the value of land used to establish airfield activity prices must be sufficient to induce the airport company to use the land for that purpose, and also to encourage them to acquire additional land for airfield activities, if it is economically desirable for it to do so. (paragraph 7.20)
- 12.4 *BARNZ agrees* that increases in valuation are part of the returns of the airport company and should be counted as such when determining required revenue.
- 12.5 *BARNZ is satisfied* that, in relation to the three international airports the subject of this Inquiry, the Commission's decision to use opportunity cost for land valuation, will result in prices which provide the right efficiency signals to users and suppliers. On this basis, *BARNZ does not have an issue* with the use of opportunity cost.

13. How the opportunity cost of airfield land should be determined?

- 13.1 *BARNZ submits* that, if the Commission uses opportunity cost as the basis for valuation of airfield land, then it should carefully consider what the next best alternative use for the land would be, if there were no airport in the vicinity.
- 13.2 *BARNZ does not take issue with* the Commission's proposal in paragraph 7.34 that "opportunity cost should be determined based on the highest alternative use value of resources used up or pre-empted".
- 13.3 *BARNZ submits* that the following are realistic scenarios for the highest alternative use of airfield land, based on adjoining use and likely development trends if there had been no airport,:
 - A. AIAL – mixture of residential and small business uses as is the case in Mangere.
 - B. WIAL – mixture of commercial, industrial and residential uses.
 - C. CIAL – mixture of intensive and extensive rural use.
- 13.4 *BARNZ submits* opportunity cost valuations, if used, should be based on these scenarios.
- 13.5 AIAL has used a raw land value of \$140,000 for its airfield land. In its submission during consultation with AIAL, BARNZ put forward a raw land value of \$70,000 per hectare.
- 13.6 BARNZ has obtained further advice from Barratt-Boyes Jefferies Ltd regarding the raw land value of AIAL's airfield land, found at Attachment BARNZ-06. Barratt-Boyes Jefferies has assessed the next best alternative use of the airfield land on two scenarios – a residential development and small-hold rural blocks.

- 13.7 The advice is that the value of the airfield land, on the assumption it is turned into a residential subdivision, ranges from \$64,000 per hectare to \$117,000 per hectare, depending upon the discount rate used and the length of the development period. These values correspond with the per hectare rate paid by AIAL when making airport land purchases between 1991 and 1999. Barratt-Boyes Jefferies has adopted a value per hectare of \$90,000 for an alternative residential use.
- 13.8 On the other hand, if zoning restrictions and town-planning issues will not permit a residential sub-division to occur, then the next best alternative use of small rural landholdings of 12.5 hectares would produce a value per hectare of \$32,000.
- 13.9 *BARNZ considers* that the alternative urban use value of \$90,000 per hectare and the alternative small rural block value of \$32,000 per hectare indicate the \$140,000 per hectare adopted by AIAL is at the upper end of the range.
- 13.10 A land value of \$90,000 per hectare would result in AIAL's land value needing to be adjusted downwards by \$17.6 million.
- 13.11 In its calculations in this response, *BARNZ has not made* this adjustment, and has continued to use AIAL's raw land value of \$140,000. This is on the basis that valuation is not an exact science, and there will always be a range of values depending upon issues such as development periods, discount rates, etc.
- 13.12 The appropriate value of the raw land is an issue which will require a judgment by the Commission. *BARNZ refers* the Commission to this further work by Barratt-Boyes Jefferies Ltd at Attachment BARNZ-06, and asks the Commission to take this into account when determining the appropriate raw land value to use in its calculations.
- 13.13 *BARNZ considers* the value CIAL has assigned to its airfield land of \$ 9.69 million, based on extensive and intensive rural use, appears to be reasonable. However, BARNZ notes the values CIAL has assigned to land associated with aircraft and freight activities and with terminals, do not reflect the concept of opportunity cost.

14. Should the costs of land include the costs associated with getting the land into airport use?

- 14.1 *BARNZ agrees* 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. (paragraph 7.33)
- 14.2 *BARNZ considers* that the costs associated with getting land into use as an airport also include the cost of use of money over the time taken to develop the

airport to the point at which historical costs are being set (in the Commission's analysis this is the date of corporatisation).

- 14.3 *BARNZ notes* that “due to lack of information, the Commission has not included any adjustment for such costs in its asset base.” (paragraph 7.33)
- 14.4 *BARNZ notes* that the Telfer Young Report does not contain a clear statement regarding the methodology for calculating the costs associated with getting the land into airport use, or how such costs should be treated.
- 14.5 BARNZ's understanding of the Seagar land valuation for AIAL was that the final zone 1 airfield land valuation of \$305,000 per hectare comprised the following elements:

AIAL Land Valuation

Raw land market value	\$140 000
Holding costs	\$133 000
Levelling costs	\$ 32 000
Value per hectare	\$305 000

- 14.6 This shows that AIAL considered the costs associated with getting its land into airport use were \$ 165,000 per hectare in June 1999, comprising holding costs and levelling costs.
- 14.7 The Commission has indicated that sunk costs should be valued on a historical basis. *BARNZ considers* that the costs associated with getting land into use as an airport are sunk costs.
- 14.8 In order to calculate the historic costs associated with getting the land owned by AIAL into airport use, BARNZ has calculated levelling costs by reference to the Consumer Price Index, and holding costs by reference to the Index published by Quotable Values, this being a proxy for market land values as at that time.
- 14.9 To calculate the levelling costs, BARNZ has taken AIAL's levelling costs of \$32,000 per hectare as at June 1999, and adjusted these by the Consumer Price Index to reflect the appropriate cost in 1985, which is when the work would have needed to have been commenced in order to have an operational airport in 1988 (the Commission's date for determining historical cost). This equates to levelling costs of \$17,536 per hectare.
- 14.10 To calculate the costs representing the development period (holding costs) the 1999 opportunity cost of \$140,000 per hectare has been adjusted by the Quotable Value index to produce a market value in 1982. Financing costs have then been calculated on this market value in 1982 at a net interest cost of 4 percent for 7 ½ years. This produces financing costs of \$6,317 per hectare.

- 14.11 These two calculations produce historical costs associated with getting the land at Mangere to the state it can be used as an airport in 1988 of \$23,853 per hectare, which equates to a combined land and improvements value per hectare of \$163,853 as follows:

BARNZ Adjusted AIAL Land Valuation and Improvements

Raw land market value	\$140 000
Holding costs	\$17 536
Levelling costs	\$ 6 317
Value per hectare for airfield land including costs associated with getting land into use as an airport	\$163 853

- 14.12 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.
- 14.13 The detail of these calculations may be found in Attachment BARNZ-01.

15. Is it correct to value specialised airfield assets at depreciated historic cost?

- 15.1 *BARNZ considers* that there are a number of different methodologies to value assets and agrees with the Commission that there are arguments for and against the use of historical cost and the use of ODRC. Whichever methodology is adopted, it is important that it is applied consistently and in an internally logical manner.
- 15.2 *BARNZ agrees* with the Commission that it is not appropriate to value specialised airfield assets at opportunity cost, since the zero opportunity cost would not provide appropriate signals. A return on and of the actual amount invested will reward the investor for the actual capital employed and provide the right signals for investment and efficiency.
- 15.3 However, it is worth noting that there are some circumstances where using historical costs will tend over time to inflate prices compared with the competitive outcome. This will happen where the real costs of producing assets with the same functional capacity decline over time as a result of improvements in technology.

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

- 16.1 *BARNZ agrees* that “only ‘used and useful’ assets should be included in the asset base on which a rate of return is calculated for pricing purposes. All other assets should be optimised out.” (paragraph 7.49)
- 16.2 *BARNZ does not agree* that “decisions to optimise assets should consider whether the decision to invest was poor at the time it was made, and not rely on the benefit of hindsight.” (paragraph 7.48) In a competitive situation, technological and other risks will fall to equity owners, not customers.
- 16.3 *BARNZ agrees* that “any runway area surplus to requirements should be optimised out”. (paragraph 7.51)
- 16.4 *BARNZ also agrees* that “the runway lengths of Auckland, Wellington and Christchurch International Airports are required for the largest aircraft and the longest routes currently operating from each airport” and therefore none of the sealed surfaces of the airports should be optimised out at this time. (paragraph 7.52)
- 16.5 *BARNZ agrees* that the seabed at AIAL “is not needed for operational purposes. Statutory planning documents are in place which provide adequate protection, without the need for AIAL to own the land” and therefore the entire seabed area at AIAL should be optimised out. (paragraph 7.54)
- 16.6 *BARNZ agrees* seawalls “do not have a separate value, but must otherwise be subsumed in the land value” and therefore the seawall at AIAL should be excluded from the asset base. (paragraph 7.55)
- 16.7 *BARNZ agrees* that “while the statutory definition of airfield charges specifically provides that land acquired or held to provide airfield activities in the future is included within the definition, it does not follow that it is included in the asset base for determining today’s prices of airfield activities”. *BARNZ also agrees* that “airports should bear the risks of not anticipating future demand correctly”. (paragraph 7.58)
- 16.8 *BARNZ considers* that no return should be sought from airfield users on any land held for future development until the land is brought into use for airfield activities.
- 16.9 *BARNZ agrees* that all the land held for development by AIAL should be optimised out. (paragraph 7.59)
- 16.10 *BARNZ is not certain* whether all land held for future development has been optimised out. During consultation AIAL found that 73.2513 ha of reclaimed land had been valued as seabed, rather than land. It corrected this, which added a further \$22,341,000 to its value (refer letter dated 25 June 2001 from AIAL to Telfer Young (Auckland) Ltd. *BARNZ* understands that this

reclaimed land comprises the lagoon reclamation and the western end reclamation: refer Attachment BARNZ-05, an aerial photograph of AIAL airfield land as at March 2001. Clearly, some of this land is already used and useful. BARNZ understands a significant portion of the land is intended to act as a taxiway from the existing runway to the second runway. As such, much of it is not yet 'used and useful' and needs to be optimised out of the asset base. Due to a lack of information regarding the precise area of this land being used today, BARNZ has not made this adjustment.

- 16.11 In the absence of a commercial or pragmatic agreement with users, *BARNZ does not agree* with the Commission's apparent concession that there may be some situations in which land held for development may be included in the asset base. (paragraph 7.58)

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

- 17.1 *BARNZ agrees* that "any new investment should be based on reasonably anticipated future demands". (paragraph 7.61)
- 17.2 *BARNZ very strongly agrees* that "the pre-financing of new investment is generally inappropriate – only 'used and useful' assets should be included in the asset base." (paragraph 7.63) *BARNZ agrees* "this should encourage airports to only undertake new investments that will be 'used and useful'". (paragraph 7.63)
- 17.3 *BARNZ agrees* that "the cost of new investment in land that is eventually included in the asset base should include the capitalised costs 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". (paragraph 7.66)
- 17.4 *BARNZ agrees* that airport companies should "consult – at the time of setting charges – on any planned capital expenditure" and that "the estimates included in five year forecasts should reflect the airlines' views on an airport's proposals" and that this "should encourage sound investment proposals". (paragraph 7.68)
- 17.5 *BARNZ agrees* that the result of the principle that "only 'used and useful' assets should be included in the asset base" means that work which is in progress, planned work or possible future investment should not be included in the asset base. (paragraphs 7.65 to 7.70) However, *BARNZ acknowledges* that capital expenditure which has been consulted over and agreed as necessary and which becomes 'used and useful' in the pricing period, can then be included in the asset base for the years when it is actually used and useful.

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

- 18.1 *BARNZ agrees* that “the asset valuation methodologies used by the airports are not necessarily appropriate” and it also “has some concerns with the airports’ application of the relevant methodologies and the valuations adopted”. (paragraph 7.86)
- 18.2 In particular, *BARNZ considers* the value assigned to airfield land by AIAL is not correct.
- 18.3 *BARNZ notes* that the principles outlined by the Commission in its draft decision, mean CIAL will need to review the value it has assigned to its terminals.
- 18.4 BARNZ has made the following adjustments to the Commission’s asset base for airfield assets at AIAL:

AIAL Airfield Asset Base

	Amount (\$000s)
AIAL Valuation 30 June 1999	\$ 312,751
Adjustments by AIAL for Pricing Purposes 2000	-27,504
CC Optimisation of Seabed	-9,800
CC Optimisation of Seawall	-9,787
CC Optimisation of Second Runway Land	-36,757
CC Adjustment to Sealed Surfaces Value (ODRC to HC)	-49,773
Commission Asset Base	179,130
BARNZ Adjustment of levelling and financing costs (ORDC to HC) (refer question 14 and BARNZ-01)	-49,644
BARNZ Adjustment for increases in land value (refer question 31 and BARNZ-03)	1,477
Optimisation of reclaimed land not yet used	?
BARNZ Asset Base	130,963

- 18.5 BARNZ has also adjusted the CIAL valuation to reflect increases in the value of the land as follows:

CIAL Airfield Asset Base

	Amount (\$000s)
CIAL Valuation 30 June 1999	\$ 41,930
Adjustments by CIAL for Pricing Purposes 2000	-381
Adjustment to Sealed Surfaces Value (ODRC to HC)	-13,491
Add back of Reseal Reserve	6,633
Commission Asset Base	34,691
BARNZ Adjustment for increases in land value (refer question 31 and BARNZ-04)	290
BARNZ Asset Base	34,981

19. Is the appropriate debt premium adopted by Commission?

- 19.1 *BARNZ agrees* that “the key consideration in determining the debt margin is what a firm of similar credit risk with an efficient capital structure could be expected to obtain financing for. The actual rates paid by the airports are of less importance.” (paragraph 8.11)
- 19.2 *BARNZ notes* that CIAL is 100% owned by entities with powers to require other parties pay them taxes or rates, and that this should lower the debt premium faced due to the resultant extremely low credit risk. *BARNZ notes* that CIAL used a debt premium of 0.5% in its original pricing proposal during consultation and adopted a figure of 0.8% in its final proposal. CIAL moved back to using 0.5% in its disclosure statement issued last year. Both these figures are below the 1.0% figure used by the Commerce Commission in its draft decision.
- 19.3 *BARNZ also notes* AIAL is a large international airport which is the international gateway to New Zealand and that this means, it too, has a very low credit risk, albeit not as low as CIAL’s.
- 19.4 *BARNZ considers* that a debt premium of 1% is excessive. *BARNZ* still favours 0.8% for AIAL and 0.5% for CIAL. The figure for WIAL should be similar to that for AIAL, at 0.8%.

20. Is the appropriate risk-free rate adopted by the Commission?

- 20.1 *BARNZ acknowledges* that the issue of the appropriate risk-free rate, like many of the WACC parameters, is one where there is significant opportunity for experts to debate this issue without necessarily reaching a resolution.
- 20.2 *BARNZ* has approached this question in two parts. The first is how the risk-free rate should be measured, irrespective of the time period. The second, is the length of bond that should be adopted, i.e. a three year, five year or ten year bond.
- 20.3 With regard to the first issue, *BARNZ notes* that the Commission has used the average yield over the six months prior to the new prices coming into effect on the grounds that this is the period during which prices were being set.
- 20.4 While such an approach is pragmatic and easy to apply, *BARNZ has been advised* that a long averaging period exposes both parties to the risk that the determined rate is anomalous to market conditions at the time the rate is set and therefore not in accordance with economic principles. Gaming could come in if rates moved in favour of one side or the other, since both sides would be able to observe the mis-pricing that would result from such a system. In addition, averaging of this magnitude may make it more difficult and

perhaps expensive for the airports to align their real interest rate exposures to the averaged rate. BARNZ has received advice that an average of the market rates over a period of ten trading days either side of the beginning of the regulatory period is more appropriate. If it is necessary to fix the rate prior to the beginning of the period, an estimate of the rate can be extracted from the yield curve using the most current possible market data.

- 20.5 With regard to the second issue, *BARNZ agrees with* the Commission's decision to use the average yield on three-year Government stock. Since price control (if imposed) would involve a resetting of the WACC at the beginning of each regulatory period, then BARNZ agrees with the Commission that for the purposes of considering price control, the maturity period should be set equal to the regulatory cycle.
- 20.6 *BARNZ notes* that in the absence of price control, it may be more appropriate for the maturity period of the risk-free rate to approximately match the average maturity period that the airports have in place. This is on the grounds that the airports have an incentive to choose the right maturity structure. In this situation, therefore the five to ten year bond might be more appropriate.

21. Is the appropriate asset beta adopted by the Commission?

- 21.1 *BARNZ agrees* that “the regulatory environment is fundamental to the performance of the airports and is, therefore, the dominant factor considered in choosing comparators” for asset betas. (paragraph 8.58)
- 21.2 BARNZ comments that:
- A. AIAL and CIAL voluntarily chose the pricing regimes they have adopted. Markets do not normally compensate owners for risks they could avoid. The airlines did not insist on multi-year prices. The airlines were not given the choice of shorter consultation rounds and lower asset betas, for instance.
 - B. The airlines cannot stop AIAL and CIAL re-opening consultation on prices at any time.
 - C. AIAL and CIAL have adopted pricing regimes for airfield activities that insulate them to a considerable extent from adverse demand shocks through setting their airfield activity charges based on MCTOW, and not passenger numbers.

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

- 22.1 *BARNZ does not agree* that “AIAL and CIAL clearly face more systematic risk than US rate of return regulated firms”. (paragraph 8.59)

- 22.2 *BARNZ agrees* that AIAL and CIAL face less systematic risk than UK price-capped firms. (paragraph 8.59)
- 22.3 *BARNZ submits* that US rate of return regulated firms are better comparators for airfield activities than UK price-capped firms. This is because the New Zealand regulatory environment allows airport companies to set prices as they see fit, and therefore replicate the almost guaranteed returns available to US rate of return regulated firms.
- 22.4 If a particular point estimate is required, then the above points, together with the factors outlined in paragraph 21.2, lead, in BARNZ's view, to an asset beta of 0.3.

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

- 23.1 *BARNZ agrees* that CIAL's asset beta may be slightly higher than AIAL's, however, the difference is considered to be so small that it is unable to be accurately measured. As noted above at paragraphs 22.1 and 22.2, BARNZ considers that the asset beta range of 0.4 to 0.5, with a mid point of 0.45 being adopted, is too high for the New Zealand regulatory environment.

24. Is the market risk premium adopted by the Commission appropriate?

- 24.1 *BARNZ agrees* with the use of a PTMRP of 8%.

25. Is the leverage ratio adopted by the Commission appropriate?

- 25.1 *BARNZ notes* that the question of appropriate leverage is one on which there are a number of differing views. BARNZ notes that the Commission has adopted a 25:75 ratio for the debt:equity ratio which is different from that used by the airports. However, BARNZ also notes that the different ratios only have a very small impact on the outcome.

26. Are the WACC estimates developed by the Commission appropriate?

- 26.1 *BARNZ agrees* with the Commission's assessment of the PTMRP and the manner in which it has measured the risk free rate.
- 26.2 *BARNZ does not agree* with the debt premium or the asset beta adopted by the Commission and therefore does not agree with the WACC estimates developed by the Commission.

- 26.3 *BARNZ agrees* that “the choice of real or nominal doesn’t matter provided these is consistency in the application – in particular in the parameter estimates and the cash flow estimates.” (paragraph 8.77)
- 26.4 *BARNZ agrees* with the Commission’s decision to use a nominal WACC in order to be consistent. (paragraph 8.78)
- 26.5 BARNZ’s estimate of appropriate WACC parameters are set out below:

BARNZ WACC Parameters

	Auckland	Wellington	Christchurch
R_f	6.92%	7.47%	6.92%
t_c	33%	33%	33%
t_{int}	33%	33%	33%
t_{div}	0%	0%	0%
t_{divm}	0%	0%	0%
Div	N/a	N/a	N/a
Div_m	N/a	N/a	N/a
PTMRP	8%	8%	8%
Debt Premium	0.8%	0.8%	0.5%
β_d	0%	0%	0%
R_d	7.72%	8.27%	7.42%
W_d	25%	25%	25%
W_e	75%	75%	75%
β_a	0.3	0.3	0.3
β_e	0.4	0.4	0.4
R_e	7.84%	8.20%	7.84%
Nominal Tax-Adjusted WACC	7.17%	7.54%	7.12%

Airfield Pricing

27. Is the Commission’s assessment of the allocative efficiency of the structure of the landing charges of AIAL, WIAL and CIAL correct?

- 27.1 *BARNZ does not take issue with* the Commission’s discussion of the structure of landing charges.
- 27.2 *BARNZ agrees* that “most of the costs of airfield activities do not vary with the number of landings, but are fixed, and indeed, sunk.” (paragraph 9.35)
- 27.3 *BARNZ agrees* that “there is no economically rational way of allocating most of the costs.” (paragraph 9.35)

27.4 *BARNZ agrees* that allocative efficiency is an important factor in determining how to recoup airfield costs. (paragraph 9.35)

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

28.1 *BARNZ does not have any substantial issue with* Table 39 in the Commission's draft report, which sets out the Commission's interpretation of each airport's basis of cost allocation.

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

29.1 *BARNZ notes* the Commission's discussion of the principles of Ramsey pricing.

29.2 *BARNZ agrees* that it is questionable whether pricing schedules set purely upon the basis of cost allocations would be as close as possible to Ramsey-compliant prices. (paragraph 9.40)

29.3 Like the Commission, *BARNZ considers* that setting airfield prices to fully meet Ramsey pricing requirements would be likely to lead to discrimination between the prices charged to similar types of aircraft, which may result in breaches of New Zealand's international obligations. It would also lead to high transaction costs as parties argue about the equity of like being charged differently. In other words, any benefits to be gained from pure Ramsey based pricing would be outweighed by the costs in analysing and implementing such pricing.

29.4 *BARNZ considers* MCTOW based pricing, while not perfect, maybe a reasonable approximation of the costs imposed in the case of aircraft movements, and is well understood and widely used in the Industry.

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

30.1 *BARNZ notes* that the Commission's consideration of the question of cross-subsidisation is related to airfield activities alone and does not extend to the terminal or other areas of the airport.

30.2 *BARNZ agrees* that "there is no evidence to suggest that there is cross-subsidisation of non-airfield activities by airfield activities." (paragraph 9.50)

30.3 *BARNZ notes* the Commission's preliminary view that the results produced by AIAL's use of ACAM "do not appear to result in any cross subsidisation of

non-airfield assets by airfield activities”. (paragraph 9.48) BARNZ’s concern at AIAL with regard to ACAM relates primarily to the terminal rather than the airfield. BARNZ considers that AIAL’s use of ACAM either results in aeronautical activities in the terminal meeting the costs of facilities also used by commercial and retail activities, or that AIAL may be recovering some costs twice (such as public areas and amenities in the terminal) – once through the ADC or TSC and a second time through rentals and concession payments. *BARNZ is concerned to ensure* there is a proper allocation of costs in the terminal areas.

- 30.4 *As BARNZ commented* earlier in relation to question 11, it would be useful if the Commission were to outline what it considers to be the correct principles of cost allocation when a multi-till pricing approach is adopted.

Performance Analysis

31. Is the Commission’s assessment of the existence of, or potential for, excess returns correct?

Comments on Draft Report

- 31.1 *BARNZ notes* the Commission’s statement in paragraph 10.6 that “an actual return in excess of an appropriate target WACC would suggest that the entity was earning an excessive or monopoly return, unless those returns reflected superior performance.”
- 31.2 *BARNZ notes* that the practical application of the concept of ‘superior returns for superior performance’ will be extremely difficult given the absence of transparency, full information disclosure and agreed service standards. In addition, BARNZ does not believe that performance which is in excess of the level required by acquirers (subject to safety and regulatory issues) should result in extra returns to the supplier for ‘superior’ performance.
- 31.3 *BARNZ agrees* with the Commission’s preliminary conclusion that “both AIAL and CIAL have exploited their market power in airfield activities by raising prices above the competitive level in a fairly sustained fashion.” (paragraph 10.20)
- 31.4 *BARNZ agrees* that “the presence of excess returns reveals an ability and willingness to set prices above the competitive level in the case of two of the airports.” (paragraph 10.21)

Comments on Model

- 31.5 *BARNZ notes* that in carrying out its projections based on recent price increases, the Commission has made “certain assumptions regarding the determination of P_C .” (paragraph 10.68) In particular, the Commission has assumed that the following will remain unchanged:

- A. The asset base
 - B. Operating costs
 - C. Output (ie MCTOW)
- 31.6 *BARNZ considers* that the assumption that these factors will remain constant affects the accuracy of the calculations carried out by the Commission.
- 31.7 While it creates complications, *BARNZ is of the view* it is necessary to attempt to factor these variables into the models developed. Nevertheless, due to the absence of full information, BARNZ has not made these adjustments either.
- 31.8 The need to adjust for alterations in the asset base, is particularly illustrated in the case of AIAL, which is carrying out a significant capital project relating to the widening of its taxiway and rehabilitation of its runway. BARNZ understands this work is currently estimated to cost \$140 million over a six year period. AIAL consulted with the airlines over the technical and operational aspects (as distinct from the financial implications) of this project in 1998 to 1999 before work commenced. During consultation over landing charges the following forecasts were provided to the airlines regarding this and other capital expenditure:

Forecast Airfield CAPEX at AIAL (Excepting Land Acquisitions)

2000		□
2001		□
2001		□
2003		□
2004		□

- 31.9 Despite knowing these amounts, BARNZ does not have sufficient information to be able to accurately alter the Commission's model. In particular, it does not know:
- A. Which portions of the forecast amounts are capital expenditure and which are simply restoring the runway to its previous level of serviceability?
 - B. The current status of AIAL's capital spend (i.e. where AIAL is in relation to the forecast amounts?)
- 31.10 Because of difficulties such as these, BARNZ has continued to apply the Commission's assumption that there will be no capital expenditure, and that operating costs and output will remain constant. However, BARNZ does consider that when the uncertainties identified above have been resolved, then it will be appropriate for the Commission to include capital expenditure in its model, at the times when such capital expenditure becomes 'used and useful'.
- 31.11 *BARNZ considers* that the accuracy of the model will also have been affected by the lack of adjustment for MCTOW growth. BARNZ suggests that figures

in the Leigh Fisher Aviation Demand Study could be used. However, this adjustment has not been made.

31.12 *BARNZ has made* the following adjustments to the Commission's calculations of excess returns (set out in Attachments BARNZ-03 and BARNZ-04):

- A. It has adjusted AIAL's asset base by calculating holding and levelling costs on a historical basis, a total adjustment of \$49.6 million as discussed in response to question 14 above and in BARNZ-01.
- B. It has applied a three percent increase to AIAL's and CIAL's land valuation in 2000, on an annual straight-line basis, to reflect increases to the opportunity value of land. This is equivalent to a cumulative rate of just under 3.0%.
- C. It has calculated the excess returns using the Commission's WACC of 8.4% as well as the BARNZ WACC of 7.17% for AIAL and 7.12% for CIAL. (Refer responses to questions 19 to 26.)
- D. It has removed CIAL's annual resale provision charge of \$806,000 from CIAL's expenses, which corresponds to the adjustment to assets made by the Commission.

31.13 This results in the following excess returns at AIAL and CIAL:

Excess Returns at AIAL and CIAL

	CC WACC	BARNZ WACC
AIAL year 2000	\$ 7,453,702	\$ 9,069,133
AIAL year 1	\$ 9,844,298	\$ 11,477,951
AIAL year 2	\$ 11,325,150	\$ 12,977,025
AIAL year 3	\$ 12,886,251	\$ 14,556,348
AIAL average	\$ 10,377,350	\$ 12,020,114
CIAL years 1 – 3	\$ 4,340,727	\$ 4,793,537

31.14 BARNZ notes again that it has not incorporated adjustments for capital expenditure which will be used and useful or MCTOW growth into the model, and that these are factors which will affect the outcome of the calculations, and which, in BARNZ's view, should be included.

32. Is the Commission's assessment of the extent of, or potential for, allocative efficiency or inefficiency correct?

32.1 *BARNZ has no major issues* with the formula the Commission has used to calculate the allocative inefficiency, and has applied the Commission's formula using the BARNZ adjusted inputs identified in paragraph 31.12 above. This has produced the following levels of allocative inefficiency:

BARNZ Calculations of Allocative Inefficiency

	CC WACC			BARNZ WACC		
	Consumer	Producer	Total	Consumer	Producer	Total
AIAL year 2000	66,055	650,529	716,584	97,789	756,680	854,470
AIAL year 1	106,194	821,264	927,457	144,364	916,457	1,060,821
AIAL year 2	133,853	921,434	1,055,288	175,748	1,011,091	1,186,839
AIAL year 3	165,046	1,022,965	1,188,011	210,599	1,107,219	1,317,818
AIAL average	117,787	854,048	971,835	157,125	947,862	1,104,987
CIAL	56,342	343,092	399,434	68,710	365,901	434,611

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

- 33.1 *BARNZ agrees* "there is likely to be some room for improvement in the productive efficiency of the airfield activities at each of the three airports." (paragraph 10.53)
- 33.2 It is well established that substantial market power tends to blunt the drive for efficiency. It follows monopoly businesses contain greater potential for total factor productivity efficiency improvements than for businesses in general.
- 33.3 Given the demonstrated monopoly elements in AIAL's and CIAL's behaviour, then AIAL and CIAL should both be able to achieve efficiencies above the level of total factor productivity improvement experienced by the economy as a whole.
- 33.4 In this respect, *BARNZ notes* that the cost containment improvement at WIAL over the period 1998 to 2000 (following privatisation and while operating under a Deed which specified prices) as measured by drop in airfield expenses, excluding depreciation, was 7.2%.
- 33.5 *BARNZ considers* that the Commission's adoption of 1.0% of airfield costs as an illustration of an appropriate measure of productive inefficiency to be too low at AIAL and CIAL.
- 33.6 *BARNZ suggests* 3% is a more appropriate reflection of available efficiency improvements at AIAL and CIAL, which produces the following result:

BARNZ Calculations of 3% Productive Efficiency Improvement

AIAL	\$ 395,730
CIAL	\$157,800

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

- 34.1 *BARNZ agrees* that “inefficiencies can arise where investment has led to too many assets being acquired—meaning that some assets are not ‘used or useful’ in meeting demand—or because some assets are overly lavish for the purpose (assets are said to be ‘gold plated’).” (paragraph 10.54)
- 34.2 *BARNZ considers* the decision whether or not to invest in assets for future use is a commercial one for the relevant airport company, with the provision that the airlines should not be charged for such assets until they become ‘used and useful’.
- 34.3 *BARNZ agrees* with the Commission’s use of the risk free rate to calculate dynamic inefficiency.
- 34.4 *BARNZ has not altered* the Commission’s calculations of dynamic efficiency.

Commission’s Calculations of Dynamic Inefficiency

AIAL	\$ 6,711,684
CIAL	\$ 49,218

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

- 35.1 *BARNZ does not currently consider* there is an issue with regard to service quality at AIAL, CIAL or WIAL.
- 35.2 However, *BARNZ notes* that as there has only been one round of disclosure under the Disclosure Regulations, and as the service level indicators contained in the Disclosure Regulations are not as comprehensive as BARNZ members would have liked, evidence of trends with regard to service levels has not yet become apparent, and may not in the future.
- 35.3 *BARNZ also notes* that there have been significant quality of service issues (particularly relating to sealed surfaces) with some of the Australian airports subject to a price cap.
- 35.4 The over-recovery by AIAL and CIAL is substantial and will inevitably have had a significant effect on the overall efficiency of the New Zealand economy by constraining travel, commerce and trade through excessive costs. There will also have been other deleterious economic social effects. Air travel is an important part of our social structure for recreation and other purposes. Excessive costs at airports impedes travel and the movement of air freight and so reduces the benefits individuals enjoy.

Section 52(b) – Control Necessary or Desirable in the Interests of Acquirers

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

- 36.1 *BARNZ agrees* that “the reference to direct or indirect acquirers requires an examination of the interests of aircraft operators (as direct acquirers), as well as the interests of ultimate consumers—aircraft passengers and those using air freight services (as indirect acquirers).” (paragraph 2.38, see also paragraph 13.9)
- 36.2 *BARNZ agrees* with the Commission's view “that it should treat all parties equally, so that the interests of overseas residents should be weighted equally with those of New Zealanders.” (paragraph 13.9)
- 36.3 *BARNZ agrees* that “it is not necessary to determine the relative shares of net benefits (if any) received by direct acquirers, such as airlines, and indirect acquirers such as passengers.” (paragraph 13.11)
- 36.4 *BARNZ notes* “the Commission proposes to approach the question as to whether control is ‘necessary or desirable...in the interests of’ acquirers by measuring at each of the three airports the likely benefits of price control that would accrue to acquirers of airfield activities, balancing against those the likely costs of such control that would be borne by those same acquirers.” (paragraph 13.3)
- 36.5 *BARNZ agrees* that “acquirers could only be said to benefit from the price control of airfield activities if they as a group were made better off, relative to their position in the counterfactual...” (paragraph 13.12)
- 36.6 *BARNZ does not agree* that allowance should be made “for any offsetting costs that they [acquirers] would bear as a result of price control ...”. (paragraph 13.12) It is the conduct of the airport companies which has created the need for the price control provisions of the Commerce Act to be invoked, therefore the shareholders of airport companies should bear any direct costs associated with price control. This issue is discussed in more detail in response to question 41.
- 36.7 *BARNZ agrees* that ‘interests’ describes economic welfare and that “the Commission is to determine whether the imposition of control would improve the economic welfare of (direct and indirect) acquirers of airfield activities” (paragraph 2.39) and that “in assessing whether the economic welfare of acquirers would be improved by control, the Commission assesses the consequences of any state of ‘limited’ competition in the relevant markets.” (paragraph 2.40)
- 36.8 *BARNZ agrees* that “consequences of a lack of competition can manifest themselves in various ways including allocative, productive and dynamic

inefficiencies, and inferior product quality” and that “lack of competition can also lead to suppliers earning excessive returns.” (paragraph 2.40)

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

37.1 *BARNZ agrees* that “a useful starting point for the analysis of how acquirers of the services of airfield activities might benefit from the imposition of price control remains the inefficiencies that may be present in the counterfactual.” (paragraph 13.14). However, as discussed below in response to question 38, *BARNZ* does not believe that continuation of the status quo is the appropriate counter-factual.

37.2 Due to the adjustments made by *BARNZ* in respect of:

- A. The cost to *AIAL* of getting airfield land to the state it can be used as an airport; (refer question 14 and *BARNZ-01*)
- B. Annual increases in the value of *CIAL*’s and *AIAL*’s airfield land; (refer question 31.12 and *BARNZ-03* and *BARNZ-04*)
- C. Removal of *CIAL*’s annual reseal provision from its airfield expenses; (refer question 31.12 and *BARNZ-04*)
- D. The appropriate asset beta and debt premium, and therefore the WACC of *AIAL* and *CIAL* for airfield activities; (refer questions 19 – 26) and
- E. The appropriate level of productive inefficiency (refer question 33)-

then *BARNZ*’s view of the extent to which excess returns, allocative and productive efficiency would be likely to be improved if airfield activities at *AIAL* and *CIAL* became the subject of price control, necessarily differs from the Commission’s. However, *BARNZ* does not differ from the Commission’s conclusion that it is necessary and desirable in the interests of acquirers that airfield activities be controlled at *AIAL* and *CIAL*.

37.3 The extent to which excess returns, allocative, productive and dynamic efficiency will be likely to be improved, is set out in the table contained in *BARNZ*’s response to question 39.

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

38.1 *While BARNZ agrees* that a review of the inefficiencies present in the counterfactual is a useful starting point, *BARNZ does not agree* that the appropriate counterfactual is the continuation of the status quo.

- 38.2 *BARNZ submits* that if the present inquiry were to lead to the recommendation that price control should not be imposed, this would affect the status quo by reducing even further the threat of price control. The airports may take greater latitude, which could lead to further monopoly pricing and greater inefficiencies.
- 38.3 New Zealand's light-handed regulatory regime depends upon there being a credible threat of price control in the event monopoly pricing occurs. The light-handed regime would not maintain its present level of effectiveness in the face of recommendation against some form of price restraint. Excessive pricing will become significantly greater and more widespread in the economy.
- 38.4 *BARNZ doubts* that, in the longer term, the current light-handed regulatory regime would survive a decision not to impose price controls on AIAL and CIAL.
- 38.5 *BARNZ considers* that the appropriate counter-factual is the short to medium term, where, free of the threat of a price control inquiry, and with the knowledge that current levels of over-recovery were not seen as serious enough to warrant price control, monopoly pricing by AIAL would be sharply higher, and where WIAL may also introduce significant monopoly pricing.
- 38.6 The position in relation to CIAL should be slightly different, as it has local body and national Government shareholders, which may impose some limited degree of constraint upon its ability to further increase prices. Nevertheless, there is still a significant risk CIAL too might further increase prices.
- 38.7 *BARNZ considers* that the penultimate pricing proposal by AIAL during its recent consultation round is a fairly good indication of how AIAL would respond to a decision not to impose price control.
- 38.8 AIAL's 17 May 2000 proposal contained an 18.14% increase for year 1, as opposed to the 8.5% increase for year 1 finally imposed on 22 August 2000.
- 38.9 The difference between the 18.14% proposed increase and the 8.5% actual increase (a difference of 9.6 percentage points) was explained by AIAL on 19 September 2000 as follows:

A. [REDACTED]

B. [REDACTED]

C. [REDACTED]

38.10 BARNZ considers that the 9.6 percentage points difference between the increase proposed by AIAL in May 2000, and that actually imposed in August 2000, is the appropriate counterfactual for AIAL. This is because:

- A. At the time AIAL set prices, there was an Airport Price Inquiry due to commence in the very near future. It is probable this acted as a partial constraint upon the airport's behaviour – a constraint unlikely to be present in the future if price control is not imposed in relation to AIAL's airfield activities.
- B. The airport noted the adjustments which caused the year 1 increase to reduce from +18.14% to +8.5% were not permanent. In the 19 September 2000 Discussion Document provided to the airlines, AIAL stated:

[REDACTED]

- C. The financial model which AIAL provided to the Commerce Commission for the purposes of the Airport Price Inquiry was a model showing an 18% increase in prices for year 1: refer Note for file – telephone call, 26 June 2001, Kristen Bowman AIAL and Susan Brown Commerce Commission.

38.11 For these reasons, *BARNZ believes* the appropriate counterfactual in respect of AIAL is one where AIAL would increase prices by at least another 9.6 percentage points. This counter-factual produces the following further benefits of price control: (refer BARNZ-02)

Benefits from Counter-factual at AIAL

Increased post tax revenue 2001	\$2 840 000
Increased post tax revenue 2002	\$2 982 000
Increased post tax revenue 2003	\$3 131 000
Average increased post tax revenue	\$2 985 000

38.12 *BARNZ notes* that in making this counter-factual adjustment, no allowance has been made for the impact the increased charges will have on the overall volume and hence on total excess returns and on the producer surplus and

consumer surplus. This is because of a desire not to over-complicate the adjustment at this stage.

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

- 39.1 *BARNZ agrees* that "it cannot be assumed that all of the potential benefits to acquirers that would emerge from the elimination of any inefficiencies and transfers present in the counterfactual would actually be realised in practice." (paragraph 13.13)
- 39.2 *BARNZ accepts* the process used to estimate the various components of benefit potentially available to 'acquirers' in paragraph 13.14 to 13.27.
- 39.3 *BARNZ, however, believes* the resulting estimates are a significant understatement of the potential benefits for the following reasons:
- A. The valuation of airfield assets used in the calculations for AIAL is too high due to the Commission not having yet made an adjustment to the value included by AIAL for getting the land to the stage it could be used as an airport or having optimised out that portion of the reclaimed land which is not yet 'used or useful'. *BARNZ has made an adjustment of \$49.6 million to AIAL's asset valuation for the former but has not adjusted for the latter.*
 - B. The WACC figures used in respect of CIAL and AIAL are too high because the debt premiums and the asset betas used are too high. *BARNZ has used a WACC of 7.17% for AIAL and 7.12% for CIAL.*
 - C. The 1% improvement in productive efficiency assumed (paragraphs 13.19 to 13.21) is almost certainly an understatement based on recent cost savings in the airfield cost centre of 7.2% achieved by WIAL and also based on productivity improvements achieved in other situations in which monopoly power has been eliminated: refer paragraph 33 of this response. *BARNZ has used a 3% improvement in productive efficiency.*
 - D. Productive and dynamic efficiency gains have been understated as a result of not being able to estimate the additional allocative effect they would have experienced due to not knowing the slope of the average cost curve. This is noted in the Commission's draft report (paragraph 13.21 and paragraph 13.24).
 - E. The correct counterfactual is not the status quo, it is, in the short to medium term, a world in which monopoly pricing by AIAL would be likely to be sharply higher. *BARNZ has adopted a 9.6% increase in charges at AIAL as the appropriate counter-factual.*
- 39.4 Applying these changes (and the other adjustments made to the excess returns calculation identified in response to question 31), the following estimates of

the benefits to acquirers of controlling airfield activities at AIAL and CIAL result:

Benefits to Acquirers Using Commission's WACC

	AIAL	CIAL
Reduced excess returns	10,377,350	4,340,727
Reduced counter-factual return	2,985,000	-
Reduced allocative inefficiency (consumer surplus)	117,787	56,342
Reduced productive inefficiency	395,730	157,800
Reduced dynamic inefficiency	6,711,684	49,218
Total benefits	20,587,551	4,604,087

Benefits to Acquirers Using BARNZ WACC

	AIAL	CIAL
Reduced excess returns	12,020,114	4,793,537
Reduced counter-factual return	2,985,000	-
Reduced allocative inefficiency (consumer surplus)	157,125	68,710
Reduced productive inefficiency	395,730	157,800
Reduced dynamic inefficiency	6,711,684	49,218
Total benefits	22,269,653	5,069,265

39.5 *BARNZ notes* that in assessing the extent to which excess returns and allocative efficiency would be likely to be improved at AIAL, the Commission has used the average for years 2000, 2001, 2002 and 2003. Arguably, it may have been more appropriate for these calculations to have been carried out on a forward-looking basis, as was the case for CIAL. On a forward-looking basis, the result for AIAL would be excess returns of \$11,351,899 using the Commission's WACC (\$13,003,775 using the BARNZ WACC) and reduced allocative efficiency of \$135,031 (\$176,904), producing total benefits of \$21,579,344 (\$23,273,091). Nevertheless, to enable comparisons to be made, BARNZ has not made this alteration and has continued to apply the Commission's method of averaging.

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

40.1 *BARNZ agrees* that "for the purposes of the present inquiry, it is the additional costs that would be imposed by price control over and above those currently incurred that are relevant." (paragraph 13.31)

40.2 *BARNZ does not agree* that the total costs of price control would be large under a 'Pricing Negotiation with Principles set by the Commission' regime as outlined in paragraphs 12.63 to 12.76, or that such costs would be greater than those of the current regime. Indeed, BARNZ considers commercial negotiation within principles and parameters set by the Commerce Commission, with the Commission acting as back-stop in the event that consensus is not able to be

reached, would cost far less than the recent consultation rounds with CIAL and AIAL.

- 40.3 The costs of the status quo (i.e. consultation, a price control inquiry, submissions to regulators, MOT consultation and review) are undoubtedly very significant, and, we understand, higher than the costs BARA members are bearing under the Australian regime.
- 40.4 Considerable time and resources were devoted during recent consultations to dealing with issues that need not have been discussed at all if a few key principles contained in the draft report were mandated. In short, AIAL are charging for over-valued assets and for a wide range of assets that are not 'in use and useful'. CIAL are charging current users more than twice what they should be paying to 'use' a domestic terminal, much of which has not yet been built, and considerably more for its international terminal than it is currently worth.
- 40.5 If price control is not now imposed, in light of the evidence of monopoly pricing found by the Commission in its preliminary decision, the time taken in the next round of consultations, and the resulting 'fall-out' as the airlines attempt to resist further monopoly pricing, will impose even higher direct costs on the acquirers.
- 40.6 *BARNZ submits* that the additional direct costs of price control for airfield activities would be nil. The direct costs of price control of the type envisaged by the Commission would be no more, and could be considerably less, than the current status quo. Moreover, those direct costs would be significantly less than the status quo that would rule if a recommendation not to impose price control is made as a result of the current inquiry. In these scenarios, rather than there being a direct cost resulting from the imposition of price control, the result would be a benefit in the form of lower compliance costs.
- 40.7 *BARNZ does not agree* with the Commission's calculation of the indirect costs of price control, which involved "halving the potential benefit figures to generate a lower bound estimate", to reflect the imperfect nature of price control. (paragraph 13.18)
- 40.8 *BARNZ considers* that the Commission's estimate that the indirect costs of price control would amount to 50% of the potential efficiency gains is far too high. BARNZ considers that a more realistic estimate of the indirect costs of price control would be no more than 25% of potential efficiency gains.
- 40.9 Based on reduced or no direct costs, and assuming indirect costs are up to 25% of the benefits of price control, the costs of price control are as follows:

Costs of Price Control Using Commission's WACC

	AIAL	CIAL
Direct costs	Benefit	Benefit
Indirect costs (up to 25% of benefits)	5,146,887	1,151,021
Total costs	5,146,887	1,151,021

Costs of Price Control Using BARNZ WACC

	AIAL	CIAL
Direct costs	Benefit	Benefit
Indirect costs (up to 25% of benefits)	5,567,413	1,267,316
Total costs	5,567,413	1,267,316

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

- 41.1 *BARNZ agrees* that “the concern is only with those costs of control that may be borne directly or indirectly by acquirers. This in turn depends upon who pays the direct costs of the control regime, and on the nature of the regime itself.” (paragraph 13.32)
- 41.2 *BARNZ does not agree* that it is a reasonable assumption that all the costs of price control and of the regulatory body would fall upon acquirers directly or indirectly. If price control is imposed, the regulatory body is able to determine whether the costs of the control fall upon acquirers or the shareholders of providers.
- 41.3 *BARNZ considers* that since the need for price control has arisen through the inappropriate behaviour of providers, airport shareholders should bear any direct costs they incur. This will provide appropriate economic signals to shareholders of providers in a limited market, not to engage in inappropriate pricing behaviour.

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

- 42.1 *BARNZ agrees* with the Commission's preliminary view that it is necessary or desirable in the interests of acquirers to control the airfield activities supplied by AIAL and CIAL. *BARNZ* believes the true net benefit to acquirers is much greater than the estimates in paragraph 13.54 of the Commission's draft report.
- 42.2 *BARNZ submits* the following revised estimates:

Net Benefits to Acquirers Using Commission's WACC

	AIAL	CIAL
Benefits to Acquirers		
Reduced excess returns	10,377,350	4,340,727
Reduced counter-factual return	2,985,000	-
Reduced allocative inefficiency	117,787	56,342
Reduced productive inefficiency	395,730	157,800
Reduced dynamic inefficiency	6,711,684	49,218
Total benefits	20,587,551	4,604,087
Costs to Acquirers		
Direct costs	Benefit	Benefit
Indirect costs	5,146,887	1,151,021
Total Costs	5,146,887	1,151,021
Net benefits to Acquirers	15,440,664	3,453,066

Net Benefits to Acquirers Using BARNZ WACC

	AIAL	CIAL
Benefits		
Reduced excess returns	12,020,114	4,793,537
Reduced counter-factual return	2,985,000	-
Reduced allocative inefficiency	157,125	68,710
Reduced productive inefficiency	395,730	157,800
Reduced dynamic inefficiency	6,711,684	49,218
Total benefits	22,269,653	5,069,265
Costs		
Direct costs	Benefit	Benefit
Indirect costs	5,567,413	1,267,316
Total Costs	5,567,413	1,267,316
Net Benefits to Acquirers	16,702,240	3,801,949

Discretion to Control

43. Is the Commission's analysis of net efficiency benefits appropriate?

- 43.1 *BARNZ does not accept* that the Commission's legal analysis of the issues relevant to the exercise of the Minister's discretion is correct.
- 43.2 The Commission appears to have elevated the concepts of efficiency and the public benefit test in section 3A of the Commerce Act above the directly relevant statutory criteria in section 52 and above the long title of the Act. BARNZ has real concerns with this approach. In essence, the consideration of efficiency benefits in chapter 14 of the Commission's report seems to have been applied to the exclusion of all else, thereby preventing a balanced analysis of all relevant discretionary factors. *BARNZ considers* that if the current approach is continued with, this would result in the Minister's exercise

of discretion being constrained in a manner which is not in accordance with section 52 and which clearly, was not intended by Parliament.

43.3 There are two thresholds under section 52 which must be met for the imposition of price control:

- A. The goods or services are, or will be, supplied or acquired in a market in which competition is limited or is likely to be lessened; and
- B. It is necessary or desirable for those goods or services to be controlled ... in the interests of persons acquiring the goods or services (whether directly or indirectly) ...

43.4 However, even when these thresholds have been fulfilled, the Minister of Commerce retains an over-riding discretion as to whether or not to recommend to the Governor General that an Order in Council be made to control the prices of the particular goods or services.

43.5 Paragraph B of the Minister's request to the Commission asks for advice as to:

Whether market conditions are such that the Commission believes that I should recommend to the Governor-General that she make an Order in Council under section 53 of the Act invoking controls over airfield activities at the three major international airports.

43.6 The discretion to recommend price control to the Governor-General is the Minister's. *BARNZ considers* the exercise of this discretion is not just a question of fact, or even, solely one of economic evidence. It is a question which is inter-twined with economic and social policy, and is not one able to be reduced to a narrow formula. It requires the careful balancing of a full range of all relevant discretionary factors.

43.7 *BARNZ does not agree* that the legislation requires "an analysis of the public benefit type used by the Commission in authorisations, under which the impact on the wider public interest would be tested for each of the three airports." (paragraph 14.5)

43.8 *BARNZ does not agree* that the approach used in authorisation provisions "would be appropriate for considering whether to recommend price control" or that "control would then be recommended only when it led to a more efficient outcome" (paragraph 14.5). *BARNZ also queries* whether paragraph 14.5 correctly states the test for authorizations.

43.9 *BARNZ does not agree* with the Commission's stated purpose of "consider[ing] whether price control of airfield activities at any of the three airports can be recommended on efficiency grounds". (paragraph 14.8)

- 43.10 The Commerce Act is silent on the specific considerations to be applied by the Minister in determining whether to impose price control, other than requiring that the two thresholds in section 52 (a) and (b) must be met.
- 43.11 *BARNZ considers* that the approach taken by the Commission has the effect of seeming to elevate efficiency and the public benefit test (including section 3A) into the statutory test for price control and even into the purpose of the Commerce Act. Such an approach loses sight of the words of the long title of the Act which emphasise the benefit of consumers. The directive to consider efficiency in section 3A relates to situations where the Commission is directed to consider the public benefit test in relation to authorising potentially anti-competitive conduct. There is no such requirement in section 52, which has, only recently, been amended. *In BARNZ's view*, to seek to elevate efficiency through the concept of public benefit above everything else, including the long title of the Act, and the directly relevant criteria in section 52, is to act in a manner which was not intended by Parliament when it recently passed this legislation.
- 43.12 *BARNZ agrees* that “in determining whether it should advise the Minister to recommend control, [the Commission] should have regard to the wider scheme of the Commerce Act, and to the goals the Commerce Act is intended to promote” (paragraph 14.3)
- 43.13 *BARNZ submits* that the purpose of the legislation, as set out in the long title of the Act, “is to promote competition in markets for the long-term benefit of consumers within New Zealand”, and for the implementation of section 52 the interests of ‘acquirers’ are the relevant interest.
- 43.14 *While BARNZ acknowledges* that an analysis of net efficiency benefits is relevant, this is only one of a number of factors that the Minister might take into account. Such factors need to include direct and indirect benefits.
- 43.15 Other factors which *BARNZ considers* the Minister needs to take into account include:
- A. **The degree to which competition is limited, including market structure and behavioural factors.**
The Commission concluded competition is limited in the aircraft movement market, that market power is probably relatively high due to the lack of supply-side substitutes and that AIAL, CIAL and WIAL are unlikely to be significantly constrained by the countervailing power of airlines under the current regulatory regime.
 - B. **The degree to which current regulation has constrained (or failed to constrain) the behaviour of the monopoly supplier, and prevented (or failed to prevent) abuse of market power.**

The Commission concluded that AIAL and CIAL have exploited their market power in airfield activities by raising prices above the competitive level in a fairly sustained fashion, and also that under the current regulatory regime, AIAL, WIAL and CIAL are unlikely to be significantly constrained by the countervailing power of airlines.

C. The overall quantum of the monopoly pricing, i.e. not just the level at which the price is above the competitive benchmark, but what this translates to in dollar terms and as a percentage of the monopoly's turnover.

The Commission concluded that AIAL has over-recovered by 38.03% or \$66 million since corporatisation 12 years ago, with it recovering more than its cost of capital in every one of those 12 years. The Commission concluded CIAL has over-recovered by \$6 million since corporatisation, or 20.84%.

The Commission concluded that such over-recoveries will continue in the next three years. CIAL's recent increases mean its prices (by the Commission's calculations) are 28% above the competitive price. The Commission calculated CIAL will earn \$3.8 million annually more than it should for the next three years, an over-recovery of more than \$11 million. The Commission concluded AIAL will over-recover by \$16 million over the period from 2001 to 2003, an average annual over-recovery of \$5.4 million.

BARNZ has been advised that the future over-recovery for the next three years is as high as \$14.5 million annually for AIAL (between 25.8% and 38.0%) and \$4.7 million annually for CIAL (between 32.8% and 37.6%).

D. How gross the abuse of market power has been? (i.e. the level of the over-recovery and the length of time over which such excess returns have been being earned).

The abuse of market power has amounted to \$66 million (38.03%) by AIAL and \$6 million (20.84%) by CIAL, and in the case of AIAL, has been for every one of the past 12 years.

E. The likely impact on other users and consumers in the economy.

Air travel is an important component of today's society and airports are key infrastructural assets. Over-pricing of the degree and sustained nature engaged in by AIAL and CIAL will have had a significant effect on the over-all efficiency of the New Zealand economy by constraining travel, trade and commerce.

F. The overall size of the benefits to the acquirers if price control was imposed.

BARNZ considers that the annual benefits which could be achieved by the imposition of price control on airfield activities at AIAL are between \$15.4 million and \$16.7 million and at CIAL are between \$3.4 million and \$3.8 million.

G. The costs of the new regime versus the costs of continuing the current regime?

BARNZ considers the direct cost of price control would be no higher than the costs of the current regime (which are not insignificant) and in fact, should even be less.

H. The effect on users and consumers if price control is not imposed. Would the current situation continue or would the level of excess pricing increase?

BARNZ believes that if price control is not imposed, prices are likely to be significantly higher in the short to medium term. Behaviour by AIAL during the recent consultation, suggests further price increases of at least 9.6 percentage points.

I. The disincentive to monopoly price in other markets which would result from a decision to impose price control as a consequence of the monopoly pricing which has occurred in this market.

Failure to impose price control in the face of past over-recovery of 38% by AIAL and 20% by CIAL, and forecast annual over-recovery of up to 15.5% by AIAL and 28% by CIAL (by the Commission's calculations) will provide a benchmark, under which it is known the price control provisions of the Commerce Act will be unlikely to be invoked.

J. The effect on the New Zealand light-handed regime if an organisation is found to be monopoly pricing but no action is taken against it.

Light-handed regulation depends on all examples of demonstrable monopoly pricing being addressed, not merely those which outweigh arithmetically calculated benefits. A decision not to impose price control at AIAL and CIAL, despite evidence existing of sustained monopoly pricing, would severely reduce the credibility of price control and undermine the effectiveness of the light-handed regulatory regime.

43.16 *BARNZ does not agree that the thresholds for price control in Part IV of the Commerce Act are low. The first test in section 52 is low. The second is not. Even if both tests are passed, it is then necessary for the Minister to agree to impose control, a policy decision which seems to have been deliberately left flexible and open to the Minister's discretion. In BARNZ's view, it is not*

valid for the Commerce Commission to seek to create a third statutory criterion of a public benefit analysis and net efficiency benefit test, when these are not present in section 52.

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

- 44.1 For the reasons set out above in response to question 43, *BARNZ does not consider it is correct* for the Commission to apply a public benefit analysis when determining whether the Minister should exercise his or her discretion to impose price control.
- 44.2 *BARNZ disagrees* with the Commission's view that when considering the Minister's discretion, "the focus shifts from the partial view—the interests of acquirers—to the broader focus of the 'interests' of the economy as a whole. Here the concern is one of maximising economic efficiency, that is to say, of maximising the attainment of allocative, productive and dynamic efficiencies. Under this efficiency standard, wealth transfers between different groups within the economy must be ignored." (paragraph 14.11)
- 44.3 *BARNZ disagrees* that "in the airports context, any reduction in excess returns would, therefore, not be considered a benefit from an efficiency perspective, unless it had other spill-over effects." (paragraph 14.12)
- 44.4 *BARNZ submits* that the test adopted by the Commission implies that Parliament did not intend section 52 to apply to pricing by a perfectly price discriminating monopolist. A perfectly price discriminating monopolist being one which prices so as to charge individual consumers the full amount which they would be willing to pay, and in so doing, captures all consumer surplus while leaving the quantity supplied unchanged from the competitive outcome. It is inconceivable that Parliament would have intended such a result.
- 44.5 *BARNZ considers* that all benefits to acquirers, including those which do not create an additional tangible benefit to the economy as a whole, must be taken into account. This accords with the thrust of the section which is directed to acquirers, and with society's condemnation of monopoly pricing.
- 44.6 In addition, *BARNZ does not consider it is correct* to use the status quo as the counter-factual when undertaking an assessment of the merits of imposing price control. *BARNZ's* view of the appropriate counter-factual was set out in response to question 38, above.
- 44.7 *BARNZ considers* that in addition to the non-quantifiable spill-over effect of making credible the threat of price control, the benefits to be gained from price control of airfield activities being imposed at AIAL and CIAL are those set out in response to question 42 above.

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

- 45.1 *BARNZ agrees* that the situation with the current inquiry is different from overseas decisions both on whether or not to regulate, which are almost invariably made when an airport is privatised, and on whether or not to continue with regulation.
- 45.2 *BARNZ agrees* both of these decisions are made “without experience of how the airport would behave as an unregulated airport”. (paragraph 11.57)
- 45.3 *BARNZ agrees* that “given the differing circumstances that New Zealand finds itself in, the lessons on the form and effect of price control are more relevant to this inquiry than any lessons on the reasons for airports being controlled in the first place.” (paragraph 11.54).
- 45.4 *BARNZ agrees* that “rather than having to try to predict whether an airport might use its market power, the Commission is able to examine the current and historical behaviour of airports.” (paragraph 11.58)
- 45.5 *BARNZ agrees* that the preferable option is “to attempt to have the airports formulate service level agreements directly with their customers.” (paragraph 11.66)
- 45.6 *BARNZ also notes* that where selected airports have been price capped this action has sent a signal to other airports and has sometimes resulted in voluntary price caps, as in the UK. *BARNZ agrees* that this “has proved reasonably effective provided that there is a real threat that an unregulated airport would be regulated if it abused its market power.” (paragraph 11.71)

46. Is the Commission's preliminary view that the airfield activities supplied by AIAL should be controlled correct?

- 46.1 *BARNZ agrees* with the recommendation that airfield activities at AIAL should be controlled. However, *BARNZ* considers that the Commission's assessment of the benefits of price control at AIAL are significantly understated.
- 46.2 *BARNZ considers* the benefits which could be achieved by the imposition of price control on airfield activities at AIAL are between \$15.4 million and \$16.7 million per annum.
- 46.3 With respect to the form of price control, *BARNZ is comfortable* with the process identified by the Commission in paragraph 12.64. Under this process, rather than the Commission setting a price, AIAL and the airlines themselves would first attempt to develop appropriate prices within the principles and parameters set by the Commission, which price the Commission would then

authorise in the form of an undertaking from AIAL. If the parties were not able to develop an appropriate price, the Commission would set a price.

- 46.4 More detailed comments on the Commission's discussion of the Form of Price Control in Chapter 12 of its draft report are contained in the response to question 48 below.
- 46.5 On 4 July, following receipt of the Commerce Commission's Draft Report, BARNZ wrote to AIAL stating :

We have now had the opportunity to read through the Executive Summary of the Report and to dip into the other documents.

We wonder whether the Report has given AIAL cause to reconsider any of the positions on the issues between us.

If that is the case we would like you to be clear that the airlines are prepared to enter into further discussion either before or after the development of your initial position on the Report.

This possibility seems to us to be contained in the draft report's recommendations.

- 46.6 As a result of this letter two informal without prejudice discussions have been held regarding the broad principles in the Commission's draft decision.

47. Is the Commission's preliminary view that the airfield activities supplied by WIAL and CIAL should not be controlled correct?

- 47.1 *BARNZ disagrees* with the recommendation that airfield activities at CIAL should not be controlled. There would clearly be net benefit for acquirers from imposing such controls, which is the test under section 52.
- 47.2 *BARNZ considers* the benefits which could be achieved by the imposition of price control on airfield activities at CIAL are between \$3.5 million and \$3.8 million per annum.
- 47.3 *BARNZ notes* that the pricing principles set out by the Commission, in its draft decision, mean CIAL needs to significantly reduce its terminal charges.
- 47.4 On 4 July, following receipt of the Commerce Commissions Draft Report, BARNZ wrote to CIAL along the same lines as it wrote to AIAL. No response to this approach has been received.
- 47.5 *While BARNZ agrees* with the recommendation that airfield activities at WIAL should not be controlled, BARNZ has not commented on the detail of the Commission's calculations with respect to WIAL due to a lack of comprehensive information.

- 47.6 *BARNZ notes* that the pricing principles enunciated by the Commission should assist both the airlines and WIAL during the consultations over charges to apply from the expiry of the current Deed in July 2002.
- 47.7 *BARNZ also notes* that any future decisions by WIAL with regard to prices of airfield activities may influence the Commission's draft decision.

General Comments

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

➤ Form of Price Control (Chapter 12)

- 48.1 *BARNZ notes* that the Commission considers that "the criteria against which the different approaches to price control should be evaluated are allocative efficiency; productive efficiency; dynamic efficiency; and regulatory burden and uncertainty." (paragraph 12.1)
- 48.2 *BARNZ agrees* these are valid considerations, but adds that the interests of direct or indirect acquirers, including any wealth transfers between acquirers and suppliers, are also relevant considerations.
- 48.3 *BARNZ agrees* that consideration must be given to the costs of the regulatory regime (including compliance costs, costs of the regulatory body and regulatory capture). However, the costs of the current regime must also be taken into account, and these are not inconsiderable, and, in some cases, are almost certainly greater than the costs of the type of price control being contemplated by the Commission.
- 48.4 The Commission has identified cost of service, price cap, sliding scale rate of return and a negotiated price approach as possible forms of control.
- 48.5 *BARNZ notes* the Commission's view that as part of an authorisation, the Commission could potentially establish pricing guidelines. In its submission on the Critical Issues Paper, BARNZ asked the Commission to impose price control for a period of 2 to 3 years to remove any over-recoveries.
- 48.6 It seems to BARNZ that the Commission has two options open to it should the Minister recommend the Governor-General make an order for price control. Either the Commission may impose a price based on the calculations in its final report, followed by the parties applying the principles set out by the Commission when the price control order expired 2 to 3 years later. Alternatively, the Commission may encourage the parties to apply the Commission's principles and parameters themselves immediately and then accept the resulting price in the form of an undertaking from the airport. In this case the Commission would only move to set an applicable price if the parties were not able to develop an appropriate price.

48.7 *BARNZ supports* the latter approach of the parties working together to attempt to apply the Commission's principles and parameters, with the Commission as a 'back-stop' if a consensus is not able to be reached. *BARNZ is therefore comfortable* with the approach described by the Commission in paragraphs 12.63 to 12.65.

➤ **Review of the Airport Authorities Act 1966**

48.8 *BARNZ notes* that the Commission has found that certain aspects of the Airport Authorities Act 1966 are not completely satisfactory, in particular the definitions of the component parts of identified airport activities. The Commission also concluded that while the Airport Authorities Act relied principally upon the countervailing power of the airlines, in fact AIAL, WIAL and CIAL are unlikely to be significantly constrained by the level of countervailing power which may exist.

48.9 *BARNZ therefore considers* that some amendment to the Airport Authorities Act 1966 is required to enable the Act to work more effectively and be compatible with the operation of airports in practice.

48.10 *BARNZ hopes* the Commission will consider including such a recommendation in its final report to the Minister of Commerce.

➤ **Guidelines Regarding Economic Peak Pricing**

48.11 *BARNZ notes* the Commission's comments in paragraph 6.32 that "price discrimination by time of day could be efficient where there is constrained capacity at peak times".

48.12 *BARNZ understands* that the general principle is airports should not be able to earn more than their required revenue, but that this is not incompatible with peak pricing whereby any excess charges to users at particular times are offset by discounted charges at other times.

48.13 *BARNZ considers* that it would be useful if the Commission outlined how it would envisage peak pricing working efficiently.

➤ **Guidelines Regarding Allocation of Costs**

48.14 The Commission has indicated in paragraphs 6.33 and 6.34 that it supports a multi-till approach to determining landing charges.

48.15 In its response to question 11, BARNZ referred the Commission to other approaches such as the modified multi-till used by the ACCC in its draft decision for SACL, and the sharing of joint and common costs which the

ACCC adopted in its decision in relation to the Adelaide Multi-User International Terminal, and which SACL applied in allocating its costs.

48.16 *BARNZ submits* it would be useful if the Commission were to set out what it considers to be the principles which should govern cost allocation and information disclosure.

➤ **Terms of Reference**

48.17 Despite BARNZ making submissions on a number of occasions regarding the need for a widening of the terms of reference, the Minister of Commerce declined to widen the Inquiry beyond ‘airfield activities’.

48.18 *BARNZ considers* that, based on the Commission’s draft determination, that “both AIAL and CIAL have exploited their market power in airfield activities by raising prices above the competitive level in a fairly sustained fashion.” (paragraph 10.20), there is now ample justification for the Commission to initiate a separate Inquiry into the pricing of terminal activities at AIAL and CIAL. If CIAL and AIAL do not initiate a review of their terminal charges based upon the principles enunciated by the Commission, then BARNZ considers the Commission should proceed with a separate Inquiry.

➤ **Conference**

48.19 The Commerce Commission has included eight days for a Conference in its timetable. BARNZ notes that the Commission intends contacting the parties in mid to late August to discuss the format of the Conference.

48.20 *BARNZ suggests* that there would be merit in the Commission convening a meeting of all interested parties to discuss the format of the Conference.

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

49.1 *BARNZ has identified* the following matters during its consideration of the draft report, which the Commission may want to consider amending or further explaining, in its final determination:

Paragraph reference	Description
4.22	This paragraph contains Table 1 which sets out airfield activities at AIAL. BARNZ notes that with regard to ‘facilities/assets held for future activities’ AIAL does not only earn “rental from current users of land (e.g. farmers)”. It also currently earns a return on this land equal to its WACC through the landing charges.

4.29	This paragraph sets out AIAL's consultation proposals. AIAL was consulting over both landing charges and the airport development charge. [REDACTED]
4.54	This paragraph notes "Christchurch City Council and Ngai Tahu have first option to purchase the Crown's shares" in CIAL. It is BARNZ's understanding that Christchurch City Council have the first option. Should the Council not exercise that option then Ngai Tahu's rights under its settlement with the Crown would give it the opportunity to acquire the shares.
4.72 (fn 47)	Footnote 47 states that "In December, CIAL had proposed charges of ...". In fact, in December CIAL had set charges at these levels. After BARNZ pointed out that the wrong inputs had been used in the case of certain aircraft, CIAL revisited its decision and changed the charges.
5.51	This paragraph states that "B747s are restricted to Auckland and Christchurch airports, so that no other airport in New Zealand could be a supply-side substitute". The Commission may not be aware that Ohakea is in fact capable of taking a 747 and is used as Air NZ's and United's paper alternate landing for 747's. Of course, it does not have the infrastructure necessary to deal with passengers or regular scheduled services, and is used perhaps once a year.
5.93	This paragraph of the draft report states "It would seem a rational negotiating tactic for airports to propose a more favourable deal, than they may be willing to accept, when commencing their consultations." The Airport Authorities Act 1966 requires airports to consult with airlines, rather than negotiate. Consultation carries with it obligations of information disclosure and good faith which are not necessarily present to the same degree in a negotiation. BARNZ does not agree that it is at all appropriate for an airport company "to propose a more favourable deal than they be willing to accept when commencing their consultations". Such conduct is, in BARNZ's view, not compatible with the requirement that consultations be carried out in good faith.
5.103	The increases set by AIAL recently are cumulative, therefore the total increase over the next three years is 19.4%, not 18.5%.
7.79	This paragraph contains Table 25 which sets out the adjustments that the Commission has made to AIAL's valuation to arrive at its own assessed value. The adjustment for the seawall is stated to be \$2.101 million yet the value of the seawall is \$9.787 million. The Commission has now released amended figures relating to this.
10.68	This paragraph forms part of the discussions relating to 'Projections Based on Recent Price Increases'. For the purpose of this calculation, the Commission has made certain assumptions. One of these is that "The asset base is unlikely to change significantly, particularly because the

	<p>Commission has adopted a historical costs approach to a significant proportion of the asset base”. However, in the case of AIAL, significant capital expenditure is occurring in relation to the sealed surfaces due to the widening of the taxiway and rehabilitation of the runway. AIAL consulted with the airlines regarding the technical and operational aspects of this expenditure and it was agreed as necessary, although at the time of consultation the project was envisaged to cost \$100 million. BARNZ is unaware of the extent to which the Commission was aware of this capital expenditure when it made this assumption. This issue was discussed in more detail in response to question 31.</p>
10.69	<p>In undertaking the calculations relating to ‘Projections Based on Recent Price Increases’, the Commission has also assumed that for AIAL and WIAL output will remain the same as for their 2000 financial years. This is stated to be due to “the absence of publicly available estimates of growth in output at AIAL and WIAL over the coming years”. Leigh Fisher Consultants undertook a detailed Aviation Demand Study in 1998 in which AIAL, CIAL and WIAL and the airlines all participated. AIAL used these forecasts in its recent decision to increase charges. BARNZ is also aware that WIAL commissioned Tourism Futures International and Airplan to produce an updated forecast for it, for use in consultation with the airlines and in the Airport Pricing Inquiry. This issue was also discussed in response to question 31.</p>